The Successful Fulltime Portfolio Manager – An Oxymoron?

by Mohnish Pabrai

17th century French scientist Blaise Pascal is perhaps best remembered for his contributions to the field of pure geometry. In the very short 39 years that he lived, he found time to invent such modern day fundamentals as the syringe, the hydraulic press and the first digital calculator. And, if that weren't enough, he was a profound philosopher as well. One of my favorite Pascal quotes is:

All man's miseries derive from not being able to sit quietly in a room alone.

I've often thought that Pascal's words slightly adapted might apply well to a relatively new subset of humanity:

All portfolio managers' miseries derive from not being able to sit quietly in a room alone.

Why should portfolio managers sit and do nothing? And why would that be good for them? Well, let's start with the story of D. E. Shaw & Co. Founded in 1988, Shaw was staffed by some of the brightest mathematicians, computer scientists and bond trading experts on the planet. As an example, Princeton grad Jeff Bezos worked at Shaw before embarking on his Amazon journey. These folks found that there was a lot of money to be made with risk-free arbitrage in the bond markets with some highly sophisticated bond arbitrage trading algorithms.

Shaw was able to capitalize on miniscule short-term inefficiencies in the bond markets with highly leveraged capital. The annualized returns were nothing short of spectacular – and all of it risk free! A friend of mine who was at Shaw at the time explained to me how Shaw was able to put about $100 Million to work in this manner.

The bright folks at Shaw had eventually put nearly all of this on auto pilot with minimal human tweaking required. They came to work and mostly played pool or video games or just goofed off. Shaw's profit per employee was astronomical and everyone was happy with this utopian arrangement.

As with all arbitrage opportunities, there are very finite limits to the amount of capital that can be deployed. Shaw was maxed out. At the same time, the nerds were getting fidgety. It is very hard to take folks with Bezos' intellect and have them play pool all day. These folks wanted challenging work and also had large egos built up from the remarkable success they had enjoyed. They felt that they had only scratched the surface and if they only dug deeper there was more gold to be mined.

What followed was a path similar to Long Term Capital (LTC). There was a gradual movement from pure risk-free arbitrage to playing the risk arbitrage game in the equity markets. A lot more capital could be deployed and the returns looked appealing. With no guaranteed short-term convergence and highly leveraged positions, the eventual result was a blow-up that nearly wiped out the firm. If only the bright folks at Shaw and LTC had read Pascal's *Pensees* and stuck to playing pool.

Compared to nearly any other discipline, I find that fund management is, in many respects, a bizarre field - where hard work and intellect don't necessary lead to satisfactory results. As Warren Buffett succinctly put it during the 1998 Berkshire Hathaway annual meeting:

"We don't get paid for activity, just for being right.
As to how long we'll wait, we'll wait ***indefinitely****!"*

Buffett and Charlie Munger are easily among the smartest folks I've come across. But, as we've seen with Shaw and Long Term Capital (LTC), high I.Q. is more likely to lead to trouble than stellar investing results. In a 1999 interview with BusinessWeek, Buffett stated:

Success in investing doesn't correlate with IQ - once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.

While I think Buffett is being too modest with the 25 IQ bit, I do believe that once you're above about 120 or so in IQ, it ceases to be the determining factor. We've also seen with Shaw and LTC that high IQ folks have a very hard time sitting around contemplating their navels. The have a need to be engaged. The problem is that once you engage in these intellectually stimulating problems, you're almost guaranteed to find what you think are the correct answers and act upon them – usually leading to bad results for investors.

Having observed Buffett and Munger closely over the years and gotten into their psyches through their speeches and writings, it is clear to me that both men need enormous doses of intellectual stimulation as part of their daily diet. How do they satisfy this intellectual hunger without the accompanying actions that get portfolio managers into trouble?

I believe the answer lies in examining their specific nuances. Consider the following:

Buffett's favorite past-time is playing bridge over the internet. Having tracked the number of hands he typically plays on www.okbridge.com, I estimate that he typically spends 10-20 hours a week playing bridge online. Having spent thousands of hours at the game myself, I can vouch for the fact that while it takes 15 minutes to learn the game, it cannot be fully mastered even after a lifetime of play. The game poses unending intellectually stimulating problems and constantly humbles one time and again. Had Buffett spent all his bridge time on portfolio management during the last 40 years, I believe Berkshire shareholders would have been far worse off.

While Buffett plays bridge, Munger spends his time mostly on expanding his worldly wisdom and constantly improving his latticework of mental models. He is a voracious reader of intellectually engaging books on a variety of subjects ranging from the various Ice Ages to the Wealth and Poverty of Nations. He spends considerable time in applying perspectives gained from one field of study into other disciplines - especially capital allocation.

This year at the Wesco annual meeting, Munger acknowledged that the first few hundred million dollars at Berkshire came from "running a Geiger counter over everything", but the subsequent tens of billions have come from simply "waiting for the no-brainers" or, as Buffett puts it, "waiting for the phone to ring".

Between the two men, Buffett still has a tendency to run his Geiger counter over lots of stuff. It's just too enticing intellectually not to. How does he avoid getting into trouble? There are three reasons I believe:

1. Running the Geiger counter can work very well if one knows *when* to run it. Reflect on the following two quotes:

   In 1970, reflecting his dismay at elevated stock prices, Buffett said:

   "I feel like a sex-starved man on a deserted island"

   In 1974, refecting his glee at the low levels the market had fallen to, he said:

   "I feel like a sex-starved man in a harem filled with beautiful women!."

By 1970, Buffett had terminated his partnership and made virtually no public market investments until 1974. The P/E ratio for the S&P 500 had gone from 20 to 7 in those four years. And in 1974, the buy and hold Buffett that we know today was so amazed that he acknowledged selling "stocks he'd bought recently at 3 times earnings to buy stocks selling at 2 times earnings". Needless to say the approach worked exceeding well as Berkshire's stock price went from $40 to $420 from 1975 to 1980 (an annualized rate of return of 60%!)

Another period of inactivity came from 1984 to mid 1987. Relative to its book value, Berkshire Hathaway was sitting on a mountain of cash. Yet, during that 3+ year period, Buffett did not buy a single new equity position for the Berkshire portfolio. In the latter half of 1987, Berkshire used that cash pile to buy over a billion dollars worth of Coca Cola stock and ended up with over 5% of the company. Buffett and Munger had invested something like 25% of Berkshire Hathaway's book value in a single company that they did not control!

What were Buffett and Charlie doing from 1970-73 and 1984-87? Both men realize that successful investing requires the patience and discipline to make big bets during the relatively infrequent intervals when the markets are undervalued and to do "something else" during the long periods when markets are fully priced or over-priced. I'm willing to bet that Buffett was playing far more bridge in 1972 than he was in 1974. In fact, Buffett's annual bridge playing hours might well have hit a 30-year low in 1974.

2. The Geiger counter approach works better in smaller, under-followed companies and a host of Special Situations. Given their typical smaller size, investing in these companies would do nothing for Berkshire Hathaway today. So Buffett usually makes these investments for his personal portfolio. A good example is his recent investment in an obscure mortgage REIT that was in the process of liquidating (Laser Mortgage Management - LMM) where there was a decent spread between the liquidation value and quoted stock price. These LMM type investments are significant for Buffett's personal portfolio and, more importantly, soak up intellectual horsepower that might get lead to not-so-good results at Berkshire Hathaway.

Being versatile, he moves his Geiger counter away from the equity markets to other bastions of inefficiency whenever the public markets get over heated. These include high-yield bonds (Berkshire bought over $1 Billion worth of Finova bonds at deep discounts in 2001), REITs (bought First Industrial Realty in 2000 for his own portfolio at a time when REIT yields were spectacular) or his adventures with investing in Silver recently.

3. The Munger/Buffett relationship is an unusual one. Both men are fiercely independent thinkers and both strongly prefer working alone. When Buffett has a investment idea, after it makes it through his filter, he usually runs it past Charlie. Charlie applies his broad latticework of mental models to find faults with Buffett's ideas and shoots most of them down. It is the rare idea that makes it past Buffett and it has to be a total no-brainer to make it past both Buffett and Munger. This unusual tag team works wonders.

The Buffett/Munger approach of multi-year periods of inactivity is in stark contrast to the frenzied activity that takes place daily at the major exchanges and nearly all mutual funds. Fund managers (and, more importantly, their investors) would be far better off if they simply took long sabbaticals during most of their careers or adopted a daily routine of playing bridge all day with the occasional break from bridge to do some capital allocation.

Which brings me back to the fundamental question: Why have we setup portfolio managers as fulltime professionals with the expectation that they "do something smart" everyday? The fund management industry needs to reflect on Pascal's potent words and how Warren Buffett and Charlie Munger have figured out how to sit quietly alone in a room indefinitely.

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