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When Buffett Was a Quant

The analyst who stressed quantitative factors

By Nick Schmitz

Today, Warren Buffett is revered as the "Oracle of Omaha." Looking back on several decades of incredible results, it's perhaps not unreasonable to attribute to Buffett some prophetic ability.

But it's especially interesting to revisit Buffett's early years, to understand how he saw himself and to what he attributed his early success. Few today would describe Buffett simply as an "analyst who stresses quantitative factors," but that's exactly how he described himself in a 1969 letter.

Let's set the stage. Buffett returned 24.5% per year net of fees compared to 7.4% for the Dow over the ten years from 1957 to 1967. He wrote to his investors that these results had "absolutely no chance of being duplicated or even remotely approximated during the next decade" and that investors should treat his result "as a freak like picking up thirteen spades in a bridge game."

Buffett was so convinced this performance was anomalous that he closed down the Buffett partnership in 1969. He did this because he was wrestling with three trends he saw in the market and his business model: valuations, selection opportunity at his new AUM levels, and the speculative nature of the market. He wrote:

(1) opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared, after rather steadily drying up over the past twenty years;

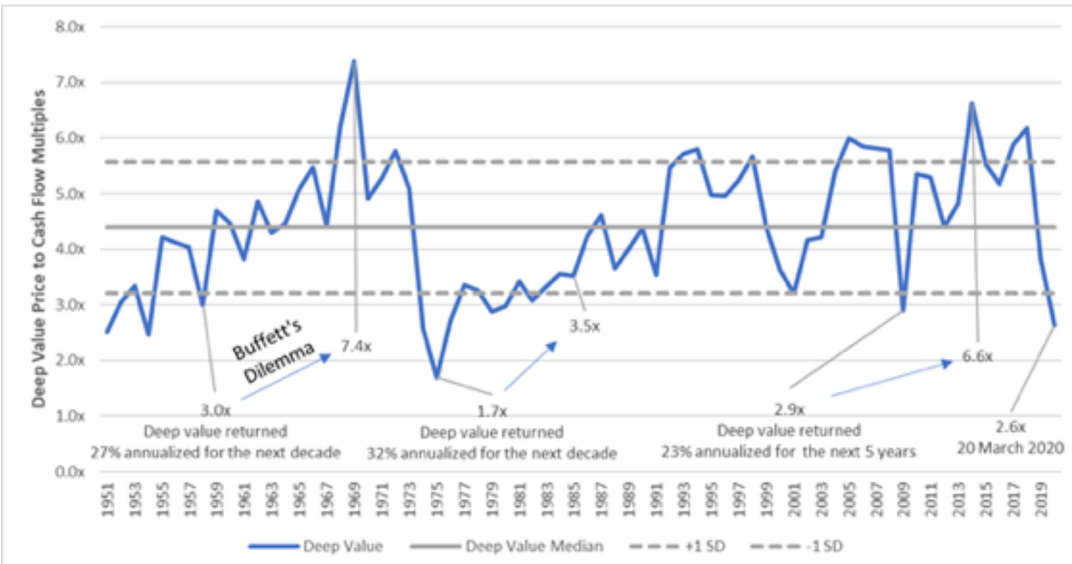
(2) our $100 million of assets further eliminates a large portion of this seemingly barren investment world, since commitments of less than about $3 million cannot have a real impact on our overall performance, and this virtually rules out companies with less than about $100 million of common stock at market value; and

(3) a swelling interest in investment performance has created an increasingly short-term oriented and (in my opinion) more speculative market.

Why did Buffett believe that investment opportunities for quantitative investors had dried up by 1969? And why did he think that an AUM of $100M (about $700M in 2020 dollars) was eliminating so much of his selection opportunity?

Let's start first by looking quantitatively at the US stock market and the opportunity set available to value investors. Below, we show the price-to-free-cash-flow multiple of the tenth percentile of cheapest stocks from 1951 to 2019.

Figure 1. Deep Value Price-to-Cash-Flow Multiples over Time



Source: Ken French, tenth percentile breakpoint on price-to-cash-flow multiples and tenth decile price-to-cash-flow long-term equal-weight returns.

From 1957 to 1969, deep-value stocks went from trading at 3x price-to-cash-flow to over 7x price-to-cash flow, nearing the all-time peak valuation for value stocks. Buffett's return of 24.5% per year in his first decade was a virtually identical result to simply buying the cheapest 10% of stocks in the market (for context, during that decade, this decile of the market was about 75 stocks that averaged about $75 million in market cap).

By the end of 1970, Buffett had legendary trailing returns but was selecting from a group of stocks that was generating about one third as much cash flow per dollar invested as when he launched his fund. And he had to do this with $100 million (a large sum in 1970), which severely limited his ability to gain meaningful exposure to the smallest and most attractive bargains, as he noted in his letter.

Buffett's decision to close down his fund proved prescient. Multiples for deep-value stocks compressed dramatically over the next few years, dropping to near all-time lows during the peak of the "Nifty Fifty" bubble.

Fast forward to 2020. What should a deep-value investor think about the US market today if they look at it the way Buffett did in 1970?

After the last few years of deep-value stocks selling off relative to growth stocks, and the last few months of deep value getting punished even further relative to others, deep-value stocks are now about as attractive on pricing as when Buffett launched his fund. They traded down to around 2.6x price-to-cash flow at the bottom in late March.

We believe that market multiples explain short- and long-term portfolio returns more than most market spectators probably appreciate. But this is how investors have historically achieved multi-year double-digit returns: buying stocks with high earnings potential at ~30% cash flow yield and holding through the near-term pessimism, rather than trying to predict next quarter's earnings.

As Buffett later noted, "The most common cause of low prices is pessimism—sometimes pervasive, sometimes specific to a company or industry. We *want* to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer."

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