PORTFOLIO MANAGER'S REVIEW

THE MANUAL OF **Ideas**
SERIOUS IDEAS FOR SERIOUS INVESTORS™

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When asked how he became so successful, Buffett answered: "we read hundreds and hundreds of annual reports every year."

Edited by the *Manual of Ideas* Research Team

"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Top Ideas In This Report

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About Portfolio Manager's Review

Our goal is to bring you equity investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary screening methodology to identify opportunities that are not yet widely followed by institutional investors.

John Mihaljevic, managing editor, is a fund manager, former banker and analyst. He is a member of Value Investors Club, an exclusive community of top money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude,* from Yale and is a CFA charterholder. He resides in New York City with his wife and two kids.

INFLATION PROTECTION SERIES – PART II:

BUSINESSES WITH PRICING POWER AND LOW CAPITAL INTENSITY

► **For-Profit Education Firms**
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Companies mentioned in this issue include:

51job, Acxiom, Administaff, Alliance Data Sys., Ambassadors Group, American Public Education, AMN Healthcare, Apollo Group, ATA, Automatic Data, Barrett Business Services, Bridgepoint Education, Burlington Northern, Capella Education, Career Education, CDI, China Distance Education, China Education, Chinacast Education, ChinaEdu, Coca-Cola Company, COMSYS IT Partners, Corinthian Colleges, Corporate Executive, Cross Country Health, DeVry, Diageo, Dice Holdings, Dr Pepper Snapple, Dun & Bradstreet, Eaton Corp., Eli Lilly & Co., Energizer Holdings, Equifax, Exterran Holdings, Fair Isaac, Foster Wheeler, Franklin Covey, GlaxoSmithKline, G… Strategies,
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Inside:

Exclusive Interview with Guy Spier, founder and CEO of Aquamarine Capital Management

With compliments of The Manual of Ideas

Exclusive Interview with Guy Spier

Guy Spier of Aquamarine Capital is a noted value investor and speaker on investment management. Guy's willingness to share his insights with fellow value investors reminds us of Buffett's penchant for sharing his wisdom with those eager to benefit from it. Last November, Guy spoke on global value investing at the Darden Value Investing Conference in Charlottesville, Virginia.[1] This past May, he was at the Value Investing Congress in Pasadena, California,[2] making a case for global for-profit education providers Estácio (Brazil: ESTC3)[3] and Raffles Education (Singapore: E6D).[4] Earlier this month, Guy presented at the Value Investing Seminar in Molfetta, Italy, highlighting an opportunity in London Mining (Oslo Axess: LOND).[5] His speech was entitled, *Navigating Between Fear & Greed Using Checklists.*[6]

On The Investment Process…

MOI: **Your fund has outperformed the market indices by a wide margin since inception, posting a cumulative net return of 115% from September 1997 through June 2009, compared to cumulative returns of 9% for the Dow Jones Industrial Average, 0% for the S&P 500 Index and -13% for the FT 100. Do you use short-selling or leverage in the portfolio and how concentrated is your fund typically?**

> *The trend of the market is up, not down. Shorting stocks puts you against that trend…*

Guy Spier on short selling: I do not use short selling. The fund has not shorted a stock since the 2002 to 2003 time frame. At that time I did short three stocks, on which I broke even on two and made money on one of them. The experience taught me that I was not going to be using short selling going forward for a slew of reasons. The first is the straightforward logic of the matter. The trend of the market is up, not down. Shorting stocks puts you against that trend and thus makes it more difficult to make money. Other than a time period like the one we've gone through, short selling will tend to be a difficult strategy to make money with.

Second, the mathematics of shorting – when you short something and it goes down, it becomes a bigger and bigger part of your portfolio, thus creating increasing risk as things go against you, making it an unbalanced and unstable thing to manage. By contrast, when you go long something and it goes against you, it becomes a smaller and smaller proportion of the portfolio, thus reducing its impact on the portfolio. So there is a tendency for long positions to self-stabilize in a certain way – they have a stabilizing effect on the portfolio, whereas short positions have a destabilizing effect on the portfolio.

[1] Watch Guy's speech at http://manualofideas.com/blog/2008/12/tom_russo_and_guy_spier_on_glo.html
[2] Read our notes from Guy's presentation at http://manualofideas.com/blog/2009/05/vic_live_blogging_guy_spier.html
[3] The investor relations website of Estácio may be accessed at http://www.estacioparticipacoes.com (English language version available)
[4] The investor relations website of Raffles may be accessed at http://www.raffles-education-corporation.com (available in English)
[5] The investor relations website of London Mining may be accessed at http://www.londonmining.co.uk/investors.asp
[6] Read our notes from Guy's presentation at http://manualofideas.com/blog/2009/07/guy_spier_live_blogging_the_va.html. To download the full presentation, visit http://www.manualofideas.com/files/content/guy_spier_presentation_2009-07.pdf

This results in two things. First, it means that if you are going to short, you have to make each short position a small proportion of the portfolio. Most of the people I respect who do short make their short positions no more than 1% or 2% of the portfolio, which means that in order to derive advantages from it, you need to short a lot of stocks. The other effect is that you have to be super vigilant. When you have shorts in your portfolio, you have to be watching them all the time, looking for indications of something that will cause the stock to go up on you many multiples and thus eat away much of the value in your portfolio.

That is not the way that I want to run money. What I found when I was short the three stocks was that I was doing things, and having to pay attention in ways that I don't think my brain is wired for. As you know, and many of your readers know, much of investing is finding a way to invest successfully to play the odds which are in tune and in congruence with the way your own nervous system is wired. I think that there are some people out there who have nervous systems that are wired to do shorting very well. I take my hat off to them, but I am not one of those people.

I would also add that short selling falls into a category of trade that Nassim Taleb has described very well in *Fooled by Randomness*. It has been described as picking up pennies in front of a steamroller. There are many trades that appear to be profitable on a cash basis, meaning that one can go for years picking up the pennies, showing an income, while pretending to one's self, or one's risk managers, or investors that the risk of a loss on that trade is minimal to zero. The practical reality is that one can go for long periods of time on those trades and can do just fine until a big bath happens that eats away all of the previous profits that were gained. I would argue that short selling is one of those kinds of trades and the big bath is exemplified by the experience that people had in the recent Volkswagen/Porsche pair trade. The price of VW went up many, many, many times and resulted in a huge loss for the people who were in that position, potentially wiping out many years of shorting gains.

…short selling falls into a category of trade that… has been described as picking up pennies in front of a steamroller.

I see a lot of these kinds of opportunities, and the right thing to do is just to say "no." I think one of the hard things about these types of trades is that they are extremely attractive. They are dressed up to look extremely sexy for the kinds of people that are thinking about investing in funds like mine. I think that often investment managers consider doing them not because they believe in the trade themselves, but because they know it will be attractive to certain types of investors who perceive the trade as being smart. I think that the best thing to do is walk away from them.

Guy Spier on leverage: I was actually levered to 110% of the value of equities, so 10% levered in 1998, as I purchased more securities during the Asian crisis. I was very lucky, because everything worked out for me and I made a little bit more return as a result. Since then, the fund has never been leveraged for a very good reason. Most of the people that you and I know, the readership of your fine publication, will be in trades that will make them money provided they can play out their hands.

We know that leverage can prevent you from playing out your hand because exactly the time when markets go into crisis is when your credit gets called. I am aware of funds that had their credit lines pulled at the most inconvenient times and suffered catastrophic losses which would not have been suffered had their credit not been pulled.

It is worth saying that except in the case of a very large fund that can arrange for some kind of long-term loan from their broker, the loans tend to be overnight. You get money overnight and the trades can usually be liquidated within a very short period of time. Good investment ideas usually take months, if not years, to play out. I would argue that levering up an investment portfolio, even if it is composed of liquid securities, is a profound mismatch of assets and liabilities.

I think that the experience of Bear Stearns and Lehman Brothers exemplifies this case. They were borrowing money short-term and the investments they were making were liquid, so from the perspective of the lender they were not bothered because they knew they could force the brokerage firm to liquidate in order to pay their short-term funding. The reality was that the bets that they were making needed time to play out and to the extent that those firms didn't have the time to let those bets play out, they suffered insolvency, and that is not something that I am about to do for my investors.

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Guy Spier on concentration: The portfolio was extremely concentrated in that about six positions were as much as 85% of the total value of the fund. I think that part of the reason for my substantial decline in 2008 was the fact that risks that I was not aware of cropped up in the portfolio and impacted some positions substantially. If I were able to go back in time and look at the information I had, I am not sure I would not have owned the things that I owned. However, I think that one of the ways I could have protected my investors from such a substantial decline is to have less concentrated positions. Going forward a 5% position will be a full position. An idea will have to be something absolutely extraordinary to become a 10% position and many positions in the portfolio are currently 2-4%.

***MOI:* When it comes to stock selection, you have talked about the importance of checklists. Why are they so crucial, and what are some of the key items on your checklist?**

Guy Spier: Those readers who have seen my two or three presentations know that I have talked about checklists. All of these ideas have emerged from conversations with Mohnish Pabrai, who noticed an article by Atul Gawande in *The New Yorker* with profound implications for investors. I'll share the basic insight that I have had as a result of these conversations: I think that we just have to acknowledge that there are some individuals out there — I think Warren Buffett in the investment world is one, Ajit Jain in the insurance world is another — who have a very particular ability to rationally analyze a situation in spite of crazy things going on in the world.

Most of us do not have that specific wiring. In spite of that, we can still improve our decision-making an awful lot by using checklists. The main way that I see it is that the investment world, either by design or by nature — and I think it is a combination of the two — throws up plenty of information that is designed to trigger one of two areas in the brain.

One is the threat detection fear mechanism, which throws up a very primeval response that has evolved within us for a very long time. It is one of the oldest parts of our brain — the fight-or-flight response. When we see something that makes us fearful, and we don't have time to act, analyze and make weighted judgments, we have to decide either to run or to stay. We all know days in the market where that part of an investor's brain is dominating and in which share prices can move around rather dramatically when compared to what appears to be very small amounts of news. So that is one sort of mode that the markets can be in, which is really the psychological mode of the majority of the participants in the market.

Then there is another side, which is irrational exuberance, as Alan Greenspan has described it, where the part of the brain that is being triggered is, as I've seen it described in various articles, the pleasure center of the brain. It turns out that the part of the brain we stimulate by the expectation of future profits is not that far away or dissimilar to the part of the brain that is stimulated, or lights up in CAT scans, when cocaine addicts either contemplate or are taking cocaine. These are very powerful centers.

Whether it is the fight-or-flight or the expectation of pleasure centers, the effect of both is to short-circuit rationally considered thoughts. They undermine the path of the brain that can make weighted, careful judgments about probabilities and about expectations. My perception is that it is the rational neocortex from which flow the very best investment decisions. Unfortunately, the world in which we operate is a minefield of opportunities to get caught up either by the fight-or-flight or by the pleasure center. So to the extent that somebody will talk about an investment being good when one is trembling with greed – I would not subscribe to that because trembling with greed implies that your greed and pleasure mechanisms in the brain are dominating the rational side.

A checklist pulls us away from the kinds of actions that we would take if we were in either fight-or-flight or greed modes.

I think that somebody like Warren Buffett is naturally wired not to be in either of those two extremes and spends his time in the happy middle. I think that what the rest of us human beings can do to train ourselves to be in that happy middle is use checklists. A checklist pulls us away from the kinds of actions that we would take if we were in either fight-or-flight or greed modes. So that is the basis for checklists.

The example I have given in talks is an airplane that is crashing. There is no question that checklists have been extremely helpful in reducing airplane accident rates. What it does is it brings the brain back to the place where one can make rational decisions.

***MOI:* What advice would you give other investors on building an effective checklist? Is it primarily a product of past investment experience, i.e., mistakes — and if so, how does one differentiate between mistakes that should go on the checklist versus others that are simply unavoidable?**

…in terms of building checklists, there is no question that the place to go is past mistakes.

Guy Spier: Obviously, in terms of building checklists, there is no question that the place to go is past mistakes. Not only one's own past mistakes, but also to look at other investors' past mistakes and see what those mistakes were. It seems to me, and it is a process that I am still going through, that the more specific the checklist item is the better.

I can give an example of an investment that I made where the CEO of the corporation was going through a divorce — a long, protracted and bitter divorce. In retrospect, when I look at what went wrong in that investment, I can see very clearly that the fact that he was going through this divorce meant that the CEO was much less able to focus both on the needs of the business and on capital allocation decisions. His whole investment, in fact, would have gone to his former wife if she had won the lawsuit. The whole company would not have belonged to him. So his emotional ties to the company were predicated on the outcome of the court case. His desire to make money for the company's shareholders would have been hugely diminished if his wife had ended up controlling the company. So one of the items in my checklist is whether the CEO is going through major divorce proceedings, in which case I would tend to weigh that very heavily.

To give an example of checklist items that don't come from individual or personal mistakes is the example of Coca-Cola and its ownership by Berkshire Hathaway. There was a period earlier this decade when Coca-Cola was trading at a multiple which was as high as 40 to 45 times earnings. We all know that Warren Buffett did not sell. I think that there is at least one statement in the public domain where he said that if given the chance to revisit that decision, he would have sold Coca-Cola.

…checklists are not wish lists.

I ask myself to what extent he was unable to make that choice at the time and execute a sale because he had already made public statements in the annual reports and elsewhere that Coca-Cola was an inevitable and permanent holding of Berkshire Hathaway. Making such a public statement is a very powerful driver of commitment consistency bias, which may have affected his ability to make rational decisions.

So what would go on the list? You would ask yourself the question, "Have I made public statements about this?" Obviously, the note to self is, don't make public statements about positions you own that will predispose you towards owning them or not owning them or being able to sell them or not.

There is another example from Berkshire Hathaway, which is the acquisition of Cort Furniture, which did not turn out to be the phenomenal acquisition that some commentators suggested it was. It seems that one of the reasons is that Cort was in the business of renting furniture to people who had a temporary need. Cort benefited dramatically from the Internet bubble in which many companies were setting up offices that needed to be furnished rather quickly and had large amounts of money to spend. In the aftermath of the Internet bubble, the demand from that portion of the market was extremely attenuated and Cort's earnings power was diminished significantly.

The basic insight that seems to have not been applied in the Cort acquisition, which has gone onto my checklist, would be, "Am I investing in an industry or a company that is benefiting from another industry that has just experienced a dramatic boom?" Another way of saying the same thing would be, "Am I investing while looking in the rear view mirror rather than looking at the road ahead?" Whether they are yours or somebody else's, I think that mistakes are the most fruitful place to look for checklist items.

It is important to note that checklists are not wish lists. Obviously, we are looking for certain kinds of businesses and certain types of investment. That is what we are navigating for. The checklists are very specific items that are designed to bring our brains away from the influence of greed and fear. I would argue that I am not sure a mistake that is unavoidable is a "mistake" in terms of your question. I think that there are so many ways where one can go wrong. In retrospect we can see what we should have known. It is hard to control for the unknowable, because it is by definition unknown. The more one can throw onto an investment checklist, the better.

…no investment is going to pass every single investment checklist item. What the investment checklist will do is to throw up issues that one should focus on

It is worth pointing out that no investment is going to pass every single investment checklist item. What the investment checklist will do is to throw up the issues that one should be focused on. Then an investor can try to weigh them to decide if they negate the benefits of the investment or not. One of the things that the checklist has done for me is to bring up the basic question: "Are we stretching to make the investment?" In this way investing is very similar to golf. In golf, one never hits a good shot if one is stretching or pushing oneself. The best golf shots come when we are acting well within our capacity. To that extent, a term that I do not think should apply to investing is, "I spent time getting comfortable." The investment should leap out to you. If you are trying to get comfortable with something or it takes too long for you to get comfortable with it, then it is probably not a good investment. You shouldn't have to get comfortable. That implies to me that I would be stretching.

***MOI:* What is the single biggest mistake that keeps investors from reaching their goals?**

Guy Spier: The biggest mistake is when we as investors stop thinking like principals. I think that when we think as principals, when we apply Ben Graham's maxim that we should treat every equity security as part ownership in a business and think like business owners, we have the right perspective. Most of the answers flow from having that perspective. While thinking like that is not easy, and most of the time the answers are not to invest and to do nothing, the kind of decision-making that flows from that perspective tends to be good investment decision-making.

I'll just give you examples from my own life and from people close to me of the ways in which that perspective can be deformed by the environment and circumstances. It can be deformed by having the wrong investors — investors who see you, the investment manager, as a proxy for their desires.

I had an experience with an investor who was admonishing me for holding too high much cash. The investor claimed that they were not paying me to hold cash balances. Well, that created a pressure on me to get fully invested. The person making the investment wanted me to show that cash was being put to work. I was responding to the situation rather than to the logical and rational dictates of having a prudent amount of cash. I was responding to the actual demand of the client. To the extent that I did respond to that pressure, I was acting less like a principal and more like somebody that was putting together a marketing story.

In another example, to the extent that I have been associated with the for-profit education industry, I have received questions as to why I don't market my fund as a global education fund. Again, if I were to do so, I would no longer be acting as a principal trying to maximize the return on investment for my shareholders, but I would be seeking to market the fund by appealing to a particular niche audience. That could result in some substantial misallocations of capital.

I think that this mistake comes in varied forms and it influences all of us. When we talk about creating the best environment for making investment decisions — a lot of that entails investing within the right structure, the right incentive structure. It also comes from having the right investors as partners and aggressively moving away from and not engaging with people who show themselves to be the wrong type of partner because they are focused on the wrong thing. I think that everything falls from having a principal's perspective.

… whenever something in Seth Klarman's portfolio is trading below the price that he paid for it, it is worthy looking at.

MOI: **How do you generate investment ideas?**

Guy Spier: My answer is "all of the above." The nature of a good investment idea is that it puts together new facts in old ways or old facts in new ways. You need to have the mental flexibility and creative ability to see something new and see why it fits together in a certain way. I think that the answer in my case is to look at everything, to do everything in a certain way, and to reserve a lot of time for thinking.

I read other managers' letters. I look at the positions they own. The lists of portfolio securities that other managers own are very useful because it means the investment has already passed a very important filter. I think that whenever something in Seth Klarman's portfolio is trading below the price that he paid for it, it is worthy of looking at, and at the same time, it performs another function. To get better at investing you want to study the moves of the masters.

I also read a number of industry publications. The publications vary at any time depending on the particular industries that I am interested in and what subscriptions I have decided to subscribe to. One subscription that I have right now is to The Nilson Report on the credit card industry. Based on my interest in following the U.S. banking sector I recently subscribed to *The American Banker.* I also recently subscribed to *The Oil and Gas Journal.* These are all interesting journals that don't necessarily throw up investment ideas *per se*, but they throw up background information. While a lot of this information is available on the web, it is very nice to look at it in the form of a publication.

So, wide reading, including the daily newspapers, is important. I like to screen for companies, but increasingly I have found that your service and other people present me with screens that perhaps provide a shortcut. Having said that, it is also worth saying that I don't think there is any shortage of ideas for anyone who is interested in investing. It doesn't take a moment of browsing on the Internet before you have 30 ideas to look at.

The real question is, as I look at the ideas, why am I discarding them and what personal biases am I engaging in as I discard them? I think something I have seen in a number of portfolios, including my own, is that the contents of the portfolio are a reflection of the particular biases of the person running the portfolio. To the extent that those biases or the model of the world that person has is faulty, it can lead to either phenomenal returns if the stars are aligned or it can lead to very bad returns if the stars do not align.

As I look at other people's portfolios, I look to understand what their biases are and what particular chinks in their armor they may have. They may have a predilection for small-cap stocks or they may have a predilection for niche companies with niche ideas. Ultimately, what I can say for myself, I have had a bias towards low-capital invested, high-ROE businesses. In general, that is a bias that has probably been very productive. However, there are environments, particularly the one that we have just been through over the past 18 months, where that has probably hurt the portfolio more than it has helped the portfolio. So the way in which we go about generating ideas is obviously both important and critical and I think that ultimately it is a journey to explore our own personal biases.

On Global For-Profit Education…

… the need for relatively low skill levels has attenuated and the need for people with high skill levels has grown dramatically.

***MOI:* Please share with us your thesis on global for-profit education. Which countries are particularly good places to invest in this growing trend?**

Guy Spier: The thesis on the global for-profit education business is a very simple one. We have an educational infrastructure whose legacy was the industrial revolution. This has been valid whether we talk about China, Brazil, the United States, or Western Europe. The basic outlook was that the vast majority of people being educated would go to work in factories. They didn't need more than a certain level of education. These educational systems would then skim off the very best who would go off to be lawyers, doctors, and accountants – white-collar suited pen pushers.

The IT and post-industrial revolution that we have been through and continue to go through over the last 30 years has been one in which the need for relatively low skill levels has attenuated and the need for people with high skill levels has grown dramatically. Whether it is people who can do research into biochemistry and biotechnology or whether it is people who are developing gaming software for the gaming industry. Obviously the people who design computer chips or computer programmers need to achieve a certain skill level.

In every growing part of the global economy, you have the need for highly skilled workers, and the infrastructure is just not set up to generate the number of people we need. For various reasons, the private and the state sector are very slow in responding to those needs. What has jumped in to fill the gaps are the for-profit institutions, which are very responsive to the needs of people who need to improve their skill sets and to prove their marketability in the workforce. That creates the demand for education.

I should add that in emerging markets the demand is dramatically heightened by the fact that these economies are trying to grow at a rapid rate, and most of the growth comes from the sectors which require skilled people. I would argue that in places such as China and Brazil there is a dramatic shortage of skilled people.

Then we come to the supply side. It turns out that the supply of educational services is profoundly constrained for a number of reasons. I think that this relates to the work that I did in the credit rating business, and there is much that is similar. First of all, the education business tends to be highly regulated. In most countries around the world, you cannot just go and set up a post-secondary college and expect to be allowed to stay in business. There are regulatory requirements which have to be met, and the tendency in all regulated businesses is that the leaders and the largest companies tend to dominate the regulatory process. There is a good aspect to the regulatory process in that it raises standards in the industry and it ensures that you do not have charlatans and fly-by-night companies engaging in the industry. At the same time, it has an anti-competitive effect. Now, from the consumer perspective, that is not good. From the perspective of an investor in those industries it is very good.

[Regulation] raises standards in the industry and ensures that you do not have charlatans and fly-by-night companies engaging in the industry. At the same time, it has an anti-competitive effect. From the consumer perspective, that is not good. From the perspective of an investor in those industries it is very good.

The other side of the story, which is not regulatory, is equally important. There is a reputational and branding effect which takes place when an educational institution has been around for some time, in which the very fact that you have attended and studied at a certain place gives you credibility in the marketplace. There are a limited number of brands that people can carry in their heads. We all know that when it comes to the United States, it is extremely unlikely that any university would displace Harvard, Yale, or Princeton. This branding effect also extends to the kinds of colleges that are offering for-profit degrees in that when they establish a brand, it becomes very marketable. The students who are going for higher education to improve their skill sets are not going to attend any institution. They are going to attend an institution with a good brand.

There are two final elements to the thesis. First, the return on investment to the student is extremely high. This is something that has been studied across economies and has been shown to be the case across many different economies. The payback of any degree, even if you spend $20,000 to $30,000 per year on a two-year degree — which is not as effective as a four-year degree — is usually within two years. Somebody earning $50,000 will end up, after they have finished their degree, earning $60,000 or $70,000. Thus, they can pay off the cost of the education very quickly.

The ROI on a degree has not been definitively studied, but I estimate to be well in excess of 50%, and the institution is only capturing a small proportion of that return on investment. Then when it comes to the institutions themselves, it turns out that you can have very high operating leverage, very high returns on invested capital, and very high returns on equity in these businesses because your customers benefit and because there are barriers to entry, both regulatory and other. That means that if you are established in the business, you can make very high returns. The key is to buy these companies at reasonable valuations and to buy companies that don't run into regulatory problems — that have a long hill to slide down.

…the international markets have been wide open for [non-U.S.] companies to pursue.

***MOI:* Do U.S. giants such as Apollo Group have a chance of becoming leaders in overseas markets, or do you expect "locally grown" companies to dominate?**

Guy Spier: I should say that I have not been particularly focused on the U.S. for-profit education sector, even though it is the most developed in the world, because my perception is that the companies have had extremely rich valuations.

I also think that since the U.S. market is so large and so full of opportunity, the majority of companies have focused, probably rightfully, on the domestic market. The result has been that the international markets have been wide open for other companies to pursue.

I can think of at least one non-U.S. company that has a substantial chance of becoming the dominant player in the for-profit industry over the next 20 or 30 years. But there are some very good United States-based companies that I believe will do extremely well. I have visited the operations of Laureate Education [taken private in CEO-led buyout in 2007] in a number of different countries. They do an outstanding job of running a campus and they also have a global vision.

I think that another company that is developing steadily internationally is Kaplan of the Washington Post [WPO], although they have been slower than Laureate to move internationally. The Kaplan testing service exam preparation service is already very international, so they have a good basis upon which to expand their operations.

A third company, DeVry [DV], has started to gingerly expand into international markets. They recently bought a company in Brazil and they have had their international medical school, Ross University, which is based in Dominica. They also have means for exploring expansion through Becker Review. The guy who runs international development is named Sergio Abramovich, who is a very interesting guy to get to know. So they are developing, but I would still argue that all those companies, except for Laureate, are very much American in their focus and that creates great opportunity for non-American companies to pursue international opportunities.

***MOI:* For-profit education providers have enjoyed significant pricing power despite the fact that many companies derive a majority of revenue directly or indirectly from government-supported loan programs. Do you expect tuition price increases to continue to outpace inflation?**

Guy Spier: It is true that the for-profit education providers have enjoyed significant pricing power. It is worth saying, as an aside, that education is a fantastic example of a Giffen good. Those of us who are economists will know that a Giffen good is something where the higher the price goes, the more we want of it. Examples usually given are luxury goods such as a Rolls Royce or a Rolex watch. Warren Buffett, in his own inimical way, has described this as when you go and buy a diamond ring for your fiancée. You don't want to come home and say, "Honey, I took the low bid." That is true when it comes to certain brands of chocolates, it is true in the case of high-end jewelry, it is true in the case of certain luxury goods, and it is also true for education. It is true in any place where price becomes an indicator of value. Where someone is engaging in a purchasing decision where there is a huge amount of uncertainty, they don't know much about the product they are buying, and they very much want to get it right. Price becomes one of the ways in which you discern that a purchasing decision is a good thing. This creates an incredibly strong business advantage for companies and enterprises that are leaders in their field.

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I have absolutely no doubt that the "Harvard Business Schools" of the world will continue to lead the industry in terms of price increases. As more and more people get rich around the world, they will all want elite educations. So as long as there is an increase in demand for their services, as there is today, the "Harvard Business Schools" of the world will be able to increase their prices at a greater rate than the rate of inflation. Those elite private universities create the pricing umbrella for the for-profit industry to move underneath. So if Harvard is raising its prices 10% per year, it is perfectly possible for a for-profit university to raise its prices 5% or 6% per year, and I absolutely expect them to do that.

It is true that much of the revenues in the United States come from government-supported programs, but ultimately the decision to take on the debt and the decision to attend an institution is taken on by the student themselves. If the companies were pricing their education above the value that their educational services would deliver to the student, then one could expect that the price rises would not continue, but that is not the case at all. In fact, studies would suggest that the value of an education is going up, not down.

One of the statistics you can look at to support this is to look at different economies and look at their salaries per degree. What is the salary of the non-college graduate workers? What is the salary of a college graduate? What is the salary of a master's degree graduate? The gap between educated and non-educated is increasing. In a knowledge-based world, degrees which help you work with knowledge become more valuable because you can add more value in the workplace. Therefore, the people who are offering these degrees can charge higher prices. I don't expect that process to end any time soon.

On International Investing…

MOI: **You have invested globally for a long time — what are the main pitfalls to global investing and how big a role do transaction costs play when investing locally in emerging markets?**

Guy Spier: I have been investing internationally for a very long time – since I started investing. The main insight I would pass along is that I try to see the world as borderless. I think this is a better way to see things. I am not too concerned as to where a company is based. I am more concerned to find the business qualities that I need to find in order to make an investment. While it is easier in the United States, I think that an investor is crazy to stop the search for great investments at the borders of the country that they happen to be living in.

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I think that the most profound pitfall and thing that one has to get over when investing beyond your borders is not to take the conditions that exist in the home investing country and assume that the same conditions exist in the country where the investment is being made. I have seen that going both ways. From the United States investing out, there are assumptions that investors have made about how the managers of the foreign company will allocate capital. There are also assumptions about what kind of standard managers hold themselves to. Not all managers of companies want to be remembered for being the best capital allocators. In some countries, being rapacious and greedy is considered a normal standard. Russia might be an example of that. At the same time, there are some countries such as Switzerland, where I would argue the ethics of drawing a modest salary and really acting for best interest of the shareholders are possibly even higher than the very high standards that already exist in the United States.

The reverse is also true. For example, Korean investors think that the United States is a very risky place to invest because they make assumptions about the way Americans act. I think that the key danger is that we make many assumptions that have to be checked and revised. One of the ways to do that is to spend some time in the country where the investments are being made. One of the rules that I have is that I want to be able to read the source documents in the language in which they are produced. I think there is a lot of subtlety that is missed when one reads a translation.

Transaction costs in international markets have been going down over time, so I don't think that they should be a big concern. I have been a buy-and-hold investor, and my average holding period is in excess of three years. To the extent that the transaction costs a bit higher, it has not been a deterrent for me.

MOI: **Is globalization irreversible?**

Guy Spier: The global economic downturn has made protectionism more popular. We absolutely know that. We see that in a number of different ways, and we all know as free traders that this is unfortunate but true. The anti-globalization and the anti-world trade movement is a strong movement. People who feel like their jobs have been lost and their livelihoods have been lost to workers from other countries have a specific and very genuine grievance which is something that all globalizing economies have to deal with.

To deal with it doesn't mean to ignore it. To deal with it means to find a way to buffer the effects of the jobs of these people going overseas. Of course, in theory a laid-off autoworker can become a creative web designer. However, the truth is that a laid-off auto worker may only be good at making cars. I have absolutely no doubt in my mind that this is one of the reasons why we pay taxes — to ensure that people who are laid off through globalization have opportunities to retrain and have opportunities to go into new professions and new jobs and be productive human beings.

In terms of whether globalization is irreversible, I would argue that it is absolutely irreversible in the same way that the phone created irreversible changes, and the Internet created irreversible changes. I would argue that much of what is driving globalization is actually the implementation of these new communications technologies around the world.

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One great example that I heard was of the remote Indian village in which there are no telephones. One day you install one telephone and the effect of that telephone is profound even though there is only one. Suddenly farmers can phone hundreds of miles away and discover the prices for their produce at markets. Suddenly, middlemen have a much diminished opportunity to engage in taking middleman profits. Farmers are able to discover weather patterns and storm fronts and thus plan when they plant and how they manage their fields. It is the subject of a talk that I have given. Once you have that convenience, you are not going to give it up at almost any price. Once you have lived in a concrete and steel constructed house, you are not going want to go back to living in a mud hut. Once you have had the benefits of speaking on the telephone to your loved ones, you are not going to want to go without that.

I would argue that globalization is inevitable and irreversible. It is similar to thinking that southern Manhattan once had fields and crops planted there. Over time there was an increased concentration of offices and residential activity in southern Manhattan, and the fields moved away from Manhattan such that you don't have any planted fields within at least a ten-mile radius of Manhattan, let alone southern Manhattan. The process by which southern Manhattan developed was inevitable and irreversible. Much as the probability that southern Manhattan would be ploughed over and turned into fields is extremely low, I would argue that the probability that globalization is reversible is equally as low.

And Finally…

***MOI:* What books have you read in recent years that have stood out as valuable additions to your investment library?**

Guy Spier: I sent Alice Schroeder's book[7] out to a bunch of investors. I think that it is a very valuable book to read. I know that it has been controversial, but setting that aside, I think that Alice probes into aspects of Warren Buffet's mind and psyche to reveal more of his personality with all of the foibles of the human being behind Warren Buffet.

[7] Alice Schroeder: *The Snowball: Warren Buffett and the Business of Life.*

For those of us that are big Buffett fans, that is a huge advantage. It helped me to understand why I am different than Warren Buffett. I think it is a valuable read in that regard. It helps to place his mind in the center of the decisions he has made. The book lets you look at the kind of emotional life that Buffett had growing up. I do not think his phenomenal track record could have come about without that emotional makeup.

There are three books that I have read not so long ago on complexity theory. I think that they are extremely valuable. One is by John Gribbin.[8] Even though I studied economics and I felt I had a good grasp of the kind of economics taught academically, I feel that the study of complexity theory as applied to the global economy is actually a much better model for understanding how the global economy evolves.

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One of the books is by Benoit Mandelbrot [9] who is famous for the Mandelbrot set. He also wrote a book about the fractal nature of financial markets. Mandelbrot is obviously a very modest guy because his fractal approach to financial markets predicts that sooner or later something like what happened over the last 18 months was going to happen. Unlike other commentators, who get in front of the TV cameras and say "I told you so," he has not done that. He is a true scientist.

Lastly, an investor of mine gave me one of the two books by Atul Gawande who is focused on the very small things that make hospitals better. One of the books is actually called *Better*. The other book is called *Complications*. Atul Gawande gives a sense of how you can be extremely knowledgeable and totally focused on the right outcomes and still fail by a wide margin to get close to the ideal that you would like. Of course, this has massive lessons for investors.

I recently took up bridge, so I have been reading a lot of bridge books. I am looking forward to going outside Borsheim's at the next Berkshire Hathaway meeting and playing bridge with whoever is willing to play me. I don't think that it is a coincidence that Buffett chose to put an area to play bridge outside of Borsheim's rather than chess or table tennis or any one of a number of other things. It is not just that Buffett likes bridge. He likes an awful lot of things. I think that he is sending a message, in his inimical way, which is not to force it down anyone's throat. But by placing an area to play bridge right outside of Borsheim's, Buffett is saying that bridge is more than just a great game, it is something that has really helped him, I believe, develop his mind. I think it can develop all of our minds in a way which is helpful to investing.

***MOI:* Guy, thank you very much for taking the time to interview with us.**

We remain indebted to David M. Kessler for transcribing the interview.

Guy Spier has been running Aquamarine Capital Management since 1995. Investors include friends and family, high net worth individuals, and private banks. The fund has market-beating returns, and has received mentions by Lipper and Nelson's world's best money managers. The investees can be obscure or they can also be very well known. The fund has also done well owning the shares of less understood, but very high quality, cash generative businesses.

[8] John Gribbin: *Deep Simplicity: Chaos Complexity and the Emergence of Life* (Penguin Press Science).
[9] Benoit B. Mandelbrot: *Fractals and Scaling In Finance: Discontinuity, Concentration, Risk.*