So, we'll talk about the portfolios. And we might talk about performance, but it won't be about short-term performance, because—forgive a perhaps incendiary statement—it's meaningless. We'll review some portfolio holdings, using some objective valuation facts and predictive attributes as they relate to security selection, but only in a long-term context. We won't reference much in the way of the macroeconomic factors that are considered a de rigueur element of the portfolio management process and security valuation models, such as the outlook for interest rates, GDP growth, future oil prices, and so forth. In actuality, they are more a source of bad decision making and return erosion than they are of assistance. Sound extreme? A couple of examples, then, to set the stage. These examples will, for contrast, include substantial data of the sort that are considered important or even critical in investment decision making by non-long-term investors, yet in reality are not able to reliably inform decisions that assure or improve returns.

What is Long Term, Anyway, and Would You Fire this Manager?

First, here are some actual 5-year performance figures for a certain investment partnership, to be identified later. These are net of management fees and expenses. Your task is to determine whether an investment consultant would have retained or dismissed this manager on behalf of clients in the fund. Without exaggeration, the underperformance is massive, a difference of roughly 28 points.

	Fund	S&P 500
1970	(0.1)%	2.4%
1971	20.6%	14.9%
1972	7.3%	19.8%
1973	(31.9)%	(14.8)%
1974	(31.5)%	(26.6)%
Cumulative	(39.7)%	(11.8)%

For illustrative purposes only.

Source: Warren Buffett, "The Superinvestors of Graham-and-Doddsville," *Hermes, the Columbia Business School Magazine* (Fall 1984), 4-15, http://www8.gsb.columbia.edu/rtfiles/cbs/hermes/Buffett1984.pdf

Is 5 years sufficient time to permit a reasoned judgment? Bear in mind that the manager underperformed during 4 of these 5 years. Worse yet, a standard statistical analysis of the fund's return patterns, such as its beta or Sharpe ratio or alpha, would have revealed that it was far more volatile relative to its returns and the returns of Treasuries than the market, such that the manager would appear to have been taking excessive risk. It probably does not require much discussion to agree that late in year 5 or early in year 6, this manager—had he managed to last that long—would have received a letter of dismissal.

But what if we add a few more data points? The preceding 8 years look very different than the 5 above. This same manager outperformed the market in each year but one, and by a yet more massive 94% points. And in the original year 6, which was the final year of this 14-year record and which would have been the year of this manager's dismissal, the fund returned a rather startling 73.2%.

	Fund	S&P 500
1962	20.1%	(10.6)%
1963	47.8%	23.3%
1964	33.1%	16.5%
1965	6.0%	13.1%
1966	8.3%	(10.4)%
1967	37.5%	26.8%
1968	27.0%	10.6%
1969	21.3%	(7.5)%
1970	(0.1)%	2.4%
1971	20.6%	14.9%
1972	7.3%	19.8%
1973	(31.9)%	(14.8)%
1974	(31.5)%	(26.6)%
1975	73.2%	36.9%
Cumulative	5.96x	2.03x
Annualized	13.6%	5.2%

Source: Ibid. For illustrative purposes only.

Over the full 14 years, the fund returned 13.6% annually versus the S&P's 5.2%, or 6.0x a client's original investment, versus 2.0x for the S&P 500. The true time period, as shown in the second table, was 1962 through 1975. The fund was Munger Partners, and the fund manager was Charles Munger, perhaps best known as the Vice Chairman of Berkshire Hathaway and longtime business partner and confidant of Warren Buffett.

No doubt, modern portfolio analytical techniques can reveal some interesting aspects of a fund manager's style, but such analysis would also have dictated the firing of Charlie Munger. Such data is no substitute for understanding the thought process behind the construction of a portfolio. They don't describe the degree of undervaluation or return expectations for the securities within it—

would the decision to dismiss have been any different if the consultant understood the nature and valuations of the holdings? Perhaps not—one might, in order to know this, have to evaluate the *consultant's* decision making and risk control processes in the conduct of that business.

One might pause, for just a moment, to again consider just how extraordinary the Munger Partners returns were for his investors, and just how extraordinary the opportunity cost was for the hypothetical dismissal of his services. Even so, the Munger Partner returns pale beside his later investment record.

Just as Warren Buffett ultimately closed Buffett Partnership and continued investing through the corporate vehicle of Berkshire Hathaway, so too did Charlie Munger eventually operate through his control of publicly traded Wesco Financial. During the 10-year period 1989 to 1999, the book value of Wesco Financial compounded at a 21.0% annual rate, from $39.54 per share to $266.21.