

A Class Discussion Project for Investment Management and Business Strategy

Patrick John Larkin¹, Baeyong Lee¹

¹Fayetteville State University, USA

Correspondence: Patrick John Larkin, Fayetteville State University, USA.

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Abstract

This paper presents an instructor's guide for a class discussion of a notable lecture on stock selection and business strategy by a successful investor and businessman.

Keywords: class discussion project, investment management, learning from business practitioners

1. Introduction

Business people can contribute to the education of business students in many ways, such as by describing and interpreting their experiences in the field and by highlighting tensions between theory and practice. When a successful business practitioner offers business students advice based on both experience and careful study of a wide range of subject matter relevant to business, the students are likely to benefit from a critical examination of that advice. In this paper we provide an instructor's discussion guide to a speech given by Berkshire Hathaway Vice-Chairman Charles Munger to the University of Southern California's Business School in 1994. A transcript of the speech was published in *Outstanding Investor Digest* and is titled "A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management & Business." It is easy to find on the internet. The speech is probably best suited for courses on investment management or business strategy. It would also be appropriate for capstone courses at some business schools. The speech could be particularly useful to instructors attempting to implement a team teaching strategy in business and finance. We suggest that instructors assign the speech along with some or all of the questions that we propose below, and then hold a class discussion for students to discuss and debate the answers.

The teaching technique suggested here is not new, but it is a bit different from the technique typically employed in business case studies. Business case studies typically present a multi-part scenario that requires students to assume a specific role and to apply the competencies learned in the course to the problems presented in the scenario. Both the case scenario provided to students and the suggested answers provided to instructors are typically provided by the case author. In this teaching technique, instead of inventing a scenario from scratch, we draw on an existing primary source and provide suggestions for instructors on how to productively steer a class discussion of the source material. Examples of other authors who have employed this technique include Lamb and Pace (1993) and Chan, Weber, and Johnson (1995).

We have employed this method successfully in our own classes using the popular finance case study "The Dividend Cut 'Heard 'round the World': The Case of FPL." That case uses an actual corporate event to illustrate several important points about dividend and capital structure policy, but the case authors do not frame the case in the typical manner and do not provide suggested solutions. We believe that this technique of identifying important primary sources and then providing instructors and students with a framework for exploring those sources as a class enhances learning and facilitates the blending of theory and practice in the classroom.

2. Questions and Instructor Notes

1. In order to avoid falling victim to "man with a hammer syndrome," Munger emphasizes the importance of having multiple mental models from multiple disciplines to draw on. Can you think of an example of this "man with hammer syndrome" in the business world?

Fields: Strategy, Management

Notes to instructor: Enron is one possible example. Enron's gas bank was an innovative idea, but then Enron tried to

create similar markets in broadband access and other goods and services, some of which were difficult to standardize and lacked sufficient transactions volume to form a well-functioning market. Students might also suggest examples of management styles or practices that succeeded in one context but failed in another.

2. When Jack Welch took over as CEO of General Electric, he decided that the firm would exit any market in which it could not be number one or number two in market share. Why did Welch make this decision? Explain some of the advantages and disadvantages that large enterprises might have in competing with smaller firms.

Fields: Strategy, Managerial Economics, Entrepreneurship

Notes to instructor: Welch made the decision because he understood the importance of scale in the industries that GE was operating in. In some industries, scale might not bring the same cost advantages. In some service businesses, such as hair salons, average costs might not be much lower for a national chain than for a single local shop that stays busy. Students might also consider how the increased agency issues that larger firms sometimes suffer from might tilt the playing field in favor of smaller firms when firms compete on quality and service.

3. Munger speculates on why some relatively concentrated industries, such as airlines, have historically been brutally competitive, and others, such as cereals, have not. When should firms compete hard for market share and when should they back off from this competition?

Fields: Strategy, Managerial Economics, Marketing

Notes to instructor: If a manager seeks to maximize shareholder value, he should not pursue market share as an end in itself. In many cases however, increasing market share is likely to increase shareholder value. Increasing market share often allows the firm to achieve economies of scale, which reduces costs and increases margins and return on capital, other things equal. Economies of scale are frequently local, so sometimes it is optimal to focus on market share in local instead of global markets. If a firm has a competitive advantage such as a brand, it can be advantageous to leverage that advantage by partnering with other firms that have dominant market positions away from the firm's home market. An example of this is the joint venture Cereal Partners Worldwide formed between General Mills and Nestle in 1991. This joint venture allows General Mills to leverage its brands in local markets outside of the U.S. where Nestle has a more entrenched distribution system.

4. Munger relays the story of Berkshire Hathaway Chairman Warren Buffett's decision to close the last Berkshire Hathaway textile mill as follows:

"For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles – which are a real commodity product. And one day, the people came to Warren and said, 'They've invented a new loom that we think will do twice as much work as our old ones.'

And Warren said, 'Gee, I hope this doesn't work because if it does, I'm going to close the mill.' And he meant it."

When can a company expect to capture the productivity advantages of investing in new technology and when will these advantages flow through to customers?

If you determine that all of the benefits of the investment would go to customers, should you close the firm (or discontinue the project) immediately?

Fields: Strategy, Managerial Economics, Corporate Finance

Notes to instructor: If an opportunity to invest in productivity-enhancing technology comes along, many managers are likely to interpret it as an opportunity to increase profits by decreasing unit costs and increasing output. It is easy to ignore the likely actions of competitors. The increase in supply that results from many firms increasing output simultaneously puts downward pressure on prices. Falling output prices offset decreased unit costs and increased unit volume. For that reason, in competitive, "commodity" industries, most if not all of the benefits of new technology are likely to flow through to customers.

Firms that have exclusive access to a new technology through patents and firms that have some degree of customer captivity should capture a large portion of the benefit of investment in new technology. The relative lack of competitive pressures facing such firms should allow them to resist cutting output prices too much. In oligopolistic industries, much depends on the pricing dynamics that typically prevail in the industry.

In our view, the really interesting part of this story is that when Buffett was confronted with the information about the new loom, his response revealed that he had already thought one step beyond the decision to replace the loom and concluded that he would exit the business entirely. Munger provides us with a window into what Buffett was thinking: "It's a lousy business. We're earning substandard returns and keeping it open just to be nice to the elderly workers. But we're not going to put huge amounts of new capital into a lousy business."

One way to see why textiles was such a lousy business for Berkshire is to combine Munger's model of

“incentive-caused bias” with the microeconomic model of perfect competition. The classic shutdown condition in microeconomics states that a firm should remain in business as long as revenues exceed variable costs. We don’t know for sure, but it seems likely that before the appearance of the new loom, the competitively determined price was above Berkshire’s average variable cost curve and somewhere in the neighborhood of its average total cost curve. Microeconomics predicts that increased output will drive down prices in a competitive market, but in theory, investment in the new technology should cease before the return on capital falls below its opportunity cost.

In practice, as Munger describes, incentive-caused bias often leads management and other employees to favor growth over returns. It’s important to grasp that Munger is not just stating that people act according to their own incentives. Munger’s incentive-caused bias refers to the tendency of people to genuinely believe that the solution that best serves their interest is the right solution, even when evaluated against an objective that does not align exactly with the person’s interest. In terms of Buffett’s decision to close the mill, it seems likely to us that Buffett predicted that incentive-caused bias would cause competitors to expand capacity well beyond rational levels, resulting in substantial economic losses for all. One general lesson is that sometimes it is optimal to exercise the option to exit, particularly in businesses that are undergoing rapid technological change. But institutional resistance to exit is often fierce, particularly when capital allocation decisions are influenced by managers who feel that their career prospects are tied to the results of specific projects or business operations.

The process that a firm’s management goes through to determine whether a large investment should be made is called capital budgeting in university corporate finance classes. There are a number of capital budgeting techniques, but regardless of the technique used, all relevant variables should be included in a capital budgeting analysis. Few variables are as relevant in business as output prices. Munger notes, to paraphrase, that in all of the capital budgeting projections that he’s seen in his long business career, he has never seen one that does not hold output prices constant. In our experience, university students of capital budgeting do not often see such examples either. We have found that Munger’s analysis tends to enrich classroom discussions of capital budgeting.

5. What does Munger mean by the term “surfing?” Give an example of a firm that has “surfed” or is “surfing” and explain the economic forces that have allowed them to “surf.”

Field: Strategy, Managerial Economics, Investment Management

Notes to instructor: One way to interpret this one is to say that a firm is “surfing” when it has incurred the startup costs required to establish a competitive advantage in an industry, and can now produce with low marginal costs. Competitive advantages such as switching costs are necessary for the firm to “surf” for an extended period of time. Examples include Microsoft, Google, and Gillette (now part of Procter and Gamble). Firms that are “surfing” in this manner will earn an attractive return on existing invested capital. For the investor to “surf” along with the firm, it is preferable for the firm to have opportunities to reinvest earnings at high incremental rates of return. Otherwise, the investor has to seek out other opportunities for reinvestment, which requires considerable effort and risk. As Munger points out, long-term investments in firms that can reinvest at high rates of return also allow the investor to minimize taxes and transactions costs, which can have a material effect on the investor’s long-term results.

6. Munger briefly reviews and praises Benjamin Graham’s system for buying cheap stocks, though Munger (and to some extent Buffett) later moved on to focus more on higher quality companies selling at higher prices. How much weight should an investor or securities analyst put on price?

Field: Investment Management

Notes to instructor: Price is what you pay and value is what you get, so in our view price should have a weight of 50%. Munger notes, to paraphrase, that once price is accounted for, it usually isn’t so easy to determine whether the higher-quality or the lower-quality business makes the best investment. As with all of the questions, the discussion in any given class might go in a different direction.

7. Why is it now harder to make money using Benjamin Graham’s strategy of buying stocks that sell for less than liquidation value?

Field: Investment Management

Notes to instructor: One reason is that Graham’s “net-nets” are simply much harder to find in today’s stock market. Investing in stocks was all but discredited by the great depression, resulting in fewer competitors to bid up the prices of undervalued stocks in Graham’s time. Information technology has also made it less costly to identify stocks that appear to be selling below liquidation value. In addition, Munger cites changes in the firm’s legal obligation to employees that make it difficult to estimate the actual liquidation value of a stock from its balance sheet. When a firm experiences distress it doesn’t have the option of simply selling the assets, paying off the liabilities and pocketing the difference. Obligations to employees and other stakeholders that did not appear as liabilities on the balance sheet when the firm

was healthy sometimes arise when it ceases to become a going concern. However, one might argue that while back in 1994 when the speech was delivered it was reasonable for Munger to expect that these obligations to employees would grow stronger, they might have instead weakened since that time, at least in the U.S.

8. Munger makes the following comment on the advantage gained from investing in high return on capital businesses:

“Over long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return - even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you’ll end up with a fine result.”

Based on the context of the statement, it seems safe to assume that Munger is referring to companies that reinvest most or all of their earnings.

Assume that company A will earn a compounded rate of return on equity capital of 6% for 40 years, and that you can invest in the stock now at one-half of its book value per share of \$100. Also assume that company B will earn a compounded rate of return on equity capital of 18% for 40 years and you can invest in the stock now at twice its book value per share of \$100. Assume also that at end of 40 years, the market value of each stock will revert to book value. Test Munger’s assertion by computing the compounded rate of return that an investor would earn on each stock over the 40 year holding period. You may ignore personal taxes.

Try to explain in plain English to a skeptical client how it is that an investment in company B, which is selling with forward earnings yield of only 9%, can end up generating such a high rate of return to investors over 40 years. Can you think of any practical problems with following a strategy of investing in companies with high returns on capital and holding them for the long-term?

Field: Investment Management

Notes to instructor: An investment in company A would earn a compounded return of 7.85%:

$100 \times (1 + 0.06)^{40} = \$1,028.57$ book value (and market value) at the end of 40 years.

$(\$1,028.57 / \$100 \times 0.50)^{(1/40)} - 1 = 7.85\%$

An investment in company B would earn a compounded return of 15.97%:

$100 \times (1 + 0.18)^{40} = \$75,037.83$ book value (and market value) at the end of 40 years.

$(\$75,038 / \$100 \times 2)^{(1/40)} - 1 = 15.97\%$

Some quantitatively inclined students might wish to set up a simple spreadsheet to play around with the assumptions and determine how big of a discount to book value stock A would need to sell at to provide the same return as stock B, for example.

In plain English, the first \$200 of an investment in one share of company B earns 9%. After one year though, the company will have \$18 ($\200×0.09) to put to work for the investor earning 18%. After 6 years, the investor will have more money invested at 18% than at 6%. If the process goes on long enough the return to the investor approaches the company’s return on equity capital.

The problem with implementing Munger’s strategy is that there are not many companies like company B. Identifying companies that can sustain high rates of return on capital on existing assets is somewhat challenging, but as Munger himself admits, finding companies that can continue to reinvest at such high rates of return over long time periods is extremely challenging. The exercise that we recommend here might turn out to be more useful in helping students to analyze the assumptions that are necessary to justify the valuations of the popular growth companies of the era.

9. Munger believes that the best way to achieve superior returns in the stock market is to wait patiently for large mispricings to appear and then to make concentrated bets on the mispriced securities. Discuss the pros and cons of Munger’s view from the point of view of both the individual investing his own money and the investment manager managing other people’s money.

Field: Investment Management

Notes to instructor: Given the extraordinary success that Munger has enjoyed with his investment strategy, many students might be quick to agree with him. If this is the case, instructors might encourage students to question Munger’s approach. The issue of the risks involved in concentrated portfolios should probably be raised. Instructors might also wish to consider whether they wish to encourage general debate about the relative merits of active versus passive strategies, or if they prefer to focus on comparing Munger’s investment style to other active approaches.

Turning to professional investment management, one interesting question that Munger touches on is whether it is even possible to manage money according to his principles in today’s environment. Other things equal, a more concentrated

portfolio will tend to exhibit more volatility in the short-run, and clients do not like downside volatility. Even if most of the volatility is to the upside, Munger notes that clients are likely to begin to question why they are paying fees to an investment manager who often goes long periods without making any changes to the portfolio. Is it possible that the success of modern portfolio theory in the investment management industry today is partly due to its ability to reduce volatility around a benchmark and maintain client assets under management, possibly at the cost of the client's long-run wealth?

Finally, we think that it is important to note that while Munger has on occasion agreed to requests to speak about his investment philosophy, he has never actively promoted it as appropriate for the average individual investor. To illustrate, Munger made the following comment to *Outstanding Investor Digest* in 1998:

“Each person has to play the game given his own marginal utility considerations and in a way that takes into account his own psychology. If losses are going to make you miserable – and some losses are inevitable – you might be wise to utilize a very conservative patterns of investment and saving all your life. So you have to adapt your strategy to your own nature and your own talents. I don't think there's a one-size-fits-all investment strategy that I can give you.”

10. What are the two ways that Munger mentions that a firm can increase operating profits without increasing unit sales? In addition to the examples mentioned by Munger, try to identify an example of each method in the business world.

Fields: Strategy, Investment Management, Managerial Economics

Notes to instructor: Two of the investment models mentioned by Munger - untapped pricing power and turnarounds which involve asset reductions - could result in operating profit increasing without an increase in unit sales. Students should understand that the increase in the contribution margin - the gross profit per sale - resulting from a price increase can more than compensate for a decrease in unit sales. There is nothing novel about that observation, but in our experience, too many students automatically assume that the correct strategy for a firm must include increasing unit sales. Munger names several historical examples of untapped pricing power, including Disney and Berkshire subsidiary See's Candies. In today's environment, we find it difficult to identify a current firm that we can confidently assert has untapped pricing power, but suggestions from students could make for an interesting discussion.

One example of a turnaround based in part on asset reductions is Ford's turnaround beginning in 2008. Ford sold Jaguar and its other European brands, closed its Mercury division, and focused on its profitable Ford and Lincoln brands. Going further back in business history, another possible example is Texas Instruments' 1983-1984 turnaround in which the firm exited the fiercely competitive personal computer business.

3. Conclusion

In our experience, business students are more receptive to ideas when they are presented by successful business practitioners. Charles Munger's speech contains a number of important lessons that both draw on and challenge the theories that students learn in school. We have attempted here to provide enough suggestions for framing a class discussion of the speech that instructors of various business and finance courses can adapt the speech to the needs of their students.

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Appendix: Questions Only (For Distribution to Students)

1. In order to avoid falling victim to “man with a hammer syndrome.” Munger emphasizes the importance of having multiple mental models from multiple disciplines to draw on. Can you think of an example of this “man with hammer syndrome” in the business world?

2. When Jack Welch took over as CEO of General Electric, he decided that the firm would exit any market in which it could not be number one or number two in market share. Why did Welch make this decision? Explain some of the

advantages and disadvantages that large enterprises might have in competing with smaller firms.

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