Resolutions, Marshmallows and Warren Buffett

In 2020, investors need to worry of overpaying for growth relative to value

Stock market exuberance tempts impatient investors to do foolish things. Trouble is, too many of us are hard-wired to opt for instant gratification and forsake long-term strategies – as the famous marshmallow experiment shows.

Anyone who attended summer camp as a kid likely equates marshmallows with the fundamental ingredient in making s'mores. When a psychologist hears the word marshmallow, however, the first thought goes beyond a taste treat to the question of delayed gratification – and the difficulty to attaining it.

The Marshmallow Experiment

Stanford researchers first conducted the marshmallow experiment in the late 1960s. Children were offered the choice between 1) an immediate marshmallow or 2) two marshmallows, if they were willing to wait 15 minutes and not eat the original marshmallow sitting in front of them. Most children in the study said they would wait for two marshmallows.

Yet of more than 600 children who participated in the original experiment, roughly two-thirds fell victim to temptation. Only a third of the children waited the full 15 minutes and got rewarded with a second marshmallow.

But that is not where the findings of this marshmallow study end. When experimenters went back to review the test subjects nearly 20 years later, they discovered that the children with the discipline and self-control to delay gratification in this simple test were more successful in nearly every measurable facet of their lives.

Controlling for factors like age and sex, the "patient subjects" had higher SAT scores, less likelihood of substance abuse, larger salaries, performed better academically, and were healthier than the subjects who could not wait 15 minutes for the second marshmallow as children. Researchers have performed the test many more times since the original experiment, with the same findings.

A World of Immediate Gratification

Delaying gratification is difficult. Overwhelming evidence demonstrates that humans are not wired to be disciplined, whether it is children with marshmallows, adults firmly sticking to a diet or investors maintaining a long-term strategy. You've heard the statistics before: the majority of Americans make New Year's Resolutions and yet only 8% successfully achieve them.

It is challenging to avoid instant gratification in a world of Amazon Prime same day delivery, Keurig instant-coffee machines, and always-handy, incredibly-connected cell phones. Long gone are the days of brewing a pot of coffee or waiting 30 seconds for dial-up Internet. Corporate executives rarely get the flexibility to ignore quarterly earnings for the benefit of a five-year plan, and coaches tasked to rebuild a sports program typically can't afford two losing seasons before getting fired.

The same need for instant gratification applies in finance. Far more exciting and entertaining than stories of diversification or long-term investing are the explanation of why stocks fell yesterday, how this morning's economic data is going to affect interest rates this quarter and where oil prices are headed over the next year. This captures the media's readers.

The ubiquitous explanations of what happened to stocks yesterday and forecasts for the coming weeks compel activity and complicate the somewhat simple and successful process of long-term investing.

The Evidence of Discipline

Many investors understand the benefits of long-term discipline, but the evidence suggests that few practice it. Consider value investing, the basic concept of favoring cheap investments over expensive ones. Historical evidence demonstrates that value investing often results in higher returns when compared with growth investing – buying the more exciting, faster-growing investments.

The evidence to support the "value premium" is considerable and it exists in nearly all markets and all long-term periods.

Along with the empirical evidence, there are several rational explanations for the outperformance of value stocks. A prominent one: Investors prefer good stories of fast growing investments and overestimate how long that growth will persist. The result is that they overpay for growth relative to value.

Nevertheless, some investors succumb to immediate gratification and give up on value stocks during their inevitable periods of underperformance. Sticking with a proven strategy that disappoints in the short term is difficult.

Take the most extreme period of value stock underperformance and the most well-known (or perhaps most successful) value investor, Warren Buffett. In the late 1990s, the Internet had changed the economic landscape and boring old-school stocks were left for dead. Value investing was allegedly a thing of the past and Buffett's stock, Berkshire Hathaway, lost more than half of its value over a 22-month period until February 2000. During that time, growth stocks – using the tech-heavy Nasdaq Composite as a proxy – more than doubled.

Doubts about Buffett's age and ability to adapt to a new environment and value investing, in general, were rife and investors gave up en masse. Of course, history confirms that this was merely one of the inevitable periods of underperformance that all investments, strategies or asset classes have relative to others. Long-term investors who maintained an evidence-based discipline were handsomely rewarded.

Déjà vu All Over Again?

Remember the comments in 2019 from David Rolfe, a longtime shareholder of Berkshire Hathaway and the chief investment officer at Wedgewood Partners? Mr. Wolfe told his clients that he sold the firm's stake in Berkshire after decades of being a shareholder, because of his frustration with Buffet's huge cash position:

"Warren Buffett's cash hoard of +$125 billion continues to be a considerable impediment of growth, rather than our previous hard expectation of a valuable call option on opportunity in the hands of one of the most elite capital allocators extant."

Consider this: Berkshire's cash went from about $23 billion in 2009 to $128 billion in 2019. In other words, Warren has increased his cash position by 6-times during the longest bull market on record. Do you think Buffett is about to abandon his long-term value discipline?

The oft-quotable Buffett said, "The stock market is a highly efficient mechanism for the transfer of wealth from the impatient to the patient."

Save Your Marshmallows

For centuries to come, kids will likely eat marshmallows before 15 minutes elapse, and investors will pay way too much attention to current noise. But just as the children with a strong self-discipline end up more successful over the long run (not to mention getting two marshmallows), so should the disciplined investor.