Buffett Succeeds at Nothing

by Mohnish Pabrai

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Warren Buffett is known as being one of the best investors of all time. But it might come as a surprise to many that his investing strategy often encompasses long periods of what he calls "sitting on my butt." There have been periods of years when Berkshire Hathaway has purchased not a single share of stock, interspersed with some enormous activity. Sometimes doing nothing is the best thing you can do.

Editor's Note: Occasionally, we like to feature articles from readers in this space. Mohnish Pabrai, the managing partner of Pabrai Investment Funds, and mpabrai on the Fool discussion boards, offers his view on the difficulty investors have – professional and individual alike – in just sitting still.

Seventeenth century French scientist Blaise Pascal is perhaps best remembered for his contributions to the field of pure geometry. In the 39 years that he lived, he found time to invent such modern day fundamentals as the syringe, the hydraulic press and the first digital calculator. And, if that weren't enough, he was also a profound philosopher. One of my favorite Pascal quotes is: *"All man's miseries derive from not being able to sit quietly in a room alone."*

I've often thought that Pascal's words, slightly adapted, might apply well to a relatively new subset of humanity: *"All portfolio managers' miseries derive from not being able to sit quietly in a room alone."*

Why should portfolio managers sit and do nothing? And why would that be good for them? Well, let's start with the story of D. E. Shaw & Co. Founded in 1988, Shaw was staffed by some of the brightest mathematicians, computer scientists, and bond trading experts on the planet. Jeff Bezos worked at Shaw before embarking on his Amazon.com journey. These folks found that there was a lot of money to be made with risk-free arbitrage in the bond markets with some highly sophisticated bond arbitrage trading algorithms.

Shaw was able to capitalize on miniscule short-term inefficiencies in the bond markets with highly leveraged capital. The annualized returns were nothing short of spectacular – and all of it risk free! The bright folks at Shaw put their trading on autopilot, with minimal human tweaking required. They came to work and mostly played pool or video games or just goofed off. Shaw's profit per employee was astronomical, and everyone was happy with this Utopian arrangement.

Eventually, the nerds got fidgety – they wanted to do something. They felt that they had only scratched the surface and, if they only dug deeper, there would be more gold to be mined. And so they fiddled with the system to try to juice returns.

What followed was a similar path taken by Long-Term Capital Management (LTCM), a fund once considered so big and so smart on Wall Street that it simply could not fail. And yet, when economic events that did not conform to its historical model took place in rapid succession, it nearly did just that. There was a gradual movement from pure risk-free arbitrage to playing the risky arbitrage game in the equity markets. A lot more capital could be deployed, and the returns looked appealing. With no guaranteed short-term convergence and highly leveraged positions, the eventual result was a blow-up that nearly wiped out the firm.

Compared to nearly any other discipline, I find that fund management is, in many respects, a bizarre field - where hard work and intellect don't necessarily lead to satisfactory results. As Warren Buffett succinctly put it during the 1998 Berkshire Hathaway annual meeting: "*We don't get paid for activity, just for being right. As to how long we'll wait, we'll wait indefinitely!*"

Buffett and his business partner Charlie Munger are easily among the smartest folks I've come across. But, as we've seen with Shaw and LTCM, a high I.Q. may not lead to stellar investing results. After all, LTCM's founders had among them Nobel Prize-winning economists. In the long-run, it didn't do them much good. In fact, they outsmarted themselves. In a 1999 interview with BusinessWeek, Buffett stated:

> "*Success in investing doesn't correlate with IQ – once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.*"

Events at Shaw and LTCM show that high-IQ folks have a hard time sitting around contemplating their navels. The problem is that once you engage in these intellectually stimulating problems, you're almost guaranteed to find what you think are the correct answers and act upon them – usually leading to bad results for investors.

Having observed Buffett and Munger closely over the years and gotten into their psyche through their speeches and writings, it is clear to me that, like the folks at Shaw and LTCM, both men need enormous doses of intellectual stimulation as part of their daily diet. How do they satisfy this intellectual hunger without the accompanying actions that get investors into trouble?

Consider the following:

While Buffett plays bridge (typically 10-20 hours per week), Munger spends his time mostly on expanding his worldly wisdom and constantly improving his latticework of mental models. He is a voracious reader of intellectually engaging books on a variety of subjects, ranging from the various Ice Ages to The Wealth and Poverty of Nations. He spends considerable time in applying perspectives gained from one field of study into other disciplines - especially capital allocation.

At the Wesco annual meeting this year, Munger acknowledged that the first few hundred million dollars at Berkshire came from "running a Geiger counter over everything", but the subsequent tens of billions have come from simply "waiting for the no-brainers" or, as Buffett puts it, "waiting for the phone to ring".

Buffett still has a tendency to run his Geiger counter over lots of stuff. It's just too enticing intellectually not to. How does he avoid getting into trouble? I believe there are three reasons:

1. **Running the Geiger counter can work very well if one knows *when* to run it.** Reflect on the following two quotes:

   In 1970, showing his dismay at elevated stock prices, Buffett said:

   "I feel like a sex-starved man on a deserted island"

   In 1974, expressing his glee at the low levels to which the market had fallen, he said:

   "I feel like a sex-starved man in a harem filled with beautiful women!"

   By 1970, Buffett had terminated his partnership and made virtually no public market investments until 1974. The P/E ratio for the S&P 500 dropped from 20 to 7 in those four years. By 1974, he acknowledged selling "stocks he'd bought recently at 3 times earnings to buy stocks selling at 2 times earnings".

   Then, from 1984-1987, Buffett did not buy a single new equity position for the Berkshire portfolio. Berkshire Hathaway was sitting on a mountain of cash, and still he did nothing. In the latter half of 1987, Berkshire used that cash pile to buy over a billion dollars' worth of Coca-Cola, over 5% of the company. He invested 25% of Berkshire Hathaway's book value in a single company that they did not control!

What were Buffett and Charlie doing from 1970-73 and 1984-87? Both men realize that successful investing requires the patience and discipline to make big bets during the relatively infrequent intervals when the markets are undervalued and to do "something else" during the long periods when markets are fully priced or overpriced. I'm willing to bet that Buffett was playing far more bridge in 1972 than he was in 1974.

2. **The Geiger counter approach works better in smaller, under-followed companies and a host of Special Situations.** Given their typical smaller size, investing in these companies would do nothing for Berkshire Hathaway today. So Buffett usually makes these investments for his personal portfolio. A good example is his recent investment in mortgage REIT Laser Mortgage Management (LMM), where there was a decent spread between the liquidation value and quoted stock price. These LMM-type investments are significant for Buffett's personal portfolio and, more importantly, soak up intellectual horsepower that might lead to not-so-good results at Berkshire Hathaway.

   Being versatile, he moves his Geiger counter away from the equity markets to other bastions of inefficiency whenever the public markets get overheated. These include high-yield bonds (Berkshire bought over $1 Billion worth of Finova bonds at deep discounts in 2001), REITs (bought First Industrial Realty in 2000 for his own portfolio at a time when REIT yields were spectacular), or his recent investing adventures in silver.

3. **The Munger/Buffett relationship is an unusual one.** Both men are fiercely independent thinkers, and both prefer working alone. When Buffett has an investment idea, after it makes it through his filter, he usually runs it past Munger. Munger then applies his broad latticework of mental models to find faults with Buffett's ideas, and shoots most of them down. It is the rare idea that makes it past Buffett, and it has to be a total no-brainer to make it past both of them.

The Buffett/Munger approach of multi-year periods of inactivity contrasts starkly with the frenzied activity that takes place daily at the major exchanges. Which brings me back to the fundamental question: Why have we set up portfolio managers as full-time professionals with the expectation that they "do something smart" every day? The fund management industry needs to reflect on Pascal's potent words and how Warren Buffett and Charlie Munger have figured out how to sit quietly alone in a room, indefinitely.

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