Brown Brothers Harriman

Core Select: A Prudent Way To Invest

With an average annual return of 10.4% for the S&P 500 from 1926–2005, U.S. equities have significantly outperformed bonds and most other asset classes over time. While the benefits of long-term equity investing are well known, many investors are nevertheless concerned about equities as an asset class because they are aware of the sharp declines in equity prices that have occurred with relative frequency in the past. These fears are well-founded.

Stock market returns have historically been negative about one in every four years and there have been several periods of extended negative returns when stocks fell by 50% or more in real inflation-adjusted terms. Severe bear markets have typically been caused by a combination of macroeconomic factors such as rising inflation, commodity price spikes, recessions, currency crises, wars, and government regulation. In addition to these macro concerns, equity investors must be prepared for company-specific business risks including competitive challenges, technological change, and legal liabilities. Add to that management risk, price risk, and transaction costs, and it is not surprising that many investors are nervous about owning equities. Yet, holding just cash and fixed income securities is also unappealing for most long-term investors, given the lower expected returns and the potential for capital erosion due to inflation. How to solve the conundrum?

We believe that investors can enjoy the benefits of equity investing — namely, higher capital appreciation over time — while significantly reducing the potential for permanent capital loss. They can do this by using the following approach:

1. Invest in *established, cash generative businesses that are leading providers of essential products and services.*

2. Require a discount to intrinsic value (i.e., a margin of safety in the stock price) at the time of purchase.

3. Invest in 25–30 companies in order to minimize the impact of unforeseen company-specific problems, but still benefit from having a relatively concentrated portfolio of companies that meet demanding business and valuation criteria.

4. For taxable investors, own businesses over many years in order to compound wealth and reduce taxes.

This approach has worked well for us over the past five years in managing 1818 Partners, L.P., a small-cap investment partnership for BBH's institutional clients. It is also how the two of us invest our own personal money.

We believe this approach is particularly appropriate today for BBH's investment management clients given the uncertain economic environment and the fact that the capital markets are currently pricing risk in financial assets aggressively. The history of equity investing has shown that one of the best ways to outperform equity indices and build wealth over time is to participate during up markets and outperform during down markets. While we are not predicting an imminent recession or bear market, there are many alarming current trends, among them the negative national savings rate, high energy prices, the potential for a housing market slow down, the large federal budget deficit, and the massive trade deficit.

In this article, we are focusing on the first of the four elements in the approach above: the criteria we use to analyze businesses and why companies that meet these criteria are well-suited for creating and protecting shareholder wealth during both good and bad times. It is important to emphasize that while this articulation of our investment criteria is new, BBH's equity investment team has been employing many of the core concepts presented here — such as sustainable competitive advantage, high returns on invested capital, and discount to intrinsic value — for some time. Accordingly, we view the newly articulated approach as a tightening of our existing investment criteria and processes rather than a radical change.

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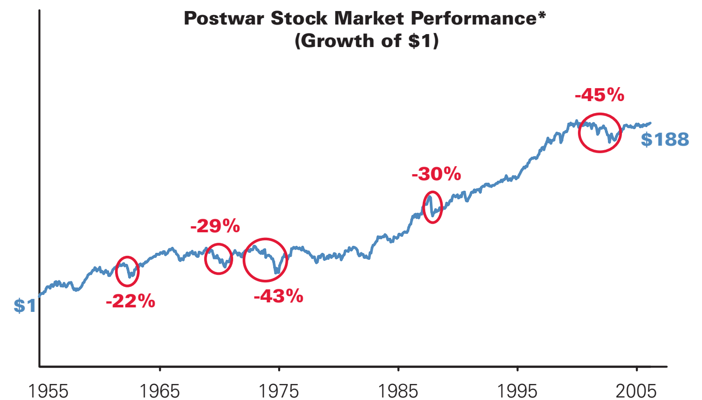
When we analyze publicly traded companies, we look for businesses with the following characteristics:

Essential products and services. Companies that provide "have-to-have" products and services are better positioned to achieve pricing power over time and gain advantages in introducing new products and services. These companies are also less sensitive to inflationary pressures and recessions, as they are able to pass cost increases through to customers and these customers generally continue buying their products and services regardless of the economic cycle.

Loyal customers. Companies that command a high degree of customer loyalty are generally able to grow faster and more profitably than other companies. Retaining customers means that new customers represent incremental, rather than replacement, business. Existing customers are also typically more profitable and lower maintenance than new customers, due to familiarity and relationship experience.

Despite some significant setbacks along the way, U.S. equities have consistently risen over time



* S&P 500
Bear markets are peak-to-trough, over 20% loss.
Source: Bloomberg & BBH Analysis

Leadership in an attractive market niche or industry. Companies that are leaders in stable and growing markets typically have far more attractive investment opportunities and fewer operational challenges than companies competing in rapidly changing or declining industries.

Sustainable competitive advantages. Companies with significant and enduring competitive advantages — such as strong brand equity, differentiated highly-valued products and services, products and services embedded in customer workflow with high switching costs, and economies of scale — are able to create greater economic wealth over time through higher margins, superior returns on invested capital, and stronger market power.

High returns on invested capital. High returns on invested capital are essential to long-term wealth creation for shareholders. Companies able to achieve them can reinvest internally generated cash and borrowed capital at attractive rates of return for shareholders. Conversely, companies that generate poor returns on capital generally destroy shareholder value by reinvesting into unattractive opportunities.

Strong free cash flow. Free cash flow is the cash that a company generates after making capital investments and paying taxes. The ability to generate strong free cash flow reduces the likelihood of financial distress, which is particularly important during periods of economic weakness when capital is more difficult to access. It also facilitates opportunistic acquisitions or repurchase of shares during periods of depressed stock prices.

In addition to these characteristics, we believe that good management is critical. We insist on managers with high levels of integrity who are the leading operators in their respective industries and have proven themselves to be good capital allocators. Without a strong management team and healthy culture, most companies will falter.

An obvious question is whether it is possible to find companies that meet these demanding business and management criteria and which also trade at a discount to intrinsic value. Our experience is that it is if one is willing to invest with a three- to five-year time horizon and worry less about short-term catalysts. We have a capable and experienced team of securities analysts and an investment process based on fundamental research that focuses on identifying key risks and enhancing objectivity. Our people and processes enable us to act decisively when opportunities arise.

We encourage clients to think about the investment criteria described above and to consider whether the companies that BBH is purchasing for them in their accounts actually meet these demanding criteria. We believe clients will agree with us that the companies are indeed established, cash generative businesses that are leading providers of essential products and services. While we clearly recognize the inherent risks of equity investing and the uncertain current economic environment, we believe that such companies will create significant wealth for clients over time.

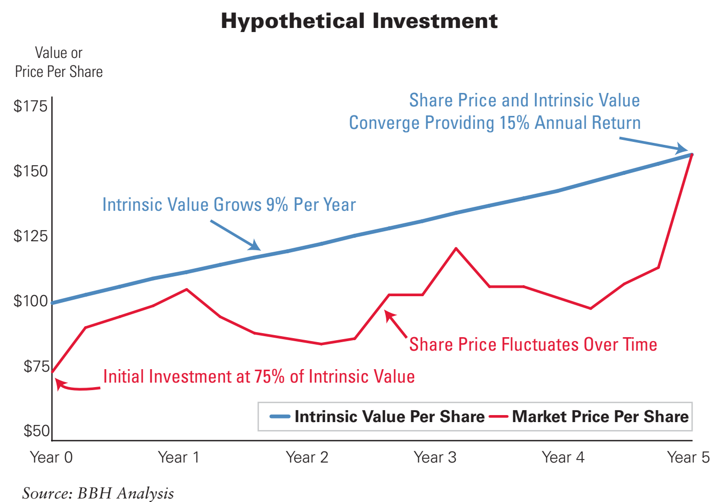
Enhancing Returns with a Margin of Safety

BBH's Core Select equity portfolios invest in established, cash generative businesses that are leading providers of essential products and services — but only when we believe they are trading in the public market at a discount to their intrinsic value. A key part of our strategy is the concept of margin of safety, which applies both to the qualities we look for in a business and the price that we pay for that business. The most obvious benefit of investing with a margin of safety is that it provides added downside protection against permanent capital loss. A margin of safety, however, also provides the potential for significant value creation.

The graph to the right is a hypothetical illustration of the upside benefits of investing in a company when there is a meaningful margin of safety in the share price. The graph makes the following assumptions:

1. An investor buys stock in a company when the market price of the stock is trading at 75% of intrinsic value;
2. The intrinsic value of the company increases at 9% per year; and
3. The market price and the intrinsic value converge at the end of a period of five years. As indicated, based on these assumptions, the investor would achieve a compound annual return of just over 15% for a total return of more than 2x the initial invested capital in five years.

Hypothetical Investment



Source: BBH Analysis

For many companies, estimating an intrinsic value is difficult since the range of potential outcomes, even over a five-year period, is quite wide. The kinds of companies that Core Select purchases have loyal customers and strong competitive positions, provide essential or have-to-have products and services, and are leaders in their respective markets. For such companies, we can project future cash flows with a reasonable degree of confidence. Unfortunately, so can many other investors, and the public market is relatively efficient in valuing large-cap companies with these qualities. Nevertheless, the market does provide a few such opportunities each year. A good example today is Microsoft, which is in our Core Select portfolios.

Research at Work

Since peaking at $59 in late 2000, Microsoft's share price has fallen to a recent low of $22. Nevertheless, Microsoft remains the dominant provider of operating systems for personal computers and of productivity software, with over 95% market share in both markets. Microsoft has also recently become the number one provider of enterprise server operating systems. Because of these leading market positions and the essential nature of its products, Microsoft has been able to grow operating profits from $8.3 billion in fiscal 2002 to a projected $19.0 billion in fiscal 2007. This represents a compound annual growth rate of 18%. Going forward, Microsoft faces increased competition and slower growth. In our opinion, however, these concerns are more than fully reflected in the current share price. Adjusting for excess cash of $4 per share, Microsoft is currently trading at 13x projected fiscal 2007 EPS. Our intrinsic value estimate based on a discounted cash flow analysis is $33 per share, a 50% premium over the current share price.

Another important factor to consider in assessing margin of safety is whether a company has valuable assets that are not contributing to current profits. In the case of Microsoft, it has four developing businesses that in aggregate have revenues of approximately $9 billion and operating losses of $2 billion: software for mobile devices; software for small and midsize businesses; its MSN and Internet business; and its X-Box/home entertainment business. While depressing current returns, these four businesses have substantial value today. In our intrinsic value calculation, we have used modest assumptions for the developing businesses, suggesting upside potential above our $33 intrinsic value estimate.

For companies trading at a discount to intrinsic value, share buybacks are an additional source of value creation. When a company redeems shares at a discount, it transfers value to its remaining shareholders. The greater the discount, the larger the transfer of value. While quite conservative financially, Microsoft has recognized this opportunity and has a $30 billion stock repurchase program in place. For long-term Microsoft investors, the buyback is a big positive.

It is impossible to know how long Microsoft will trade in the public market at a large discount to its intrinsic value.

Other companies have traded for many years with large discounts and Microsoft's could grow larger. Ultimately, however, market prices reflect fundamental financial performance. Accordingly, the margin of safety in Microsoft's current share price should create significant value for shareholders over time.

The Benefits of Customer Loyalty

Many investors do not fully appreciate the importance of customer loyalty. A business with consistently high customer retention rates has much stronger future prospects than a company with mediocre or poor retention rates. As described in more detail below, high customer retention rates create recurring and predictable revenue streams and lead to sustainable growth, higher profit margins, and a stronger competitive position. The alternative, a business with a high level of defectors, ends up with detractors and a tarnished reputation. Financial accounting typically requires companies to expense customer service and customer acquisition costs. Accordingly, a company's balance sheet and income statement may not reflect the full value of a company's loyal customer base.

For our Core Select equity portfolios, which invest in established, cash generative providers of essential products and services, we explicitly seek to measure customer retention rates and satisfaction levels in order to identify underappreciated and undervalued equity securities. In the following, we explore three key benefits of customer loyalty, and look at an example from our own portfolios.

The Growth Benefit

The most obvious benefit of high customer loyalty is faster and more sustainable growth. For a business that retains most of its existing customers, new customers are additions rather than replacements. The cumulative impact over time can be significant. Consider three companies that each have 1,000 customers and are adding 300 new customers per year. Company A retains 90% of its customers each year, Company B retains 80%, and Company C retains 70%. After five years, Company A will have 82% more customers than Company C and 36% more than Company B, even though each company added the same number of new customers over the five years.

This analysis actually understates the likely growth differential between the three companies since a company with loyal and satisfied customers will typically receive a high level of referrals, whereas a business that is churning through customers will find it difficult and expensive to win new customers. The company with the high retention rate and growing business will also be able to reinvest more in its business and to support an expanded customer support and sales effort. This reinvestment may create a virtuous cycle of higher customer satisfaction leading to even stronger retention and growth.

Profitability Potential

A second key benefit of customer loyalty is higher profitability per client, since mature customers are usually much more profitable than new customers. New customers often require expenditures on advertising/promotions, sales commissions, and implementation. For many products and services, there is also a significant learning curve as the company and the customer learn how to interact with each other. Satisfied existing customers are far more receptive to new product introductions and they typically purchase a greater number of products over time. Selecting the right customer (i.e., a customer that derives significant value from a company's products or services and does not make too many difficult demands) is also critical for profitability: a business that has a large base of loyal customers can afford to be much more selective in accepting new customers. Last, loyal customers result in more recurring revenues, which may enable a company to adopt a more aggressive capital structure that can drive higher returns for equity holders.

The Competitive Position Advantage

A third advantage of customer loyalty is a stronger competitive position. Loyal customers are much less likely to switch to a competitor for a modestly lower price or small improvement in functionality. Loyalty thus discourages new entrants and provides a company with time to adjust to technological changes and competitive threats. High customer retention levels and the resulting profits also boost employee morale and enable a company to reward and retain valuable employees. Predictable revenue streams also enable a management team to plan better and use resources more efficiently. The cumulative effect of these factors is a competitively advantaged business with high returns on capital and excellent growth prospects.

Example from BBH Core Select: Costco

One company that clearly understands the benefits of customer loyalty is Costco. Costco operates 487 warehouse clubs that offer exceptionally low prices on a limited selection of nationally branded and private label products. Membership is required and Costco currently has 5 million business members (55–60% of sales) and 17 million retail members (40–45% of sales). Annual membership charges are $50 for basic membership and $100 for an executive membership, substantially higher than the fees at other warehouse clubs. Despite the higher fees, Costco's compelling value proposition has led to consistently high membership renewal rates of 91% for business owners and 84% for consumers. Costco also generates substantially higher sales per club and per member than competing warehouse clubs and retailers — evidence of high levels of perceived value by members.

The membership fee is a critical source of income for Costco and enables the company to reinvest in its business in the form of lower pricing, higher levels of customer service, and new product categories. For example, Costco pays its employees a higher wage rate ($17 per hour) and offers a richer benefit package than other retailers. Because of the better compensation, Costco's employee turnover is only 6% after one year of employment, which leads to superior customer service and better employee productivity.

As a result of these many positive factors, Costco's revenues have nearly tripled and its profits have more than quadrupled over the past 10 years. Impressively, this growth has come largely through internally funded, organic growth. Today, Costco owns most of its own real estate and has no net debt.

While Costco has become quite a large company, we believe that many investors still do not fully appreciate the substantial value of Costco's loyal customer base and the favorable implications for future profits.

Warren Buffett: Manager and CEO

In the second quarter 2006 issue of the Wealth Management Quarterly, we described the investment criteria for our Core Select equity portfolios. We noted that we seek managers who possess high levels of integrity, are excellent operators, and are strong at capital allocation. One individual who possesses all three traits is Warren Buffett. Although best known as America's leading investor, Buffett is also a superb manager. Just as it is instructive to us as portfolio managers to study management exemplars like Buffett, we felt it would be instructive to our clients as well, both as participants in Core Select portfolios and as investors themselves. So in this article we highlight some of the reasons for Buffett's success as chairman and CEO of Berkshire Hathaway.

The Compelling Berkshire Story

Since Buffett took control of Berkshire Hathaway in 1965, its book value per share has increased from $19 to $59,377, a compound annual increase of 21.5% over 41 years. For Berkshire shareholders, the results have been even better; $100 invested in Berkshire back in 1965 would today be worth more than $700,000. Berkshire's phenomenal success is commonly attributed to Buffett's prowess as a stock picker and today thousands of investors, ourselves included, study closely Berkshire's annual letters and quarterly disclosures of stock purchases and sales.

Berkshire today is much more than an investment company. It is the 13th largest American company measured by sales and the 12th largest measured by market capitalization. It owns and operates 68 distinct businesses, including auto insurer GEICO, reinsurance companies General Re and National Indemnity, utility conglomerate MidAmerican, carpet manufacturer Shaw Industries, and numerous other manufacturers, retailers, and service companies. Collectively, these businesses employ approximately 190,000 individuals, operate in over 150 countries, and have annual net income of approximately $9 billion. Remarkably, Buffett oversees all of these businesses from Omaha, Nebraska, with a corporate staff of only 17.

BBH Core Select Invests in established, cash generative businesses that are leading providers of essential products and services	
Investment Criteria:	
Business	– Essential products and services – Loyal customers – Leadership in an attractive market niche or industry – Sustainable competitive advantages – High returns on invested capital – Strong free cash flow
Management	– Integrity – Excellent execution – Strong capital allocation
Valuation	– Discount to growing intrinsic value

Integrity

Berkshire's code of conduct contains the following message from Buffett: "I want employees to ask themselves whether they are willing to have any contemplated act appear the next day on the front page of their local paper — to be read by their spouses, children, and friends — with the reporting done by an informed and critical reporter." Buffett himself has consistently lived up to this rule of thumb. He treats shareholders as "owner-partners" and is as candid as possible with them about Berkshire's financial results and outlook. When business setbacks occur, as they inevitably do, Buffett mentions them in his annual letter and acknowledges his own responsibility. Buffett believes this candor with shareholders benefits him as a manager since "the CEO who misleads others in public may eventually mislead himself in private." One area where Buffett's strong integrity has benefited Berkshire enormously is stock options. Buffett was an early and outspoken critic of stock option grants, arguing that they were clearly an expense and that many executives were unjustly enriching themselves through large option grants. This year, over 100 public companies have admitted that their executives improperly back-dated option grants, thereby diverting billions of dollars away from shareholders to themselves. In contrast, Berkshire has never issued any stock options and Buffett receives an annual salary of only $100,000.

Efficiency

Berkshire's tiny corporate staff reflects Buffett's deep understanding of his own strengths and limitations. In areas where he is strong, such as assessing and motivating people and allocating capital, Buffett and his long-time colleague Charlie Munger make their own decisions without any corporate meetings and without input from outside experts such as compensation consultants and investment bankers. Because Buffett and Munger have clear "mental models" and criteria for evaluating managers and businesses, they can quickly rule out

most opportunities and instead focus their time on the few that are promising and within their circle of competence. Buffett also delegates virtually all operating decisions to the managers of his subsidiaries. This willingness to delegate stems from the fact that Buffett hires only managers whom he likes, trusts, and admires. Having selected the right managers, he trusts them to make the right business decisions. The trust that Buffett shows his managers engenders deep loyalty in return. Since Buffett became chairman in 1965, Berkshire has never had the manager of a significant subsidiary leave to join a competitor.

Capital Allocation

Allocating capital is one of the most important tasks of a CEO, yet the heads of many public companies have little skill in this area. This inadequacy is not very surprising. As Buffett has noted, "most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics. [Capital allocation is] a critical job that they may have never tackled and that is not easily mastered." In contrast, Buffett became chairman of Berkshire because he was a large shareholder with considerable capital allocation skills. During his tenure at Berkshire, he has proven himself adept at taking money from cash generative businesses and redeploying it at reasonable prices into other businesses that earn high rates of return.

While Buffett's skill at identifying attractive new investment opportunities has been critical to this success, he has also shown a willingness to confront reality about Berkshire's subpar businesses. Although Berkshire rarely sells or completely shuts down any business, Buffett routinely harvests and extracts capital from his poor performers. Buffett reacts "with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures." His experience has taught him that "the projections will be dazzling and the advocates sincere, but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand."

Acting Like an Owner

Buffett aptly describes himself as an "owner-manager." He owns 31% of Berkshire and this ownership interest represents 99% of his net worth. Buffett's personal interests are thus truly aligned, both on the upside and downside, with his fellow Berkshire shareholders. Unlike most agent-managers who stand to benefit disproportionately from positive results, Buffett has no incentive to make risky bets with shareholder capital. As a controlling owner with "no exit strategy," he also has the luxury of not having to waste energy worrying about Berkshire's current share price. Instead, he can focus on actions that will maximize Berkshire's intrinsic value per share over the long term.

In Berkshire's 2005 annual report, Buffett stated that "it's hard to overemphasize the importance of who is CEO of a company." We totally agree, and in our role as managers of BBH's Core Select equity portfolios, we seek to invest in companies led by executives like Buffett who exhibit high levels of integrity, operate efficiently, allocate capital prudently, and think like owners.

Recommended Reading: *The Real Warren Buffett: Managing Capital, Leading People* by James O'Loughlin (London, Nicholas Brealey Publishing, 2003), which was a source for this article.

The Hazards of Indexing, The Benefits of Active Management

Several clients have recently asked why they should invest in Core Select rather than in a passively managed index fund or exchange traded fund (ETF). This is a timely question since equity indices have performed extremely well over the past four years and there has been a surge of capital inflows into passive products. The proponents of index funds and ETFs are quick to point out that passively managed portfolios have historically outperformed approximately two-thirds of actively managed U.S. equity portfolios. Given this record, why are we confident that the BBH Core Select approach can outperform passive products over a full market cycle?

Our answer is threefold: portfolio construction, valuation, and investment criteria and process. We also believe that Core Select's strategy is an understandable and low-risk strategy that enables clients to invest in equities with confidence that their capital is well protected.

Portfolio Construction

To outperform the index with an actively managed portfolio, one must first construct a portfolio that is different from the index. The alternative — a portfolio that closely mirrors an index but has higher fees and expenses than a passive product — is almost guaranteed to underperform because of the higher fees. A recent study of equity mutual funds by Yale Professors Martijn Cremers and Antti Petajisto found that over 30% of equity assets are actually in "closet" index funds and that these funds consistently underperform their benchmarks by 1.41% per year after fees and transaction costs.[1] The Yale study also found that the funds with the highest "active share" (defined as the percentage of a portfolio that is different from its index) beat their benchmark indices by 1.39% per year after fees and transaction costs. The professors concluded that skilled active managers who use fundamental analysis to select individual companies can

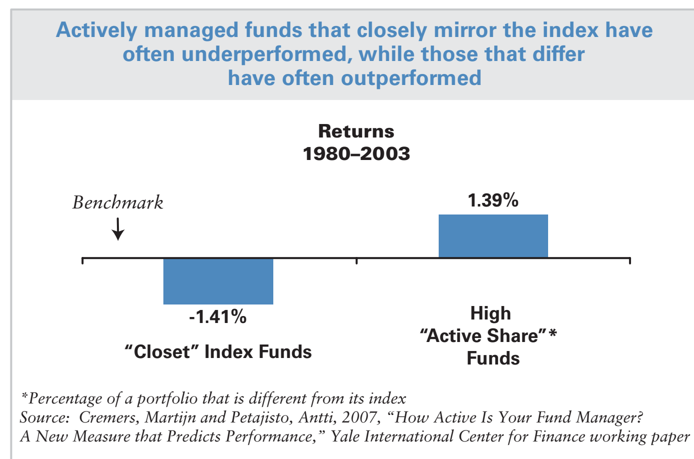
"generate alphas that remain positive after fees and transaction costs."

One way for active managers to increase their chances of beating an index is to reduce portfolio turnover and trading costs. Equity mutual funds have an average annual turnover of almost 100% per year.[2] This frenetic trading activity results in large trading costs (sometimes as much as 1.5% of assets per year) in the form of brokerage commissions, bid-ask spreads, and market impact costs. Trading costs are thus an important expense, which can have a negative impact on returns. For taxable investors, the benefits of a low turnover portfolio are even greater since long holding periods enable them to defer taxes and avoid short-term gains, which are taxed at a higher rate.

Our Core Select model portfolio currently owns 26 established, cash generative companies that provide essential products and services. While most of the Core Select companies are part of the S&P 500 index, the portfolio overall is extremely different from the index. The top 10 positions currently account for over 45% of total assets and the portfolio has been constructed security-by-security with no intention of matching the S&P 500's sector weightings. Applying the methodology suggested by professors Cremers and Petajisto, Core Select has an "active share" versus the S&P 500 of over 90%, placing it in the category most likely to outperform. Similarly, Core Select seeks to protect and grow wealth by owning interests in superb companies over many years. When making an investment, we typically have a five-year time horizon and we strive for long-duration investments in companies with growing intrinsic values. The result is a portfolio with low turnover and trading costs.

Valuation

Most index funds are highly diversified portfolios of several hundred companies. This diversification reduces the potential losses from a single, company-specific problem. On the other hand, it also reduces gains from a winner. Diversification across several hundred securities does not protect investors from general stock market risk. If the stock market is generally expensive, owning a basket of 500 or even 1,000 different stocks does nothing to protect one's capital from a broad market decline — in fact, it guarantees a poor return. For investors in conventional index funds, this problem is even worse since such funds own more of companies after they have risen in value and less when they have declined in value. Index fund investors discovered the dangers of overvaluation in 2000 with the collapse of the dot-com and technology bubbles; the S&P 500 fell 47.4% and the NASDAQ fell 77.9% from peak to trough. The equity investors who did best during this difficult period were the ones who invested in the subset of public companies that were still reasonably valued on an absolute basis.



*Percentage of a portfolio that is different from its index
Source: Cremers, Martijn and Petajisto, Antti, 2007, "How Active Is Your Fund Manager? A New Measure that Predicts Performance," Yale International Center for Finance working paper

For Core Select, valuation is central to our investment process. We seek to invest in companies when they are trading at a meaningful discount to our estimate of intrinsic value and we have a goal of not suffering a permanent loss of capital on any single investment. We sell shares when they are trading above our intrinsic value estimate. We define intrinsic value as the present value of the cash that a company will generate over its remaining life. Importantly, intrinsic value is an absolute value concept that does not depend on the prices of other companies. If we cannot find companies trading at a discount, we revert to cash. Our strategy of investing in companies when they are attractively valued on an absolute basis may sound like common sense, but it is an approach that is surprisingly rare. During the late 1990s, it was common to hear investors say that growth was all that mattered. Today, some investment firms are advising buying stock in companies based on which ones pay the highest dividends — even though the actual yields on dividend paying companies are low by historical standards. Many other investors rely exclusively on relative value metrics that offer no protection if a sector or the market is overvalued. Estimating the intrinsic value of an individual company takes a considerable amount of time and expertise, and requires a number of tools and approaches. But if done well it enables an investor to make more objective decisions about when to purchase and sell securities. The discipline of selling companies that trade above intrinsic value also protects investors from a permanent loss of capital.

Investment Criteria and Process

In past issues of the *Wealth Management Quarterly,* we have written about the qualities we look for in a business, including loyal customers, essential products and services, a strong competitive position, leadership in a healthy industry, strong free cash flow, and high return on invested capital. We have also written about the benefits of partnering with managers who are honest, good operators, and excellent at capital allocation. Our Core Select investment team conducts due diligence and extensive analysis on each portfolio company to confirm that they meet these demanding criteria. We have great confidence in the power of these criteria, having employed them over many years. We are of the view that investors are better off owning shares of superior companies for many years (so long as the shares are not overvalued)

than trying to trade in and out of weaker companies to capture what may appear to be large valuation discrepancies.

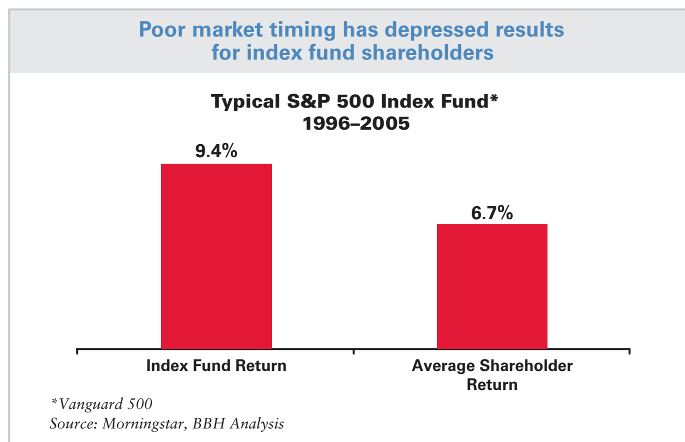
In contrast to the carefully chosen companies in Core Select, broad market indices typically contain hundreds of companies with varying business qualities, financial characteristics, and management teams. Collectively, the companies in an index may be facing significant business and valuation risks. Their inclusion in the major indices is primarily based on market capitalization and sector representation rather than on any investment attribute. Companies are also excluded from indices for arbitrary reasons unrelated to their investment merits. Standard & Poor's, for example, excludes "holding companies" and companies with significant insider ownership. These rules have kept Berkshire Hathaway out of the S&P 500 for years, to the detriment of index investors.

Conviction in Our Approach

In order to capture the higher, long-term returns associated with equity investing, investors need to have conviction in their investment strategy so that they can remain invested in equities through the inevitable market downturns. Many investors in index funds and ETFs claim to be long-term investors but their actual behavior suggests otherwise. Investors tend to pour more money into index funds and ETFs (as well as other equity products) after several years of strong equity performance. Investors then typically lose confidence in equities when markets decline and they withdraw capital near market bottoms. As a result, the return for the average investor in an index fund or ETF has historically been much worse than the published time-weighted returns. For example, a Morningstar study found that the weighted average return for actual investors in the Vanguard S&P 500 index fund from 1996–2005 was 6.7%, substantially less than the published return of 9.4% for the fund itself.

This difference is not a fault of the index fund companies or ETF sponsors, but it does highlight one of Core Select's advantages. With Core Select we always know why we own the companies in the portfolio and we have the ability to assess their progress. We also have selected a portfolio that meets very demanding business and valuation criteria and thus should be less volatile, particularly in down markets, than the S&P 500 Index. The higher conviction level and lower volatility should thus enable investors with long time horizons to invest a higher percentage of their assets in equities and improve their ultimate returns.

Poor market timing has depressed results for index fund shareholders



*Vanguard 500
Source: Morningstar, BBH Analysis

In Summary

We view passively managed equity index funds and ETFs as strong competitors and we understand why certain investors and advisors choose these options. But when we compare the investment merits of the companies in Core Select to the 500 companies in the S&P 500 Index, we vastly prefer the 26 companies that we have been able to select after careful consideration. And it is for all these reasons that we have invested our own capital in Core Select.

[1] *Cremers, Martijn and Petajisto, Antti, 2007, "How Active Is Your Fund Manager? A New Measure that Predicts Performance," Yale International Center for Finance working paper*

[2] *Ibid.*

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