Buffett on the Value of Patient Optimism

March 3, 2015

by William Smead

of Smead Capital Management

Dear Fellow Investors,

Like picking up the Good Book, a read of Berkshire Hathaway's Annual Shareholder Letter yields insight, wisdom, and encouragement for the long-duration common stock investor in a world of short-term thinking and 30-second sound bites.

Over the weekend, we culled the letter to distill out the most applicable lessons. The excerpts below are what we at Smead Capital Management find to be most striking, pertinent and valuable.

1. **Child-like faith and the optimism of far younger generations**

> Indeed, who has ever benefited during the past 238 years by betting *against* America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, *real* per-capita U.S. output has *sextupled*. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket).
>
> The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.

We read Buffett's letter as saying that today's Millennials, especially in America, are going to be just as successful as previous generations. The productivity devices at their disposal are more easily incorporated into their business life and their current selfishness should disappear fast when marriage and children come along. Buffett knows and trusts time as the greatest asset of the patient optimist.

2. **Analyze and operate in long-durations**

> There is an important message for investors in that disparate performance between stocks and dollars. Think back to our 2011 annual report, in which we defined investing as "the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future."
>
> The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been far safer to invest in a diversified collection of American businesses than to invest in securities – Treasuries, for example – whose values have been tied to American currency. That was also true in the preceding half-century, a period including the Great Depression and two world wars. Investors should heed this history. To one degree or another it is almost certain to be repeated during the next century.

To Buffett, the key for most investors is the maintenance and expansion of purchasing power. It's nearly a mathematical fact that interest-earning "currency" investments can't provide long-term real returns which enhance purchasing power. Additionally, we think the benefits of being a patient investor in American businesses compounds over time.

3. **Understand what risks are useful and useable**

> Stock prices will always be far more *volatile* than cash-equivalent holdings. *Over the long term*, however, currency-denominated instruments are *riskier* investments – *far* riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is *far* from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray.

> It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. That is relevant to certain investors – say, investment banks – whose viability can be threatened by declines in asset prices and which might be forced to sell securities during depressed markets. Additionally, any party that might have meaningful near-term needs for funds should keep appropriate sums in Treasuries or insured bank deposits.

Stocks don't perform in anything close to a straight line. Long-duration holding periods melt away the significance of price volatility and the variability of results. Buffett suggested that most professional investors and asset allocators have no interest in long-duration time frames; instead, they want to scare investors into accepting mediocre to poor results by toning down volatility.

4. **Scars of Experience—being a better shareholder/better business owner**

> I've mentioned in the past that my experience in business helps me as an investor and that my investment experience has made me a better businessman. Each pursuit teaches lessons that are applicable to the other. And some truths can only be fully learned through experience.

Most professional investors fall into two categories. Many are young with passion and enthusiasm who lack the scars and wisdom drawn from experience. Others are older with much wisdom from the scars of experience, but are heavily affected by the insidious creep of cynicism and personal limitations. Buffett is neither envious nor jealous of younger men's enthusiasm and vitality, nor has he grown cynical and frustrated by the human condition (fallibility). We can't underscore enough how critical this personal combination has been to Buffett's success.

This year's letter, like the prior 49, reinforces the importance of and patience required for long-duration investing. We would like to thank Mr. Buffett (and Charlie Munger) for their yearly reminder.

Warm Regards,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. Bill Smead, CIO and CEO, wrote this article. It should not be assumed that investing in any securities mentioned above will or will not be profitable. A list of all recommendations made by Smead Capital Management within the past twelve month period is available upon request.