



What's My Guru Talking About?

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May 23, 2007

Warren Buffett has been advocating for quite some time that small investors put their savings into index funds. It seems an ironic stance from someone who became the third wealthiest person on the planet primarily from investing in undervalued stocks. He has outperformed the indexes by a wide margin for longer than I've been alive -- the book value of his **Berkshire Hathaway** has grown 21.4% per year, after tax, versus the S&P 500's 10.4%.

So that's double the index. Right? Well, no, it's really way more, because those results began in 1965, so by the power of compounding, Buffett's results are nearly *56 times* the index.

The key to success

It's true that the market beats two-thirds of all money managers over most periods. But that also means that one-third of the managers are worth investing with. And as Buffett has proved, and rightly pointed out in the past, value managers who practice their trade properly can be expected to outperform the market.

The value proposition

Value buyers essentially aim to construct portfolios out of 50-cent dollars -- stocks that trade for half of their [intrinsic value](#). Not easy to find. Sometimes, only 70-cent dollars or higher are available. But, the value investor will ask, why would you ever want to pay 100 cents -- fair value? And if you can find a value manager who has shown an ability to outperform the markets using this approach, why shouldn't you try allowing his or her outperformance to compound your funds to much higher long-term results?

Value investors have shown an ability to hold their own in down markets, even when index investing was clearly not much fun through the onset of the new millennium. While indexers were forced to own index stocks such as **GE** (NYSE: [GE](#)), **Microsoft** (Nasdaq: [MSFT](#)), and **Cisco** (NYSE: [CSCO](#)) at nosebleed valuation levels that still remain below their peaks, value investors could pick and choose their undervalued selections from the thousands of listed companies. And we did. We made money for clients in those down years and shorted some of the stocks with nonsensical valuations.

Beating the market with value

Like Buffett did years ago, we could also assemble a list of value managers who buy stocks as if they're buying the whole company and at discounts to their appraisals of fair market value,

whether it's mutual fund managers like Fairholme, Longleaf, Third Avenue, Oakmark, and RS Partners, or long/short hedge-fund managers like Glenview, Akre, Greenlight, and Canyon -- to name only a few.

The managers behind these names have delivered market-beating results by a wide margin, net of all fees -- fees that Buffett mocks. While we do agree with him that a 2% fee and 20% profit participation with no hurdle is excessive, one *can* find managers who outperform even with high fees. Our own firm, much like Buffett's original partnership, charges a 20% performance fee, though only when we beat an 8% hurdle, net of all expenses. Buffett himself does not expect market returns to exceed 8% per annum. So shouldn't a manager be rewarded for being able to beat an index-like return? Since our organization's inception in October 1998, our Long/Short Composite has [compounded at more than 30% annually](#).

Big investors such as pension funds have more limited opportunities, but if you're a small investor, find a value manager who has a sound strategy, a disciplined approach to value, and a solid above-market historical track record. And let the power of compounding work for you, too.

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Microsoft and Berkshire Hathaway are Motley Fool Inside Value recommendations. For more value picks, [take a free, 30-day peek](#) at the service.

Fool contributor [Randall Abramson](#) is CEO and a portfolio manager with Trapeze Asset Management. He does not own shares in any of the companies mentioned. The Motley Fool has a [disclosure policy](#).

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