

JOHN NEFF

on investing

*To invest smarter,
listen to John Neff."*

—*Money*

with S. L. Mintz

JOHN NEFF
ON
INVESTING

JOHN NEFF

with



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New York • Chichester • Weinheim • Brisbane • Singapore • Toronto

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Published by John Wiley & Sons, Inc.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Neff, John (John B.)

John Neff on investing / John Neff with S.L. Mintz.

p. cm.

Includes index.

ISBN 0-471-19717-3 (alk. paper)

1. Investment analysis. 2. Investments. I. Mintz, Steven L.

II. Title.

HG4529.N43 1999

332.6—dc21

99-16345

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

ACKNOWLEDGMENTS

I AM INDEBTED to my family: Lilli and our children, Lisa and Stephen, for their support, interest, and understanding during the time-consuming period when this book was developed. I constantly and perhaps excessively used them as a sounding-board for different parts of this book and they were always willing and enthusiastic participants.

My collaborator, Steven Mintz, really did the heavy lifting in organizing my thoughts, accomplishments, and convictions into the chapters that make up this book. His patience, diligence, work ethic, and amiability were very much appreciated.

Another responsibility, in addition to managing the Windsor Fund, I shared with Bob Doran, Duncan McFarland, and Nick Thorndike over a 16-year period was managing partner of Wellington Management Company LLP, an investment advisor now managing upwards of \$200 billion of discretionary assets. Their level of integrity, good judgment, dedication, sense of humor, and accomplishments were constant companions as we tried to lead Wellington in the never-ending quest to be an outstanding investment organization.

Over the years, both good and bad, I basked in the warmth of constant encouragement and support from Jack Bogle, Jack Brennan, and other Vanguard directors. Despite the occasional rough patches we suffered, I never had the feeling that I didn't have the confidence of this outstanding group of individuals.

All of Windsor's success would not have been possible without the remarkable team that contributed so mightily over my tenure. Chuck Freeman, my successor, made a stellar contribution over 26 years. He was sharing and the epitome of intellectual honesty that resulted in such

ACKNOWLEDGMENTS

coups as Tandy, Citicorp, and Chrysler as well as many others. Both Jim Averill and Jim Mordy over a ten-year period flushed out in admirable fashion typical Windsor fare.

I had the good fortune to have a trio of superb mentors that aided me along the way. In college at the University of Toledo, Dr. Sidney Robbins, head of the Finance Department and professor of the only two undergraduate finance courses I took, opened my eyes to the fascinations of the investment business and convinced me that I could make a contribution therein. Arthur T. Boanas, a Yorkshire man, who came to the United States after World War II, took me under his wing in my first job out of college and with endless patience and encouragement schooled me in the wonderful world of common stock investing. Paul M. Miller, one of the founders of Miller, Anderson and Sherred, an investment advisory firm now part of Morgan Stanley Dean Witter, and Chairman of the Board of Trustees of the University of Pennsylvania for eight years, through subtle, understated example helped me to mature a bit later in life.

I have had the good fortune to have outstanding helpmates over the years. Janet Ragusa took dictation and with customary tirelessness, accuracy, patience, and good cheer pounded out a rough draft of the hundreds of letters to the Vanguard Directors that make up the journal that accounts for about half of this book. Darla Knoll, administrative assistant extraordinaire for some 20 years, made me better than I am by keeping me organized and managing my affairs effectively. In my semi-retirement, Fran Kelly has looked after me with tender loving care.

Three people have encouraged and occasionally harangued me over the past couple of years to do this book: Charlie Ellis, who paid me the fine compliment of writing the Foreword to this book; Bill Hicks who helped with Windsor Fund out of the embryo; and Gene Arnold who sent me a bevy of messages to “get on with the book.” To all of these people, as well as to many others who have displayed wisdom and friendship over the years, I am sincerely grateful.

J. N.

FOREWORD

JOHN NEFF IS the investment profession's investment professional. Nobody has ever managed a large mutual fund so very well for so very long a time. And no one is likely to do so ever again.

The record of his management of the Windsor Fund for more than 30 years is truly astounding. During an era when professional investment managers' returns have increasingly lagged the market averages, John Neff delivered an annual *average* that exceeded the "market" rate of return by more than 3 percent. (His results were actually 3.5 percent ahead of the market. After expenses, the *net* rate of return, over one-third of a century, averaged 3.15 percent *higher* than the market—year after year after year.)

Consider what his record really means, given the great effect of compounding (which Albert Einstein regarded as one of humanity's most enlightened ideas). Compounded over 24 years, 3 percent per year will *double* the original investment. John Neff achieved *more* than 3 percent for *more* than 24 years!

A sweet extra advantage for the tens of thousands of investors who have benefited from John Neff's splendid performance is almost unknown. Contrary to the reasonable expectation that to achieve higher returns, investors must accept more risk, the investment risks taken by John Neff were *lower* than the riskiness of the overall stock market. John would remind us: "That's just one of the several good reasons for being a contrarian investor!"

A true statement, but not the *whole* truth. John Neff is too modest to cite the main reason he was so effective as a "contrarian," or independent-minded investor: *Discipline*. John Neff was able to go against the tides of conventional market opinion because he knew more about the companies

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in which he invested. In addition to being original, independent, and *very* rational in his evaluations, John knew more because he worked longer and harder.

When John Neff received the worldwide investment profession's highest award, one of his "secrets" was revealed. At home (or wherever he might be visiting), every Saturday at 1:00 P.M., John retires to the privacy of his room to read—again—every word in every issue of *The Wall Street Journal* for the preceding week of business. This is only one evidence of the remarkable self-discipline with which this unique professional prepares himself for the very competitive work of professional investment management.

John engages most vigorously in meetings with securities analysts—both those at his own firm and those at the leading stockbrokerages. After cheerfully challenging their assumptions, analyses, and projections, he always makes his own independent price judgment. For the unprepared, meeting John Neff can be a "disaster." Those who meet Neff's standards appreciate that John answers his own phone ("Neff!"), and he always gives as good as he gets, or better, in both information and insight. Neff's rigorous discipline in "doing his homework" has one important consequence: His portfolio's turnover and the cost of transactions are kept to unusually low levels. Correcting errors—and, of course, making errors—is costly to investors. So are the taxes levied on short-term profits. John skillfully works to minimize both.*

John is not only the profession's professional investor, he is an exemplar as a "servant fiduciary"—always centered on his chosen responsibilities as investment manager for the families and individuals who have entrusted their savings to the mutual funds he manages.

The best investment decision I ever made[†] was to buy—25 years ago, on maximum margin—the so-called "Capital" shares of the Gemini duo-fund. A duo-fund (no longer allowed) was a special class of mutual funds

* John is a Trustee of the University of Pennsylvania. (He was never a student there, but he has taught in the university's Wharton Business School.) When asked to manage the equities of the university's endowment, he took it on *pro bono* for 16 years and delivered a strong performance. The university's endowment fund increased from \$170 million to \$1.8 billion. John has also served for many years as one of three Managing Partners of Wellington Management Company. His investment acumen complements his business acumen.

[†] My *most profitable* investment decision was different. More than 20 years ago, my partners and I invested in Berkshire Hathaway. That was a rational decision, but it was based more on faith in Warren Buffett than on knowledge.

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in which half the money invested at the initial public offering got all the dividends, and half the money invested got all the appreciation or capital gains. In the then-prevailing bear market, stocks were far below their past valuations, and investor sentiment was and had long been consistently negative. This scenario created great opportunities for a contrarian investor, particularly one specializing in “value” stocks, which had been particularly hard hit. Gemini’s Capital shares had, of course, borne the brunt of the bear market and were selling at a serious discount. If the market recovered, the Capital shares would rise with disproportionate rapidity—roughly, twice as fast—because of the duo-fund structure. If value stocks returned to normal relative valuations (a reasonable expectation among those who recognize the powerful tendency of stock market valuations to “regress to the mean”), a portfolio managed by John Neff would enjoy at least a quite favorable environment. And that superior performance could soon eliminate the then-current market discount.

John was recognized as a superior investment manager who could be expected to outperform the market (as he had done again and again). So, I had five complementary forces ready to work hard together for me: John Neff, value stocks, mean regression, a current market discount, and nearly two-for-one leverage on the upside. Still, the key factor in this investment decision was the sure knowledge that John Neff would have structured the portfolio and selected its holdings with extra care and attention to *risk*.

Emboldened by the conviction that America was being “sold short” by investors, I made a “worst case” estimate of the risk of a further drop in the market. The most I could imagine was another 20 percent. If this figure was correct, the rational course of action would be to borrow the maximum 30 percent of margin through my stockbroker and plunge deeply into purchasing the Capital shares of Gemini.* The stock market went up; the Capital shares went from a discount to a premium; value stocks became the market’s darlings; the leverage of a duo-fund worked its wonders; and John Neff continued to outperform his peer group. All five forces locked in together, and a sixth, margin leverage, ensured my sons’ education expenses.

Luckily for me, in many ways, my relationship with John Neff goes way back. When I first met him in Philadelphia 35 years ago, I knew

* Special and continuing thanks to Jay Sherrerd, who first pointed out, 25 years ago, “You can get Neff at a discount.”

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two things almost instantly. First, he was very smart, well informed, and serious about knowing more. Second, I liked him and I liked the cut of his jib. A few months later, John Corcoran, investment strategist for Donaldson, Lufkin & Jenrette (DLJ) was giving an erudite discourse on the investment opportunities available in different sectors of the market. While all the other professional fund managers in his rapt audience were cheerfully focused on how much some particular stocks could go up, the meeting was brought to an awkward halt by Neff's blunt question to Corcoran: "John, what about *risk*?"

That cinched it for me: Here was a truly independent thinker.

I've been listening to John Neff on every possible occasion ever since—as a share owner in the mutual funds he manages, at professional meetings sponsored by the Association for Investment Management and Research (AIMR), at portfolio manager seminars sponsored by DLJ, and, quite happily in recent years, in his role as a Director of Greenwich Associates.

A cheerful confession: From the very beginning, I strongly encouraged John to write this book—partly so I could read *John Neff on Investing*, partly so my sons and friends could, and partly so any serious student of the profession could benefit from the best thinking by this great investor.

CHARLES D. ELLIS

Greenwich, Connecticut
June 1999

PREFACE

IN THE SPRING of 1998, I taught a graduate seminar on investing at the Wharton School in Philadelphia. A very lively group of students sparked extensive reflection on my part. Aspects of my life fell together in answer to dozens of questions about the nature of the investment process and why I chose the path I followed. This book continues my conversation with these students.

A book is a one-sided conversation, to be sure. But, like a good conversation, it can express a point of view in an informal manner, unencumbered by charts and graphs that often clog books on this subject. If we shared a compartment on a long train ride, what you read in these pages is what I'd tell you about investing. I have highlighted the ideas that seem most enduring to me after three decades at Windsor, rather than supply a laundry list of topics related to investing. You can find other books for that.

Teaching invited many questions about my own learning curve. I'm not sure where it began, exactly. I joined the U.S. Navy and studied aviation electronics before I dreamed of trading stocks, much less managing the largest equity mutual fund in the United States—the status Windsor held until the doors were closed to new shareholders in 1985. Perhaps my career started before I learned to count. I was always a stubborn little fellow, which my mother expressed very succinctly: “John Brown,” she declared, “You would argue with a signpost.” She was not only right, she was prescient. My whole career, I have argued with the stock market. Happily, as the Windsor Fund's record shows, I won more arguments with the market than I lost.

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Wherever learning curves begin in this mercurial business, they never seem to end. That's the marvel, and also the heartbreak, of the stock market. You can line up more experts than you can shake a stick at, but none can predict with certainty what investors really want to know: How will the market do tomorrow, or next week, or next year? An inexhaustible flow of new information produces outlooks no one has seen before. An early Greek philosopher, Heraclitus, observed that a person cannot step twice in the same river, because the river changes constantly. Nor, in the same sense, can an investor step twice in the same market, because the market changes constantly.

Hang around long enough, though, and you will begin to recognize the market's personality. It is irrational and unsentimental. It is cantankerous and hostile. At times, it is forgiving and congenial. The market has good days and bad days, good years and bad years. You can't predict them, and they can reverse course with stunning speed. But you can learn to cope with them and improve your odds. In the bargain, you can make good money.

Contrarian that I am, the format for this book is intentionally unorthodox as books on investing go these days. It is not about Hail Mary passes; it's about grinding out gains quarter after quarter, year after year. My kind of investing rests on three elements: character, goals, and experience. Therein lies the three-part structure. Part One (My Road to Windsor) is about my character, Part Two (Enduring Principles) portrays goals and mechanics, and Part Three (A Market Journal) records how events played out during the last quarter-century of my Windsor career. All were written with an eye to smarter investing, whether you trade one stock a year or a stock a day (I don't recommend the latter).

It seems pertinent at this juncture to add a note about the performance of value investing in the late nineties. Many so-called value funds have suffered a rough road. As a contrarian, I say that's to be expected. When better to write a book about out-of-favor investing than when it's out of favor? Being out of fashion ultimately enhances opportunities on the other side. On my watch, Windsor weathered trying times more than once but still managed to spring back with championship results.

Individual investors enjoy a key advantage over professionals in one critical respect. You can pick and choose stocks and bide your time unflustered by the fierce and often corrosive quarterly performance sweepstakes, especially in hostile market climates. Value investing (with a focus on low price-earnings ratios, as I practice it) demands sober

PREFACE

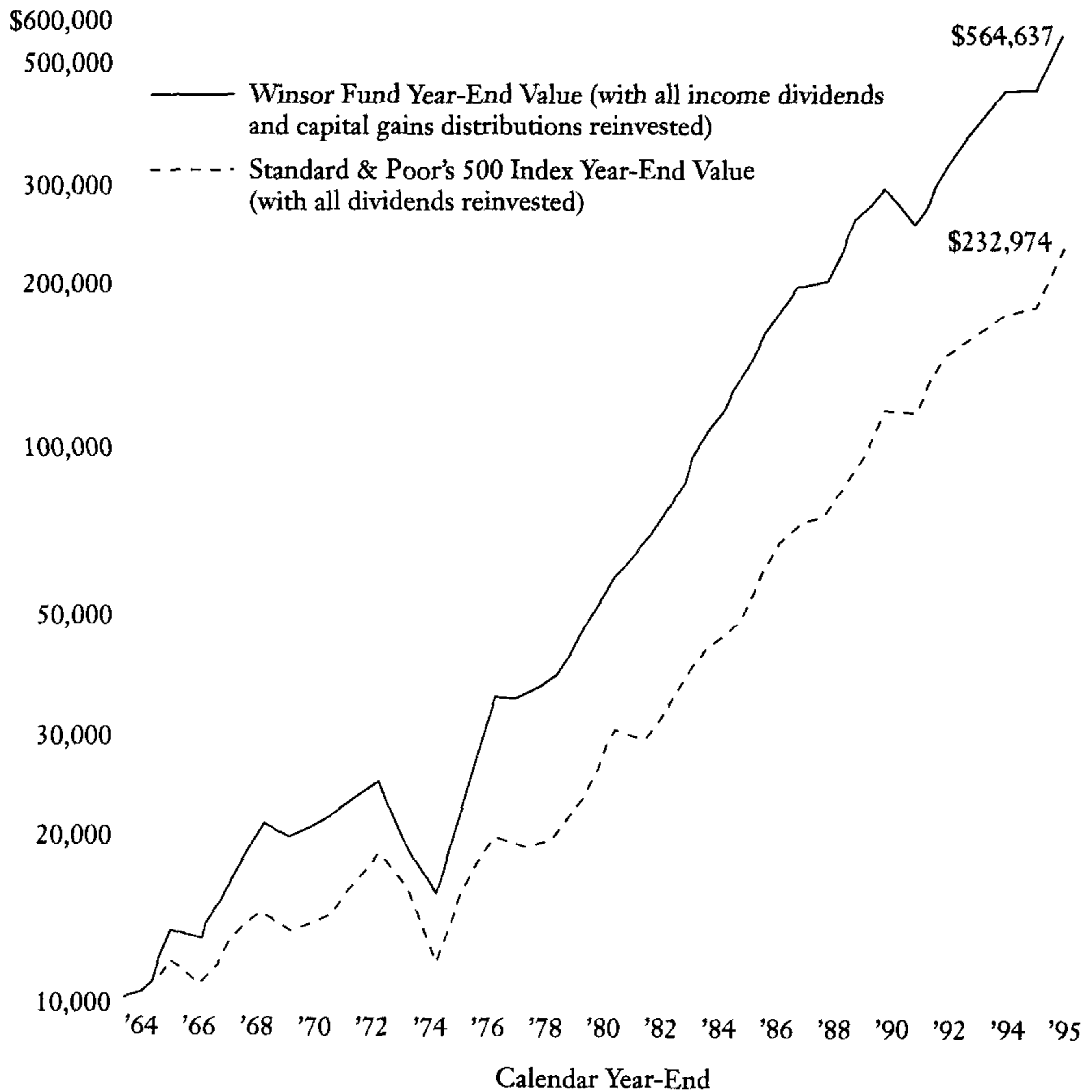
reflection. Scarce to begin with, sober reflection gets even scarcer as bull markets progress.

Eventually, good stocks of good companies with solid earnings and low price–earnings ratios receive the attention they deserve. With patience, luck, and sound judgment, meanwhile, you keep moving forward. That’s the nature of the investment game: now and then a windfall, but mostly a four-yard gain and a cloud of dust. My investment style can give investors a lucrative edge over the long haul. But if you can’t roll with the hits, or you’re in too big a hurry, you might as well keep your money in a mattress.

JOHN NEFF

Valley Forge, Pennsylvania
June 1999

Windsor vs. the S&P 500 (1964–1995)



TOTAL RETURN PERFORMANCE SUMMARY PERIODS ENDING OCTOBER 31, 1995

	Cumulative		Average Annual	
	Windsor	S&P 500	Windsor	S&P 500
5 Years	+154.2%	+121.1%	+20.5%	+17.2%
10 Years	+268.4	+319.8	+13.9	+15.4
15 Years	+902.3	+696.0	+16.6	+14.8
20 Years	+2,314.6	+1,352.4	+17.3	+14.3
Lifetime*	+5,546.4%	+2,229.7%	+13.7%	+10.6%

* Reflects tenure of Portfolio Manager, John B. Neff.

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PROLOGUE

CITI SAGA

MOST INVESTORS FEARED for Citibank in May 1991. Amid real estate problems galore, and on the heels of cleaning up disastrous loans to developing countries, Citi's prospects were bleak. Billions of dollars had been set aside to cope with bad real estate loans and to correct enormous problems, but monumental hurdles remained. Other banks were recovering from similar problems; still, the headlines blasted Citi, and regulators swarmed over its books. Continental Bank's specter lurked in the background, reminding investors that venerable banks here today might vanish tomorrow. The stock price plunged almost daily. Critics besieged Citi's energetic chairman, John Reed, who was in the fight of his life with his job on the line.

At Windsor, after weighing Citi's situation carefully, we decided this was a good time to buy.

It wasn't as if Windsor owned too few Citi shares. The bank had drawn our attention in 1987, when we were seeking to replace our stake in J. P. Morgan following a very successful run-up in the stock price. Citi shares at the time were changing hands for between 7 and 8 times earnings, down from a heyday when the former chairman, Walter Wriston, briefly transformed Citi into a growth company. His efforts actually squeezed out growth of 15 percent a year. For a time in the

JOHN NEFF ON INVESTING

early Seventies, Citi belonged to the very stylish Nifty Fifty, a list of household-name growth stocks that had captivated the stock market. When Citi's growth rate settled down and lost its grip on investors, Windsor swooped in. We experienced a much rougher ride than we had bargained for.

Citicorp exercised Windsor's contrarian streak from the start. Citi's important sizzle in 1987 was a steep discount to prevailing price-earnings ratios. This discount reflected genuine apprehension about loans to Latin American countries—aggravated, at least in Mexico's case, by the downward spiral in oil prices. Preoccupied with these concerns, the stock market overlooked an important perspective. Forced by banking regulations to set aside reserves in case these loans failed, Citi's earnings in 1985 and 1986 bore severe burdens. Other investors paled at the losses. We reached a different conclusion: Citi's earnings were very conservatively stated and probably would be higher.

By 1988, it looked as if Citi would reward our faith. A year after posting record losses, the bank was on the road toward record profits. And then recession hit, and its impact on widespread overdevelopment of commercial real estate was especially severe. Developers went bust, leaving banks on the hook with nonperforming real estate loans. Pressed to replenish their capital, banks routinely unburdened themselves of these loans at 50 cents on the dollar, or even less. In a smart move that raised eyebrows at the time, Citi held on to its loans rather than fold.

Despite this litany of crippling problems, Windsor steadily increased its stake in the downtrodden financial services sector. But things got worse, particularly for Citi. Through interactions with Reed, mainly because I offered a piece of my mind from time to time as Windsor's stake mounted, I grew to appreciate his determined, round-the-clock hard work. I also developed some concern for him personally. Tough as things were, I advised him not to give up golf. Introducing him, on one occasion, to an investment audience, I confessed to early confusion about Reed's first name. With so many reports in the media referring to "beleaguered John Reed," for a long time I thought that "beleaguered" was his first name.

Ignoring the pundits, we bought more shares of Citi in early 1990. Real estate woes notwithstanding, we believed that Citicorp had an extraordinary consumer position that would eventually win recognition in the marketplace. We noted that the problems primarily afflicted the bank's commercial real estate business. Earnings on the consumer side