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Staley Cates: Southeastern's Advantage as a Value Investor

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By Robert Huebscher

David Swensen, the manager of Yale's endowment who passed away on May 5, 2021, wrote the following in his 2005 book, Unconventional Success:

Southeastern Asset Management (sponsor of the Longleaf Partners mutual-fund family) exemplifies every fundamentally important, investor-friendly characteristic conducive to active-management success. Portfolio managers exhibit the courage to hold concentrated portfolios, to commit substantial funds side by side with shareholders, to limit assets under management, to show sensitivity to tax consequence, to set fees at reasonable levels, and to shut down funds in the face of diminished investment opportunity.

Southeastern Asset Management is a Memphis-based, employee-owned global investment management firm founded in 1975 by O. Mason Hawkins. It is the investment advisor to the Longleaf Partners Funds. Longleaf's flagship fund, Longleaf Partners Fund (LLPFX), was launched in 1987. It was followed by Longleaf Partners Small-Cap Fund (LLSCX) in 1989, Longleaf Partners International Fund (LLINX) in 1998 and Longleaf Partners Global Fund (LLGLX) in 2012.

Here is a link to the interview I did with Staley in 2015, when described Southeastern's approach to value investing and the criteria it looks for in a potential investment. Here is a link to an interview I did last year with Staley and his partner, Ross Glotzbach, about Southeastern's small-cap fund.

I spoke with Staley Cates, the vice chairman of Southeastern, on May 18, 2021. To listen to this interview as a podcast, go here.

Bob: Did you know David Swensen? If so, what influence did he have on the way you invest?

Staley: I did know him and he very much changed our business life. But he did not affect how we invest.

Let me put some context around that quote. When he wrote that in 2005, we had a great track record, but Mason and I were still Gomer and Huckleberry from Memphis, and nobody really cared. I think that gave us credibility that was unbelievable, and it helped us grow and prosper. There is a reason that we wouldn't take that snippet and put it on our website, even though we're not allowed do so. The context of why he wrote that in the book was he could not stand active management in the mutual fund industry. That was not a straight-up plug for us.

He was doing it in the following context: These guys are as good as it gets, but even then you have some worries and some potential pitfalls. He went on to ask, "What if Mason and Staley fail with succession planning?" I pushed back very hard on that, as he would know, because we fostered Ross Glotzbach's career path to fill that need. We think we're in great shape, but that's why we don't just walk around with those quotes and flog them every day. His context was very negative towards our industry and yet very helpful to us.

I actually did go to see him a few years ago to do nothing but thank

Staley Cates

him for that. We both knew there was no way he would give us an endorsement. He knew it was not a marketing call.

It was just to thank him, because that set us on a different trajectory.

You asked about investment style. The reason that his thoughts would not affect how we do investing is we would disagree on some very fundamental things. We agreed to disagree. For example, one of the reasons he hated public equities is not just what he saw as terrible structures in the mutual fund industry, but that public companies were under so much short-term pressure that they couldn't think for the long haul.

We'd pushed back very hard, considering our experience with Jeff Storey at Lumen, John Elkann at EXOR and Lawrence Ho at Melco. We find the

right partners that think long-term, but I get why he thinks that. He felt like private equity could take a long view because of the nature of what they do. Our pushback there would be that, considering the leverage and the time horizon on funds, we don't think they have necessarily a long-term horizon. I have great affection for him personally and great gratitude, but different investing religions for sure.

Bob: We are coming off a decade when value underperformed the market, and when value funds, including the Partners Fund, underperformed. But as of 4/30/21, the year-to-date performance of the Partners Fund has been strong. It has returned 19.74% versus 11.84% for the S&P 500, which is an outperformance of 790 basis points. Has the tide turned to favor value? What has caused this, and will this be sustainable?

Staley: I'm not sure we bring any special insight to this any more than you would. In one way, as you say, it has turned this year to date. If we regress to the mean to what value multiples might historically be versus growth, then we've not gone very far to correct the imbalance.

As for the causes, again, we have no special insight. But some of this happened with rates going up. If interest rates are not near zero forever, you would expect that this little glimpse we saw over a few months which did help value, would help value over the longer haul. It would make sense to us that rates going to zero have helped a lot of "theme" and growth stocks. If that's over, especially if rates go up or stay flat, it would seem logical that it would help value. But we can't just sit around and hope that that happens.

Bob: Markets in general have performed strongly over the last year, leading some to speculate whether equity prices are in a bubble. How generous is the opportunity set for the types of companies you like to buy, compared to the market bottom in March of 2020?.

Staley: I would divide the answer into U.S. and non-U.S. In the U.S., it's very difficult. It's a lot harder than it was in March of last year. You can see that very simply in a snapshot of our cash positions building to pretty high levels in our domestic funds. In the non-U.S., the indices are not as overvalued. Some of the "themey" stuff, the SPACs, tech excesses, and some of the things going on here are not going on there. We do see that in our International Fund, which is primarily non-U.S. and is much closer to fully invested. We still find outliers — we find weird animals that we'll talk about here soon that fall between the cracks of value and growth, despite the U.S. market selling at a really high P/E on really full earnings expectations.

Bob: In our prior interviews, you discussed your investment criteria and valuation methodology. The largest position in the Partners Fund is Lumen (formerly CenturyLink), which was approximately 10% of the fund's holdings as of March 31. What makes Lumen such a compelling investment?

Staley: You've known us for a long time. Our primary filter to run things through is: business, people, price. Let's start with the business, which is part of the misunderstanding that makes Lumen attractive. The business is primarily, in terms of value and not revenues, a fiber network that is almost unparalleled globally. That came from the Level 3network combined with TW Telecom, combined with Qwest combined with WilTel. All these formerly independent global fiber networks are now the biggest part of this company's value. It also has what its better known for, which is some dying landline phone assets, which came from the old CenturyLink, which is still a big part of revenues, but not a big part of value. Many people would say it is primarily a regional landline phone business. We would say it is primarily a fiber network in terms of the business.

In terms of the people, Jeff Storey runs it. Jeff did a fantastic job running Level 3 up until the merger with CenturyLink. He later took over the whole thing, CenturyLink, now called Lumen. In terms of operations, Jeff has done a fantastic job. The only category that he, his board, his critics and we as shareholders have not checked the box on would be organic revenue growth. But he and his team have done such a good job on cost reduction that it has offset revenue disappointments and cashflow expectations have been met. We're big fans of him and his team operationally. At the board level, it is headed by Mike Glenn. Mike was an ex-top executive at FedEx who built huge value there. He went on the Level 3 board. He's now the chairman of the Lumen board and a great person, great friend and great board chair.

At the management and the board level, we very much check the people box.

As to the price, that's where it stands out. You can look at it several ways. One way is that the whole company sells for five and a half times EBITDA. That's crazy because we would submit that the worst parts of what it owns, which would look like a lot of what Frontier looks like now that it's public after coming back from bankruptcy, should sell for that kind of multiple. Even some of the dying landline stuff can be fiberized, if you will, to become something that's like a rural broadband utility. Then on the high end of what it owns, infrastructure funds all day long are paying mid-teens multiples on EBITDA. That's what the best assets that they have would be worth. Pick your spectrum of value somewhere between five and a half times EBITDA for pieces of this, and mid-teens EBITDA for the best parts of it.

You would get something blended that is way, way above the five and a half times EBITDA that the whole company sells for. One interesting and unique thing about this valuation and about the price discount is that companies hate to put their own NAVs on their own investor presentations on their websites. If it's a huge number, it holds them to a stretch goal that they don't like to be held to. The lawyers hate it if it's way above the stock price. Well, on its investor page, you can see its own very crude, but simple and incredibly defendable, number of a value of like $24 per share up to $35 per share. It's meant to be bulletproof, not super detailed. But our own appraisal would be at the high end of that range. That's against the stock that is still less than $15.

One final way to look at this value would be its multiple on free cash flow because its debt is well-structured and cheap, and the bond market isn't worried about it. Even though it's at a five and a half times EBITDA, it's only at a five-times after tax, after everything, free-cash-flow multiple, which is ridiculous. It's a price that makes no sense. That is why it is our largest position.

Bob: You mentioned that you are seeing a better opportunity set outside the U.S. Talk about one of the opportunities that you see there that illustrates the opportunities that are attractive outside the U.S.

Staley: Like Lumen is our largest domestic position, I will go with one of our largest international weightings, which is EXOR. EXOR is the Agnelli family vehicle that came out of Fiat, but it is now way more diversified. It is run by John Elkann, who has built his own long-term fantastic investment record. It's easy to assess these pieces and we understand them. PartnerRe is a large reinsurance company it bought and is the largest single piece of the value. We would value that at a pretty modest premium to book value, which would be a typical way to look at that. It has a publicly held, but very large position in CNH, which is the number two agricultural equipment company, after Deere. The oversimplified way to look at that is if you could just be a close number two to Deere, both in terms of margins and value, then that's an incredibly attractive, high quality company and way more reasonably priced than Deere.

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You get the car parts that it is best known for. Ferrari interestingly is the most important piece of that. That's way more of a global brand than a local or national car company, it is worth a lot and it's publicly traded. Finally you get what was Fiat Chrysler and is now Stellantis, which is the merged company with Peugeot. That is a less important part of its overall NAV and to us, the lesser quality of those parts.

Most of these are public. You tote up those values and you get to north of a hundred euros per share the way we do that math; its stock is less than 70. This gets to bad, old correlations. This stock used to correlate with Italy and with the auto sector and those things that are not relevant in economic terms. But in price terms, they still correlate. It's also viewed as a European holding discount company. Yet this is much more of an emerging Berkshire Hathaway model. If John doesn't mess it up, he will be as well-known as Warren Buffett at that age. It's got everything we're after, including high quality and great diversification, and that's another reason we're comfortable with waiting.

Bob: Going back to the subject of value and growth, in one of his recent memos, Howard Marks of Oaktree explored the distinction between the two. He argued that the distinction has been blurred, in part because book value has become unreliable as a metric in our service-based economy. The main assets of those service-sector companies, which include software companies, are their people, who don't show up in their book values. Have you confronted this issue? Has your methodology changed, say, in response to last decade of dominance by growth?

Staley: We confronted that a long time ago, and our methodology has been consistent. For most companies, book value isn't relevant. I don't even know what the book value is for some of the stocks I follow the most closely. But in some, in a few industries, it is very meaningful. For an insurance company or a bank, we know what the book values are and they are relevant because the balance sheet is something close, or at least is supposed to be close, to intrinsic value. Using GAAP accounting on much of what we own, whether it's Mattel Brands or writing off Lumen's metro fiber, book value is not relevant and never has been. We would agree with that, but we don't think that is any change to our methodology.

Bob: Southeastern does its own podcasts, and you had a very interesting conversation with Jonathon Jacobson, who managed money for Harvard before starting his own hedge fund, Highfields Capital, which he

closed in 2018. One of the things Jon said was that his methodology caused him to miss opportunities in some of the fast-growing technology companies. Did you have similar regrets?

Staley: It's a great question. The answer is probably unsatisfactory, in that it is "no" and "yes." As we look at technology companies, what determines whether it's in our "too hard" bucket or not is if we think we can assign a terminal value. If it is a software company that's a super high-flyer, but there's no reason that other people are coming at them in three to five years and that you don't know who's going to win, then no matter how well they're doing, it is something that is in the "too hard" category. Sometimes we can assign a long-term terminal value to it, which we can't do with full crystal-ball clarity. But we can have a rough idea, as we did when we owned Alphabet by making an educated guess on the terminal value of search.

If we think we can get it there on the terminal value, then we should definitely be involved. The "no" part of my answer is that there are some companies that are always going to be too hard. We are not going to understand its terminal value. If it goes up and we miss it, so be it.

The "yes" part is we have missed things we would not have with better knowledge, harder work, or whatever we've done wrong, which is plenty of things. We could have understood that. We just didn't get there. In the future, we've got to do a better job. If it's something we can figure out, that terminal value, we should be involved with it. Those are the mistakes that we'd like to correct. This is not necessarily the time in terms of where the market is to have a great opportunity set. There's a lot of time to figure this out and there's a lot of stock price corrections that would have to take place for some of these things to get back on the radar.

Bob: Another issue that you and Jonathon discussed was how to attract and cultivate the most desirable investors, those will a long-term focus. As a mutual fund, you have much less control than as a hedge fund. What are your thoughts on this issue and has there been a trend among your investors to focus more on short-term results, causing more flow volatility?

Staley: The dynamic that you're talking about is definitely true of the mutual fund industry, but I don't think we have that issue as much because we've worked hard for a long period of time to address that. If you go back for a long period of time, we have had funds like our small-cap fund that were closed way more years than they were open. Our Partners Fund has probably been open more than closed, but there have been periodic closings. We closed our real estate fund all together. The reason that addresses this topic is anybody who invests the way we do is going to have periods when the performance deteriorates and periods when it is hot. It's easier to take money in when it's hot, but that's exactly when you get the shareholders who are going to flow back out when it's bad.

We've tried to run counter to this. We've tried to be open to bring in assets when the numbers are terrible, which is of course hard. But if you get that shareholder, you are by definition philosophically aligned with them. That's the only reason they come to you when your record is bad. If you're not taking in the money at the top, when it's easy to get it, that's much better when you get in the hard times and they stick with you. It's neither accident nor are we paying a compliment when we say we have a great set of shareholders. But we are philosophically aligned and they are long-term. We are all working together on this dynamic.

Bob: While we are on the topic of hot funds and asset flows, the hottest investment over the last five years has been Cathie Wood's ARKK, which is an actively managed ETF. Do you have any thoughts about offering your services through an actively managed ETF or converting any of your funds to ETFs?

Staley: This will be my shortest answer of the day. Nope, we won't be doing that.

Bob: I presume that's because it would attract the wrong type of investor.

Staley: That's part of it. Some people argue in favor of tax structure. We're not sure that's in a "too good to be true" camp that gets changed someday. There's showing your positions daily. There's a lot of issues about ETFs.

Bob: Another popular approach is quantitative or factor-based investing. Many of our listeners use a factor-based approach to gain exposure to value strategies. What guidance do you offer to those who choose that approach versus an actively managed approach such as yours?

Staley: They're chocolate and vanilla. They're different ways of coming at value. We use a lot of quantitative techniques and screens to be aware of what that brings to the table. Generally speaking, that involves looking at correlations, at the various metrics compared to the statistics with peers, and historical multiples. Those things make sense. You're trying to tilt the odds to your favor, but you're still at the end of the day, playing a statistical bet. We are trying to find things that would fall between the cracks. That applies not only to the growth investor, who doesn't care about some of these things because there's hair on them, and on their future growth and quality.

But those simple value metrics are going to miss what we're after. A good example would be Mattel. When we bought Mattel, it was a shambles. It was not earning a lot of money. Traditional value metrics on cashflow, earnings, revenues would not be impressive, especially if compared at the time to Hasbro. None of those quantitative characteristics would have captured the brand value of the IP that they have, especially with Barbie and Hot Wheels, which have not yet been monetized in movies, TV and games, which is coming. As I mentioned, with EXOR, there are correlations that are logical in a backward looking way that the factor-based models are going to keep using, but they're not relevant anymore.

That would also apply to Lumen. Lumen doesn't have anything to do with Frontier and Windstream, but people keep using those multiples. Sometimes to find comparable peer multiples, they may compare Lumen to AT&T and Verizon because that's the metro fiber competition for the salesman every day. But that is not a good peer-valuation comp because those two companies are driven by the wireless businesses. When the quant, stats, correlations and metrics miss something that can happen, that's our opportunity set. We're not knocking that approach. It's a different kind of approach, but we're just trying to be cognizant of what it's not going to catch. That's what we're going to try to catch.

Bob: As a value investor, I know that macroeconomic factors are not a part of your investment process. But the central debate among economists and strategists is inflation versus deflation — essentially whether the inflation we are seeing now will be transitory or more long lasting. What are your thoughts, specifically as it relates to the stocks you own?

Staley: As you say, we're not macro people. But we would come at this with the micro, from what we learned from our companies. On this all-important inflation question, which relates to where bond yields should be and where margins are going, we'd say a couple of main things. The summary bullet point of the book, *The Great Demographic Reversal,* is about labor arbitrage being over. We see that in our companies. There were years of companies we'd either own, visit or study having huge labor-cost benefits because of what grew in China and the way that China grew, and then moving to Southeast Asia and Latin America. But that low hanging fruit at a company level is true for the bigger themes of inflation labor costs. We see that and would agree with that.

The second thing that we're seeing with our company composite is that there's almost a cost honeymoon for this first part of coming out of the pandemic. People have restructured. Working from home has led to some cheaper rents and salaries and some reconfigured ways of doing business: zero-based budgeting and better cost structures, such that we're coming out of this pandemic with big revenues. But that is temporary in that these companies are looking past that honeymoon of a few and they're seeing labor-cost pressure, especially at the lower end of wages. Real estate is going up, materials are going up, and there could be margin and cost pressures that are not in CPI.

How do we flow that through? We think inflation roaring back could be a huge risk. Every primary analyst on any of the companies we own has to address that. What is this company going to do? Is it going to be able to raise prices flat out as FedEx does? Or does it have a level of margin it can gain that's in the category of "self-help," where even if there are costs pressures from inflation, its margins will still grow. We need to have something to protect us for anything we're going to own right now.

Bob: If there is one key takeaway you would like to leave our listeners with, specifically with respect to the future for value investing and the approach you employ at Southeastern, what would that be?

Staley: For the value investing part of your question, I would say reiterate the old thing, price matters. People don't think it does because they've been bailed out for 10 years with cost of money going to zero. You could be wrong assessing your moat and your franchise. You could be wrong on what you thought the company's earnings were going to do. But you were often bailed out by the multiple, which has been the inverse of interest rates. That kind of bailout factor is very unlikely to repeat. We're back to saying price is going to matter, especially as a protection against when any of us are wrong projecting what companies or their earnings are going to do.

As to the more specific Longleaf answer, what gets lost in the shuffle is we have a nuance or a balance. On the one hand, we stress that price matters. We are one of the few people left exercising a very strict value discipline. But the balance is because all of our own money, and our foundation's money, is in these funds. Quality matters deeply to us.

When we say price matters, that doesn't then mean we are in a deep-value category buying junk that's cheap. We have a more Buffett-like version of value. The people have to be great along with buying a discount. This is where all of our own capital is. Sometimes the demand for quality gets lost. You can't see it on the surface, or the company would be at a P/E of 30. But nobody would call Mattel or EXOR quality until they dig into the components. It's fiber, it's a Barbie brand, it's Ferrari, integrated reinsurance company, on and on. We have quality that is assets we'd love to own for five or 10 years. It's just not a visible, obvious, or easy definition of quality.

Disclosure

Average annual total returns for the Longleaf Partners Fund and its benchmark for the one, five, ten year and since inception periods ended March 31, 2021 are as follows: Partners Fund: 83.70%, 10.46%, 7.23%, 10.19%; S&P 500: 56.35%, 16.29%, 13.91%, 10.40%.

Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting southeasternasset.com.

Before investing in any Longleaf Partners fund, you should carefully consider the Fund's investment objectives, risks, charges, and expenses. For a current Prospectus and Summary Prospectus, which contain this and other important information, visit southeasternasset.com/account-resources. Please read the Prospectus and Summary Prospectus carefully before investing.

The total expense ratios for the Longleaf Partners Funds are: Longleaf Partners Fund 1.00%/0.79% (gross/net of fee waiver), Longleaf Small-Cap Fund 0.93%, Longleaf Partners International Fund 1.17%/1.15% (gross/net of fee waiver),and Longleaf Partners Global Fund 1.32%/1.20% (gross/net of fee waiver). The Longleaf Partners Fund's expense ratio is subject to a fee waiver to the extent the Fund's normal annual operating expenses exceed 0.79% of average annual net assets. The Longleaf International Fund's expense ratio is subject to a fee waiver to the extent the Fund's normal annual operating expenses exceed 1.15% of average annual net assets. The Longleaf Global Fund's expense ratio is subject to a fee waiver to the extent the Fund's normal annual operating expenses exceed 1.20% of average annual net assets.

RISKS The Longleaf Partners Funds are subject to stock market risk, meaning stocks in the Funds may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Funds generally invest in 15 to 25 companies, share values could fluctuate more than if a greater number of securities were held. Mid-cap stocks, held particularly in the Partners Fund, may be more volatile than those of larger companies. Smaller company stocks, held particularly in the Small-Cap Fund, may be more volatile than those of larger companies. Particularly for the International Fund and Global Fund, investing in non-U.S. securities may entail risk due to non-US economic and political developments, exposure to non-US currencies, and different accounting and financial standards. These risks may be higher when investing in emerging markets.

Holdings discussed represented the following percentage of assets as of March 31, 2021: Melco International- International Fund 6.1%, Global Fund 4.5%; Lumen – Partners Fund 10.0%, Small Cap Fund 12.7%, Global Fund 9.4%; EXOR- International Fund 8.7%, Global Fund 9.5%; Mattel – Partners Fund 6.0%; Small Cap Fund 6.2%; FedEx – Partners Fund 4.1%, Global Fund 4.1%. Fund holdings are subject to change and are not recommendations to buy or sell any security. **Current and future holdings are subject to change.**

EBITDA is a company's earnings before interest, taxes, depreciation and amortization.

Price / Earnings (P/E) is the ratio of a company's share price compared to its earnings per share.

Net Asset Value (NAV) is a statement of the value of a company's assets minus the value of its liabilities.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services.

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