
Fund Manager Q&A**Davis: If You Can't Predict, Prepare**

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Christopher C. Davis is the portfolio manager of the [Davis New York Venture Fund \(NYVTX\)](#). He recently answered our questions on evaluating financial companies, how institutional investors can set a better precedent for smaller investors, and what investors should keep in mind as they prepare for the next decade.

1. What's the single most important lesson you've learned during the past three years and how will it manifest itself in the way you and your colleague, Kenneth Charles Feinberg, run money?

As a learning culture, we try to adhere to the fundamental investment principles we've been utilizing since 1947, while at the same time adjusting to changing environments and most importantly, incorporating lessons we have learned from the mistakes we have made. Since investing is a batting-average business, we know we're going to make our share of mistakes, but the key is to learn from them and to continually improve our research process so our shareholders have the best opportunity to build long-term wealth.

This is why we have the "Mistake Wall" directly outside my office where we hang the stock certificates of companies where we felt our analysis on a company was flawed. Underneath each stock certificate is a plaque with the specific lesson learned. With this reminder, we hope to incorporate these lessons into our research process so that we can constantly improve.

As I reflect on the past few years, there are really two crucial lessons that are being added to the "Mistake Wall" and incorporated more directly into our research process:

First, although we had always focused on the amount of debt a company carried relative to its earnings and its net worth, last year we learned that the date on which debt comes due can be just as important as the amount. In other words, the ability of even relatively sound companies to refinance debt should not be taken for granted. Last year, we were shocked at the way in which a number of companies with reasonable amounts of debt still faced liquidity problems. For any company, access to liquidity is like oxygen. Take it away, especially in a tough economy, and there is a good chance the company won't survive. As a result, debt maturities schedules have been added to our analysis of debt levels at all companies in which we invest.

The second lesson from the past few years was the dramatic reminder that the chief executive officer of any large financial institution must have the skills, experience, and discipline to also serve as the chief risk officer. Quite simply, risk management cannot be delegated. Although the CEO can't look at every asset, she or he must understand the nature of the risks and be especially vigilant in allowing incentive systems to exist that might foster the wrong sort of behavior. In all of our meetings with CEOs at financial institutions, we now spend a great deal of time in detailed discussion about incentive systems and particular types of risk.

2. You've referred to a "silver medal strategy" to describe how you're constructing your portfolio in this environment. Can you elaborate on this and highlight where you're finding opportunities?

If there was one truth that all investors were reminded of last year it is that no one can predict the short-term movements in the market, economy, interest rates, or earnings, with any degree of accuracy or consistency. Few predicted the steep declines in the beginning of last year and of those that did, we don't know any who predicted the subsequent steep rebound. One of my favorite quotes on this topic is that "an economic forecaster is like a cross-eyed javelin thrower: they don't win many accuracy contests, but they keep the crowd's attention." During a long investment journey, we know we will face all sorts of different environments, including bear markets, recessions, inflation, and so on. We just can't predict precisely when.

However, just because we can't predict doesn't mean we can't prepare. This preparation consists of trying to structure portfolios of durable, globally dominant, well-capitalized companies that can make progress in good times and survive the bad times. This approach means that during significant market downturns, cash and T-bills will probably outperform the Davis portfolio, while portfolios with low-quality or more speculative companies will probably underperform us. Our portfolio would garner the "silver medal."

Conversely, during roaring recoveries, cash and T-bills would probably do the worst, while more speculative portfolios would do the best. Again, the Davis portfolio of durable, globally dominant, well-capitalized businesses would probably get the "silver medal." So though we recognize that there are always strategies that can do better in any shorter-term period, it is our philosophy that earning a silver medal in short-term periods can lead to a gold medal over the long term.

3. Regarding the financial businesses in your portfolio, in general, what do you look for when evaluating financial companies? More specifically, you've owned American Express through the good times and bad. Although the stock has significantly rebounded off its lows, how has the company's management changed in the way it may run the business and how have you changed the way you might evaluate it?

We think financial services are a nonobsoletable business. At some point, most of us have been and will continue to be consumers of some type of financial service, so the group as a whole has a pretty powerful tailwind behind it. That being said, most financial companies carry leverage that puts them at risk if they are not well managed. As a result, success boils down to individual stock selection rather than a bet on the sector.

The financial businesses we currently own in our portfolio share key characteristics that we believe should not only help them survive any short-term uncertainty, but to thrive over the long term. In general, these companies are world-class franchises that have strong management teams, solid balance sheets, strong competitive positions, and CEOs that understand risk. They are also selling at reasonable valuations, given their attractive long-term earnings power, and should enjoy the

benefits of historically wide spreads and decreased competition, despite a more stringent regulatory environment.

Regarding [American Express \(AXP\)](#), in our view, it is one of those rare financial businesses that has built a sustainable competitive advantage through its brand and the virtues of owning its own payment-processing network. This combination of brand and network creates a virtuous circle as it allows American Express to capture a greater proportion of revenue from card use than its major competitors. Some of this revenue can then be reinvested in its brand through marketing, better service, and, importantly, the industry's leading rewards program. These investments drive higher average use of American Express cards which in turn creates more revenue, and the circle begins again.

The recent credit freeze and economic slowdown negatively affected American Express' loan portfolio, cardholder spending, and financing. We have been encouraged by the speed and effectiveness of the actions taken by American Express in response to these challenges. In fact, by quickly cutting costs, reducing credit exposure, and adding bank deposits to bolster liquidity, American Express was one of the few financial firms able to maintain its dividend during this difficult period. Furthermore, the poor macro environment has reinforced the attractiveness of the company's core high-margin and less risky charge card business as opposed to its less profitable and more risky credit card business.

4. One of the issues that you have frequently highlighted is that small investors are often their own worst enemies: They buy after rallies and sell after downturns, lowering their returns. However, the reality is that this behavior extends, typically more dramatically, to institutional investors, as well. As such, what can institutional investors be doing to set a better precedent for smaller investors?

An unfortunate part of human nature is that we always want to do now what we wish we had done years ago. In investing, this is a costly tendency as investors at all levels chase what has done well in recent years. While historically, institutions were considered more disciplined than individuals, more recently institutions have fallen prey to the same tendency as individuals, although with subtle differences. For example, when individuals were tempted into Internet funds in the late 1990s because technology investments had done so well, institutions were lured into venture capital funds for the same reason. Both suffered as a result.

More recently, while many individuals inappropriately increased their personal leverage through mortgage, home equity, and credit card loans, many endowments and institutions increase their leverage through investments in hedge funds, derivatives, private equity, and asset-backed securities.

On top of the tendency to chase what has already gone up, both individuals and institutions have a tendency to want to get out of what has done poorly after it has already gone down. This is particularly problematic when it comes to the process of hiring and firing investment managers. The fact is that no matter how skilled your portfolio managers are and how attractive their past results have been, at some point

during your journey with them they will suffer through a period of underperformance. We ran a study at Davis that evaluated the top-performing large-cap managers for the 10 years ended 2009. We wanted to answer the question: On the way to delivering top-quartile 10-year returns, how many of these managers did lousy for at least a three-year period along the way.

The results were startling: 96% of these top-performing managers spent a three-year period in the bottom half of their group; 79% spent a three-year period in the bottom quartile of their group and 47%--almost half!--spent a three-year period in the bottom decile of their group. Remember, these were the top-performing managers during the entire 10-year period--and yet they still experienced periods of underperformance on the way to delivering these stellar long-term results. To the extent that individuals and institutions have a tendency to fire managers after three poor years, they missed out on the opportunity to benefit from the great results these managers generated over the course of a decade. While there are many legitimate reasons to change managers, basing the decision solely on short-term underperformance isn't one of them

In sum, disciplined asset allocation combined with an understanding that periods of underperformance are inevitable can help both individuals and institutions avoid the tendency to buy high and fire low.

5. Given where we've come from and your long-term outlook for the markets, what are the two or three most important ideas investors should bear in mind as they prepare for the coming decade?

There are three things we think investors should always bear in mind:

First, recognize the folly of forecasts and don't base your long-term financial decisions on short-term economic and market predictions. They are usually wrong. It's best to maintain a diversified portfolio that can weather inevitable storms and participate in eventual recoveries.

Second, don't make emotional-based investment decisions. Emotions can wreak havoc on an investor's ability to build long-term wealth. This can be seen in a recent Dalbar Study which shows that from 1989-2008, the average stock fund returned 8.4% per year, while the average stock fund investor earned only 1.9% per year. How is this possible? Well, investors of any degree of sophistication are prone to buying what has recently gone up and avoiding what has recently gone down.

Fear and greed often influence their investment decisions. One way to remove emotion from the equation is to invest systematically, where a regular amount of money is invested on a regular basis--say weekly, monthly, quarterly--regardless of the market environment. Such a disciplined, systematic approach cannot only help you maintain the counter-emotional mindset necessary to build long-term wealth, but it can also help you capitalize on any market volatility. It will further help you stay focused on the long term and ride out the inevitable periods of underperformance that any active investor will experience.

Lastly, don't invest using a rearview mirror and rush to purchase the asset class or investment category that has the best recent results. For example, during the past decade, fixed income has done tremendously well, while equities have delivered disappointing results. Rather than fall into the trap of investing in what has already gone up, investors with long-term financial goals need to fast-forward into the future and ask themselves, "Ten years from now, in 2020, what is it that I'm going to wish I would have done in my portfolio today?" Chances are investing in equities with reasonable valuations after a decade of poor performance will turn out better than buying bonds at a time of record-low interest rates after a decade of outperformance.

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