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Less is More

"Simplicity is the ultimate sophistication."
Leonardo da Vinci

Simplicity of design has been a goal for many throughout the ages. Artists, engineers, designers, scientists and many others have all strived for the uncluttered representation, the elegant solution, the neatest explanation. And now, after years of increasing complexity fused with dubious results -- from complex trading algorithms gone awry to ballooning regulations failing to protect investors -- the concept of "less is more" finally may be gaining ground on Wall Street.

At the Federal Reserve's recent economic policy symposium in Jackson Hole, Wyoming, two regulators from the Bank of England gave what the *Wall Street Journal* has deemed the "Speech of the Year." Entitled "The Dog and the Frisbee," its authors, Andrew Haldane and Vasileios Madouros, argue that while the regulations for the global banking industry have become more complex over the last quarter century, they have also become less effective and more costly -- a potentially catastrophic combination.

On Wall Street, "less is more" is usually drowned out by the widely promoted notion of "more is more." But for many investors "more is more" typically results in opaque investments that are hard to understand, costly to maintain and difficult to manage and track. Frequently the investment results are less than satisfactory. In this Letter, we review Haldane and Madouros' findings and show an example of "less is more" from the portfolio of one of our long-time clients.

The title of Haldane and Madouros' speech refers to the fact that even though Frisbee-catching is difficult, the average dog easily masters the task. If a human physicist using calculus were to describe Frisbee-catching, he or she would need to understand the intricate details of Newton's Laws of Motion. In contrast, a dog follows a simple rule of thumb: run at a speed so that the angle of gaze to the Frisbee remains roughly constant. Humans catching Frisbees use this rule of thumb too. The authors' point is that complexity usually makes solving problems more difficult. Simple is often better.

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Haldane and Madouros begin by reviewing the history of regulation in the global banking industry. The current regulatory framework was established in 1988 as the Basel Accords, named for the Swiss town where they were created. The first Accord, Basel I, established minimum credit risk standards for global banks and was only 30 pages long.

The next agreement, Basel II, was established in 2004 and it allowed banks to use internal risk models as a way to fine tune their credit risk calculations. As the authors note, at 347 pages, Basel II was an order of magnitude longer than Basel I.

The financial crisis struck just a few years after Basel II was adopted and it exposed many regulatory deficiencies. Basel III was adopted in 2010 with the goal to strengthen the global banking industry. It weighed in at 616 pages -- almost double that of its predecessor Basel II. Haldane and Madouros note that in addition to dealing with more regulations, global banks today also are required to run millions of risk calculations, compared to about ten required 25 years ago.

They also discuss the status of financial regulations in the United States. In response to the Great Depression, the Glass-Steagall Act was enacted in 1933. It may have been "the single most influential piece of financial legislation of the 20th century. Yet it ran to a mere 37 pages."

In contrast, the Financial Reform Act of 2010 (*a/k/a* "Dodd-Frank"), the response to our generation's financial crisis, consisted of 848 pages with an additional 400 pages needed for implementation. And, as of last July, only one-third of the required rules have been finalized but they added an additional 8,843 pages to the rulebook. The authors note that at this rate, when Dodd-Frank is completely implemented, the entire set of rules could number some 30,000 pages -- a thousand times larger than its closest legislative cousin, Glass-Steagall.

Such dense and massive rulemaking not only pushes the boundaries of human comprehension, it also pushes the boundaries of regulatory effectiveness. Nobody can have an intuitive grasp or understanding of 30,000 pages of regulations. Making an industry, or an investment, more opaque and harder to understand is a recipe for trouble, not success. In addition, as the authors note, the costs associated with such regulatory complexity are not in any way trivial.

Haldane and Madouros estimate that in Europe, a mid-size bank implementing and maintaining Basel III means about 200 full-time jobs, a significant increase. In the U.S., they estimate that complying with Dodd-Frank will mean tens of thousands of full-time jobs across the financial industry. But these are not jobs associated with developing new products and services and increasing revenues and profits. These jobs increase administrative expenses and reduce earnings and profits, all in challenging economic times.

A fresh approach is needed, one that is less rules-focused and more judgment-based and Haldane and Madouros note that just such an approach will be the foundation of the new supervisory model currently being created for the Bank of England.

For investors, applying the concept of "less is more" to their portfolios can result in lower costs and easily understood and manageable investments. Almost 30 years ago, Roger Kirby described an example of this application in an article for *The Journal of Portfolio Management*. Kirby, who passed away in 2005, was a founder of Capital Guardian Trust Company, a large investment management firm for tax-exempt retirement and other institutional funds.

The article was entitled *"The Coffee Can Portfolio"* and Kirby describes an experience he had with one of his clients. The client was a woman but her husband handled her financial affairs and was Kirby's primary contact. After working with the couple for about ten years, the husband suddenly passed away. The client inherited her husband's estate and wanted to add his portfolio to hers for Kirby to manage.

In Kirby's words: "When we received the list of assets, I was amused to find that he had secretly been piggy-backing our recommendations for his wife's portfolio. Then, when I looked at the total value of the estate, I was also shocked. The husband had applied a small twist of his own to our advice: He paid no attention whatsoever to the sale recommendations. He simply put about $5,000 in every purchase recommendation. Then he would toss the (stock) certificate in his safe-deposit box and forget it.

"The portfolio was an odd-looking assortment of stocks -- there were a number of small holdings of less than $2,000 and several large holdings in excess of $100,000. Finally, there was one jumbo holding worth over $800,000 that exceeded the total value of the wife's portfolio. It came from a small commitment in a company called Haloid -- which later turned into 'a zillion shares of Xerox.'"

Thus for investors, the theoretical Coffee Can Portfolio would be about as simple as you could get. It would mean no transaction costs and no administrative costs. It would also mean no short-term tactical moves in response to changing market conditions and of course, no strategic reallocation of assets based on some computer model or algorithm.

Kirby admitted that the Coffee Can Portfolio is an extreme and probably unworkable concept. Few investors, or for that matter clients of an investment advisory firm, would have the patience to wait ten years before evaluating the results. In addition, the upfront costs to the investor would be enormous as they would have to be enough to support the investment advisor over the following ten years. However, Kirby notes there are a number of important lessons to be gleaned.

First, a constant focus on performance frequently has the effect of actually reducing investment results over the long-term. Responding to daily events by "doing something" in a portfolio means that many holdings end up being bought high and then later sold low. Investment ideas are never given enough time to work out and the transaction costs associated with such active buying and selling eat into results.

And, by looking at a portfolio as just a collection of stocks to be bought and sold, an investor completely ignores the businesses that the stocks represent. As Kirby wrote, ". . . most of us are faster than Wyatt Earp ever dreamed of being when it comes to taking a profit. The concept of being a long-term partner in a sound and growing business enterprise seems as far away as the Stone Age."

In many ways, over the thirty-odd years since our firm's founding, our investment philosophy has been similar to the "less is more" Coffee Can approach. We recommend the common shares of high-quality, financially strong companies with top-notch management teams. Their businesses are usually fairly easy to understand and their shares tend to be widely-traded and thus easy to track and price. In contrast, some of Wall Street's products can be difficult to price (hedge funds), unpredictable (leveraged ETFs), and/or broker-friendly (wrap accounts). "Broker-friendly" is, well, broker-friendly.

We try to keep our clients' portfolios concentrated on quality companies with superior growth prospects for the coming years. We tend to "let our winners run" by maintaining the holding for as long as the company is on track and do not jump in and out of the market. Many of our clients' portfolios are concentrated in as few as twenty-five to thirty holdings. On the other hand, some portfolios we have seen from Wall Street firms are diversified to the point of meaninglessness -- one in particular had upwards of 200 holdings. As with Dodd-Frank's potentially 30,000 pages of regulations, nobody can have an intuitive understanding of a portfolio consisting of hundreds of companies.

The following table shows a few of the holdings that we purchased in one of our client's portfolios. This individual became a client in 1983 and is still a client. The portfolio is taxable, dividend income is not withdrawn and there is an annual budget for capital gains:

Current Number of Shares	Company	Date Purchased	Total Amount Invested	Current Market Value	Annual Income
4,800	Abbott Labs	1985-1987	$ 20,113	$ 336,000	$ 9,792
5,400	McDonald's	1984	13,325	507,600	15,120
4,800	PepsiCo	1987-1988	27,552	340,800	10,320
6,000	Wal-Mart	1988-1989	24,023	450,000	9,540

Note the long holding periods. Over the last twenty-five years or so, the original amount invested in each of these companies has grown more than ten times -- in fact, the average increase for this group is twenty-two times. Of course, these are just a few of the holdings in the client's portfolio and of course not all have been as successful. Nevertheless, they are an example of "less is more" Coffee Can investing. Purchase a few high-quality companies and hold on to them for long periods of time, through thick and thin.

Investors today are challenged by increasing complexity, burgeoning regulations and struggling economies around the world. But those who follow a long-term approach of focusing on quality and financial strength are likely to be well-rewarded over time. Simplicity *is* the ultimate sophistication -- for artists, engineers, designers and scientists, as well as investors.