5 Questions for a Superinvestor: Christopher Davis, Davis Advisors

By Alex Dumortier, CFA
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In 1984, to celebrate the 50th anniversary of the publication of Benjamin Graham and David Dodd’s classic text, Security Analysis, Ben Graham’s most accomplished student, Berkshire Hathaway CEO Warren Buffett, wrote an essay titled *The Superinvestors of Graham-and-Doddsville*. In it, Buffett presented a “group of investors who have, year in year out, beaten the S&P 500 (SNPINDEX: ^GSPC ) stock index” and debunked the fashionable academic notion that their performance was the result of pure chance.

Instead, Buffett pointed to a common intellectual tradition harking back to Graham and a common theme these superinvestors shared: “they search for discrepancies between the value of a business and the price of small pieces of that business in that market.”

In a new series of articles, I’ll put five questions to members of the current generation of superinvestors in order to try to pinpoint the principles, methods, and thought patterns that have been instrumental in their success (and, hopefully, pick up a few stock ideas along the way). For the inaugural article, I sought out Christopher C. Davis, co-portfolio manager of the Selected American Shares and Davis New York Venture Fund and chairman of Davis Advisors.

Grandson of the late Shelby Cullom Davis, Christopher Davis has established himself as a highly successful practitioner of a long-term, value-oriented investing style that spans three generations of his family. A hypothetical $10,000 investment in the Davis New York Venture Fund on Feb. 17, 1969, compounded to $1,596,670 as of Dec. 31, 2013, versus only $722,295 for the S&P 500 Index and $763,345 for the average large-cap fund. Christopher Davis has co-managed the Davis New York Venture Fund since 1995; in 2006, he and then co-manager Kenneth Feinberg shared Morningstar’s award for 2005 Domestic-Stock Fund Manager of the Year.

The following are Chris Davis’ unedited answers to my questions, in which he explains why temperament is often the greatest obstacle to investing success and why the recent success of index strategies has sown the seeds for a stock-picker’s market.

**Alex Dumortier:** Why is investor behavior important? Please highlight two or three things investors should bear in mind as they navigate today’s market and beyond.

Christopher Davis: If the brain is the most important organ for successful investing, the stomach may well be the second, as reason and judgment can easily be distorted by fear and emotions. Over sixty years and three generations of investing, our family has seen this play out again and again. While common sense would dictate that buying stocks when prices are low is better than...
buying when they are high, people often do the opposite. Falling prices make people fearful and soaring prices make them greedy.

At its essence, healthy investor behavior means being disciplined, patient and unemotional. This requires having the temperament and discipline to invest especially when prices are low. In contrast, unhealthy investor behavior typically leads to selling during periods of great pessimism (most recently in the depths of the financial crisis) and leaping in at the top of bubbles (for example, into tech stocks during the Internet boom or into real estate during the housing bubble.) Such emotional decisions can wipe out years of compounding.

Below are three specific lessons to bear in mind:

First, disregard short-term market and economic forecasts. It is amazing how often we read interest rate forecasts and stock market predictions despite overwhelming data that these have no predictive value. For example, we tracked the average interest rate forecast from The Wall Street Journal Survey of Economists from December 1982 to December 2012. This forecast was then compared to the actual direction of interest rates. The result? Overall, the economists’ forecasts were wrong in 39 of the 61 time periods—64% of the time! To build long-term wealth, investors must disregard such forecasts.

Second, don’t chase the hot performing investment category or asset class and do not try to time the market. Again and again, we see investors flock to strategies and managers that have recently done the best, only to be disappointed when those same managers go through the periods of underperformance that so often follow such hot streaks.

For example, over the last few years, passive, index-oriented investment strategies have delivered strong returns as the correlation between stocks has been very high. As a result, investors have poured money into these passive strategies. We feel the landscape may be changing, however, and we may once again be entering a ‘stock-pickers’ market in which success will depend on a professional portfolio manager using discipline and judgment to separate the good businesses from the bad. Even though active management may not be in fashion at the moment, we do not intend to change an investment strategy that has served us well for decades or give up the ability to use judgment rather than formulas in managing our clients’ savings.

Finally, invest systematically. Investors who require the growth potential of equities but may be too nervous about a market correction to begin investing should consider utilizing a systematic investment plan. Systematic investing involves investing money in equal amounts at regular intervals, regardless of the market environment.

For example, an investor with $10,000 to invest in stocks may opt to invest $1,250 every three months over a two year stretch. A systematic investment strategy has three key benefits: 1) It removes the emotion that can adversely affect the timing of investment decisions 2) It means that the investor automatically purchases more shares during periods of uncertainty when prices are low and fewer during periods of euphoria when prices are high. 3) It capitalizes on market volatility in that should the market drop during the investment journey, more shares are automatically purchased at more attractive prices. This sort of systematic approach is an excellent characteristic of many 401k plans in which investors make regular investments based on pay periods. But we believe that many other types of investment accounts could benefit from using this same approach.
AD: What are the two or three factors that have made the biggest contribution to your success as an investor?

CD: We believe that perspective, discipline and alignment are the three biggest drivers of our long term outperformance:

1.) In terms of perspective, we never forget that stocks represent ownership in real underlying businesses. As a result, we focus relentlessly on the durability and long-term growth of the businesses we own rather than the fluctuations of their stock prices. If we are right about the business fundamentals, then time will work to our advantage given the power of compounding.

2.) In terms of discipline, we recognize that the growth of the underlying business can be amplified if the business is bought at a bargain price. As a result, we maintain a strong valuation discipline as a central tenet of our investment philosophy. This discipline also serves to reduce risk by including a “margin of safety” in our purchase price in order to reflect inherent uncertainties and give us the staying power to weather occasional but inevitable economic storms.

3.) In terms of alignment, we have always believed in eating our own cooking. Our firm’s employees, Board of Directors and their families have over $2 billion invested side-by-side with our clients. This alignment means that in addition to thinking about the upside of any investment, we also think about the downside. As fellow investors, we also are incentivized to maintain a relentless focus on research and results while avoiding the sort of ‘agency’ problems and conflicts that can arise when portfolio managers invest their own money differently from their clients.

AD: If you had to identify just one, what is the key mistake investors make that prevents them from being successful?

CD: The most common reason why certain investors fail to achieve satisfactory results over the long term has more to do with temperament than ability. Quite simply, people want to do today what they wish they had done five years ago. Time and again people choose to invest after prices have gone up or sell after prices have gone down. Furthermore, what is true for individual stocks is also true for funds and even asset classes. People want to get into funds and asset classes that have strong trailing results and out of funds and asset classes that have lagged. Such behavior reflects emotions rather than rationality. It is important that investors remain grounded not in optimism or pessimism, but in realism and take into account the key “important and knowable” realities, both positive and negative, that will impact their returns over time. In our view, durable businesses run by able and honest managers with strong competitive moats, reasonably sure growth prospects and high returns on capital can be the best vehicles for compounding wealth, provided they are purchased in a disciplined fashion and held for the long term.

Swinging for the fences or trying to move in and out of the stocks, funds, investment styles or asset classes based on what has already gone up or down generally results in less-than-satisfactory long-term returns.

AD: Please describe your selling discipline: What are the circumstances under which you sell a stock?

CD: We pare or exit positions based on one or a combination of three primary factors: (1) a long-term decline in our estimate of the earnings power and intrinsic worth of the business that exceeds the decline in the business’ price (2) an increase in the price of the business that exceeds the increase in our assessment of its earnings power and intrinsic worth, (3) our identification of a
more attractive investment opportunity. With most stocks fluctuating 50% in any given year, it’s important, therefore, to note that price volatility alone is not part of our sell discipline.

**AD: What are you reading right now? Alternatively, please recommend a book you’ve read — it need not pertain to finance/investing.**

*The Outsiders* by William Thorndike

*The Rational Optimist* by Matt Ridley

*Genghis Khan and the Making of the Modern World* by Jack Weatherford

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