BESTINVER
Asset Management

How I see portfolio management

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I didn't buy my first share at the age of twelve like Bill Miller or Warren Buffet and my father wasn't "connected" to "The Street". My only early experience of the markets was having heard when young that my father bought shares a month before the 1973 crash and sold them at a loss 12 years later just before the boom in 1990s. He on both occasions, at the buying and at the selling, followed the advice of a "renowned stock market expert". May be this anecdote put into my brain that experts in Wall Street are not like experts in medicine or engineering…

My first real experience began when I joined in the mid 90's a small German boutique founded by a former Fidelity manager who had worked for ten years directly under Peter Lynch. A few months later, I had read all the greats (Benjamin Graham, Phil Fischer, Warren Buffet, Mr. Lynch himself…) and couldn't wait to start research! We were allowed to analyse any company in any sector or country and there was no guide on how to do it (1). Only one thing was compulsory: we had to present our research in a 60 seconds speech.

After repeating this exercise many times, I reached a conclusion that I still believe holds true today: never invest in something you don't know a lot more than most about. (2)

1. My first rule is "know what you are buying", but what does this really mean?

For most of us this means little more than understanding the business. But a company is its business and a great deal more: it is its assets, employees and background, and it is "ALSO" in a certain sense the assets, employees and background of its competitors! You can invest in a company without this knowledge of course, but without this "homework" you would perhaps not have the courage to hold onto (or buy more) if the shares suddenly drop 25% the day after your initial purchase (3).

More specifically, before parting with their money I believe investors need know about:

- The company's background (who's the founder and the most important events in its history)
- The background of its sector/competitors (who has survived the crises and why, what strategies have been employed in the past by the different players, etc.)
- Financial statements for the last 8-10 years (4)
- Incentives for top executives
- The names of its shareholders, their tasks and the role they play (tacit or explicit) in the decision-making process
- Information from former employees
- Past positions adopted by the regulator if we are talking about a regulated business
- Competitors' visions of the company and its managers
- Past corporate transactions made by the company and its competitors (who did it acquire, when, why and what was the valuation)

Clearly, it is not always possible to talk to former employees, sometimes we don't even have access to reliable financial statements going back so many years. But this should be borne in mind, and if we decide to BUY despite this lack of knowledge it should be reflected in a smaller weighting for the company in the portfolio.

2. The second rule: Buy cheap

The first thing that really caught my attention barely a year after I starting researching listed companies was the idea of buying "a dollar for fifty cens". In the distinct words of Warren Buffet: "If you don't understand this in the first five minutes, you possibly never will".

Far from extolling value investment as "the only valid investment method" (5), I believe it is fair to say no other method is so lucrative while letting practitioners sleep so well.

Regarding the "eternal" debate over what is cheap and what is expensive, everyone is free to use their own method of valuation but I believe the best recipe is the following: an investor is buying cheap when he hopes the share price of the company bought on Monday will slump on Tuesday so that he can buy more shares. And if he doesn't want that to happen, he shouldn't buy.

I sincerely believe that by following these two rules, any investor can obtain a reasonably attractive return.

In my opinion, when an investor buys shares of a firm he knows well and pays a reasonable price, there is nothing more to say. But others may beg to differ …

3. Value or growth? Small Caps or Blue Chips…? …why not "two ways" of making money: easy money and hard money?

In order to segment a fund and its methods or returns, experts and the press alike suggest "compartmentalizing" each manager according to his style and comparing returns with other fund managers who use the same style: "comparing apples to apples", as the argument goes. I do not believe in the differences between "value" and "growth" management or in investment styles based on big or small companies. I believe that an investment should consist of knowing what you are buying and buying it at the cheapest possible price.

Based on my own experiences (and I have no wish to create any "new categories"!), I would say that returns can be classified as "easy" or "hard"; and this is, I believe, a significant distinction.

3.1 "Easy money"

Here is a theoretical example based on real figures (but not proportions). If there are 100 listed companies in the world, all experts (analysts, brokers, fund managers, journalists) "FOLLOW" (i.e. write about, research or study) barely 40 of them. This means that 60 companies are COMPLETELY UNKNOWN for most experts (6). These are usually small companies, sometimes local firms or companies releasing little information about themselves, sometimes with low average daily turnover, etc. But their real beauty lies in that for whatever reason almost nobody (big brokers, fund managers, analysts) knows anything about them. While they may require more in-depth analysis, sometimes a market niche leader can be found trading at ridiculously low multiples.

I call this type of investment "easy money" because these companies are undervalued simply because few investors know they exist. It is true that if nobody were to realize they exist, they would be condemned to remain undervalued and would not be a good investment opportunity in the long run. **But this DOESN'T EVER happen,** or at least this has been my experience in the dozens of investments of this type I have made: so long as the calculated value is correct, either the share price rises or a take-over comes. I call these investments "easy money" because they're real no-brainers. Take for example an investment in the shares of a leader in its niche that go from trading at 6x to a P/E of 12x (see Esprinet between August 04 and May 05). Does it have a lot of MERIT?? NO.

This is important because "easy money" is becoming increasingly difficult to find as the number of assets under management grows. (7). With more assets under management, a larger number of no-brainers has to be found to maintain their impact on returns. In our global equity fund (with a universe of more than 20,000 listed companies in the US and the UK alone), the problem, more than whether or not sufficient opportunities exist, lies in our ability to research these stocks (we have a limited number of man hours per day). When we will reach "100% capacity utilization", we expect to carefully hire additional managers fitting our investment profile.

3.2 "Hard money"

Here I include investments in companies which are KNOWN but generally "derided" by the market for the "usual reasons": analysts don't expect short-term earnings growth (here patience is enough to make money), or the firm is going through a big but solvable problem, or simply the market does not "like" the management team for what we believe are the wrong reasons ...

In this case, BUYING means taking **an active DECISION against the consensus:** ie "what if earnings stay flat for a couple of years", or "what if the problem is a one-off and gets solved" , or simply believing in an honest management team which refuses to follow the Street recommendations (I like particularly the one on "taking more leverage to get efficient balance sheets", I love when a management team refuses to follow this!!)

<u>The advantage</u> of these "bigger but tougher" investments is the Return on research (ie you can easily buy a lot of shares to leverage the work spent on study). <u>The risk</u> lies in falling into what we call a "value trap" (8). If we have serious doubts, we will extreme caution and work to the full the arguments of the bears (further talks with competitors, employees, the regulator, suppliers, customers, etc...(9)) before being carried away by something that is optically cheap (and perhaps effectively expensive or at its fair price!)

3.3 Some investments to obtain "hard money" are not as hard as they seem ...

As difficult as it may be to make money by investing in well known companies against the consensus, I would mention three cases in which the money is not so "hard" as long as some precautions are taken.

Downturns

Cyclical companies alternate periods of large profits with other less favourable times in which earnings are much lower or in the red (10). If shares are bought when profits are lower than average, investors will almost certainly make money. The only caveat is to make sure the companies selected are reasonably efficient and have a sufficiently sound balance sheet to withstand a prolonged downturn, (for example: buying Acerinox or oil companies at the end of 1998). While I almost always buy too early (11), these are investments that generally work well and do not carry as much risk as the front pages of papers or bearish articles would suggest.

Turnaround stories

These are companies losing money or under-earning. Buying turnarounds is almost always risky, but in a few cases it isn't. For instance, when consolidated losses "hide" other profitable divisions whose value covers the entire market cap…. In my experience, the most common case is the company whose business works well in its country of origin but fails to take off abroad (for instance; Adolfo Domínguez in 1999). As soon as management realizes it (and either closes or sells the bad business) the shares recover swiftly to reflect the value of the good business.

Sound businesses with no-growth in sight for 1- 2 years

When a "good" company (strong market position, disciplined and trustworthy management team) goes through a period of "non-growth", it is usually penalised excessively by the market. If the shares fall to attractive multiples (i.e. Procter&Gamble in 1999), they are usually a good investment on a 4 - 6 year time horizon. The only source of "Alpha" here is PATIENCE.

4. Conclusions: De-mythifying fund management

Without wishing to DEMYTHIFY the fund management INDUSTRY, I do believe there is "excessive noise": every day thousands of analysts make macroeconomic forecasts on hundreds of variables, which are in turn sent to thousands of fund managers and classified and analysed by hundreds of rating agencies and publications who are constantly bombarded by millions of news items …

I know people with over 25 of "experience" who had just "watched Bloomberg screens" in their working-lives. I promise you they ignore all the basic things (the value of companies) but are experts of the irrelevant, unpredictable things (the level of IR, consumer confidence last indicator, etc…). I would be very careful before giving them money, despite the label "25y experience".

And I have met people with less than two years' experience but who have wisely used their time in company research and have bought only those they understood and were cheap. I would not doubt before handing some of my money over to them, despite the "junior" denomination in their business card.

I do not wish to make any far-reaching conclusions with this. But I understand today what I understood 10 years ago: that disciplined, daily analysis plus the two golden rules (1. "buy what you understand" and 2. "buy it CHEAP!") will give an excellent risk-adjusted return for many years to come to whoever decides to put them at work…

Notes:

(1) Although they did give us two rules. First, “Never lose money”. And second, “Never forget rule number 1”. Later I discovered that these rules were actually Warren Buffet’s.

(2) As with all the conclusions in this article, this echoes earlier and much-quoted advice from Warren Buffet and his partner Charlie Munger “to restrict one’s circle of competence”.

(3) … and “if you have studied everything you will have the best tool to evaluate whether the fall is justified or a buying opportunity”

(4) This is important because it is often difficult to check as many points as we would like. However, looking at statements for 8-10 years we can see more easily whether profits are “real” or not. This requires advanced accounting knowledge (i.e. to be able to “square” the income statement and balance sheet with the cash flow statement). Warren Buffet said of those who invest without this accounting knowledge are “like a one-legged man in an ass-kicking contest”.

(5) There are many investors who have apparently made huge profits using macroeconomic analysis, technical analysis or even quantative analysis. But to date there is no large, HOMOGENOUS group of investors that has made huge profits using similar techniques or using the technique stated above. The “superinvestors of Graham and Dodsville” (which include Ben Graham, Warren Buffet, Bill Ruane, Walter Shloss and many other lesser known figures) are a group of investors who obtained very high returns over a long period of time by applying the same principles. After chatting to me for an hour, one Bestinver customer, with no knowledge of the markets (but a holder of four university degrees and a very astute man) said: “You make investments based on the value of a company … BUT is there any other way to do it?” ….I couldn’t think of an answer to that.

(6) Because they are not mentioned in the newspapers, because they are not “covered” by analysts, because they only publish their financial statements in the language of their country or because they do not hold regular information meetings with analysts.

(7) In general, “easy money” is to be found in smaller companies as the bigger ones are usually widely known. But where does the definition of “big” begin: we have encountered “easy money” in companies with market caps of up to EUR2bn, i.e. bigger than 70% of the companies listed on the Spanish continuous market!

(8) Where the apparent undervaluation of a company is only optical, and in reality the problems are more long-term. Here we talk of “permanent impairment of value” as THE thing to avoid above everything (ie a case in which the level of future profits will never return to previous higher one)

(9) The mythical investor, Phil Fischer gave the name “Scuttlebutting” to the process of “checking” which consists of talking with as many agents (customers, suppliers, employees, competitors) related to the company as possible.

(10) This is the case of commodities producers (i.e. steel, oil and raw materials in general), who generate large profits when the price of what they produce is high and may even lose money when it is low; but also for other types of company such as auto manufacturers or those which depend on advertising (i.e. newspapers).

(11) You are buying “early” when the negative period undergone by the particular company you are investing in (steel company, oil company) lasts longer than it is expected to. In such cases, the shares may continue to fall (sometime sharply!), even though you have bought them “cheap”.