

**Leithner
& Co.
Pty. Ltd.**

Australian Financial Services Licence 259094
Street Address: Level 3, Benson House, 2 Benson Street, Toowong Qld
Postal Address: P.O. Box 4019, St Lucia South, Queensland 4067

Tel/Fax: (07) 3870 3550
E-mail: info@leithner.com.au
Website: www.leithner.com.au

Eight Distinguishing Features

Updated March 2009

In the past 50 years, mutual funds [which in Australia are usually called “managed funds”] have gone from a \$2.5 billion also-ran in the financial-services industry to a \$7 trillion titan. Funds now enjoy an unchallenged position of leadership, accounting for 70% of the \$2 trillion that U.S. families added to their savings over the past five years.

But while mutual funds may be the best game in town, they aren’t playing nearly as good a game as they should. The returns of fund shareholders in stock, bond and money markets have fallen far short of what is available in those segments. A diminishing focus on stewardship, shrinking investment horizons and soaring costs are responsible. The mutual fund industry has lost its way.

I’ve been studying mutual funds since 1949, when I began researching my senior thesis at Princeton University. The change in industry direction has been dramatic. Back then, the mutual-fund industry was more a management business than a marketing business; today the reverse is true. We have moved from treating funds as investment trusts designed to serve their owner-beneficiaries to treating funds as consumer products, designed to attract the largest possible assets. This new approach has ill-served the interests of [investors].

John C. Bogle
[How Mutual Funds Lost Their Way](#)
(*The Wall Street Journal*, 20 June 2000)

1. A Private Company and Not a Managed Fund

Leithner & Co. Pty. Ltd. (LCO) is a private company, limited by shares and based in Brisbane, which specialises in the purchase of securities.¹

LCO is a private company and not a managed fund (unit trust). This structure has important implications for its operations. A corporate rather than a unit trust structure facilitates long-term and “businesslike” investment operations. LCO’s focus is not upon shares or bonds; and still less is it upon fluctuations of their prices from day to day, month to month, etc. Businesslike investment operations stress the businesses (or loans) to whose earnings (or payments of interest) our part-ownership entitles us. It also directs attention to the development of those businesses over the years. Hence LCO’s primary activity is not the *management* of businesses or the *trading* of securities: it is the *part-ownership* (i.e., selection and monitoring) of businesses and loans.

After they are purchased and until they are sold, the market prices of the assets owned by LCO (as opposed to the operations and results of the businesses underlying those assets) are irrelevant. These prices and their short-term ebb and flow affect neither LCO’s statement of profit & loss nor its balance sheet; accordingly, they do not affect the measurement of LCO’s results (see distinguishing feature 2). Hence

- the incentive of LCO’s shareholders to consider their company as a business whose progress is gauged through its financial statements;
- their motivation to focus upon the operations of the companies of which they are part-owners (or part-creditors);
- and (except to the extent that it provides an opportunity to buy securities more cheaply or to sell them at an inflated price) their rationale to ignore the fluctuations of those securities’ market prices.

Most market participants obsess about market prices and their ups and downs from one day, week or month to the next. This is because the unit trust structure of the vast majority of investment vehicles encourages them to do so. A unit trust is *open ended* – that is, each time a new investor enters the trust (or an existing one invests more money) new units are created; and each time an investor withdraws some or all of his investment, units are redeemed. The price of units varies in direct proportion to the variation of the fund’s *net asset value*. If, for example, the current market valuation of a trust’s assets is \$1,000

¹ Like many private companies, LCO has more than one class of share. These are Class C (owned by Leithner Investments Pty Ltd) and Class E (which others, such as individuals, companies, family trusts and self-managed superannuation funds, own in their capacity as Equity investors). Point 4 below shows how the Company’s profits, if they materialise, are allocated among these two classes of shares.

and the trust comprises 1,000 units, then its NAV is \$1.00. Each time that money is invested, new units are created to match the prevailing unit buying price; and each time units are redeemed, the assets sold match the prevailing unit selling price. A unitholder leaves the trust by “cashing out,” i.e., by requesting that the trust redeem his units. The basis on which the trust does so is typically the units’ NAV on the day the redemption is requested – which, in turn, stems from the market prices of the securities the trust owned on that day. Hence the relentless and obsessive focus upon market prices, short-term “performance” and the association of prices to performance.

In sharp contrast, shareholders of a corporation like LCO have no direct claim to its *assets*. Rather, they have a claim to its *earnings* – *if they eventuate* – and if the company is wound up or liquidated, they have a claim to its *equity* (if it exists). He who owns shares of Woolworths Ltd, for example, is not a part-owner of Woolies’ assets and thus cannot present himself at a Dan Murphy’s or BWS outlet and proceed to help himself *gratis* to bottles of Bundaberg Rum. Unlike unitholders, shareholders don’t “cash out;” instead, a shareholder sells his shares to a third party. This transaction, which leaves the number of shares unchanged, does not affect the corporation and thereby doesn’t oblige it to sell assets.

The phrase “claim to the company’s earnings” is used in order to emphasise the importance of the Statement of Profit-and-Loss and its relationship to the Balance Sheet. In sharp contrast, unit trusts seldom emphasise and sometimes do not even mention them. Hence the counter-intuitive point: it’s in the short-term interest of LCO shareholders that the market prices of the assets that LCO has purchased *fall*. As long as their ability to generate earnings remains intact, more of a good thing can be bought at a lower price, increasing the earnings relative to the amount spent in order to generate them.

2. Businesslike Measurement of Results

LCO’s structure as a private company also has fundamental implications for the measurement of its results. Here, too, the key term is “businesslike.” Unlike a managed fund, its results have everything to do with the dividends generated by the businesses of which it is a part-owner (and the payments of interest from the debt of which it is a part-owner, etc.) and nothing to do with either the price volatility of the stocks or bonds, or their level at a given point in time. As a business, LCO’s results are gauged like that of any other business: in terms of its earnings, return on equity, etc.

To understand this point fully, consider LCO’s shares. Each has been and will continue to be issued to existing and new shareholders in exchange for \$1.00. The initial choice of \$1.00 was arbitrary; but its maintenance at a constant level over time keeps everybody (i.e., existing and new shareholders) on an equivalent accounting (and, since we are sharing risk, moral) footing.

As a simple example, let us say that on 1 July (i.e., the beginning of the financial year) LCO's capital structure consists in \$1,000 and 1,000 shares. Its balance sheet thus consists in \$1,000 of assets (let us assume cash), no liabilities and therefore \$1,000 of shareholders' equity (i.e., assets minus liabilities). It also follows that LCO has a book value of \$1.00 per share (i.e., shareholders' equity divided by the number of shares). Let us now say that during the financial year LCO buys 1,000 shares of X Ltd at \$1.00 per share. Its balance sheet still comprises \$1,000 of assets. The form of these assets, however, has changed: what was \$1,000 of current assets (i.e., cash) has now become \$1,000 of non-current assets (i.e., investments). As before, there are no liabilities, \$1,000 of shareholders' equity and book value is \$1.00 per share.

To extend this example, let us say that during the financial year LCO receives a dividend of \$100 from X Ltd. For simplicity, let us also ignore taxes, expenses, etc. If no other income is received before the end of the financial year, then *LCO's return on its equity for the financial year is thus 10%* (i.e., \$100 of earnings ÷ \$1,000 of assets). At the end of the financial year its assets have increased by \$100 and its balance sheet consists of \$100 of cash and \$1,000 of investments, making a total of \$1,100; it has incurred no liabilities and issued no other shares and thus has \$1,100 of shareholders' equity; and its book value is \$1.10 per share (i.e., \$1,100 of assets ÷ 1,000 shares).

Clearly, then, "return" has nothing to do with assets' market prices and price fluctuations; rather, it has everything to do with the cash generated by those assets and hence the earnings appearing on LCO's P&L. The return to LCO shareholders is thus the cash (net of costs, taxes, etc.) generated by their equity – not the changes in the quoted market price of LCO's assets. It is no accident that Mr Buffett normally begins Berkshire Hathaway's Annual Letter by stating that year's return on shareholders' equity; equally significantly, his most celebrated purchases such as See's Candies, *Buffalo News*, etc., remain on Berkshire Hathaway's balance sheet at their initial purchase price.

Let us now assume that LCO pays the entire \$100 to its shareholders in the form of a dividend. That creates a current liability on its balance sheet. Note that the form of the dividend – i.e., whether it is paid to shareholders as cash or additional LCO shares – does not affect this point. After the declaration of but before the payment of the dividend, LCO's balance sheet looks like this:

Assets	Liabilities
\$ 100 Cash	\$ 100 Dividend Payable
\$1,000 Investments	\$1,000 Shareholders' Equity
-----	-----
\$1,100 Total	\$1,100 Total

Given in this example that LCO has 1,000 shares on issue, its book value is $(\$1,100 - \$100) / 1,000$ or \$1.00 per share. After the payment of a (say) cash dividend, LCO's balance sheet looks like this:

Assets	Liabilities
\$1,000 Investments -----	\$1,000 Shareholders' Equity -----
\$1,000 Total	\$1,000 Total

If the dividend were paid in the form of additional shares, which is LCO's normal practice, then its balance sheet looks like this:

Assets	Liabilities
\$ 100 Cash \$1,000 Investments -----	\$1,100 Shareholders' Equity -----
\$1,100 Total	\$1,100 Total

In each case, the share's book value remains at \$1.00. Repeating this process over time, a shareholder's per-share dividend may remain static but (because her holding of LCO shares increases over time) the absolute size of the shareholder's dividend stream may increase. Similarly, new shareholders can join on the same moral and accounting basis (i.e., \$1.00 of per share book value) as existing shareholders.

3. Graham-and-Buffett "Value" Investment Philosophy

LCO adheres strictly to a businesslike, long-term, "value" approach to investing. LCO is a value investor in the manner practiced by [Benjamin Graham](#) (for a detailed description of this approach, see LCO's [Investment Philosophy](#)). Graham-style value investors share several identifying characteristics:

- they invest on the basis of underlying value, and never on the basis of popularity with other investors, commentators or other "experts";
- they buy only at prices which provide a significant "margin of safety";
- they strive to hold securities for the long-term (typically five years and often much longer); and at all times
- they embrace logic and reject emotion, popularity, fashion and conventional wisdom as a basis for their decisions.

4. Sharing of Risks and Rewards

Graham-Newman Corporation (1926-1955) and Buffett Partnership Ltd (1955-1969) shared [risks](#) and rewards in a unique way that harmonised the interests of stewards of capital (who were also investors) with those of other investors. As

a consequence of this concord, and Graham's "value" approach to investment, over time they achieved outstanding results for both investors and stewards.

LCO has adapted the spirit and structure of Graham-Newman Corp. to Australian legal and taxation conditions.

Most importantly - and unlike virtually all other Australian investment vehicles – the Company levies no management fees. Further, Directors derive no benefit from the Company's investments until Class E shareholders have done so.

Each year's investment returns (if any) are allocated among shareholders as follows: the first five percentage points of any return will accrue to Class E shareholders (as dividends in the form of either cash or additional shares); and any return above this threshold will accrue equally (again, either in the form of dividends or bonus shares) to Class E shareholders and the Class C shareholder.

As a simple example, let us say that the Company earns a return of 10% on its investments (see distinguishing feature #2). The first five percentage points of this return will accrue to Class E shareholders; and of the remaining five percentage points, one half (2.5 percentage points) accrues to Class E shareholders and the other half (again 2.5 percentage points) to the Class C shareholder. If the Company earns a return of 10% on its investments, then Class E shareholders will receive three quarters of it on a pro-rata basis and the Class C shareholder will receive the remaining quarter.

Notice, then, that if the Company earns 5% or less from its investment portfolio, then the Class C shareholder receives no return whatever. Further, in order to receive compensation equivalent to 2.5% of LCO's assets – which a large number of funds managers receive regardless of the gains or losses they generate – LCO's Directors must generate profits that are equivalent to 10% of the Company's equity.

The Class C shareholder sits last at the dining table, and receives a helping only after Class E shareholders. If the Class C shareholder wishes to earn a return from the Company's activities (which it most assuredly does), then it must ensure that Class E shareholders first do so. Further, the better are the returns for Class E shareholders, the better is the return for the Class C shareholder. The self-interest of LCO's Directors and Class C shareholder thus harmonise with the self-interest of its Class E shareholders.

The contrast of this arrangement with institutional investment managers and unit-trust structures is stark. With few exceptions (the larger the investment institution, the less likely is the exception), investment managers shoulder relatively little investment risk and yet obtain much of the reward from the

management of other people's money. Moreover, they seldom invest large amounts of their own capital in the funds that they manage, and virtually always charge management fees regardless of the results which they obtain for their investors. Because, in effect, they do not eat their own cooking, other investment managers have surprisingly little incentive to cook well. Perhaps that is why surprisingly few of them feed their investors well.

5. Sticking To Basics

LCO's incentive structure gives its Directors a strong incentive to invest conservatively and for the long term. It also allows LCO to stick resolutely to basics. Although it tends to buy securities that others regard as anathema, it does not use instalments or other warrants, call and put options, futures contracts and other popular – and, as Graham, Buffett and others believe, speculative and dangerous – derivative financial instruments. Nor does LCO borrow money. These constraints will cause the Company to forego what others might regard as exciting short-term opportunities. At the same time, however, they reduce the [risk](#) to shareholders' capital and thereby facilitate reasonable long-term results.

6. Transparency of Operations

Twice each year, after the conclusion of the financial year and also at its half-way point, LCO reports its results to its shareholders. And at regular intervals between the Annual and Half-Year reports, Newsletters describe developments that directly or indirectly affect the Company.

Chris Leithner writes Annual Reports and Half-Year reports with a view towards what he would want to know if his position and that of Class E shareholders were reversed. Absent, therefore, are costly irrelevancies and distractions such as glossy paper (too expensive), colour photos (LCO's Directors are too ugly) and catchy graphics (often incomplete or misleading). Instead, present are extended descriptions and explanations of Directors' actions – which are requisites to an understanding of LCO's current and future operations and the results they might produce.

7. Frugality of Operations and Avoidance of Hidden Costs

As important as the transparency of an investment vehicle's operations is the frugality of its operations. Fat dividends tend to be associated with thin corporate carpets; similarly, Charles Munger, Berkshire Hathaway's Vice-Chairman, has emphasised that the rationality of a business is inversely related to the opulence of its quarters.

LCO's approach to investment gives its Directors a strong incentive to act frugally. Value investing entails dispassionate analysis of financial statements

(which is a painstaking but low-cost activity): it does not require attendance at overseas conferences and sporting events, hosting extravagant entertainment, lobbying politicians in Canberra and other lowlifes, and undertaking “fact-finding” missions. Accordingly, because no management fee is levied upon shareholders and overhead expenses are pruned wherever possible, its Directors cannot indulge themselves in the manner to which most other investment managers are accustomed.

LCO’s structure as a private company also enables it to avoid a host of what have been described as “hidden” costs. Norman Sinclair, in a paper entitled “The Hidden Costs of Managed Investments” (prepared in July 1998 for the Australian Shareholders’ Association), analysed fees levied by investment vehicles structured as unit trusts. Sinclair concluded “the current state of play [in these large-scale unit trusts] leaves the average investor in a very disadvantaged position. Whilst managed investments are theoretically good for savings, they will remain expensive unless the gatekeepers can be converted to a more transparent and professional fee-for-service and the managers can be forced to more honestly describe the cost implications of their management style. Until that time, *caveat emptor* applies!”²

Managers’ investment styles may create significant costs for investors. Active managers tend to buy and sell (“churn their portfolio”) much more frequently than do passive managers who follow a “buy-and-hold” strategy. Two “hidden costs” in particular are attributable to overactive funds managers:

- *excessive transaction costs*: because the “churn” of their portfolio greatly exceeds the turnover of those who follow a buy-and-hold strategy, brokerage, stamp duty and other transaction costs are usually much higher for “active” than for passive managers. This means that investors in “active” investments tend bear high transaction costs. And the higher the costs, all else equal, the lower are the returns.

² A decade later, little has changed. [An IFSA Guide to Understanding Managed Investments](#), produced by the Investment and Financial Services Association and dated May 2007, distinguishes seven types of fees that a typical managed fund may levy. These include an *establishment fee* (“the fee to set up your account in the fund”); a *contribution fee* (“the fee for the initial and every subsequent investment you make to the fund, or that may be made on your behalf, e.g., by an employer”); a *withdrawal fee* (“the fee charged for each withdrawal you make from the fund”); a *termination fee* (“the fee when you close your account with the fund”); *ongoing fees* (“the total of all ongoing administration, investment management ex-pense recovery and other fees charged by the fund”); *switching fee* (“the fee charged when you switch between investment options offered by the fund”); and an *adviser service fee* (“the fee charged by your adviser for advice about your investments in the fund. An adviser may also receive other amounts as a commission”). See also the [Superannuation Fees Report 2008](#) prepared for IFSA by Rice Warner Actuaries.

- *early liability of capital gains tax*: a major implication of higher portfolio turnover is that capital gains are realised earlier (and the consequences are transferred to the investor sooner) than they would under a buy-and-hold strategy (see also LCO's [Investment Philosophy](#)).³

The costs of managed investments, overt and hidden, impose heavy burdens upon investors. John Bogle, dean of the American managed funds industry, has calculated that, net of expense ratios, turnover costs, sales charges and other expenses, the typical managed fund earned an average of 9.3% per year from 1984 to 2001 (versus 12.2% for the S&P 500). Yet after taxes, switching and other fees, the average investor in a managed fund earned just 2.7% per year during these years. *The Australian* (18 March 2002) cited a similar finding. "Most individual investors probably still don't know how badly they have done, but when they figure it out they will be angry and chastened."

According to Alan Kohler ("Throw Your Money Away: Put It in a Managed Fund," *The Australian Financial Review*, 19-20 July 2003), "it seems Australian equity fund managers lose less money for their clients than American ones; in fact, maybe don't lose much money at all. Roughly speaking, over the long term, local fund managers go close to adding just enough value to pay their fees – unlike their American counterparts, who get nowhere near it." A study prepared for Kohler by InTech (which, Kohler emphasised, contained "several biases that tilt the local numbers towards looking better than they really are") showed that "Australian fund managers have averaged a return 2.1% above the ASX/S&P 300 index. After fees, however, the outperformance would be closer to zero, and clients ... are underwater compared to the market indices." "The bottom line," says Kohler,

is that putting one's money with a "brand based" fund manager, like a bank, in which a large organisation operates an in-house investment bureaucracy, is simply another way of throwing it away. Some individuals, usually in smaller fund managers, do have a feel for investment and can, over a long period, do better than the market. But not many.

Another disadvantage of managed funds and their unit trust structure becomes painfully apparent during market slumps. During tough times, some funds may be forced to sell assets in order to meet heavier-than-usual requests for redemption. This happens because significant numbers of investors, panicked

³ The distribution that an investor receives from a managed fund has two main components: dividend income and net realised gains (i.e., the net profit incurred when the fund's manager trades the underlying shares). In a typical year, ca. 80% of the distribution is in the form of net realised gains. In most instances, the dividend income is partly or fully franked; but the realised gains carry no imputation credits and are therefore fully taxable. Given the potential CGT liabilities that the fund forwards to the investor, investors and their advisers must recognise that a fund's after-tax return may be considerably less than its published rate of return.

by the slump, rush to withdraw their money. At the same time, the extent of trading on the market typically falls, such that there simply aren't enough buyers of the securities of smaller or more speculative companies, and only the securities of the largest and most "liquid" companies can be quickly and easily sold. The result is that during slumps the unit prices of managed funds may fall particularly heavily. They fall because the prices of the securities these funds hold are falling; and prices are falling partly because the funds must raise cash (and thus sell shares) in order to meet investors' requests to redeem their units.

David Fried ([The Feeling Isn't Mutual](#), *Forbes*, 8 May 2002) concludes

one of America's most popular [investment vehicles], the mutual [i.e., managed] fund, is inherently flawed. Mutual fund investors tend to pay high taxes and high fees for an investment that invariably underperforms the S&P 500. Investors also often choose their mutual fund poorly, in part because making that choice is complicated by changing management, misleading marketing and confusing prospectuses and fee schedules. In addition, a successful fund one year tends to be a bad fund the next year. Even a fund with good returns year after year tends to have lower profits as the years pass. There are seven key reasons for these problems ...⁴

Because LCO imposes no management fees, and also because LCO's Directors and its Class C shareholder derive no benefit from the Company's operations until other shareholders have done so, LCO's Directors and its Class C shareholder have every incentive to minimise costs and not to burden shareholders with high overheads, extract hidden costs from their investors or otherwise increase the costs of their investment.

8. Defying the Institutional Imperative

Distinguishing features 1-7 allow LCO to ignore the institutional imperative – the lemming-like tendency to imitate others' behaviour, no matter how silly or self-destructive it is (see also [Principle #5](#) of LCO's Investment Philosophy).

At first glance it seems reasonable to suppose that funds managers within large organisations, having greater resources and expertise at their disposal, will achieve better results than their counterparts in small organisations. Alas, as

⁴ John Bogle ([How Mutual Funds Lost Their Way](#), *The Wall Street Journal*, 20 June 2000) concurs: "Investment horizons that are too short and costs that are too high are the principal problems facing the mutual-fund industry. The root cause of these failings is the industry's failure to focus on the primacy of the fund shareholder. It's called stewardship. The Investment Company Act of 1940 warns against organizing, operating, and managing funds in the interest of investment advisers rather than the interest of shareholders, but that warning isn't adequately heeded today. It is high time that fund managers and independent directors, as well as public officials and the media, give these issues the attention they deserve." Almost a decade later, *plus ça change, plus c'est la même chose*.

with lemmings so too with many large-scale institutional investors: each moves periodically, dramatically and irrationally in response to the behaviour of his peers. Warren Buffett has noted that periodic wild swings of share prices have much to do with the lemming-like actions and reactions of institutional investors. He has also noted that neither this erratic behaviour nor the failure of many institutions to create significant wealth for their clients is a product of poor intelligence; rather, it reflects the perversities that permeate institutions.

Most decisions within large organisations are made by groups or committees. Membership of a committee, in turn, encourages a desire to conform to certain norms, standards and articles of conventional wisdom. Within a closely-knit group, adherence to standard practices (whether sensible or not) tends to be rewarded, and independent thinking (no matter how firmly justified by logic and evidence) which challenges the group's cohesion is often discouraged. As a result, what investment managers in large organisations ultimately fear is not so much the possibility of being wrong but of the possibility of being out of step with peers and competitors. Within an organisation, in other words, failing conventionally is a rational and sensible route. As Buffett reminds us, "lemmings as a group have a bad reputation, but no individual lemming has ever been ridiculed or received a bad press."

Richard FitzHerbert, in a paper presented in 1998 to the Australian Institute of Actuaries, has provided Australian evidence of this "investment groupthink" phenomenon (see also his excellent book *Blueprint for Investment: An Approach for Serious Long-Term Investors*, Wrightbooks, 1994). FitzHerbert found that the environment in which large Australian funds managers work virtually precludes dispassionate analyses and decisions about investments. This is because they tend to give more weight to their own interests and careers than to their clients' money. FitzHerbert finds that institutional managers "know that they risk losing clients and their jobs if their portfolios are significantly different from [those of] their peers" and concludes that sensible investment decisions are short-circuited by the managers' self-interest. As a result, "rational assessment of risk may no longer be an important part of the investment decision-making process" within large organisations.

According to Buffett and FitzHerbert, for the sake of their careers funds managers cannot allow their (often deeply-felt) fiduciary duty towards their investors' long-term interests to dictate their actions. As a result, the institutional imperative encourages and rewards short-term speculating rather than long-term investing. Alas, speculation almost invariably punishes investors.

Chris Leithner
6 March 2009