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# Why It's So Hard to Copy Charlie Munger's Secret Sauce

For quality stocks to outperform in the long run they have to be underpriced. That's the hard part.

*By James Mackintosh* Follow

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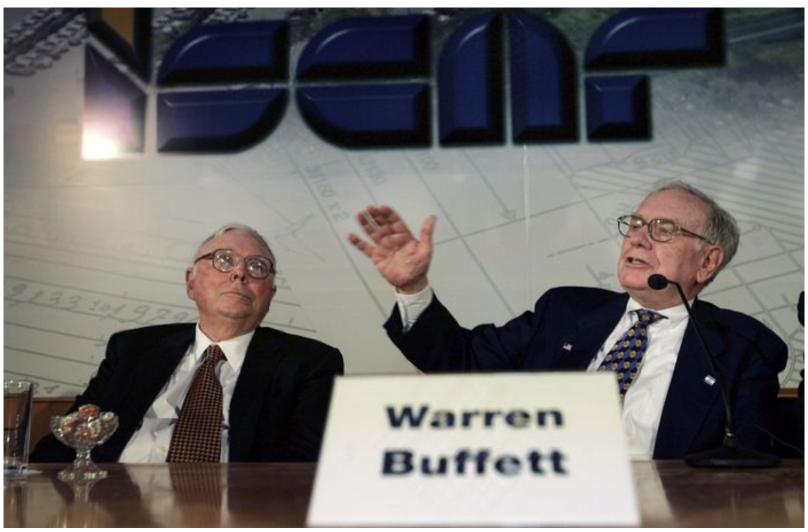


Charlie Munger and Warren Buffett, with hand raised, in 2006. Munger persuaded Buffett to focus on buying 'wonderful businesses at fair prices.' PHOTO: DAVID SILVERMAN/GETTY IMAGES

If you want to invest like Charlie Munger, you're late to the party. The investor's genius in spotting what's become known as the "quality factor"—buying good companies—made a ton of money for him and business partner Warren Buffett. Nearly 50 years on, it might not be such a great time to copy his strategy.

For those who missed the late Munger's brilliance, he's the one who persuaded the billionaire Buffett to shift Berkshire Hathaway's BRK.B **0.45%** ▲ focus from "cigar butt" value stocks—bad companies that no one else wants, and so are cheap—to buying "wonderful businesses at fair prices."

Before getting to the difficulty of doing that, consider how investors and academics define a "wonderful" business: Quality means consistent earnings growth, solid profit margins and not too much debt. These are companies for all seasons, growing less in good times than the highly leveraged boomtime winners but surviving downturns and prospering always.

That might seem reason enough to buy them and is certainly how they've been presented by Buffett and Munger over the years, thanks to the magic of compounding. However, we need to dig deeper.

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### Quality Street

Investors who bought high-quality stocks did well in the long run, with difficult periods.

**High minus low quality U.S. stock performance since 1989***


*Portfolio long the 30% highest quality, short the 30% lowest quality
Source: AQR Capital Management

Their stability means quality stocks are usually more expensive than low-quality stocks. But for decades the premium was smaller than it should have been. In a perfectly efficient market, quality stocks would produce the same risk-adjusted returns as others, because everyone already knows that they're good quality and understands risk and compounding. In the real world, markets aren't perfectly efficient, and quality stocks historically weren't as expensive as they should be, as research by AQR Capital Management demonstrated.

My favorite theory for why quality stocks were cheaper than they should be is that they don't appeal to gamblers in the market hoping to make a fast buck. Quality stocks ought to help you get rich slow, and that's just less attractive to the frequent trader, who likes the big price moves that come with leverage and unpredictable profits.

This analysis helps explain long periods of poor performance for quality stocks. In bad times they do well and accordingly become expensive as strong balance sheets and regular profits have appeal. Just as being too cheap makes for good future returns, being too expensive sets them up for years of bad performance. This has happened after every period of great performance for quality, which tended to be around recessions—in the early 1970s, 1990s, the dot-com bust and the financial crisis.

Buffett and Munger had an even longer time in the doldrums after perhaps their biggest mistake: not selling Coca-Cola stock when it had a mini-bubble in 1998. Coke briefly traded at 50 times earnings, an insane valuation that should have prompted them to exit their largest position. But a mantra of long-term compounding kept them in. They held on through the bust that inevitably followed the bubble, and the stock took 13 years to get back to its high.

The risk is that something similar is on the way. High-quality stocks have resoundingly beaten low-quality ones since the collapse of the speculative frenzy in SPACs, cannabis, crypto, clean energy and tech startups in early 2021. They continued to do better as investors anticipating recession used them to hide from danger, while also benefiting as investors searched out high-profit-margin companies.

Rob Arnott, chairman of Research Affiliates, says that investors are rewarding high-margin stocks with much higher valuations than usual, positioning themselves for disappointment when valuations fall back to normal levels. That's raised valuations for most measures of quality to above long-run averages, because quality typically includes high-margin stocks.

One example: MSCI's quality index, used by the largest quality-factor ETF, from iShares, is expensive compared with the market and with history, thanks to the valuation of high-margin stocks. The index's selection criteria, including profit margin, make its biggest holding the chip maker Nvidia; that's produced stunning returns this year but also pushed up the valuation multiple. In other words, it's a quality stock, but super expensive.

Even if you adjust for sectors to reduce the importance of a handful of tech stocks, quality is a bit more expensive than usual. Worse, it's no longer special. When Munger started, there were plenty of opportunities to find quality stocks that had been overlooked, because few paid attention. Now, quality as a so-called investment factor is widely used. Investment bank UBS this week recommended "quality at a reasonable price" as a way to play an economic slowdown while steering clear of the most expensive quality stocks.

Buying wonderful businesses at a fair price is a decent way to make money slowly. With so many others now wanting to do the same thing, the problem is to find them when the price is still fair.

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