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Quality is Missing the Point

Dear fellow investors,

I got very excited when I came across an excerpt from Jordan Ellenberg's book, *How Not to Be Wrong*. His book was written to teach readers how much logic and common sense is provided by math. He tells the story of Abraham Wald during World War II, who worked for the Statistical Research Group (SRG). The SRG was a group of mathematicians who sought to improve the U.S.'s chances of success by analyzing data on a myriad of subjects. The case that opens Ellenberg's book is how Wald approached analyzing bullet holes on planes that came back from missions. Below is the data that was provided in the book:

Section of plane	Bullet holes per square foot
Engine	1.11
Fuselage	1.73
Fuel system	1.55
Rest of the plane	1.80

The army officers wanted to reinforce the planes with armor to protect them during missions. You didn't want too much armor, due to weight and fuel usage. You didn't want too little to protect the plane either. You needed it where it was most efficient. The officers wanted to reinforce the planes where the bullet holes were in the highest numbers. As Ellenberg notes, Wald had separate mathematical reasoning for his recommendation. His ultimate mathematical conclusion was survivorship bias.

Wald looked at the same data as the officers. Yet he came to the opposite conclusion. In a Charlie Munger-esque way, his mind knew to invert what others saw. He knew the armor needed to go where the bullet holes were the least. His reasoning was that they weren't analyzing the planes that didn't come back. The planes that got hit in the engine never made it back. The likelihood of a successful voyage was much higher if the other parts of the plane were hit by bullets. In the engine, the odds were much closer to zero.

We love this logic because the same thing is going on in common stock markets as we speak. Investors are looking at stocks, money managers and strategies that have done well the last 10 years, trying to ascertain where success will be achieved going forward. They are only looking among the survivors.

As an example, we were on a call with a potential investor last week, who explained that he had started his career at a deep value-oriented investment management firm. He said he doesn't believe that this is what creates the best returns. He told me that quality is far more important than people can understand. I was captivated by his statement as I thought about Wald's story.

People my age (mid-thirties) in most cases have only seen 10 years of markets, though I've been luckier to have seen fourteen years. Voracious reading and working with my father have helped me supplement the decades prior. The planes that have come back in today's stock market still must pass one test. Are they indicative of the overall population of common stock experiences?

As Ellenberg's writing keeps it simple, we will keep this simple by sampling the movement of the 10-largest-market-cap companies every decade, since 1980.

1980	1990	2000	2010	2020
1. IBM	1. IBM	1. GE	1. ExxonMobil	1. Microsoft
2. AT&T	2. Exxon	2. ExxonMobil	2. Apple	2. Apple
3. Exxon	3. GE	3. Pfizer	3. Microsoft	3. Amazon
4. Standard Oil of Indiana	4. Phillip Morris	4. Citigroup	4. Berkshire Hathaway	4. Google
5. Schlumberger	5. Shell	5. Cisco	5. General Electric	5. Facebook
6. Shell	6. Brystol-Myers Squibb	6. Walmart	6. Walmart	6. Johnson & Johnson
7. Mobil	7. Merck	7. Microsoft	7. Google	7. Berkshire Hathaway
8. Standard Oil of California	8. Walmart	8. AIG	8. Chevron	8. Visa
9. ARCO	9. AT&T	9. Merck	9. IBM	9. Proctor & Gamble
10. GE	10. Coca-Cola	10. Intel	10. Proctor & Gamble	10. JPMorgan Chase

As you can see from this table, the largest market caps in the S&P 500 tend to be very cyclical. This is why planes not making it back are somewhat unlike stocks. Most stocks don't disappear. They languish. Languishing is awful, but it's not fatal like a hit to the engine.

As an example, IBM was the largest market cap in 1980. It was also that in 1990. This wasn't because it succeeded more. It was just so large to start. It massively underperformed the S&P 500 to stay at the top during that decade. Oil companies were seven of the ten largest companies in 1980 and only two of them made it to 1990. Poor stock performance didn't cause IBM to disappear as one of the largest market caps, but it did for five energy companies from 1980 to 1990. You'll notice the only one on the list by 2000 was a merger of two of 1980's biggest, Exxon and Mobil. Not exactly the way you want to stay big.

In 2000, tech showed up with Cisco and Microsoft and pharma was represented by Pfizer and Merck. By 2010, Microsoft stayed (despite miserable price performance) while Cisco, Pfizer and Merck languished their way off the list.

Look for what's missing on the board of largest companies, not what is there. This is only a sample of the current stock market. It may not be representative of the overall population of common stock success/returns. Are we like the military officer only looking at the survivors to determine our decisions for the future?

Fawning over the survivors

Back to the potential client call. What the dialogue with them made me feel is that investors are emulating the same people and attributes at the same time because they can see all those attributes in the survivors (read: winners) and among the most praised managers/strategies in our industry. Quality is an overused word to describe the winners (surviving planes) of today's stock market. People will explain the profitability or return-on-equity of a company like Microsoft. In my mind, it's like explaining the fuselage's ability to take bullets when all that should be focused on is whether the engine is well armored. The only way to measure that from a historical perspective is to ask the question, has success come to investors paying 40x earnings for a stock from the 10 largest market cap list? Chance of fatality is low, but it's usually just another chance to languish.

The common sense of mathematics is no different than economics. Quality (QmJ) is a powerful factor in investing, as Cliff Asness and his colleagues have laid out in their work and as Munger has espoused during his life. However, when economic thought strays to believe that quality overcomes all other factors, like the value factor, you run into problems. Ellenberg writes: "As a mathematical discipline travels far from it empirical source, or still more, if it is a second and third generation only indirectly inspired by ideas coming from 'reality' it is beset with very grave dangers…at a great distance from its empirical source, or after much 'abstract' inbreeding, a mathematical subject is in danger of degeneration." Once again, the mathematical advantage of quality is no different. Quality at any price is a degenerate idea.

The managers that didn't survive

For young, aspiring investors, there is one problem for survivorship-bias stocks: What should you do if the survivors don't show you what you need to know? If quality is overpriced, what places would you go to find managers that execute disciplines which are unwilling to pay insane valuations for some of the greatest American businesses? The managers that come to our mind as we think about price sensitive, book value-

oriented investing are people like Ben Graham, Sir John Templeton, John Neff, Michael Price and Marty Whitman. They are investors that would be associated with what the investment industry would term deep-value strategies.

There are very few role models as the market has put these styles of investing and investment disciplines out of business, due to sheer lack of interest or trust. Understanding book value is considered a dead art to the point where Warren Buffett has given up on book value as way to measure the progress of Berkshire Hathaway.

Buffett began as early as 12 months ago buying the five largest Japanese trading houses. THESE COMPANIES HAVE DONE TERRIBLE OVER THE LAST 30 YEARS! Why are Charlie and Warren sinking capital into these? We have a two-part suspicion: 1. These businesses are trading below the book value of the equity on their books. 2. These are the planes that didn't come back. They've been a terrible investment which means no one is picking through the dead for investment merit. These companies have much of their operations tied up in commodity-oriented businesses that would be best understood by a manager with a deep-value or book value-oriented discipline.

In the recent past, Charlie and Warren had looked among the healthiest and most expensive of the survivors that trade with no relation to their book value in U.S. stocks. Maybe Charlie and Warren are reminded of their Sunday School classes in their old age. After all, when the followers of Christ showed up at the tomb looking for Jesus, the angels asked His followers, "Why do you seek the living among the dead?" Like Wald, we advise you to beware of the information that you look at among the survivors! They may cause you to draw the wrong conclusions. You'd be missing the point.

Warm regards,

Cole Smead, CFA

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