The Bumpy Ride: 
BBH’s Approach to Selling Decisions

Peter Lynch’s famous saying, “Don’t cut your flowers to water your weeds,” highlights perhaps the most daunting challenge any investor faces: determining the right time to depart from a business, asset or fund. Indeed, ask a capital allocator what the most difficult decision to get right on a consistent basis is, and whether the respondent is a part of a company’s management team, stock picker of a fund or CIO of an endowment, the answer is most commonly “when to sell,” including avoiding both selling too early and holding on for too long.

Why is selling at the right time so difficult? The answer can be found by simply looking in the mirror. It’s largely due to our own human biases, unfortunately. Loss aversion, or regret minimization, is an obvious bias that makes it hard to effectively part ways with assets. This bias is related to the disposition effect, the tendency of investors to sell investments whose price has increased while keeping assets that have dropped in value – or the exact type of behavior Lynch warns investors to avoid. Other biases that cause investors to sell too soon or hold on for too long include overconfidence bias, which tends to grow the longer one owns an asset; recency bias, or the application of recent experience as the baseline for what will happen in the future, which is typically dangerous when investing; representative bias, or when we infer too much from a small amount of information, such as selling a stock or fund based on short-term underperformance; and the endowment effect, which describes when individuals value something they already own more than something they do not yet, making it more difficult to sell and move on when news is bad. Unluckily for us, this is not an exhaustive list.

While our biases offer little help, there may be a darker reason to why effectively selling is so difficult for investment professionals: career risk – a topic most investment professionals will never broach with their clients. Unfortunately, it permeates all areas of investment behavior, ultimately creating an investing environment where one must never be wrong on his or her own. This risk typically results in investors selling an underperforming security at a loss too early to avoid difficult conversations with their clients. As Oaktree Capital’s Howard Marks elegantly said at our 2015 Investor Day event, “Unconventional behavior is the only road to superior investment results, but it isn’t for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes.” He followed by asking, “Can you hang in long enough for the wisdom of your correct actions to become apparent?” The answer for most in the investment business is a resounding “no,” largely due to the fear of losing one’s job. Fund managers often grow tired of talking about the short-term losers in their portfolios, preferring to sell short-term “mistakes” to avoid less-than-pleasant conversations. CIOs typically prefer to avoid having to discuss an underperforming fund with their investment committee. Financial advisors will do just about everything within their power to avoid red on client statements. This type of behavior is driven primarily by career risk and the ever-growing short-term mentality pervasive in the industry. We do not expect this to change. The herd is alive and well.
The Perils of Selling Based on Short-Term Stock Performance

As we stated in our fourth quarter 2014 InvestorView article, “BBH’s Approach to Manager Selection”: “Research shows convincingly that both hiring and firing decisions based on past performance alone is not a successful exercise.” 1 While we wish our decision-making framework could be solely based on past performance, as that would be relatively easy and straightforward, we are constantly reminded by Charlie Munger’s saying, “It’s not supposed to be easy. Anyone who finds it easy is stupid.”

Results from 2014 research conducted by Windhorse Capital Management CIO David Salem deserve a significant amount of attention as they relate to the topic of the timing of selling. His study, “A Crash Course in Capitalism: Part I,” analyzed the 10 highest-returning U.S. stocks over the 25-, 20- and 15-year periods ending September 2014. Over the 25-year period, the top stock compounded at an annualized 31.8%, and the 10th best stock at an annualized 23.2%. In comparison, the S&P 500 compounded at 9.5%. This type of outperformance over this long of a period results in almost incomprehensibly different outcomes for long-term owners. The top-returning stock compounded from $1 to $988 by the end of the 25-year period, vs. from $1 to $10 for the S&P 500. Long-term owners of financial services software provider Jack Henry & Associates are surely not complaining and have a good understanding of the eighth wonder of the world: compounding!

The consistency of these 10 companies’ returns is interesting on its own – and inspirational to any long-term investor. Even more interesting, though, is that each stock experienced a maximum drawdown of at least 73.4% during the 25-year period. Furthermore, the maximum underperformance of these stocks relative to the S&P 500 ranged from a low of 98.3% to as high as 624.3%. Pouring it on further, periods of relative underperformance ranged from a low of about three years to a high of 14 years. When running Warren Buffett’s Berkshire Hathaway’s performance through this analysis, the company compounded at 13.6% over this time period, experienced a maximum drawdown of 51.5% and underperformed relative to the S&P 500 at a peak of 159.5%, with this time period lasting for a little over five years. Yes, even the investment vehicle stewarded by him. Munger ran the Wheeler, Munger partnership from 1962 to 1975, prior to joining Buffett at Berkshire Hathaway in 1978. The partners in his fund earned six times their initial investment after 14 years, while investors in the S&P 500 doubled their money. On a relative basis, Munger’s fund underperformed the market 36% of the time. On an absolute basis, his three down years (21% of the time) cumulatively cost his partners 53% of their wealth, compared with a cumulative wealth decline of 53% for the market in its five down years (36% of the time). Despite a hefty fee burden, Munger’s net annual return to partners was 13.7%, or 850 basis points better than the market, and his gross (before fee) numbers beat the market by more than 1,450 basis points per year.4 Other examples of long-term winners who experienced periodic bouts of relative underperformance include Bill Ruane of Sequoia Fund5 and Lou Simpson of GEICO.6

One obvious takeaway is that extreme long-term winners are destined to become short-term losers both on an absolute and relative basis at some point in the future, making owners look wrong for some period of time. While this is a somewhat insightful point, the key question is: What should one do to avoid being an investor who succumbs to such investing pitfalls as our own human biases and career risk? We believe the answer lies in having the combination of:

- An unusually long-term orientation
- A sound temperament and natural propensity for independent thought
- A process purposefully built to lessen the influence of biases and a culture that encourages intellectual honesty
- A concentrated number of holdings so that one knows what he or she owns and will not be easily swayed by outside forces
- The right expectations with clients from the beginning

This is easier said than done, but it is what we seek to possess at Brown Brothers Harriman (BBH).

What Applies to Stocks Applies to Managers

The theme of extreme winners going through periods of losing applies at the manager level as well, as stocks, or other asset types, comprise manager portfolios. An analysis of the track records of some of the most successful long-term investors on record confirms that relative underperformance is a near certainty with the very best investors and that duration of lagging performance can extend for multiple years. Since we quoted Charlie Munger earlier, we will pick on him. Munger ran the Wheeler, Munger partnership from 1962 to 1975, prior to joining Buffett at Berkshire Hathaway in 1978. The partners in his fund earned six times their initial investment after 14 years, while investors in the S&P 500 doubled their money. On a relative basis, Munger’s fund underperformed the market 36% of the time. On an absolute basis, his three down years (21% of the time) cumulatively cost his partners 53% of their wealth, compared with a cumulative wealth decline of 53% for the market in its five down years (36% of the time). Despite a hefty fee burden, Munger’s net annual return to partners was 13.7%, or 850 basis points better than the market, and his gross (before fee) numbers beat the market by more than 1,450 basis points per year.4 Other examples of long-term winners who experienced periodic bouts of relative underperformance include Bill Ruane of Sequoia Fund5 and Lou Simpson of GEICO.6

While studying the track records of investment legends is insightful, studies using recent performance data support similar conclusions. In their 2016 study, “The Harm in Selecting Funds that Have Recently Outperformed,” Bradford Cornell, Jason Hsu and David Nanigian reported that:
Investors who chose funds with poor recent performance earned higher excess returns than those who chose funds with superior recent performance (measured by trailing three-year data). If past performance is used at all in selecting funds, it is the best-performing funds that should be replaced.

The report goes on to say: “A heuristic of hiring recently outperforming managers and firing recently underperforming managers turns out to be 180 degrees wrong.” Realistically, however, a policy of replacing successful funds with poor performers is unlikely to gain widespread acceptance and is not tax efficient. Instead, the authors find that asset owners should focus on factors other than past performance, such as a high level of fund manager ownership, high active share and a strong positive firm culture.

Another study, “The Bumpy Road to Outperformance,” conducted by Brian Wimmer, Sandeep Chhabra and Daniel Wallick in 2013, found that “nearly all the funds that beat their benchmarks over that 15-year period [ending December 2012] suffered at least five individual years of underperformance.” In the report, they noted:

Our findings strongly suggest that investors should refrain from using short-term performance as the primary criterion for divesting (or investing in) an active mutual fund. Short-term underperformance will likely accompany an active fund that achieves long-term outperformance. As a result, for those investors interested in pursuing active management, it is important to understand that to increase the odds of success they must be willing and able to endure numerous and potentially extended periods during which their fund will lag its benchmark.

In addition, they added, “Manager timing can be very tempting to investors focused on short-term performance, but it’s a strategy that prior research has shown to be generally unsuccessful.”

A peer of ours also carried out a study analyzing the incidence of top-quartile U.S. large-cap managers underperforming the S&P 500 for at least one period of indicated duration. From the first half of 2003 to the first half of 2013, 31% of the managers over that trailing 10-year period had at least one seven-year period during which they underperformed the index, and more than 99% had at least one three-year period of negative excess return.7

BBH’s Framework

How does BBH determine when to end a partnership with a manager given that basing decisions on past performance alone is the wrong approach? The process begins at initial underwriting. We document our investment thesis, including our expectations for how the investment will perform in different market environments, and it is paramount that these expectations match those of the manager. In addition, we determine the most appropriate benchmark, if any, to compare a manager’s performance against. We make it clear to our partners at the outset that we do not obsess over short-term performance. In turn, we seek to partner with investors who focus more on the input than the output and are more concerned with improving their process than trying too hard to generate strong short-term results. We prefer our partners not assess their performance too frequently, as it can drive even the most long-term-oriented investor to become a short-term thinker, and try our hardest to do the same. Importantly, we also understand that because we invest in high active share, concentrated portfolios, the question is not if, but when our managers will experience periods of underperformance.

Once an investment is made, BBH monitors a manager’s investment decisions closely. This process consists of regular quarterly interactions with key decision-makers and a review of quarterly materials, such as letters authored by our managers and purchase and sale activity, as well as annual onsite visits and ad hoc communications. All interactions are documented, including a formal annual reunderwriting memorandum. Our monitoring process aims to evaluate whether an initial investment thesis is playing out as expected, whether our managers are doing what they said at initial underwriting and whether the opportunity set available to the managers is still attractive relative to other options available. We specifically look for investment style creep (that is, if managers are moving outside of their circle of competence), key team personnel losses, changes to firm culture, personal life distractions, changes to the time allocation of key decision-makers and the firm’s business decisions, such as the management of growth in assets, client selection and ownership changes.

When a manager underperforms for a multiyear period, BBH first determines why the strategy underperformed, evaluating the decisions made at the individual stock level. We look to see whether there have been repeated mistakes and if there are any patterns in when the manager experienced permanent impairments. Our primary focus is to determine whether the risk-adjusted returns generated meet our investment thesis and expectations. We evaluate rolling three-, five-, seven- and 10-year performance figures, with a particular focus on peak-to-peak (or full cycle) performance, which is typically seven years or longer. While the returns are an important component of this analysis, we understand that returns unaccompanied by an assessment of risk do not provide the full picture; thus, we analyze metrics such as batting average (percentage of positions that have made money vs. lost money), slugging percentage (how effective the manager has sized positions) and downside capture (how the manager does vs. its benchmark in periods where the benchmark is down) to determine whether the manager has managed risk appropriately and in line with our expectations.
When We Sell

BBH will sell investments and part ways with partners for several reasons. If terminating for performance reasons, we must conclude that the risk-adjusted return the manager has generated over a full cycle has not met our expectations and that we no longer believe that the strategy’s return will be able to meet our expectations going forward. The majority of manager terminations will be for qualitative reasons. We have and will end partnerships for the following reasons:

- Managers diluting their edge by growing their assets too large
- Managers launching new strategies that distract them from the strategy in which we have invested our capital
- A change in the firm’s ownership or in the terms (such as fees or liquidity) that negatively affects alignment
- A change in firm culture tainted by things such as complacency, lack of focus or overconfidence
- The loss of key personnel
- Our conclusion that the current team is not fully qualified to execute the strategy in the current environment

Importantly, we do not allow a manager to steward our capital over a full cycle if we identify any of these qualitative issues.

Lastly, we will part ways with managers if we determine their investable universe is no longer attractive relative to other available options. We strive to develop deep relationships with our managers, along with other investors we respect, to help us understand when certain asset classes are unattractive, or alternatively, when there is an opportunity to increase the amount of capital allocated to a particular asset category. In these cases, we may withdraw capital or end a partnership with a manager that underperformed our expectations or add to a manager that underperformed if we have developed a strong view of its opportunity set.

Final Thoughts

Assuming we manage the risk in our portfolios correctly and never put ourselves in the position of a forced seller, we favor a bumpy ride (from a relative return perspective) to superior returns over a smooth ride to mediocre returns. In order to reach the final destination, it is paramount that we see through short-term turbulence or outside pressures with each of our investments. While we wish we could promise to never succumb to our human biases, that goal is unrealistic. Rather, our investment team aims to mitigate most of that risk through our process and a healthy debate. Lastly, we confront career risk head on, always focused on what is in the best long-term interests of our clients, whether or not it makes us look wrong for some period of time – even for an uncomfortable amount of time to most.

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1 As the manager of the Magellan Fund at Fidelity Investments between 1977 and 1990, Lynch averaged a 29.2% annual return – consistently more than doubling the S&P 500 market index and making it the best-performing mutual fund worldwide. Lynch has written (with co-author John Rothchild) three texts on investing: One Up On Wall Street, Beating the Street and Learn to Earn.


3 Concentrated portfolios can have greater price fluctuation.


5 Sequoia Fund was launched in the second half of 1970 and run by Ruane through 2004. Looking at Ruane’s record, he underperformed the S&P 500 in 13.5 years (39% of the time). On an absolute basis, he had down years 13% of the time and on a cumulative basis lost 50% of investor wealth in those years. The S&P 500, by comparison, had down years 23% of this time and on a cumulative basis lost 67% of its wealth. Investors with Ruane for the full 34.5 years saw their money multiply 173 times in value, compared with approximately 49 times for the S&P 500. Ruane’s net returns were 16.1%, or 420 basis points better than the market.

6 On a relative basis, Simpson’s portfolio underperformed the S&P 500 28% of the time. Simpson suffered just three down years (12% of the years), during which it gave back a cumulative 25% of wealth. The market had five down years during this period, cumulatively losing 43%. In a testament to the power of compounding money over long periods of time, Simpson’s 25-year return was 10,061% (102 times) vs. 2,283% (24 times) for the S&P 500.
