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Market Flash

Listen to Graham, Not Buffett

It is well known that if something factually not true is repeated often enough, people will eventually come to believe that it is true. Nowhere is the phenomenon more common than on Wall Street. The most recent example is the overwhelmingly positive press coverage given to the unfounded assertion that passive investing is the best way to participate in the stock market. The result has been a stampede of money into S&P 500 ETF index funds. **Contributing to the stampede is a recent article in the *Financial Times* in which Warren Buffett, a Ben Graham disciple no less, recommends passive over active investing.**

What Buffett now says certainly flies in the face of what Graham advised after his 60-year career in the investment business. What Buffett now says also contradicts his own life-long investing philosophy, as well as the studies we have conducted to confirm the validity of Graham's approach to picking stocks.

Graham's key to investment success was to focus on two simple principles:

1. **Invest with discipline.** The metrics Graham used are: price to earnings (P/E), price to book (P/B), and dividend yield. This enabled one to avoid the Achilles' heel of investing, which is overpaying for stocks – precisely the risk that index investing embodies.

2. **Invest for the long term.** Graham said it was crucial that investors understand that markets are completely unpredictable on a one-, two-, three- or even a four-year basis; but using a five-year time horizon allows earnings to emerge as the dominant driver of stock prices – which is significantly more important than short-term factors like fear, greed, momentum, and the like.

Our study, founded on Graham's approach to the market, presented the yearly-adjusted performance of the bottom 20% of the S&P 500 based on P/E, compared to the S&P 500 itself. We tracked all of the consecutive five-year periods from 1968 to 2015. **What you can see in the table below is that the five-year time periods tend to smooth out the volatility of yearly performance, <u>while they also consistently outperform the passive S&P 500</u>.** Because some of the five-year periods presented challenging conditions for owners of equities, our study includes all of the recessions and bear markets found within each period. Remarkably, almost every one of the five-year periods went through a severe market downturn.

Long-Term Investing: Active vs. Passive

Consecutive 5-Year Periods 1968 - 2015

	Bottom 20% Stocks by P/E	S&P 500 (Passive)	Recessions	Bear Markets	
1968 – 1972	8.0%	7.5%	1969 – 1970	2/1968 – 5/1970:	-36%
1973 – 1977	14.2%	-0.3%	1974 – 1975	1-1973 – 2/1974:	-46%
1978 – 1982	24.4%	14.1%	1979 1981 – 1982	4/1981 – 8/1982:	-24%
1983 – 1987	20.1%	16.4%		8/1987 – 10/1987:	-33%
1988 – 1992	18.1%	15.1%	1990 – 1991	7/1990 – 10/1990:	-20%
1993 – 1997	22.5%	20.3%			
1998 – 2002	7.0%	-0.6%	2000 – 2001	7/1998 – 8/1998: 1/2000 – 9/2001: 3/2002 – 10/2002:	-19% -34% -34%
2003 – 2007	18.2%	12.8%		10/2007 – 3/2009:	-56%
2008 – 2012	5.6%	1.7%	2008 – 2010	4/2011 – 10/2011:	-19%
2013 – 2015*	17.4%	15.1%			
Annualized Average:	**15.1%**	**9.5%**			
1968 – 2012 ($1 million)	**$570 million**	**$59 million**	***Who needs passive investing?***		

*Annualized Returns. The three-year period (2013-2015) is shown for informational purposes only and is not included in the annualized averages or cumulative returns. Source: SCCM Research, 2016

Given all of the recessions and bear markets present in all of the five year periods, what Buffett might have been suggesting is that the average investor is simply better off buying an index. Why? Because the ever persistent downturns the market throws up are so hard to manage emotionally and otherwise that the investor might as well go with the averages, which in any case are hard to beat. **But, Warren Buffett has always called himself a disciple of Ben Graham, and so it is unfortunate that he has become allied with the financial press to get investors to buy into passive investing during a time of historically high relative valuation levels.**

History shows that the major risk of index buying is that when the stock market makes new highs and becomes popular with the public, valuations get extended. And when valuations get out of line, there eventually follows a long period of index underperformance.

It Works:

Market participants seem to have forgotten that it wasn't that long ago, the late 1990's, that we witnessed the biggest build up in S&P 500 index funds in market history. **As stocks approached their year 2000 top, the NASDAQ provided most of the drama and the headlines. Equally dramatic, however, was the huge growth of Vanguard's S&P 500 index fund when it became the largest mutual fund in stock market history, overtaking and dwarfing active manager Peter Lynch's Magellan fund.** To show how the S&P 500 index performed after the 2000 market top, we compare in the table below the passive index fund to our two active strategies – Value, which focuses on a P/E discipline, and the High Dividend, which focuses on a P/E and dividend discipline.

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Value Equity & High Dividend Composite - Annual

Date	S&P 500 Index	SCCM Value (after Fees)	Difference *Value v. S&P*	SCCM High Div (after fees)	Difference *High Div v. S&P*
2000	-9.1%	13.1%	***+22.2%***	16.90%	***+26.0%***
2001	-11.9%	3.7%	***+15.6%***	2.20%	***+14.1%***
2002	-22.1%	-14.3%	***+7.8%***	-5.20%	***+16.9%***
2003	28.7%	29.5%	***+0.8%***	27.80%	***-0.9%***
2004	10.9%	14.4%	***+3.5%***	13.10%	***+2.2%***
2005	4.9%	10.2%	***+5.3%***	6.40%	***+1.5%***
2006	15.8%	20.6%	***+4.8%***	24.90%	***+9.1%***
2007	5.5%	10.6%	***+5.1%***	4.50%	***-1.0%***
Cumulative Annual Return	**1.6%**	**10.1%**		**10.8%**	

As for truth versus untruth, the real factual truth is that active management dramatically outperforms the passive approach if one invests with a discipline and invests for the long term. It is sometimes hard to stay the course, but the results of doing that are clearly evident. In our mid-year Market Letter, we will discuss the matter of index performance in more detail.

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