Copycats?

"If you're in the investment business and have an IQ of 180, sell 30 points to somebody else." - Warren Buffett

Unless you've been stranded on a deserted island, you are likely familiar with Warren Buffett's legendary investment success. His returns have been remarkable in every vehicle he's piloted:

a. his early 1950s partnership fund- 1957-1969 annualized returns of 29.5%

b. his $1 billion private investment account- unknown, but must be good to be $1b

c. the growth in Berkshire Hathaway's book value (a rough measure of what an accountant would say it is worth)- 1965-2015 compound annual gain 19.2%

d. Berkshire Hathaway's stock price (a rough measure of what market participants think it's worth)- 1965-2015 compound annual gain 20.8%.

People often ask us (and we've always wondered), how has Warren Buffett been able to create such amazing returns for so many decades without more people copying him?

It's not like Mr. Buffett has been operating in a shroud of mystery. He's laid out his entire investment playbook several times over in Berkshire's annual reports, at the annual meetings, and in TV interviews. He's also required to file public disclosure announcements when he purchases a large enough part of a company, which is almost every investment when you're running a portfolio that massive. Anyone can see what he's doing, almost in real time. So the question remains, why don't more investors emulate Mr. Buffett's success?

Some may argue that Mr. Buffett is just a once-in-a-lifetime genius and impossible to copy. There's no denying he's incredibly intelligent and he's always had a knack for numbers. But there have been plenty of other geniuses who have been terrible investors. Sir Isaac Newton lost a fortune when the South Sea Bubble collapsed, and he discovered calculus to help himself solve physics problems! Being a genius doesn't automatically make you a great investor.

On the flip-side, there have been many "average" minds who have shot the lights out. It doesn't take an IQ of 180 to realize investment success. Walter Schloss was an investor who shared an office with a young Warren Buffett. Schloss compounded returns at 15.3% over a 45-year career.

FARNAM STREET Investments

FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630

916.542.2008
www.farnam-street.com

Here's what Warren had to say about his friend. "He knows how to identify securities that sell at considerably less than their value to a private owner: *And that's all he does...* He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me." Schloss had no college degree and professed to not being an earth-shattering intellect, yet he had Hall of Fame investment results.

Is it something else? Academics have claimed that with enough iterations, there would have to be a statistical outlier with a track record like Buffett's. They liken it to a coin-flipping contest with millions of participants where someone would naturally win by correctly guessing heads or tails one hundred times in a row just by chance. No real skill would be necessary-- the investment equivalent of a monkey with a typewriter producing Hamlet.

It's true that outliers are part and parcel of any large collection of numbers, but it doesn't explain that a disproportionately significant number of successful investors trace their roots back to the father of value investing, Benjamin Graham. Both Buffett and Schloss learned how to invest from Graham. This lineage of investors' outsized returns for decades eviscerates the academic coin-flipping argument. There have simply been too many successful investors coming from the value school of thought to crown one of them a Shakespearean monkey.

So if it isn't Mr. Buffett's raw intellect or just a naturally occurring statistical fluke, what do we have left?

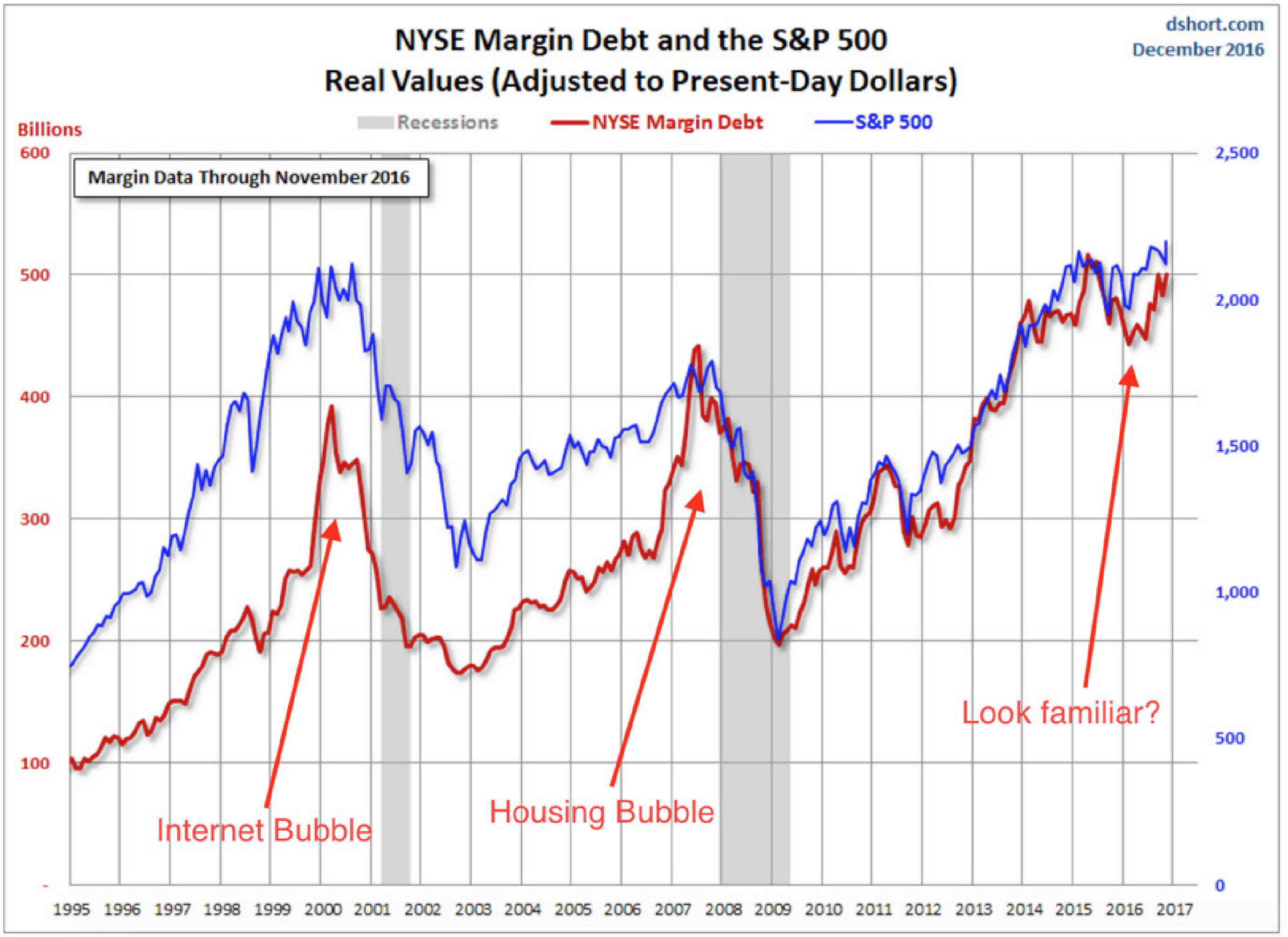
Recognizing the risk in simplifying Mr. Buffett's success to one factor, we keep coming back to his unflappable patience as the real-difference maker. His ability to control his emotions and sit and do nothing when it's the time to do nothing is incredibly rare in the investment world.

"Lethargy bordering on sloth remains the cornerstone of our investment style." -Warren Buffett

How does that lethargy manifest itself? Cash! Notice how the cash at Berkshire headquarters has grown over the last four years as market prices have increased.

12/31/13 - $48 billion
12/31/14 - $63 billion
12/31/15 - $71 billion
09/30/16 - $85 billion

Contrast Buffett's increased conservatism with the below graph of margin debt, which is the borrowing of money to invest. This is the direct inverse of holding extra cash; think of it as "anti-patience." You use debt when you're in a hurry, and just like speeding in a car, you're more likely to crash and not arrive at your destination.



So what can we take away from all of this?

Simple. Be more like Mr. Buffett by being patient during expensive markets. If Berkshire is building up cash on the balance sheet, it's probably for a good reason and it behooves you to maintain a conservative stance as well. There may just be a lucrative buying opportunity in your near future.

It's simple, but not easy. The fear of missing out is strong and it goes against our human instincts to do something different than the crowd. But that's the only way we can be more patient like Mr. Buffett and approach his success.

Cost Basis Discrepancy with Fairholme

We've had a few questions from clients about the performance of two of our investments from Fairholme Funds (FAIRX and FAAFX). For many, it looks like they're down considerably. (Our smaller investor aren't in either fund as the minimums are quite high.) We want to make sure you're looking at the right numbers. There's an error (not really an error, more of an accounting difference) that's slightly complicated, but will do our best to explain here.

The issue is that every December the Fairholme funds provides a dividend to all of us. We get the cash, which is usually auto-reinvested back into the Fairholme product it came from. With the cash out of the fund and back into our accounts, the quoted price of the fund drops by the amount that's distributed. In December 2015, the quoted price dropped over 40% to reflect the dividend, but we weren't down 40%. We have a new lower post-dividend "market value" vs. the original higher cost basis, so Schwab shows a healthy loss. The loss isn't real because the dividend we received. For the sake of all of us, we've talked to Schwab about updating the cost basis to reflect a lower post-dividend price, but they say there's nothing they can do on their end.

Each client will have slight different numbers based on when they came on board, but to give you a representative example, Schwab showed one client down about 32% on both FAIRX and FAAFX. Adding back the dividends, they were really only down 10%. Disappointing, but not devastating like the initial numbers indicate.

We're unlikely to see a resolution on this any time soon, so just remember that any bigger red number you see attached to FAIRX or FAAFX carries an asterisk.

1982 All Over Again?

We've **written previously** (and even **made a video**) comparing today's economy and market to what investors faced in 1982. When we saw this chart, we figured it was worth passing along with little additional commentary necessary.

	1982	Today
Fed Funds Rate	18.00%	0.50%
10 Year Treasury Yield	15.00%	2.30%
Mortgage Rate	16.25%	3.87%
Household Debt to Income	62.00%	130.00%
U.S. Government Debt to GDP Ratio	30.00%	105.00%
Total U.S. debt to GDP Ratio	.90x	3.60x
Productivity Growth	2.00%	0.25%
Annual Inflation Rate (CPI)	8.00%	1.60%
Personal Savings Rate	10.00%	5.00%
Labor Force Participation	64%	63%
S&P 500 - CAPE10	7	26
S&P 500 - Median Price to Sales Ratio	.50x	2.20x
Median Age Baby Boomer	26	60
Global Trade Barriers	Falling	Rising

As always, we're thankful to have such great (and patient!) partners in this wealth creation journey.

Jake & Lonnie

Performance since Jan 2008*

FSI (after all fees)	+78.3%
S&P 500 (w/ dividends)	+85.7%

* Based on auditable track record of our flagship The 5505 Fund formerly named RCM Partners Fund.

FARNAM STREET Investments

FARNAM STREET INVESTMENTS
1847 Iron Point Rd, Suite 180 Folsom, CA 95630

916.542.2008
www.farnam-street.com