Where style meets substance

The endgame of maximizing returns is common to all investors. But the strategies they adopt and the categories of security they end up favoring naturally differ considerably. As our portraits of five of the world's most successful investors, **Warren Buffett, Anthony Bolton, Peter Lynch, Richard H. Driehaus** and **Bill Gross**, suggest, the chosen style says as much about the values, temperament and risk tolerance of the investor as it does about intrinsic value.

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Unspectacular businesses, outstanding returns

Warren Buffett _ According to ratings published by Forbes in October 2008, he is the wealthiest man in the world, with assets of USD 58 billion. Yet Warren Buffett continues to live in the same old five-bedroom house he purchased for USD 31,500 in 1958. In just under four decades, he has seen the value of his investment company multiply by a factor of 2,800. Despite his immense personal wealth as Berkshire Hathaway's CEO and largest shareholder, Buffett pays himself an annual salary of exactly USD 100,000. The politician's son from Nebraska has never changed his ways, remaining a down-to-earth entrepreneur from the Midwest. The legendary investor cut his teeth under Benjamin Graham, himself a legendary figure on Wall Street in the 1950s. It was Graham who introduced him to rule number one: that a stock is part of the real economy. What matters is not short-term stockmarket trends, but whether a company has assets that generate sustainable value and real earnings. Indeed, Buffett's judgment as to whether or not a company has real earnings power has now become so assured that he has jettisoned another principle of Graham's: portfolio diversification. If Buffett is convinced that a company is fundamentally valuable, he builds up substantial positions – a practice that runs counter to today's prevailing investment strategies. Until recently, finance experts believed spreading risk ever more finely would allow them to hedge to an ever greater extent against losses. In fact, doing so led them to become increasingly removed from the real economy. Buffett cares less for the risk models and more for the balance sheets and management of the businesses he backs. It's a homemade recipe, but one that has generated outstanding performance. Another of Buffett's principles is particularly rel-

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Warren Buffett, **78 and often referred to as the "Sage of Omaha," is one of the most successful investors of all time, with a renowned value investing philosophy. His Berkshire Hathaway holding company is primarily engaged in the US consumer goods market and the insurance sector. Between 1965 and the end of 2007, Berkshire Hathaway stock rose from USD 19 to above USD 140,000. Warren Buffett is also a philanthropist who plans to leave 80% of his personal wealth to charity.**

evant today: he only invests in things he understands. This approach enabled him to steer a steady course through the treacherous waters of the dot.com era. He insisted that he understood nothing of the high-tech world, and therefore refused to invest in high-tech stocks. When the dot.com bubble finally burst, Buffett emerged unscathed. The "Sage of Omaha" also foresaw the systemic risks that have brought the global financial system to the brink of collapse. As he warned five years ago in an annual letter to shareholders, securitizing debt instruments could cause a "meltdown" of the system, and allowing large risk positions to become concentrated in the hands of relatively few derivatives dealers could trigger a serious systemic crisis. The secret to Berkshire Hathaway's success lies in its simple, low-risk business model. Buffett and his partner Charles Munger financed its spectacular expansion not with borrowed funds, but with sources that are safer and cheaper: profits – a handsome sum, given an average annual return of more than 20%; and a plentiful supply of liquid funds from their acquisition of insurance companies. The insurance firms owned by Buffett's holding company generated a cash pool of almost USD 60 billion in 2007, which he was then free to invest in equities, bonds, and acquiring new businesses. This expansion model is also known as the "Babushka principle." It starts with earnings in the real economy, and only these earnings are reinvested. It is impressive how much money Buffett is capable of making through wholly unspectacular investments, such as the Californian chain See's Candies. Buffett purchased this company for USD 25 million back in 1972. Sales growth has remained modest, but thanks to the investment of a further USD 32 million, returns have increased dramatically. Buffett has transformed this small candy-making business into a cash cow.

True, even Berkshire Hathaway has suffered against the backdrop of the current financial crisis, but the company possesses huge reserves. With market prices now low, Buffett has begun buying up substantial equity stakes. For example, he has invested USD 5 billion in Goldman Sachs and a further USD 3 billion in General Electric. "Be greedy when others are fearful, and be fearful when others are greedy." Warren Buffett has always stuck to this principle. So far it has served him well. ■

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Unfashionable and cheap, contrarian to the core

Anthony Bolton _ Above his desk at Fidelity International's office in the City of London, Anthony Bolton keeps a cartoon depicting himself as a street cleaner. The joke refers to comments made by a disgruntled client in a letter from 1991, following heavy losses the year before in Fidelity Special Situations, the fund Bolton managed from 1979 until 2007. The letter announced the dissatisfied client's belief that Bolton wasn't fit to sweep the streets, let alone manage other people's money. It was true that the UK recession of 1990 knocked almost one-third off the value of Bolton's flagship fund. The following year saw a slight recovery. But for the ten years prior to recession, from its launch in December 1979, the Special Situations Fund had clocked up exponential returns for its original investors. The good times reappeared. On an annualized basis, the fund comfortably outperformed the stockmarket by several percentage points each year, defying the old adage that, in the long run, active management does not work. A client who put in just

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GBP 6,850 at the beginning would have become a millionaire by the time Bolton relinquished his role in 2007. Like all truly great fund managers, however, Bolton's performance has been durable; not smooth – as attested by disgruntled clients – but outstanding over time. Perhaps the best way to begin to understand this success is to start with that cartoon. Bolton is humble enough to remember errors as much as victories. After all, he was already established by that time as a star performer. Instead, he chose to keep it as an aide-mémoire. Alongside, there are report books on all the company meetings he has made over the last three decades: handwritten notes to help remember what company executives said. Like a good detective, Bolton's working day consisted of meetings, not just with management but any interesting party that could provide him with information pertinent to the job. He once said he would be prepared to listen to the tea lady if she had something useful to say. Although the company for which Bolton worked most of his career, Fidelity, is famous for the quality of its in-house research, Bolton never ignored external brokers, analysts or contacts. Such openness makes for a long working day, but it also begs the question: Whose views carry the most influence? "Analysis paralysis" is a common criticism of modern investing, and the view that stockmarkets such as the UK are efficient only piles on the burden for portfolio managers to seek out even more information sources to gain the competitive edge. Bolton is a contrarian investor. Here is his own definition of what that means: "My ideal is a company where things have gone wrong, but where it looks as if things may be changing. I am looking for stocks that are unfashionable and cheap, but where there is something that will recapture investors' attention before too long."[1]

In other words, Special Situations would often be traveling in the opposite direction to the majority of investors. Where market sentiment would be bearish, Bolton might be bullish; and vice versa. For example, during the "new economy" bubble of 1998–2000, he ignored Internet and mobile phone companies because he saw they were overvalued. The stance hurt performance initially, but over the five years to the end of 2003, which includes the last bear market, Special Situations triumphed. The fund more than doubled its value while, over the same period, the broad UK equity market lost 5%. Bolton, his employer and unhappy clients would all remark that such returns may be lumpy. By nature, contrarian investing takes time to work. This is evident from the final phrase in Bolton's own explanation that he is looking for something that will "recapture investors' attention before too long." The meantime requires patience. In Anthony Bolton's case, that patience has been handsomely rewarded. ■

Anthony Bolton **joined Fidelity in 1979 as a portfolio manager, managing the FIF Special Situations Fund. He also managed the Fidelity Special Values plc investment trust since its launch in 1994, before retiring from managing money for Fidelity International in December 2007. In October 2008, he announced he had recently invested his own money in the stockmarket for the first time in years.**

[1] Investing with Anthony Bolton, Jonathan Davis, page 19

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Plenty of work and a strong stomach

Peter Lynch **was born in Massachusetts in 1944. He graduated from Boston College in 1965 and received his MBA at Wharton in 1968. He first went to work for Fidelity Investments in 1966. In 1974, he was made Director of Research, and in 1977, chief executive of Magellan. He stepped down in 1990. Along with co-author John Rothchild, Lynch has written "One Up on Wall Street" (1989) and "Beating the Street" (1993), as well as a book for young people, "Learn to Earn" (1995). He currently manages the Lynch Foundation.**

Peter Lynch _ One day, in the 1970s, Peter Lynch's wife came home with a new pair of stockings packaged in a white plastic case in the shape of an egg. Called "L'eggs," the product was being test-marketed in the Boston area by the Hanes hosiery company. Normally women had to go to specialty stores to buy good stockings. But here was an excellent product that fit and that was available in drugstores and supermarkets, where women did most of their regular shopping. So Lynch invested in Hanes. Not long after, a competitor came along with a similar product and business model. Lynch went to a drugstore, bought 48 pairs of the competitor's stockings, and handed them out at the office for his female colleagues to try. The women reported that the stockings weren't as good, and Lynch held on to his position in Hanes. The stock became a huge hit, in baseball lingo, a "ten-bagger": a stock that earns ten times the money you put into it. The "L'eggs" story illustrates one of Lynch's now famous investment strategies: Buy what you know. Lynch's commonsensical but somehow non-obvious style is widely credited for his knockout success as chief of Fidelity's legendary Magellan fund.

Lynch became interested in stocks working as a golf caddie and overhearing conversations among wealthy golfers when he was barely in his teens. In those days, the focus was on individual stocks. When Lynch took over Magellan in 1977, people still were not all that interested in funds. Moreover, the market was in a slump. Nevertheless, Lynch proceeded to buy stocks such as fast-food outlet Taco Bell, home décor retailer Pier 1 imports and Dunkin' Donuts – companies that might not look particularly exciting, but whose business fundamentals were sound. Then, in the early 1980s, Americans began to have doubts about the solvency of the country's social security system, and market interest in mutual funds picked up as an alternative means of financing retirement. Media interest followed. In fact, Magellan became such a household word that, when a popular TV game show called "Jeopardy" asked what fund was named after an explorer, all three contestants jumped on the button with the answer.

The success of Magellan turned Lynch into a guru of the "growth" style of investing. Investors large and small clamored for advice, and Lynch was happy to give it: stick to what you understand, make sure the growth prospects of the companies are solid, stay focused on the long term. The formulas sound simple, but they imply a substantial amount of work. Lynch himself claimed to spend 70 hours a week picking stocks. "The more rocks you turn over," he told the New York Times, "the more you'll find."

Being in stocks also requires a strong stomach. In the crash of 1987, for example, Magellan lost a third of its value in two business days. Lynch, who bears an uncanny resemblance to the artist Andy Warhol, interrupted a vacation in Ireland to fly home. But he wasn't really worried because the fundamentals of the companies he held were good. When Lynch retired in 1990, at 46, Magellan was managing over a thousand individual stock positions.

In philanthropy as in investing, Lynch goes for what he knows and can understand. The Lynch Foundation was created in 1988. Today, the foundation supports a wide range of organizations primarily in Massachusetts. Grantees have included the Boston Children's Museum, Partners In Health (a not-for-profit health care organization that focuses on the needs of the poor) and even First Night, a New Year's Eve event in Boston that has been adopted by other cities as well. In August 2008, Forbes magazine included Lynch on their list of top mutual fund managers of all time. "One thing they all have in common," wrote the magazine, "is that they often took an unconventional approach to investing and went against the herd." ■

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Embracing the volatility others dread

Richard H. Driehaus — He has been called a daredevil, an innovator, a voice of dissent. Writing in Money magazine in 2003, Adrienne Carter described him as a master investor "who talks almost as fast as he trades." In 2000, Barron's named him one of the 25 most influential individuals in the mutual fund industry over the last century. The 66-year-old Driehaus, who among other things has a reputation for giving great parties, was born on the South Side of Chicago. His mother was Irish Catholic, and his father a German design engineer and inventor whose own career frustrations helped to shape Driehaus's determination to succeed. As a teenager, Driehaus had a job delivering newspapers and read the Wall Street Journal. His first (unsatisfactory) experience in buying stocks made him want to understand how to pick them. That steered him toward a career in money management and research. Driehaus figured out early that the price of a stock and the value of a company are two different things. He realized, too, that prices are influenced, among other factors, by investors' emotions. It seemed to him that people's reasons for making investments were generally based on old-fashioned ideas about buying stocks low, hanging on to them forever, and selling them high. Instead, Driehaus audaciously advocated buying stocks high and selling them at even higher prices. Accordingly, he focused on companies that had performed well in the recent short term – in particular small and mid-size companies in the technology and health care sector – and monitored them closely. Just at the point where a company with good earnings was attracting enough attention to enjoy a surge in the market, Driehaus would buy. By the same token, if the stock started performing badly, he would sell.

Where other investors dreaded volatility, Driehaus embraced it. This style, which came to be known as momentum investing, is not for everyone. It requires high-energy, active management, and such quick reflexes that the New York Times once referred to it as a "nosebleed strategy." But in Driehaus's hands, and up to the recent severe global downturn, it has worked very well. In 2008, by the company's own reckoning, Driehaus Mutual Funds fell by percentages roughly similar to those of the various MSCI indices; in one case doing slightly better, in other cases slightly worse. The oldest of the Driehaus funds, however, still show a substantial positive cumulative return over time.

Investing isn't Driehaus's only passion. All his life he has been captivated by architecture, an interest that he channels into the Richard H. Driehaus Foundation, a philanthropic organization he formed with his two sisters that supports work to enhance the urban environment. Somewhere along the line, he also became impressed with the potential of mechanisms such as microcredit in helping the poor to become entrepreneurs. Consequently, the foundation especially looks for projects that combine both cutting-edge art and architecture and the potential to address social problems. Here, too, Richard Driehaus seeks to innovate. ■

Richard H. Driehaus **was born in Chicago in 1942 and obtained a degree in business administration from DePaul University. In 1980, he founded Driehaus Securities Corporation, a brokerage firm. In 1982, he created Driehaus Capital Management and in 1996 Driehaus Mutual Funds. In 1984, he established the Richard H. Driehaus Foundation.**

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Illustrations: Martin Senn

Bill Gross **is a founder of PIMCO and managing director and co-CIO in the Newport Beach office. He oversees the management of more than USD 800 billion of fixed-income securities. He is the author of the book "Everything You've Heard About Investing is Wrong." In a survey conducted by Pensions & Investments magazine in 1993, he was recognized by his peers as the most influential authority on the US bond market.**

Good things come to those who wait

Bill Gross — Most people say that gambling is dangerous. Most of the time they are right. But just occasionally, someone approaches the bright lights of Las Vegas armed with a suitably analytical mind and turns the table on the casinos. In 1966, that person was Bill Gross, a young graduate who had just absorbed a seminal book on systematic gambling, while recovering in hospital from a car crash. From a USD 200 outlay, Gross racked up USD 10,000 in four months on the blackjack tables. For many, that success would be cause enough for celebration. Gross's own conclusion was that he had done pretty well for a summer job earning about USD 5 per hour. By his own estimate, Gross was at the tables sixteen hours a day. After this "summer job" Gross joined the Navy and then took a rather dull job in a Californian insurance company, Pacific Mutual Life Insurance, having failed to get a job elsewhere analyzing stocks.

Feeling he had arrived at a dead end, Gross persuaded his superiors to let him trade bonds instead of merely buying and holding them to maturity. In 1975, his bond portfolio began its amazing performance, with two years of high double-digit returns. Even today, few bond managers trading in developed markets would promise more than 7% returns. Three decades later, Gross is regarded as the "king of bond management", and PIMCO, the subsidiary of Pacific Mutual that he heads, is widely regarded as the house which put fixed income investing on the map. Only Dan Fuss of Loomis Sayles, another veteran, could be considered to rival Gross as a consistent outperformer.

PIMCO's flagship, Total Return Fund, is the world's largest mutual fund, with USD 127 billion under management (as at 31 October 2008), while the firm runs USD 790 billion (end-September 2008) in all. Gross himself is among the top 400 richest people in the USA, with an estimated net fortune of USD 1.3 billion (Forbes 2007). So how does he do it? The essence of PIMCO's success is to wring out systematic inefficiencies. One of the staples was exploiting the US homeowners' tendency to prepay outstanding mortgages. It is a feature of the US housing market that homeowners have the right to pay off the loan. PIMCO's contention was that people do so without much regard to interest rate trends, i.e. they overpay for this prepayment facility – which means owning that option, preferably via mortgage-backed securities, brings a small but durable profit. Another PIMCO standard has been to borrow at the short end using futures, i.e. at marginal cost, then use the spare collateral to invest in higher-yielding long-dated instruments. This strategy bears similarity to classic banking that pays current account holders a small rate of interest while loaning the accumulated capital out in longer-term mortgages and commercial debt at a higher rate. More recently, PIMCO stood out by widely purchasing agency mortgage-backed securities (MBS) before the US government's takeover of Fannie Mae and Freddie Mac.

Gross continues to systematically hone the search for big money. For a billionaire, he maintains the kind of punishing routine usually associated with ambitious juniors in investment banking. His day begins close to 3.30 in the morning and he continues to work at the same firm where he started 37 years ago. He is also chairman of the PIMCO Foundation, PIMCO's charitable giving arm. He and his wife, Sue, are also well known for their philanthropic endeavors through the Gross Family Foundation, funding projects like the Hoag Hospital's Sue and Bill Gross Women's Pavilion, and the University of California Irvine's Sue and Bill Gross Stem Cell Research Center. ■

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