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Objectives and Possible Returns

(Updated 12 February 2009)

It is an irrefutable fact that in the long run it is economics that triumphs over emotion. Since 1872, the average annual real stock market return (after inflation but before intermediation costs) has been 6.5%. The real investment return generated by dividends and earnings growth has come to 6.6%. Yes, speculative return slashed investment return by more than one-half during the 1970s and then tripled (!) it during the 1980s and 1990s. But measured today, after this year's staggering drop in stock prices, speculative return, with a net negative annual return of -0.1% during the entire 130-year period, on balance neither contributed to, nor materially detracted from, investment return. Is it wise to rely on future market returns to be enhanced by a healthy dollop of speculative return? Don't count on it!

John C. Bogle
Don't Count On It! The Perils of Numeracy
(18 October 2002)

For the seriously long-term investor, the value of a portfolio corresponds closely to the present value of [its] dividends. The present value of the (eventual) capital appreciation dwindles greatly into insignificance.

ABN AMRO Global Investment Returns Yearbook (2005)

Objectives

Leithner & Company (LCO) has two objectives:

1. *to preserve wealth* – that is, to preserve the value of its shareholders' capital by compounding it at a rate which compensates for the effects of inflation.
2. *to build wealth* – that is, to invest its shareholders' capital in a portfolio of securities whose rate of return, given cautious assumptions, can reasonably be expected to exceed the returns offered by 5-year Commonwealth Government bonds.[1] When securities capable of generating such returns are difficult to locate, as was increasingly true from the time of LCO's formation in 1999 until the end of 2008, prudence demands that it accumulate cash – and that it continue to do so until securities become available at attractive prices.

A General Caution and Some Specific Starting Points

These objectives have strongly influenced LCO's results since its inception, and will continue to do in the future. Accordingly, given

- the unavoidable risks that inhere in the investment operations that the company undertakes;
- the volatility of short-term results encountered even by the Super-investors of Graham-and-Doddsville; and
- average ("benchmark") results generated in Australia since the 1870s,

it is not realistic or reasonable for shareholders to expect a medium-term (ca. 5-year time horizon) return – capital appreciation plus dividends – on their investment of more than ca. 8-10% per annum. Further, when considering LCO's objectives and possible results, you should keep several additional points in mind:

- the greater your expectations, the greater the likelihood that they will be disappointed;
- a point that I emphasised in previous updates of this document (namely "it is very unlikely that the results obtained during late 1990s … can be extrapolated into the indefinite future. This is because regression to the

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[1] For an extended discussion and analysis justifying the yield of the five-year Commonwealth Government bond as a foundation stone of equity analysis – despite the fact that these bonds are more often "loss guaranteed" than "risk free" – see *The Intelligent Australian Investor* (John Wiley & Sons, 2005, Chaps. 5, 6 and 11).

mean, or something very similar to it, exists in financial markets") has, alas, come to pass;[2]

- the fruits of value investing can and often do include reasonable medium-term (five years or more) results. The results achieved by prominent value investors (see pp. 9-16) tend to distinguish themselves over the long-term. But from one year to the next they can be more volatile than their relevant "benchmarks;"
- value investors encounter short-term "under-performance" (i.e., year-to-year results which are inferior to others' or some relevant benchmark) on average in one of every three years (specifically, they tend to "under-perform" during periods of economic boom and euphoria in financial markets);
- the frugality of LCO's operations, together with the fact that it levies no management fees, will, other things equal, tend to boost its results.

Some Typical Investment Returns Over Time and By Class of Asset

What is an average investment result? A justifiable answer depends upon the period and length of time – and to some extent the class of asset – under consideration. Table 1 (page 4) shows the best, worst and average total returns (dividends plus capital appreciation) of the Standard & Poor's 500 Index, a commonly-used index of American stock market prices, between 1925 and 1996. (In order to remove and distinguish the effects of the Internet Bubble of the 1990s and the Great Bubble of 2004-2007, Table 1 excludes the years since 1996.)[3] These returns do not include the cost of buying and selling securities, or the other expenses typically incurred by investment managers.

One-year returns are very volatile. The S&P 500's best one-year result during these years was +54%, its worst was -43% and the mean was 8.0%. (More recently, returns have also varied greatly from one year to the next: in 1999, the S&P 500 returned 21.0%; in 2000, 9.1%; in 2001, -11.9%; in 2002, -22.1% and in 2003, 28.7%.) Yet the greater the time span under consideration, the lower is the volatility of the return and the greater is the likelihood that the overall

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2 See also Golden Era or Gilded Age? Inflation and Mean Regression in Australian Stock and Bond Markets, 1965-2006 – and Some Base Rates for 2007-2011 (a paper prepared for the National Investors' Conference of the Australian Investors' Association, 23-26 July 2006, Marriott Resort, Surfers Paradise, Queensland).

3 More recent results are much less appealing than many people suppose. Since 1996, the annual return of the S&P 500 has varied from 33.4% (in 1997) to -37.0% (in 2008). The mean return during these years has been 5.7%, and the median 8.2%. $1.00 invested on 1 January 1997 in a portfolio that perfectly mimicked the S&P 500 would by 31 December 2008 have grown to $1.49 – a compound rate of growth of 3.5% per annum. Also since 1996, five-year rates of return have fallen steady and drastically, from an average of more than 20% per annum in the late 1990s to -2.2% in 2008; similarly, ten-year returns have fallen from an average of almost 20% per annum in the late 1990s to -1.4% in 2008. Further, as measured by the S&P 500, January 2008 was the worst January on record. It declined 8.6% for the month, exceeding the previous record (-7.7%) in January 1970.

return will be positive. Considering each consecutive five-year period (i.e., 1925-1929, 1926-1930, … 1991-1995 and 1992-1996), the best result was a compound return of 24% per year, the worst was minus 13% per year and the average was 10% per year. Considering each rolling ten-year period, the worst result was a compound return of minus 1% p.a. (note from footnote 3 that the decade to 2008 has been worse) and the average was 11% p.a. In no twenty-year period since 1925 – including those encompassing the Great Depression – has a negative return been obtained.

Table 1: Total Investment Returns, S&P500 Index, Rolling Periods, 1925-1996

	1 Year	5 Years	10 Years	20 Years
Best	+ 54%	+ 24%	+ 20%	+ 17%
Worst	- 43%	- 13%	- 1%	+ 3%
Average	+ 8%	+ 10%	+ 11%	+ 11%

Source: Vanguard Investment Group

These points also apply to the All Ordinaries Index, which is the basis upon which many share market returns in Australia are computed and compared. Although it was created in 1980, it can be extrapolated into the 19th century. Using monthly observations (i.e., the All Ordinaries in January 1875, February 1875, … November 2008 and December 2008), the best-ever return (82.2%) occurred in the twelve months to September 1987 and the worst-ever return (-45.7%) punctuated the year to December 2008. Since 1875, the mean annual return has been 6.49% and the median 6.32%. (Again, these returns include neither the cost of buying and selling securities nor the other expenses typically incurred by large investment managers, or distributions and dividends.)

Let us compute the 12-month returns of the All Ords for each month since December 1875 (i.e., the intervals January 1875-December 1875, February 1875-January 1876, … December 2007-November 2008 and January 2008-December 2008) and then rank-order them from worst to best. Let's then separate this ordered list of 12-month returns into five groups of equal size ("quintiles"), where Quintile A contains the lowest 20% of observations … and Quintile E contains the highest 20%. We can then compute the mean and median of each quintile.[4] The results appear in Table 2 (p. 5).

Given that these observations are roughly normally (that is, the distribution likely has fat tails) and independently distributed, and assuming that 12-month

[4] For further details of this method, which has a rather long history in financial analysis, see Francis Nicholson, "Price-Earnings Ratios in Relation to Investment Results," *Financial Analysts Journal* (January-February 1968); David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998); and James P. O'Shaughnessy, *What Works on Wall Street* (McGraw-Hill, 1998).

returns will in the future continue to derive from such a distribution, we can infer that there's a one-in-five chance that the return in any randomly-selected 12-month interval will be minus 4.75% or less. If so, then there's a 50-50 chance that it will be between minus 4.75% and minus 11.77%, and a 50-50 chance that it will be between minus 11.77% and minus 45.7%. The return in the year to December 2008 is extreme, but losses *per se* are not unusual. (The probability that a loss occurs during a twelve-month interval is 29.0%.) Similarly, there's a one-in-five chance that any future 12-month return will be 16.95% or more; and there is a three-in-five chance that it will be greater than minus 4.75% and less than 16.95%. In Australia, then, steep losses over short intervals are not remarkable; nor are hefty gains. Still, the typical result is ca. 6.4%.

Table 2: Twelve-Month Returns, All Ordinaries Index, 1875-2008

Quintile	Range	Mean	Median
A (Lowest 20%)	from -45.7% to -4.75%	-14.17%	-11.77%
B (Next Lowest 20%)	from -4.74% to 3.61%	0.06%	0.50%
C (Middle 20%)	from 3.62% to 8.96%	6.32%	6.47%
D (Next Highest 20%)	from 8.99% to 16.94%	12.26%	12.19%
E (Highest 20%)	from 16.95% to 82.16%	28.26%	24.01%

Imagine now that the average return of the All Ords for each five-year interval since January 1876 (i.e., January 1875-December 1879, February 1875-January 1880, … December 2003-November 2008 and January 2004-December 2008) is computed and then rank-ordered from worst to best. Again, this list of returns is divided into quintiles, and the mean and median of each quintile are computed. The results appear in Table 3.

Table 3: Five-Year Returns, All Ordinaries Index, 1875-2008

Quintile	Range	Mean	Median
A (Lowest 20%)	from -10.24% to 0.94%	-2.36%	-1.60%
B (Next Lowest 20%)	from 0.97% to 5.04%	2.98%	3.00%
C (Middle 20%)	from 5.05% to 8.53%	6.79%	6.74%
D (Next Highest 20%)	from 8.55% to 12.04%	10.12%	10.08%
E (Highest 20%)	from 12.05% to 69.47%	18.82%	15.76%

These observations, too, are approximately normally and roughly independently distributed; for this reason, we can infer that there is a one-in-five chance that the return in any randomly-chosen five-year interval in the future will be 0.94% or less. If so, then there's a 50-50 chance that it will be between 0.94% and minus 1.60%, and a 50-50 chance that it will be between minus 1.61% and minus 10.24%. (The probability of a negative return over a ten-year interval is 16.0%.) In the same way, there's a one-in-five chance that any future 60-month return will be 12.05% or more; and there is a three-in-five chance that it will be greater than 0.94% and less than 12.05%. Steep losses over five-year intervals, then, are unusual – and so too are the gains to which many Australians became accustomed during 2003-2007. For any given 60-month period, the typical result is a gain of ca. 6.75% per year.

Finally, let us consider the returns of the All Ords for each ten-year interval since January 1876. Table 4 summarises them. The chance is one-in-five that the return (including a future return) in any randomly-chosen ten-year interval will be 3.26% or less. (The probability of a negative ten-year return is 4.6%.) Similarly, there's a one-in-five chance that a ten-year return will be 11.46% or more; and there is a three-in-five chance that it will be greater than 3.26% and less than 11.46%. Steep losses over these intervals, then, are unknown (although modest losses are not), and hefty gains are rare. For any given 120-month interval, the average result is a gain of ca. 6.65% per year.

Table 4: Ten-Year Returns, All Ordinaries Index, 1875-2008

Quintile	Range	Mean	Median
A (Lowest 20%)	from -2.15% to 3.26%	1.31%	1.63%
B (Next Lowest 20%)	from 3.29% to 5.47%	4.38%	4.41%
C (Middle 20%)	from 5.48% to 8.13%	6.69%	6.61%
D (Next Highest 20%)	from 8.15% to 11.45%	10.12%	10.08%
E (Highest 20%)	from 11.46% to 65.70%	18.42%	14.36%

Hence the vital tendency: the longer the period of investment under consideration, the less volatile are the overall results and the more likely it is that they will be positive. *More specifically, the longer the period, the greater is the tendency for results to gravitate towards ca. 6.5% per annum. Accordingly, without the boost that dividends provide, Australian investors have little reason to expect a long-term compound rate of return from their stock market investments more than – and they have solid grounds to expect a return less than – 8-10% per annum.*[5]

5 In any given period, some investors will achieve results that exceed an overall market benchmark. But a particular investor can seldom do so consistently. Indeed, most sub-sequently "regress to the mean." As an example (sourced from gurufocus.com), consider these recent results generated by investors whom Chris Leithner admires:

Investor	Vehicle	1- Year Return (to 31-10-08)	5-Year Compound RR (to 31-10-08)
Tweedy, Browne	Tweedy, Browne LLP	-41.3%	3.2%
Warren Buffett	Berkshire Hathaway	-30.3%	7.1%
Chris Davis	Davis Advisors	-50.1%	3.5%
William Miller	Legg Mason Value Trust	-62.9%	4.5%
Mohnish Pabrai	Pabrai Investment Funds	-67.0%	n.a.
Ruane Cunniff	Sequoia Fund	-53.8%	7.3%
Martin Whitman	Third Avenue Value Fund	-61.6%	11.8%

Table 5: Major Booms, Busts and Times Required to Recover (All Ordinaries Index 1874-2008)

Episode	Boom Maximum	Bust Minimum	Fall fm Max to Min	Years Req'd to Reach Min	Years Req'd to Return to Boom High
Depression of 1890s	Nov 1888 (10.2)	Dec 1893 (6.5)	36%	5.0 years	15.0 years (Dec 1903)
Great War	Jun 1914 (22.5)	Dec 1916 (17.5)	22%	2.5 years	6.75 years (Feb 1920)
Great Depression	Jul 1929 (51.6)	Aug 1931 (27.8)	46%	2.0 years	5.25 years (Jan 1934)
Recession of 1970s	Jan 1970 (431.2)	Jan 1974 (193.7)	55%	4.75 years	9.75 years (Sep 1979)
Recession of 1980s	Nov 1980 (736.4)	Jul 1982 (461.4)	37%	1.75 years	3.0 years (Dec 1983)
Crash of 1987/Recession of 1990s	Sep 1987 (2,239)	Feb 1988 (1,227)	45%	0.5 years	8.0 years (Jan 1996)
Internet Bubble	Feb 2002 (3,392)	Mar 2003 (2,779)	18%	1.0 years	2.0 years (Mar 2004)
Great Bubble/Great Recession?	Jan 2007 (6,698)	??	??	??	??

This central tendency applies to the short (one-year), medium (five-year) and long (ten years or more) terms. Obviously, there is considerable variation around it. Equally clearly, certain historical developments – most of them stemming from the business cycle – have obscured (but not overturned) it. Most notably, Table 5 lists the eight most severe stock market ructions (as measured by the All Ordinaries Index) in Australian history.

On average, the All Ords has fallen 37% from the peak of a bull market to the trough of a bear market. The shallowest bust occurred during the First World War, and the most severe one in the recession of the 1970s. The journey from peak to trough has taken an average of 30 months or 2.5 years. The quickest journey (after the Crash of 1987) took five months, and the longest one (in the Depression of the 1890s) five years. The time required to recoup the losses of a bust (i.e., to return to the maximum of the preceding bull market) has taken an average of 86 months or 7.25 years. The quickest recovery occurred after the Internet Bubble, and the slowest during the Depression of the 1890s.[6]

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[6] A naïve extrapolation of these figures implies that the current bear market (which by November 2008 had slashed the All Ords by more than 50%) is more than a garden variety one. If so, then it is equally naïve to extrapolate that the Ords will reach its nadir by the middle of 2009 and that it will recoup its losses by the middle of 2014. If an historically average rate of return henceforth applies,

Table 6: Average Australian Investment Returns (to 30 June 2007) by Time and Asset Category

	1 Year	5 Years	10 Years	20 Years	50 Years
Australian Stocks	30.3%	19.6%	13.0%	11.2%	12.8%
International Stocks	7.8%	4.7%	5.6%	7.2%	N/A
Australian Bonds	4.0%	5.4%	6.1%	9.6%	7.8%
Australian Listed Property	17.2%	18.2%	14.6%	12.1%	N/A
Australian Cash	5.3%	5.6%	5.5%	7.7%	7.7%

Source: Vanguard Investment Group, Realistic Sharemarket Expectations; see also ASX Investment Sector Performance Report (2003) and ASX Investments Report (2004).

What is an average investment result? The answer to this question also depends upon the type of asset under consideration. Although the distinctions are easy to exaggerate, some types entail more risk than others.[7] Table 6 compares the returns (including dividends and other distributions) achieved by conventional categories over the short term (i.e., the year to 30 June 2007), medium-term (five years), long-term (10 years) and the very long term (i.e., the half-century to 30 June 2007).[8]

Table 6 confirms that short-term results tend be more volatile than longer-term ones. In conjunction with Table 2, it shows that the year to 30 June 2007 (whose return was more than double the 50-year average) was an exceptionally good one for owners of Australian stocks. In conjunction with Tables 3-4, it also indicates that the five years and ten years to 30 June 2007 were unusually kind to Australian investors. He who purchased a representative portfolio of Australian stocks on 30 June 1997 and held it for five years earned an average compound return of 13.0% per annum; and he who purchased in 2002 obtained almost 20% per year for five years. Owners of Australian listed property also basked in years of double-digit returns.

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then the All Ordinaries Index will require ten years – that is, until early 2019 – to return to the summit it first climbed in late 2007.

7 For an overview of Grahamite conceptions of risk, see Risk, Its Management and Disclosure.

8 Unlike Tables 2-4, Table 6 reports "accumulation" returns; that is, they assume that any dividend, payment of interest or other distribution received during the relevant period is reinvested. Comparing Tables 2-4 to the first row in Table 6, we can infer that that the very long-term average dividend yield for Australian stocks is ca. 5.0-6.0%.

These results should have alerted Australians to their good fortune – and cautioned them that it wouldn't last. Instead, it enthused them, convinced them that the past has no relevance for the present and future and that excellent returns had become the norm, and encouraged them to respond to the rising prices by demanding more securities, i.e., to chase returns *because* they had risen. During these years, Australians bought on the basis of price, not value; as a result, they acted like speculators, not investors. The trouble, as Ben Graham put it in *The Intelligent Investor* (1949), is that "while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster."[9,10]

Given the different results from among the various classes of asset, Table 6 confirms that, as a very rough rule of thumb, investors should not expect the long-term compound return (including dividends and other forms of distribution) of a balanced portfolio of assets to exceed ca. 10% per annum. For example, a portfolio comprising 30% Australian stocks, 25% Australian bonds, 25% Australian listed property, 15% International stocks and 5% cash and held during the very kind ten years to 30 June 2007 would have earned an average return of ca. 3.9% + 1.5% + 3.7% + 0.8% + 0.3% = 10.2% per annum.

Some Prominent Value Investors' Results

Given LCO's Graham-style "value" approach to investing (see also its Investment Philosophy), it is useful to examine the records of the most prominent and successful value investors. Table 7 summarises them.

Mr Buffett has contended that these outstanding results are not products of chance; rather, and despite the very different investments they made and the diverse points in time when they made them, these results can be attributed to these investors' disciplined adoption and shrewd adaptation of Graham's philosophy and approach. Balancing this pleasant point is a sobering one: from one year to the next, the returns of these investors (except Buffett) are often more volatile than the benchmark.

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9 "Many investors who expect to be ongoing buyers of investments throughout their lifetimes," wrote Warren Buffett to his shareholders on 1 March 1991, "illogically become euphoric when stock prices rise and unhappy when they fall. They show no such confusion in their reaction to food prices: Knowing they are forever going to be buyers of food, they welcome falling prices and deplore price increases." As in the supermarket, so too in financial markets: the point is to pay an objective price that is lower than the perceived subjective value. "Given these intentions," continued Mr Buffett, "declining prices for businesses benefit us, and rising prices hurt us."

10 More recent experience has reacquainted investors with historical reality: namely that hefty loss can occur over the long term. On 28 January 2009, for example, the benchmark index of Australia's listed property sector (S&P/ASX 200 REITs Index) plumbed depths not seen since 1986. The past 18 months of capital losses have outweighed twenty-two years of gains. Accordingly, without a sudden, utterly unprecedented and sustained rebound, it's likely that the medium- and long-term returns of Australian listed property will remain negative for years to come.

Table 7: Annualised Results, Prominent Value Investors

Investor	Period	Minimum (1-year)	Maximum (1-year)	Average (p.a.)	Benchmark
John Maynard Keynes	1928-1945	- 40%	+ 56%	+ 13%	- 1%
Walter & Edwin Schloss	1956-1996	- 13%	+ 42%	+ 17%	+ 13%
Buffett Partnership	1957-1969	+ 7%	+ 59%	+ 30%	+ 9%
Wheeler, Munger Partnership	1962-1975	- 32%	+ 73%	+ 24%	+ 6%
Berkshire Hathaway, Inc	1965-2007	-6%	+ 59%	+ 21%	+ 11%
Average		**- 17%**	**+ 58%**	**+ 21%**	

Sources: R. Hagstrom, *The Warren Buffett Portfolio* (John Wiley & Sons, 1999); T. Vick*, Wall Street On Sale* (McGraw-Hill, 1999); Berkshire Hathaway, Inc.

John Maynard Keynes

John Maynard Keynes, 1st Baron Keynes of Tilton (1883-1946) was one of the twentieth century's most influential – and damaging – economists. As Bursar of King's College, Cambridge, manager of its Chest Fund, and of several investment and financial firms (such as the Chairman of National Mutual Life Assurance Society), after several false starts he also became an excellent investor. His eventual approach bore some similarities to that of Ben Graham. Both via Graham and directly, Keynes has influenced Warren Buffett.[11]

From 1928-45, Keynes achieved an average return of 13% per annum compared to the British market return of minus 0.5%. Considering the vicissitudes of these years – the Great Crash, Great Depression and Second World War – Keynes's results were impressive. The Great Interventionist was hardly circumspect about them. In a letter written in 1944, he commented: "The financial concerns where I have had my way have been uniformly prosperous … My difficulties in financial quarters all through have been the difficulty of getting unorthodox advice accepted by others concerned."

Well, not quite. What's certain is that King's investment returns were almost three times more volatile than those of the overall British market. Accordingly, in exchange for long-term gain they often endured short-term pain. In 1930,

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11 See Roger Lowenstein, *Buffett: The Making of an American Capitalist* (Weidenfeld & Nicholson, 1996); Robert Hagstrom, *The Warren Buffett Portfolio*; and Justyn Walsh, *Keynes and the Market* (John Wiley & Sons, 2008).

1938 and 1940, for example, the Chest portfolio fell far more than the overall market. Its ride was also bumpy from year to year, earning returns of +56% in 1936 and -40% in 1938; but over the entire period it outpaced the British market (which fell marginally) by a significant margin.

It's important to emphasise that Keynes's year-to-year results were volatile. The purpose of his first major outlay of capital was to back the pessimistic (and ultimately correct) views he propounded in *The Economic Consequences of the Peace* (1919). He speculated heavily in foreign currency markets, going "short" continental European currencies and "long" the $US. Such activity, he suggested to undergraduates at Cambridge, could be viewed as a "great game, a kind of high-stakes chess where the nimble-minded could cash in on their intellectual superiority." After some initial success, in January 1920 Keynes and a colleague raised £30,000 from family and friends. By May, he felt obliged to confess "the slaughter of a large part of our holdings." Undaunted, he liquidated personal assets, procured the advance payments of royalties, some-how managed to borrow more money – and by the end of 1922 had recouped his losses and repaid his loans.

During the mid-1920s, Keynes reduced his speculations in foreign exchange markets – and, influenced by Edgar Lawrence Smith's book *Common Stocks as Long-Term Investments* (1923),[12] increased them in the stock market. Seduced by "the dizzy virtues of compound interest," Keynes became a leading evangelist of the cult – launched by Smith – of the common stock. In book reviews, at meetings of shareholders and in memoranda to fellow members of boards, he extolled the merits of equities. He browbeat colleagues and eventually prevailed: by 1926, the proportion of National Mutual's policyholders' funds invested in shares was more than three times the average of other British insurance societies. Moreover, borrowings financed well over half of Keynes's portfolios.

The speculator's key task, Keynes believed during these years, was correctly to time the purchase and sale of securities. Success was a simple matter of anticipating the actions of the crowd. As he wrote in *A Treatise on Money* (1930),

> … it may often profit the wisest [speculator] to anticipate mob psychology rather than the real trend of events, and to reason proleptically [i.e., in the expectation of others' actions] … Thus, so long as the crowd can be relied on to act in a certain way, even if it be misguided, it will be to the advantage of the better-informed professional to act in the same way – a short period ahead.

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12 An excellent discussion of Smith's book and the mentality it reflected and encouraged – and which reappeared in the 1990s and 2000s – appears in James Grant, *The Trouble With Prosperity: A Contrarian's Tale of Boom, Bust and Speculation* (Random House, 1996).

Drawing upon a vast reservoir of self-regard, Keynes convinced himself that he possessed the foresight and skill to navigate the ever-shifting shoals of speculative sentiment. As an undergraduate, he had boasted "I want to manage a railway or organise a Trust, or at least swindle the investing public. It is so easy and fascinating to master the principles of these things."[13]

The Great Crash of 1929 and ensuing Great Depression shattered these delusions. During the late 1920s, Keynes sold many stocks – not because he foresaw the Crash, but because his "terrifying adventures" on speculative markets (this time commodities) had brought him to his knees. In 1928, after several years of profitable trading, his positions in the rubber, corn, cotton and tin markets generated large losses, and he was forced to sell many of his stocks in order to cover them. Then came the Crash, which decimated the stocks he retained. As a result, Keynes's net worth fell from £44,000 at the beginning of 1928 to less than £8,000 by the start of 1930. For the second time, he found himself "posed on the precipice of financial ruin."

Like Graham, so too Keynes: the massive losses incurred during the Crash and early years of what became the Great Depression provoked radical rethinking. In May 1938, he conceded (with his trademark hubris)

> I can only say that I was the principal inventor of credit cycle investment [by this Keynes meant something along the lines of what these days is called "momentum investing"] and have seen it tried by five different parties acting in detail on distinctly different lines over a period of nearly twenty years, which has been full of ups and downs; and I have not seen a single case of a success having been made with it.

Henceforth, Keynes paid little attention to the short-term actions of the herd, and devoted much attention to the long-term results of the companies whose securities he owned. He sought to estimate a firm's value and compare it to its price. "I am still convinced," he told the MD of the Provincial Insurance Co. in April 1940, "that one is doing a fundamentally sound thing [when] backing intrinsic values [sic] enormously in excess of the market price, which at some utterly unpredictable date will in due course bring the ship home." "My pur-

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13 Keynes was an insufferably arrogant bastard and an execrable economist. (Consumption and government spending beget prosperity? What sane person could believe such nonsense?) Even worse, like many Pommies of his caste and generation, he was a wicked anti-Semite and a despicable Nazi sympathiser. *The London Morning Post* (3 December 1925) quoted him: "the Jews are worse than my own people. Those Jews who still want to be the chosen race (chosen by the late Lord Balfour) can go to Palestine and stew in their own juice. The rest had better stop being Jews and start being human beings. This is the real enemy, the invader from the East, the Druze, the ruffian, the oriental parasite; in a word: the Jew." And in the immediate wake of Hitler's rise to power, he told *The Sunday Dispatch* (4 June 1933): "the Nazi movement is in many respects one which has my warm sympathy; in fact, I might fairly claim that Herr Hitler has repudiated Karl Marx to enlist under the banner of Bernard Shaw." To put it mildly, Keynes was not an admirable person.

pose," he added in 1942, "is to buy securities where I am satisfied as to assets and ultimate earning power and where the market price seems cheap in relation to these." For good measure, during these years Keynes considerably reduced his portfolios' lever-age, such that debt financed only a tenth or so of his holdings. Following these precepts, and hugely boosted by extremely low prices relative to value and a sharp recovery of prices, Keynes's net worth rose to ca. £500,000 by the end of 1936.[14,15]

Schloss Partnership

"At 91", said *Forbes* magazine in a profile, "the man Warren Buffett famously dubbed a 'Superinvestor' is still picking unloved stocks. Walter Schloss has lived through 17 recessions, starting with one when Woodrow Wilson was President. This old-school value investor has made money through many of them. What's ahead for the economy? He doesn't worry about it." Of the investors listed in Table 7, the approach and results of Walter Schloss most closely resembled those of Ben Graham. Mr Buffett has written "Walter never went to college, but took a course from Ben Graham at night at the New York Institute of Finance. Walter left Graham-Newman Corp. in 1955 [and, together with his son, Edwin], achieved the record shown [in Table 7]." He had no "connections" or access to "useful" information. Practically nobody in élite Wall Street or other investment circles knew him. He simply read manuals, sent for annual reports, conducted his own analyses and kept his own counsel.

According to Mr Buffett, "Walter … knows how to identify securities that sell at considerably less than their value to a private owner. *And that's all he does.* He doesn't worry about whether it's January, and he doesn't worry about whether it's Monday, he doesn't worry about whether it's an election year. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me. And he does it over and over and over again … I don't seem to have much influence on Walter. That's one of his strengths; no one has much influence on him."

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14 Like Ben Graham, Keynes's results also took a battering in the late 1930s. For this reason, and also because he gave significant amounts of money to a variety of causes, when he died in 1946 Keynes's net worth was ca. £500,000.

15 The figures in Table 7 are an amalgam of the results of Keynes's investments for his own account, for investment companies and insurance firms like National Mutual, and for the Chest Fund. A study of the Fund's performance concluded that, although it was far more volatile than the broader market, "the Fund's performance was clearly superior to that of the market … On the basis of modern performance evaluation measures, the evidence indicates that Keynes was an outstanding portfolio manager, 'beating the market' by a wide margin" (see J. Chua and F. Woodward, "J.M. Keynes's Investment Performance: A Note," *The Journal of Finance*, vol. 38, no. 1, March 1983). Donald Moggridge, editor of Keynes's *Collected Writings*, concludes "whereas in the 1920s Keynes was generally less successful than the market, after 1929 his investments (treating Wall Street and London separately) outperformed the market on 21 of the 30 available accounting years and did so cumulatively by a wide margin."

Charles Munger Partnership

Warren Buffett is rightly regarded as one of the world's most gifted investors. Yet the outstanding record compiled by Buffett Partnership Ltd and later by Berkshire Hathaway, Inc., should not obscure the excellent record achieved by Berkshire's Vice Chairman, Charles Munger, between 1962 and 1975.[16] Of the investors in listed in Table 7, Munger's approach least resembles that of Ben Graham. "I thought a lot of [Graham's precepts] were just madness," he has said. "They ignored relevant facts." Yet according to Janet Lowe, Munger accepts "Graham's most fundamental teachings, and they have been part of the Buffett-Munger success formula from the start."

Born and reared in Omaha, Munger is the son of an attorney and the grandson of a federal judge. After the Second World War, which interrupted his studies at the University of Michigan, he gained admission to Harvard Law School (his father's *alma mater*). After graduation, he decamped to California, practiced law and in 1962 founded his own firm.[17] Yet during the 1950s he became increase-ingly bored with corporate law and ever more of the view that his commercial acumen equalled or surpassed his clients'. Hence (as was common at the time) he joined colleagues and clients in various business endeavours, particularly property developments. After meeting Warren Buffett (their families knew one another and Munger worked in Buffett's grandfather's grocery,[18] but the two did not meet until 1959), he gradually became a full-time investor. He founded a partnership (whose structure was similar to the Buffett Partnership's) with a friend, Jack Wheeler, in 1962, and left his law practice in 1965.

Not all of Munger's investments proceeded smoothly or produced stellar results. One of the earliest was particularly fraught. Munger had conducted some legal work for a small manufacturer of specialised transformers. Eventually, and by borrowing some of the required funds, he became a part-owner of the business. In the wake of the Korean War, demand for its products was great and its future seemed bright. Alas, problems soon plagued it. Competition intensified; a key engineer died slowly of cancer; the advance of technology

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[16] For details, see Janet Lowe, *Damn Right! Behind the Scenes With Berkshire Hathaway Billionaire Charlie Munger* (John Wiley & Sons, 2000).

[17] Munger, Tolles & Olson LLP has long been one of America's most prestigious and selective law firms. In 2008, *American Lawyer* ranked it the nation's best and *Vault's 2007 Guide to the Top 100 Law Firms* ranked it the country's most selective.

[18] Munger has recounted the experience: "Ernest Buffett was a strict employer and he held strong political views. He paid $2 for twelve hours' uninterrupted work. Social Security had just been enacted, and he used to require each boy to bring two pennies to the store to pay his contribution to the system." At the end of each day, Charlie handed Ernest two pennies "and in return received two dollar bills, plus a lecture on the evils of socialism … the hours were long, the pay low, opinions cast in iron and foolishness zero."

suddenly rendered key products obsolete; acquisitions soured and the burden of debt grew. With the help of a specialist in business reorganisation, the firm was shrunk to an appropriate size and then sold. Munger concludes: "it was a lot of struggle, a lot of nerve pain. We damn near lost everything. We finally made it work, but not fabulously. But we got a very respectable return on investment – eventually."

At Berkshire Hathaway's AGM in 1998, a shareholder asked why Buffett and Munger eschewed investments in real estate. Munger replied: "Here's an area in which we have a virtually perfect record extending over many decades. We've been demonstrably foolish in almost every operation having to do with real estate that we've ever touched."[19] Describing his partnership's early years, Munger reminisces: "at one time, as part of a bargain-priced package, we bought a manufacturer of car wash machines and a group of loans to car wash operators. Every time it rained, people called to explain why they weren't paying. That was not one of my happier moments. So we had a lot of experiences, good and bad."

This assessment, too, is far too dour. In its first eight years, the annual return (before the partners' override) of the Wheeler Munger partnership averaged 37% per annum – which greatly surpassed the S&P500's average of 5.7% p.a. But in the three-year period ending in 1972, its average return dropped to 11%, slightly lagging the benchmark's 12%. Then results really fell off the cliff: the partnership lost 32% in 1973 (versus -13% for the index) and fell a further 32% in 1974 (versus the benchmark's -23%). An investment of $1 on 1 January 1973 would have shrunk to $0.467 two years later. On a five-year basis, $1 invested in the partnership on 1 January 1970 decreased to $0.63 by 31 December 1974; and taking the CPI into consideration, the purchasing power of the initial investment fell to $0.54 after five years.

Yet despite that horror stretch, from the day Munger founded it until he folded it early in 1976, the partnership generated a compound return of 19.8% per annum, such that $1 invested in 1962 grew to $12.56 in 1975. In contrast, during these years the S&P500 generated a compound return of 5.4% p.a., such that $1 invested in 1962 grew to $2.08 in 1975. Like Keynes's, Munger's short-term results fluctuated much more erratically than the benchmark. After a two-year horror stretch, which included his second-worst year (1974), came his best year: in 1975, the capitalisation of the partnership's portfolio soared 73% (compared to 44% for the S&P 500).

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19 That assessment is far too harsh. Despite ups and downs, at the conclusion of the property-development phrase of his career Munger "had $1.4 million … That was a lot of money at the time [and was] a substantial backlog of economic security. I did a total of five projects, then stopped. I didn't like constantly borrowing more money. Also, it was an activity with many details, each crucial, difficult to handle as a full-time activity and extremely difficult as a part-time activity."

Even the Best Regularly "Underperform"

Keynes's and Munger's results imply something that Table 8 makes explicit. It is inappropriate to judge any investor's results on a short-term (one-year) or even a medium-term (five-year) basis. In roughly one year in three, the "Super-investors" other than Buffett generate results that are inferior to the benchmark. Clearly, outstanding long-term results have been compiled in conjunction with short-term volatility and "underperformance."

Table 8: Superinvestors' Regular Underperformance

Investor	Years In Operation	Years of Under-performance of Benchmark	Under-performance as a Percentage of Years in Operation
Berkshire Hathaway	42	6	14%
Buffett Partnership	13	0	0%
JM Keynes	18	6	33%
Munger Partnership	14	5	36%
W&E Schloss Ltd	42	14	33%

Sources: R. Hagstrom, *The Warren Buffett Portfolio;* T. Vick, *Wall Street On Sale*

Leithner & Company's Results

The short-term, medium-term and long-term results that have obtained historically (Tables 1-5), together with those of the Superinvestors of Graham-and-Doddsville (Tables 7-8), help to put LCO's results into context. So does its "cash weighting." Recall that LCO invests its shareholders' capital in a portfolio of securities whose overall rate of return can reasonably be expected to exceed that of 5-year Commonwealth Government bonds. If such securities are difficult to locate, as was increasingly true from the time of LCO's formation in 1999 until the end of 2008, then it accumulates cash (and very rough proxies such as certain income securities). Graph 1 (page 17), which depicts LCO's "cash weighting" at each 30 June and 31 December since its inception, shows that cash and its rough-equivalents have comprised a steadily increasing percentage of LCO's assets.

LCO is a private investment company and not a managed fund (unit trust). This structure has important implications for its operations and the measurement of its results. As a company, LCO's results derive from the receipt of dividends and payments of interest, and also from the realisation of capital gains (that is, from the sale of assets) – but not from the fluctuations of the market prices of the businesses and securities that comprise its portfolio. A managed fund's results, on the other hand, derive from dividends, interest and capital gains and losses – whether realised or unrealised. LCO's results thus have everything to do with the income received from the businesses of which it is a part-owner – and nothing to do with either the price volatility of these shares, bonds, etc., or their price level at a given point in time. Given identical portfolios, over time a company's results will tend to be steadier and the fund's results subject to the market's ups and downs.

Graph 1: The "Cash Weighting" of LCO's Portfolio

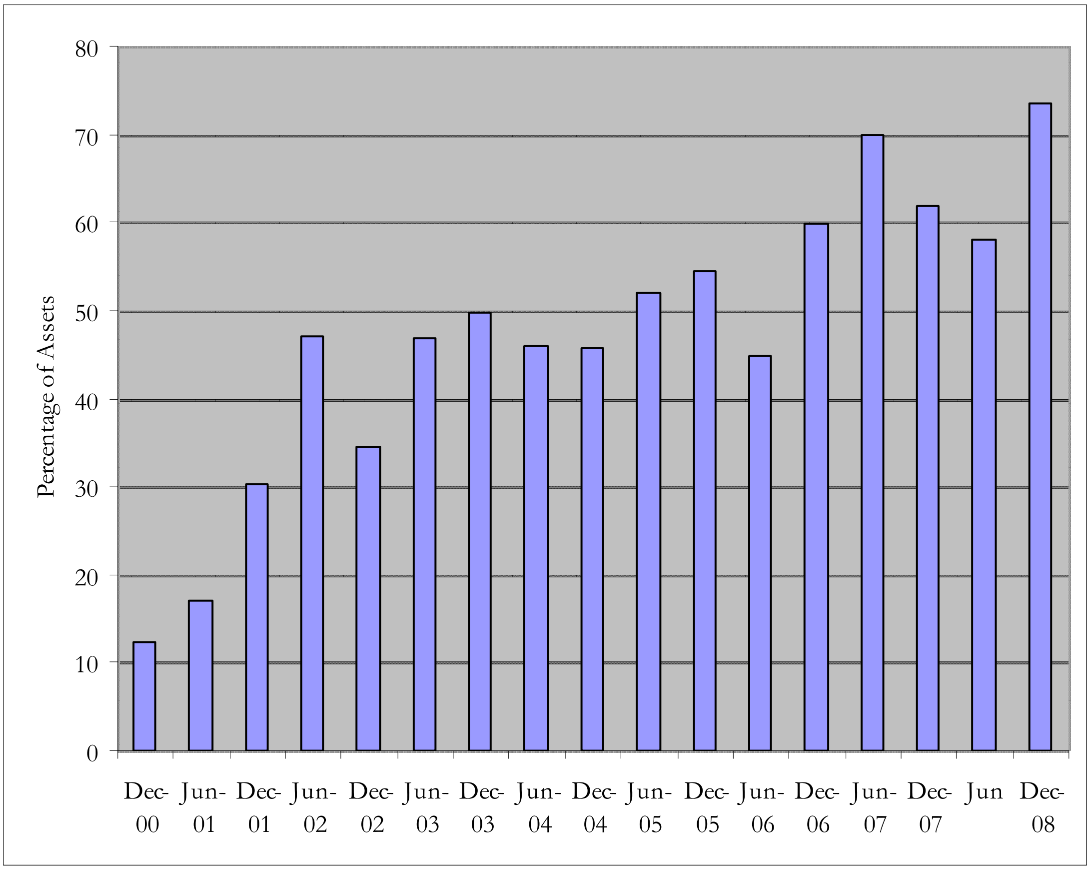

Table 9 (page 18) summarises LCO's results. Its *Annualised Return* has averaged 17.8% per year, and *Annualised Return to Class E Shareholders* has averaged 13.4%. Annual Return expresses the sum of *Total Beneficial Earnings Per Share* for the current and immediately preceding half-year (T.B.E.P.S. means all investment income per share. It is a conservative and "businesslike" measure: it does not include unrealised capital gains and is therefore not influenced by fluctuations in the market prices of investments; it also includes the franking credits associated with this income. Annualised Return (Class E Shareholders) expresses the sum of the *Grossed-Up Dividend* per Class E share for the current and immediately preceding half-year as a percentage of the Company's assets. (G.U.D. means the dividend including franking credits paid per Class E share.)

Table 9:
LCO's Cumulative Results
Six-Month Periods Since Inception

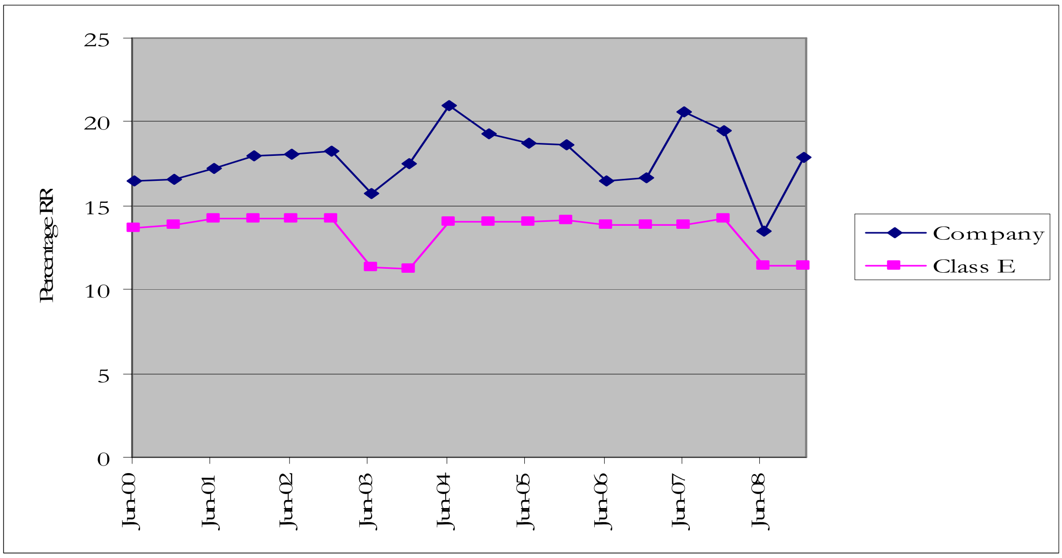

Table 10:
LCO's Accumulation of Capital Since Inception
(versus Australian Shares and Bonds)

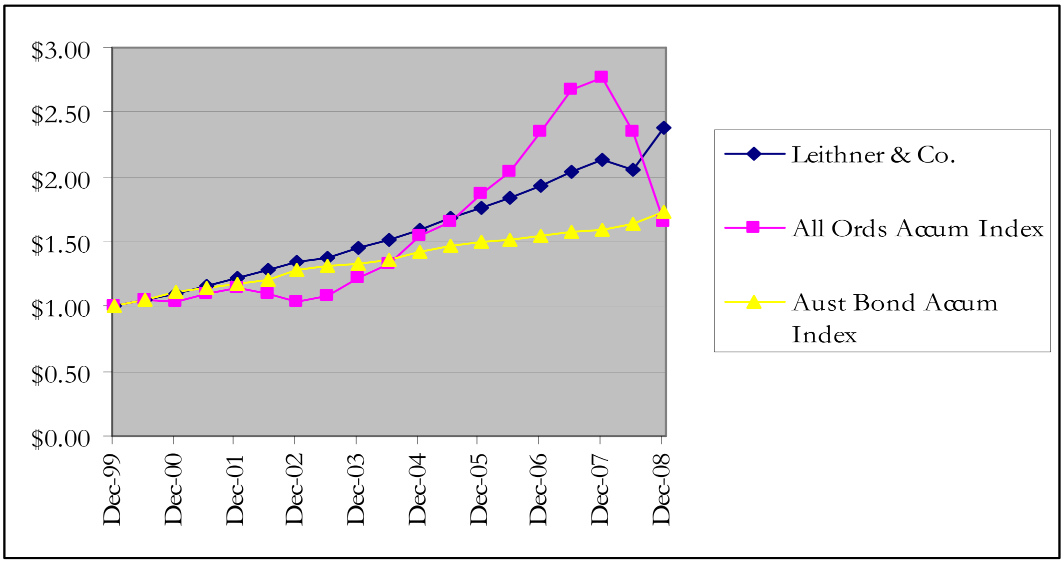

Table 10 compares LCO's results to the All Ordinaries Accumulation Index and the Australian bond accumulation index. Each dollar invested in Leithner & Co. on 30 June 1999, if it had been reinvested in the Company's Class E shares, would by 31 December 2008 have grown to $2.31, generated $0.35 of franking credits and possessed net unrealised capital gains and undistributed franking credits of ca. $0.04 per share. This equates to a total gain of 175% and a compound rate of growth since 1999 of 12.6% per annum. A dollar invested in the All Ordinaries would by 31 December 2007 have grown to \$2.77. Alas, it then shrunk to \$2.35 by 30 June 2008 and to \$1.65 by 31 December 2008.

Three points emerge from a comparison of LCO's results with the historical "benchmark" results in Tables 2-4. First (and probably reflecting its corporate structure and the fact that dividends and distributions tend to be much less erratic than the prices of listed securities), LCO's results are relatively stable from year to year. Second (and again reflecting the importance of dividends), LCO's rate of accumulation of capital over one-year, five-year and ten-year periods seem to compare favourably to the historical means and medians (which, as mentioned previously, do not include dividends and distributions).[20]

Third, from June 2002 until December 2004 LCO modestly "outperformed" the All Ordinaries Accumulation Index. As the Great Bubble gathered steam, however, LCO "underperformed" by an ever-wider margin. Its underperformance decreased considerably in June 2008, and by December 2008 it had once again begun to outperform. Like the tortoise and the hare, so too LCO and the crowd: LCO has lagged during bull markets and economic booms, and surpassed during bear markets and busts. And like the "Superinvestors" other than Buffett, LCO has underperformed roughly one-third of the time. Alas, the results generated for Class E shareholders over a decade are only 60% of the average achieved by the "Superinvestors" over much longer intervals.

The Most Important Benefit

The fruits of value investing can include reasonable long-term results. Regardless of the short-term volatility of investment markets, part-owners of quality businesses tend over the years and decades to enjoy moderate prosperity. They also tend to lead unfettered and relatively peaceful lives – or, at any rate, their investments do not cause them to lose sleep or undue amounts of hair. LCO's ultimate objective, and its greatest potential benefit, is the cautious creation and long-term accumulation of wealth through a vehicle that harnesses and melds the enlightened self-interest of its Directors and share-holders (see also its Distinguishing Features).

Chris Leithner
12 February 2009

20 It's important to emphasise that it's not reasonable for shareholders to expect exceptional (or even above-average) results from their investments. They should always remember that regression to the mean or something very similar to it pervades financial markets. Further, investment operations, including those undertaken by LCO, are inherently risky. LCO's results in the future will certainly fluctuate, losses may be incurred and the results of the past are not reliable indicators of what might transpire in the future. As the vital phrase goes, "past performance does not guarantee future performance."