Super Investors

Can you believe there once was a time when Warren Buffett had to defend his investment track record from the academic naysayers? These days, it seems like the whole world is in agreement that it's possible for an investor to beat the market over a significant time period, and that Exhibit A for that fact is Mr. Buffett himself. Sure, it's extremely rare to find someone who can, but it's possible.

But it hasn't always been that way. In the late 1970s and early 1980s, when Mr. Buffett was only in his third decade of handily beating the market, several prominent academics of the time suggested that the reason for his success was none other than pure chance.

That is, let's say you're going to have a contest where everyone in the U.S. pairs off with another person and then flips a coin. After the first flip, there will be about 150 million "winners." If you send the losers home and have the one-time winners pair off and flip another time, then there will be 75 million individuals who correctly called two consecutive coin flips.

If you repeat this process for another 8 rounds, you will eventually be left with 293 thousand people who were able to correctly call ten consecutive flips of the coin. Or in percentage terms, 99.9% of the country would have lost in one of those rounds, but 0.1% of us would still be standing as the ten-time coin flip winners.

Can you imagine the books these people would write? "How I Called Ten Flips in A Row, and You Can Too!" Or the talk shows that would waste their time interviewing these folks, trying to figure out how they were able to do it?

And this absurd argument is exactly what some academics were saying about Mr. Buffett's investment track record in the 1970s: he was nothing more than a lucky coin flipper.

Come to Scenic Des Moines!

So in 1984 Columbia University offered Mr. Buffett a chance to rebut the professors. And his response was, of course, brilliant in its simplicity.

He first described the coin-flipping scenario we just laid out above, then he asked an important question: what if 200 thousand (out of those 293 thousand lucky coin flippers) all lived in Des Moines? *[Well, that's not exactly the question he asked, but it's practically the same.]*

Kind of makes you think, huh? Is there something in the water in Des Moines? Do Des Moinians have some special magnetic energy that allows them to anticipate how small metal objects will behave?

Of course, this whole bit about Des Moines and the coins is just a hypothetical stand-in for the topic we're really talking about, which is investing.

What Mr. Buffett was saying is that there is indeed a group of people who have demonstrably beaten the market over a significant period of time, and the strange thing about that group is that many of them all share the same investment philosophy. That is, they were all educated in the same way, at about the same time, and taught the same techniques.

Come to Scenic Graham-and-Doddsville!

The common thread shared by the group that Mr. Buffett discussed in that famous 1984 speech was that they were all educated by Benjamin Graham using a textbook that Mr. Graham wrote along with his research assistant David Dodd.

The book is called *Security Analysis*, and its basic premise is that each investment has a certain intrinsic value, based on its assets, liabilities, profits, growth characteristics, and competitive position. If an investor can buy a security for significantly less than that security's intrinsic value, then the theory goes that the investor should realize a decent return over the course of time.

Not everyone subscribes to these tenets, but those who do—those who hold Benjamin Graham and his teachings in high regard—are sometimes referred to as being residents of a town called Graham-and-Doddsville.

So Mr. Buffett simply gathered up the list of professional investors who were educated by Mr. Graham in the 1950s and who had established an official investment track record between then and the time of the speech in 1984. He didn't cherry-pick only the best performers, or otherwise pick and choose whose records to examine. He looked at them all, and what he found was pretty amazing.

The chart below shows the returns that each of these investors was able to achieve for their clients. That is, all numbers presented are after accounting for fees, and some of these guys were running hedge funds so their fees were pretty hefty.

Investor	S&P 500 CAGR	Investor CAGR	Years Of Career	$10K in S&P 500	$10K with Investor
Walter Schloss	8.7%	16.1%	28	$98K	$678K
Pacific	7.9%	23.6%	19	$42K	$563K
Perlmeter	8.8%	18.6%	16	$37K	$182K
Charlie Munger	5.1%	13.7%	14	$20K	$60K
Warren Buffett	8.9%	23.8%	13	$25K	$160K
Tweedy, Browne	10.2%	17.2%	13	$34K	$104K
Sequoia	9.0%	16.8%	13	$37K	$88K

Source: The Superinvestors of Graham-and-Doddsville, Inkwell analysis

[Notes: CAGR = Compound Annual Growth Rate, and final two columns represent the value an investor would have at the end of the Years Of Career based on an initial investment of $10,000.]

Can you imagine? The lowliest record of the bunch still produced an annual return of 13.7%. The worst result in terms of relative performance was Tweedy, Browne, which bested the overall market by "only" 7% a year. And the worst result in terms of relative dollars was Sequoia, who only made their investors 2.4 times wealthier than they would have been had they invested just in the market as a whole.

To us, that pretty much closes the case on whether or not the market can be beaten. These residents of Graham-and-Doddsville not only beat the market—they *crushed* it.

Value Investing Works Because It Doesn't Always Work

But before we end our story, we'd like to focus on one interesting side note from the data that has not been talked about much since Mr. Buffett's famous speech more than 30 years ago.

Look again at the table above. These men had plied their craft for anywhere from 13 to 28 years at the time of the 1984 speech, and they had racked up impressive records over those time frames. But in each and every case represented in the table above, there came a period of time in which the investor significantly *under-performed* the market.

In fact, there were some periods during which these investors would have been judged by almost anyone as being completely incapable of ever beating the market, and they surely must have had many crises of personal confidence during those times.

Let's look now at another chart showing the depths to which these incredible investors sank. All return figures in the following chart are presented relative to the S&P 500. For example, Walter Schloss' worst year was when he lagged the market by 11.8%: the S&P was up 3.6% in 1970, but he was down 8.2%.

Investor	Worst Year	Worst Downturn	Longest Downturn
Walter Schloss	-11.8%	-12.4%	5
Pacific	-27.4%	-53.4%	7
Perlmeter	-13.4%	-14.6%	3
Charlie Munger	-17.2%	-30.6%	4
Warren Buffett	-11.5%	-11.5%	1
Tweedy, Browne	-16.2%	-17.6%	4
Sequoia	-19.9%	-25.1%	4

Source: The Superinvestors of Graham-and-Doddsville, Inkwell analysis

Amazing, isn't it? Every entity on this chart is one of the greatest investors the world has known, and yet each and every one of them had a year in which they lost to the market by *more than 10%*. It almost boggles the mind.

And aside from Buffett himself, every other one had to endure a multiple-year period in which they were trailing the very market they were trying to beat. Pacific went through a period of seven years—*seven years!*—in which it was losing to the market. These guys were getting paid to beat the market, and for seven long years they did not.

And this is exactly why the Graham-and-Doddsville style of investing will continue to work: because there will inevitably come a time when it does not work for a season. It's during those times that the wheat is separated from the chaff—the true believers gut it out, and the fair-weather friends leave town to look for another investment style that may be better suited to the times.

For those who are able to hold on for the long and painful ride, they can be richly rewarded for doing so. In our first chart above, Pacific's investors made out the best in dollar terms. They made more than 13 times what they would have if they had simply been invested in the S&P 500.

Conclusion

Yes, the market can be beaten. It's terribly difficult, and it's even more difficult today than ever before. But it can be done, and one of the surest ways possible is to align yourself philosophically with Benjamin Graham and David Dodd. Become a resident of Graham-and-Doddsville, and you will increase your chance of investment success.

In our next memo, we'll attempt to update Mr. Buffett's 1984 speech to the current time period. We'll look at some of today's most prominent residents of Graham-and-Doddsville and see how their track records stack up.

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