Columbia Business School

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

Excerpt from Issue VIII — Winter 2010

Inside this issue:

Graham & Doddsville is the student-run investment newsletter of Columbia Business School. The newsletter builds on Columbia's proud heritage in value investing and focuses on promoting a sound investment philosophy through interviews with the world's leading investment practitioners. The following interview with Mason Hawkins is an excerpt from Issue VIII of Graham & Doddsville.

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"Parsimony is Extremely Profitable" — Mason Hawkins

Mason Hawkins, Portfolio Manager - Southeastern Asset Management

Mason Hawkins founded Southeastern Asset Management in 1975, and today the firm manages over $30 billion in value investments. The firm built on its tremendous track record in 2009, with its Longleaf Partners Fund posting its best absolute annual return of nearly 54%.

G&D: Could you tell us a little bit about how you developed an interest in investing?

MH: When I was in high school, my dad gave me the first edition of the Intelligent Investor and the second edition of Security Analysis. Like most teenagers, investing was not my primary focus, but I did read the Intelligent Investor and much of Ben Graham's three main tenets resonated with me. After high school, I was lucky enough to have Security Analysis as the core textbook in an undergraduate course, in an MBA program later, as well as in the three CFA courses. I'm grateful that the proper foundation was established in my early years. The most significant catalyst for me occurred in the bear market of 1970. During my senior year at University of Florida, I went through the entire S&P stock guide and recorded companies selling below net-net, indentified those selling below their net-cash and bought a few, literally buying dollars for fifty cents. That experience hooked me for my career. There were no computer screens at that point.

G&D: That sounds similar to what John Templeton talked about doing in some emerging markets. Were there any other influences on your investing style, in addition to Ben Graham?

MH: Chronologically, my Dad, Ben Graham, John Templeton, Warren Buffett and my partner, Staley Cates shaped my investment thinking.

G&D: When Buffett moved back to Omaha he said that escaping the hectic New York atmosphere allowed him to think more clearly. Do you think that has been a factor at Southeastern in Memphis?

MH: Yes. We depend almost exclusively on our appraisals and our assessment of our management partners and their companies' competitive positions. We clearly remind our associates that you're right because of your facts and reasoning, not because someone agrees or disagrees with you. And you do eliminate a lot of interference by being in Memphis as opposed to Manhattan.

G&D: That's a very independent approach, sticking to your facts and reasoning and not being swayed by outside factors. One thing that sways a lot of managers is a desire to minimize career risk by hugging a benchmark. Your firm takes a completely different view on that. Could you talk about the benchmark you use and your attempts to track that benchmark?

MH: We try to hug good investments not benchmarks. We've established inflation plus 10% as our absolute investment goal and that's been the case for our his-

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tory. There's not a lot of solace in being down 20% when the market is down 30%. Investing should lend itself to risk avoidance.

G&D: A lot of people talk about value investing, but what does value investing mean to you and how does that differentiate your firm?

MH: Graham provided the definition in the Intelligent Investor. An investment is one that promises safety of principal and an adequate return. By deduction, those that don't are speculators. We believe that buying securities at large discounts to conservative appraisals provides the best route to above average compounding. We're focused on nailing down our evaluations so we can use them to make significant long-term investment commitments when sellers are under duress or traders are consumed with ephemeral short-term issues.

G&D: Where do you look to find these ideas?

MH: Value Line, new low lists around the globe, industry rags, computer screens, investee managements and boards, competitors of our investees, respected investors, US and international "best company" wish lists, and 35 years of appraisals help produce our investment ideas.

G&D: Obviously management is very important to you. How do you approach evaluating a management team?

MH: We strive to know as much as we can about our prospective CEO-partners. We want to understand their business acumen and their personal histories. As others have said, we believe it's impossible to do a good deal with a bad person.

We endeavor to read everything that's available on management, but meeting them in person is critical. It's always important to hear their challenges and how they're addressing them. Business is tough, and the more realistic the manager is the more likely he'll be successful. We talk to their competitors, ex-employees, board members we've known, and community associates – to name a few of our checks.

G&D: When you're setting an appraisal for a business, what process do you follow?

MH: We spend a lot of time on free cash flow generation after required capex and working capital charges and then assess the value of that free cash generation. If the company is not reasonably predictable and competitively entrenched, we are very careful about using DCFs. We also look at the net asset or liquidation values.

We then compare DCF and net asset values to our comparable sales database. We've recorded most M&A, take-private, or liquidation transactions. We compare those comparable sale yardsticks against our assessment of the net-asset or free-cash values and we use the lower of the two. It's important to make sure that when you record a transaction, you note the interest rate environment under which it occurred. If you recorded a transaction in 1982 when the long treasury was 15%, you're going to see a much lower set of metrics than if the comp occurred in 2007 when the long treasury was under 4%.

We've made a lot of money in net-asset investing. There are companies that have significant asset values that don't produce any earnings. Burlington Northern in the early 1980's became very cheap in relation to its land, oil, natural gas, gold, timber, and pipeline assets when the company operated at a loss.

G&D: What do you think about Buffett's decision on BNI?

MH: I think Mr. Buffett's a very, very able investor, if not the most talented long-term investor, and I think he values highly BNI's competitive position. I believe they have over 95% of the rail traffic in Montana, for example. Burlington Northern is

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a call on much higher energy prices. It is understandable. It has significant operating leverage coming out of our economic funk. It will deliver significantly better-than-treasury returns in my opinion, but we believe it was a fully-priced acquisition.

G&D: It seems that your funds are more concentrated than the average mutual fund. How do you think about concentration on an individual name and sector basis?

MH: Mathematically, you can diversify about 80% of your individual company risk with a dozen names in different industries. You can eliminate some 90% with 18 to 20 companies. Beyond that, there's very little diversification benefit. Ideally, you want to have your money in your most attractive quantitative and qualitative qualifiers to give you the best opportunity for returns. It's been our longstanding belief that it does not make sense to own your 30th best qualifier when you can concentrate in your top 15. You reduce your return potential as you add names. It's mindless to do so after you've achieved adequate diversification.

G&D: What is the dynamic on your team when evaluating new positions?

MH: There are 9 and a half of us - I'm a half. Each analyst is opportunistically searching for a terrific investment. When somebody finds an idea, they write it up. They assess business, people, and price and then everybody gets a copy of the report which attempts to lay out the relevant facts and the investment case. Seniority plays no role. We are all very mindful that the investment succeeds or fails based on the facts. Usually, if an important question can't be addressed adequately, the idea fails. Furthermore, we assign a devil's advocate to each investment idea.

"We've made a lot of money in net-asset investing. There are companies that have significant asset values that don't produce any earnings."

G&D: What is a normal gestation period on a new idea?

MH: It can be 5 minutes, or it can be 5 months. If we're buying a company that's selling below the cash on its balance sheet, it can be done quickly. If we're buying a normal operating business that has competitive challenges, you want to be able assess it conservatively and explore all the potential threats. Usually, our best ideas are vetted quickly.

G&D: Not only are your funds more concentrated, they also have a much lower turnover rate. How often do you add a new idea to the portfolio?

MH: We've averaged less than 20% turnover over the long run, which means our average holding period is over 5 years. We sell businesses when they approach intrinsic value and there's no longer a margin of safety. We also might sell a company if we can improve our position by 100%.

John Templeton called it the 100% rule. He wanted a 100% improvement in his position to make a change. If a stock was at 80% of appraisal, he wanted to buy one that was about 40% of value to make the switch. That's because taxable investors have to pay taxes, and you have to be right on the appraisal of the company you're selling and the

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Columbia Business School is a leading resource for investment management professionals and the only Ivy League business school in New York City. The School, where value investing originated, is consistently ranked among the top programs for finance in the world.

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company you're buying. Also, in Templeton's day, there were substantial transaction commission costs, and even today there are still material market impact costs from buying and selling.

Another cause for change in our portfolio is deterioration in the competitive position of the company, which will usually occur quite slowly. We've had some that have been challenged more quickly than you might expect. Another reason for turnover is that management might turn out to be less than trustworthy or capable and changing them out would be too difficult or expensive.

G&D: As you're discussing appraisals and margin of safety, you've mentioned investing in net-nets. Do you find margin of safety in the quality of the business or just a cheap price?

MH: Valuable growth is the great eraser if you misprice your purchase. Buying good businesses is critical to profitable long-term equity investing. There are three components of an equity investment's return. One is the discount to intrinsic value. The second is the growth in intrinsic value. And the third is the rapidity at which the gap between price and value closes.

Mathematically, we know that if you buy a business at half of value, and value accretes at 12% per annum, and the price reflects intrinsic value in the 5th year, you get 29% per annum compounding. And you sleep very well at night knowing that the value is greater than the price. Clearly, Ben Graham wrote a lot about

"Valuable growth is the great eraser if you misprice your purchase. Buying good businesses is critical to profitable long-term equity investing."

the margin of safety and protecting your principal, but there was less emphasis on the benefits to returns from buying good businesses at cheap prices.

If you bought this example at fair value and it stays at fair value, you just get the value accretion, 12%. However, if you bought it at half of intrinsic value, you pick up another 17 points per year of compounding. So, parsimony is extremely profitable. The less elaborated aspect of value investing is the huge plus you get from stealing a good company.

G&D: What areas of the market do you think are particularly interesting?

MH: If we had to cite one, it would be US natural gas. Natural gas is currently cheaper than other hydrocarbons, oil and coal. It is by far the cleanest. It is politically secure. Risk adjusted, it is most attractive. Lastly, using more of it benefits security, our balance of trade and therefore the US dollar. We believe companies that have growing reserves and production of natural gas in this country should fare very well. Chesapeake Energy and Pioneer Natural Resources are our two major commitments.

G&D: The market's opinion on the natural gas situation in the US has changed significantly with shale deposits and increasing reserves. You used to hear about natural gas dependent industries being at a permanent competitive disadvantage in the U.S., and now there is a lot of talk about oversupply and lower prices moving forward. Are you concerned about this increase?

MH: We believe demand

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will rise to that supply, as you substitute natural gas for oil and coal and as the industrial use of natural gas recovers. Furthermore, we believe natural gas directly, or indirectly via hybrid and electric power trains, will be used in transportation, both in autos and in trucking.

G&D: Does your investment thesis anticipate any government spurred action or is independent of a public policy response?

MH: Our appraisals do not build in any government mandates, but we believe they're probable.

G&D: Another sector that is garnering a lot of discussion is health care, which I notice has a zero percent weighting in the partner's fund. Is that related to uncertainty regarding how things will shake out or simply better opportunities elsewhere?

MH: I was an ethical drug analyst in my first job, and we have partners here that have explored all aspects of the health delivery systems. We have exposure through Phillips' medical equipment business, which is its most valuable division. The reason health care is not a large weighting is because we haven't found compelling values. Drug companies have depleting revenue sources that you have to replenish and there are price pressures from the purchasers of those products, be they individuals or third parties. We'd like to participate in the wonderful demographic healthcare demand profile of this country and that of the world, but we haven't found a company that qualifies business, people, and price.

G&D: Another area is international opportunities. Obviously, you have a lot of international exposure. Do you think about international investing any differently than domestic investing? Do you have a greater deal of optimism for emerging market investments?

MH: Much of the world outside the United States will grow more quickly, and as real incomes rise, you'll get pretty rapid demand growth in emerging markets. However, investment challenges are numerous. High security prices is the paramount one. Proper corporate governance and stewardship are others. If there's not corporate democracy, and there's not a focus on shareholder interests, it's probably not going to make it into our portfolios. Some countries, though, protect shareholders better than the US. For example, in South Africa when we owned DeBeers, we were able to block a sub-optimal takeover bid with a 20% vote and demand appraisal rights which got us intrinsic value. Thus, we spend time looking at governance rules. We want to be treated fairly, and we believe in corporate democracy and accountability. Nationalization risk is not one we'll knowingly take. Said another way, if you wouldn't feel comfortable leaving your money in a bank in a country, you certainly wouldn't want to own the equity of a business in that country.

G&D: So does that put more of a focus on developed markets as opposed to emerging, more volatile markets?

MH: It does. There's another challenge if the currency is an issue. Many years ago, we found a terrific Coca-Cola bottler in Brazil, but the currency was going to cost us 20+% a year, and that prevented us from making the investment.

G&D: You mentioned that labor issues could be a factor on an investment. You've been an investor in the auto industry in the past — what are your thoughts on the sector now?

MH: We are not interested in labor-intensive, capital-intensive, low-return businesses. Our foray into GM was predicated on a sum of the parts appraisal, where there was significant value at the time in their investments in DTV, GMAC and some of the separable assets that they had. It was not based on the automobile industry's economics.

G&D: In that case, you transitioned into convertibles. How do you think

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about investments in other areas of the capital structure?

MH: Yes, we bought convertible senior debt, but the rules for the debt-holder changed in that particular incident. The rule of law was threatened. Indentures and contracts were jeopardized.

G&D: In some ways the auto industry is representative of the broader U.S. manufacturing industry. Do you think the U.S. can be competitive in those industries longer-term?

MH: There are major headwinds, but it is company specific and hard to generalize. But if a business is highly capital and labor intensive, they'll have trouble.

G&D: You've had a long career in investment management and seen the industry change over your career. What's your outlook on the industry going forward? Do you have any thoughts on how the industry should be changing?

MH: We've never thought of our business as an industry. We think more about our existence as investors. We believe that if we deliver good returns with low risk for our partners, then the rest takes care of itself. We assume an owner-operator mentality as you know. If you work for Southeastern, you have to do all of your equity investing via the Longleaf Partners Funds. I believe that benefits us in two ways. It removes conflicts of interest, and it focuses everyone's attention on the companies in the portfolio. When you see your boss in the mirror in the morning, you can assess your career risk solely on your investment results and not on politics or relative returns. Our owner-operator culture helps us focus on the investments and doing the right thing for our partners.

"If people are very fearful, you normally can buy in great quantity. And if people are very greedy, you normally can sell in great quantity."

Another thing that advantages the Longleaf Partners Funds is our long-term time horizon. It's very difficult to find a long-term investor today, and we believe that's beneficial to us. The average holding period on the New York Stock Exchange has dropped to 6-months from 5 years, 30 years ago. So, there's a lot of "moving about" in the industry and that average NYSE holding period dropping is an indication of just how short-term everybody has become in their thinking.

More participants are traders, believing that investing for long-term returns is not a worthwhile pursuit. We know it is. Growth in corporate intrinsic value is often obfuscated by stock price movement, which does not appropriately track the accretion in business value. That's good for all of us who are appraisers of businesses, because it means you get more mispricing and better opportunity to get a franchise at a cheap price.

G&D: You're also willing to close the funds when they get too big. Has size been a major detractor as the firm's gotten bigger?

MH: We had our best absolute and relative year in 2009 when our AUM was significant. We've closed our funds when the opportunity set was small and we believed that the investment prospects were not attrac-

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tive. We don't need to hold excessive amounts of cash and people don't need to pay us to buy treasury bills. So if our cash is building rapidly and our prospect of finding good investments is diminished, then we close the funds and wait patiently.

Secondly, the question should be how big is the qualifying investment universe vis–a-vis the pool of capital. In a vacuum, the larger the pool of capital, the more difficult it is to manage. But, an intelligent investor knows there is great liquidity at each end of the psychological barbell. If people are very fearful, you normally can buy in great quantity.

And if people are very greedy, you normally can sell in great quantity. It's in between the two extremes that liquidity is a challenge. I might add that in the fourth quarter of 2008 to the first quarter of 2009, we probably could have put 10x the amount of assets that we had to work effectively. In today's environment, it's a challenge getting smaller sums invested appropriately.

G&D: That's interesting, because in some ways you seem very optimistic, with your portfolio price to value below your long-term average.

MH: If you read our annual report, you'll see that our average price to values have been around 68% over our funds' histories and currently they are still meaningfully below that average, and we've delivered good returns from the average. So if the individual companies are selling at prices of 62-63% of conservative appraisals, they're still attractively offered. If you had landed on this planet today and you were reviewing our long-term price to value relationships, you would say that they're adequately discounted. Only if you compare them to the extreme discounts that stocks got to in the fourth quarter of 2008 and the first quarter of 2009 would they seem less compelling.

"You want to pursue it for the intellectual challenge, for the reward of being correct about your investment decisions, and for the opportunity to help others. Those would be the three primary reasons...to pursue a career in investing."

G&D: One final question, what advice do you have for business school students interested in a career in investing?

MH: You want to pursue it for the intellectual challenge, for the reward of being correct about your investment decisions, and for the opportunity to help others. Those would be the three primary reasons I would council you to pursue a career in investing. If you start out just doing it because you want to make a lot of money, I doubt that you'll be as successful.

G&D: Not many managers talk about investing in terms of helping others, but that's an interesting perspective to have.

MH: Most of our partners at Southeastern come in daily for altruistic reasons, not only to help retirees and college students, but to produce the free cash flow coupon at Southeastern that can be reinvested to help those who are less fortunate.

G&D: That's a great note to end on. Thank you Mr. Hawkins.

Professor Bruce Greenwald at the 2009 G&D Breakfast

Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as "a guru to Wall Street's gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.