

## Investment Considerations

"I will tell you the secret of getting rich on Wall Street. Close the doors. You try to be greedy when others are fearful and you try to be very fearful when others are greedy." (Warren Buffett)

"Don't gamble, buy some good stock. Hold it till it goes up...and then sell it. If it doesn't go up, don't buy it". (Will Rogers)

1996 was another good year, which we did not expect but in which we participated. Fortunately we are investors who are slow to buy and even slower to sell. It really paid to be patient.

We are in the business of building wealth. You may say they jolly well ought to do it, otherwise they would not have a right to be around. However, after one of the best bull markets in history many people wonder whether they should still keep their investments or whether they should get out to avoid the coming plunge.

In our case here before us we have tripled the funds in about 8 years. This is a very good result. Does it mean we just have been lucky and better get out before the seven lean years set in? We do not think so but it is true that there are good reasons to be cautious as there are reasons to continue with the investments.

By now all of you know that we are long term investors. We believe that excessive caution probably destroys as much wealth as does too little. By constantly trying to avoid the next correction you may miss a good part of the profits. A ten percent correction should not throw you off balance after tripling your funds.

A look at the long term chart of an investment fund enables us to put things into perspective. The Tempelton Growth Fund, a worldwide equity fund was started on November 29, 1954. Let us assume you had invested boldly **\$10'000** in it right at the start. Today we know, that its growth rate over the next **42 years** has been **14.6%**. The original \$10'000 grew thanks to the compounding effect to **\$3'177'800**. The fund normally is fully invested; it had its ups and downs, but it achieved this fabulous result only by being invested at all times and not by trying to avoid the next downturn.

Alan Greenspan recently addressed the question of the rich valuation of the market. "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?" His answer, however, was very diplomatic. He noted that sustained low inflation tends to be good for stock prices. He said the Fed should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy.

Wayne Angell, a former governor of the Federal Reserve, answered Mr. Greenspan that this time around everything is different from the situation in 1929. Money in 1929

was quite tight, interest rates therefore high, and this mistaken monetary policy led to deflation, a rise of protectionism and wrecked the banking system. Higher stock prices today just reflect lower inflation in the recent past and for the foreseeable future. Lower interest rates, lower stock yields and higher price-to-earnings ratios will go hand in hand.

Peter Lynch, the former Magellan Fund manager, points out the importance of the strong rise in profitability as the cause for higher valuations. He recommends to concentrate on analyzing earnings and not to worry too much about higher stock prices. In 1997 profits are expected to climb 14% above those for 1996. Earnings yields on stocks are now below bond yields. Rising earnings will eventually catch up with the bonds, but disappointments will cause prices to decline.

Will Warren Buffett now sell all his beloved wonderful businesses? We don't think so. "Selling a familiar stock is like dumping your wife when she gets old," he once said. He believes that the intrinsic values of outstanding companies can be much higher than conventional methods would indicate. The high probability of their growth allows and justifies a much higher PE-ratio than for the average company. There is no problem as long as their growth lasts. A change in their rating however would signify much lower prices.

It is a fact that many of the great fortunes in the world have been made by owning a single wonderful business. There aren't that many wonderful businesses in the world. So if you own a few just hang on to them as long as they perform well. We should just worry about the business and not about the price. What are the economics? How strong is the competition? How attractive will eventually be the return on equity? Does it have the right management? Are they honest with their shareholders? We should find out what makes one business better than another.

Investing requires a high degree of self-discipline and objectivity. It means stripping decisions of emotions, of hopes and fears, of impatience and self-delusion and all purely subjective elements. Required is objectivity about where you rank in the scheme of things. Being cold-blooded, analyzing coldly the possibilities with hard-nosed objectivity.

I think investors should lower their expectations to realistic levels of maybe 8 to 10 percent. They should also prepare mentally for the inevitable corrections. It is important not to panic when the market tumbles and to stick with the investments over the long haul. Owning great stocks should also in the future be the best way to gaining wealth.

Today is not the time to go on achieving prodigious results by increasing risks and skating on thinner and thinner ice. After a few successful years the portfolio manager should remain as realistic and critical as ever and not venture outside his circle of competence. What is being acquired today in an environment of low interest rates and low premiums for inferior quality will have to prove its value under more trying conditions. What is most important is confidence in one's own judgment, from which will flow the cool to keep one's head when all about you are losing theirs. In market terms, if you know what a stock is worth - what a business is worth - then a falling quotation is no cause for alarm.

And now some observations from Warren Buffett in his 1996 Annual Report of Berkshire Hathaway:

In last year's letter, with Berkshire at \$36'000, Warren Buffett pointed out that the market value had moved beyond the intrinsic value. In 1996 however, while the share price didn't change, the intrinsic value has increased significantly, so that now Berkshire's share price is "more appropriate".

Two of his largest holdings, Coca Cola and Gillette, got a new labeling, "The Inevitables". Buffett thinks that these two companies, which have increased their market share over the last decade, will continue to dominate their fields and even increase their number one position in the next decade. An investor like Buffett prefers the certainty of their good results to the possibility of even faster growth in start-up or high tech firms. This is a good reminder to us that not the highest possible return in the short run but a high and sustainable rate of growth over a long period will bring the best rewards.

There obviously are very few "Inevitables". Buffett thinks he will never come up with a "Nifty Fifty", or even a "Twinkling Twenty". To the absolute market leaders he adds a few "Highly Probables", companies that one day may climb up the ladder or be relegated to the broad mass of stocks.

He adds the following assessment of today's stock market valuations:

"You can, of course, pay too much for even the best of businesses. The overpayment risk surfaces periodically and, in our opinion, may now be quite high for the purchasers of virtually all stocks, The Inevitables included. Investors making purchases in an overheated market need to recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid.

A far more serious problem occurs when the management of a great company gets sidetracked and neglects its wonderful base business while purchasing other businesses that are so-so or worse. When that happens, the suffering of investors is often prolonged. Unfortunately, that is precisely what transpired years ago at both Coke and Gillette. Loss of focus is what most worries Charlie and me when we contemplate investing in businesses that in general look outstanding. All too often, we've seen value stagnate in the presence of hubris or of boredom that caused the attention of managers to wander."

Roland Schwab  
Zug, March 19, 1997