"One of the Investment Greats" Explains His Portfolio Strategy

Lisa Röper

A Q&A with renowned investor Lou Simpson.

Based on insights from Robert Korajczyk and Louis Simpson

From casual daytime traders to professional asset managers, everyone wants to know the secret to building a strong portfolio. What is the best way to pick a stock? When is it best to sell your shares, and when is it better to hold on?

Lou Simpson, former chief investment officer for Geico—a Berkshire Hathaway subsidiary—and current Chairman of SQ Advisors, has been called "one of the investment greats" by none other than Berkshire Chairman and legendary investor Warren Buffett. At the time of his retirement from Geico in 2010, Simpson managed a portfolio valued at more than $4 billion. Today he is also a senior fellow and adjunct professor of finance at Kellogg, and a member of the Advisory Council of Kellogg's Asset Management Practicum as well as a member of Northwestern University's Board of Trustees.

Robert Korajczyk, a professor of finance at the Kellogg School, sat down with Simpson to discuss his remarkably successful investment strategy.

This interview has been edited for length and clarity.

Bob Korajczyk: What would you say is the essence of your investment philosophy?

Lou Simpson: The essence is simplicity. The base case for investing in any area of the market is a passive product, such as an index fund. That's something any investor can access.

If you're a professional investor, the question is: How can you add value? The more you trade, the harder it is to add value because you're absorbing a lot of transaction costs, not to mention taxes.

What we do is run a long-time-horizon portfolio comprised of ten to fifteen stocks. Most of them are U.S.-based, and they all have similar characteristics. Basically, they're good businesses. They have a high return on capital, consistently good returns, and they're run by leaders who want to create long-term value for shareholders while also treating their stakeholders right.

Korajczyk: So you concentrate your investments in your very best ideas.

Simpson: You can only know so many companies. If you're managing 50 or 100 positions, the chances that you can add value are much, much lower.

So far, this year we bought one new position, and we're looking pretty seriously at one more. I don't know what we'll decide to do. Our turnover is 15, 20 percent. Usually we add one or two things and get rid of one or two things.

Warren [Buffett] used to say you should think of investing as somebody giving you a fare card with 20 punches. Each time you make a change, punch a hole in the card. Once you have made your twentieth change, you have to stick with what you own. The point is just to be very careful with each decision you make. The more decisions you make, the higher the chances are that you will make a poor decision.

One thing a lot of investors do is they cut their flowers and water their weeds. They sell their winners and keep their losers, hoping the losers will come back even. Generally, it's more effective to cut your weeds and water your flowers. Sell the things that didn't work out, and let the things that are working out run.

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Korajczyk: Are investors afraid to let the goods ones run?

Simpson: If I've made one mistake in the course of managing investments it was selling really good companies too soon. Because generally, if you've made good investments, they will last for a long time. Of course, things can change. Amazon is changing the retail business quite dramatically.

Korajczyk: What is the correct balance between quantitative and qualitative skills in your approach to investing?

Simpson: Well, I think you need a combination of quantitative and qualitative

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skills. Most people now have the quantitative skills. The qualitative skills develop over time.

But, as Warren used to tell me, “You’re better off being approximately right than exactly wrong.” Everyone talks about modeling—and it’s probably helpful to do modeling—but if you can be approximately right, you will do well.

For example, one thing you need to determine is: Are the company’s leaders honest? Do they have integrity? Do they have huge turnover? Do they treat their people poorly? Does the CEO believe in running the business for the long term, or is he or she focused on the next quarter’s consensus earnings?

Korajczyk: It sounds like the qualitative skills can help you assess the downside of having a concentrated portfolio—namely, concentrated risk. What are some of the factors you look at when you’re worried an investment might blow up and damage your portfolio?

Simpson: There are a few factors that we look at. First, is this the business we thought it was? If you figure out that a business is not what you thought it was, that’s a bad sign.

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The second factor is the management, which can also differ from what you thought. Unfortunately, a lot of managements are very short-term oriented, and that can be another reason to sell. This goes back to the basic integrity and the focus of people in charge.

The third factor is an overly high valuation, and this is often the most difficult, because you're investing in something you wouldn't buy at current prices, but you don't want to sell because it's a really good business and you think it's ahead of itself on a price basis. It might be worth holding on to it for a while.

Korajczyk: My sense is that you and Warren Buffett have very compatible investment styles. Are there any interesting *differences* between you and Warren?

Simpson: The biggest difference between Warren and me is that Warren had a much harder job. He was managing 20 times the amount of money we were. We were managing five billion. In equities, he might have been managing 80, 90, 100 billion. So he was much more limited in what he could buy if he wanted to have a concentrated portfolio, which he did.

Korajczyk: You emphasize a long-term focus and low turnover. It seems to be true that the more you trade, the lower your returns.

Simpson: Yes, I think there's a strong correlation. There's also a negative correlation between the number of people making the investment decisions and the results. If you have a lot of people involved, you tend to have the least competent person making the decision, because you need consensus.

One thing I say to people is if you really don't think that you can add value—and most people can't—then I think your base investment case should be a passive product with a low cost.

Korajczyk: Is there a way for somebody to be an active investor, but only spend a few hours over the weekend doing research?

Simpson: You probably could. But even among professionals who trade full time, the majority do not add value. Because, again, you have fees, you have transaction costs.

Yes, I think there are people who have the right mindset and maybe contacts, and certainly luck, who could outperform the market. But if somebody's going to invest using hot tips, or listening to CNBC, or investing with so-called wealth managers at brokerage firms, I think it's a loser's game for them.

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