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Portfolio Management: Which Risks to Take

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Dear Fellow Investors,

At Smead Capital Management, we make it a practice of constantly reviewing our discipline of stock selection and portfolio management. Like a sports agent compares athletes, one of the ways we do this is to follow competitors with proven track records of success. Many portfolio managers of U.S. large-cap equity funds have had a very difficult time during the last several years in the U.S. stock market. The market has been especially harsh on many high-conviction, long-duration portfolio disciplines lately. What do history and current circumstances teach us about our stock picking discipline?

To answer these questions, we draw on Mark Twain, who said, "History doesn't repeat itself, but it rhymes!" The worst thing I have ever sat through as a portfolio manager was the last two years of the tech bubble of 1994-2000. From April of 1998 to March of 2000, the technology and telecom sectors grew to be close to 40% of the S&P 500 Index and caused huge gains, while the other eight sectors went virtually nowhere. Unwillingness to own tech at ridiculous prices was tortuous. Under-performance among value managers was rampant, as PE multiples for non-tech companies continued to shrink. How would an investor know that the tech bubble was about to break?

Many events contributed to the tech bust starting in March of 2000. In our opinion, three events happened in a three-month stretch in early 2000 which convinced us that things were about to change and signified the end of that phase in the market.

On January 12, 2000, one of Fidelity's most successful managers, George Vanderheiden, "retired." Vanderheiden was only 54 years old and ran three of Fidelity's most impressive funds, Fidelity Destiny I and II, and the Fidelity Advisor Growth Opportunities Fund. Here is how *theStreet.com* reported his circumstances:

> *"Fidelity Wednesday announced the retirement of George Vanderheiden, who manages three funds and $36 billion for the $589.1 billion Boston fund heavyweight.[…]*
>
> *More recently, however, the fund's performance has sagged. Vanderheiden couldn't justify buying technology shares at thin-air valuations and the fund posted a paltry 5% return last year.*
>
> *In 1998 and 1999, Vanderheiden came under fire for poor performance. Last year the fund's shareholders approved the removal of performance-based fees on the fund. Still, he says his retirement from portfolio management is voluntary."*[1]

It is not outlandish to say that Vanderheiden was one of the four most successful stock pickers of the last fifty years at Fidelity.

On March 22, 2000, Oakmark forced out the manager of their very successful flagship fund for very similar reasons to why Fidelity eliminated Vanderheiden's position. We will rely on the *Wall Street Journal* to remind us of the circumstances:

> *"Robert Sanborn, the mutual-fund manager who comes closest to being a poster child of Old Economy investing, has stepped down as manager of Oakmark Fund after several years of dismal investment returns.*
>
> *The shift in managers underscores how difficult it has been for value adherents to produce solid returns in a stock market that has rushed to embrace fast-growing technology stocks at the exclusion of almost anything else. Over the past few years, Mr. Sanborn has shunned the New Economy technology stocks, arguing they are too expensive.*[2]

Lastly, Julian Robertson was a successful portfolio and hedge fund manager. He ran the $6 billion Tiger Fund. In late March of 2000, he threw up his hands, declared that he didn't understand the stock market anymore and announced he was liquidating his multi-billion dollar portfolio. The *New York Times* covered the story this way:

> *"The financial markets humble ordinary investors all the time. In Julian H. Robertson Jr., head of Tiger Management, they have humbled an investing giant.*
>
> *After 20 years of generating superlative investment returns by buying stocks that were undervalued and selling short those that carried excessive valuations, Mr. Robertson, 67, confirmed yesterday that he was shutting Tiger's operations. He has essentially decided to stop driving the wrong way down the one-way technology thoroughfare that Wall Street has become."*[3]

Notice the commonality of the three announcements. Vanderheiden and Sanborn were shown the door and treated like their poor performance in 1998-1999 was due to an obvious decline in their skills as portfolio managers. The "retirement" came from parent company frustrations via investor withdrawals due to the greater excitement and short-term results in tech-oriented portfolios. Robertson fired himself and admitted that he didn't believe in a finance world void of value investing, thinking that there was no place for him at a table of futuristic speculation. The bottom line and the temporary sin was avoidance of the biggest bubble in the stock market since the 'Nifty-Fifty' stocks of 1970-1973.

Was there anything we could learn to enhance our discipline by avoiding what these managers went through? The answer is not only no, but we actually exist and get our long-term success by being lonely and contrarian in our view of the U.S. stock market. After all, our theme song is "Only the Lonely Can Play."

This brings us to today and the resignation of Robert Goldfarb as the lead portfolio manager at Sequoia. Here is the *Financial Times*' version of the announcement:

> *"The Sequoia Fund, the $5.6bn mutual fund with historic ties to Warren Buffett, said on Wednesday that Bob Goldfarb, its manager for the past 36 years, would retire following huge losses on its investment in Valeant Pharmaceuticals.*
>
> *"While we have beaten the market over the past decade, through the end of 2015, our investment in Valeant has diminished a record that we have built over two generations and in which we take great pride," he said.*
>
> *The Sequoia Fund, the flagship fund at New York fund manager Ruane, Cunniff & Goldfarb, traces its origins back to 1970 and Mr. Buffett's decision to wind up his first investment partnership; he told his early investors to put their money instead with Bill Ruane, his friend and Sequoia's first manager."*[4]

Goldfarb accepted the blame for over-staying Sequoia's welcome in their formerly mega-successful position in Valeant Pharmaceutical. He also took credit for the mistake of adding to the position in the fall of 2015 on the way down. We as a firm believe that there are things to learn as high-conviction stock pickers from this episode at Sequoia and the examples of history.

Sequoia had always been a concentrated fund, but its concentration had been centered around owning Berkshire Hathaway. Valeant effectively used borrowed money to create a fund of healthcare companies and Sequoia put the same amount of confidence in Valeant's CEO as they had put over the years in Warren Buffett, from a position-size standpoint.

Ironically, Goldfarb and Sequoia have had two prior major underperformance streaks in its 45-year history. They underperformed in their first four years during the height of the 'Nifty-Fifty' stocks from 1970-1973. They lagged during the tech bubble when the other highly thought of managers got knocked out of the box (the baseball season just started, after all). Hear the rhyme?

We believe our readers can benefit from this discussion because of what it tells us about portfolio management. We can learn a great deal about the risks worth taking and the ones that warrant avoidance. Like Sanborn and Vanderheiden, our discipline does not require us to apologize for taking a contrarian stance, even of the most unpopular sort. We currently believe that the major banks are historically cheap and worth participating in. We own numerous old-media stocks that tech fans believe will not exist in ten years. It is hard not to buy even more of our favorite healthcare stocks which politicians have scared most investors out of. We are getting very favorable prices from the lack of cheery consensus in these areas.

These vignettes can also give strong anecdotes towards risk management. While we actively let our winners run, we will also trim our positions once they grow to 8-10% of our portfolio. Sequoia's results would have suffered in 2013 and 2014 from trimming back on their position in Valeant, but it would have saved them the current torture chamber and Robert Goldfarb's sword could still be a decoration on the wall. His resignation is sad because of the good stock picking discipline he practiced over 45 years at Sequoia!

Secondly, we believe it is possible that Mr. Goldfarb had a vision of repeating his long experience with Berkshire Hathaway, a buyer of businesses, in the shares of Valeant, a healthcare conglomerator. Even Warren Buffett has over-stayed his welcome in companies over the years. He admitted he should have been selling Coke and Gillette when he called them "the inevitables" back in the 1990s.

In conclusion, contrarian investing as practiced in a concentrated portfolio with low turnover is an easy thing that is hard to execute. We are thankful to be able to examine other successful disciplines and learn more about which risks to take and which ones to avoid.

Warm Regards,

William Smead

[1]Source: TheStreet (http://www.thestreet.com/story/859968/1/fidelitys-vanderheiden-retires.html)
[2]Source: Wall Street Journal (http://www.wsj.com/articles/SB953681829305722131)

[3]Source: NY Times (http://www.nytimes.com/2000/03/31/business/the-end-of-the-game-tiger-management-old-economy-advocate-is-closing.html?pagewanted=all)

[4]Source: Financial Times (http://www.ft.com/intl/cms/s/0/0fa7d92a-f149-11e5-9f20-c3a047354386.html#axzz44bZKtatb)

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