The Equus Report

—BY BARNABY LEVIN

The Pareto Principle

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"The Pareto Principle" *aka* Let Your Winners Run

According to **The Pareto Principle**, 80% of all outcomes (or outputs) result from 20% of all causes (or inputs) and the *amazing* thing is that this Principle can be applied to just about ***every*** aspect of our lives. Whether it's money, work or how we allocate our time, if we focus on those inputs that are most productive, the more effective we'll be in everything we do.

For example, according to the 80/20 (or, better, **20/80 Rule**), one of the *problems* with **investing in Indexes** is that they're filled with a lot of "Losers" that hold you back but, because they're part of an Index, you have no effective way to prune them without selling your Winners as well. So, your only Defense is, either

a) based on whether you feel the "Market" is "over" or "under" valued *in general*, you under- or overweight ***stock*** in your Portfolio as a whole; ***or***

b) to periodically "re-Balance" your Equity exposure to maintain some, arbitrary Stock-to-Bond ratio – like an Age-Based, Asset Allocation or the (in)famous "60/40" Rule[1] -- that are based on historical returns dating back to the early '80s when interest rates were in the teens instead of today, when they're closer to Zero.

The latter provides the foundation upon which "Passive Investing" (championed by Burton Malkiel in his book, **A Random Walk Down Wall Street**) is built – that is, on the belief that trying to beat the

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[1] The "60/40 Rule" means 60% Stock / 40% Bonds. The "Age-Based" formula is a "rule of thumb" whereby an investor would subtract their age from 100 to know how much of their portfolio they should hold in stocks. A 30-year-old, for example, would allocate 70% of their portfolio to stocks, while a 60-year-old would allocate 40%. However, as life expectancy continues to increase, perhaps the new suggestion will be to subtract from 110? Or, even, ***120***?!

Market is a "fool's errand." Either way, when following either of these approaches, you're always selling your best performers as well.

On the other hand, most Indexes (like the S&P500) are "Capitalization-Weighted" (that is, the greater a Company's *Market Value*, the more of an impact it has) – and, once a stock has been added, there's seldom (if ever) any rebalancing. So, if you *truly* remain "Passive" (and let things go) ***and*** you invest in a ***Cap-Weighted Index***, the ***winners will become a bigger part of the Index*** over time and 20% will (once again) drive 80% of the return!

When you come to think of it, some of the Stock Market's ***biggest*** Winners have, over the years, risen in the face of extreme criticism or controversy (think Apple, Amazon and Tesla). Now, "Conventional Wisdom" would argue that, when you get "*lucky*" and one of your stocks is up 50-100%, you should always sell down to your Initial Investment or Target Allocation – to make sure you're locking in your gains ("while you have them") because, at *some* point (the assumption is), the company *will* screw up and your success is, simply, "too good to be true."

Besides the fact that it's demeaning (to suggest that *any* Value *any* Portfolio Manager might have is sheer "luck"), there are two problems with this thinking. The first is that people seldom (if ever) follow the same discipline with their **Losers** (which they tend to hold onto) and, as you pare back your Winners, your Losers become a bigger part of your Portfolio again. Also (and even more *importantly*), if you do this, you'll ***never*** be the Beneficiary of what's known as the "**Snowball Effect,**" *without* which the chances of ever achieving anything ***other*** than "average" performance are minimal at best and you ***may as well*** buy an Index, after all, and save yourself the trouble!

The Bottom Line – according to Gerald Loeb in **The Battle for Investment Survival** – is that "the ***greatest*** safety lies in putting ***all*** your eggs in ***one*** basket and ***watching the basket***!" [2] He believed one should always maintain a hefty allocation to Cash – and to only make small, targeted bets on a handful of stocks in which you have the highest confidence and adding to them on the way ***up***. He proved, through some of the most difficult times including the Great Depression, that great fortunes are ***only*** made through **Concentration**. In other words, while we Diversify to protect ourselves from the possibility we'll make a ***mistake*** – we should, instead, be constantly **Cutting our Losers Short** *and* **Letting our Winners** (when we find them) **Run!**

And, finally, if *all* we have is a Portfolio of truly Magnificent, Blue-Chip Companies – instead of selling our *best* performers – consider the following: As long the Company continues to innovate and generate a large and reliable stream of earnings – as long as ***Management*** continues to maintain market leadership and a strong Balance Sheet, so they can survive and continue to invest in their business through any storm – consider (as Warren Buffett says) **doing "nothing"**! Maybe (just ***maybe*** ;-) take your original investment off the table at some point -- but ***then*** let the rest run for all its worth and think of it like you're "playing on the house."

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[2] "The Battle for Investment Survival," by Gerald M. Loeb, first published in 1935

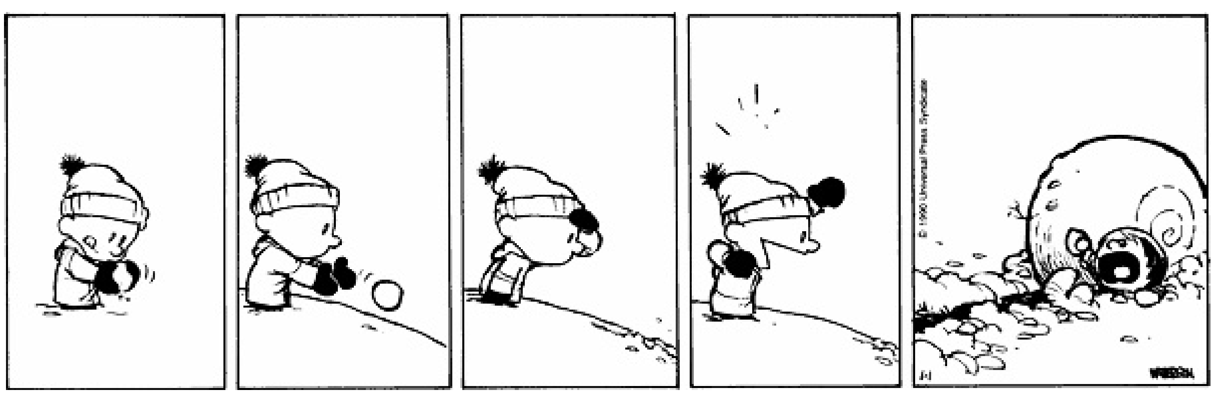
"All there is to investing is picking good stocks at good times and staying with them as long as they remain good companies."
– Warren Buffett

"Compounding is the most powerful force in the universe."
– Albert Einstein

Choosing the right CEO is, in my opinion, one of the most-important considerations. It's "crucial," as Warren Buffett says, that they have "a broad understanding of business and good insights into human behavior" and "be 'all in' for the company," not for themselves, so they can ward off "bureaucracy and complacency."[3] But, when it comes to ***Compounding***, Buffett once asked who got the better deal – Peter Minuit or the Manhattan Indians, who sold their island for $24 in **1626**. When he wrote his Annual Letter in **1965**, Buffett figured the land value of the island was roughly $12.5 billion, which works out to a 6.12% compounded annual gain. Not bad. However, had the "Tribal Mutual Fund" managed to earn 6.5% instead, their $24 would have been worth $42 billion. And, if they could have squeaked out just another half-percentage point – to 7% per year – the value would have jumped to $205 billion! ***That's*** what's known as

"The Snowball Effect"

Think what happens when you push a small snowball down a hill (and what this might have to do with growing ***wealthy***). Well, when you push a snowball down a hill, it continues to pick up snow so that, by the time it reaches the bottom, it has become a snow **boulder**.



Source: Calvin & Hobbes

In other words, the snowball keeps growing (or "*compounding*") as it travels down the hill and, the bigger it gets, the more snow it adds with each revolution, magnifying the result. This is why the term, "Snowball Effect," is such a great metaphor – because it explains how small actions, carried out over time, can lead to ***big*** results and, when it comes to "building *wealth*," vividly demonstrates the power of Einstein's "compound interest."

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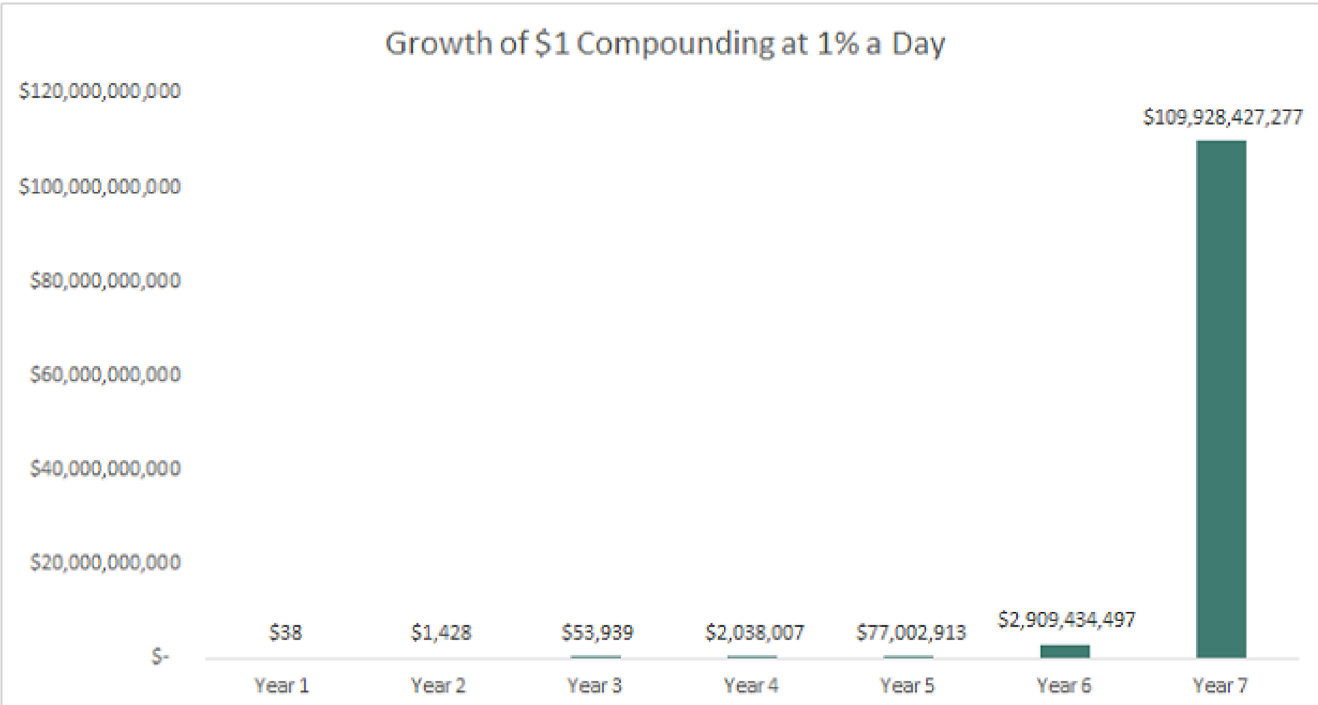
[3] Berkshire Hathaway's "2021 Letter to Shareholders," by Warren Buffett, 27 February 2021

Imagine, for example, that you invested $1 that compounded at 1% a day:[4]



I'm struck by what begins to happen after Years 3 and 4 (let alone the ***Leap*** from Year 6 to 7!) and how the value seems to "balloon"! Now, I'm pretty sure there aren't any investments that compound at 1% a day, year after year, in the *real* world. But with the "Snowball Effect" in mind – and Buffett's Buy-and-Hold approach to investing – let's see what happened to Berkshire Hathaway's ***portfolio*** when he finally made an exception and bought **Apple** in 2016.

Buffett had always avoided "Technology" stocks, in favor of Consumer Goods (like Coke and Gillette); Financials (like American Express and Wells Fargo) – and, of course Insurance (including GEICO) and Industrials (like the BNSF Railroad), both of which he ultimately bought outright. He did so because he and Charlie Munger felt they didn't understand them and wanted to stick with industries "unlikely to experience major change." For example, while forecasters may differ how much soft drink or shaving-equipment a Coke or Gillette might be selling in ten or twenty years, most would likely agree they'll continue to dominate their fields, worldwide, over their lifetime.

My point is that, in making an exception with ***Apple*** – while I actually think he simply "justified" it by deciding that Apple's products were "Consumer Goods" – it was a good thing he did!

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[4] The formula for compound interest is **P (1 + r/n)^(nt)**, where P is the initial principal balance, r is the interest rate, n is the number of times interest is compounded per time period and t is the number of time periods.

As of December 31, 2020, [5] the top **10** holdings (by number of shares) were Bank of America; *Apple*; Coca-Cola; Kraft Heinz; American Express; Verizon; U.S. Bancorp; General Motors; Bank of New York Mellon and Wells Fargo – and a number of those in the Top ***20*** (including Coke, American Express, Gillette[6] and Wells Fargo) are names he'd owned for more than 30 years.

By ***Value***, however, his top ***5*** stocks made up 77.5% of the portfolio – and ***one*** holding, **Apple**, accounted for ***most*** of that:

- **43.86**% is invested in **Apple Inc. (AAPL)**
- 12.67% in Bank of America (BAC)
- 8.77% in Coca-Cola (KO)
- 7.08% in American Express (AXP)
- 5.09% in Kraft Heinz (KHC)

Now, I'm sure Warren would be the first to admit that he's made his share of mistakes – including Waumbac Mills in 1975 and Dexter Shoe in 1993, both of which subsequently went bankrupt. But when he gets it ***right*** – because he lets it run – it has more than made up for his mistakes in terms of his long-term return and, as he has often said, "We continue to make more money when snoring than when active."[7] As *Charlie* says in this year's Letter to Shareholders, "Overall, Berkshire's acquisitions (whether outright or through investments in marketable securities) have worked out well – and ***very*** well in the case of a few large ones."[8]

"Inactivity," Warren said (again in his 1996 Letter), "strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should we behave differently with our minority positions in wonderful businesses? The art of investing in public companies is little different from the art of successfully acquiring subsidiaries. In each case you simply want to acquire, at a sensible price, a business with excellent economics and able, honest management. Thereafter, you need only monitor whether these qualities are being preserved."

"**When carried out capably,"** he continues, **"an investment strategy of that type will often result in its practitioner owning a few securities that will come to represent a very large portion of his portfolio**. This investor would get a similar result if he followed a policy of purchasing an interest in 20% of the future earnings of a number of outstanding, college basketball stars. A handful of these would go on to achieve NBA stardom, and the investor's take from them would soon dominate his royalty stream. To suggest (however) that this investor should sell off portions of his most

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[5] Investors.com, "Warren Buffett Stocks: What's Inside Berkshire Hathaway's Portfolio," 17 February 2021
[6] Now owned by **Procter & Gamble**
[7] Berkshire Hathaway's "1996 Letter to Shareholders," by Warren Buffett, 28 February 1997
[8] Berkshire Hathaway's "2020 Letter to Shareholders," by Warren Buffett, 27 February 2021

successful investments simply because they have come to dominate his portfolio is akin to suggesting **that the Bulls trade Michael Jordan** because he has become so important to the team."

Again, with companies like Coke and Gillette – which he calls "**Inevitables**" and whose dominance, he believes, will only strengthen – he acknowledges that "Charlie and I can identify only a few **Inevitables**, even after a lifetime of looking for them… Some industries or lines of business exhibit characteristics that endow leaders with virtually insurmountable advantages and tend to establish Survival of the Fittest as almost a natural law. But most do not – and for every Inevitable, there are dozens of Impostors, companies now riding high but vulnerable to competitive attacks." As a result, "considering what it takes to be an Inevitable, Charlie and I recognize that we will never be able to come up with a Nifty Fifty or even a Twinkling Twenty" and, so, "to the Inevitables in our portfolio, we add a few '**Highly Probables**.'"

When it comes to individual investors, he suggests that "most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees." But for those who insist on constructing their own portfolio, he offers the following thought: "**Intelligent investing is not complex, though that is far from saying it is easy**. What an investor needs is the ability to correctly evaluate *selected* businesses." In other words, "you don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence," because "the *size* of that circle is not important" – "knowing its *boundaries* ***is***."

Also, in Buffett's opinion, "to invest successfully, you need ***not*** understand **beta**, **efficient markets**, **modern portfolio theory**, or **option pricing** (and may, in fact, be better off knowing *nothing* of these "which," he admits, "is not the prevailing view at most business schools"). Instead, "your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. **Over time, you will find only a few companies that meet these standards - so when you see one that qualifies, you should buy a meaningful amount**. You must also resist the temptation to stray from your guidelines: **If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes.** Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

Following this line of thinking, in spite of technology – despite "AI," quantitative analysis and 24/7 Trading by some of the biggest hedge funds in the world – it is still ***people*** that make markets. And, while Investor Sentiment surely has an influence over short-term market direction and stability, the long-term value of a stock is ultimately determined by the economic progress of the business. It's just that investors must be both **financially** *and* **psychologically** prepared to deal with the everyday market fluctuations. In this day and age, the market can rise or fall by more than 10% on *any* given day so, unless you can watch the value of your stock holdings decline by as much as ***50***% (which, since 1965, Berkshire Hathaway itself has done *three times*!)[9] …without becoming ***panic stricken***…it will be difficult to succeed. And if you ***do*** have a more concentrated Portfolio, some of those swings may be even *more* exaggerated and, in the short-term, more uncomfortable at times. But if you're investing for the ***long-term*** and are willing to let compounding and the "Snowball Effect" take place with your highest-conviction holdings, I have also found that great companies also tend to snap back more quickly and to a greater degree than the Market overall, so price declines should be thought of as (dare I say it?) a (somewhat) "welcome" way to add more shares to your portfolio at lower prices and, as long as you're investing in a soundly run business with good fundamentals, the market *will* eventually acknowledge success. As Benjamin Graham once said, while "in the short-term, the market is a **Voting** Machine; in the long-run, it acts as a ***Weighing*** Machine."

Needless to say, investment **success** is *not* the same as ***infallibility*** – and the moment ***any*** of us start to get cocky, that's when you'll *know* we're in trouble. Instead, **success comes by doing more things *right* than wrong** – and, in order to do that, in my opinion, **we need to *reduce* the number of things we can get wrong while focusing on the things** (that is, on the ***20%***) **we expect to get *right***.

In the words of the "Oracle of Omaha": **''An investor should act as though he had a lifetime decision card with just twenty punches in it. With every investment decision his card is punched, and he has one fewer for the rest of his life.''[10]**

I hope you have an *Awesome* Year.

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[9] Berkshire Hathaway's "2020 Letter to Shareholders," by Warren Buffett, 27 February 2021
[10] Berkshire Hathaway's "1996 Letter to Shareholders," by Warren Buffett, 28 February 1997