The Investor's Dilemma - Mutual Funds or Stocks?

by Mohnish Pabrai

Conventional investing wisdom is that one needs to concentrate one's investments when amassing wealth and diversify when preserving wealth. Most successful entrepreneurs, at some point, have 90+% of their wealth tied up in a single company – they are in wealth amassing mode and represent the extreme of asset concentration. Ironically, most entrepreneurs are quite comfortable with their non-diversified assets.

If one is young and have several decades before retirement, most of us would like to amass wealth, not preserve it. How is one to amass wealth if one is not an entrepreneur?
As Charlie Munger succinctly points out, the first step to wealth is to spend less than you earn from the outset. As we generate savings, the most logical choices we have in front of us are to invest either in individual stocks or mutual funds or both.

Mutual Funds have been one of the most rapidly growing industries for the last two decades. The number of funds has mushroomed to over 8000 and assets under management have grown consistently to several trillion dollars over the years. This is in spite of the fact that five out of every six funds lags the performance of the Indices over time (Figure 1). The industry is one of the only ones I know of where even if you perform poorly, you still continue to grow revenues and profit!!
If the objective is to amass wealth, then mutual funds are not the answer. Mutual Fund regulations do not permit funds to invest over 5% of assets in a single stock. Thus, at a minimum, any fund has at least 20 stocks. In practice, virtually all mutual funds have

hundreds of stocks with no single one being more than 2-3% of the portfolio. Any portfolio with hundreds of securities has a very high probability of under performing the market and an infinitesimal probability of outperforming it. I find it difficult to find more than 4-6 winners in a year. I don't know how a fund manager can find 200 winners. There is very good logic behind the 5% rule – it protects investors from big losses. The side effect is that it pretty much guarantees mediocrity.

The best way to sum up mutual fund investing is the following quote from Warren Buffett taken from the 1996 Annual Report of Berkshire Hathaway:

"…The best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results delivered by the great majority of investment professionals."

Since Index Funds are the way to go to preserve wealth, should one invest in a few stocks directly to amass wealth? When Warren Buffett ran his Buffett Partnerships he rarely made an investment in his portfolio with less than 5 or 10% of assets. At one time in the sixties, he invested 40% of the Buffett Partnership funds' assets in a single stock - American Express. Buffett's partner Charlie Munger has an even more extreme perspective. He feels that 3-4 stocks are all that are needed to have a stellar portfolio. It reminds me of a former CEO of Coca Cola, Woodrow Wilson. He was once asked by an analyst if it was a good time to sell Coca Cola Stock. Wilson responded, "I don't know. I've never sold any." Till today, the Wilson Foundation has never diversified. Over 90% of its assets are in Coca Cola stock. Needless to say, its returns have trounced the overall market. Charlie strongly endorses the Wilson Foundation's perspective on non-diversification. The Buffett Foundation will inherit over 99% of Buffett's estate and it too will be 98+% concentrated in a single holding – Berkshire Hathaway.

So should investors build their own portfolios? I can't resist another Buffett quote from the same annual report on the subject that sums it up succinctly:

"Should you choose ... to construct your own portfolio, there are a few thoughts worth remembering. Intelligent Investing is not complex, though that is far from saying that it's easy. What an investor needs is the ability to correctly evaluate selected businesses. 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 the circle is not important; knowing its boundaries, however, is vital."

The key point in Buffett's quote is that while intelligent investing is simple, it's far from easy. Over the last 5 years, 90+% of funds have lagged the S&P 500. The Odean and Barber study (done at the University of California at Davis) covering 78,000 Individual Investors showed that, on average, individual investors also lagged the market. My own experience with individual investors concurs with the results of the study. Most individuals would do better with an index fund.

I think investors who take the time to study and then only invest in a few outstanding businesses that they think are available well below their Intrinsic Value (see Silicon India article on Intrinsic Value in the July 2001 issue) and then hold those great businesses for a long time will come out ahead on their journey to amass wealth. However, there are only a few of us who have the discipline, analytics and patience to follow this approach.

To sum up, most managed mutual funds will lag the market. Index funds are a good way to preserve your wealth but not make you rich, while individual stock picking is a loser's game for most investors. To make matters worse, Buffett predicts that the US stock market will only deliver a 4-6% annualized rate of return over the next 10-15 years. I agree with Buffett's thesis. So the next decade will be a disappointing one for most investors.

To close on a somewhat positive note, I'd like to add that there are a few professional investors who have consistently beaten the market following Buffett style of focused value investing closely. I'd recommend that the reader stick to index funds or investigate investing with managers like Marty Whitman (Third Avenue Value Fund), Bill Ruane (Sequoia Fund), Mason Hawkins & Stanley Cates (Longleaf Partners), Bill Nygren (Oakmark Fund) and Seth Klarman (Baupost Fund). They have all delivered results that have been vastly superior to the indices and have a focused investment style with limited securities in the portfolio.

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