



# THE SUPERINVESTOR

**As the global financial markets roil under the credit excesses and investors come to terms with the leverage fallout, its time to get back to basics. Outlook Profit spoke to the legendary disciple of value investing, Walter Schloss, who has lived through 17 recessions and seen the best and the worst of times. In a free-wheeling telephonic conference that lasted nearly two hours, the 91-year-old spoke about his investing style and why he abhors debt. (That his aversion to leverage is deep-rooted was evident during the course of the interview where he said "I don't like debt" more than 20 times!)**

**Mohammed Ekramul Haque**

**H**e is not the most famous name in the world of stock markets because of his concise effort to keep a deprecably low profile. He has the distinction only a handful of investors have achieved in the history of stock markets generating returns of 16 per cent (after fees) against 10 per cent for the S&P 500 as an investor over four decades. None other than the world's richest man and the best known investor Warren Buffet calls him "super-investor" of Graham & Doddsville approach to value investing and a "flesh-and-blood refutation of the efficient market theory." While most of us feverishly look at quarterly earnings growth and takeaways from management meetings to gauge whether a particular stock is investment worthy, Walter shows how you can disregard those metrics and still come out tops in the investment game. His strategy? Simply buying stocks cheap.

Like most value investors, Walter would not like to play into anything that's unpredictable. That should explain why the man is no great fan of earnings. "Earnings have a way of changing, and it's far more fickle than assets." Even if you get your projections of earnings right, the market's view of the company's multiples that it deserves can change so he would rather rely on the book.

One of Walter's and, in fact, Graham's favoured investment strategies was buying stocks trading at 2/3rds of their net current asset values and selling them when the price got up to the working capital per share. "We'd have made 50 per cent on our money and the firm averaged about 20 per cent a year on that basis." However, with such stocks disappearing in the US, Walter decided to go for the second best value: buying below book.

Walter explains how by investing in such junk stocks quoting below book value you can insure yourself against the risks of investing and can stand to benefit from them. Companies and industries get into disrepute and nobody wants them because they don't make much money and since the market is looking for earnings, who wants a company that doesn't earn much? According to Walter, historically, such companies have made a comeback; a decline does not necessarily signify the end.

One signature feature of Walter's stock picks was that he never declared his holdings - not even to his investing partners. He would explain later that apart from preventing others from buying into his potential investments and, consequently, raising his purchase price, one of the real reasons was that most of his investors could not stomach the names of the stocks that he loved to invest in.

Walter displayed his hawk-eye on investments when he shorted Yahoo and Amazon just before the tech meltdown. Following the crash, Walter and Edwin liquidated their firm on not finding any more good buys. In the final years of his operations, the beauty of value investing sparkled yet again. In 2000, when the markets world over were bleeding, Walter

returned 28 per cent and, in 2001, he gave 12 per cent compared with the S&P's -9 per cent and -12 per cent respectively. Walter remained one-half of a two-man investment firm, the other being his own son Edwin. Together they worked out of a small room leased out to him by the other legendary value investment firm Tweedy, Browne and Associates. Working with a single phone they hired no employees. He would comment later that he would like to keep overheads to a minimum and more importantly that he did not have the heart to fire somebody!

Walter never went to college but got inspired into the world of investing after attending the evening school securities analysts conducted by Benjamin Graham in the New York University. He joined as an employee of Graham-Newman in 1934. Just after the Great Crash of 1929, the prevalent view of the stock market was so pessimistic that Walter's mother was criticised for allowing him to go to Wall Street. "There would be no stock market in 1940," people would say then, he recalls. In 1955, Graham decided to retire and, Walter, with his experience of working with Graham started his firm.

Though Walter Schloss is often considered an ultra conservative investor -- a person who will strongly and confidently tout his policy of investing below book -- the fact remains that he has shown that investing the way he does can work. He has a 40-year record to prove it. We would like to thank Walter's wife, Anna Pearson Schloss, for the immense help in assisting us through the telephone conversation. Excerpts:

#### **What did you learn from Graham about investing?**

Graham taught me about market valuation and I learned how to find stocks selling below working capital. In those days, you could find a slew of them. It was right after the Depression of '29 and the financial markets were still in decline. Today prices are much higher, and it's much more difficult to find stocks selling at deep discounts. So many investors today focus on earnings, but I focus on assets and don't try to predict next months' earnings, which is a much more difficult approach to investing.

#### **Can you tell us about your last visit to India?**

I was very upset when Japan attacked Pearl Harbor and I enlisted in the army soon after that. They sent me to Missouri for training and then they shipped me to Bombay. We landed in Bombay on the way to Iran. The Russians were attacked by Germany and we were helping with the truck assembly plant that supplied equipment to them. I received a medal from the Russians thanking me for my war effort. I traveled on the Rhona, which was sunk later during the war, and there was a loss of 1,190 lives. I guess I was lucky. I spent a week in Bombay because that's where we were repairing the ship.

## How did you get into investing in the first place?

In 1934, I got a job as a runner at a firm called Carl M. Loeb & Co. (Later to be known as Loeb Rhodes). The following year, I went to one of the partners of the firm and asked if I could get into the security analysis department, but they turned me down. The gentlemen I spoke with recommended a book written by Benjamin Graham called Security Analysis, and he said if I read this book I wouldn't need to read anything else; so, I bought the book and I discovered that Carl M. Loeb & Co would pay a fee to the New York Stock Exchange Institute to teach members of the firm who worked there the workings of the stock exchange, so I took the course.

Benjamin Graham was teaching the course on security analysis and I liked it. I graduated from there in 1939. After spending a year-and-a-half in Iran, I returned to the States and went to the Officers Cadet School. I became a second lieutenant and was posted in the Pentagon. After the war was over, Graham wrote me a letter that he was looking for a security analyst and I accepted the offer, and that's how I got started.

## What is the starting point for your stock pick?

First of all, I like to look at the balance sheet and I don't like debt because it can really get a company into trouble. I prefer to buy basic businesses with strong balance sheets. I try to protect myself from permanent loss of capital by investing in stocks that are depressed. My son, Edwin, and I look at computer screens to see which companies look reasonably priced, and then we send for the annual report.

I am largely interested in companies that are into manufacturing products, be it shoes or automobiles, rather than a television (broadcast) company or a radio company. As long as the company manufactures a product that is okay, I am game. In manufacturing companies too there are challenges. For example, automobile companies in America today run high costs because wages are higher here than say China. So you need to assess such things but largely we prefer products to services.

## Don't you miss out on a lot of opportunities if you focus only on manufacturing companies?

I probably will, but you know you have to live the way it is comfortable for you. For instance, I would not like to invest in a company like McDonald's even though it is successful, because in the restaurant business if people are poisoned by bad food then nobody wants to eat there anymore.

## What do you look for in annual reports apart from debt?

I like to look at the financial records to see the history of the company. If the company is a relatively new business, I probably wouldn't buy it because it would be much harder to evaluate. But if the company was in business for the past 20 or 30 years or so, you would get a wider picture of its track record and then you would look at the balance sheet.

## Do you dislike debt completely? Would you prefer a company with zero debt as opposed to a company with some debt?

I like to buy companies with very little debt so it has a margin of safety. If you've noticed, a great many companies today are in trouble because they've taken on too much debt.

## How do you assess when a company is truly undervalued?

When you look at any company, you see where the stock has been selling for in the past. You also see what the company manufactures. I like to buy basic businesses not high flyers that sell at huge multiples.

## How do you determine what is a high price?

I like to look at the market price versus the book value, because it gives you a good starting point. I like companies that sell near their book value. I find the Value Line Survey of stocks very helpful to get an overview on different industries. You have to do a certain amount of research.

## How often do you meet the company managements?

I'm really not in the position to run around the country to meet with management like Peter Lynch used to do. It takes too much out of you. I want to live to be a hundred, so I decided against doing so. I limit myself to looking at the annual report, the balance sheet, looking at the background of the company, seeing that the management owns a lot of stock in the company and the reputation of the people running it. You have to make judgments about each individual stock. If you do all this, you don't have to meet the management. I don't really focus on what the earnings are going to be next year, I try to protect myself and that I don't lose money.

## Are you still actively investing?

Not as active as I once was, but I do buy occasionally if I like something.

## What is your sell strategy?

I think it's much easier to identify when something is cheap rather than when to sell. We would probably sell at where the stock sold out in the past when earnings had recovered. If we think there is a possibility of a deal we are tougher on our sell price.

Sometimes we sell when the whole industry has moved up sharply, and there are also times when we sell because we find something better or cheaper. In value investing, if you find A has gone up but B is much cheaper you switch to the cheaper but generally we sell after a period of one year to get the benefit of taxes.



1945: As second lieutenant

## What do you mean exactly when you say you see the price of the stock in the past?

Basically, we see if we buy the stock at the 20's and, historically, the price has gone up to the 40's and 50's, when it gets back to the 40's and 50's we feel it has got back to where it was before.

But that does not mean that it won't go higher, but we just use it as a benchmark. If we think the stocks are still undervalued, then we hold it. We often find that we sell a little too early. But when you sell something you have to make it attractive for someone to buy it. So if you wait to the point where the stock is really overvalued then you run the risk of nobody wanting to buy it and it could go down again.

## What do you do if a stock falls further after you have bought it?

When we see something that has gone down in price a great deal, we buy it. We like to buy stocks on the way down. A lot of people don't like that approach but I'm comfortable buying on the way down.



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Factors needed to make money in the stock market

1. Price is the most important factor to use in relation to value.
  2. Try to establish the value of the company. Remember that a share of stock represents a part of a business and is not just a piece of paper.
  3. Use book value as a starting point to try and establish the value of the enterprise. Be sure that debt does not equal 100% of the equity. (Capital and surplus for the common stock).
  4. Have patience. Stocks don't go up immediately.
  5. Don't buy on tips or for a quick move. Let the professionals do that, if they can. Don't sell on bad news.
  6. Don't be afraid to be a loner but be sure that you are correct in your judgment. You can't be 100% certain but try to look for ~~wxk~~ weaknesses in your thinking. Buy on a scale and sell on a scale up.
  7. Have the courage of your convictions once you have made a decision.
  8. Have a philosophy of investment and try to follow it. The above is a way that I've found successful.
  9. Don't be in too much of a hurry to sell. If the stock reaches a price that you think is a fair one, then you can sell but often because a stock goes up say 50%, people say sell it and button up your profit. Before selling try to reevaluate the company again and see where the stock sells in relation to its book value. Be aware of the level of the stock market. Are yields low and P-E ratios high. If the stock market historically high. Are people very optimistic etc?
  10. When buying a stock, I find it helpful to buy near the low of the past few years. A stock may go as high as 125 and then decline to 60 and you think it attractive. 3 years before the stock sold at 20 which shows that there is some vulnerability in it.
  11. Try to buy assets at a discount than to buy earnings. Earnings can change dramatically in a short time. Usually assets change slowly. One has to know much more about a company if one buys earnings.
  12. Listen to suggestions from people you respect. This doesn't mean you have to accept them. Remember it's your money and generally it is harder to keep money than to make it. Once you lose a lot of money it is hard to make it back.
  13. Try not to let your emotions affect your judgment. Fear and greed are probably the worst emotions to have in connection with the purchase and sale of stocks.
  14. Remember the work compounding. For example, if you can make 12% a year and reinvest the money back, you will double your money in 6 yrs, taxes excluded. Remember the rule of 72. Your rate of return into 72 will tell you the number of years to double your money.
  15. Prefer stocks over bonds. Bonds will limit your gains and inflation will reduce your purchasing power.
- WJS
16. Be careful of leverage. It can go against you.

**When you identify a stock to buy, what will be your initial allocation? Do you keep some money to average if the stock falls?**

Well, you don't know how low it is going to get to begin with. I think if you think it is an incredible situation you should probably put in at least 50 per cent of what you would put in that stock. But sometimes, if we think, it is really good, we put 70 per cent. You never know because it could go up immediately and I think sometimes you think that the stock is not that cheap but you want a little bit to get your feet wet then you would buy only 10 per cent.

**What is your usual holding period?**

The average is four to five years; because when I buy a stock that is depressed it hardly ever turns around immediately.

**What is your biggest investment mistake?**

I don't want to tell (laughs)! Well, when I was working with

Graham in 1949 I think a man came to me and said that there is this company whose product is rather good because it deals with computers. I went to Graham and told him that I like the stock - it had risen quickly from 18 to 21 - and Graham said, "You know Walter, we don't buy that kind of stock." The stock then went up to 50, and in due course to 2000 before the stock was split. The stock was Xerox. It turned out to be a tremendous buy, but Graham did not want to buy it because he did not know enough about the business.

**What books do you recommend on investing?**

Benjamin Graham's Intelligent Investor with the updated version byw Jason Zweig.

**What is your favorite pastime?**

I love playing bridge. But, unfortunately, it's hard to get a game together. I also find traveling with my wife, Ann, very enjoyable. □