

Now concentrate: here's a different approach to building a portfolio

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Meet Wayne Peters, a chief investment officer who hasn't bought a single stock this year. He gives "selective" a whole new meaning.

Many fund managers insist that diversification is the name of the game. What is to be made, then, of a fund that has held only 17 different stocks worldwide in the seven years of its existence, holds just seven stocks today, yet has produced an average compound return of 28.84 per cent in that time?

That's the story of Peters MacGregor, a Warren Buffett inspired fund that takes concentration to a whole new level. "If I find one new stock I want to buy in a year, it's a good year," says chairman and chief investment officer Wayne Peters. Calendar 2003, by this appraisal, has not been a good year, as he hasn't found anything worth buying.

This is buy-and-hold on a grand scale: every stock the fund buys is taken up with the intention of holding it for a decade. This has included just three Australasian stocks in seven years: QBE, which Peters sold out of three years ago; Freedom Group; and Michael Hill, the New Zealand jeweller.

Most of the fund's stock analysis takes place in the North American markets, where the focus is on the top 3500 stocks. Within that field, Peters is looking for good businesses that he understands, with strong cash flow, competitive advantages, impressive return on capital and operating in an environment that is very slow to change.

Plus, of course, the price must be right: Peters only goes into businesses that are trading at a 25 per cent discount to what he thinks the actual value is. That doesn't happen often to good businesses and consequently the fund has no fewer than 146 North American businesses on its watch list, waiting for the right time to buy in. There are a handful of Australians on the list too, though he declines to disclose who they are.

When Peters finds a stock in which he wants to invest — apart from it being something of a red-letter day, since statistically it seems to happen about as frequently as a solar eclipse — he tends to bet big, never putting in any less than 5 per cent of the entire portfolio. Since the minimum investment size from clients is \$2 million and some of them invest up to \$20 million, that suggests a large chunk of a company's stock — but Peters says it's almost never enough to allow the fund to agitate for change on a board, for example (though the shareholding in Freedom would have been an exception).

The fund charges no flat fees but 20 per cent of all positive performance, subject to a high watermark. Exit fees are levied on anyone who pulls out in less than five years.

It's the concentration methodology that will strike most investors as interesting, since it seems to go against accepted investment wisdom.

But there is statistical support for it. Richard Brearley, a recognised authority, once looked into the risk in portfolios ranging from two stocks to 2000.

He found that a five-stock portfolio provided 77.4 per cent of the benefits of diversification.

Eight companies brings the number to 85.7 per cent, and from there on up the benefits diminish accordingly. By the time you get to 100 stocks you're no longer gaining much in the way of diversification by adding a few more.

It's fair to say that Brearley's conclusion is not going to be parroted by everybody: index funds, for example, can include exposure to thousands of stocks and their managers would argue that this diversification brings with it a great safety net to protect against mismanagement at individual companies.

One finds many nods to Warren Buffett in Peters MacGregor's approach to the markets. One, which Buffett in turn borrowed from his own mentor Ben Graham is quoted verbatim in the firm's marketing literature. It's an interesting way of viewing the market and bears repeating:

"He [Graham] said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr Market who is your partner in a private business.

"Without fail, Mr Market appears daily and names a price at which he will either buy your interest or sell you his."

But, Buffett continues, Mr Market has incurable emotional problems. "At times he falls euphoric and can see only the favourable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains." At other times, he is depressed and can only see trouble ahead and will name a very low price.

Regardless, Mr Market doesn't mind being ignored and if you don't like his quotation today, he'll be back with another tomorrow.

Buffett concludes: "Mr Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom that you will find useful." Which is to say that if you fall under the influence of the market, rather than just focusing on the inherent value of individual companies, you'll quickly get into trouble.

There are other Buffett and Graham-isms too, such as the definition of the difference between investing and speculating: "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return."

Or Graham's rationale on thinking independently. "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right."

All of which serves to demonstrate the reason Peters focuses on only a handful of businesses and won't be rushed by the market into buying more. He is in no great hurry to find his first purchase of the year. "Patience," he says, "is a big prerequisite at this company."