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At Longleaf, 'Partners' Is More Than a Name

Fund Spy | 03-11-10 | By Gregg Wolper

One of the more discouraging aspects of the recent financial crisis was the exposure of misbehavior among certain members of the corporate and investment worlds. In a few cases, these actions are alleged to have been illegal, while in many other cases, they were simply distasteful or showed a lack of respect for shareholders.

Mutual fund firms mostly have steered clear of ethical problems this time, but they're not immune from scandal. Headline-grabbing misdeeds can occur. Perhaps what's more informative, though, is the way that shareholders are regarded on a mundane day-to-day basis. Fund companies vary greatly in the manner in which they treat fund shareholders.

For this reason, Morningstar's fund analysts focus attention on stewardship of capital. In recent months, we have published a series of columns providing new reviews of the stewardship practices of a number of families. Lately, we've taken a look at Federated, Janus, and Putnam. Today we examine a firm whose stewardship practices rise well above the levels of those three competitors: Southeastern Asset Management, advisor to the Longleaf Partners funds.

Consistent Approach, Impressive Results

In nearly all respects, Southeastern Asset Management acts in a shareholder-friendly manner. Unlike many rivals, the firm has not created a broad lineup of funds in order to gather as many assets as possible or to increase the chances that at least one of its funds would be performing well at all times. Instead, the firm relies on a single investment approach, in which its managers have specialized for decades: a value-oriented, low-turnover, contrarian style targeting superior results over the long term.

As a result, Southeastern has only three funds. It hasn't come out with a new one since 1998, when Longleaf Partners International (LLINX) arrived on the scene. Southeastern also closes funds to new investors when the managers think they've run out of ideas for putting money to work. In fact, all three Longleaf funds were closed to new investors for a year and a half until mid-2006, when the International fund reopened. The firm's flagship offering, Longleaf Partners Fund (LLPFX), reopened only after the sharp decline of stock prices in 2008 provided more investment opportunities for the managers. Longleaf Partners Small-Cap (LLSCX) remains closed.

The firm's dedication to its investment style, and to its core beliefs, has served its funds well over time. To be sure, there have been some painful stretches of underperformance (most notably in 2008). But over the 23 years from its April 1987 inception through early March 2010, Longleaf Partners Fund has beaten the S&P 500 Index by more than 2.5 percentage points on an annualized basis, a hefty margin. The other Longleaf funds also have outstanding records over the long term versus their benchmarks and peers. And while a couple of managers have left in recent years (neither went to another fund firm), Mason Hawkins, who founded Southeastern in 1975, and Staley Cates, who joined in 1986 and became a manager a few years later, have stayed in place—and have continued to set the tone.

You Know Where They Stand

Meanwhile, Southeastern is a model of clear and detailed disclosure. The Longleaf Partners web site provides a statement of "governing principles" as well as additional documents that collectively make Southeastern's style of investing, its ethics policies, and its core beliefs as clear as possible to prospective and current shareholders. As one example, the literature for the flagship Longleaf Partners Fund actively discourages investments from anyone who has a time frame of less than five years.

The communication doesn't stop there. For many years, the Longleaf funds have published lengthy and detailed quarterly letters that list every purchase and sale during the period and usually discuss the reasoning behind each of these decisions. The reports also provide the managers' thoughts about other long-term holdings, as well as broader issues in the economy or stock market, if the managers think those are relevant at the time. These reports, going back to the mid-1990s, are available in an easy-to-access archive on the Longleaf web site.

Moreover, at the most alarming point of the financial meltdown, in late 2008, the managers issued a special report on the situation—

with firm and strong opinions, not just a review of the news. They also held a conference call for fund shareholders in which they stated their opinions and took questions from advisors and other shareholders. Those actions weren't unique during that dismal period, but relatively few managers engaged in those actions to such a deep level.

Such candor and clarity increases the likelihood that Longleaf shareholders will understand their funds' unusual strategies and stick with them when they hit the inevitable hard times. In fact, in 2008, when Longleaf Partners Fund's performance was awful, the outflows were not nearly as severe as one might have expected, judging from the experience of many other funds that have hit such turbulence.

It's also reassuring that the firm requires all of its employees to keep all of their equity investments in Longleaf Partners funds unless granted special clearance by a compliance committee. It also requires all trustees to have investments in the funds at least equal to the compensation they receive from the funds. Such practices ensure that the interests of the firm's employees and the fund's trustees are aligned with those of fund shareholders.

A Mixed Record on Fees

The one strike against Southeastern is that it has a mixed record when it comes to fund fees. On the positive side, Southeastern pulled its funds out of Schwab's fund supermarket years ago rather than pay the extra fees charged by Schwab. That decision kept the fund out of a popular sales channel, but the managers said, with justification, that the added fees would have harmed fund shareholders who did not hold their shares through Schwab.

However, when it comes to the steep management fee charged by the International fund, Southeastern hasn't been as shareholder-focused. For more than a decade after its 1998 inception, that fund's expense ratio was one of the very highest of any broad-based (that is, not limited by region or sector) international fund with more than $500 million in assets. The managers have said that the International fund was expensive to run because it maintained foreign offices to conduct research and noted that alternative investments such as hedge funds were even more expensive.

Only in late 2009 did the management fee on Longleaf International come down, and even then the fund remained relatively expensive. The other Longleaf funds do not have such steep management fees, but even so, their expense ratios can't be called inexpensive considering the size of their asset bases, particularly Longleaf Partners Fund. Meanwhile, in the advisor's otherwise extremely detailed and forthright shareholder communications, which sometimes refer to shareholders as "investment partners," only very rarely has there been any mention of the issue of cost or any discussion of efforts to bring the expense ratios down in order to put more money in the pockets of those investment partners.

It's important to note, however, that a fund's directors are the ones specifically assigned to look out for the interests of fund shareholders, with fees being a key area. The board would have better-served shareholders by negotiating a lower management fee.

Conclusion

Southeastern Asset Management, therefore, is not perfect. However, when every aspect of the firm's corporate culture is taken into consideration, and its actions, beliefs, and behavior are compared with those of its many competitors in the mutual fund arena, it's clear that the firm stands well above the norm when it comes to stewardship.

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Important Disclosure Information

Average annual total returns for the Longleaf Partners Funds and their respective benchmarks for the one, five and ten year periods ended December 31, 2009 are as follows: Longleaf Partners Fund, 53.6%, (0.98)% and 5.31%; S&P 500 Index, 26.46%, 0.42% and (0.95)%; Longleaf Partners Small-Cap Fund, 49.31%, 3.13% and 8.23%; Russell 2000 Index, 27.17%, 0.51% and 3.51%; Longleaf Partners International Fund, 23.17%, 2.54% and 7.46%; EAFE Index, 31.78%, 3.54% and 1.17%. Fund returns and those of the unmanaged and unhedged indices include reinvested dividends and distributions, but do not reflect the deduction of taxes. Current performance may be lower or higher than the performance quoted herein. Historic numbers include periods in which the Funds used currency hedging as an investment strategy. Beginning in the third quarter 2009, and following a transition period ending in early 2010, the use of currency hedging as a routine investment strategy was ceased. Past performance does not guarantee future results, fund prices fluctuate, and the value of an investment at redemption may be worth more or less than the purchase prices. Please call 1-800-445-9469 or view Longleaf's website (www.longleafpartners.com) for more current performance information, or for a current copy of the Prospectus, which should be read carefully before investing to learn about the investment objectives, risks, charges and expenses of the Longleaf Partners Funds.