

Insight & Comment

There won't be another Buffet because no one will have his advantages

The world is moving in the opposite direction to Berkshire Hathaway

TERRY SMITH



"I shall not look upon his like again," declares Hamlet, ruminating over the loss of his father at the beginning of the play. Since Warren Buffett announced his retirement from Berkshire Hathaway this month, financial commentators have been asking themselves the same question: can anyone live up to Buffett's successes?

And they are remarkable. Buffett started to use Berkshire Hathaway — a New England textile business — as his investment vehicle in June 1965. Over the next 60 years he managed to compound the Berkshire share price at 20 per cent a year, a rate twice that of the S&P 500, a fantastic record, as we have spent the past two weeks hearing about.

To determine whether or not someone can match Buffett's record we first need to examine how he achieved it. Buffett was a good stockpicker, but this alone does not account for Berkshire's performance, and in

any event it was not solely his ability which drove this aspect of its returns. He was able to forge an effective partnership with Charlie Munger, Berkshire's vice-chair, who died in 2023. Munger must have some of the credit for turning Buffett from an investor obsessed with valuation — that led to him controlling an ailing textile company — into a quality investor who sought good businesses which could compound in value. He also helped educate the Sage in the use of float.

Buffett first encountered float in two businesses. One was American Express during the era of travellers' cheques. Before credit and debit cards became ubiquitous, travellers managed their cash requirements by purchasing travellers' cheques before venturing abroad. They paid for them in advance of use and commonly bought more than they needed. The result was that Amex had a free float of cash.

The second was trading stamps. To have experienced trading stamps you would have to remember the 1960s and 70s. They were an early form of loyalty programme. Shoppers were given stamps as a percentage of each purchase which they stuck in a book and when it was filled they could exchange it for household goods — a toaster was a popular item. The supermarket had to purchase the stamps in advance of issuing them — hence the float in the hands of the issuer. Buffett experienced the benefits of this through Berkshire's ownership of Blue Chip Stamps, which came courtesy of Munger.

Buffett's stockpicking aptitude was amplified by the use of leverage — money which did not belong to Berkshire's shareholders. On average, he leveraged Berkshire's portfolio by about 1.6:1. Leverage can take many forms. You can borrow money and hedge funds can obtain leverage by shorting some stocks.

Float is another form of potential leverage — you can use the cash which you have in advance to invest. Berkshire's leverage came from another source of float — insurance. Starting with Geico, Berkshire owned a series of insurance operations. Providing it wrote at least the same amount of insurance each year it had the insurance premiums, received at the outset of the cover, to invest. If underwriting losses are contained, the result can be a free source of funds.

The final advantage Buffett enjoyed is that Berkshire is a closed-end company, which he controlled. Most funds are open-ended. The result is that money invariably arrives and leaves at the worst times in terms of market opportunities. There are other closed-end investment vehicles such as investment trusts — but their managers

do not control them.

Given that even the best active managers experience periods of underperformance, it is likely that at some point the trust will trade at a discount to NAV and face calls to take action, such as buy back shares, or even liquidate the fund and/or replace the manager. As he held a controlling stake in Berkshire Hathaway, Buffett never faced such problems, even though he experienced periods of underperformance, and so was able to stick to his strategy.

I'm afraid I agree with the gloomy prince of Denmark. In my view, no one will be able to replicate Buffett's performance record as no one else will be able to replicate these advantages. Apart from the absence of Buffett himself and Munger, it seems unlikely that any regulators will allow someone to control an insurance company and invest the premiums in equities. Invest-

ment grade bonds will be required.

Second, when it comes to the fund's structure, the world is moving in the opposite direction to Berkshire Hathaway. The overwhelming majority of new funds and flows into funds are directed into ETFs, whether actively managed or index tracking. These are subject to intraday flows of funds and are the diametric opposite of Buffett's vehicle. There is no chance that any of them would survive years of underperformance no matter how well founded their long-term strategy.

But there are things we can learn from Buffett. Some maintain that the fact that Berkshire never paid a dividend settles the long-running debate about whether investors should seek income from equities. They are both right and wrong. It does resolve the debate, but it is not true that Berkshire never paid a dividend.

It paid one of 10 cents a share on January 3 1967 to give a total distribution of \$101,755. However, Buffett quickly realised that distributing earnings from a company which was able to compound at 20 per cent per annum was folly and no further dividends were ever paid.

If, instead of paying the dividend it had been retained in Berkshire's stock, it would have been worth about \$4.8bn today. Nonetheless, you will continue to hear advisers, commentators and managers of income funds tell you that the majority of the return from equities is from dividends. That Warren Buffett – what does he know?

Terry Smith is the chief executive and chief investment officer of Fundsmith LLP. The views expressed are personal