Leithner Letter No. 241-244
26 November 2019-26 February 2020

It's hard to imagine a more futile act than this week's rate cut by the Reserve Bank. … The problem is that there has been too much lending … [Artificially] low interest rates suppress productivity and growth by allowing unproductive firms to keep operating. … Moreover, [such] rates benefit the already well-off because asset prices rise and those with assets can borrow [to buy more assets].

… Why do savers have to be deprived in order to reduce over-geared borrowers' debt servicing costs? … And how did the practice of economics and central banking get into this mess? First, because debt and immigration have been used to create the illusion of growth and prosperity … because that's easier than growing productivity … Second, the economics profession and its druids in the central banks have made the mistake of equating the economy with asset prices. For two decades or more, central banks have been manipulating asset prices – shares and real estate – in the misguided belief that they are managing the economy. They're not – they're simply making a few people a lot richer and a lot of people unhappy that they're missing out …

Which brings us to the other reason interest rates are being reduced from not much to even less: to prevent mass bankruptcy. If interest rates rose the Australian household sector would become insolvent en masse, and many countries would do a Lehmann Brothers and go broke, starting with Italy, Greece and Japan. Not that cutting rates removes the debt; it just puts off the reckoning, otherwise known as the Restructuring.

Nations restructure their debts all the time [sic], forcing bondholders to take a haircut, but a mass household debt restructuring would be rather more serious. That's because the lenders sitting in the barber's chair would be banks, [whose finances] are more precarious than bondholders' … So while a sovereign bond haircut is painful, a bank haircut is life-threatening, to the bank and therefore to the economy. Can't happen [until it does].

Alan Kohler
"Why Monetary Policy Doesn't Work Any More"
The Weekend Australian (6-7 July 2019)

Leithner & Co.'s 20th Anniversary – What's Worked for Us Since 1999

Leithner & Company Pty Ltd (LCO) is a private investment company that adheres strictly to the traditional "value" approach to investment pioneered by Benjamin Graham and adapted by Warren Buffett. It conducts thorough research; provides reasonable safety of principal and offers an adequate return; and informs its shareholders regularly, fully and in plain language about its investments and results. It's long been a low-cost, low-risk and reasonable-and-steady-return investment vehicle.

LCO was formed in May 1999, commenced operations in August and recorded its first results for a full six-month period in January-June 2000. Hence our 20th anniversary occurs during the 2019-2020 financial year. This provides an appropriate juncture to review the assumptions, means and objectives that have underpinned our operations, assess their results, trim our sails and plot our course for the future.

Objectives and Benchmark

Since its inception, LCO has sought to construct and maintain a portfolio of securities whose long-term rate of return can reasonably be expected to

1. exceed the current yield of the ten-year Commonwealth Government bond,[1]
2. approach the historical rate of return of the All Ordinaries Accumulation Index (AOAI).

When stocks are prohibitively dear (which has been the case most of the time since 1999, see Figure 5, Figure 16 and Table 4 below), prudence demands that LCO accumulate bonds, cash deposits, etc. The more it does so, the more its return will tend to gravitate closer to the ten-year bond's yield than the AOAI's historical average. A portfolio comprising 50% bonds/deposits and 50% stocks implies a target rate of return midway between the bond's yield and the AOAI's long-term return. Using monthly measurements, Figure 1 plots (1) the AOAI's average annualised return

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[1] For an extended discussion and analysis justifying the yield of the ten-year Commonwealth Government bond as a foundation of equity investment, see Chris Leithner, *The Intelligent Australian Investor* (John Wiley & Sons, 2005), Chaps. 5, 6 and 11. The gist is that bonds' prices and yields are inversely related, and that bonds' and stocks' prices are generally positively correlated. When bonds' yields fall, their prices rise – and so, generally speaking, do the prices of stocks. As a rough rule, the higher are stocks' prices, the lower is their subsequent return – and the less appealing is their current valuation. As a result, the lower bond yields fall, the less appealing stocks tend to become.

since June 1999, (2) the yield of the ten-year Commonwealth Government bond and (3) LCO's target annual return (i.e., the mean of (1) and (2)). The bond's yield represents the lower bound of LCO's target; the AOAI's average return denotes its upper bound. During the 20 years to June 2019, the AOAI's return has averaged 7.8% per year and the mean of the bond's yield has been 4.6%. The yield has steadily fallen and cumulatively plunged. Late in 1999, it briefly exceeded 7%; by mid-2019, it was little more than 1% (and in August it sagged below 1%). *As a result, during the past 20 years LCO's target return has also decreased.* Late in 1999 it neared 7.5%; early in 2019 it was less than 5%. Today's target, bulls would likely say, is much too modest. Unlike their assertions, however, it's logical and realistic; it also mirrors the S&P 500 Index's sombre prospects (see also the "Prognosis" on pp. 33-36).

Figure 1:
LCO's Target Rate of Annual Return, 1999-2019

LCO's Approach to Investment

Graham's key insight – and the basis of Buffett's success – is that investment is successful when it's businesslike. This means two things. First, it's superficially true that LCO buys and sells securities. *More fundamentally, however, we look through these securities to the businesses that underlie them:* hence LCO acquires parts of sound and growing enterprises; similarly, we lend to creditworthy firms. We don't focus upon *shares or bonds* – and still less upon the fluctuations of their prices from week to week, month to month, etc. This approach removes myriad distractions; it thereby frees us to concentrate upon the *businesses* which we seek to acquire and of which we are long-term part-owners. LCO's business isn't the management of firms; still less is it trading their securities; rather, it's lending to and owning businesses – and reaping the long-term benefits of proprietorship. LCO's shareholders are, and should regard themselves as, (indirect) part-owners of and lenders to a range of enterprises.

Businesslike investment has a second implication. *Most buyers and sellers of securities seldom recognise – and more than a few wilfully ignore – the fundamental distinction between price and value.* Price is what's paid; value is what's received. Over time in financial markets, these two things tend to gravitate ("regress") towards one another but at any given point they may diverge – sometimes considerably. Hence the investor seeks securities whose value exceeds their price. To obscure this distinction (for example, to buy a security on the basis of its current popularity and in the hope that its rising price, reflecting this status, will continue to increase) is to forsake investment and embrace speculation. From the perspective of a Graham-style value investor, most transactions occurring daily in financial markets are speculations rather than investments.

Moreover, and egged by "experts," mainstream media, etc., speculators exaggerate and extrapolate into the future short-term adverse events; they also overestimate the likelihood and longevity of long-term positive developments. In both instances they ignore regression to the mean; as a result, they routinely inflate the prices of enterprises' securities to unrealistic highs – and occasionally depress them to appealing lows. LCO seeks to profit from the resultant opportunities, i.e., to buy low and sell high. It purchases the stocks of robust firms from pessimists (who've slashed their prices to unwarranted depths) and subsequently sells them to optimists (who, once these companies have resolved their difficulties, tend to boost their prices to improbable heights). LCO holds and seeks to accumulate a portfolio of sound enterprises whose securities, depressed by what we regard as significant but surmountable difficulties, we've acquired at sensible or even bargain prices. *Investors, in short, embrace reason. As a result, they become part-owners of quality companies when their stocks' prices plummet. In diametric contrast, speculators are thoroughly unbusinesslike: succumbing to emotion and ignoring business fundamentals, they greedily buy stocks of whatever quality because their prices have soared*[2] *– and hastily abandon them when they sour.*

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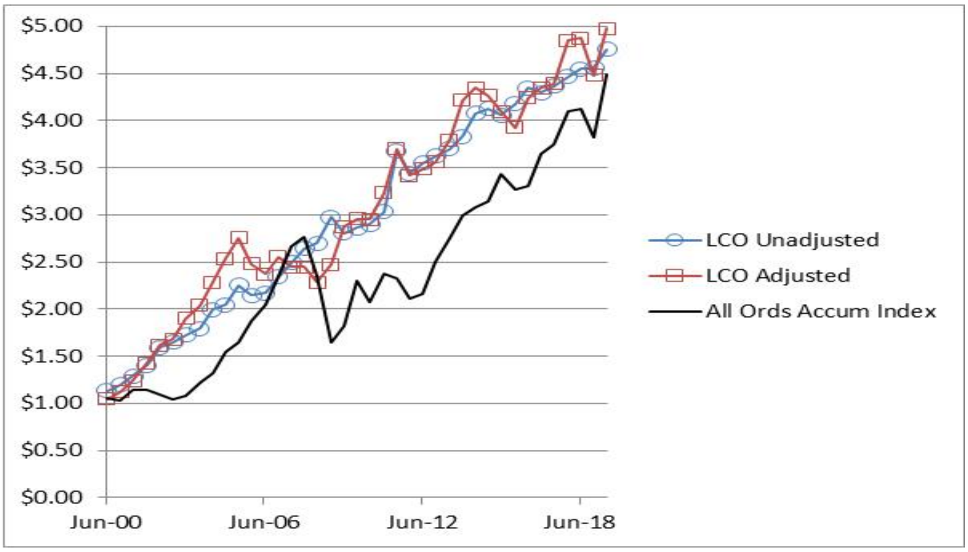
2 In *The Intelligent Investor* (1949), Benjamin Graham wrote: "If we assume that it is the habit of the market to overvalue common stocks which have been showing excellent growth or are glamorous for some other reason, it is logical to expect that it will undervalue – relatively, at least – companies that are out of favour because of unsatisfactory developments of a temporary nature. This may be set down as a fundamental law of the stock market, and it suggests an investment approach that should prove both conservative and promising. The key requirement here is that the enterprising investor [must] concentrate on the larger companies that are going through a period of unpopularity. While small companies may also be undervalued for similar reasons, and in many cases may later increase their earnings and share price, they entail the risk of a definitive loss of profitability and also of protracted neglect by the market in spite of better earnings. The large companies thus have a double advantage over the others. First, they have the resources in capital and brain power to carry them through adversity and back to a satisfactory earnings base. Second, the market is likely to respond with reasonable speed to any improvement shown." (Unless otherwise indicated, all subsequent quotes of Graham come from *The Intelligent Investor.*)

Overview of Returns

Figure 2 plots LCO's shareholders' long term return. Each dollar invested on 30 June 1999, if the dividends subsequently received had been reinvested, would by 30 June 2019 have grown to $4.76 (unadjusted for the portfolio's unrealised capital gains and losses) and $4.98 (adjusted). *This equates to a compound rate of growth of 8.1% per year (unadjusted) and 8.4% per year (adjusted).* These results are net of all expenses, taxes and Directors' share of profits (see footnote 24 on p. 31); they also include franking credits. Clearly, you shouldn't assume that results like these will persist during the years to come (see in particular the "Prognosis" section). Each $1.00 invested in the AOAI in June 1999 (dividends reinvested) would have grown to $3.82 in June 2019. That's a total gain of 282% and a compound rate of growth of 7.8% per annum.

Figure 2:
Growth of Shareholders' Capital, Inception to June 2019



Over the very long term, LCO hasn't merely "outperformed" its benchmark: it's also outpaced the AOAI. It's one of very few investment vehicles that have done so. On 29 May 2019, *The Australian* ("High Fees Pushing Fund Managers to 'Extinction'") reported:

> The underperformance of active managers is backed by research from S&P Dow Jones Indices. Its SPIVA Scorecard recently found that over the one-year period ending December 2018, 86.7% of equity funds and 98.4% of bond funds in Australia underperformed their benchmarks …

Most managers consistently underperform; as a result, all but a few underperform over five-year, 10-year and 15-year periods. (Few investment vehicles have 20-year track records; hence S&PDJI doesn't track them.) LCO hasn't merely outpaced its benchmark: *an investment in LCO has grown more steadily than one that mirrors the AOAI.* On the eve of the Global Financial Crisis in December 2007, the value of the investment in LCO was \$2.45; by June 2008, it reached its GFC-low of \$2.28 – a fall of 6.9% and a decrease of 17% from its pre-GFC peak (\$2.75 in June 2005). In contrast, in December 2007 the investment in the Index was worth \$2.77 (which was also its pre-GFC peak); in December 2008, it reached its GFC-low of \$1.65 – a plunge of 40%. *LCO didn't just suffer far less during the GFC: for this reason (and also because it possessed plenty of dry powder; see below) it recovered much more quickly.* The investment in LCO surpassed its pre-GFC peak in June 2009 (when its value rebounded to \$2.88); the investment in the Index, on the other hand, took until December 2013 (when its value reached \$2.99) to return to its GFC peak. By that latter month, the investment in LCO had risen to \$4.22.

The Relative Insignificance of Short-Term Returns – and the Critical Importance of Consistent Long-Term Returns

LCO is a conservative and therefore a long-term investor. As such, it's indifferent to short-term fluctuations of securities' market prices; instead, it focusses upon long-term growth of enterprises' values. Figure 3 plots its total (i.e., including MTM gains and losses) return net of the AOAI's total return during each half-year since LCO's inception. A net return greater than 0% indicates that it "outperformed" the Index during a given period, and one less than 0% implies that it "underperformed." Two points are critical: first, *in the short-term LCO has regularly underperformed; indeed, it's done so during almost one-half (42%) of the half-year periods.* Secondly, however, during the average half-year LCO has slightly outperformed. For the entire period, the mean of its half-yearly total return net of the Index's is 0.4%.

How did LCO achieve these benchmark- and market-beating results? We've already seen that it didn't do so by outperforming the Index each and every half-year, or by recording spectacular short-term gains. *Instead, it's avoided crippling short-term losses. In other words, LCO's Directors have minded the immediate "downside" and let the eventual "upside" mind itself.* (Notice that its strongest outperformance occurred at the GFC's height.) This approach's wisdom becomes clear when we sort LCO's half-yearly total returns since inception into two categories: those when it generated a positive return and those when it produced a negative return (Table 1). On average in the short-term, LCO has slightly "outperformed." Yet during the sub-set of half-years whose total returns are positive, it has underperformed. Whence, then, comes its long-term outperformance? *LCO has endured slightly fewer negative half-years (28% of all half-years since inception) than the AOAI (32%). Most importantly, the average loss during its losing half-years (-4.7%) is much less – indeed, virtually half – the average loss experienced by the Index (-8.1%) during its losing half-years.*

Figure 3:
LCO's Total Return (Net of AOAI), Half-Yearly since Inception

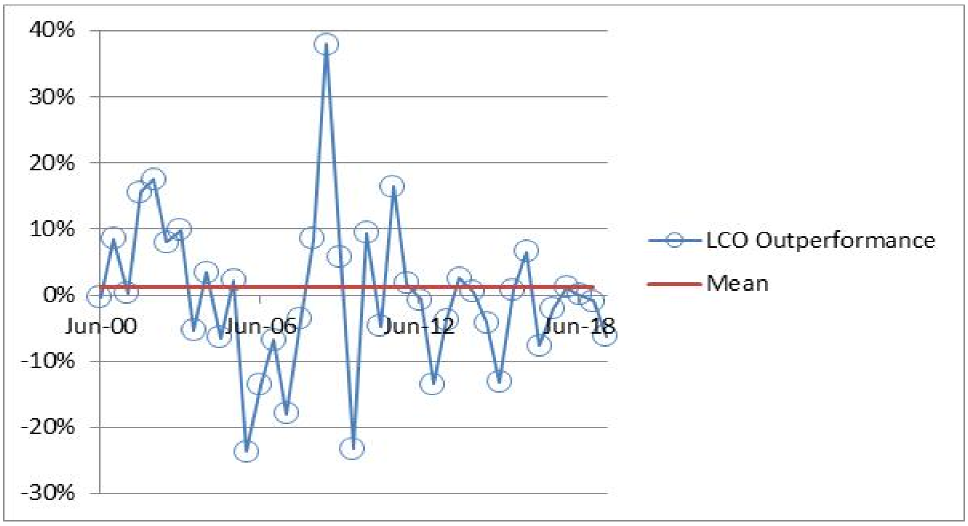


Table 1:
Disaggregating LCO's and Its Benchmark's Six-Month Total Returns, 1999-2019

	AOAI	LCO	LCO's "Outperformance"
% of Half-Years with –'ve Return	32%	28%	4.0%
Mean Return (+'ve Half-Years)	9.1%	7.7%	-1.4%
Mean Return (–'ve Half-Years)	-8.1%	-4.7%	3.4%
Mean Return (All Half-Years)	4.1%	4.5%	0.4%
Standard Deviation (All Half-Years)	10.3%	7.2%	3.1%

At this juncture it's vital to emphasise that managed and superannuation funds' marketing materials rarely present their results in a format like Figures 1-3 and Table 1: in particular, they don't take a given dollar amount as a starting point, assume that distributions have been reinvested and compare resulting amounts that accrue after various periods of time. In other words, they ignore an investment's *long-term compound rate of return*. Instead, they typically parade a series of percentage returns (often but not invariably from "good" years) and compute a *short-term average rate of return*. Yet even when it hasn't been cherry-picked, which it is often is, an average percentage rate of return isn't really meaningful: quite the contrary, it can be downright misleading.

Consider as an example a two-year investment. Let's say that it gains 20% in its first year and then loses 20% in the second. What's overall rate of return? Many people would say 0%. The mean of these two percentages, after all, is (20% - 20%) ÷ 2 = 0%. If you invest $1, then during the first year your investment increases by 20%, such that at the end of the year you have $1.20. During the second year, however, you lose 20% such that you have $1.20 × (1 – 0.20) = $0.96. In other words, you're not back to square one: you've lost an amount ($0.04) equivalent to 4% of your initial investment. *The average return is zero, but the compound return is negative.*

Further, note that in order to recoup a loss, one requires a greater gain than the negative return that generated the loss. A loss of 20%, for example, requires a gain of 25% to offset the loss: $0.80 × (1.25) = $1.00. Further, the compound return from x periods of y% returns exceeds any other sequence that averages y%. If, for example, you earn 5% per year for three years in succession, your simple average return and your compound return are both 5%. If, however, you earn 6% in the first year, 5% in the second and 4% in the third, your simple average return remains 5% but your compound return drops to 4.997%.

This is a seemingly minor difference; its implications, however, are momentous. *The greater the volatility of short-term returns (the standard deviation of LCO's is 7.2%; the Index's is 10.3%), the greater the deterioration over time of the long-term compound rate of return.* If your average return over three years remains 5% but you earn 9% in the first year, 5% in the second and 1% in the third, the compound rate of return over the three years falls to 4.95%. And if you gain 10% in the first year, lose 10% in the second and gain 15% in the third, your average rate of return remains 5% but your compound rate of return falls to 4.42%. More generally, *the greater is the number of negative returns in a series of returns, and the more volatile are the series' components, the lower is the compound rate of return – and hence the less meaningful and the more misleading is the average percentage return.*

How important are short-term results? How should investors evaluate them? "It's January," wrote Mark Hulbert ("The Year's Fund Returns Are In – Do They Matter?" *The Wall Street Journal,* 7 January 2018),

> which means it's time for all those performance scoreboards, highlighting the top-performing financial advisers, investment-newsletter editors or mutual funds of the previous year. These scorecards can provide some worthwhile information. *But beware: They also can be hazardous to your wealth. That is because sooner or later, but probably sooner, these investing kingpins will incur losses so large as to make it almost impossible to ever recover. A far better approach is to focus on those strategies with market-beating records over the long term.*
>
> Consider the performance of a hypothetical portfolio that each January invested in the recommendations of the investment newsletter at the top of the previous calendar year's performance rankings. According to [research conducted by Hulbert Interactive], this portfolio created from each year's winners has lost almost everything—incurring an 18.0% annualized loss

> since 1991. *So, $100,000 invested in this portfolio back then would today be worth just $471 today. This suggests that the appropriate response to the one-year performance sweepstakes is to run, not walk, the other way.*[3]

Why is it such a bad idea to follow the herd and plough your savings into the previous year's top performers? A foundation of LCO's investment operations – regression to the mean – provides a major reason. Hulbert cautions that speculators almost inevitably get their comeuppance. *Those who enjoy terrific results today will usually suffer terrible ones tomorrow:*

> Consider the Persistence Scorecard that is periodically updated by S&P Dow Jones Indices. It measures the odds that a mutual [known in Australia as a "managed"] fund will remain an above-average performer for several years in a row. … S&PDJI found that "an inverse relationship generally exists between the measurement time horizon and the ability of top-performing funds to maintain their status." *In other words, as you focus on shorter and shorter time periods, there is a higher and higher chance that the top performer in one period will be a bottom performer the next.*

The higher they rise, in effect, the harder they soon fall. What causes a handful of funds, in a given period, to produce astonishingly large gains? Hulbert warns that it's NOT skill; instead, it's the draw of a dodgy set of cards. Many financial advisors, investment-newsletter editors and funds managers "pursue wildly risky strategies."

> Though on average they lose, occasionally one of them will hit the jackpot and rise to the top of the annual rankings. By choosing that lucky adviser or manager, investors who invest ["speculators who speculate" is more apt] with the previous year's top performer are in effect betting that lightning will strike twice. *They inevitably get sabotaged by their advisers' sky-high risk. … [In sharp contrast, the small band of managers who invest prudently and possess strong records of] long-term performance … is hardly ever at the top or bottom of the calendar-year rankings. Slow and steady really does win the race.*

The tortoise, in other words, beats the hare. "The clear implication" is that

> You improve your chances of picking a winning [adviser or investment manager] by focusing on performance over periods far longer than one year. How long? *Our analysis … suggests that even 10 years isn't enough. Only when performance was measured over at least 15 years were there better-than-50% odds that a top performer would be able to repeat*. [Moreover,] when fol-

[3] "See also "How to Lose 93% of Your Money" (*The Wall Street Journal*, 12 January 2018).

> lowing a top performer over the previous 15 years, you are unlikely to be at the top of the rankings in any given calendar year …

The problem, of course, is that very few investment managers – LCO is an exception – possess continuous track records of at least 15 years. *Lacking a long-term record, short-term, "career risk" compels most managers to speculate with other peoples' money.* Unless they take big risks, they cannot hope to generate the stellar short-term results that underpin splashy ads – and attract the mainstream media's attention. The publicity and plaudits that result from a lucky draw of the cards, in turn, prompt the large inflows of money that underpin fat management fees (see below). *Yet as time passes this same risky behaviour produces increasingly bad results.* For this reason, before long most funds (their average longevity is ca. 7 years) close or merge. This high rate of mortality expunges many managers' poor long-term records; it thereby encourages them to resume their risky short-term ways. The resultant "survivorship bias" greatly understates most managers' long-term "underperformance."[4]

Long-run outperformers, on the other hand, are quiet achievers – or even modest underachievers – in the short-run. Their results within any 12-month (or even 24-36 month) period are usually unremarkable. Hulbert finds that their

> average yearly performance rank for those 15 calendar years was at the 59th percentile. But that's a shortcoming only if you're a thrill seeker who finds it intolerably boring to be merely above-average year in and year out – even if that does lead to being at the top of the rankings for very long-

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4 In the decade to 2012, according to an analysis conducted by John Bogle (the founder and former chairman of the colossal – ca. $3 trillion dollars under management in a family of 140 funds – Vanguard Group and widely acknowledged as the father of the managed funds industry), every year an average of 7% of all funds failed, closed or merged. That's versus just 1% per year in the 1960s. Of the ca. 6,500 funds that existed in 2002, approximately 5,500 – 85% – had "been liquidated or merged" by 2012. Bogle expects that this very high rate of mortality will continue. If so, then at least 3,000 of the 4,600 funds that existed in 2012 will no longer do so in 2022 (for details, see Mutual Funds Biting the Dust at an Alarming Rate, *Forbes*, 13 May 2013).

In The Mutual Fund Graveyard … and Its Implications for Investors (*Seeking Alpha*, 1 June 2016), Louis Kokernak asked: "what problems arise from all these 'deaths'? One of the foremost is the survivorship bias introduced to mutual fund performance aggregates." Survivorship bias is the error of logic that concentrates upon the people or things that passed (or survived) some selection process and thereby overlooks those that – typically because of their lack of visibility – didn't. If the average scores or survivors and non-survivors differ significantly, then biased inferences occur. Survivorship bias plagues the managed funds industry's performance data. Kokernak concludes: "The funds that disappeared tend to be those that have logged poor investment performance. … It's pretty clear that a lot of skeletons are getting stuffed in the closet" (see also "Can We Be Brutally Honest about Investment Returns?" *The Wall Street Journal*, 19 January 2018).

> term performance. … *[Accordingly, assuming that] you are seriously focused on building up wealth over the long term, you should be more than willing to give up the hope of ever being at the top of the calendar-year rankings* [italics added].

In one key sense, then, short-term returns ARE important – but NOT in the way that the mainstream assumes. *What the crowd and most professionals mostly ignore is precisely what truly matters: in the short-term, it's vital to eschew the risks that occasionally generate astounding (but ephemeral) gains but eventually produce hefty (and permanent) losses.* The prudence that generates reasonable outcomes year after year and through thick and thin might be tedious; yet it reliably cumulates into remarkable – and rewarding – long-term results.

Directors' Mindset

How did LCO achieve these long-term market-beating results? Its Directors applied Graham's and Buffett's principles. This means something that most people (including intelligent people who call themselves "investors") comprehensively misunderstand: LCO's Directors don't strive to become – nor claim that they are – brilliant, prescient, etc. *The mainstream vastly over-rates the importance of intelligence; it also falsely claims that it's a necessary (or even a sufficient) condition of success.* Eleanor Laise[5] comically yet insightfully debunked this myth. She profiled an investment club whose "record has been nothing short of a fiasco, thanks to an overweighting in trendy tech stocks and pitifully bad timing … All told, the club saw the value of its assets fall by more than 40% over the past 12 months." One member said "we can screw up faster than anyone else;" another, a member since the mid-1960s, describes its investing strategy as "buy low, sell lower." From 1986-2001, the club's investments returned an average of 2.5% per year (versus the S&P 500's 15.3%). Laise writes:

> It sounds as if this group could really use an intelligent investing strategy. And that's ironic, given who its members are. This is the Mensa Investment Club. That's right, Mensa, the organisation founded in England in 1946 with the aim of assembling the brightest Britons to advise the government in times of crisis. The cost of admission: an IQ in the 98th percentile (or better). A half-century later the organisation, which *Vanity Fair* once dubbed "a dating service for dorks," has 47,000 members in the U.S. (100,000 worldwide) and one of the sorriest investment clubs you will ever see.

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5 "If We're So Smart, Why Aren't We Rich? The Inside Story of How a Select Group of the Best and the Brightest Managed to Bungle the Easiest Stock," *Dow Jones Newswire* (15 May 2001).

We can learn much from these geniuses: namely that seemingly intelligent people – including those who allegedly rank among the world's brightest – can actually be (in the sense that they proceeded without a coherent or justifiable framework, and after fifteen years of failure were apparently incapable of learning from their repeated mistakes) astonishingly stupid. In his Preface to *The Intelligent Investor*, Buffett concluded:

> to invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework. This book precisely and clearly prescribes the proper framework. You must supply the emotional discipline.

Graham and Buffett provide LCO's intellectual framework. What about its emotional mindset? In particular, how does an investor worthy of the name respond to sudden and sharp falls, as well as extended contractions, of individual securities' prices and overall markets' levels? *Successful investment isn't primarily a matter of intelligence: it's about character.* An investor's results – good or otherwise – stem from a particular temperament. Graham recalled William Shakespeare's *Julius Caesar*:

> The investor's chief problem – and even his worst enemy – is likely to be himself. ("The fault, dear investor, is not in our stars – and not in our stocks – but in ourselves" …) … We hope to aid our readers to establish the proper mental and emotional attitudes toward their investment decisions. We have seen much more money made and kept by "ordinary people" who were temperamentally well suited for the investment process than by those who lacked this quality, even though they lacked an extensive knowledge of finance, accounting, and stock-market lore.

In an interview in the early 1970s,[6] Graham added:

> The main point is to have the right general principles and the character to stick to them. … There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently.[7]

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6 "An Hour with Mr Graham," reprinted in Janet Lowe, *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (John Wiley & Sons, 1999).

7 What is an "intelligent" investor? In *The Intelligent Investor*, Graham stated that intelligence has nothing to do with IQ. Instead, it comprises discipline, humility, patience and the willingness to learn; it also entails the ability to harness one's emotions to one's intellect, learn from one's

Genius, then, is unnecessary; if anything, it's a hindrance. What's required is ethos – specifically humility, intestinal fortitude and a laser-like focus upon clear, rigorous and above all independent thinking. According to Graham, the investor doesn't seek brilliance:

> He is not trying to be smarter than his fellow investors but simply trying to be less irrational than the mass of speculators who insist on buying after the market advances and selling after it goes down. If the market persists in behaving foolishly, all [the investor] seems to need is ordinary common sense in order to exploit others' foolishness.

In his letter (25 February 2018) to Berkshire Hathaway's shareholders, Buffett reiterated this vital point:

> Though markets are generally rational, they occasionally do crazy things. Seizing the opportunities then offered does not require great intelligence, a degree in economics or a familiarity with Wall Street jargon such as alpha and beta. What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential.

LCO's Directors disclaim brilliance and embrace basics: they seek to buy the securities of quality companies from pessimists at low prices and subsequently sell them to optimists at high prices. *They understand that investing is only partly cognitive and rational; it's also a psychological trial and an emotional tussle. Unless it's countered with businesslike principles applied strictly, unemotionally and even stoically, the heart is the odds-on favourite to conquer the head.* Hence it's worth repeating: the purchase of assets whose value (ascertained from rigorous and cautious analysis) exceed their price by a reasonable margin, and to ignore – or at least endure – short-term fluctuations and vicissitudes, is the essence of Graham-and-Buffett value investing.

LCO's Portfolio's Weightings of Bonds-Cash-Term Deposits versus Equities

"Because of the uncertainties of the future," said Graham, "the investor cannot afford to put all of his funds into one basket – neither in the bond basket, despite the unprecedentedly high returns that bonds have recently offered, nor in the stock basket, despite the prospect of continuing inflation." Hence the crux of his portfolio management policy: "he should divide his funds between high-grade bonds and high-grade common stocks." Specifically,

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inevitable mistakes and think logically and independently. This kind of intelligence, said Graham, "is a trait more of character than of the brain."

> We have suggested as a fundamental grading rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with a consequent inverse range of between 75% and 25% in bonds. There is an implication here that the standard division should be an equal one, or 50-50, between the two major investment mediums. According to tradition the sound reason for increasing the percentage in common stocks would be the appearance of the "bargain price" levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock component below 50% when in the judgement of the investor the market level had become dangerously high.

This rule conforms to common sense: in principle, the rational investor strives to buy low and sell high. But as Graham noted, it flatly contradicts human psychology. In practice, people who mistakenly believe that they're investors but are actually speculators (this group comprises most people, including advisers and brokers) pray for a bull market, rejoice when it appears and seek to buy ever more securities as their prices rise. Conversely, they fear and loathe a bear market – and reduce their holdings as prices fall. Consequently, and because the heart rules the head, the crowd tends to buy high and sell low. Such behaviour, alas, defies both common sense and the laws of economics. *Grahamite investors, on the other hand, welcome and buy during bear markets, and understand that the bull has only one use: he provides the means to offload holdings at unreasonably high prices.*

The "aggressive" investor, Graham continued, "should start from the same base as the defensive investor" – namely a roughly balanced division of his portfolio into stocks and bonds.[8] "He will be prepared to branch out into other kinds of security commitments, but in each case he will want a well-reasoned justification for the departure." Accordingly, except on those rare occasions when he can buy them at a significant discount, he will leave high-grade bonds to defensive investors and instead will focus upon "second grade" bonds (where significant divergences of values and prices are more likely to arise). Similarly (and again except on those rare occasions when his estimate of their value significantly exceeds their price), he will leave "blue chip" stocks to defensive investors, and will concentrate upon smaller, unfashionable and misunderstood companies and special situations.

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[8] "The defensive investor," said Graham, "is one interested chiefly in safety plus freedom from bother." He seeks to maximise the soundness of his sleep and minimise the time and energy he devotes to his investments. The defining characteristic of the "aggressive" (Graham also uses the more appropriate term "enterprising") investor, on the other hand, is NOT the amount of risk of capital loss he is willing to bear: it is the amount of time and effort he is prepared to devote to the search for and analysis of securities. Like his defensive counterpart, the enterprising investor seeks to sleep well; but unlike the defensive investor, the enterprising investor knows that a full day of diligent, useful and satisfying work begets sound sleep.

Figure 4:
Stocks and Cash/Bonds as Percentages of LCO's Total Assets

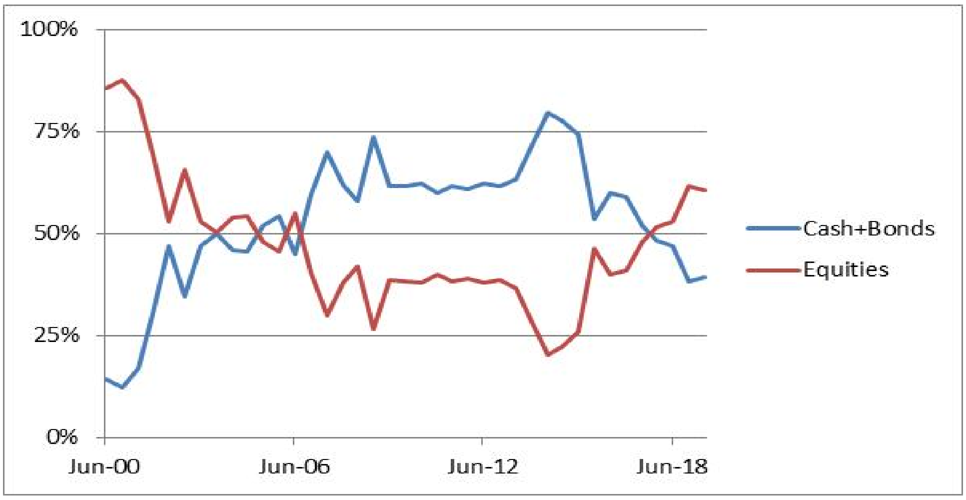


Figure 4 categorises LCO's holdings as cash at-call, bonds and term deposits on the one hand or stocks on the other, and expresses each category as a percentage of the entire portfolio on 30 June and 31 December of each year. (The two series sum to 100%; hence the one is the mirror image of the other). *In this critical respect, too, LCO has adhered faithfully to Graham's policy:* only on one occasion – in 2001 – has the portfolio's weighting towards shares exceeded the 75% upper bound; similarly, on only one occasion (2014) has stocks' weighting fallen below 25%. On average, bonds and deposits have comprised 54% and stocks 46% of LCO's portfolio.

Additional Reasons to Hold Much Cash and Relatively Few Shares

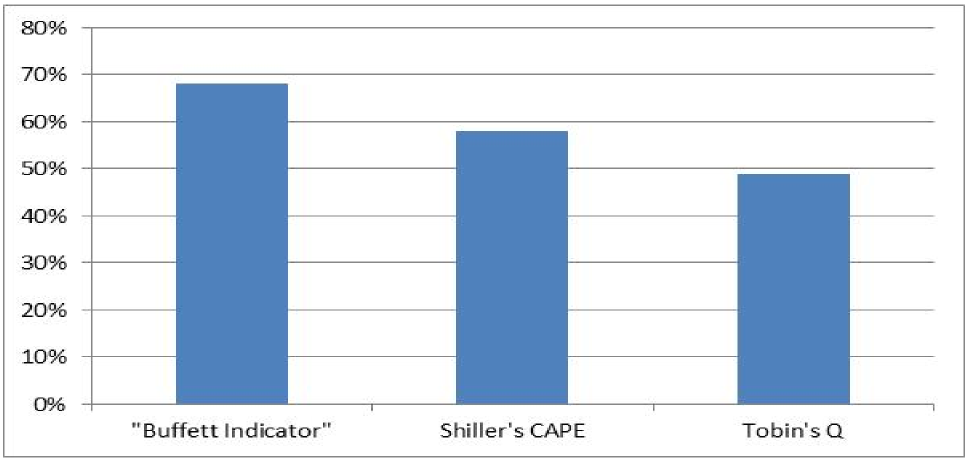
On 13 February 2019, in "Global Fund Managers Pare Equity Holdings, Bolster Cash Reserves: BAML," *The Australian Financial Review*, citing research conducted by Bank of America Merrill Lynch, reported:

> [Bank of America Merrill Lynch] found that the number of fund managers who were "overweight cash" had risen to the highest level since January 2009. Their cash levels were at 4.8% this month, compared with a 10-year average of 4.6%.

Major Markets' Overvaluation

Since 1999, the weighting of LCO's portfolio to bonds, cash and deposits – which we regard as a rough proxy of its conservatism – has been ca. ten times heavier than the average managed fund's. *This heavy "overweighting" reflects our conviction that since the 1990s the prices of stocks in Australia (and Britain, Canada, the U.S., etc.) have been unreasonably and perhaps dangerously high (see also Figure 16).* During the past 20 years, LCO's Annual Reports and Half-Year Reports to its shareholders have repeatedly described and analysed in detail the three (in our view) most valid and reliable measures of the stock market's valuation: (1) Warren Buffett's ratio of market capitalisation to GDP, (2) Robert Shiller's Cyclically-Adjusted Price to Earnings ratio (CAPE; see the Prognosis below), and (3) James Tobin's "Q" ratio.[9] A decade after the GFC, each exceeds its historical average by ca. 50-70% (Figure 5). *The implication is that the S&P 500 (and, by extension, other major equity market indexes) is greatly overvalued: in order to return to "fair value" it must fall by one-half or more.*

Figure 5:
Overvaluation, Three Major Measures, S&P 500 Index (June 2018)



LCO is well-prepared if and when this happens. When shares aren't cheap – which, as we'll see in Figure 16, has since the late-1990s been almost all of the time – LCO's conservative approach has required that it hold few shares and plenty of cash and equivalents. This very cautious stance has formed a low ceiling above and a firm floor below LCO's half-yearly results. Today, we haven't just accumulated plenty of dry powder: we've thoroughly researched many possible investments, rejected all but the most promising and compiled a "wish list" of major enterprises whose securities we're prepared to buy if and when their prices fall to attractive levels. Thereby equipped, and unlike most others, we can regard any downward fluctuation of the stock market as an opportunity rather than a threat.

Bonds Can – and Sometimes Do – "Outperform" Stocks

Is the convention wisdom true – do equities *always* outperform Treasury Bills? Hendrik Bessembinder,[10] finds that the answer to this question is clearly "no." Indeed,

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9 For a readable description of these indicators, see Mark Hulbert, "The Eight Best Predictors of the Long-Term Market," *The Wall Street Journal*, 5 August 2018.

> Most common stocks do not outperform Treasury Bills. Fifty eight percent of common stocks have holding period returns less than those on one-month Treasuries … When stated in terms of lifetime dollar wealth creation, the entire gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed stocks.

In "Sometimes, It's Bonds for the Long Run" (*The Wall Street Journal*, 2 November 2018), Jason Zweig reported:

> Maybe investors should question the dogma of "stocks for the long run." History shows that a portfolio of bonds has outperformed stocks surprisingly often and for shockingly long periods. That's the intriguing argument in a new research paper[11] … Investors have long taken it as an article of faith that stocks have always beaten bonds—and always will—if you can just hang on long enough. Prof. McQuarrie's research is a healthy reminder that this belief is wrong.
>
> … The popular belief that there's never been a 30-year period in which stocks had lower returns than bonds is false. As recently as 2011, bonds earned higher returns than stocks over the prior 30 years (long-term Treasury bonds, 10.7% annually; U.S. stocks, 10.4%). That's no aberration, says Prof. McQuarrie. … He assembled an index of bonds back to 1793. That has enabled him to calculate 30-year returns beginning in 1823. Between then and 2013, he shows, bonds earned higher returns than stocks in one-quarter of all 191 three-decade-long periods.

Bonds, Deposits and the Like Provide "Optionality"

Never mind today's rates of interest: cash is most valuable during market crashes, downturns and panics – when seemingly nobody else has any. "Ask anyone with a neat nest-egg sitting in the bank how they feel about it," wrote Merryn Somerset Web (Cash Gives the Private Investor an Edge, *The Financial Times*, 24 May 2013),

> and they'll answer that they're guilty that it isn't "working" for them. But the truth … is that being able to sit in cash – without having to put up with snide remarks about being paid to do nothing – is yet one more factor that gives the intelligent investor an edge over the [institutional speculator] …

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10 Do Stocks Outperform Treasury Bills? *Journal of Financial Economics*, Vol. 129, No. 3 (September 2018), pp. 440-457

11 See Edward F. McQuarrie, The First Eighty Years of the US Bond Market: Investor Total Return from 1793, Combining Federal, Municipal, and Corporate Bonds (4 October 2018).

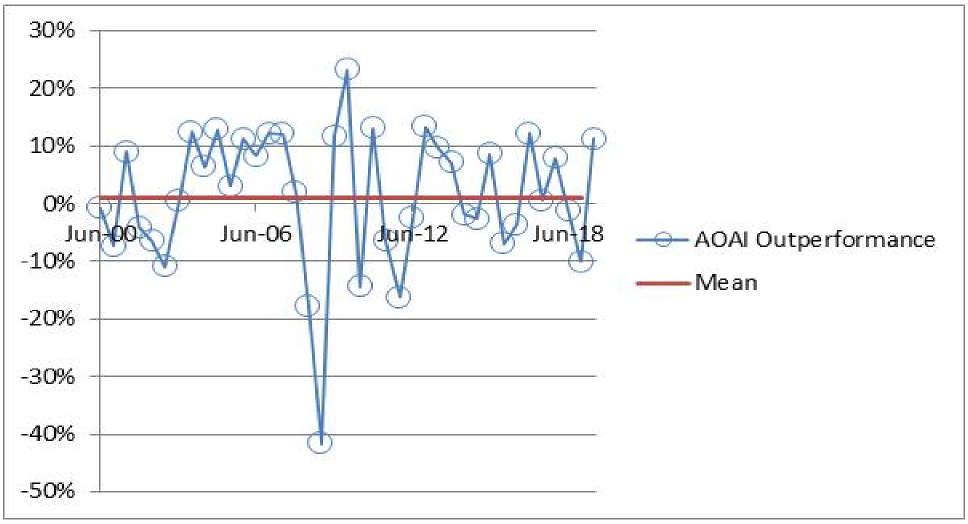
> The key to this is to think of cash as offering what economists like to call optionality. Sure, it hasn't been a comfortable thing to hold as markets have frothed and bubbled [and rates of interest have plunged]. *But great fortunes don't rest on holding what other people are holding at the top. They rest on being able to buy what other people can't afford at the bottom* [italics added].

Cash provides the means, when opportunities eventually arise, to buy securities at bargain prices. It resembles a call option with no strike price or expiry date. Seth Klarman, a follower of Graham (and CEO and portfolio manager of the Baupost Group, a Boston-based private investment partnership he founded in 1982), has rightly dubbed cash "the ultimate contrarian investment."

Tamping Volatility at Little Cost to Returns

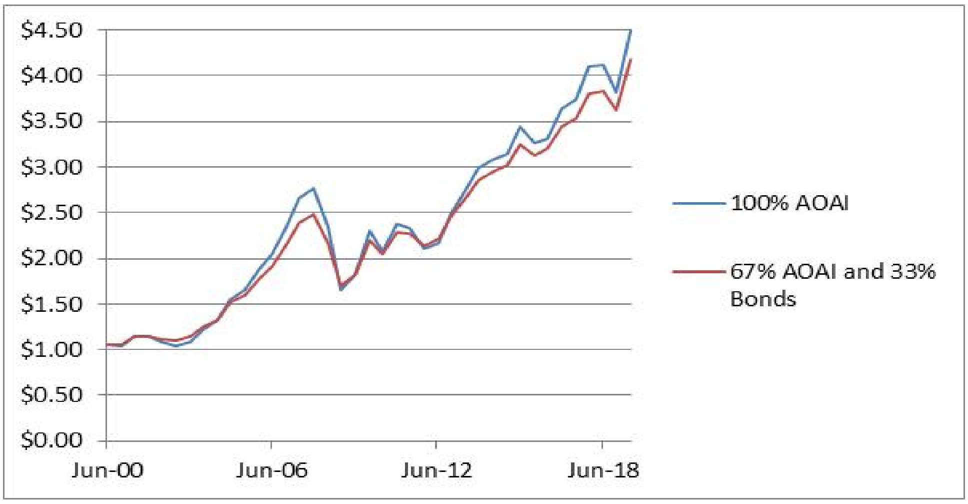
Figure 6 plots, for each half-year since LCO's formation, the percentage return of the AOAI net of the return of the Australian Bond Index compiled by Vanguard. During the average half-year, stocks have "outperformed" bonds by 1.12% (during the average half-year, the AOAI has returned 4.13% and the bond index 3.01%). Yet in 45% of half-years stocks have "underperformed" – and on occasion have done so egregiously. Most notably, in the six months to December 2008 stocks' return was the worst (-29.7%) for the entire 20-year period. In that same half-year, however, bonds generated record returns (12.0%). Hence stocks "underperformed by a massive -29.7% - 12.0% = -41.7%.

Figure 6:
"Outperformance" of All Ordinaries Accumulation Index versus Australian Bonds, Half-Years since June 2000



Moreover, bonds' half-yearly returns are just one-quarter as volatile than stocks'. The standard deviation of the AOAI's half-yearly return is 10.3%; that of the bond index is just 2.5%. Hence in only three half-years (ca. 8% of the total) did bonds generate a negative return. *As a result, after 20 years, an investment of $1 in the AOAI accumulates little more than an investment of $1 that comprises $0.67 in the AOAI and $0.33 in the bond index* (Figure 7). By December 2018, the "all stock" investment grew to $3.82. The two-third stock and one-third bond investment generated 95% as much, i.e., $3.63. The all-stock portfolio's 20-year CAGR was 7.1%; the mixed (stock-and-bond) portfolio's was 6.9%. Yes, the former outpaced the latter – but not by much, and its ride was bumpier.

Figure 7:
Investments of $1 in Two Portfolios,
Growth of Capital at Half-Years since June 2000



Awaiting Opportunities and Following Buffett

LCO's weighting to bonds, cash etc., follows Buffett. He has long retained a significant portion of Berkshire Hathaway's total assets in the form of cash, short-term government securities and preferred stock. Prem Jain writes:

> What should you do if the stock market does down substantially and you find some excellent investment opportunities? Of course, you should buy stocks. However, you will miss this opportunity if you are fully invested … and do not have cash or cash equivalents ready to invest.[12]

As a result, Jain concludes, "Berkshire can invest large sums of money quickly whenever a good investment opportunity arises." LCO's shareholders have entrusted its stewards (Directors) to decide when to hold cash and when to invest it – to de-

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12 *Buffett Beyond Value: Why Warren Buffett Looks to Growth and Management When Investing* (John Wiley & Sons, 2010), p. 157.

termine, in other words, when the expected return from a prospective investment justifies the risks it entails – and when it doesn't. To invest successfully is to choose among a series of trade-offs. To hold cash and bonds, income securities and term deposits is a reasonably safe way of keeping one's powder dry until compelling opportunities arise. This stance offers a limited return in exchange for reasonable safety of principal. Absent better alternatives, this is the most sensible thing to do.

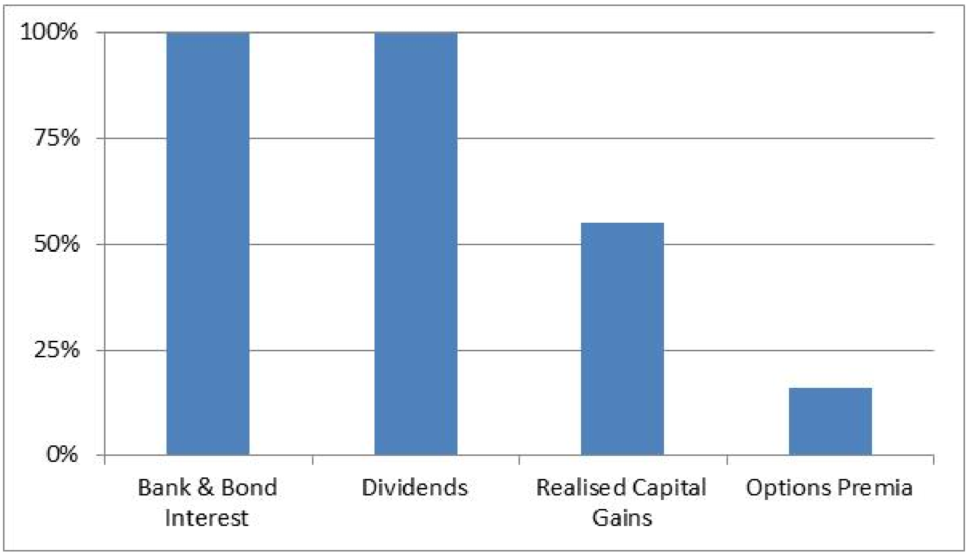
LCO's cannot *time* the stock market, but it can – albeit roughly – *value* it; and having ascertained for most of its existence that prices exceeded values, making bargains few and difficult to locate, we've allowed stocks to comprise a relatively small (and bonds, cash, term deposits, etc., a correspondingly large) percentage of our assets. By mainstream standards, this is highly unusual; in retrospect, it's clearly been sensible. LCO, in other words, is a very *unconventional* but highly *conservative* investor. This conservatism clearly hasn't crimped our long-term results: quite the contrary, by mitigating losses during bear markets and financial crises it has boosted them.

Sources of LCO's Income

LCO's cash income derives from four sources:

1. receipt of franked and unfranked dividends from stocks;
2. payments of interest from bonds, cash balances and term deposits;
3. realisation of capital gains from the profitable sale of securities; and
4. premiums from the options contracts.

Figure 8:
The Consistency of LCO's Sources of Cash Incomed (Half-Years since June 2000)



Notice that these sources do *not* include the market-to-market (MTM) fluctuations of the market prices of the securities that comprise its portfolio. In two respects, payments of dividends and interest have underpinned LCO's income. First, Figure 8 shows the percentage of half-years since June 2000 in which each source has been received. Dividends and payments of interest from bank deposits, bonds etc., have been received in all (100%) of the half years. *These steady receipts of income, in turn, have financed LCO's payments of dividends: having from inception received two continuous sources of income from its portfolio, it has been able to pay a dividend to its shareholders in 100% of the half-years since June 2000.* In sharp contrast, capital gains have been realised as and when they've become available – which has been in slightly more than half of the half-years. Finally, and largely because LCO has written options only since 2016, premiums have been received only 16% of the time.

Figure 9:
Categories of Cash Income Received Since Inception
(as a Percentage of All Cash Income Received during the Half-Year)

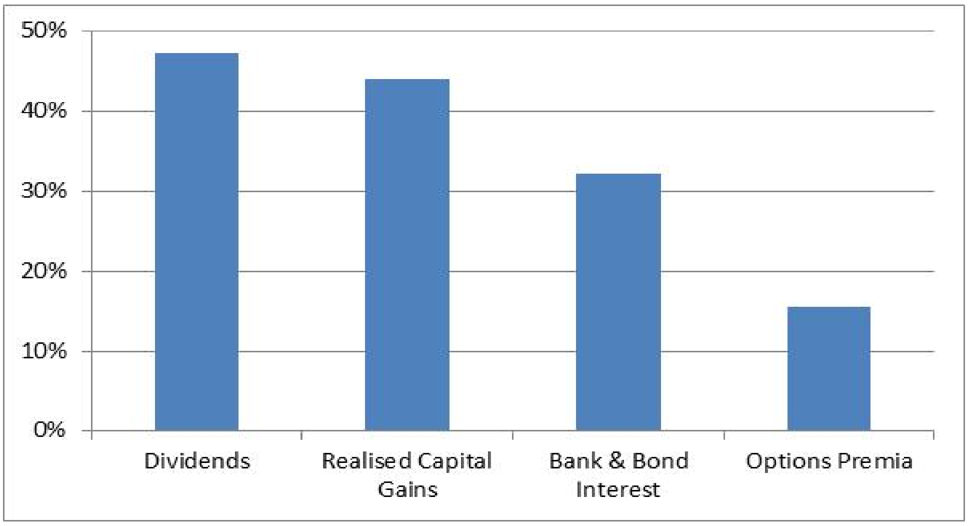
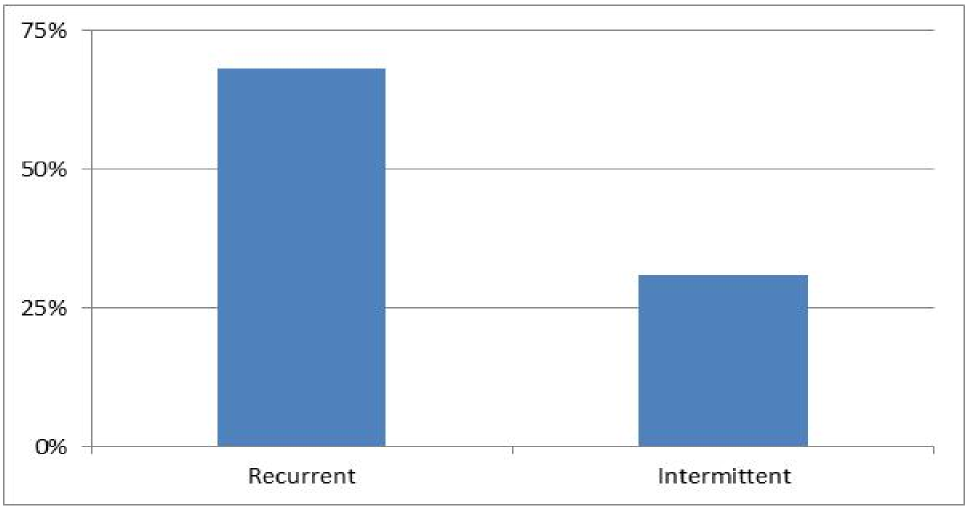


Figure 9 shows the average percentage of each category of LCO's cash income as a percentage of the total cash income during each half-year since inception. On average, dividends have comprised 47% of income, realised capital gain 44%, bank and bond interest 32% and premiums from options 15% (these percentages don't sum to 100% because the analysis ignores rather than scores as zero those quarters in which a given category of income wasn't received).

Figure 10 restates in two ways the data in Figure 8 and Figure 9. First, it reduces the categories of cash income from four to two. It combines dividends and payments of interest into one category (which comprises a "recurrent" stream of income); it also combines capital gains (net of capital losses) and premiums from options as a second category (which comprises irregular, i.e., "intermittent" lumps of income). Secondly, it scores as zero those quarters in which a given category of income wasn't received; as a result, the percentages of these combined categories do sum to 100%. Since June 2000, the recurrent stream has comprised, on average, more than two-thirds (68%) of half-yearly income, and the intermittent lumps an average of 32%. *The implication is vital: although many people discount their importance, dividends and payments of interest are clearly a sine qua non of reasonable long-term investment results. Accordingly, LCO's half-yearly earnings have been reasonably stable and its investors' returns and growth of capital have been comparatively steady because LCO has relied (by a roughly two-to-one margin) upon a regular rather than an irregular source of income.*

Figure 10:
Streams vs. Lumps of Income (as Percentages of All Income Received during a Half-Year), Half-Years since June 2000



LCO's Portfolio: Focussed Yet Diversified

Diversification is a necessary condition of successful long-term investment. Its justification is simple and compelling: "Don't put all your eggs in one basket." This logic underpins key aspects of our non-financial and day-to-day lives. We must, for example, acquire and hone a variety of skills in order to earn a living; similarly, a person who possesses wide experience and a diverse base of knowledge usually makes better decisions and navigates life's ups and downs more successfully.

By mitigating the impact of adverse events, diversification helps to protect investments against risk. It's thus a kind of insurance. When you plough all of your capital into one or two companies, you can easily – even if they're outstanding firms with seemingly bright futures – lose heavily if one company faces unforeseen difficulties. On the other hand, if you construct a portfolio of (say) 10 strong enterprises spanning several different industries then you're still likely to obtain good results even if a few don't do as well as expected. Yet if you diversify excessively then the quality of your holdings will tend to fall; moreover, you'll receive approximately the same return as the market as a whole. That's great if you invest at the trough of a bear market, but could be disastrous if you invest at the peak of a bull market.

How many stocks should a portfolio contain? Other things equal, the greater the number of stocks, bonds, etc., it contains, the more diversified it becomes. Clearly, no portfolio can be more diverse than the overall market. Equally evidently, the benefits of diversification are not costless. According to Morningstar (How Many Stocks Diversify Unsystematic Risk? undated),

> while much of academia has focussed on the risk of not being diversified enough, we believe that there's a practical risk to being too diversified. It becomes nearly impossible to know your companies really well. Instead of having a competitive insight, you begin to run the risk of missing things … When you lose your focus and move outside your circle of competence, you lose your competitive advantage as an investor.[13]

Hence academics have rephrased this question: what's the minimum number that receives most of the benefits but incurs few of the costs of diversification? Since the 1960s, academics haven't reached a definitive conclusion, but have attained a considerable degree of agreement. John Evans and Stephen Archer were the first to evaluate the reduction of portfolio risk as portfolio size increased. *They showed that on average eight to ten stocks are sufficient to achieve almost all (90%) of the benefits of diversification*.[14] Similarly, in *Investment Analysis and Portfolio Management* (Cengage Learning, 10th ed., 2011), Frank Reilly and Keith Brown concluded that "about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks" (p. 213). In other words, if you own this number of randomly-selected and equally-weighted stocks, you obtain 90% of the benefits of diversification. If your portfolio contains more than this number, you get more diversification but will incur increased costs – and thus achieve little or no net benefit.

John Maynard Keynes (always an execrable economist but eventually a very good investor) understood this point. "As time goes on I get more and more convinced,"

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13 Phillip Fisher has warned that most investors embrace diversification to the point of excess. As a result, most place "eggs in so many baskets that a lot of the eggs do not end up in really attractive baskets, and it is impossible to keep watching all the baskets after the eggs get put into them" (*Common Stocks and Uncommon Profits and Other Writings*, 2nd ed., John Wiley & Sons, 2003 p. 144).

14 John L. Evans and Stephen H. Archer, Diversification and the Reduction of Dispersion: An Empirical Analysis, *The Journal of Finance*, vol. 23, no. 5 (1968), pp. 761–767.

he wrote to the board of National Mutual (which he chaired) in 1934, "that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about … It is a mistake to think one limits one's risks by spreading too much [among] enterprises about which one knows little and has no reason for special confidence." In a memo to the Provincial Insurance Company (whose board he advised) in 1938, he added: "to carry one's eggs in a great number of baskets, without having time or opportunity to discover how many have holes in the bottom, is the surest way of increasing risk and loss."[15]

In his annual letter to investors in 1962, Warren Buffett was more specific: "We usually have fairly large portions (5% to 10% of our total assets) in each of five or six [stocks], with smaller positions in another ten or fifteen." During the next half-century, no other single sentence better expressed the essence of Buffett's portfolios. "If the one basket I owned was Wal-Mart stock," said Peter Lynch, "I'd have been delighted to put all my eggs into it." Yet Lynch famously worked 70-hour weeks throughout the year, in a given year studied thousands of companies – and stuffed hundreds of stocks into his Magellan Fund. How did he reconcile these seemingly-contradictory positions? "In my view, it's best to own as many stocks as there are situations in which: (a) you've got an edge; and (b) you've uncovered an exciting prospect that passes all the tests of research. Maybe that's a single stock, or maybe it's a dozen stocks."[16]

The standard practice of the investment management industry flatly contradicts the results of academics' research and the practices of leading successful investors. The average mutual fund holds 91 stocks and the top quintile of most diversified mutual funds holds on average 229 stocks. Several studies have concluded that a properly-diversified portfolio requires 100 or more securities. Yet the latest research, which analyses data from Australia, Britain, Canada, Japan and the U.S. and covers a relatively long period of financial history (1975-2011), concludes that a portfolio's ideal number of holdings – in the sense that it achieves 90% of the benefits of diversification 90% of the time – is 38-49.[17]

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15 Cited in Oliver Westall, *The Provincial Insurance Company 1903-1938: Family, Markets and Competitive Growth* (Manchester University Press, 1992), p. 369.

16 Peter Lynch with John Rothchild, *One Up on Wall Street* (Penguin Books, 1989), p. 242.

17 Travis Sapp and Xuemin (Sterling) Yan, Security Concentration and Active Fund Management: Do Focused Funds Offer Superior Performance? *The Financial Review*, vol. 43 (2008), pp. 27-49; Vitali Alexeev and Francis Tapon, Equity Portfolio Diversification: How Many Stocks are Enough? Evidence from Five Developed Markets, University of Tasmania Discussion Paper, Series N (2013-16).

Warren Buffett famously stated that "diversification is protection against ignorance. It makes little sense if you know what you are doing." The problem with diversification, in his view, is exactly what the mainstream hails as its justification: it offsets losses from one investment against gains in another. As a result, it doesn't just mitigate losses: it also crimps returns. *How, then, do Buffett and his followers alleviate risk? Not by dispersing but rather by concentrating their efforts and focussing their portfolios*. "The first thing I think about when evaluating a business," Buffett has said, "is whether it's in my circle of competence." Studying a handful of industries in depth and structuring one's investments accordingly can be very effective; dissipating one's energies and spreading a portfolio across a broad array of sectors almost certainly isn't. The follower of Buffett, in other words, doesn't select investments randomly: her portfolio emerges from extended research within her circle of competence. What Buffett calls a "know-nothing" investor (who, more often than not, is unwittingly a speculator) hasn't taken the time and devoted the effort to develop this specialist expertise; a "know-something" investor has. Prem Jain summarises:

> by studying the teachings of Graham and Fisher, and taking into account analyses in modern financial literature and the practices of Buffett, we can conclude that a prudent investment strategy involves investing in 10 to 30 stocks.[18]

In a key respect, LCO's portfolio has from the start and in this key respect resembled Buffett's: it has consistently comprised a manageable number of securities. Buffett's portfolios since the 1950s have tended to hold ca. 20-30. Yet even by Buffett's standards, LCO's portfolio has been concentrated: since 1999-2000, it has averaged only 11.4 (Figure 11). We have sought to diminish the risk of capital loss not by *diversifying* the portfolio among a large number of stocks and bonds which we have only superficially analysed; rather, we have sought to reduce this risk by *concentrating* the portfolio among those securities which (1) we have researched comprehensively and (2) exhibit the greatest disparity between purchase price and perceived underlying value. These securities are most likely to provide the greatest "margin of safety" against financial loss over the long term.

We conclude, in light of our track record and results of academic research, that our construction of portfolios has been prudent and our portfolios' number of holdings has been roughly optimal. From that point of view, LCO's market-beating results aren't greatly surprising. They corroborate Morningside's conclusion: "holding a concentrated [by the standards of the conventional wisdom] portfolio is not [risky] … In other words, it takes fewer stocks to diversify a portfolio than one might intuitively think."

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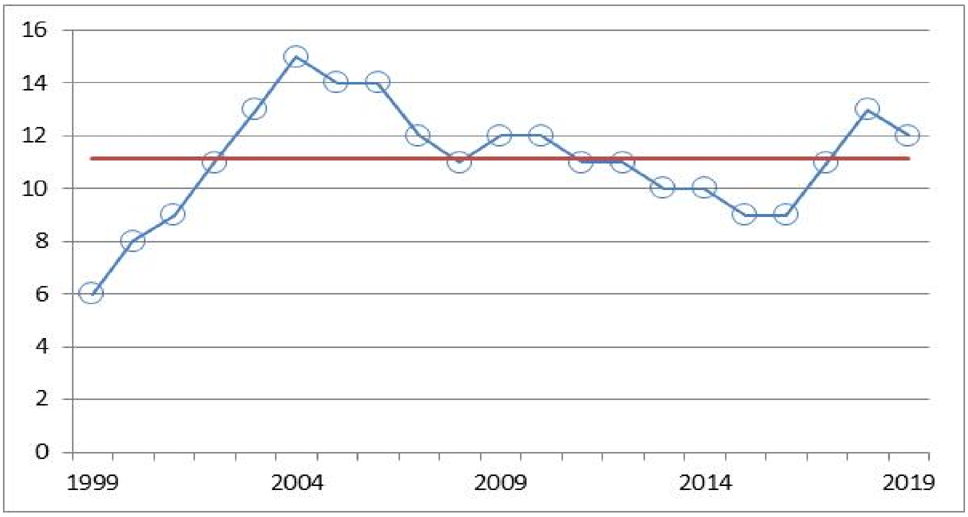
18 Prem C. Jain, *Buffett Beyond* Value, p. 167.

Figure 11:
LCO's Portfolio, Number of Equities on 30 June



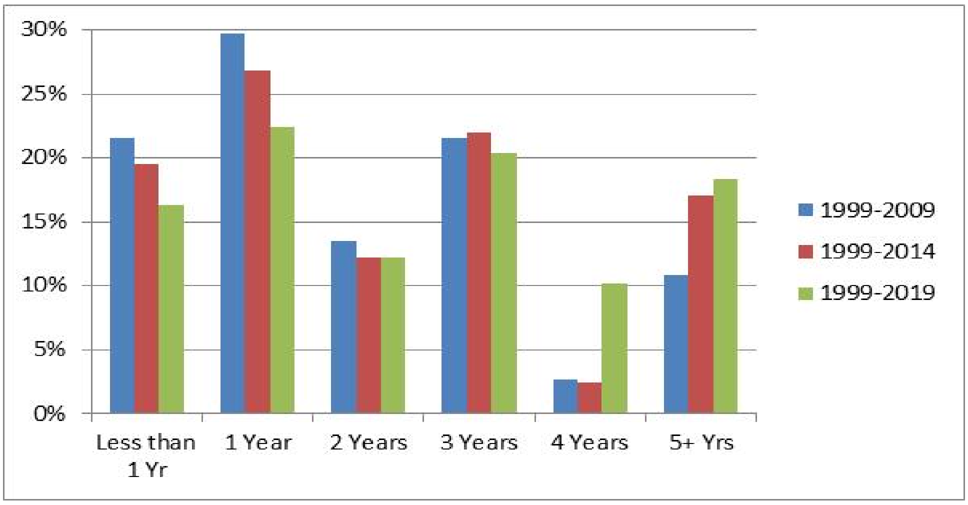
Length of Time Securities Held Before Sale

No security enters LCO's portfolio without extensive research, and our analyses assume (if we purchase it) that we will retain a security at least five years. We don't assume that the gap between price and value will close more quickly, and must allow the realisation of full value to take its time. In the meantime, payments of interest have generated roughly two-thirds of our cash income.

Yet as Figure 12 shows, our actual average holding period has been much shorter: just 2.7 years. This average has risen over time: in 1999-2004 it was 2.1 years, and in 1999-2014 it was 2.4 years. In this sense, LCO's portfolio reflects Graham much more than Buffett. For many of his purchases, Graham presupposed a holding period of a couple of years; more generally, he was not, as a rule, a "buy and hold" investor. In sharp contrast, on numerous occasions Warren Buffett has stated that, once he invests, his preferred holding period is "forever."

Why the disparity between the assumption underlying our analyses of securities (minimum five-year holding period) and the shorter actual holding period? First, it appears that corporate raiders think like we do. Within a year or two of our purchase of a small minority of a company's shares, a corporate raider spotted the same divergence between price and value – and decided to purchase 100%. Of the 28 sales depicted in Figure 12, 18 (64%) were forced either by the compulsory acquisition provisions of the Corporations Act (whereby a raider who buys 90% of a company's stock can compel the owners of the remaining 10% to sell) or the redemption of a bond (which is usually triggered by a change-of-control event such as a takeover).

Figure 12:
Length of Time LCO Has Held Securities before Sale



Second, the phrase "the higher they rise, the harder they fall" has a corollary: "the harder they fall, the more quickly they rise." "Many shall be restored that are now fallen, and many shall fall that are now in honour." This line, from the Roman poet Horace's *Ars Poetica*, appeared opposite the title page of Graham's text *Security Analysis*. Regression to the mean underlies many of the developments in financial markets, and constitutes a cornerstone of LCO's approach to investment. In our experience, the more extreme has been the disparity between the price of a company's shares and their value, the more quickly at least part of that disparity has narrowed.

Selling Assets: Infrequent Occurrence and High Success Rate

Table 2 summarises the results of the 49 investments which LCO purchased and subsequently sold. (These figures exclude the 13 investments which it presently holds; they also exclude bank, money market and related deposits.) LCO hasn't bought and sold many investments – 49 over 20 years is an average of just 2.5 per year. This reflects our (1) heavy emphasis upon in-depth research, (2) disciplined buy-with-intention-to-hold approach, (3) willingness to wait/reap long-term returns and (4) resultant concentrated portfolio.

Hybrids, etc., have comprised more than one-quarter (28%) of these investments. Hence dividends, distributions and other income comprise a relatively large (40%) portion of the average investment's total return. This stream of distributions, together with LCO's very large holdings of cash, have underpinned the stability of its results; moreover, they (together with intensive research, patience, etc.) have enabled it to buy boldly when companies experience temporary disruptions, markets panic, etc. Our "success" rate is very high: 92% of these investments, and 89% of equity investments, have generated a positive total return. In other words, only ca. 10% have lost money. This demonstrates the rigour of our research; it also reflects our willingness to accept "sins of omission" in order to minimise "sins of commission."

Table 2:
LCO's Investments Resulting in Sales, 1999-2019

Investments Resulting in Sales	No.	Percent of Total	% Generating Positive Return	Average Total Return	Distribution as % of Total Return	Realised Cap Gain as % of Tot Ret
Equities (incl. preferred stocks)	36	72%	90%	190%	28%	72%
Hybrids	8	16%	100%	85%	57%	43%
Other (e.g., CDOs, etc.)	6	12%	100%	72%	87%	13%
TOTAL	**50**	**100%**	**92%**	**158%**	**40%**	**60%**

Selling Assets: Distribution of Winners and Losers

It bears repeating: LCO's portfolio is focussed. Over the years it hasn't purchased many securities; for this reason, it hasn't sold many, either. And because it has acquired securities very selectively, and has purchased with the intention of holding indefinitely, it has tended to sell securities very profitably.

Figure 13: LCO's "Success Rate" Over Time

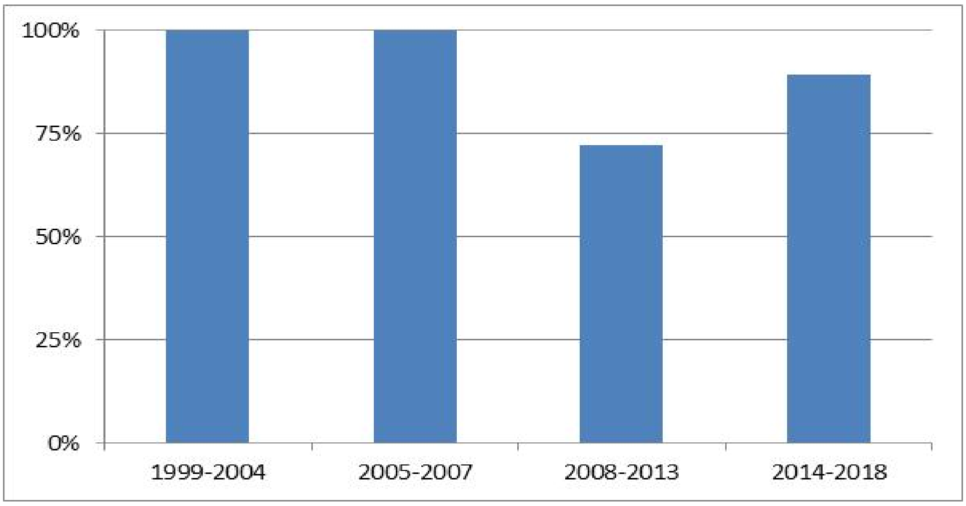


Figure 13 disaggregates LCO's success rate (i.e., number of profitable sales expressed as a percentage of total sales) across time (the most recent sale occurred in 2018). It's been very high throughout our existence: only during the GFC and its immediate aftermath did it decrease. Since then, it's rebounded. Figure 14 confirms that LCO's overall success rate doesn't derive from a small number of lucky strikes. Although it's skewed towards the high end of the distribution, returns spread widely across its positive range – and the percentage of losses is very small. Of the 35 equity investments it's sold, LCO held them an average of 3.4 years. And although the relationship is weak its direction is clear: the longer the length of time investment has been held, the greater on average, is its total return (Figure 15).

Figure 14:
Distribution of LCO's Total Returns, Equity and All Investments, 1999-2019

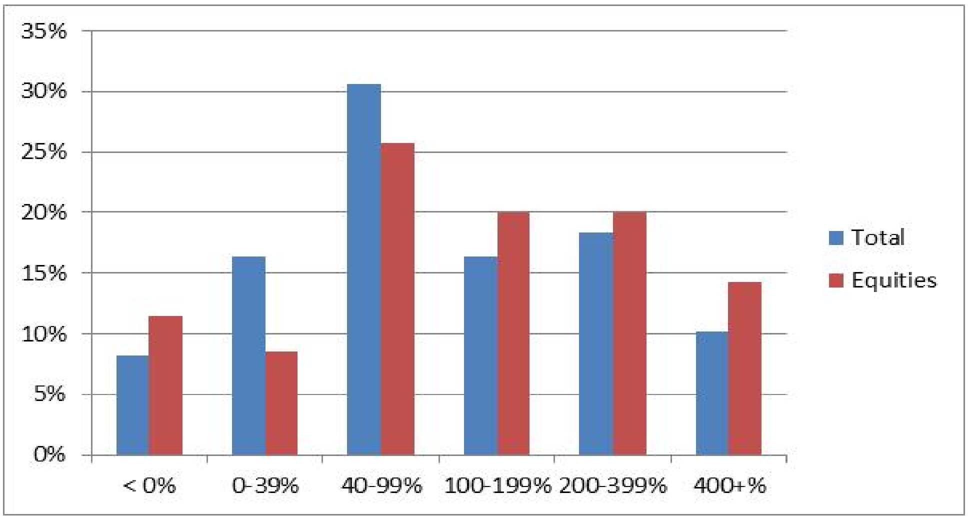
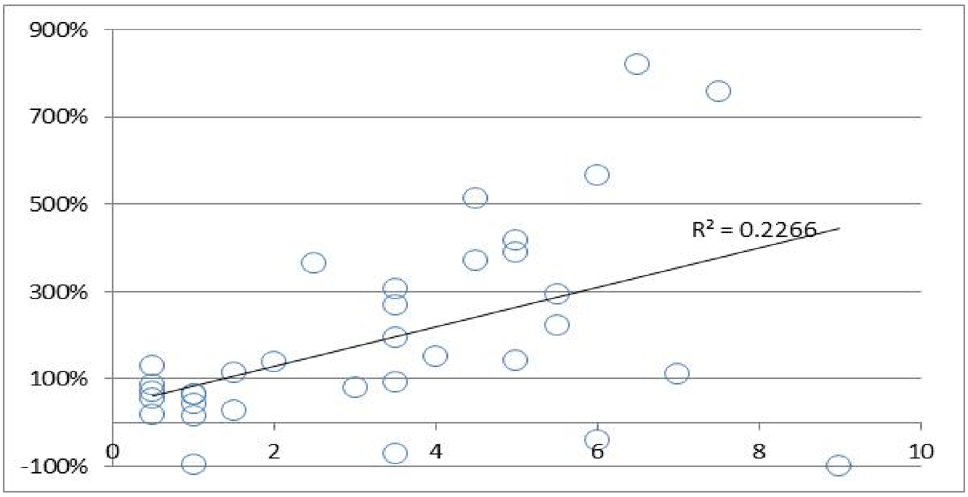


Figure 15:
Number of Years Investment Held and Total Return (Equities)



LCO's "Corporate Governance" – You Show Me the Incentive and I'll Show You the Outcome

"Evidence of lies, deceit and fraud just keep on coming at the Royal Commission [into Misconduct in the Banking, Superannuation and Financial Services Industry]," ABC News reported on 26 April 2018, "much of it [having] occurred under the noses of directors holding some of the country's most prestigious positions." These directors, as well as professional and regulatory bodies, etc., avoided key questions: did they *really* not know? If not, why not? Whether or not they didn't, or did know but did nothing, or did know and also abetted misconduct, criminality, etc., is now beside the point – namely that Australia's financial services industry stands condemned. If it were a stock, it'd be a prime candidate for short sale.

ASIC's deputy chairman informed the Commission on 16 April that "poor conduct and consumer rip-offs" are so widespread that financial advisors and planners are "not entitled to call themselves professionals."[19] *The Australian Financial Review* ("The Remarkable Hypocrisy of AMP," 20 April) concluded that the Commission "has exposed the industry's gross hypocrisy" – it crows that it maintains the highest standards of ethics whilst picking its clients' pockets. One of the Reserve Bank's retired governors, Bernie Fraser, joined the chorus of chastisement. On 26 April, he wheezed that the Commission had exposed a "cesspool" of misbehaviour. On 8 August, Prof Alan Fels, a former chairman of the Australian Competition and Consumer Commission (ACCC), rasped that "deep structural conflicts of interest" would overwhelm piecemeal attempts to curb unethical behaviour within the financial services sector. The RBA's current Governor, Dr Phillip Lowe (who also chairs the Council of Financial Regulators which includes APRA, ASIC and Treasury, all of whom were caught napping), waxed hypocritical: on 17 August he noted that the foundations of the finance sector were trust, service and good risk management. Yet "what we've seen in the Royal Commission is deficiencies in all those three areas." *The Weekend Australian* ("System Shaken to Its Core by Rogues," 28-29 April) bluntly concluded: "Thieves and liars want to get their hands on your money."

Tragically for outsiders – and conveniently for insiders – very few people seem to realise that pervasive incompetence, systematic malfeasance and outright criminality

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19 But is ASIC professional? In Regulator ASIC Has a 'Culture of Subservience to the Big Banks,' Says Former Employee (25 April 2018), ABC News reported: "ASIC has a culture of subservience and acquiescence when it comes to the big banks, says a former lawyer for the corporate watchdog … 'If I wanted to get a job with a bank, I'd go work for a bank instead of doing the banks' work through ASIC." Its main problem, he said, is that it defers to the banks, lawyers and their lobbyists. 'I thought my job as a lawyer within the regulatory policy branch at ASIC would be to enforce the law, because that's what it says in the ASIC Act … But while there he said he saw exactly the opposite. 'I saw ASIC literally changing the law, amending the Corporations Act to benefit the banks and the lobby groups for the banks,' he said. ASIC has the power to take the law as drafted by Parliament and make certain changes, within strict rules. But … 'ASIC made changes to the law to benefit the banks, at the request of what is now known as the Financial Services Council. The question of protection of retail investors was a distant second.' He said the banks, their lawyers and their lobby groups still treat ASIC with contempt. 'They lie about big things, they lie about small things, they do it as a matter of course. I saw that when I was there 12 or 13 years ago — it's still going on today.'"

are not *problems*: they're merely *symptoms* of an underlying disease. The Roman poet, Juvenal, asked: "who will guard the guardians?" Don Chipp, the ex-Liberal cabinet minister and inaugural leader of the Australian Democrats, put this question in trenchantly Australian terms: who'll "keep the bastards honest"? *Whether in its classical or colloquial variant, this question encapsulates a fundamental problem: how can people in positions of responsibility be held to account?* At any point in time, some will succumb to the temptation to abuse their authority, i.e., reward themselves and harm others.[20] And at some junctures – today, it seems, is one – many apparently do so. Referring to financial services, we might elaborate Juvenel's question: who advises the advisors? Who manages the managers? Who regulates the regulators?

Directors of LCO cannot claim that they've resolved Juvenel's ancient problem; they have, however, greatly mitigated it. First, LCO has no employees: it has only Directors. Moreover, these Directors receive no salary. Second, it has no clients – only shareholders. As a result, *the Company's employees can't cheat its clients: there are neither employees to do the double-dealing nor clients to deceive.* Finally, "Always back the horse named self-interest," Jack Lang, the premier of NSW (1925-27, 1930-31), wisely quipped. "At least you'll know it'll be trying." Directors own all of LCO's ordinary shares and are the biggest owners (ca. 25% during the past several years) of its Redeemable Preference Shares; further, these assets comprise meaningful percentages of Directors' total wealth. *Through these stakes, they have plenty of skin in the game – hence any attempt by Directors to dud the Company's shareholders would, because it'd harm Directors most, be self-defeating.*

Individually, these traits are highly unusual; collectively, and at least in Oz, we believe that they're unique. They serve a fundamental purpose: we (LCO's Directors) are major owners as well as managers of the Company's capital. Like Buffett and Charlie Munger, we eat our own cooking;[21] accordingly, we're strongly incentivised to act as proper stewards of capital.[22] We receive not a penny of salary; instead, we

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20 This problem extends well beyond business and the private sector. Most notably, "trust in all levels of government is falling, driven by growing concern … that public officials are using their position to benefit themselves and their families"(see, for example, "Trust in Politicians Plummets, *The Australian*, 20 August 2018).

21 Berkshire's *Owner's Manual* states: "In line with Berkshire's owner-orientation, most of our directors have a major portion of their net worth invested in the company … Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you elect to be our partner." In other words," said *The Financial Times*, "the interests of the managers are closely aligned with those of shareholders" (Berkshire Directors Eat Their Own Cooking, 24 August 2016).

22 Clear and sensible incentives have other happy consequences. For example, they proscribe inane and fraudulent statements of "values." The Royal Commission has abundantly confirmed

receive a fixed percentage of cash profits. That is, concrete results rather than lofty intentions underpin our rewards. In order to maintain and increase their ownership, we reinvest their share of profits into the Company. *Consequently, our incentive is to undertake long-term investment rather than short-term speculation and to minimise costs in order to maximise cash profits – and hence dividends.*

LCO's track record corroborates its ability to invest for the long-term; Canstar, which runs Australia's biggest financial products comparison site, confirms its Directors' incentive to run a frugal ship. It recently examined how management fees differ among managed funds – and whether the funds that charge higher fees also produce better returns (see Do Higher Fees Charged by Managed Funds Result in Higher Returns? 6 March 2018). It stated:

> managed funds charge [a fixed and] ongoing fee for managing your investment, often called the management fee or management expense ratio (MER). This ratio may not include all administrative fees, so it's important to check a fund's prospectus for a full picture. For managed funds rated in Canstar's 2018 Star Ratings, the management fee ranges from 0.19% up to 2.50%, with the range varying across fund types.

Fees are a major determinant of returns; the lower is the total fee, on average, the higher is the total long-term return.[23] Canstar finds that if you invest $100,000 in an Australian managed fund, it'll charge you an average of $960 and as much as $2,500 per year. If it earns a pre-fee return of 7.5%, the management fee averages 13% (and can rise as high as 33%) of the pre-fee return; net of the fee, then, the return falls to 5.0-6.5%. Fees add lead to the saddlebags: the higher is the fee, the higher must be the pre-fee return in order to grow the investment.

LCO doesn't levy a fixed and ongoing charge for the management of its assets; nor does it impose admin fees, commissions, etc.[24] It does, of course, incur expenses. Ta-

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that such statements are mere compendia of babble, cant, drivel, hypocrisy and outright bald-faced lies. They're worse than useless: they use flowery language to promise, in effect, that employees will love their clients as they love themselves – whilst distracting clients' attention from employees' incentives to cheat, mislead and steal.

23 "On average," stated *The Australian* ("Big-Four Planners 'Could Be Charged' for Failing Clients," 1 May 2018) citing recent research from Morningstar, "the more a person pays for experts to manage their superannuation savings the worse the investments perform" (see also Marta Vidal, et al., The Relation between Fees and Return Predictability in the Mutual Fund Industry, *Economic Modelling*, vol. 47 (June 2015), pp 260-270).

24 As owners of the Company's common shares, LCO's Directors receive 20% of its cash profit; the dividend paid to these owners is thus, in effect, a performance fee. Importantly, it's paid upon the achievement of *outcomes*. In sharp contrast, the typical funds manager's bread and

ble 3 expresses expenses incurred during each of the past three financial years as percentages of total assets on 30 June of the corresponding year. Its average expense ratio over the past three financial years (0.16%) is less than one-fifth of the average MER (0.96%) of the funds that Canstar analysed: *for every $100,000 of assets, LCO incurs ca. $160 per year of expenses.* Further, its *highest* ratio during these years is a mere one-tenth of the analysed funds' average maximum MER; it's also equivalent to these funds' *lowest* MER.[25]

Table 3:
Comparing LCO's Recent Expense Ratios to Australian Managed Funds' MERs

Type of Fund	Min MER	Avg MER	Max MER
Aust Cash/Fixed Interest	0.19%	0.46%	1.00%
Aust Shares Large Cap	0.35%	1.01%	2.05%
Aust Shares Small Cap	0.77%	1.27%	2.50%
Aust Real Estate Invest Trust	0.35%	0.85%	1.58%
Global Fixed Income	0.35%	0.59%	0.78%
Global Shares Large Cap	0.35%	1.09%	2.02%
Global Shares Small Cap	1.12%	1.32%	1.50%
Multisector Aggressive	0.35%	1.20%	2.20%
Multisector Balanced	0.35%	0.84%	2.42%
FUNDS' MEANS	**0.46%**	**0.96%**	**1.78%**
LEITHNER & CO.	**0.12%**	**0.16%**	**0.19%**

LCO's principles of "corporate governance" are thus very similar to – but even purer than – Buffett's. He and the CEOs of Berkshire's wholly-owned subsidiaries receive comparatively low salaries: Buffett's, for example, has been fixed at $100,000 per year since the 1980s – that's now a mere 1% of the median ($US11.5 million) annual compensation of a Fortune 500 CEO. Moreover, neither Buffett nor any of his executives receive options over shares. Critically, however, although their salaries are comparatively modest, Buffett's and his lieutenants' financial net worth is great. That's often because significant numbers of them have sold to Berkshire the businesses they founded. In his Letter to Shareholders (1989), he wrote: "Most of [Berkshire's] managers have no need to work for a living; they show up at the ballpark because they like to hit home runs. And that's exactly what they do." *Specifically, shares of Berkshire*

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butter – his management fee – is paid on the basis of *inputs*, that is, quantity of funds under management, before the manager generates a penny of return for investors.

25 Unsurprisingly, Canstar "found that across all types of managed funds, a higher [management] fee does not guarantee better returns." Research cited in *The Australian* ("Super Funds 'Skimming over $700 Billion in Fees,'" 13 July 2018) concluded: "the greater the degree of separation between managers and [investors], the worse the performance seems to be, partly because less attention is given to how the members fare, partly because there are more layers of cost."

Hathaway comprise virtually all of Buffett's and most of his senior managers' wealth. In Robert Miles' words,

> Berkshire has a select group of managers. Primarily, they are centimillionaires who work hard for billionaire board members and long-term millionaire shareholders … This unique structure has led to superior investment and management successes and has proven to be Buffett's finest cultural and structural strategy (pp. 4-5) … *The "owner-CEO" method is the best way to align the interests of the long-term shareholder with those of the manager* (*The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers*, John Wiley & Sons, 2002, p. 350; italics added).

Prognosis for the Next Decade

We've seen that when they become extreme, short-term returns tend subsequently to regress to their long-term mean. An abnormally high return during the current period, in other words, typically presages a much lower one during the next. If they're not extreme, short-term returns are typically random: accordingly, last month's tells us nothing about next month's. But can today's *valuations* provide clues about the next decade's returns? In the press release (14 October 2013) that announced the winners of The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel – commonly but erroneously called "the Nobel Prize in Economics" – The Royal Swedish Academy of Sciences stated:

> There is no way to predict the price of stocks and bonds over the next few days or weeks. But it is quite possible to foresee the broad course of these prices over longer periods, such as the next three to five years, … as Robert Shiller discovered in the early 1980s.

Some measures of market valuation possess a rough ability to forecast long-term returns. LCO uses what's commonly called the "Shiller PE" to value the Australian, American and other markets. Robert Shiller and John Campbell devised it in 1988,[26] and Shiller popularised it in *Irrational Exuberance* (Princeton University Press, 2000). It's also called CAPE (cyclically adjusted price-to-earnings ratio). LCO uses it because its pedigree stems reasonably closely – and to our knowledge closer than any other measure of valuation – from Benjamin Graham and David Dodd, the authors of the value investor's bible *Security Analysis* (McGraw-Hill, 1934).[27]

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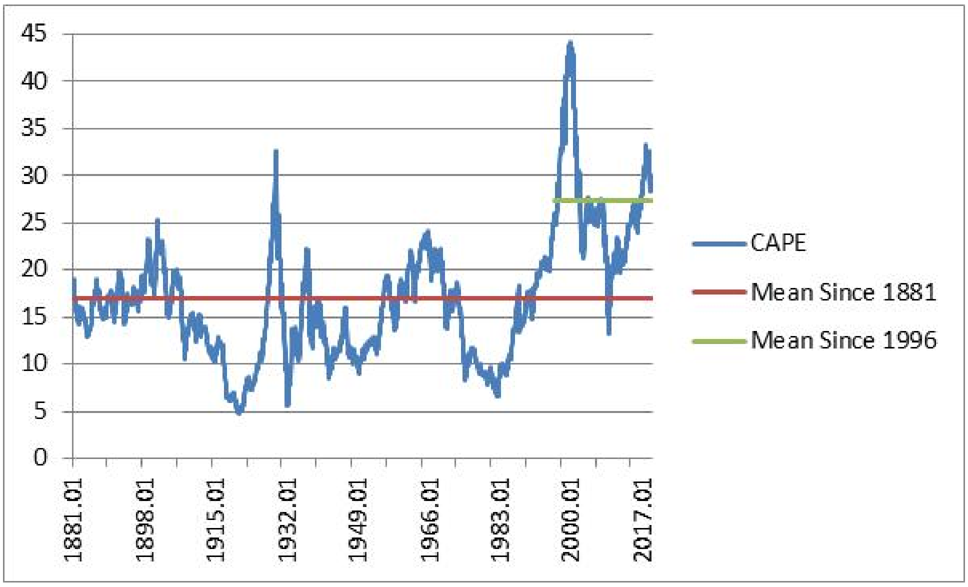
26 See Stock Prices, Earnings and Expected Dividends, *Journal of Finance*, Vol 43, No. 3 (1988): pp. 661-676.

Figure 16 plots the CAPE of the S&P 500 Index from January 1881 to June 2019. Since 2017, it's mostly exceeded 30; in June 2019, it was 29.4 – that's 73% above its mean since 1881 (16.9). *Today's CAPE is sky-high: only during the "New Era" of the late-1920s and the Internet bubble of the 1990s-2000s was it greater than it's been during the past several years. In fact, it's presently higher than 88% of the time since 1881.*

Figure 16:
Cyclically-Adjusted PE Ratio, Standard & Poor's 500 Index, 1881-2019



Why should anybody care that CAPE is currently so elevated relative to its historical average? *On previous occasions when it's risen above 20, the S&P 500 has subsequently tended to generate poor returns.* Table 4 sorts the S&P 500's returns during every rolling decade since 1881 (i.e., January 1881-January 1891, February 1881-February 1891, … and June 2009-June 2019) into deciles (i.e., ten groups with equal numbers of observations) ranked by CAPE. Its value during the past several years falls into the highest (10th) decile (in bold red font).

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[27] The observation, attributable ultimately to Graham, that one-year earnings are volatile and yet mean-reverting, prompted Campbell and Shiller to devise CAPE. When earnings are high and rising, the one-year PE might emit a false signal (namely that stocks are too cheap); conversely, when earnings are low and falling, the one-year PE can emit the opposite false signal (namely that stocks are too dear). CAPE adjusts for this problem imperfectly but still simply and effectively: instead of one-year trailing earnings, it uses the average of the past 10 years of CPI-adjusted trailing earnings. A decade is, of course, arbitrary: you'd be hard-pressed to find a theoretical argument for 10 rather than, say, eight or 12 years. Put simply, the one-year PE represents what an investor pays for the last year's earnings (which tends to be a very volatile number). In contrast, CAPE represents what an investor pays for the average of the past 10 years of "real" (CPI-adjusted) earnings. This 10-year average is usually more stable than one-year trailing earnings; accordingly, it provides a better estimate of long-term earnings – and a better insight into long-term returns.

As the starting CAPE rises (that is, as one reads down Table 4's second column), the S&P's subsequent annualised compound annual growth rate (CAGR) over the next ten years falls. And although the relationship isn't clear-cut, as CAPE increases its best-case returns weaken and its worst-case returns worsen. *The tenth decile – the one to which current conditions apply – is ugly. It implies that during the next decade the S&P's average rate of return will barely exceed 1% per annum.* If so, an investment that mirrors the S&P 500 of $100 in January 2019 will (ignoring dividends) be worth $114 in January 2029. The historical record's worst case is a CAGR of -9.2% per annum: at this rate, he who invests $100 today will after 10 years possess just $38.

Table 4:
Compound Annual Rates of Return, S&P 500,
Deciles Ranked by Shiller CAPE 1881-2019

Decile	Mean CAPE	Min CAPE	Max CAPE	Avg Sub-seq 10-Yr CAGR	Worst Subseq 10-Yr CAGR	Best Subseq 10-Yr CAGR	SD of Returns
1	7.4	4.7	9.1	**8.8%**	-4.1%	15.2%	9.1%
2	10.1	9.1	11.0	**9.3%**	-2.1%	15.0%	8.2%
3	11.6	11.0	12.3	**5.6%**	-1.1%	12.4%	7.6%
4	13.3	12.4	14.1	**5.5%**	-3.4%	15.8%	8.5%
5	15.0	14.2	15.7	**5.4%**	-3.6%	16.1%	10.9%
6	16.4	15.7	17.1	**5.5%**	-4.8%	16.2%	8.5%
7	17.8	17.1	18.5	**5.1%**	-5.5%	15.1%	8.3%
8	19.6	18.5	20.8	**4.3%**	-5.6%	11.7%	5.5%
9	22.2	20.8	24.7	**2.5%**	-7.8%	9.2%	5.0%
10	**30.7**	**24.8**	**46.1**	**1.3%**	**-8.2%**	**5.0%**	**4.7%**

If you're a short-term trader (which most people, including brokers and funds managers, are) then perhaps it makes little sense to heed CAPE. If, however, like LCO you're a long-term investor – or seek to invest in a vehicle like LCO that is – then Table 4 should temper your expectations about the next decade.[28] Given today's CAPE, if your long-term plan assumes a 7-8% rate of return from stocks, then – whether you realise it or not – you're assuming not merely that your results will drastically exceed the historical average: you're wagering that you will outdo the best-ever return in Table 4's tenth decile. *In plain English, given the historical record – and whether or not you realise it – you're assuming that "this time it will be different."*

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[28] It's important to bear in mind that the overvaluation of equities in the U.S. doesn't automatically mean that stocks in Australia are also overvalued. Nonetheless, according to *The Australian Financial Review* ("Brace for 5pc Super Fund Returns," 6 September 2019) "superannuation funds should consider downgrading their 'promise' to members to reflect the likelihood they will get lower returns over the next decade."

Perhaps you'll be right. Indeed, you've been right most of the time since the mid-1990s (except, of course, during the "Dot Com" bust and the GFC). *The historical record offers a range of possibilities about the future, but they aren't all that's possible.* In other words, since 1881 when CAPE has exceeded 30 the best subsequent 10-year CAGR is 5.0%; but that doesn't mean that the CAGR during the next decade cannot be higher. There's a first time for many things. It's conceivable – particularly if the world's central banks continue to slam their monetary accelerators through the floor, and governments become even more profligate, deficits widen and debt deepens – returns may continue to surprise to the upside. But can they do so forever?

If you're unwilling to stake your financial future upon fond hopes, then you should attach more weight to history – and thus consider the possibility that the next decade's returns will be much lower. *You might also consider an investor like LCO which successfully navigated the GFC and is well-prepared for the next crisis.* The Western world now stands uncomfortably between Scylla (namely governments' untenable deficits and debt) and Charybdis (stocks and bonds whose prices governments' crazed policies have inflated to artificially-high levels). *Rhetorically*, the mainstream readily agrees that governments must balance their budgets and trim their debts – *eventually*. Like St Augustine's plea to God, their refrain is: "Grant me chastity and continence, but not yet." In the meantime, they insist, the bacchanalia must continue because the alternative – living within one's means – is too heretical for the secular religion even to contemplate. To confess the plausible reality of the future is to renounce the fantasy of the past: in particular, it disavows the nonsense that deficit and debt can increase indefinitely. Is today's relative calm merely the prelude of the next storm? When will the gales resume? We wish we knew.

Summary and Conclusion

Since its inception in 1999, Leithner and Company Pty Ltd has applied in an Australian context the principles of investment pioneered by Benjamin Graham and extended and elaborated by Warren Buffett. Because it's very conservative, it's also highly unconventional. As a result, it hasn't just preserved its shareholders' wealth: it has fructified it. *Its first 20 years corroborate Graham's key insight: investment is most successful when it's most businesslike.* This approach removes costly distractions and frees us to concentrate upon essentials – namely the businesses which we seek to acquire and of which we're long-term part-owners. LCO purchases the securities of sound firms from pessimists and sells them to optimists. It holds and seeks to accumulate a portfolio of enterprises, depressed by what we regard as significant but surmountable difficulties, have been acquired at sensible or even bargain prices.

Since 1999, LCO has "outperformed" its benchmark. In Australia and elsewhere, very few investment vehicles have done so. We haven't merely outperformed: an investment in LCO *has grown more steadily than one that mirrors the Index.* Its Directors don't strive to become – nor claim that they are – brilliant, prescient, etc. Sensible investment doesn't presuppose genius or even unusual intelligence: because it breeds arrogance, unalloyed brainpower's a hindrance. *Successful investment necessitates character in the form of discipline, intestinal fortitude, humility and above all clear and independent thinking.* LCO's Directors aren't trying to outsmart other investors; instead, and in Graham's words, they're "simply trying to be less irrational than the mass of speculators who insist on buying after the market advances and selling after it goes down."

LCO's experience has confirmed Graham's rule of thumb: a conservative investment portfolio should hold a minimum 25% of cash and bonds and a maximum 75% of shares. "The standard division should be an equal one, or 50-50, between the two major investment mediums." *As a result, its portfolio has been able to withstand – indeed, profit from – bear markets and financial crises much better than most others.* We've also weighted it heavily towards securities that have emitted hefty streams of dividends and payments of interest; accordingly, and because LCO has relied (by a roughly two-to-one margin) upon regular rather than irregular sources of income, its half-yearly earnings have been reasonably stable and its investors' returns and growth of capital have been comparatively steady.

Like Buffett, LCO has alleviated risk not by dispersing its investments but by focussing its rationality. Its portfolio is concentrated but diversified; it hasn't bought and sold many investments; and its "success" rate (i.e., profitable sales as a percentage of total sales) is very high. Because it's acquired securities very selectively and purchased with the intention of holding indefinitely, it's tended to sell very profitably. This success demonstrates the rigour of LCO's research; it also reflects its willingness to accept "sins of omission" in order to minimise "sins of commission." Finally, LCO's principles of "corporate governance" ensure that its Directors have plenty of "skin in the game." *They receive no salary but are the Company's biggest shareholders; hence they possess a strong incentive to maximise ALL shareholders' long-term returns.*

As it's been since 1999, so it'll remain into the future: LCO's Directors will derive no pleasure from acting with or against the crowd, and will take no comfort because important, vocal or great numbers of people agree – or, more likely, disagree – with us. Current fashion is no substitute for a calm disposition, justifiable principles, reasonable premises, valid reasoning and hard evidence. Accordingly, for the next 20 years and through thick and thin, we'll continue to apply our proven philosophy.

Chris Leithner

15 September 2019