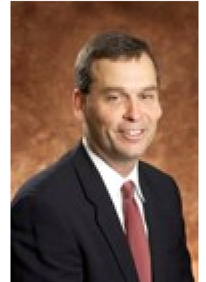
Staley Cates on Why Active Management Wins in the Long Term

September 28, 2015

by Robert Huebscher



Staley Cates is President and Chief Investment Officer of Southeastern Asset Management. Southeastern Asset Management is a Memphis-based, employee-owned global investment management firm founded in 1975 by O. Mason Hawkins and 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.

I spoke with Staley on September 17.

Please describe your approach to value investing and the criteria you look for in a potential investment.

It is pretty simple and requires a strong business with good people and a deeply discounted price.

For the business part, we need companies with an edge that you can articulate on one page. That can be a brand or distribution network, low-cost status or some kind of moat – that over-used word. It's got to have a true competitive advantage.

As a little aside, sometimes people will look at our holdings and think because we are "deep value" that we care more about the price discount than the value growth. But we actually demand super-high quality, which often masquerades as lesser quality. That is why we can pay a low price. For example, some cyclical businesses such as agricultural equipment or cement, have strong pricing power, dominant market share, and/or big barriers for new competitors, but at cyclical bottoms, we sometimes can buy them at deep discounts to their underlying longer term values. If it is blatant, easy-to-see quality, then one usually must pay a lot more in terms of multiples or P/E ratios.

Good people is about management's vesting, whether their compensation is aligned with their shareholders', and what kind of people they are. Their value-add is not soft and fuzzy but real as rain because the good CEO partners expand value way beyond what is on our appraisal spreadsheet. Within our appraisal, we assume the discount rate is the reinvestment rate for management's capital deployment. If, for example, you have John Malone, Warren Buffett or Nassef Sawiris investing for you, that rate doesn't apply. They get a way better return. By contrast, if there are people who misallocate capital, we don't get the returns we thought we were going to have.

The last thing is the price. We want $.60 on the appraised dollar. Another way we talk about this is

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paying a very low going-in free-cash-flow multiple.

Our approach is simple to articulate, but it is very hard to execute.

One of the trends that has been drawing a lot of attention is the increase in share buybacks by corporations, triggered by low interest rates. How does that factor in your analysis?

Share buybacks are a great idea gone bad by being overdone. At its core, buybacks are just like mergers and acquisitions. A company is just buying itself instead of another company, and it should be viewed as such. The lower the price, the better. The lower the price, the lower the risk.

Yet the broad buybacks occurring today have that totally backwards. More than 400 companies in the S&P 500 are buying in their shares. That cannot be right and cannot be good because overall the market is efficient enough that not many things are cheap. The history is companies have typically bought at the wrong time, such as before a crash. When they really should be buying shares back, following a crash, most get scared and don't.

Our answer is bifurcated based on our names, a small subset of the overall market. We are only in these investments because they are selling at a big discount to value, so most of our companies are growing value per share with their current buybacks. But we own a small subset of rare birds.

Overall, the market's rapid buyback pace, which is approaching the previous high in 2007, has fed this whole passive-indexing bubble because the larger companies that dominate the S&P 500 are buying more shares, driving prices even higher. Systemically it makes no financial sense for every company to be buying in shares, and yet here we are prescribing it for a bunch of our investees - the ones that are still selling at huge discounts to value - because unlike an acquisition, it is a zero risk way to build value per share. An acquisition has integration risk.

Energy prices and the associated debt and equity securities in that industry have declined significantly. Are you finding securities there that meet your investment criteria?

We already own enough energy companies to be over-weighted in the portfolio, and unfortunately, have paid a performance price for being there ahead of the decline. Although interestingly, like the answer to your buyback question, you cannot generalize about opportunities. We don't think most of the energy group is cheap. People would assume that because the related commodity prices are down so much, the names are a bargain paradise. We don't think it is.

In our previous interview with *Advisor Perspectives* in 2011, we talked about using the strip [the price of oil or gas implied by the futures market], and sadly we were way off because the strip has moved much lower. But using the strip remains our go-to methodology because we are agnostic on the commodity. Most of the energy companies are not cheap based on the strip.

With a fresh piece of paper and after this big crash – not just bear market, but crash in energy – we find very little value. But like the buyback phenomenon, a few specific companies have their own

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reasons for cheapness that go beyond the strip coming down. Chesapeake's (CHK) unfavorable differentials make it the most sensitive to gas price. Murphy Oil (MUR) has had a bad recent international exploration record. CONSOL (CNX) is still viewed as a coal company even though its gas assets are a much bigger part of its value. The view that coal is environmentally untouchable has a lot of people divesting regardless of price.

Those are rifle shot opportunities, but we don't really think the whole energy group is that compelling.

Does the devaluation of the Chinese currency have any direct or indirect implications for your investments in Macau gaming stocks?

Short-term, it has a small impact – the almost three percent devaluation that you've seen. Macau is a Hong Kong-dollar place (we own WYNN, which has a Macau casino, in our U.S. funds; in our international and global funds we own Macau casinos via Melco as well as indirectly through K. Wah which holds a large stake in Galaxy Casino). The more important issue that most people miss is that, despite the devaluation against the US dollar, so many other currencies in Asia have gotten destroyed against the US dollar. The renminbi strength against everything else has the Chinese traveling in large numbers to other places such as Japan, Australia and Europe. That cannot help Macau. Part of our thesis about Macau is based on keeping Chinese tourists home.

Long-term, we don't worry about it because we don't see a case where the renminbi and the Hong Kong dollar don't move together. Over the long term, we believe the two currencies are not going to get unhinged and adversely impact Macau.

How much is Google worth and how do you value it?

To answer that question I need to walk a line between not giving up proprietary research data and yet being helpful.

You start with a seemingly high P/E if you simply use a price of $625 and assume they are going to make between $25 and $30 per share in the next twelve months. But, if you dig deeper to appraise the different pieces of the company, the picture looks much more interesting. First, you take almost $100 of net cash out of the price. The next biggest adjustments are for YouTube and Google Play which are basically bouncing around breakeven. The disclosure is bad. That's why everybody is excited about this Alphabet restructuring; they think they will get to see the pieces in clearer form. But you can basically get to substantial appraisals for YouTube and Google Play, even in conservative Memphis dollars – not just Silicon Valley dollars. So you back out those two segments from the stock price, and the remaining stock price is tied to the earnings from Google's search business.

Now you are in a zone of paying less than a 15 P/E for search. You can then adjust for some of the other efforts they are currently investing in like the driverless cars. Whether they work or not, it is going to be a zero or a huge win. It is not going to be a negative value that you would keep capitalizing and would be a drain on R&D. Google just hired John Krafcik who previously ran Hyundai Motors in the U.S. and came from Truecar. They have Ford's Alan Mulally on the Board. They are clearly serious

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about this effort.

After making assumptions about how much their R&D investment efforts are dinging the EPS, you get to an estimate of earnings that really come from search. The bottom line is we think we are paying an 11 or 12 P/E for search. It may be even higher. Baidu (BIDU) just released its search margins, and if you could believe them, they would be even better than we are assuming at Google.

The other piece has to do with YouTube. We've owned a lot of entertainment businesses as you've seen before, and we've invested in distributors. So they've all taken us to school on YouTube. We very much believe in the long-term model with YouTube. With YouTube bouncing around we wonder, "Are they just going to not make money forever, or could they show us the money whenever they wanted because they are just growing so fast?" We think it is in that latter happy bucket. The business value is totally unappreciated when people are just doing their multiples.

Like Longleaf, many value investors have had a difficult time in the past eight years. What has changed in the world over that time period? What have you learned?

Part of the difficulty with value investing has been that the passive movement is not just a big trend. It is a bubble. Share buybacks are feeding the index run. Passive investing has created momentum that is making it hard for value investors.

We've learned an embarrassingly large amount from our various mistakes or omissions. It hasn't been a single thing – like being hit by a lightning bolt – but there have been a lot of execution challenges. We have learned a lot of country-by-country lessons, which will have an enormous benefit for us in the long term. Our record has suffered badly, and to many it doesn't look like we're learning anything. But having our international and global research effort is amazing – for example, we have learned so much more about China through our Singapore office and our international investments.

A lot of our learning has been in portfolio management (PM) and not just in company-related research. We always talk in research terms because that's at the core of what we are. But some of our PM decisions, led to owning those individual commodity-based rifle-shot opportunities, which at the portfolio level, put us overweight in a commodity that is obviously not treating us well.

In the context of a market that has been up so much, there has been a lesson in our selling discipline. Many value managers will say, "Well, I'm great at buying, but I always sell too early." It's not acceptable to simply say that. We spend a lot of time discussing how to improve. We do more intense underwriting at the point-of-sale. We've always done intense underwriting at the point of purchase. But it's too simplistic when a company hits its sell target, to immediately sell it. We are trying to be more intense in that part of our analysis.

On the research process, there also have been governance lessons. Some of them have been sad lessons, like with Dell Computers. Some of them have been big wins like at Chesapeake, although we do not have performance to show for that yet. We have had some good results from becoming more engaged with managements. On the ones that have been a big win, we look back and say we probably

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waited too long before becoming more actively engaged. How can we be more systematic about pulling the trigger, like when returns are not acceptable? Instead of waiting for the primary analyst to ring the bell, we review the underperforming names more objectively, because the analyst is usually slow to do that.

As of June 30, the Partners fund and the Small Cap fund had approximately 10% in cash, although I understand some of that is inflated because of the options you hold, while the Global fund cash was at 6%. Are there more opportunities globally than domestically?

Absolutely. We thought that going into this recent swoon in the U.S. We wrote about that in our shareholder letters and explained why.

You can see this in the Hang Seng Index or any of the other indices by looking at the value differences compared to the S&P. As a result, in the Partners fund especially, we maximized our non-U.S. names as a way to protect ourselves from overvalued US investments. And then what happened? In the short term, those holdings have been hit even harder than our U.S. holdings in some cases, especially the Hong Kong companies in the last few months. We still think we will benefit long-term, but that is part of the reason Partners has been smoked.

Of course that means the Partners fund is even more attractive from here. Just look at the multiple differences. The Hong Kong market overall is less than 10 P/E, a 4% yield and below book value. Compare that to the S&P. You just have a better place to hunt.

That's why we are at our maximum 30% non-U.S. allocation in Partners. We have holdings in Partners that would count as U.S. but really have meaningful non-U.S. exposure, like Wynn (WYNN). Wynn is our newest name that is down big in the short run. The decline is really all about Macau, while its U.S. business is doing fine. The holding counts in the U.S. bucket.

We are talking on September 17, the same day the Fed is meeting to address its interest-rate policy. I understand that as a value investor you don't focus on macroeconomic issues. But do any of the big macro issues – like interest rates, the crash in China's market or the troubles in Europe – create opportunities or problems for your funds?

Short-term, yes, of course; but long-term, no.

One common theme here is that the macro has swamped the micro, especially with energy and Macau, driven by China's broader anti-corruption campaign. Over a longer time horizon, micro truly wins. The 80-year history of the E&P sector is just like you'd expect; the commodity has had a zero real return while energy stocks as a whole have made higher returns than the S&P. So it doesn't take the commodity moving for you to make a lot of money in the sector. In the short term, however, that is out the window. We are not oblivious to the short term. It will remain impossible to forecast. All we can do is try to protect ourselves against macro tsunamis. Then long-term, the micro wins out. That's why almost all of our analytical energy goes into knowing the details of the companies we own rather than trying to forecast macro events or changes.

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We are in a fight of short-term versus long-term arbitrage.

Looking back at our 2011 interview, I see that we blew through our energy assumptions on the downside. We still need to get better at modeling the worst-case. But that is not the same as saying, we throw our hands up and macro is going to win.

China has had an impact in all kind of ways. It can hurt certain industries and affect a lot of opportunities we look at. It can also be a great place. China is just too big and too multifaceted to deem it either good or bad.

Last year, in 2014, 93% of all net flows went into indexing. I was actually pretty shocked when I read that. What do you say to financial advisors who are anticipating shifting their allocations towards passive Index strategies?

They should look at what they are buying instead of its record.

Its record has been up for a really long time with low volatility and low fees, which are, of course, always good. Everybody is extrapolating that, which is why the market is at this unseemly high number.

When you realize you are buying an actual asset in this basket of stocks, you see you are paying historically high multiples on margins that can't go up. Without margin improvement, you are tethered to organic revenue growth. Pick your organic revenue assumption for the U.S., which is the amount we are going to grow, perhaps a few percent annually. That is going to be your best case, and it may be down if margins regress to Jeremy Grantham's mean. And for that you are paying 15 times EBIT and 11 times EBITDA. That usually doesn't work.

The P/E is misleadingly low, of course, because you have free-interest expense for now and that can change at 2:00 PM [if the Fed decides to raise rates]. You can't just say it is a 16 P/E. When you are calculating EV to EBIT or EBITDA, that is what you are buying. That's why owning the S&P 500 scares us to death.

Tied into that, this year has been the largest year for net outflows from U.S. equity funds since 1993. What other advice would you offer to advisors and financial planners, particularly to those who are worried by the data showing that U.S. equity market is overvalued by historical standards?

This is self-serving because we have an international fund, although nobody wants it because our recent returns are bad, but look more non-U.S. The values are just clearly better.

I know advisors worry about currency risk, and some don't want the exposure. But it's easier than ever to hedge that away. So you don't have to take the currency risk anymore, especially if you are with a concentrated manager, because it's easier to see the buckets that you need to hedge.

The second thing is a more minor one, although it's important this year -- especially to us. It is the

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manic mindset around tax planning, and more specifically, tax loss selling. People miss two things. They take the net gain, and they apply their tax rate to that. They say, "If I don't harvest this loss now, I'm screwed." That is not right. If you don't harvest it now, you haven't lost it for next year. So we are not talking about the tax loss; we are talking about the NPV of the tax loss and whether it makes more sense to sell now or wait.

Against that, we have two things that many ignore. There is the trading cost you can't see for the associated harvesting transactions. That is not just waiting 31 days to re-invest. Even if you found like-asset for like-asset, you are moving them around. More importantly, in trying to pick up the NPV of a long-term loss, you may turn something into short-term. So you may go like-asset for like-asset, but if it does bounce back up, and next year you are selling, while you will have booked your long-term loss this year, next year, you are paying a short-term gain. You just gave much more to Uncle Sam and paid extra transaction costs.

So there is more to it than, "Oh, my gosh, I've got a gain." Advisors would help their clients more if they also analyze and consider the different scenarios of how tax loss selling could be more costly than taking a current long-term gain.

Are there any other thoughts you would like to offer to our readers?

I have personally never seen this much disconnect between the short-term and the long-term. Some people give up on us, especially if our funds are doing poorly, because they say, "The market's just too efficient. There is too much competition. There are too many funds. In U.S. mid- and large- cap, you just can't win."

There might be more competition and more quant power, but the quant power won't ever change fear and greed. Some of investing success is psychology and not math. But what makes up for that and makes us think we can win, and the advisor can as well, is that everything is so short-term.

If you are really long-term, that's how you win. That's the arb you take. Macau is a perfect example. Will Macau, in the next year, stay ugly? Who knows? Is the Chinese corruption crackdown going to change? Probably not. Nobody, however, not even the bears, has a low forecast or a diminished forecast 3-5 years out. If you can wait the 3 to 5 years, it is just a layup.

For us as a manager, and this is completely applicable to an advisor, if you are one of the few people who are really long term, you win even bigger because so few are.

Sometimes an advisor will say, "Well, I get your proposition, as an active manager, that over time with your high active share you will win against passive. But it is so volatile, it's not worth the trouble."

An active manager should be viewed in the same opportunistic way that we view buying and selling a stock. Instead of avoiding volatility, investors should use it to improve their returns. When a proven manager is down like we are now, that's usually a fantastic time to put additional money to work. Conversely, when everything is clicking well for a manager, that's probably a good time to harvest.

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By taking advantage of the volatility of an active manager's returns, an investor can create dollar-weighted results that are better than the manager's reported returns, which in turn are hopefully better than the market's long-term performance.

Disclosure Information

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 longleafpartners.com. Please read the Prospectus and Summary Prospectus carefully before investing.

The statements and opinions expressed are those of the speaker and are as of the date of this article. Fund holdings are subject to change and holding discussions are not recommendations to buy or sell any security. ***Current and future holdings are subject to risk.***

Average annual returns for the Longleaf Partners Funds for the one, five, ten, and since inception periods ended September 30, 2015 are as follows:

Longleaf Partners Fund: -21.89%, 5.96%, 2.81%, 9.96% (inception April 8, 1987)

Longleaf Partners Small-Cap Fund: -8.84%, 12.66%, 8.05%, 10.58% (inception February 21, 1989)

Longleaf Partners International Fund:-17.75%, 0.11%, 0.96%, 6.63% (inception October 26, 1998)

Longleaf Partners Global Fund: -21.36%, na, na, -0.68% (inception December 27, 2012)

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 longleafpartners.com

The total expense ratios for the Longleaf Partners Funds are: Partners Fund 0.91%, Small-Cap Fund 0.91%, International Fund 1.25%, and Global Fund 1.58%. The funds' expense ratios are subject to fee waiver to the extent a fund's normal annual operating expenses exceed the following percentages of average annual net assets: Partners Fund 1.5%, Small-Cap Fund 1.5%, International Fund 1.75%, and Global Fund 1.65%.

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.

The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. An index cannot be invested in directly.

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

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

EBIT is a company's earnings before interest and taxes.

Net Present Value (NPV) is the difference between the present value of the future cash flows from an investment and the amount of the investment.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Book Value is the value of an asset as carried on a company's balance sheet.

Earnings per share (EPS) is the portion of a company's net income allocated to each share of common stock.

The Hang Seng Index is a market capitalization weighted index of the largest companies that trade on the Hong Kong Stock Exchange.

E&P stands for earnings and profits.

R&D stands for research and development.

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As of September 30, 2015 the holdings discussed represented the following % of the Longleaf Partners Funds: Chesapeake Energy: 0.4% Partners (5.0% adjusted for close of options and purchase of underlying stock), Global -0.5% (3.1% adjusted for close of options and purchase of underlying stock); Murphy Oil: Partners -0.7% (1.8% adjusted for close of options and purchase of underlying stock), Global 0.3% (2.4% adjusted for close of options and purchase of underlying stock); Consol Energy: Partners 2.7%; Small Cap 3.3%; Global 1.7%; K Wah: 5.7% International; 4.0% Global; Baidu: 3.6% International; Melco International:6.3% International, 4.4% Global, Wynn Resorts: 4.9% Partners, 4.7% Small-Cap; Google: 6.4% Partners, 4.9% Global.

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LLP000379
1/31/2016

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