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Edition 29, 30 August 2013

This week's top articles

How institutional investors influence listed companies

Chris Cuffe

There's a common public perception that institutional investors are not active enough in influencing decision-making in listed companies. As owners of companies, fund managers and asset owners should be voicing their opinions on issues such as executive remuneration, wasting money through poor acquisitions, inefficient use of scarce capital and any number of company decisions. Yet go to a company annual general meeting, and it is the retail investors and peak bodies such as the Australian Shareholders' Association asking most of the questions.

So where are the big institutions? In fact, they're usually acting in what might be characterised as an 'Australian way'. They are not grandstanding and they are not chasing public profile in front of thousands of people. In the United States, fund managers routinely cause public stoushes to raise their own profile and enhance fund-raising ability. In Australia, the approach is more often a quiet influence behind closed doors, letting the companies know their views in a professional and forthright manner. This is not done at annual meetings with a couple of senior executives, but for major shareholders, regular updates and a sharing of ideas. There are exceptions when an argument gains media coverage, but they are far outnumbered by the private actions.

An analogy that comes to mind is a duck floating calmly across a pond, seemingly making gentle easy progress, while underneath the water it is paddling furiously. Asset managers are always prodding and pushing companies to justify their actions or explain the business better.

Examples that don't reach the public domain

Sensitive issues can be raised privately that may be embarrassing for both sides in public. Consider these examples:

- Jamie Dimon is the Chairman, President and Chief Executive Officer of JP Morgan Chase. Corporate governance best practice would say these roles should be separated, as one is a counter and check for another. Dimon wants all the roles, and there is a risk he may leave if he is forced to give up one of them. An asset owner with an investment in his bank who believes Dimon is an outstanding executive can have a close discussion on the issue, put a position forcefully, but not place Dimon in an even more compromised position. This may not satisfy the governance purists, but it could be the preference of the shareholder.

- All companies like to boast about their diversity policies (relating to gender, age, ethnicity, disability, race, etc), and state them publicly on their website. In truth, they often pay lip-service to the aspirations. You can walk through the offices of most major companies who have, say, a disability employment policy and a wheelchair user on the cover of a public document, but you'll rarely see a wheelchair. How many senior executives of Australian listed companies have Asian origins? There may be a strong focus on gender equality, but diversity is a much bigger issue. A fund manager or asset owner who feels strongly about the benefits of diversity may never stand up at an AGM and ask where the Asian executives are, but could confront the CEO personally.

- Most major Australian asset managers have signed the United Nations Principles for Responsible Investing (UNPRI). You can see a complete list of Australian names on their website, divided into asset owners (34 Australians), investment managers (79) and professional partners (16). Every fund manager with institutional clients has to establish its PRI credentials before any money is allocated by the client, whether the individuals actually managing the money care about 'responsible investing' or not. The time to check the credentials is in private meetings, not on the floor of *The Westin*.

A good example is forestry operator Gunns, under fire for many years for cutting down old growth forests in Tasmania and placed under administration in September 2012. Fund managers were loath to confront the feisty management team at AGMs, but tried to reflect community concerns and investment expectations in more personal meetings.

Of course, there are 'activist' shareholder interventions, such as Geoff Wilson of Wilson Asset Management meeting with the board of Australian Infrastructure Fund to make his point that the company should not be liquidated, leading to an Extraordinary General Meeting. Another that entered the public domain was the investor action which reversed Aurizon's decision to boost profit margins artificially using accounting changes, which would have counted towards management performance targets. Direct criticism by analysts, in some cases overtly public, ensured the company changed the performance calculations.

More frequent, less formal

Bruce Teele, the retiring Chairman of Australia's largest Listed Investment Company, AFIC, has been managing investments with the company for 47 years. He recently told *The Eureka Report* than one defining characteristic of successful companies is that they listen to shareholders. He encourages less formal meetings purely for discussion where no decisions are made, as issues such as executive remuneration preoccupies time at many AGMs.

In fact, contrary to the belief that such 'private' briefings are a compromise to continuous public disclosure and may even lead to insider information, the meetings are never one-on-one, as every CEO has 'minders' with them, usually the CFO to cover the numbers, and the legal counsel to watch for governance issues.

Everyone is intensely aware of their legal obligations, and rather than giving special inside information, the conversation is more likely to relate to:

- general market conditions in which the company operates, for example, the type of lending activity that a bank CEO might see

- a drill down into the numbers by an analyst trying to understand the business better

- an opportunity to see whether the CEO and his management generally understand the company and its opportunities

- whether the company focusses on the short-term for the benefit of the current executives, when most investors are more interested in holding the stock for the longer term.

An example of where companies have become far more willing to consult with major shareholders is the 'two strike rule'. If 25% or more of shareholders at a company's AGM vote against the remuneration report the first time, the company must review its executive remuneration policies. The second and final strike is delivered the following year if at least 25% again vote against the report, and shareholders may even be given the right for a board spill. Companies want to ensure such embarrassments do not occur, not least to protect a few senior jobs.

There are also companies which specialise in identifying governance risks in listed companies, and providing advice to asset managers on how to use their shareholder rights to influence companies. They analyse all AGM proposals from the owners' perspective, and may provide proxy voting services on standard decisions.

Who actually controls the stock?

Although a major asset owner like an industry superannuation fund may outsource its asset management to an external party, the asset owner will instruct the manager how to vote on its behalf, especially for contentious resolutions such as executive remuneration. Even where a fund manager does not speak at an AGM, it is likely to vote on the motions, often dissenting from company preferences. Goldman Sachs Asset Management was reported to have voted against about 20 proposals during the 2012/2013 reporting season. Some large funds have even been educating companies on who actually owns the stock – it is often a surprise to the company executives who are the ultimate owners, and can lead to a sudden heightened responsiveness.

It is important that regulators realise that company engagement by asset owners – be it at an AGM, via voting intentions or private meetings – is active and robust. There is evidence overseas that regulators are watching the space. For example, from 2014, Switzerland's constitution will require the country's pension funds to vote all their domestic shareholdings and then disclose their voting records. This is particularly aimed at curbing executive remuneration at big Swiss firms. There are also calls for funds to use their powers to force banks to engage in less risky lending practices, in an attempt to avoid the excesses of European banks in the past.

Don't judge institutional investors by the big public event, the AGM. Other than providing a forum for certain parties to see or access the senior executives briefly, not much is achieved other than completing formalities. As far as major asset owners are concerned, the AGM has lost its relevance over the last decade, while meetings with listed companies are ongoing and lively.

Wipeout – the problem with 'goodwill'

Roger Montgomery

Billabong's recent 'big bath' writedown marked yet another arguable example of hubris and investor loss by a major Australian company. It is worthwhile examining the investment merits of analysing balance sheets with the express intention of avoiding the permanent capital impairment that occurs with corporate writedowns.

Australia corporate graveyards are quite literally filled with the detritus of past attempts at greatness, where management's actions exceeded their abilities and where 'synergistic' corporate kisses fell flat. For long-term investors in companies that suffer from being managed by such lauded corporate chieftains, time is an enemy that robs wealth. More importantly, clichés about investing for the long term are inappropriate at best and downright irresponsible at worst.

The dreaded 'earnings update' with a goodwill writedown

Companies regularly make announcements that may be hopeful and promotional or confessional and reluctant but it is the 'earnings update' containing a writedown that fires me up. This is where so many Australian companies have dashed their owner's retirement dreams and hopes for financial independence.

In the 12 months to 30 June 2009 – admittedly the GFC was reaching its nadir - Australian companies wrote off, took a bath on, drew a line through or just plain old destroyed $47 billion dollars. And if you think 2009 was unique, that was on top of $16 billion in writedowns the previous year. In 2010 Asciano took a $1.1 billion bath. In 2013 it was Billabong's turn to make a writedown three times larger than its total market value. The result was affected by $867 million in significant items, including more than $604 million in writedowns in the value of goodwill, brands and other intangibles. It also included a $129 million writedown as a result of transactions involving US brand Nixon.

It's the so-called 'goodwill' that I would like to examine today.

A business is worth much more than its net tangible assets when it produces profits well in excess of market-wide rates of return. When this transpires the company is said to have economic goodwill.

A company's book value is its net worth. Book value is made up of tangible assets and intangible assets. Tangible assets are physical and financial and include property, plant and equipment, inventory, cash, receivables and investments. Intangible assets aren't physical or financial. These are trademarks, copyrights, franchises, patents and accounting goodwill.

Tangible and intangible assets

I have earned a bit of a reputation for warning investors about capital intensity, particularly with respect to investments in airlines. When it comes to physical assets, less is more. For a business to double sales and profits, there is frequently the requirement to increase the level of assets to produce those increased sales and profits. The higher the proportion of physical assets compared to sales that are required, the less cash flow available to the owner. This is the antithesis of the intangible-heavy business that continually produces profits without the need to spend money on maintenance, upgrades or replacements.

Take two companies Rich Pty Limited and Poor Pty Limited. Both companies earn a profit of $100,000. Rich Pty Limited has net assets of $1 million. Intangible assets, such as patents and a brand, represent $600,000 while physical assets including machinery running at full capacity and inventory represent $400,000. Poor Pty Limited also has a net worth of $1 million, but this time the intangible/intangible mix is reversed. Tangible assets are $800,000 and $200,000 is intangible.

Rich P/L is earning $100,000 from tangible assets of $400,000 and Poor P/L is earning $100,000 from tangible assets of $800,000. If both companies sought to double earnings, they might have to also double their investment in tangible assets. Rich P/L would have to invest another $400,000 to increase earnings by $100,000. Poor P/L would have to spend another $800,000.

For many investors a large proportion of physical assets – also reflected in a high Net Tangible Assets – was seen as a solid backstop in the event something catastrophic should befall a company. The opposite may be true. A high level of physical assets may be a drag on returns. Physical assets are only worth more if they can generate a higher rate of earnings. Any hope that they are worth more than their book value is based on the ability to sell them for more, and that, in turn, is dependent on either finding a 'sucker' to buy them or a buyer who can generate a much higher return and therefore justify the high price.

But while a high level of tangible assets producing low returns can suggest the tangible assets are overvalued, so too a high level of intangibles assets – particularly accounting goodwill – combined with low returns, can suggest a write down is in order.

Accounting goodwill is not economic goodwill

Back in December 2006, Toll announced the separation of its logistics business from its infrastructure and port assets. This was not a requirement of the ACCC who had asked Toll to merely divest 50% of its stake in Pacific Rail. Nevertheless, Asciano was born – its head was Mark Rowthorn, Paul Little's deputy and son of former Toll chairman Peter Rowsthorn. Its balance sheet would be dominated by $4.5 billion of debt, $2.3 billion of property, plant and equipment (PP&E) and $4.2 billion of accounting goodwill – what I think the auditors should rename 'Oops-I-paid-too-much' before adding it to the balance sheet.

Wouldn't it be nice if we could all just add a few hundred million of goodwill to our own personal balance sheets before we headed down to the bank for a loan? You see, accounting goodwill is not economic goodwill.

Under the restructure Toll shareholders received a fully franked dividend that was compulsorily applied to subscribe for Asciano units. While this was another non-cash transaction it had the effect of ascribing a value. Asciano's goodwill was inherited as part of the split that saw Toll shareholders retain one Toll share and receive an Asciano Stapled Security. The market (in its great wisdom) ascribed a value of $10.76 per security for Asciano on its debut, giving the company a market value of $6.8 billion. The net assets were $2.9 billion and net tangible assets were negative.

Would you pay $680,000 for a house and mortgage 'package' that comprised equity of $290,000? You would only if the profits the house was generating produced a decent return on the $680,000. Assuming an after tax return of, say 12%, the house would need to produce a profit after tax of $81,600. Turn the thousands into millions and that means, paying $6.8 billion you would need Asciano to produce an after tax profit of $816 million –a figure that has thus far not been achieved. Unsurprisingly, in the interim, Asciano had its own big bath writedown.

What's happened since 2011?

With these ideas in mind, it may worth going back in time and looking at a list of companies that may have had very high levels of tangible assets compared to their profits. Indeed we may as well also throw in those companies that might have had highly valued intangible assets too. If they were generating low returns on these assets, as for example, Billabong and Fairfax have been recently, the auditors should arguably have taken a knife to their stated 'book' values. This is precisely what happened at Fairfax some time ago and more recently at Billabong.

But if high levels of intangibles are not written down by the auditors – even after years of generating mediocre returns – the market will often do the writing down for them. Either way, shareholders receive lousy returns.

Let's go back in time to 2011 and see what has happened since. Starting with the 156 companies with a market capitalisation of more than $1 billion, I ranked them by return on equity (return on book value) in ascending order and there were 49 companies generating returns less than a bank term deposit. The biggest 17 are presented below and I have excluded resource companies for while there are plenty that qualify, their returns are dependent on commodity prices.

Companies with either possible high levels of tangible assets or possibly overstated intangible assets carried on the balance sheet in 2011 include:

Company Name	Code	Last ROE
Westfield	WDC	4.39%
Santos	STO	5.17%
Insurance Aust. Grp.	IAG	3.07%
AGL Energy	AGK	5.24%
GPT Group	GPT	3.13%
Alumina	AWC	1.09%
Goodman Grp.	GMG	-3.88%
Qantas	QAN	2.47%
Lend Lease	LLC	0.74%
Mirvac	MGR	3.00%
Sims Metal	SGM	4.58%
BlueScope Steel	BSL	1.88%
OneSteel	OST	5.49%
James Hardie	JHX	0%
SP Ausnet	SPN	5.05%
CSR Limited	CSR	3.73%
Hutchiston Telecomm.	HTA	5.19%

And what has happened to the value of a hypothetical portfolio invested in the above shares since? You will not be surprised that the market, in aggregate, has done a pretty good job on both an absolute and relative basis, of 'writing them off'.

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ATO to increase surveillance of SMSFs in 2013/2014

Andrew Bloore

I recently read an article that claimed the Australian Taxation Office (ATO) was not keeping an eye on the SMSF space. Let me assure you, that statement is not correct. An increase in SMSF numbers has made them an easy attack, and the recently released ATO Compliance Program 2013/14 will endeavour to keep critics of SMSFs silent.

The following aims not to argue that point but to look at what the ATO has in store for SMSFs in 2013/14 and the implications for trustees. It will examine one of the main areas that the ATO's compliance activity will focus on this year – related party transactions.

ATO Compliance Program 2013/14

The ATO has stated that it will continue to focus on SMSFs that misuse the concessional tax environment, deliberately or unintentionally.

The ATO will monitor the registrations of SMSFs using information on the Australian Business Register (ABR). If a fund is in its first year of operation and the ATO considers it highly likely that it will not operate correctly, its lodgement concession will be removed. This means that the fund must lodge by 31 October, and the ATO will follow up to ensure it lodges by that date. The ATO has stated that it will not issue a notice of compliance until after the fund has lodged its first annual return and it is satisfied that the fund is doing the correct thing.

The ATO will focus on:

- whether the fund has been established as a genuine superannuation fund
- lodgement obligations
- use of prohibited loans
- related party transactions
- funds with a history of non-compliance
- incorrect reporting of exempt current pension income, tax losses and non-arm's length transactions.

The ATO also stated that it will provide ongoing support to approved auditors whilst also monitoring their competence, including via contravention reports. It will continue to refer any concerns to ASIC, with whom it works closely on the registration regime for auditors of SMSFs.

Last year, the ATO reviewed the regulatory compliance of over 9,000 SMSFs, raising $16.4 million in tax liabilities. The audits resulted in 132 SMSFs being made non-compliant due to serious breaches of their obligations. The ATO Program highlighted that most trustees met their obligations with reported breaches running at less than 2% of all such funds.

So should we be worried?

The answer is NO. With the largest number of funds in the industry and over one-third of superannuation assets, even the Cooper Review generally confirmed that the SMSF sector is largely successful and is a well-functioning part of Australia's super system. The Cooper Review stated that on the face of it, the SMSF sector performs at least as well as the large APRA fund sector and that significant changes were not required.

Impact for SMSF trustees

It is well known that the main reason for establishing an SMSF for both members and trustees is to gain control and flexibility over investments. Individual members become, as trustees, their own fund manager. Ultimately, they are responsible for both the investment decision-making and the administration of the fund. An SMSF provides its members with many benefits such as the opportunity to actively decide upon the fund's investment strategy and to select appropriate asset classes.

There are also rules that trustees need to consider when devising an investment strategy, including the acquisition of assets. This will be one of the main focus areas for the ATO's compliance activity this year.

The trustees of SMSFs in general are prohibited from acquiring assets from related parties of the SMSF, including assets contributed in-specie.

However, there are several exceptions to the rule, including where:

- the asset is a listed security (for example, shares, units or bonds listed on an approved stock exchange) and the asset is acquired at market value
- the asset is business real property and acquired at market value
- the asset is an in-house asset, but the level of your fund's in-house assets does not exceed the threshold for SMSFs of a maximum 5% of total fund assets, or is an asset specifically excluded from being an in-house asset.

A **related party** of a fund includes all members of a fund and their *associates*, as well as all standard employer-sponsors of a fund and their associates.

An **associate** of a member of an SMSF includes the following:

- every other member of a fund
- the relatives of each member
- the business partners of each member
- any spouse or child of those business partners, any company a member (or their associates) controls or influences and any trust the member (or their associates) controls.

Trustees are also prohibited from lending money or providing financial assistance from the SMSF to a member or a member's relative. The use of an SMSF asset by a member or a member's relative for no cost or as a guarantee to secure a personal loan, for example, is not allowed and would breach the investment restriction.

In keeping with the ATO Compliance Program 2013/14, it is recommenced that specific advice be sought before an SMSF invests in any type of investment as there are a number of rules that need to be considered.

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This information is intended as a guide only and is based on proposed policy announcements as at July 2013. We believe the information contained in this update has been obtained from reliable sources but we do not accept responsibility for any errors, omission or inaccuracies.

That's racing: financial markets and wagering parallels

Paul Umbrazunas

My first real experience with risk management was working as a penciller for a bookmaker during my university days. Back then, there were no laptops and the book was actually a real book, not an Excel spreadsheet. The punter would receive a ticket with a largely illegible scrawl indicating details of the wager and hope (if collecting) that the ticket could be translated.

Recently, I was reflecting on parallels between the bookmaking industry and the financial services sector. No doubt a number of participants will gasp in horror at this assertion. 'Parallels' may be too strong a contention but perhaps there are some things we can learn from the world of professional wagering and apply to financial services.

For each race we would frame a field with risk (loss) parameters and initially set our board with unduly 'expensive' odds. These odds would be adjusted on the basis of betting patterns to attract or dissuade further bets, and an ultimate percentage book set just before the start reflecting preferred risk and return (an efficient frontier maybe? – the first parallel).

For those unfamiliar with the art of bookmaking, each set of odds is converted to a theoretical win percentage, so 3/1 represents a 1 chance in 4 of winning which equals 25%. A book is the cumulative total of odds offered and the theoretical 'win' rate is that percentage over 100. However, this makes certain assumptions about betting trends and how the book is weighted.

Data analysis is the second parallel. If there is one place where the amount of publicly available data is close to that of financial markets, it's the form guide. I can find out how each horse has run under various conditions, with different weights, over multiple distances (with subsequent breakdowns over and within these distances), with a variety of experienced jockeys. If horses were an asset class, I could do a plethora of relative value analyses, which is actually what the bookies do to set odds in the first place – the third parallel.

So, surely this should allow me to make a fully informed decision when betting. Quite possibly, but does fully informed mean successful? Punters (wrongly) believe so. As we've seen, it's how you interpret and what you do with the numbers that matters.

Take the Melbourne Cup. The bookies love it. It is one of the most difficult races to predict as evidenced by the odds on offer. Yet annually, as surely as Xmas comes, every person becomes an expert for the day. Given the amount of (not so smart) money wagered, Xmas does indeed arrive in November for the bookies as they can work their odds far better than when 'plunges' or a lack of diverse bets arrive.

"But," I hear you say. "You must overlay the data with the vagaries of animal instinct - the horse just doesn't get it or jockey's poor judgment." Quite true, but is this a fourth parallel to financial services? Is that akin to when stock pickers (or economists or macro analysts etc) overlay their own expertise after analysing the multitude of data available? Tosh – such facetiousness.

Perhaps though, an interesting exercise could be to ask analysts to add a 'confidence weighting' (i.e. odds) to their price target or call. I know for certain their number will be either right or wrong (so zero or 1 probability) but the real probability of accuracy lies somewhere in between.

That however doesn't preclude and possibly invites some neat Bayesian inputs whereby the analyst can suggest 'odds of X' that the price target or number will be achieved. One would intuitively think these indications should be odds on given a coin toss is an even money bet. Analysts could change their odds subject to new inputs. They already change their price targets regularly.

Why not extend this to those wonderful business news articles where a cross section of experts is asked to opine on every main economic and financial indicator in the next 12 months? Please add odds so we can see how well you rate your form.

Consider the implications. One could start to follow an expert with far more confidence based on their form. An 'outsider' might be considered if they show some relative movement in form and we agree that all things mean revert eventually.

Moving from parallels, here's what I consider the main difference between the bookies and the financial experts. If the former gets his efficient frontier and relative value analysis wrong, he loses his own money. Now, I am not suggesting that the complexities of financial forecasting and analytics be subject to individual penalties for experts being wrong but conversely, shouldn't there be some degree of accountability? Particularly if they are wrong to a very meaningful extent. Perhaps the Form Guide for Financial Expertise? We would definitely have the data.

And we should extend this discussion in *"That's Racing Part 2: Revenge of the Disaffected Banker"* to the ability of asset consultants to pick the best managers for asset classes.

But such an idea would be hobbled before it reached the finishing line.

Paul Umbrazunas worked for a bookmaker whilst at university before a long career in financial markets including debt capital markets, syndicate, ALM and Chief Operating Officer roles across Goldman Sachs, BZW, Deutsche Bank and Credit Suisse.

Skilled managers do exist

Peter Elston

John Authers of the *Financial Times* recently asserted that nobody can tell which "investors are more skilled than others" and that active fund managers are unaware of their skills. These assertions are wrong. I suggest – with statistics very much on my side – that Berkshire Hathaway's Warren Buffett and Renaissance Technologies' Jim Simons are more skilled than most and furthermore that there are others who with a little work can be identified. I also know that at Aberdeen we are keenly aware where we possess skill and – more pertinently – where we don't.

Knowing where you possess skill however requires knowing what it is. Simply, investment skill involves identifying non-randomness (pattern) in financial markets then profiting from it. It is about knowing the difference between what is predictable (pattern) and what is not (randomness). It is about understanding where and when one has an edge then swooping in for the kill.

The sad fact is that the vast majority of investors waste their energies and capital guessing the equivalent of which side a coin will land, often supported by written and verbal justification that is both sincere and articulate.

Know when the odds are in your favour

The key to investing is knowing when the odds of a coin landing heads have increased to, say, 70 or 80%. And this is where serial mean reversion comes in. Occasionally, random walks take asset prices so far away from their mean or trend that they are pulled back towards it rather than continuing in a random fashion. If a coin lands heads ten times in a row, the odds of a tail on the next throw are still 50%. In the world of investing however, it may be 70 or 80%. Put another way, despite the ubiquitous disclaimer, past performance can sometimes be a guide to the future.

Identifying pattern is very much what the two aforementioned maestros do in their own different ways. Buffett's edge, in my humble opinion, has been his remarkable understanding of human nature, both its strengths (what it takes to build a great company) and its weaknesses (propensity for humans to be greedy or to panic) combined with discipline, patience, honesty and a very good grasp of statistics. Jim Simons, on the other hand, is a brilliant mathematician and has smarter and faster computers than anyone else. While Buffett is the king of predicting share prices over 10 years, Simons is unrivalled over 10 minutes.

Buffett and Simons are rare birds yet many still believe themselves to be good investors when the facts may tell a blatantly different story. The reason for this is that we humans evolved a survival mechanism to believe that we are better than we actually are. A timid approach to facing down a sabre-toothed tiger or attracting a cave mate would have been disastrous. Furthermore, we have an asymmetrical ability to blame our failures on (bad) luck but to attribute our successes to skill, a bias termed the fundamental attribution error. Thus you only need a couple of successes amongst all the failures to think that you're a skilful investor.

Need to use your edge

If you have correctly identified an edge, the next step is to know how to use it. Question: if you have a biased coin that you know has a 60% chance of landing heads and you are playing with someone who does not know the coin is biased, what percentage of your bankroll should you bet each round in order to increase your wealth over time?

If you bet nothing, you're wasting your edge (you know, he doesn't) and your wealth will remain the same. If you bet your entire purse, there's a 40% chance the coin will come up tails, and you'll lose everything and be out of the game (even with the bias, the chance of there being one tail in ten tosses is 99%.) So the optimal percentage must be somewhere between 0% and 100%. The answer, in fact, is 20%. Bet 21% or 19% and over time you'll end up less wealthy than if you bet 20%. If you want to know the formula, look up the term 'Kelly betting criterion'.

How does this apply to investing? In Buffett's case, he of course understands that to put all one's eggs in one basket is foolish, but also that being overloaded with baskets will wear you out. The efficient market hypothesis asserts that you should diversify as much as possible to eliminate stock specific risks. Buffett on the other hand actively seeks out stock specific 'risk' because he knows that's where his edge lies. As he has noted, 'Wide diversification is for people who don't know what they're doing.'

Does Buffett know precisely what his odds are? Of course not. What he does know is that he has a good feel for where a company will be in 10 or 20 years' time, giving him the confidence to run a concentrated portfolio. There's much we can learn from him, though I'll admit I'm not the first to suggest that.

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