Jacob D. Benedict

A $10,000 investment in Berkshire Hathaway on May 10, 1965 (the day Warren Buffett took control of the company) would be worth over $55 million at the end of 2009, an annual compounded return of 21% per annum.[1] The same $10,000 invested in the general stock market would be worth just $500,000 at the end of 2009, a compounded return of 9% per annum and only 0.91% of the value of the Berkshire stock.[2] Warren Buffett has proven to be one of the greatest investors of all time. What's more, he has achieved this stellar record with a relatively open dialogue about his approach and his investment decisions. Jason Zweig writes:

> Probably no other investor…has publicly revealed more about his approach or written such compellingly readable articles [than Buffett].[3]

Buffett's approach is neither complex nor unintelligible (Charlie Munger, Buffett's partner, quips: "Pragmatism is [Berkshire's] universal theory. We are demonstrating the fundamental algorithm of life – repeat what works."[4]) One would expect that based upon Buffett's record of achievement and frank, understandable discussion of investment strategy, investment managers would flock to Buffett-like strategies. While many managers pay lip service to the "Oracle of Omaha," surprisingly few structure portfolios that meet Buffett's investment criterion. We call this phenomenon the "Warren Buffett Paradox."

Robert Arnott, Andrew Berkin and Jia Ye, using market returns over a 20-year period, found that the odds of an actively managed mutual fund beating the overall market index were just 5 to 22% before taxes and 4 to 14% after taxes, with average margins of defeat approximately twice as large as average margins of victory. The typical actively managed mutual fund trailed the Vanguard 500 Index by 3-5% per year.[5]

Proponents of the Efficient Markets Theory (EMT) use such data as key evidence in arguing that active investment managers can only beat markets by luck over longer periods of time (in other words, the market is "efficient"). They maintain that skill and informational advantages are non-existent. Their views require them to classify Warren Buffett's record as essentially luck – a "six sigma" event in the world of investing. EMT proponent Burton Malkiel writes:

> No one can consistently predict either the direction of the stock market or the relative attractiveness of individual stocks, and thus no one can consistently obtain better overall returns than the market…a blindfolded chimpanzee throwing darts at the Wall Street Journal could select a portfolio that would do as well as the experts.[6]

But such data overlook a vital caveat – a majority of investment managers follow poor investment strategies, rendering manager samples fundamentally *biased*. Buffett made a related argument in his 1984 essay entitled *The Superinvestors of Graham-and-Doddsville* where he argued that while it may be logically plausible to explain his record as luck, such statistical reasoning falls apart when one realizes that his colleagues, who also studied under mentor Benjamin Graham and employed investment approaches similar to Buffett, also beat the market on a consistent basis.

[1] See Lowenstein, Roger, *Buffett: The Making of an American Capitalist* (2008), p. 130. The day Buffett assumed control of Berkshire Hathaway, the stock closed at $18 per share. At the close of business on December 31, 2009, Berkshire-A shares were worth $99,200.
[2] Analysis for the general stock market uses data from Ibbotson for large-cap stocks over the period 1966-2008 and data from Bloomberg Financial Markets for the S&P 500 for 1965 and 2009.
[3] See Zweig, Jason in Graham, Benjamin, *The Intelligent Investor* (2006), Revised Edition, p. 401.
[4] Berkshire Hathaway 2009 shareholders meeting, May 1, 2010, Omaha, NE; quote taken by author.
[5] See Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), p. 213-217.
[6] See Malkiel, Burton G., *A Random Walk Down Wall Street* (2007), p. 246-247.

This paper reviews two of Buffett's tenets of portfolio management and illustrates that the majority of active equity mutual fund managers disregard Buffett's advice. These two tenets are just examples of the wide disconnect between Buffett's investing methodology and accepted practice on Wall Street. They would likely not be classified, in fact, as points of greater import. They were chosen based on the ease of comparative metrics, not on their relative importance. Yet our experience indicates that the Warren Buffett Paradox runs much deeper than these two examples and is a fundamental occurrence on Wall Street. Accordingly, investors should not look to benchmark studies of active equity managers as evidence of a failure of value investing. While beating the market is certainly difficult, it is not impossible. Potential reasons for the Warren Buffett Paradox, though not the focus of this study, are discussed at the end of the paper.

Note: The following discussion includes results from the "Morningstar database." This database was constructed using Morningstar's Premium Fund Screener and employing the following criterion: domestic stock ex-specialty, no index funds, no fund of funds, no enhanced index funds, no life cycle funds and distinct portfolios only. The resulting database produced over 2,000 distinct, actively managed mutual funds that were studied further. Data on Berkshire Hathaway's portfolio is taken from Buffett's annual letters to shareholders, in which he details the composition of Berkshire's publicly traded investments. All quotes presented below, unless noted differently, are from Warren Buffett and are denoted by grey text. For ease of citation, I have cited most Buffett quotes to the essay compilation work done by Lawrence Cunningham as opposed to the original shareholder letters and essays. Any mention of "we" or "our" refers to the investment professionals of AMI Investment Management, Inc.

Portfolio Turnover

Buffett's View

- High levels of portfolio turnover create a significant hurdle for active investors to overcome in the form of transaction costs and capital gains taxes (if applicable). Frequent trading generates high commission costs and more difficult to observe market impact costs. It is estimated that trading costs range from 0.63% for large-cap stocks to over 4.00% for small cap stocks for a portfolio with high turnover (>100%).[7]
- Over time, such costs compound and act as a significant drag on wealth creation. Taxes are an even bigger headwind. Roughly two-thirds of mutual fund assets reside in taxable accounts.[8] Robert Arnott and Robert Jeffrey find that turnover rates of 50-100% cost investors approximately one-third of their pre-tax returns.[9]

> [O]wners must earn less than their businesses earn because of "frictional" costs. And that's my point: These costs are now being incurred in amounts that will cause shareholders to earn *far* less than they historically have…Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of the stars, but not the madness of men." If he had not been traumatized by this loss, Sir Isaac might have gone on to discover the Fourth Law of Motion: *For investors as a whole, returns decrease as motion increases*.[10]

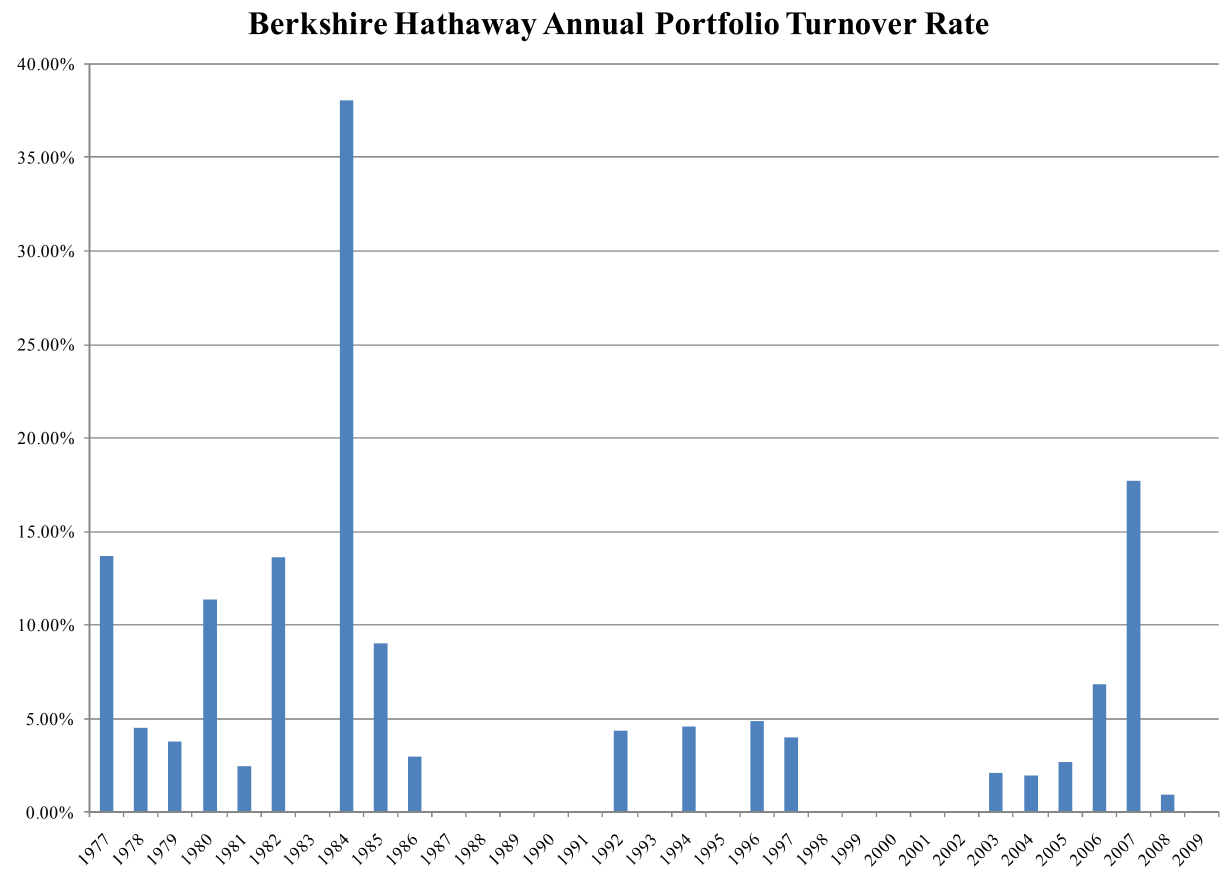
- The mindset that corresponds to frequent trading establishes a poor backdrop for disciplined, successful investing. Ben Graham, Buffett's teacher, explained that common stock investing should be carried out in the same manner as the purchase of private enterprises, afforded similar care, concern and commitment.[11] The most successful investments create shareholder wealth over extended periods of times. The limit of human knowledge suggests that investors should expend resources searching for a few investments that they can confidently predict will create sustainable returns, rather than constantly looking for many investments to last for a short period of time.

> I always tell the students in business school they'd be better off when they got out of business school to have a punch card with 20 punches on it. And every time they made an investment decision they used up one of those punches, because they aren't going to get 20 great ideas in their lifetime. They're going to get five, or three, or seven, and you can get rich off five, or three, or seven. But what you can't get rich doing is trying to get one every day. The very fact that you have, in effect, an unlimited punch card, because that's the way the system works, you can change your mind every hour or every minute in this business, and it's kind of cheap and easy to do because we have markets with a lot of liquidity – you can't do that if you own farms or [real estate] – and that very availability,

[7] See Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), p. 247-248.
[8] See Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), p. 257.
[9] See Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), p. 258.
[10] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 157-160.
[11] Graham wrote: "Investment is most intelligent when it is most *businesslike*. It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. Yet every corporate security may best be viewed, in the first instance, as an ownership interest in, or a claim against, a specific business enterprise." See Graham, Benjamin, *The Intelligent Investor*, Revised Edition (2006), p. 523.

> that huge liquidity which people prize so much is, for most people, a curse, because it tends to make them want to do more things than they can intelligently do.[12]
>
> You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes.[13]
>
> Charlie and I are simply not smart enough, considering the large sums we work with, to get great results by adroitly buying and selling portions of far-from-great businesses. Nor do we think many others can achieve long-term investment success by flitting from flower to flower. Indeed, we believe that according the name "investors" to institutions that trade actively is like calling someone who repeatedly engages in one-night stands a romantic.[14]

Since 1977, Berkshire Hathaway's turnover rate in its publicly traded stock portfolio has been below 15.0% each year except two, with a median rate of just 2.1%. In 14 of those 33 years (42%), turnover was 0%:[15]



The average turnover rate, 5%, suggests an average holding period of 20 years![16] This seems unbelievable, but consider the holding periods of some of Buffett's largest investments:

- Washington Post: 1977-Present (33 years)
- Geico: 1977-1995 (19 years, until Buffett acquired the remaining outstanding stock of the compay, making it a subsidiary)
- Coca-Cola: 1988-Present (22 years)
- Wells-Fargo: 1990-Present (20 years)

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[12] Lecture by Buffett, Warren E. to the Faculty of the University of Notre Dame Business School, Spring, 1991; edited by Whitney Tilson.

[13] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 108.

[14] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 96.

[15] Data compiled by author from Berkshire Hathaway annual letters to shareholders, available at www.berkshirehathaway.com. The turnover represents the percentage of the fund that changed over the past year. It is calculated by dividing the lesser of total sales or purchases by the average total asset value.

[16] The holding period is simply the inverse of the turnover rate. If the portfolio manager sells X% of his stock each year, he holds each stock on average for 1/X years.

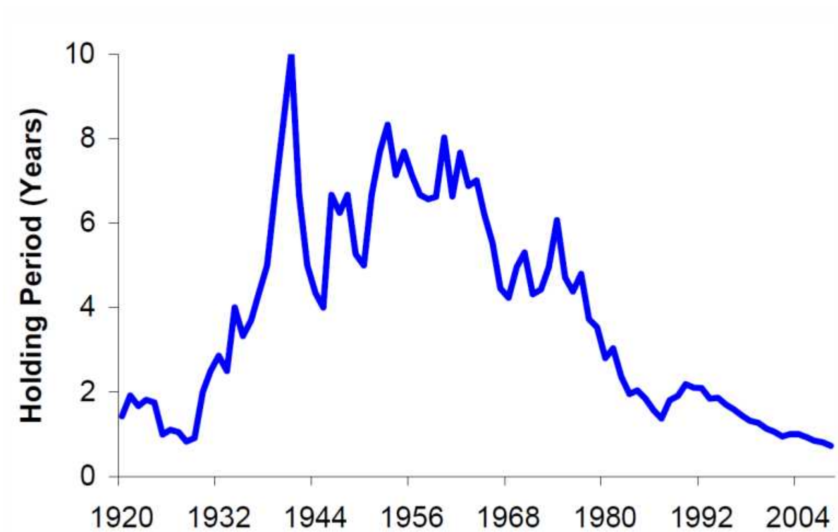
- Gillette: 1991-Present (19 years, including Procter & Gamble after Gillette acquisition)
- American Express: 1994-Present (16 years).

Wall Street Practice
According to the Morningstar database, less than 14% of active mutual fund managers exhibit portfolio turnover rates less than 25% and only one-third have turnover rates below 50%. One-third of managers sport turnover rates above 100%!

Portfolio Turnover…

Rate of Turnover	*# of Funds*	*% of Funds*	*Cum. %*
< 25%	278	13.6%	13.6%
25 - 50%	403	19.7%	33.3%
50 - 75%	398	19.5%	52.7%
75 - 100%	271	13.2%	66.0%
> 100%	696	34.0%	100.0%
Total	2,046	100.0%	n/a

The figure below, constructed by James Montier of GMO, shows the average holding period for a stock on the New York Stock Exchange (it is no coincidence that the previous low occurred just prior to the Great Depression):[17]



David Swensen, Chief Investment Officer of Yale University, writes:

> In an industry characterized by a long litany of shockingly dysfunctional behaviors, the frenetic churning of mutual-fund portfolios stands near the top of the list. In 2002, the weighted-average turnover of equity mutual-fund portfolios registered at a staggering 67 percent…Frequent trading of mutual-fund portfolios takes a toll on investors ranging from easy-to-measure commission costs to difficult-to-assess market impact costs to impossible-to-defend tax consequences. Rapid portfolio turnover proves inconsistent both with strategy for investment success and with fidelity to fiduciary responsibility.[18]

Portfolio Concentration
Buffett's View

- For competent investors, over-diversification represents the bane of *out*performance. Logical deduction illustrates that the more closely a stock portfolio resembles the market portfolio, the lower the probability the stock portfolio will outperform

[17] See Montier, James, *Was It All Just a Bad Dream? Or, Ten Lessons Not Learnt* (2010).
[18] See Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), p. 242.

the market portfolio by a meaningful margin. Investors hoping to outperform the market seem required to focus on their best ideas. ("[A]fter all, an active manager can only add value relative to the index by deviating from it."[19])

> John Maynard Keynes, whose brilliance as a practicing investor matched his brilliance in thought, wrote a letter to a business associate, F.C. Scott, on August 15, 1934 that says it all: "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence. One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put *full* confidence."[20]

- If such concentration sharpens investor focus, it should serve to *reduce* risk, contrary to conventional investment thinking. Disciplined managers wait for "fat pitches" – investments with an extremely high probability of being more valuable in five to ten years – and swing hard when they find them.

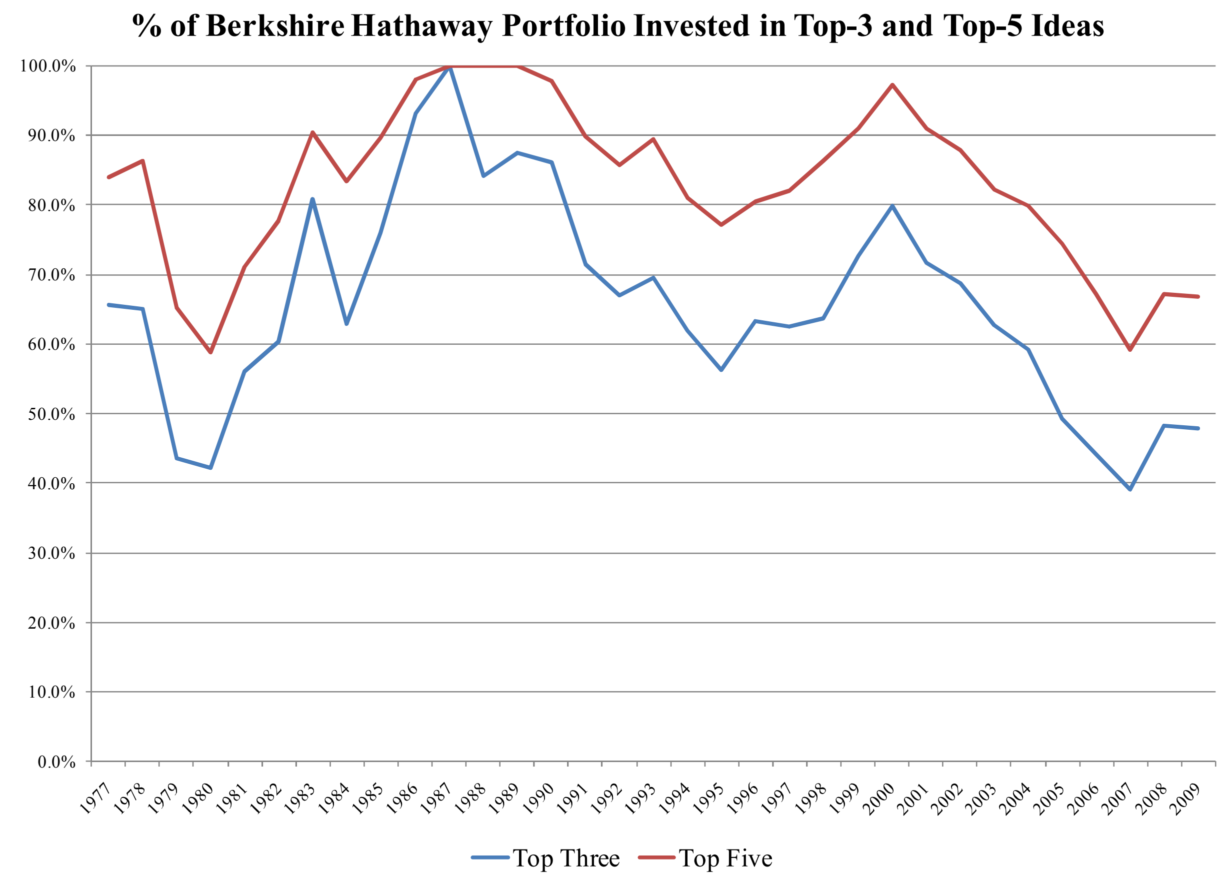
> The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.[21]

- Swinging at a fat pitch necessitates that investors understand the underlying economics of the industry in focus. Enacting investment decisions with little understanding of business conditions is speculation, not investment.

> Intelligent investing is not complex, though that is far from saying that it is easy. What an investor needs is the ability to correctly evaluate selected businesses. Note that word "selected": You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital.[22]
>
> If we have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter.[23]

The graph below shows the percentage of Berkshire's publicly traded stock portfolio invested in Buffett's top three and top five ideas, respectively:[24]

[19] See Cremers, K.J. Martijn and Petajisto, Antti, *How Active Is Your Fund Manager? A New Measure That Predicts Performance* (2009).
[20] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 96.
[21] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 90-91.
[22] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 108.
[23] See Buffett, Warren E., *The Essay of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 110.
[24] Data compiled by author from Berkshire Hathaway annual letters to shareholders, available at www.berkshirehathaway.com.

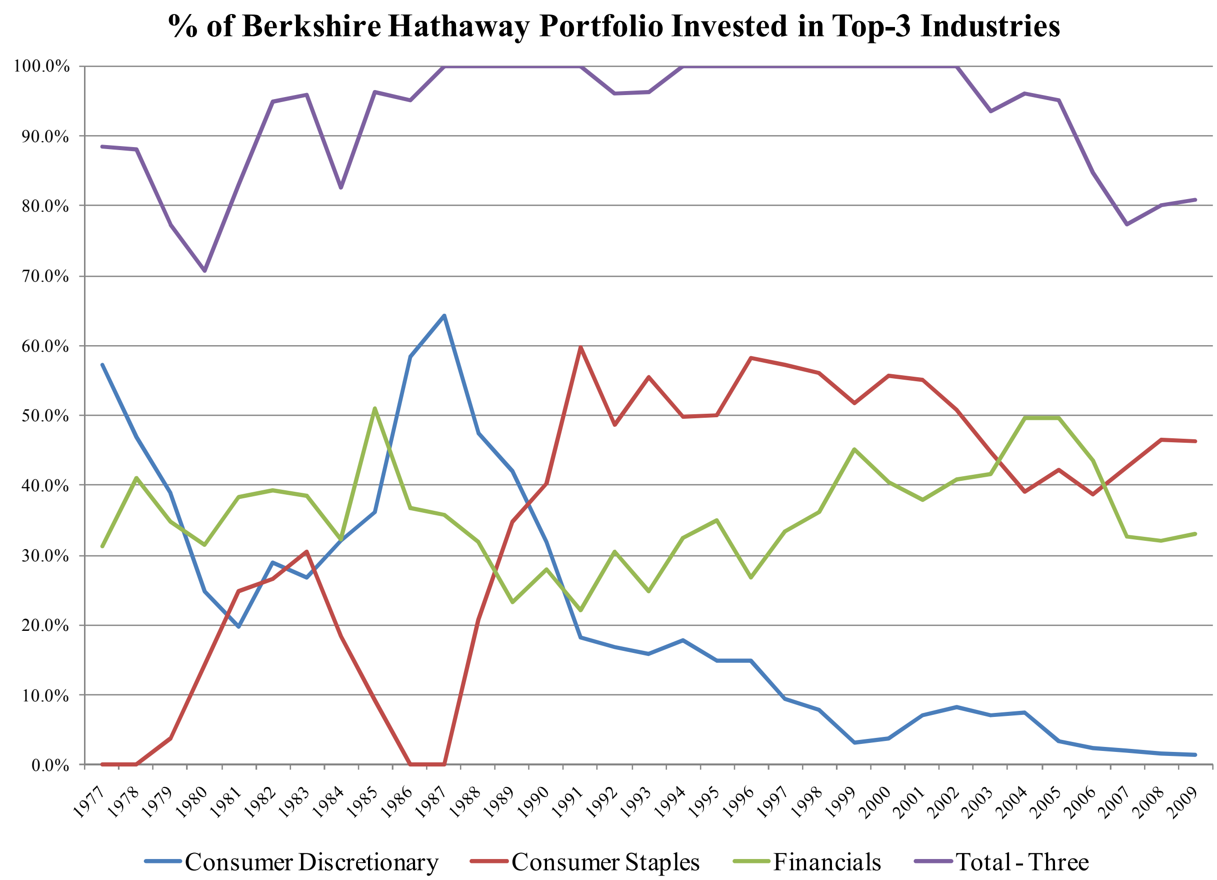


Buffett's largest position has risen to as much as 50% of the portfolio and rarely dropped below 20%. Swensen describes the importance of portfolio concentration when trying to outperform the stock market:

> Portfolio concentration increases the likelihood of beating the market. Instead of following the maxim, "Don't put all of your eggs in one basket," fiduciaries ought to hire managers who put all of their eggs in one basket, and watch that basket very carefully…The common practice of using multiple managers, each constructing a diversified portfolio, often produces an overly diversified portfolio…Simply pursuing passive management strategies provides a superior alternative to an overly diversified, actively managed portfolio…Deeply researched, concentrated portfolios provide the greatest opportunity for investment success.[25]

Buffett doesn't just concentrate his portfolio, he concentrates it in industries where he believes he understands the underlying fundamentals of the given business. Over the last 33 years, Berkshire's portfolio has invested greater than 80% of assets in three of ten industries – consumer discretionary, financials and consumer staples – as defined by GICS codes.[26]

[25] See Swensen, David, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (2000), p. 197-200.
[26] Data compiled by author from Berkshire Hathaway annual letters to shareholders, available at www.berkshirehathaway.com, and GICS industry codes.



In 21 of those years (64%), these industries represented over 95% of the Berkshire portfolio. The companies in these sectors produced everyday products with understandable underlying economics: newspapers, soda, insurance, banking, razor blades, etc. Before 2005, five of the ten GICS industries – Health Care, Industrials, Information Technology, Telecommunication and Utilities – never garnered more than 6% of the Berkshire portfolio (it should be noted that in recent years the sheer size of Buffett's portfolio has diminished his investable opportunity set, forcing him to look in places he may have ignored previously).

Wall Street Practice

While there is no right number of stocks an equity portfolio should hold, analysis suggests that the incremental benefits of diversification become negligible after a domestic portfolio reaches 30 stocks.[27] Ben Graham, Buffett's mentor, wrote:

> There should be adequate though not excessive diversification. This might mean a minimum of ten different issues and a maximum of about thirty.[28]

Yet active managers are typically nowhere near a portfolio of 30 stocks. Only 5% of our Morningstar database holds less than 30 stocks and just 23% hold less than 50 stocks. Over half manage a portfolio that contains over 75 stocks!

[27] For example, see Malkiel, Burton G., *A Random Walk Down Wall Street* (2007), p. 191.
[28] See Graham, Benjamin, *The Intelligent Investor*, Revised Edition (2006), p. 114.

Portfolio Holdings…			
Number of Stocks	*# of Funds*	*% of Funds*	*Cum. %*
< 30	107	5.2%	5.2%
30 - 50	364	17.6%	22.7%
50 - 75	463	22.3%	45.1%
75 - 100	356	17.2%	62.3%
> 100	782	37.7%	100.0%
Total	2,072	100.0%	n/a

Likewise, portfolio managers don't show high conviction in their best ideas, placing a low percentage of assets in their top 10 stocks:

Portfolio Concentration…			
% in Top 10	*# of Funds*	*% of Funds*	*Cum. %*
> 50%	123	6.0%	6.0%
40 - 50%	172	8.4%	14.3%
30 - 40%	485	23.6%	37.9%
20 - 30%	766	37.2%	75.1%
< 20%	512	24.9%	100.0%
Total	2,058	100.0%	n/a

Interestingly, two different studies have demonstrated that fund managers that make active bets often outperform. Research by Randy Cohen, Chris Polk and Bernhard Silli shows that fund managers' "best ideas," signaled by active bets relative to the index, exhibited strong performance during the period 1991 to 2005. The top 25% of such ideas posted 19% annual returns versus 12% for the market. The authors conclude:

> The poor overall performance of mutual fund managers in the past is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to over-diversify.[29]

K.J. Martijn and Antti Petajisto of Yale construct an index that measures the degree of active management ("Active Share") pursued by funds and then plots this measure against returns. The authors find:

> Active share predicts fund performance: funds with the highest Active Share significantly outperform their benchmarks, both before and after expenses, and they exhibit strong performance persistence. Nonindex funds with the lowest Active Share underperform their benchmarks…Fund performance in excess of the benchmark is significantly related to active management…Economically, these results suggest that the most active stock pickers have enough skill to outperform their benchmarks even after fees and transaction costs.[30]

Martijn and Petajisto classify one-third of the active funds in their database as "closet indexers" – funds that are essentially index funds posing as active management funds (and charging active management fees). Closet indexers by necessity invest in a wide range of industries, likely well outside their range of competency or understanding. The typical fund's informational placard will reveal that its industry allocations are alarmingly similar to that of the index.

None of this is to say that diversification is inherently bad; the spread of diversification practices has been a net positive for the investing community. But in relation to equity markets, investors should choose one of two ends on the continuum – either maximum diversification in a low-cost index fund or relative concentration with a competent investment manager (or with multiple competent investment managers that run concentrated portfolios). The large bulk of closet indexers that charge high fees and offer low probabilities of besting market returns deserve far less assets than they currently manage.

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[29] Cohen, R., Polk, C., and Silli, B. (2009) Best Ideas, working paper.
[30] Cohen, R., Polk, C., and Silli, B. (2009) Best Ideas, working paper.

> By periodically investing in an index fund, for example, the know-nothing investor can actually out-perform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb. On the other hand, if you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk.[31]

Reasons for the Paradox

These examples of disconnect between Buffett's teachings and standard industry practice only scratch the surface of the Paradox. Indeed, the issues discussed here may more appropriately be labeled corollaries of Buffett's central theories as opposed to core tenets themselves. Yet the degree to which market participants have rejected Buffett's views discussed here is indicative of the wider problem. Warren Buffett's approach to investment management surely isn't the only way to achieve satisfactory or superior returns (though we think it is the most robust approach for the great majority of investors). However, the investment management tendencies criticized here are not a subset of an alternative yet competent system; they do not meet the standard of investment logic and stand at odds with Buffett's investing framework.

Why does the Paradox persist? The answer to that question is outside the scope of this paper and likely our ability to address it. Nonetheless, we venture to engage in a short discussion. Possible explanations include:

- Managers frequently exhibit overconfidence in their own ability. While the market is not perfectly efficient, it is "frequently efficient,"[32] meaning that outperformance is difficult. Yet managers sometimes believe that they can make hundreds of small decisions annually that add up to better than market returns; the odds of such a program finding success are small. Some managers reject the idea that they should only act when there is a clear and logical reason to do so and ignore the concept of a circle of competence.
- Buffett's program for investment success is straightforward and logical, but difficult in application. It is not difficult because of complexity but because of the emotional fortitude required to carry it out. Market participants are always looking for novel ways to beat market returns and control risk, frequently employing fancy formulas and proprietary methodologies. A review of the history of investment markets illustrates that the probabilities of such programs succeeding through future market cycles are extremely low and that in the event they are promising, their benefits are typically arbitraged away once they are discovered.

  > In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace.[33]

- Managers may have explicit financial incentives to engage in inefficient portfolio activity. The presence of commissions, for instance, may pressure brokers to engage in a heightened level of portfolio turnover or push certain securities relative to others regardless of investment merit, even if such activity comes at the detriment of end clients.
- Wall Street, as a whole, benefits from investors engaging in inefficient behavior. Increased activity, high management fees, expensive research, multiple consultants, different forms of investment organization, over-diversification, etc. increase the amount of fees earned by the financial community at the expense of investors. This creates institutional inertia towards bad investing behavior.[34]
- Most importantly, investor (client) behavior creates implicit incentives for investment managers to act in suboptimal ways. Frequently, this conflict arises because of undue investor focus on short-term results. Consider the manager of a multi-billion dollar mutual fund. He earns a nice fee on assets managed. However, his mutual fund investors react strongly to short-term results. True, if he beats the market by a substantial margin investors may flock to his fund. But if he takes a risk and trails the market by any meaningful amount over a short-time period, investors may stampede for the exits. It makes more sense for him, based on a cost-benefit analysis, to play it safe, making only marginal bets relative to the stock market index. In some quarters he will outperform a bit, in others he may underperform, but in neither case by a margin substantial enough to significantly erode his client base. Additionally, investors typically look only at his before tax returns, meaning that he can avoid the costs of frequently recognizing capital gains. James Montier concludes:

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[31] See Buffett, Warren E., *The Essary of Warren Buffett: Lessons for Corporate America*, Second Edition, Selected, Arranged and Introduced by Lawrence A. Cunningham (2008), p. 94.

[32] See Buffett, Warren E., *Annual Letter to Berkshire Hathaway Shareholders*, February 28, 1989.

[33] See Buffett, Warren E., *Annual Letter to Berkshire Hathaway Shareholders*, February 29, 1988.

[34] For example, see Buffett, Warren E., *Annual Letter to Berkshire Hathaway Shareholders*, February 28, 2006. In the section entitled "How to Minimize Investment Returns," Buffett discusses a hypothetical family called the "Gotrocks" to illustrate how investors hurt themselves through frictional costs.

> Why are fund managers so wedded to relative performance? The simple, although unpopular, answer is that clients and consultants force them to be.[35]

Jeremy Grantham, head of asset management firm GMO, writes that one of his firm's divisions lost 60% of their book of business in just two and a half years as they made the eventually correct call to avoid stocks in the late 1990's. Clients, who were too focused on short-term performance, withdrew money to chase the recent performance of other managers.[36] John Maynard Keynes counsels:

> Worldly wisdom teaches that it is better for reputation to fail conventionally then to succeed unconventionally.[37]

In short, the Warren Buffett Paradox observed in the market is likely the result of two reinforcing tendencies – that of Wall Street to increase the market's "frictional costs" and that of investors to be all too willing to play the game.[38] It functions much like a casino, with the operator encouraging the all too willing participants. Any aggregate improvement in investor behavior will require reformation by both parties.

In the meantime, however, inefficient market activity can provide an opportunity for the Buffett-schooled investor. By employing an objective focus on long-term, fundamental value, he can greatly improve his odds of beating the investment markets over an extended period of time. Such odds are not reflected in the often-quoted success rates of active managers, which are burdened by a fundamentally biased sample.

> Our stay-put behavior reflects our view that the stock market serves as a relocation center at which money is moved from the active to the patient.[39]

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[35] See Montier, James, *Was It All Just a Bad Dream? Or, Ten Lessons Not Learnt* (2010).
[36] See Grantham, Jeremy, *Letters to the Investment Committee XVI,* Part 1: "Friends and Romans, I come to tease Graham and Dodd, not to praise them" (2010).
[37] Keynes, John Maynard, *The General Theory of Employment, Interest and Money*.
[38] Ben Graham wrote: "Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble…to give way to hope, fear, and greed." Retrieved from The Ben Graham Centre for Value Investing on June 16, 2010.
[39] See Buffett, Warren E., *Annual Letter to Berkshire Hathaway Shareholders*, February 28, 1992.