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MANAGEMENT ASSOCIATION

Issue XV

Spring 2012

Jim Chanos — Rooting out Fraud



Jim Chanos

Mr. Chanos is the founder and Managing Partner of Kynikos Associates, a firm he founded in 1985. Throughout his career, Mr. Chanos has identified and sold short the shares of numerous well-known corporate financial disasters; among them, Baldwin-United, Boston Chicken, Sunbeam, Conesco and Tyco International. His most celebrated short-sale of Enron shares was dubbed by *Barron's* as “the market call of the decade,

(Continued on page 16)

Tom Russo — “Capacity to Suffer” is Critical



Tom Russo

Thomas A. Russo has been a partner at Gardner Russo & Gardner since 1989. The firm has over \$5 billion under management, and he oversees \$4 billion as general partner of Semper Vic Partners limited partnerships, as well as in individually managed accounts. Prior to joining Gardner Russo & Gardner, Mr. Russo was at the

(Continued on page 31)



Alex Roepers

Alex Roepers — Concentration Key to Outperformance

Alexander J. Roepers is the founder and Chief Investment Officer of Atlantic Investment Management. Previous employers include Thyssen-Bornemisza Group and Dover Corporation, where he was responsible for acquisitions and divestitures. Alexander holds a Master of Business Administration from Harvard Business School and a Bachelor of Business Administration from Nijenrode University, the Netherlands School of Business, which he obtained in 1984 and 1980 respectively. Alexander is fluent in Dutch, German and French.

(Continued on page 44)

Julian Robertson — Looking for Competitive Spirit



Julian Robertson

Mr. Robertson founded the legendary investment firm Tiger Management, one of the first hedge funds. Mr. Robertson has trained and supported some of the best hedge fund managers in the world (collectively known as “Tiger Cubs”). He graduated from UNC-Chapel Hill and also served in the US Navy.

G&D: How did you get your start in investing and what has shaped your

(Continued on page 53)



Columbia Business

Pictured: Bruce Greenwald at the Columbia Student Investment Management Conference in February 2011.

The Heilbrunn Center sponsors the Applied Value Investing program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.



Pictured: Heilbrunn Center Director Louisa Serene Schneider at the CSIMA conference in February 2012.

Louisa skillfully leads the Heilbrunn Center, cultivating strong relationships with some of the world's most experienced value investors and creating numerous learning opportunities for students interested in value investing. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.

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Welcome to *Graham & Doddsville*

We are very pleased to present you with Issue XV of *Graham & Doddsville*, Columbia Business School's student-led investment newsletter, co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association.

Before we introduce you to this issue's cadre of outstanding investors, we would like to take a moment to thank several individuals who have made our time at Columbia Business truly special.

Our deepest thanks go to Bruce Greenwald, Louisa Serene Schneider '06, Tano Santos, and the entire Heilbrunn Center's Board of Directors for their outstanding leadership of the Applied Value Investing program at Columbia Business School. Their tireless contributions to improving the investment management curriculum at Columbia Business School were greatly noted and appreciated. We would also like to thank Heilbrunn Center's small but very capable staff of Julia Kimyagorov and Preeti Bhattacharji.

Noted value investor **Tom Russo**, member of the Advisory Board of Heilbrunn Cen-

ter for Graham & Dodd Investing, outlined his global value equity investing strategy. Mr. Russo noted that he focuses on companies with high reinvestment opportunities by management that possess the "capacity to suffer" through early burdens on reported profits in order to advance their competitive advantage. Mr. Russo detailed his investments in Nestle, Mastercard, Martin Marietta, Brown-Forman, and E.W. Scripps.

We were thrilled to speak with **Jim Chanos** of Kynikos Associates, one of the world's most successful short sellers and someone we deeply respect for his contributions to finding and calling out fraud in corporate America. Mr. Chanos discussed the early days of his career and outlined what qualities he believes are essential to being a successful short seller. Mr. Chanos also talked about his bearish view on the Chinese real estate market, the U.S. natural gas industry and for-profit education sector.

Julian Robertson, legendary founder of Tiger Management, talked about his history of mentoring numerous successful hedge fund managers. He also described the need for analysts to focus on companies with strong management teams. Mr. Robertson outlined his belief

that Apple and Google will continue to outperform and talked about some personal qualities that he believes are key to successful investing.

Alex Roepers, founder of Atlantic Investment Management, described his transition from being "Mr. Divestiture" at an industrial conglomerate to establishing his own firm, Atlantic Investments that has had a very successful investment track record. Mr. Roepers outlined his investment process, which is centered on staying within his circle of competence and having a very concentrated portfolio. Mr. Roepers described the reasoning behind his investments in Joy Global and Owens Illinois.

Robert Luciano, founder and managing partner of VGI Partners, outlined his investment philosophy, which closely mirrors that of Warren Buffett. Mr. Luciano detailed his investment theses behind Oracle and WD-40.

Our time at Columbia Business School was filled with many memorable moments and great friendships, and we are grateful to all the individuals who have made our experience so unique and wonderful. We hope you enjoy reading this issue of *Graham & Doddsville* where we have tried to highlight some of those special moments!

Robert Luciano — "Concentrate Capital In Your Best Ideas"

Robert Luciano, CFA is the founder and Managing Partner of VGI Partners. Mr. Luciano has over eighteen years experience gained as a portfolio manager, equities analyst and accountant. Prior to founding VGI Partners in 2008, Mr.

Luciano spent five years as an Executive Director and Investment Manager with Caledonia Investments in Sydney. Mr. Luciano earned his B.Com and M.Com from the University of New South Wales. Mr.



Robert Luciano

(Continued on page 58)

2012 CSIMA Conference in Pictures



William von Mueffling and Eduardo Silveira Mufarej



Daniel Loeb



Michael Karsch



Bruce Greenwald and David Einhorn



Daniel Krueger



And the hundreds of guests and students that made it all possible...

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2012 Pershing Square Value Investing and Philanthropy Challenge

Students and alumni gathered on April 25, 2012 for the Fifth Annual Pershing Square Value Investing and Philanthropy Challenge, a value oriented stock pitch competition, co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and Pershing Square Capital Management. The cash prize for the competition is \$100,000, half of which is directed to the school for philanthropic purposes, and the remainder to the winning teams. The prize structure supports the goals for value investors of doing well and doing good.

William Ackman, of Pershing Square, kicked off the competition by introducing the team of judges. Each team then gave ten minute prepared presentation of the idea that they had chosen, followed by Q&A.

The five finalists were selected from a pool of 36 teams, which enrolled in the Applied Security Analysis class at Columbia Business School. This highly practical investment management course was taught by Professors **Andrew Brenner** and **Naveen Bhatia**. Students learned the mechanics and philosophy underpinning idea search and selection, and the analytical elements required to reach defensible conclusion. They were asked to craft compelling written pitches that



would stand on their own and learn to deliver oral investment pitches efficiently and effectively.

Throughout the semester, investment management industry practitioners generously donated their time and worked closely with the teams to provide feedback and suggest further areas of research.

First place was awarded to the team of **Anna Baghdasaryan '12** and **Rohit Dhingra '12** who presented a long recommendation on Avon Products, Inc. (AVP). The judges agreed that Avon had been mismanaged in the past and the equity had significant potential for upside resulting from new management implementing a turnaround while the potential downside was minimal both due to the resiliency of the assets as well as the Coty bid. They were impressed by the depth of the Avon team's primary research and understanding of the underlying business (see write-up on page 6).

Our deepest thanks to Bill Ackman of Pershing Square Capital, Professors Brenner and Bhatia, the panel of judges, and the Heilbrunn Center for their sponsorship of this competition.

	Pershing Square Challenge Finalists	Investment Idea
First Place	Anna Baghdasaryan '12 Rohit Dhingra '12	Long Avon Products (AVP)
Second Place	Jonathan Au '13 Arjun Bhattacharjee '13 Rory Ellison '13	Long Ingersoll-Rand (IR)
Third Place	Rod de Crayencour '13 Jake Lubel '13 Grant Smith '12 Michael Durand '12 David Hendrickson '13 Sean Morgan '12 Robert Fournier '12 Ian Holmes '12 Kartik Nehru '12	Long Legg Mason (LM) Long FleetCor Technologies (FLT) Long H&R Block (HRB)

Judges

William Ackman	Pershing Square Capital
Anand Desai	Eton Park Capital Management
Craig Effron	Scoggin Capital Management
Mark Gallogly '86	Centerbridge Partners
Greg Hall	Blackstone Alternative Asset Management
Phil Hilal	Kingdon Capital Management
Alex Klabin	Senator Investment Group LP
Craig Nerenberg	Brenner West Capital Partners
John Paulson	Paulson & Co. Inc.
Scott Pearl	Seneca Capital
Whitney Tilson	T2 Partners, LLC

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2012 Pershing Square Capital Challenge in Pictures



Professor Andrew Brenner making opening remarks



Finalist teams make their case



Pressure is on... Q&A begins



Judges deliberate



The Verdict

Team Avon is the Winner of 2012 Pershing Square Capital Challenge



Anna Baghdasaryan is a second year MBA student in the Applied Value Investing Program. She is the Editor of *Graham & Doddsville*, Columbia's student-run value investing newsletter. While at school, she worked at Cantillon Capital Management, a global investments firm and at Clinton Group, small-cap activist-oriented hedge fund.



Rohit Dhingra is a second year MBA student at Columbia Business School. He has four years of work experience in IT Consulting, Equity Research and Technology Strategy roles, having worked with Adobe Systems, Amba Research and Sapient Corporation.

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Avon Products, Inc. (AVP) - Long Winner — 2012 Pershing Square Capital Challenge

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Recommendation:

At \$20 per share, Avon common stock represents an opportunity to buy an \$11 billion dollar iconic global beauty products company near its historical trough value. Avon's extensive distribution network in fast growing emerging markets and its resilient and pervasive brand name are valuable assets which have proven their ability to generate significant cash flow over 80 years across multiple cultures despite occasional and significant mismanagement. We see an upside of up to 100% in 2.5 years depending on new management's skill in improving operations as well as market conditions.

Business Description

Avon is the 5th largest global Beauty and Personal Care products company with \$11.3 billion in revenues. The Company is diversified across geographies, with ~70% of sales from fast growing emerging economies in Latin America, Eastern Europe and Asia Pacific. Avon has strong market shares in the range of 10-40% in color cosmetics, skin care and fragrance categories in countries such as Brazil, Mexico, Russia and Turkey. Large growth opportunities remain as per capita consumption of beauty products is still very low in emerging markets, with only \$11 dollars per year spent in China on beauty products relative to \$129 in the UK and \$217 in Japan. As a direct seller, Avon is very nimble relative to the big beauty peers as its sales are not reliant on well developed retail infrastructure. We believe that the company's model is very resilient due to the social aspect of their network and provides an employment avenue for women where such opportunities are in short supply.

Investment Thesis

We believe that Avon has been poorly run in recent years, with its board showing disregard for shareholders and tolerating revolving-door leadership and major operational faux-pas. Supply disruptions, combined with lack of innovation in a key area, skin care, have resulted in market share losses in recent years and have severely impacted the margins.

So why are we recommending a buy on this stock at this time? First, we believe that Avon will continue to be a beneficiary of powerful secular tailwinds in emerging markets. Second, we believe that the very credible new management team can pare back its bloated SG&A structure and settle the FCPA litigation that has been costing the company millions of dollars. Third, the new management team can also help mitigate the fulfillment challenges through strengthening the supply chain infrastructure of the company. These actions could result in significantly improved margins and >\$8 billion equity value creation in the next 2.5 years, representing an annualized return of 20-35% to shareholders. If the new management proves to be incapable of fixing the above mentioned issues, a strategic buyer like Coty will likely step in.

(US\$ in mm, except per share data)

Capitalization	
Share Price	\$20.00
FD Shares	431
Market Cap	\$8,619
Plus: Debt	3,237
Less: Cash & Equivalents	1,245
TEV	\$10,611
Dividend Yield	4.5%
Insider Ownership	0.2%
Short Interest	2.1%

	Summary Financials					
	2010	2011	2012E	2013E	2014E	2015E
Revenue	10,863	11,292	11,606	12,073	12,670	13,299
<i>Growth</i>	6.4%	3.9%	2.8%	4.0%	5.0%	5.0%
<i>Organic Growth</i>	6.0%	1.0%	2.8%	4.0%	5.0%	5.0%
Adjusted EBITDA	1,428	1,397	1,422	1,587	1,729	2,034
<i>Margin</i>	13.1%	12.4%	12.3%	13.1%	13.6%	15.3%
Adjusted EBIT	1,233	1,158	1,149	1,310	1,440	1,737
<i>Margin</i>	11.4%	10.3%	9.9%	10.8%	11.4%	13.1%
<i>Less: Restructuring</i>	(81)	(40)	(200)	(200)	(40)	(40)
<i>Less: Taxes @ 35%</i>	(403)	(391)	(332)	(388)	(490)	(594)
<i>Less: Capex</i>	(331)	(277)	(280)	(280)	(260)	(260)
<i>Plus: D&A</i>	195	240	273	277	289	297
<i>Less: Net Change in WC</i>	(22)	(36)	(37)	(34)	(44)	(46)
Normalized UFCF	\$591	\$653	\$573	\$684	\$895	\$1,094
<i>Growth</i>	69%	10.4%	-12.3%	19.4%	30.8%	22.2%

Based off of Base Case Estimates	Trading Multiples			
	2012E	2013E	2014E	2015E
TEV/Base Case Adjusted EBITDA	7.5x	6.7x	6.1x	5.2x
TEV/Adj. EBITDA - Capex	9.3x	8.1x	7.2x	6.0x
TEV/Adj. EBIT	9.2x	8.1x	7.4x	6.1x
P / UFCF per share	15.0x	12.6x	9.6x	7.9x

Avon Products, Inc. (Continued from previous page)

Detailed Thesis

Resilient Assets and Significant Secular Tailwinds in Emerging Markets: In skin care, color cosmetics and fragrances, emerging markets still trail Western markets and are projected to grow at high single digit growth rates for several years. Avon gets an “early bird” advantage in emerging economies and offers affordable, good value products. Avon has very low capital requirements and high asset turnovers, with 20-30% returns on invested capital. The company should therefore be able to generate significant amount of cash flow that can be used for buybacks or dividend payments. Many of company’s “reps” are self-users of the products, demonstrating the “pull” that Avon’s brand continues to have in many markets, particularly outside the US.

Red Flags are Opportunities for New Management: Avon has been meaningfully under-earning over the past 7 years with EBIT margins declining from 15.9% in 2004 to 9.9% in 2011. This has resulted from increases in SG&A overhead, legal costs, higher bad debt provisions and misplaced investments. We believe that under its new focused and motivated management, Avon can increase EBITDA margins from current ~12% to ~15% through taking the following steps:

- **Reducing the SG&A overhead:** Former employees and industry experts believe that more outsourcing and better expense controls can have a sizeable impact. A ~\$300m reduction would yield a 30%+ gain in market value at current multiples.
- **Settling outstanding FCPA litigation:** Avon has spent ~\$250m in FCPA related expenses up to date, and currently spends at a rate of ~\$100m a year on this, while corporate penalties in similar past cases have averaged around ~\$80m. Among other factors, the size of alleged illicitly obtained profits is a key determinant in FCPA disgorgements. With China accounting for only 2% of sales and virtually no profit, we believe this could have been settled for well under the associated legal spends made. We believe the old management has not expeditiously addressed this issue due to fear of personal criminal liability.
- **Reducing bad debt expense:** Avon’s bad debt expense stands at 2.2% of sales, much higher than that of any of its peers.
- **Reinvigorating sales by increasing R&D and optimizing advertising:** Company’s R&D is only 0.7% of sales and lags that of peers. We believe that additional investments in product development R&D will allow the company to generate incremental sales as correlation between increases in R&D spend and revenue growth is very strong in the industry. In addition, the company needs to focus on its best selling categories and products and avoid venturing into new areas (such as silver jewelry Silpada line) where it has limited expertise.

Recent Coty bid shows the presence of alternative exit opportunities: We believe Coty would be willing to increase its current \$23.25 bid up to 30% more for Avon in its current state if allowed to conduct due diligence. Coty and Avon have little overlap between geographies, selling channel and product category (Coty’s fragrances are in the premium category while Avon skews mass). Revenue synergies between Coty and Avon are likely to be substantial if Coty’s products were to become available through Avon’s extensive distribution network in emerging countries. As Coty is private, it is hard to discern what the immediate expense synergies will be, although overtime there may likely be synergies from combining global functions, such as IT and finance.

Valuation

If the company were to implement the recommended changes, we believe that it would result in an increase in EBITDA margin to 15% by 2015 or to \$2 billion, from current \$1.4 billion in 2011. With a multiple expansion to 9.5x (the direct seller average), we estimate that a 2.5 year investment in Avon would have a 35% IRR.

Investment Risks/Considerations

Unit declines in North America reflect structural issues with direct selling and might affect earnings: *Mitigant - Many direct sellers, including Avon in certain markets, are continuing to gain market share in developed economies (examples include NuSkin in Japan and the US, Avon in the UK and Italy, and Tupperware in France and Austria).*

Sales growth slows in key emerging markets leading to significant business deleveraging: *Mitigant: There are many geographies where Avon is underpenetrated and where it can grow the category substantially (India, Middle East, Africa).*

	Without Multiple Expansion	With Multiple Expansion
2015E Base Case Adj. EBITDA	2,034	2,034
Forward Multiple	7.3x	9.5x
TEV	\$14,842	\$19,321
Gain to Current	40%	82%
Less: Debt at 12/31/14	3,254	3,254
Plus: Cash at 12/31/14	2,088	2,088
Equity Value	\$13,677	\$18,155
Gain to Current	59%	111%
Implied Stock Price	\$31.74	\$42.13
Gain to Current	59%	111%
2.5 Year IRR	20%	35%

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Ingersoll-Rand plc (Continued from previous page)

The high degree of customization of the business's products and the network effects derived from longstanding incumbency and brand loyalty make this market extremely difficult for competitors to enter. IR's Industrial Technologies segment, which comprises the golf cart, compressor and air tools businesses, also holds #1 or #2 market share positions in its respective niches.

Significant Free Cash Flow Generation: IR converts >50% of its EBITDA into FCF and ~100% of its Net Income into FCF. The Company generated over \$3bn of FCF from 2009-2011 despite industry headwinds and trough volumes. For 2012E and 2013E Ingersoll Rand should generate \$1.2bn and \$1.4bn respectively and Management has demonstrated itself to be prudent with their use of cash repurchasing 36mm shares in 2011 (\$1.2bn) which was greater than 10% of the float outstanding and increasing its dividend to \$0.64 per year. Management has also guided to a 300-400mm share buyback this year, a number that we view as extremely conservative and likely to be increased.

Strong Marco Tailwind: Residential security and residential HVAC account for 15% of IR's total revenues. Residential HVAC is driven by replacement sales (~85%) and new construction (~15%). During the recession, consumers deferred replacement with cheaper repairs. Since these repairs only extend the life of HVAC units by 3 – 4 years, a wave of deferred units is expected to hit the market in the next few years. It is important to note that this phenomenon is true even without the assumption of increasing replacement rates (despite rising rates in 2011). Increases in new home construction are an added boost—new construction used to account for 45% of Residential sales during peak years (2006/2007) versus 15% currently. Commercial construction is IR's largest end market. IR is exposed to this expansive market through its Commercial HVAC (Trane) and Security divisions—together accounting for 50% of revenues. Commercial construction is at 1975 lows. That said, recent data is pointing to an improving environment. The ABI index has been above 50 for the last five months, non-residential building jobs have increased for the last eight months and non-residential starts were up 27% this March. These indicators all point to an improving end market. Furthermore, IR's peers have all pointed to strengthening end markets—both Lennox and Carrier pointed to strong commercial HVAC sales and backlog.

Margin Expansion: Analysts are not giving IR benefit for margin improvements because of 2011 missteps (2011 margins hit by one-time R-22 loophole and related \$50—\$70 million of one-time expenses). However, IR's participation in R-22 market in 2012 alone will contribute to margin improvement. In addition, the residential HVAC segment is still operating well below capacity (65%) suggesting that volume gains will drive operating leverage. The company also has a restructuring initiative in place that will drive operational improvements through better materials management, "Lean" manufacturing and workforce productivity improvements.

Valuation: Our target price represents a ~43% upside to the current share price of \$40.61, and is based on a 14.4x 2013E P/E multiple (consistent with the current P/E multiple and below the long-term P/E multiple of 16.0x-17.0x for IR stock). Our Downside case, uses a 2013E P/E of 11.0x (2013E EPS of \$3.22) and our Upside case uses a 2013E P/E of 16.0x (2013E EPS of \$4.57).

Companies	EV/EBITDA			EV/(EBITDA - Capex)			Price / Earnings			Div. Yield	2012E Payout Rat.	Net Debt / EBITDA
	2011	CY2012	CY2013	2011	CY2012	CY2013	2011	CY2012	CY2013			
Emerson Electric	8.0x	8.0x	7.3x	9.2x	9.3x	8.4x	15.2x	14.3x	12.3x	3.2%	46%	0.7x
Lennox	10.1x	9.2x	7.6x	12.4x	11.7x	9.2x	18.8x	16.1x	12.3x	1.9%	30%	1.8x
Stanley Black and Decker	9.8x	8.0x	7.3x	12.1x	9.2x	8.4x	14.8x	13.2x	11.6x	2.1%	28%	1.6x
Dover	8.1x	7.1x	6.5x	9.8x	8.4x	7.7x	14.3x	12.4x	11.1x	2.1%	26%	0.6x
Illinois Tool Works	8.9x	8.2x	7.5x	10.0x	9.2x	8.3x	13.7x	13.5x	12.1x	2.6%	35%	0.8x
United Technologies	8.3x	7.9x	6.8x	9.3x	8.9x	7.7x	14.6x	14.4x	12.1x	2.4%	35%	0.5x
Atlas Copco	10.4x	9.8x	9.3x	10.4x	11.0x	10.4x	14.9x	14.4x	13.4x	3.1%	45%	0.7x
Assa Abloy	14.1x	10.3x	9.5x	14.1x	11.6x	10.7x	15.2x	14.2x	13.0x	2.2%	32%	2.1x
Mean	9.7x	8.6x	7.7x	10.9x	9.9x	8.8x	15.2x	14.1x	12.2x	2.4%	34%	1.1x
Median	9.4x	8.1x	7.4x	10.2x	9.2x	8.4x	14.8x	14.3x	12.2x	2.3%	33%	0.8x
Ingersoll Rand	7.7x	7.4x	6.6x	8.9x	8.4x	7.5x	14.4x	12.6x	10.1x	1.6%	20%	1.3x

Near-term Catalysts

1) Earnings outperformance (our 2012 EPS is ~10% above management guidance/consensus)

- Recent data suggests top-line recovery is imminent (dealer surveys reiterate end-market improvement)
 - Q1 results were strong and ahead of consensus but management kept FY2012 guidance in tact
- Management has already grown operating margins 250bps through 19 value streams with minimal volume improvement (Management indicated 100 value stream potential)

2. Increased Share Buyback

- Management guided to a share buyback of 300-400mm which we believe they will increase later this year
 - We assume a 500mm buyback in 2012

3) Increased Dividend

- We believe management will steadily increase the dividend and target a 30% payout ratio (currently ~20%)
 - We assume a 25% increase in 2012

Key Investment Risks: (1) slower-than-expected rebound in commercial construction; (2) failure to deliver on productivity targets; (3) inability to pass through price increases to offset inflation; and (4) continued weakness in residential HVAC replacement rates.

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Legg Mason Inc. (LM) - Long Third Place — 2012 Pershing Square Capital Challenge

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As of 4/20/12; in USD m except per share data

Current Capitalization		Trading Statistics		
Stock Price	\$25.76	Short Interest	5.4%	
52-Week Range	\$22.61-\$37.82	Annual Dividend	\$0.32	
Diluted Shares (M)	139.8	Dividend Yield	1.2%	
Market Cap	\$3,601	Avg. Daily Volume (m)	1.75	
Cash & Investments	(\$2,009)	Valuation and Target Price		
NPV of Tax Credits	(\$914)	Trading Valuation	Statistic	Multiple
Revolving Credit Line (Feb13)	\$250	EV / FY'13 EBITDA	\$485	5.0x
2.5% Senior Convertible 2015	\$1,250	EV / FY'13 Unlv. EPS	\$2.33	7.5x
Other Debt	\$267	Upside	\$43	68%
Enterprise Value	\$2,445	Downside	\$21	-19%
		Reward/Risk		3.6x

Recommendation

The common stock of Legg Mason ("LM" or "the Company") offers a compelling long opportunity. At \$26 a share, the market is discounting the past more than the future and fails to recognize the value that lies with LM's significant tax credits. Once taken into account \$6.50 per share in tax assets, LM trades on less than 5x EV/EBITDA and less than 8x cash earnings. We think LM is poised for a rerating as soon as the Company's improved performance starts translating into its reported financials. Further catalysts that could help close the gap between price and intrinsic value include: improving fund performance at Western, an accretive stock buyback program, and the expiry of Nelson Peltz's standstill agreement at the end of the year.

Business Description

Legg Mason owns a collection of money managers across a wide range of assets classes including Western in fixed income (\$442bn AuM as of December 2011), Royce in small caps (\$36bn), Permal in fund of hedge funds (\$18bn), and ClearBridge in equities (\$51bn). Most of these managers have leading market positions within their niche and strong long-term track records.

Investment Thesis

Legg Mason is hated by the investing community and priced accordingly. This is partially the result of the downfall of a well-known portfolio manager and partially a consequence of a number of misunderstandings:

- Legg Mason owns a diversified collection of asset managers that operate independently and transfer a fixed portion of their revenue to the parent company. This franchise-like business model is more robust and has a lower operating leverage than competitors.
- Legg Mason has more than \$900m in tax credits that do not show up on the balance sheet and are largely ignored by the Street. However, the value of these tax credits currently amounts to close to 25% of LM's market cap.
- The recent restructuring program is hurting reported numbers and obscuring the true earnings power of the company. While the LTM GAAP EPS in only \$1.45 (implying a PE multiple of 18x), the "owners' earnings" are close to \$2.29 per share for a PE of 8x.

Rod de Crayencour is a first year MBA student. Prior to Columbia, Rod worked as an investment analyst in a family office and on a debt restructuring desk at Credit Suisse.

Jake Lubel is a first year MBA student. Prior to Columbia, Jake worked as a small-cap research analyst at T. Rowe Price.

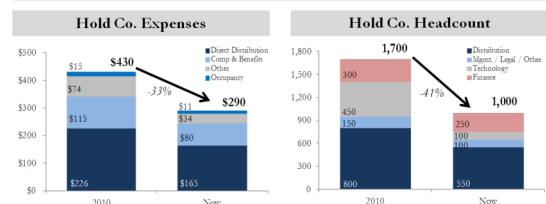
Grant Smith is a second year MBA student participating in the Value Investing Program. Last summer, Grant interned at T. Rowe Price. Prior to Columbia, Grant worked as an equity analyst at Ensign Peak Advisors.

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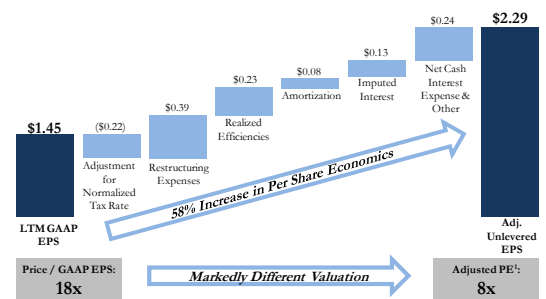
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Significant Cost Cutting at the Hold Co. Level



Noisy P&L Obscures Cash Flow to Shareholders



¹ Adjusted PE assumes value of tax credit is accounted for separately and EPS are subject to a full 34.5% tax rate

Legg Mason Inc. (LM) (Continued from previous page)

Valuation

Once adjusted for the value of the tax credits, Legg Mason currently trades at 5.0x FY'13 EBITDA and 7.5x FY'13 unlevered EPS which does not reflect the quality of the underlying affiliates.

- We estimated the earnings power value of the Company at \$43 (70% upside) assuming a 15x multiple on FY'13 unlevered earnings and adjusted for the tax credits and the net cash position.
- Our sum-of-the-parts analysis which reflects what an informed buyer would pay for each of the affiliates suggests a value of up to \$54 (100% upside).

Earnings Power Valuation (70% Upside)

All figures in USD mn, except per share data

	Value	\$ / Share
FY'13 Unlevered EPS	\$317	\$2.33
Fair Multiple	15.0x	15.0x
Enterprise Value	\$4,762	\$34.90
Cash & Investments	\$2,009	\$14.37
NPV Tax Credits	\$914	\$6.54
Debt	(\$1,767)	(\$12.64)
Additional Value	\$1,156	\$8.27
Equity Value	\$5,917	\$43.17
Upside from Current Price		68%

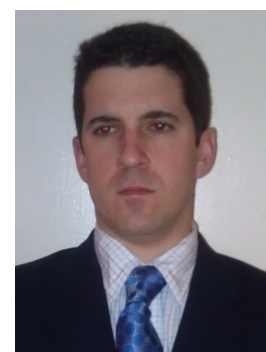
Sum-of-the-Parts Valuation (100%+ Upside)

All figures in USD bn, except per share data

Affiliates	AuM	% AuM	Value	\$/Share	% Total
Western Asset Management	442.0	0.69%	3.05	21.82	41%
Royce & Associates	35.9	2.75%	0.99	7.06	13%
Permal	17.8	4.00%	0.71	5.09	9%
ClearBridge Advisors	51.4	1.50%	0.77	5.52	10%
Batterymarch Financial Mgmt.	17.6	1.25%	0.22	1.57	3%
Brandywine Global Invest. Mgmt.	33.1	0.95%	0.31	2.25	4%
Legg Mason Capital Management	8.4	0.93%	0.08	0.56	1%
Other	20.8	1.00%	0.21	1.49	3%
Total Enterprise Value	627.0		6.34	45.36	85%
Cash & Investments			2.01	14.37	27%
NPV Tax Credits			0.91	6.54	12%
Debt			(1.77)	(12.64)	-24%
Total Equity Value			7.50	53.63	100%
Diluted Shares Outstanding				0.14	



Rod de Crayencour



Jake Lubel



Grant Smith

Catalysts

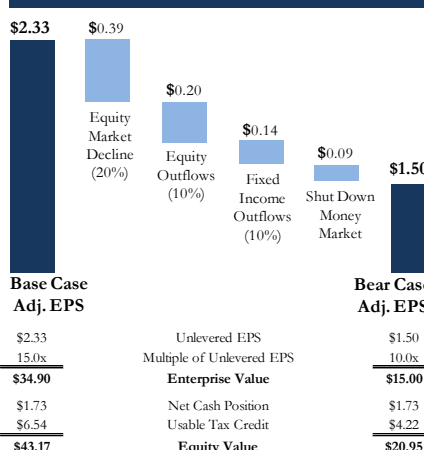
A number of catalysts will help trigger a re-rating of the stock in the near future:

- **Earnings will become cleaner** starting in the quarter ended June 2012 as the restructuring process is now completed. This should reveal the true earnings power of the company.
- Western's flagship products are now all ranking in the top quartile for 3-year performance which should lead to positive fund flows.
- The highly **accrative stock buyback** program currently in place will support LM's share price. LM has already reduced the share count by 13% over the past two years but current FCF of 13% offers ample opportunity to do more.
- **Nelson Peltz**, who owns 10% of the Company has entered into a standstill agreement with management in exchange for a seat on the Board. Under the terms of the agreement, Peltz cannot publicly speak negatively about management, call for divestitures, or publicly call for further restructuring. This agreement expires at the end of 2012.
- **Further restructuring** at the holding company level of up to \$40m pretax could be achieved as LM's cost structure remains well above its peers in the industry.

Risks

- **Sensitivity to AuM flows.** Mitigated by lower operating leverage than peers. We estimate that a 1% change in AuM will have a 1.5% impact on EPS (split between .84% on equity assets and 0.61% on fixed income assets).
- **History of poor capital allocation.** Mitigated by Nelson Peltz' presence on the Board.
- **Money market funds regulation.** This could lead to LM having to shut down the business entirely, which would impact our fair value estimate by 5% (\$400m).
- **Continued shift toward ETFs.** This is real, but overshadowing a much bigger trend: the rising share of households' assets allocated towards investment funds.

20% Downside in Bear Case Scenario



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H&R Block, Inc. (NYSE:HRB) - Long Finalist — 2012 Pershing Square Capital Challenge

Robert is a second year MBA student. Prior to Columbia Business School, he was an Associate at Penfund Management, a \$350 million private equity fund. Robert holds a Bachelors of Commerce from Queen's University.

Ian is a second year MBA student. Prior to Columbia Business School, he was a Restructuring Associate at Miller Buckfire & Co. Ian holds a B.S. from Lehigh University.

Kartik is a second year MBA student. Prior to Columbia Business School, he was an Associate at Lindsay Goldberg, a \$10 billion private equity fund. Kartik holds a B.S. from the Wharton School at the University of Pennsylvania.

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Capitalization & Valuation (SMM)					Summary Financial Information (SMM)					
Current Capitalization					FY Ended April 30,					
					2009	2010	2011	LTM		
Share Price (April 27, 2012)	\$14.96				Assisted Tax Prep	\$2,411	\$2,268	\$2,219	\$2,275	
Shares Outstanding	293				Digital Tax Prep	215	216	231		
Equity Market Capitalization	\$4,383				Ancillary & Other	507	491	462		
Add: Debt	1,296				Total Revenues	\$3,133	\$2,975	\$2,912	\$2,905	
Less: Cash	(1,219)				Operating Income	\$886	\$826	\$721	\$729	
Total Enterprise Value	\$4,460				% Margin	28%	28%	25%		
Historical Valuation Metrics					Adjusted FCF	\$461	\$497	\$450	\$552	
	2009	2010	2011	LTM	% Margin	15%	17%	15%		
P/E	11.4x	11.7x	12.8x	11.2x	Earnings Per Share	\$1.38	\$1.34	\$1.26		
P/FCF	11.4x	10.2x	10.9x	7.9x						
Dividend Yield	3.8%	3.8%	3.7%	5.3%						
ROIC	14.3%	13.9%	15.2%	15.9%						

Recommendation

H&R Block, Inc. ("HRB" or the "Company") is an attractive investment with near-term catalysts. The stock trades at 11x earnings and has a 11% free cash flow yield. HRB suffers from misperceptions around cannibalization of its core business and excessive fear surrounding potential liabilities from a discontinued subsidiary. These fundamental misunderstandings and fear create a dislocation between price and intrinsic value. Over the next twelve to eighteen months HRB will achieve significant earnings growth as it benefits from regulatory changes taking place in the assisted tax market. Furthermore, HRB is poised to re-lever its balance sheet and return capital to shareholders. All-in the investment has an asymmetric 4:1 upside-to-downside profile, bolstered on the downside by a 5% dividend yield and a 5% normal course buyback yield.

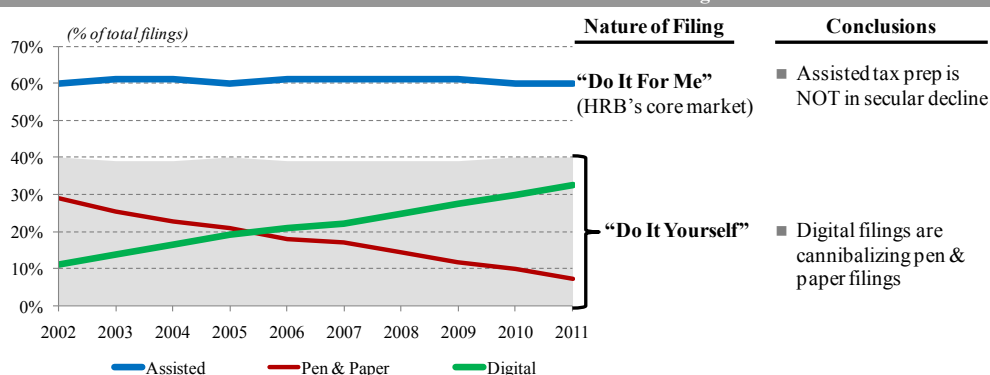
Business Description

H&R Block, based in Kansas City, MO, operates 11,000 assisted tax preparation offices (60% company owned, 40% franchised), primarily in the United States. HRB is the largest player in the assisted market with 19% market share (its next largest competitors have 3% and 2%, respectively). The assisted tax market is highly fragmented with 76% of the market comprised of independent operators (e.g., CPAs and mom-and-pop seasonal operators). HRB focuses on the lower income segment of the market and therefore HRB's main source of competition is the mom-and-pop seasonal operator (CPAs focus on high income filers). In connection with its assisted tax preparation services, HRB also offers a number of ancillary products such as credit cards and debit cards. The Company also offers digital tax preparation software for the do-it-yourself at-home filer.

Investment Thesis

HRB's Core Business is Misunderstood: Over the past 10 years there has been a rapid increase in the number of digital tax filings (e.g., TurboTax). The market *assumes* that this growth is cannibalizing the assisted tax market (e.g., H&R Block). However, closer examination of the data reveals that the growth in digital tax filings is coming purely at the expense of "pen-and-paper" filers. Over the past 10 years, the assisted tax market has remained 60% of all tax filings, while the other 40% of the market has shifted from pen-and-paper to digital. Therefore HRB's core business, assisted tax preparation, is not threatened by the growth of digital filings.

The Proof is in the Numbers – 10 Years of IRS Filing Data



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H&R Block, Inc. (Continued from previous page)

Subprime Overhang is Excessive: Prior to 2007, HRB's subsidiary, Option One, originated subprime mortgages. The subsidiary was shut down in 2007, however HRB's stock continues to be weighed down by the risk of putback liabilities (i.e., if Option One is deemed to have violated its reps and warranties, the buyers of defaulted loans could seek to unwind the purchase). With \$36 billion of loans outstanding, the market *assumes* that the liability to HRB is significant. However, after examining (i) the historical loss rates, (ii) recent settlement comparables, and (iii) the risk of corporate veil piercing, we believe the liability is less than \$400 million (less than 10% of the stock price).

HRB Will Benefit From Regulatory Changes in the Assisted Tax Market: There are two regulatory changes taking place in the assisted tax market (i) the elimination of refund anticipation loans ("RALs"), and (ii) the national registration process. RALs are a form of payday lending in the assisted tax market. HRB stopped providing RALs in 2010, but HRB's main competitors, the independent mom-and-pops, have continued to offer RALs; which has put HRB at a competitive disadvantage. However, the FDIC has recently forced all banks to stop offering RALs. Therefore after April 2012, RALs will no longer be available to the mom-and-pop competitors. This is significant because RALs drive traffic to mom-and-pops and account for the majority of their profitability. Secondly, beginning in 2013 all tax preparers must register with the IRS and submit to a background check, pass a competency examination, and achieve 73 hours of continuing education. We believe that the combination of (i) the loss of highly profitable RALs and (ii) the burden of the registration process will drive the marginal mom-and-pop out of the market and increase HRB's market share. Due to high incremental margins on an additional filing, even a small increase in market share will drive significant earnings growth.

HRB Can Re-Lever its Balance Sheet and Return Capital to Shareholders:

The Company is significantly under-levered today. HRB's core business has many characteristics of an attractive credit (recurring revenue, diverse customer base, high cash flow, leading market share) yet it sits in a net cash position. Furthermore, HRB pays \$0.80 in dividends for a 5% dividend yield; therefore the pre-tax cost of funding the dividend is approximately 9%. In today's credit markets, HRB can issue debt at less than 6%. Therefore it is actually cheaper to buyback a share than it is to pay the dividend on that share. For this reason a levered share repurchase is financially compelling. We believe that management will pursue such a transaction within the next six months (in conjunction with the refinancing of HRB's 7.875% Senior Notes due January 2013).

We believe that they will take on an additional \$600 million of debt (which would put total debt/EBITDA at 2.0x) and use the proceeds to repurchase stock. The Company's CEO has recently taken a number of steps to return capital to shareholders including: (i) increasing the dividend by 33%, (ii) selling a non-core asset for \$500 million, and (iii) reducing the minimum equity covenant on the Company's line of credit.

Valuation

We believe that HRB is worth ~\$23 per share, with an upside of ~\$28 and a downside of ~\$14 per share. With an 11% free cash flow yield, the stock is trading cheap; however our base case valuation assumes that the stock continues to trade at 12x-13x P/E due to the market concerns about subprime overhang (i.e., headline risk). The more significant return-driver is growth in earnings from the current \$1.36 per share to \$1.73 per share. The growth in EPS is due to (i) higher operating income (driven by regulatory changes) and (ii) lower share count driven by a levered share repurchase transaction.

Investment Risks/Considerations

Simplification of the Tax Code: Many people believe simplification of the tax code would drive HRB's customers to do their own taxes. However, HRB's target customer (the low-income filer) already has relatively simple taxes. The reason they go to H&R Block is because their tax refund check is likely the largest check that they receive all year (50% do not have bank accounts). For HRB's customers, the risk/reward of doing their own taxes and potentially missing a deduction is unattractive.

Return-Free Filing: Return-free filing is where the government prepares your taxes for you and simply sends you a bill. While this system is technologically feasible and has been proposed a number of times, it is overwhelmingly unpopular with the American public. In an October 2011 survey, 73% of Americans said that they would not trust the IRS to prepare their taxes for them, and 80% said that they would not vote for a candidate that supported a return-free filing system.

	Current Credit Profile			
	4Q/11	1Q/12	2Q/12	3Q/12
Capitalization				
Sr Notes due Jan 2013	\$600	\$600	\$600	\$600
Sr Notes due Oct 2014	400	400	400	400
FHLB and Other	78	75	105	296
Total Debt	\$1,078	\$1,075	\$1,105	\$1,296
Less: Cash	(1,678)	(1,013)	(573)	(1,219)
Net Debt	(\$600)	\$63	\$532	\$77
Leverage Statistics				
Total Debt / EBITDA	1.3x	1.3x	1.3x	1.6x
Net Debt / EBITDA	(0.7x)	0.1x	0.7x	0.1x
Coverage Statistics				
Interest Coverage	10.1x	10.1x	9.8x	9.8x
Fixed Charge Coverage	5.7x	5.4x	5.1x	4.9x

Trip to Omaha to see the Oracle

Columbia's team thrilled to meet and have lunch with Warren Buffett



Some of the funniest and most memorable moments from the trip



Louisa Serene Schneider '06 teaching Warren Buffett his first yoga lesson



How about a new jersey for Mr. Buffett?



... Or a shoe shine?



Relaxing on Warren Buffett's favorite bed at Nebraska Furniture Mart



But the best of it all, learning from Warren Buffett

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On behalf of the Applied Value Investing Class of 2012, thank you! You've made our time at Columbia Business School one we will always remember

Heilbrunn Center's List of All-Stars

Arnaud Ajdler	Crescendo Partners
Gavin Albert	Soros Fund Management LLC
Christopher Begg	East Coast Asset Management
Avi Berg '97	Jennison Associates
Naveen Bhatia	40 North Industries LLC
Ethan Binder '06	Slate Path Capital
Mike Blitzer '04	Kingstown Capital Management
Michelle Borre '96	Oppenheimer Funds Inc
Andrew Brenner	Columbia Business School
Margaret M. Cannella '76	CHF International, LLC
Jeff Cino '06	Ramius LLC
Mark Cooper '02	PIMCO
Michael Corasaniti '92	Tourmalet Advisors
Wouter Dessein	Columbia Business School
Cheryl Einhorn	Columbia Business School
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Jefferson Gramm '03	Bandera Partners
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Dan Krueger '02	Owl Creek
Michael Mauboussin	Legg Mason
Ian McDonald	Hilltop Park Associates
Neal Nathani	Axial Capital Management, LLC
T. Charlie Quinn '06	Gardner, Russo, and Gardner
Jon Salinas '08	Marble Arch Investments
Tano Santos	Columbia Business School
Louisa Serene Schneider '06	Columbia Business School
Guy Shanon '99	Kingstown Capital
Ken Shubin-Stein	Spencer Capital
Paul Sonkin '95	Hummingbird Fund
Joseph Stiglitz	Columbia Business School
Grant Toch '04	Steinberg Asset Mgmt
Tom Tryforos '84	Grand Street Capital
Martin Whitman	Third Avenue Value Fund
Artie Williams '02	Summit Street Capital
Dan Yarsky '06	Morgan Stanley

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Jim Chanos



Jim Chanos

(Continued from page 1)
if not the past fifty years.” He is a Visiting Lecturer in Finance at the Yale University School of Management and a graduate of Yale University.

G&D: Mr. Chanos, you studied economics and political science at Yale. At what point did you get interested in the stock market?

JC: My father had been a stock market investor since the 1950s, in addition to running the family business. He drilled into me the notion that to be financially independent, I would have to work for myself, work hard, save my money and invest wisely. He began teaching me about the stock market when I think I was in third or fourth grade. From this point onward, I became fascinated by investing. I was fascinated by the math and the numbers and the fact that you could invest and, unlike with a savings account, you might be able to double your money. This was my first introduction to investing and it occurred in the late '60s. I continued to read about investing and took the only two undergraduate accounting classes while at Yale.

After I graduated I decided that I wanted to pursue an investment career. I didn't get a job offer from any of the big New York banks, which in 1980 were the source of most of the employment offers. I joined one of the first investment banking analyst programs with Blyth Eastman

“... I handed out a two page memo to the senior banker discussing the impact of buying back stock. The senior banker looked at me with an icy stare and stated that we were not in the business of recommending share buybacks to our clients; we were in the business of selling debt. This was my first dose of cold water regarding Wall Street and I became pretty disillusioned after that episode. I had learned that Wall Street wasn't necessarily doing things in their clients' best interest...”

Dillon's regional office in Chicago. I put in 16 hour days six days a week working on deals for senior bankers. This was a good intro-

duction into the numbers of investing.

There was a defining moment, however, when I realized investment banking wasn't for me. A year into my stint at Blyth, we were working on a recommendation for McDonald's to issue a bond. At that point in its history, McDonald's was generating a lot of cash and reinvesting it back into its restaurants, each of which generated high returns. But the stock market was valuing McDonald's at only 8 or 9x earnings despite the company growing at 20-25% a year pretty consistently with real cash earnings. Around this time, I read that Teledyne and Radio Shack were growing earnings rapidly by buying back stock, as the management of these firms believed that their companies were undervalued in the stock market. This was at a time when interest rates were at double-digits. I ran some numbers independent of the blue book that the associate, the senior banker and I were compiling, and determined that instead of the debt deal, we should recommend that McDonald's buy back stock with some of its cash flow and cut back its expansion slightly. This could lead to a larger EPS increase relative to the bond issuance and they wouldn't have to add leverage to the balance sheet. Given where rates were, the impact on EPS from

(Continued on page 17)

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Jim Chanos

“I recommended a short position in Baldwin-United at \$24 based on language in the 10-K and 10-Qs, uneconomic annuities, leverage issues and a host of other concerns. The stock promptly doubled on me. This was a good introduction to the fact that in investing, you can be really right but temporarily quite wrong... I went home to visit my parents for Christmas and received a phone call from Bob Holmes telling me that I was getting a great Christmas present – the state insurance regulator had seized Baldwin-United’s insurance subsidiaries.”

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(Continued from page 16)

buying back stock rather than issuing debt was dramatic. When I made this case to the associate, he turned white and said he wanted no part of presenting this idea to the senior banker. Being pretty naïve and not realizing the political implications of such a recommendation, I handed out a two page memo to the senior banker discussing the impact of buying back stock. The senior banker looked at me with an icy stare and stated that we were not in the business of recommending share buybacks to our clients; we were in the business of selling debt. This was my first dose of cold water regarding Wall Street and I became pretty disillusioned after that episode. I had learned that Wall Street wasn’t necessarily doing things in their clients’ best interest but was instead focused on maximizing fees.

G&D: So was it this incident that led to your transition to the buy-side?

JC: Around this time, I had been talking stocks with the head of retail client brokerage at the Chicago office, Bob Holmes, during my lunch hour. That’s what I really enjoyed; going over to his office and checking the market and punching tickers into the Quotron machine to see what was up and what was down. I would look forward to that part of my day more than any

other. I had a little money saved and was trading like a lunatic in my own brokerage account, not making any money. Finally one day, Bob called me into his office, shut the door, and told me that he was leaving to start a retail brokerage firm with a couple of partners. He asked me if I wanted to join their new firm as an analyst. I could barely contain my excitement.

One of the first stocks they had me look at was insurance holding company called Baldwin-United. Baldwin was growing very rapidly by selling annuities that were uneconomic. To plug the hole that was developing within their insurance subsidiaries, the holding company was closing acquisitions. In exchange for the insurance companies’ cash, the holding company was providing the subsidiaries with overvalued securities. However, the regulators of the insurance subsidiaries were becoming wise to the development as Baldwin-United’s stock shot up. We acquired a copy of the insurance department public files and we were able to see from regulators’ letters that they were becoming increasingly concerned about the valuation of those affiliated assets held by the insurance company. They went as far as to imply that if Baldwin-United didn’t downstream additional capital to its insurance subsidiaries, they would have to declare the subsidiaries insol-

vent. While this was occurring, every brokerage house was recommending the stock. Although the company was rapidly growing earnings, those were all non-cash earnings because Baldwin-United was using gain on sale accounting when it sold annuities. This fictitious “gain” was based on the expected persistency of the policies and the present value of the estimated spread generated by their returns on investment in excess of the annuity payouts. The problem was that they were paying 14% on the annuities and were far too optimistic on their investment return estimates. My first research report was published in August of 1982. I recommended a short position in Baldwin-United at \$24 based on language in the 10-K and 10-Qs, uneconomic annuities, leverage issues and a host of other concerns. The stock promptly doubled on me. This was a good introduction to the fact that in investing, you can be really right but temporarily quite wrong. I put another report out in early December of 1982 with the stock at \$50 and reiterated my thesis while pointing to additional evidence that had come out in the interim. I went home to visit my parents for Christmas and received a phone call from Bob Holmes telling me that I was getting a great Christmas present – the state insurance regulator had seized

(Continued on page 18)

Jim Chanos

“A lot of what happens in your life is merely serendipitous and really just luck. In a lot of ways, that’s the lens through which I look at my own career. If the McDonald’s share buyback episode hadn’t occurred, maybe I wouldn’t have left Blyth and I’d probably still be doing deals and be miserable. To join a new firm and to have the first company I look at turn out to be an enormous financial fraud was equally good luck.”

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Baldwin-United’s insurance subsidiaries. Baldwin filed for bankruptcy shortly thereafter.

That’s the idea that sort of put me on the map. After that, big New York hedge funds to which we had been trying to pitch the Baldwin short started calling us to see what other companies were short candidates. I had no predisposition to be a short seller but I thought that there could be a business niche in that arena. Maybe I could, as a young analyst, carve out a good business by being an institutional skeptic and come out with two or three really good short ideas that were thoroughly researched with the evidence clearly presented and documented. This would then be expected to lead to some nice commissions for the firm.

A lot of what happens in your life is merely serendipitous and really just luck. In a lot of ways, that’s the lens through which I look at my own career. If the McDonald’s share buyback episode hadn’t occurred, maybe I wouldn’t have left Blyth and I’d probably still be doing deals and be miserable. To join a new firm and to have the first company I look at turn out to be an enormous financial fraud was equally good luck.

G&D: For a brief period, you also worked for Deutsche Bank. How did

that come about?

JC: In late 1983, Deutsche Bank came knocking and asked me to move to New York to be an analyst in their new boutique investment research operation. In the summer of 1985, I began looking at the Drexel Burnham companies which Michael Milken was putting together through junk bonds. I was particularly focused on a real estate syndicator called Integrated Resources which was playing unbelievable accounting games and financing itself with junk debt issued at 14%. The company would overpay for office buildings and then syndicate their ownership interest to wealthy individuals via tax sheltered partnerships in uneconomic deals. Since there wasn’t enough cash to pay their fees, Integrated was taking their fees via overvalued third mortgages on the syndicated properties. The company’s earnings were not only overstated but were also heavily negative cash flow. I started to ruffle some feathers, and Integrated put a lot of pressure on Deutsche Bank and others to muzzle me. Later that summer, there was a Wall Street Journal front page article by Dean Rotbart describing an evil cabal of short-sellers who were saying terrible things about Integrated Resources. According to an illustration on the inside of that Journal issue, the per-

son orchestrating this short-selling pressure across all categories of investors was me. Within a day or two, I was summoned to a superior’s office and told that my employment contract which expired in October of 1985 would not be renewed. Luckily, for a year or so I had been talking to a couple of investors who wanted me to run a portfolio of fundamental short ideas for them. Though my bargaining power had declined a bit since I was going to be out of a job in a few months, they agreed to set up Kynikos Associates with me. The fund was capitalized with \$16 million, \$1 million of which was my own, and we started on October 1st, 1985.

G&D: What were the early days like?

JC: From 1985 to 1990 was a golden era for short sellers because it was a highly idiosyncratic, uncorrelated market. Although the market was slowing, it was dominated by institutions. If you could make a case that a company was playing games with its numbers or had some other serious problem and the company then admitted wrongdoing, the stock would go down quite a bit. Meanwhile, the broader stock market had a few periods of run-up following some crashes leading up to 1990. The so-called alpha

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Jim Chanos

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 was off the charts in this time period. It was probably in the 20% area. Money flooded into any hedge fund that said they had short-selling skills. By 1990 we were running \$660 million and were one of the top ten largest hedge funds in the world. Then it all came crashing down from '91 to '95. After the Gulf War, the Fed eased and the market took off for a good three years until '94 and then began to take off again in '95. I believe the NASDAQ or the Russell doubled in 1991. There was no place to hide on the short side. Everything became correlated on the way up. The worse the news a company reported, the more its stock price appreciated. It was a tear-your-hair-out market if you were a short-seller. With client withdrawals by '93 and in '95, we were down to \$150 million and I was wondering if I was going to stay in business. I didn't want to do what a lot of people have done in that situation – close up shop and start again two years later – because I didn't think that was fair to my investors for whom I had lost money and who had high water marks. We agreed to soldier on and I paid most of the employees out of my pocket for a few years because there were no performance fees. I had a core group of people who were very loyal and stayed with me through this period. Then in 1995,

two large clients came forward and said they believed we were still adding value to their portfolio and that they

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were willing to invest additional money. They agreed to lock up some additional capital for a slight cut on the fees. So, in effect, those two clients saved the business in '95. We never really looked back.

Their timing was exquisite because although the market kept going up between 1996 and early 2000 during the dot-com era, it was again bifurcated and uncorrelated much like in 1985. If you had a good short idea,

it could still go down; for example, Boston Chicken, Oxford Health, and Sunbeam were all collapses. So we had some great years despite the bull market. Something else that we did was to change our compensation formula for our managed accounts so that compensation was determined based on an inverse benchmark basis. For example, if the S&P was up 20% and we were up 10%, we would be paid as if we were up 30% but alternatively, if the S&P was down 20% and we were up 20%, we would be paid nothing because we created no excess return, or alpha. That arrangement saved the business as well. We generated a lot of alpha in the late '90s so those were some of our best years financially and performance-wise. We still have that compensation structure today. Most of our dollar assets are paid on an alpha basis, so the clients like it and we think it's fair.

G&D: *At what point did you open your long-short fund in addition to the short-only fund?*

JC: In 2003, we launched our first long-short fund – Kynikos Opportunity Fund – because we realized that through our research process, we were coming across a lot of good long ideas upon which we couldn't act. This ability to go long acted as an adjunct to our short research. A stock might

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“... numerous studies have shown that most rational people’s decision-making breaks down in an environment of negative reinforcement... You’re basically told that you’re wrong in every way imaginable every day. It takes a certain type of individual to drown that noise and negative reinforcement out and to remind oneself that their work is accurate and what they’re hearing is not.”

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collapse and the bonds might fall in price but based on the work we have already done we might think there is some value in the firm and that the bonds are money good. The Opportunity Fund allowed us to capitalize on these types of opportunities. We might also utilize a pair-trade strategy in this fund. For example, for a number of years we were long Honda and Toyota and short Ford and GM. Right now in the Opportunity Fund, we’re short Chinese property companies and long Macau casinos.

In 2005, one of the clients that saved us in ’95, inquired about our interest in running a fundamental short portfolio in Europe with a fund based in London. They were willing to finance it in exchange for a five year exclusive limited partner stake. Having been in business with this client for many years, we were certainly interested in the opportunity and we wanted to see if we could apply our process globally. We opened an office in London for non-US ideas and that too proved to be successful. We found that our approach to company and security analysis could be ported over to non-US situations. We had a great run. The exclusivity arrangement expired last year and so we now have a global short fund which we offer to clients, in addition to the

domestic short fund and the long-short fund.

G&D: *Could you describe your process in a bit more detail for our readers?*

JC: I used to think that good short-sellers could be trained like long-focused value investors because it should be the same skill set; you’re tearing into the numbers, you’re valuing the businesses, you’re assigning a consolidated value, and hopefully you’re seeing something the market doesn’t see. But now I’ve learned that there’s a big difference between a long-focused value investor and a good short-seller. That difference is psychological and I think it falls into the realm of behavioral finance. The best way I can describe it is as follows: almost all of your readers, and I suspect you as well, are beneficiaries of positive reinforcement. That is, you’re told early in life to work hard, study hard, to get good grades and get into a good school, and then to do well there and to get a good job and so on. All of that is a virtuous circle.

On the other hand, numerous studies have shown that most rational people’s decision-making breaks down in an environment of negative reinforcement. If you think about it, Wall Street is a giant positive reinforcement machine. When I turn on my Bloomberg at home at night, I’m going to see that

about 20%+ of our ideas have some sort of positive analyst report out or the CEO is on CNBC or there’s a takeover rumor. Almost all of this is noise; there’s just not a lot of informational content in this stuff. But this is the music of the investment business. It’s like a (more often than not) comfortable river that every investor floats down on. If you’re a short-seller, that’s a cacophony of negative reinforcement. You’re basically told that you’re wrong in every way imaginable every day. It takes a certain type of individual to drown that noise and negative reinforcement out and to remind oneself that their work is accurate and what they’re hearing is not. Most people are in the “life’s too short to put up with this stuff” camp.

The other problem is that there’s an asymmetry on the return patterns of short ideas. Because markets tend to go up over time and you need discrete news to affect a short idea, you tend to have weeks and months and even years when you’re not making money in your ideas. Then when you do make money with a short idea, it happens all at once. Here once again, most people are just not hard wired to find that asymmetry comfortable but good short sellers are. Though I listen to the noise to make sure there’s no new information that I need to know, I don’t

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worry about most of it. You need to be able to drown out what the Street is saying. I've come around to the view that to be a good short seller, in addition to having the important skill set, one must have the right mindset. I believe this is why a lot of great value investors aren't particularly good short sellers. Part of what weighs on value investors is the view that any given stock can appreciate an infinite amount but can only depreciate in the worst case to \$0. They always have this nagging concern that one bad short idea could bankrupt their firm. I continue to respond to this argument by stating that I've seen a lot more stocks go to \$0 than infinity. In general, the short side can come with a more unpleasant feeling than the long side and I think that's why there are so few short-sellers out there.

G&D: Is there anything in particular that you look for to determine if a company is a good short candidate? How do you distinguish between a stock that is truly overvalued and one that might grow into its valuation?

JC: We try not to short on valuation, though at some price even reasonably good businesses will be good shorts due to limitations of growth. We try to focus on businesses where something is going wrong. Better yet,

we look for companies that are trying -- often legally but aggressively -- to hide the fact that things are going wrong through their accounting, acquisition policy or other means. Those are our bread-and-butter ideas. In fact, I've given some lec-

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tures on the concept of value traps. Probably our best ideas over the past ten or 12 years have been ideas that looked cheap and which actually ensnared a lot of value investors. The investors didn't realize that these businesses were deteriorating faster than their ability to generate cash. Eastman Kodak was a great example of that. A few famous value investors were buying it all the way down because they assumed that the decline in the business would be a slow glide that would allow the company to harvest cash flows for the benefit of shareholders. The fact of the matter is that, for most declining businesses, management tends to redeploy cash flow into things outside of their core competencies in a desperate attempt to save their jobs. In the case of Kodak, they took some of their patent proceeds and cash flow and invested in a printer business, which is another declining business model. They ended up being decimated by their own invention of digital photography. When analyzing Kodak as a short candidate, valuation was almost the last aspect that we considered because, as I said, some of the best short ideas can look cheap from a valuation standpoint.

G&D: Can you talk about your valuation framework?

JC: We look at the same things everyone else does,

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“Valuation itself is probably the last thing we factor into our decision. Some of our very best shorts have been cheap or value stocks. We look more at the business to see if there is something structurally wrong or about to go wrong, and enter the valuation last.”

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but with the idea that these are moving targets. Balance sheets should give you some sense of intrinsic value on the downside. On the upside, we have to worry about the unlimited potential. We look at things like market sizes and the law of large numbers, as to whether companies can grow their way out of a bad accounting situation or a leveraged situation. On the short side, the financials are often misleading. What might appear to be value sometimes is not. A book value that is comprised of goodwill and soft assets sometimes might not provide downside support if a company is troubled. Valuation itself is probably the last thing we factor into our decision. Some of our very best shorts have been cheap or value stocks. We look more at the business to see if there is something structurally wrong or about to go wrong, and enter the valuation last.

G&D: Some investors believe in the life cycle of investing in that a company can go from a growth stock to a value stock to a value trap – do you look at companies that way?

JC: I try not to. Companies can certainly go through life cycles. I think people who put themselves in a category of being a growth investor or a value investor limit themselves. A “growth” stock can be a

great investment at the right price and sometimes “value” stocks are too expensive. On the short side, we’ve been generalists globally for six or seven years. The further you look for ideas the greater the chance you will see a unique idea.

G&D: It seems like you’ve initiated short ideas in practically every industry. Are there any industries that you gravitate to more than others for ideas?

JC: We’ve historically been drawn to financial services, where companies can really boost earnings by generating bad loans for a while. We’ve also been in consumer products, certain parts of the natural resource situations (which effectively become accounting plays) and generally companies that grow rapidly by acquisition. Where we see the juxtaposition of a bad business combined with bad numbers, that’s really in our wheel house.

G&D: Do you find more examples of fraud in smaller companies?

JC: There is probably more evidence in smaller companies, but we usually don’t short many small cap companies due to the restraints on borrowing and our size. So it was hard to short some of those Chinese reverse merger opportunities last year, though we did have a couple. Most of our positions are mid cap or

large cap companies.

G&D: Could you talk about some characteristics that would make for an enticing yet, in reality, risky short candidate?

JC: Open-ended growth stories tend to have a life of their own. Our celebrated disaster was America Online. We shorted it in ’96 at \$8 a share and covered our last share at \$80 two years later. It was never a big position so it didn’t kill us but it was very painful for two years because people were able to make open-ended growth forecasts. We try to avoid those to some extent or we get involved further along the growth curve.

G&D: With short-selling, the timing of your idea can be particularly important. How do you address this somewhat unique challenge?

JC: That is certainly one of the unique aspects of short-selling. It is possible that when you see something developing, others are seeing it as well so at that point you may be unable to borrow the shares. This is why sometimes short-sellers borrow the shares when they can get their hands on them, even if they are early on the thesis playing out. In the ‘80s and ‘90s, when interest rates were high, you were effectively paid to wait out your short thesis be-

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“I teach a class at Yale’s Business School on the history of financial fraud. One of the things I teach my students, which I also teach my analysts here, is that nothing beats starting with source documents. You have to build a case for an idea, and you can’t do that without doing the reading and the work.”

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cause you could earn interest on the proceeds received from the short sale. However, in a rate environment like the one we’re experiencing today, initiating on a short too early can be somewhat more painful relative to those prior decades.

G&D: How is your firm different from other hedge funds with respect to sourcing new ideas?

JC: From an approach point of view, one of the things that distinguish other hedge funds from us is that a typical hedge fund has the intellectual ownership of an idea separate from the economic ownership of that idea. By that I mean you have the partners and the portfolio managers at the top and you generally have the analysts, who are more junior at the firm, at the bottom. The way the model works at most firms is that the guys at the top command the people at the bottom to come up with good ideas from which the portfolio managers ultimately select the additions to the portfolio. The problem with this model is that the profits go disproportionately to the people at the top of the pyramid but the risk -- or the intellectual ownership of the idea as I like to call it -- resides at the base of the organization with the most junior, inexperienced people. Consequently, if things go right,

everyone makes money, but if things go wrong, the person at the bottom disproportionately shares the blame and the risk. This is why turnover is so high in the hedge fund industry. People try to do carve-outs, which I think are very bad policy. This model puts all of the power of the idea generation, and therefore the alpha generation, with the most junior people in the firm, whereas the senior people are just doing portfolio allocation. We’ve always viewed it the opposite way. We have six partners at Kynikos who have 150 years of experience in the securities business amongst us and we have been together 100 years in aggregate. For example, my number two has been with me for 20 years. Because of our experience, we generate ideas up at the top. We are looking for the new ideas and we’ll do the first read-through of a company’s 10-K and other research in addition to talking to people in the industry. The next step is to *then* send the idea down the chain to our research team to process. I will never blame the analyst for a stock that goes against us. Putting the stock in the portfolio is my responsibility and the other senior partners’ responsibility. I think this leads to a better intellectual environment at the firm. So we get analysts who love working here and will stay for 10 or 15 years. It’s a much more stable model in terms of process

than some other models.

G&D: What are some of the skills that are essential to succeeding in this field?

JC: I teach a class at Yale’s Business School on the history of financial fraud. One of the things I teach my students, which I also teach my analysts here, is that nothing beats starting with source documents. You have to build a case for an idea, and you can’t do that without doing the reading and the work. We’ve had a little game where we’ve been watching a company that just put out its 10K. When it came out, prominent in the disclosure was that the company had just changed its domicile to Switzerland for a variety of important reasons. I told the analyst, let’s play a game: call the sell side analysts and try to ask them some questions to see if they know that the company, under the advice of their legal counsel, changed their domicile. She said that of the eight analysts that followed the company, it was the seventh analyst who had a clue of what she was talking about. None of the others had any idea, which meant they hadn’t read the document, and that 10K had been out for 10 days. This happens more than you think. It happens because Wall Street research departments are marketing departments. The people with the most experience in these departments spend

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“... start first with the SEC filings, then go to press releases, then go to earnings calls and other research. Work your way out. Most people work their way in. They’ll hear a story, then they’ll read some research reports, then they’ll listen to some conference calls, and by that point may have already put the stock in their portfolio. It’s amazing what companies will tell you in their documents.”

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 much of their time market- ing. The junior people are back at the shop doing mod- els and such, but there isn’t much thought going into this. So I teach my students and analysts: start first with the SEC filings, then go to press releases, then go to earnings calls and other research. Work your way out. Most people work their way in. They’ll hear a story, then they’ll read some research reports, then they’ll listen to some con- ference calls, and by that point may have already put the stock in their portfolio. It’s amazing what companies will tell you in their docu- ments. Enron is a great example – most of the stuff was hiding in plain sight. There was one crucial piece of missing information, which was the “make good” in the SPVs that Fastow was running. The reason people invested in those and bought crummy deals from Enron was that there was a provision that if you lost money, Enron would issue stock and make you good. So that was a key missing piece of information. But in any case, it was amazing how much information was out there. Investing is like a civil trial. You need a pre- ponderance of evidence, not beyond a reasonable doubt.

G&D: Do you recommend investors start with reading the newer filings first?

JC: Yes, look for language changes. Read the most

current ones and work your way backwards. Read the proxy statements that are often neglected and are full of great information. By doing that and by spending a night or two with those documents, you can have a remarkably comprehensive view about a company. So start there and work your

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way out. This way you are looking at the most unbi- ased sources first. People on earnings calls will try and spin things, and analyst re- ports will obviously have a point of view. All of that is fine, because hopefully you will have first read the un- varnished facts. Primary research is crucial and not as many people do it as you think. Because there is so much information out there, it almost behooves people to read the source docu- ments. If you are an airline analyst, you could be read- ing about airplane orders, traffic trends, fuel price

trends, etc. all day long, and not have a better idea of what is going on at Delta Airlines or Japan Airlines. Start by reading the docu- ments of Delta Airlines or Japan Airlines. Overtime, understanding what to read and how much time to spend reading various things becomes an art as much as a science. You need to be- come a good information editor nowadays.

G&D: When you make macro calls, what primary sources do you use?

JC: People think we make big macro calls, but the fact of the matter is we don’t. We might end up with some macro calls but that’s only a function of our calls on the micro side. China is an ex- ample. People think we made a big macro call on China. In fact, our position on China came from the mining and commodity stocks in the summer of 2009. We were scratching our heads trying to figure out how in this terrible re- cession the prices for indus- trial commodities were go- ing up. Well, we very quickly ascertained that China, which was 8% of the world’s economy, was gen- erating 80% of the marginal demand for iron ore, ce- ment, and steel. It didn’t take much work from there to realize that it was be- cause of fixed asset build- out. As we did more and more work, we focused on the Chinese property sector

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“This is a bubble that has a long way to go on the downside. Residential real estate prices, in aggregate in China, at construction cost, are equal to 350% of GDP. The only two economies that ever saw higher numbers at roughly 375% were Japan in 1989 and Ireland in 2007, and both had epic property collapses. So the data does not look good for China.”

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and couldn't believe what we saw, and then we moved to the banks, etc. So it was our work on individual companies that led us to the view that this was a macro problem in China property market. It was similar to our work on subprime lending in the U.S. We started by looking at the Florida real estate market in 2005, which was the first to go. I have an apartment in Miami Beach and I remember counting cranes along the horizon in 2005 and 2006. They were just multiplying. At the same time, we were doing some work on the banks and property companies in Florida. We saw that the securitization business was fueling this build out, and then we looked at the rating agencies and the big banks and worked right up the chain and realized it was a system-wide problem. The same occurred with the commercial real estate market in the 1980s. We started with Integrated Resources, the syndicator I mentioned, and then tax laws changed in 1986. The laws meant that you could no longer write off passive losses from real estate against ordinary income, and that devastated the industry as they were just leveraging up to buy buildings everywhere. So we looked at syndicators, we looked at the savings and loan industry, and worked our way up the system. We're not macro people. Even though we have a macro call on

China real estate, it really derived from our work on individual companies.

G&D: Chinese students we spoke with seem to think that although the real estate bubble in China seems to be bursting as we speak, it may heat back up if the government starts stimulating the market. What would you say to that?

JC: That is the overall belief in China. When we first started talking about this, my critics said, well, Mr. Chanos doesn't speak Mandarin and has never been to China. I said, that's true, though my clients pay me for performance, not how many visas I have in my passport. Most people who go to China visit Shanghai and Beijing. That's like saying I went to London and New York and didn't see any problems in 2006 and 2007. Well, if you had gone out to Phoenix or Las Vegas maybe you would have seen them. So the critics, who initially in 2010 said our call was wrong, are now saying “well, there are problems, but the government can reflate and fix them.” My response to that is the government is the one that got you into that problem. People in the U.S. always said, if the U.S. gets into trouble, the Fed will just cut rates. The problem is that the government policy has been loose in China regardless. The one restriction they have in place is the House

Purchase Restrictions (HPRs), which apply for second and third homes. But people who own more than a couple homes are almost always speculators. The bulls are saying the government will loosen the HPRs, but the problem is that the government doesn't want speculation in real estate. So I think that's a pretty bad argument. Secondly, the flood of construction has continued apace, and the unsold inventory is piling up. What if the speculators turn into sellers as opposed to buyers when the HPRs are relaxed?

G&D: Do you think the government is seeing that?

JC: They are seeing it, and just a few weeks ago Premier Wen gave a speech saying they are going to keep the restrictions in place because they still think prices are still too high and they want to stop speculation. Anyone who is counting on the government to fix that market is, I think, counting on hope rather than analysis. This is a bubble that has a long way to go on the downside. Residential real estate prices, in aggregate in China, at construction cost, are equal to 350% of GDP. The only two economies that ever saw higher numbers at roughly 375% were Japan in 1989 and Ireland in 2007, and both had epic property collapses. So the data does not look good for China.

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“In China, everyone is incited by GDP. They are fixated on growth. In the West, we go about our economic lives, and at the end of the year the statisticians say, this year your growth was 3%. But in China, it’s still centrally planned. All state policy goes through the banking system. They decide what they want growth to be and then they try and figure out how to get there.”

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G&D: If a collapse occurs, will it be very damaging to the global economy?

JC: Interestingly enough, it may not impact the U.S. all that much. The U.S. might even be a beneficiary due to lower commodity costs. The commodity companies however will be hit hard. I also think the renminbi is overvalued. If there is some depreciation of the currency, that could lead to cheaper products from China, which could actually help the U.S. economy. Places like Australia and Canada and Brazil would be hit pretty hard, however, because they rely on exporting commodities to China.

G&D: You talked at the Value Investing Congress a few years back about the difficulty of investing in companies with so much of their profitability tied to commodities. How do you determine what’s a sustainable average price for a commodity-focused company?

JC: It’s difficult, and you determine the price based upon a probabilistic range. If you look at the price of iron ore in real terms since the 1920s, it basically traded between \$30 and \$45. Iron ore is not hard to find, it’s pretty much everywhere. The cost to extract it was around \$30 per metric ton in real terms. In 2005 it suddenly took off and it got

to \$180 last year. It’s back down to \$140 right now, and people are modeling out their profit forecasts based on a range of \$120 to \$160. Well, what if it gets back to \$30 or \$40? You might want to put your lower bound a bit lower here. Everyone’s just looking at the last four years. The last four years was the China boom. It was a once in a lifetime build out of infrastructure in the most populous country of the world. After you have your third international airport in Hainan, China, you probably don’t need a fourth one – especially when no one is using the second one. In this case, things are really two or three standard deviations from the norm, and that’s what you need to be looking for. If iron ore prices were \$50, I really wouldn’t care, but at \$140-\$180 with more capacity coming on and lower demand in the future, I think we’re in for a disaster.

G&D: But why do you think the government is tolerating this?

JC: It’s all about incentives. In China, everyone is incited by GDP. They are fixated on growth. In the West, we go about our economic lives, and at the end of the year the statisticians say, this year your growth was 3%. But in China, it’s still centrally planned. All state policy goes through the banking system. They decide what they want

growth to be and then they try and figure out how to get there. The easiest way to do that, in an economy where consumption is only 30% of the total economy and net exports are determined by the world markets, is to stick a shovel in the ground and build another bridge, since that contributes to GDP. So a random party chief knows they will never be sacked if they make their GDP targets.

G&D: Why are they targeting 8% instead of something like 4%?

JC: Because that’s how they’re compensated. These are not profit maximizing enterprises. China doesn’t produce GNP numbers, they don’t put out figures net of capital depreciation. If they did, the numbers would be much lower because there is so much that needs to be depreciated. The problem is that Western investors have fallen for the idea that, if there is rapid growth in this country, they must be able to make a lot of money. Well, not necessarily. In fact, GDP growth in China is poorly correlated with stock returns. If you were a European investor in 1832 and you were looking for a great growth story, you would have invested in the U.S. The U.S. went through probably the greatest 100 year period of growth in history from 1832 to 1932, and yet, if you had invested

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Jim Chanos

“It’s dire for Greece... The new twist in 2011 is that the donor countries installed their technocrats in Greece’s ministries to oversee tax collections and interior policy, and that has really hit a nerve. Now Germany is basically dominating Europe. You ignore that political calculus at your peril. All of this connects to historical issues, such as how the Germans treated the Greeks in World War II. Greece lost one million people in World War II out of a population of eight million.”

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over that period you would have probably lost all of your money five different times. Just because something’s growing over the long term doesn’t make it a great investment.

G&D: Given your Greek heritage, we’re especially curious about your observations about the situation in Greece?

JC: It’s dire for Greece. Clearly the European Union has made an example out of the country. As has been said, the problem with the EU is that it’s a currency union without a fiscal union. The incentives are all skewed. People who say that Germany suffers from having to share the EU with these Southern countries like Greece are missing the point. Germany is very happy to have those Southern countries in the EU, because it keeps the currency lower than otherwise. If Germany had its own currency, it would go through the roof, and harm German exports, which are the big driver of that economy. So in effect what’s happening is that German taxpayers are bailing out European banks, who’ve lent money to the Southern European countries, which are buying German products. The problem is that it’s a political issue and so many people just want to look at it as a financial and economic issue. There’s an interesting alignment of interests where the

taxpayers in the donor countries are upset, and rightly so. In other words, the typical German taxpayer is saying, why should I pay for this? The other thing is the recipient countries are upset, too. It’s not as if the typical Greek citizen wants this money. They’re not seeing any positive results from the money – it just goes right to the European banks. It’s not financing any new growth initiatives. I’m not going to apologize for Greeks who didn’t pay their taxes or retired at 42. The stories are out there and they’re all true. But be that as it may, there are an awful lot of law abiding Greeks who are being destroyed by what is going on in Greece now. The new twist in 2011 is that the donor countries installed their technocrats in Greece’s ministries to oversee tax collections and interior policy, and that has really hit a nerve. Now Germany is basically dominating Europe. You ignore that political calculus at your peril. All of this connects to historical issues, such as how the Germans treated the Greeks in World War II. Greece lost one million people in World War II out of a population of eight million. The only country with a comparable (and higher) ratio was the Soviet Union. In the fall of 1941, after the Germans invaded Greece, they left the Greek government intact but they put Reich’s ministers in charge of all the ministries to oversee them.

One of the things they did was to loot the country of its harvest. Eight hundred thousand Greeks died in that famine of 1941. Almost every Greek family has someone who died in that famine. So this twist has opened up a 70 year old wound. Keep an eye on Spain and Portugal because they’re next. The other issue that is coming about is cutting your way to growth. Is austerity key to getting these countries back on track? So far the evidence is pretty poor that it is. We may look back and say, wow, what a policy mistake.

G&D: Where do you come down on the nature vs. nurture debate? You made a great investment in Baldwin United at 24, a time when many are barely learning about investing.

JC: I always used to say, on the short side, people are made not born. I’ve changed my view on that a bit. I do think there are enough asymmetries between the long side and the short side that it makes it difficult for people who are otherwise very bright investors, particularly people in the value world, who look at things and see great short opportunities, but can never get their mind to the point where they can become good short sellers. I do think, to some extent, the temperament of a good short seller is probably genetic. So I think the skill set

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Jim Chanos

“I always used to say, on the short side, people are made not born. I’ve changed my view on that a bit. I do think there are enough asymmetries between the long side and the short side that it makes it difficult for people who are otherwise very bright investors, particularly people in the value world, who look at things and see great short opportunities, but can never get their mind to the point where they can become good short sellers.”

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is the same in terms of trying to do deep research and finding unique value in companies is the same, the mindset can be very different. You need to be able to weather being told you’re wrong all the time. Short sellers are constantly being told they’re wrong. A lot of people don’t function well in an environment of negative reinforcement and short selling is the ultimate negative reinforcement profession, as you are going against the grain of a lot of well-financed people who want to prove you wrong. It takes a certain temperament to disregard this.

G&D: How often do you see companies that are fudging the numbers able to maneuver their way out of it?

JC: If a company is very fraudulent, it is very difficult to recover. Where companies have simply fudged the numbers, such as Tyco International, they are able to come back but the shareholders and sometimes bondholders are wiped out. If we end up being right on the fundamentals, it’s very rare that a company in mid-problem can turn itself around. Usually it requires a cleansing of the old order for things to change. Generally the problems we see are deep-seated enough where they need to confront them, pay the economic price, and move on.

G&D: Could you give us an example of some current ideas?

JC: Currently we are short the natural gas industry in the U.S. for a few reasons. First, there has been a major technological innovation -- fracking -- that has created displacement. This has driven prices from high single digits per MCF of natural gas down to \$2 per MCF. Most of the companies in the natural gas area began an exploration boom that has created this glut. These companies counted on the price to remain above \$6-7 per MCF. A number of companies that had structured their balance sheets and paid up for acquisitions with this expectation of higher prices are now struggling. So they’ve got weakened balance sheets in a commodity business that is in oversupply, and on top of that, many of them are engaged in some pretty egregious accounting games, like hiding negative cash flows in various ways. I think this area will be a very fertile area on the short side for a number of years. The good news is that this happens to be an amazingly positive development for the U.S. because energy prices have dropped so much. As an ancillary development, the other industry that gets killed by this is coal. Natural gas prices are now half the price of coal. Coal used to be one of the cheapest sources of energy, but it was the dirtiest. Now it’s

becoming one of the most expensive fuels and is still the dirtiest. Utilities and others are rapidly transforming from burning coal to burning natural gas, which I do not think bodes well for the coal industry.

G&D: Haven’t some of the stocks of companies in these industries been hit hard already?

JC: You have to remember that if you are shorting a leveraged company, with 90% of the capitalization in debt and 10% in equity, a 50% decline in the stock price only wipes out 5% of the total capitalization. You have to look at the total capitalization. In some of these cases the total capitalization is only down a little while cash flow has been cut by 75%. This is the reason that some investors get killed in value traps. They look at the stock and they don’t look at the total capitalization. They don’t realize that the debt burden is forever, meaning it’s not shrinking, whereas the equity capitalization may fluctuate in the market. If the cash flows have diminished dramatically the company’s ability to service the debt, then the stock going down by half doesn’t mean anything. You could still be at risk of losing all you capital.

G&D: Any other ideas that we can talk about?

JC: I think for-profit educa-

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Jim Chanos

“You need to be able to weather being told you’re wrong all the time. Short sellers are constantly being told they’re wrong. A lot of people don’t function well in an environment of negative reinforcement and short selling is the ultimate negative reinforcement profession, as you are going against the grain of a lot of well-financed people who want to prove you wrong. It takes a certain temperament to disregard this.”

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tion business is a flawed business model. The outcomes are very poor, as I feel that these degrees are sold, not earned. Anyone that wants to sign up for these things can get in, but tuition is up there with many private schools. People are coming out of these schools with \$20,000 - \$50,000 in debt and many don’t even graduate but incur the debt nonetheless. Some of the technical schools do good practical training, but most of the business has now shifted to online degree granting because it is more lucrative. I remember a couple of years ago, the head of human resources at Intel was quoted in a front page New York Times article saying that if someone came in from an online college, they won’t even look at them. The types of jobs these graduates get are no better than if they just had a high school degree, and yet they are incurring all of this debt. Ultimately defaults will go so high in the student loan area that the federal government will see mounting losses and will change the student loan program guarantee to force institutions to take a bigger chunk of the risk. Once this happens, the business model is broken. The only reason these companies exist is because of the federal loan guarantee on student debt.

G&D: What are some characteristics of the best

analysts that have worked for you?

JC: The thing I look for most is intellectual curiosity. One of the best analysts we ever had was an art history major from Columbia. She had no formal business school training. She was so good because she was very intellectually curious. She was never afraid to ask why and if she didn’t understand something she would go figure out everything she could about it. This is almost something that you can’t train. You either have it or you don’t.

G&D: Who are other investors that you respect?

JC: I have a lot of respect for other investors that have gone public on the short side. People like David Einhorn and Bill Ackman have been willing to go negative and be public. To the extent that they are willing to take a controversial stand, I think it is a courageous thing to do. It is also an important thing to do because for too many years short sellers have been demonized for being anonymous. We have been one of the few public figures out there. We believe that if you are willing to put an investment hypothesis out there before people with a face on it, it adds to the overall level of investment debate. All kinds of people are willing to say why they own something, but are afraid, because of retaliation

by the companies, to say why they are short something.

G&D: What are some of the avoidable mistakes that you see analysts make?

JC: One of the biggest things I see quite often is getting too close to management. We never meet with management. For all of the bad asymmetries of being on the short side, one of the good asymmetries is that we don’t rely on the company. We can get information from the company if we want to, as we can go through the sellside. Those that are long the stock and are close to the company almost never hear the negative side in any detail. The biggest mistake people make is to be co-opted by management. The CFO will always have an answer for you as to why a certain number that looks odd really is normal, and why some development that looks negative is actually positive.

A second mistake some people make is not reading all of the documents. I guide people to always start with the SEC documents, and then go to other sources for information. It’s amazing how few analysts actually read SEC filings. It blows me away. We have the greatest disclosure system in the world and people by and large don’t take advantage of it. I am a big believer in looking for

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Jim Chanos

“If you ever have an idea and you think you need to take career risk to accomplish it, do it early in your career. Life intrudes -- as when you get older you end up with more responsibilities and your ability to take risk diminishes. If you are 25 and have a great idea and you fail, no one is going to hold it against you, and future employers and investors might actually look favorably upon it.”

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changes in language in a company’s filings over time. During the year we were short Enron, each successive filing had incrementally more damning disclosure about the company’s off-balance sheet entities. It was obvious that internal lawyers were pushing management to give investors more detail on these deals that were being done, as they felt uncomfortable about them. Language changes are not accidental. They are argued over internally.

G&D: What is your view on the banking industry today?

JC: I believe that right now the banking industry is at the tail-end of its credit problem in the United States. We addressed it before everyone else. I call it the ‘pig-in-the-python’, where the python is the world credit situation. If the pig at the end of the snake is the U.S., the pig in the middle is Europe, and the pig being eaten now is China and Asia.

G&D: The investment management industry is extremely competitive. What do you recommend students do who have not been successful in getting the job of their choice?

JC: In one word, network. Go to as many lunches and dinners as you can. Try and meet as many investment

management people as you can. Find out where the investment management people at your firm hang out, or join an investment ideas group. There are lots of different doors that can open throughout your career. Stay intellectually curious and meet as many people as you can.

“When fortune smiles your way as it does in any business career a number of times, take advantage of it. That’s when people grow, that is when you see quantum leaps and step functions in career moves.”

G&D: What are some of the things that you think business school students who want to follow in your footsteps should do?

JC: If you ever have an idea and you think you need to take career risk to accomplish it, do it early in your career. Life intrudes -- as when you get older you end up with more responsibilities and your ability to take risk diminishes. If you are 25 and have a great idea and

you fail, no one is going to hold it against you, and future employers and investors might actually look favorably upon it. So if you really want to pursue something, do it while you’re young – you’ll have more energy and you’ll be able to take more financial and career risk. If it doesn’t work you still have your whole life ahead of you.

G&D: In the beginning of our interview, you mentioned how your father’s advice about working hard and working for yourself was important for you in your life. What kind of advice do you give to your children?

JC: Do something you really want to do. There are few feelings worse in the world than waking up every morning and not liking what you do. Whatever field it might be, you should do what you want to do. Life is too short. The people that are the most productive are those that are happiest in their jobs and find intellectual curiosity and stimulation in what they do. And when fortune smiles your way as it does in any business career a number of times, take advantage of it. That’s when people grow, that is when you see quantum leaps and step functions in career moves.

G&D: Thank you very much Mr. Chanos.

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Tom Russo

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Sequoia Fund. Mr. Russo is a graduate of Dartmouth and has an MBA and JD from Stanford.

GD: You are well known for investing in high quality, high cash flow generative companies with a long-term focus. Yet some of these companies, like Nestle and Heineken, have become giants in their respective industries. Does it ever concern you that maybe in a few years they won't be able to grow at a rate that could provide satisfactory investment returns?

TR: My feeling is that there is still so much white space that is addressable for these companies. In the newer markets that these companies do not yet dominate, there is a lot of capacity to grow. If you scale Nestle from 1991 to today, the Company's returns have compounded at approximately 14%. In 1991 they could not sell in China and had a pretty small business there. Russia had just opened up, India was not yet engaged, there was no presence in Vietnam, and they hardly had a pulse in Brazil. Africa was also not developed. These are now the areas where they can commit the most capital in search of new business.

Additionally, in terms of the traditional markets that Nestle already dominates, it is still the case that Nestle's returns extracted from these businesses can grow

as they become more efficient. It's amazing to see the kinds of costs that can be removed from a business (e.g. energy, water, packaging) even while addressing corporate social responsibility. There is an interesting transition that is taking place where a company like Nestle, Heineken or Unilever can take hundreds of millions of dollars out of the business because they have chosen to operate in a socially responsible way – i.e. waste less water, use less energy, less plastic, etc.

Then the question becomes that of the reinvestment possibilities and corporate culture. The corporate culture is key to making sure Nestle stays on track. Management must continue to think of the owners when they reinvest and not reinvest in a way that ensures that management can own bigger cars or afford other luxuries.

GD: There was an article in *The Wall Street Journal* around a few months back ago about how Nestle is making investments in Africa that will provide no near term return but should provide significant return over the longer term. What is your take on the subject?

TR: Africa represents a great opportunity for patient firms like Nestle. The quality that I look for in managements is the "capacity to suffer." They have "capacity to reinvest" because they have brands whose awareness has al-

ready affected much of the world. Some of these brands have widespread awareness because they were originally colonial brands, such as Unilever or Cadbury. Some of these businesses have even predated Communism. For example, Nestle has had a presence in the Czech Republic for decades. British-American Tobacco had the tobacco monopoly in China before Communism. Similarly, Chesterfield was the brand of choice in an Eastern European country (I believe Romania) before Communism. It is amazing that now when people in these countries have the opportunity to purchase whichever products they choose, they go back to the brands that have been historically in the region, even though those brands haven't been advertising for 70 years.

The three prongs that I look for when investing in a business are: the fifty cent dollar bill, the capacity to reinvest in great brands and the "capacity to suffer." The "capacity to suffer" is key because often the initial spending to build on these great brands in new markets has no initial return. Many companies will try to invest smoothly over time with no burden on currently reported net income, but the problem is that when you are trying to invest in a new market, smooth investment spending really doesn't give you enough power to make an impression. You end up

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"Many companies will try to invest smoothly over time with no burden on currently reported net income, but the problem is that when you are trying to invest in a new market, smooth investment spending really doesn't give you enough power to make an impression. You end up letting in a lot of competition that will drive down future margins."

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 letting in a lot of competition that will drive down future margins. If you're smart, like Starbucks was in China for instance, then you invest a lot of money up-front to build your store presence, distribution, advertising, etc. Then you become a first mover and your brands become identified with a particular product category.

GD: Do you like investing in small foreign subsidiaries of large multinational companies that trade separately from the parent?

TR: I used to years ago. In many situations they end up being acquired by the parent company. Additionally, you used to be able to acquire those subsidiaries at a lower price. But I found that if the parent did not buy the company and the market matured, the lack of reinvestment opportunities became a problem. For example, at some point Unilever Indonesia will no longer be able to reinvest in Indonesia at attractive returns, and then you are capital trapped.

GD: Would the parent then come in and try to essentially "steal" the subsidiary at an unfair price?

TR: There have certainly been a lot of lawsuits associated with that question. For example, Sears Holdings attempted to buy its Canadian subsidiary. There were a lot of lawsuits back and forth and it was never con-

summated. At that point, you are at risk, because you don't have control over how the parent company treats the subsidiary and the subsidiary may no longer possess attractive reinvestment opportunities.

GD: Given your focus on global multinational companies, do you also try and look for smaller companies that might be acquired by one of these multinationals?

TR: I have owned such businesses that have been acquired. For example, I owned Cadbury. The very domestic nature of Kraft ultimately compelled the purchase of Cadbury. At the end of the day, Kraft realized it needed more international exposure which it thought it could obtain on the back of the infrastructure that Cadbury had. It is a tough way to grow though.

GD: What was your view on the Cadbury acquisition?

TR: While sorry to lose the future returns Cadbury promised, I was pleased by the deal's timing. The acquisition gave cash at a time when two companies that were new to the portfolio were struggling because of temporary setbacks in North America. One of those companies was MasterCard and the other was Anheuser-Busch. MasterCard and Visa together suffered because of the Durbin Amendment that was intended to regulate

interchange fees for debit cards. Ironically, the real protagonist in that story was presented as the small merchant. But the truth is, for the small merchant, the benefits of a debit transaction outweigh those of a credit card or check. Despite that, debit fees were reduced by 70%. The market reacted with a sharp share price sell-off due to a fear over the loss of revenue. Visa dropped even further than MasterCard because they were the dominant player in this area. We invested in MasterCard.

I thought MasterCard was the preferred alternative at the time for a few reasons. For one, it was cheaper. That valuation was 12x forward year's earnings. For a company with a capacity to grow like MasterCard, that was simply too low a valuation. MasterCard has a tremendous amount of international exposure – relatively more than Visa. MasterCard also had a recent management change. Ajay Banga, the new CEO, has a global background and is very smart. For example, he is now negotiating with the Indian government to have a state stored value card that is biometrically identified. If the government wants to transfer money to a part of the country that is very poor, the risk of theft of cash is very high right now. With the biometrically identified card, you can secure your remittances from the gov-

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ernment in a way that isn't currently available. I think MasterCard will benefit enormously from Ajay's global agility. You have to remember that eighty-five percent of the world's commerce outside of the United States still uses cash. Commerce outside of North America is also a fraction of what it will become.

GD: Do you feel comfortable investing in some foreign-domiciled companies given that the rule of law in certain countries is not strictly enforced?

TR: Well, I'm not as comfortable as those who have expressed their comfort through higher allocations to such countries in their portfolios. In my portfolio, 60-65% of the assets are in non-U.S. companies. But what you have not seen is many non-U.S., emerging market companies. One of the reasons is due to reinvestment risk. For example, there is a big dairy company called American Dairy in China. I could invest directly in China through shares in that business. However, I don't need to because I already "own" exposure to Chinese dairy through Nestle. Nestle is a big player in dairy. So I have a big position in dairy in China run by a group I know and like. I could supplement my position, as I often do, but I chose not to buy American Dairy because I have more confidence in the management team of

Nestle. For our lifetimes, American Dairy will probably have the capacity to reinvest, but at the end of the day, it will stop having an opportunity to deploy capital in China. And then the question becomes, what will the company do with the cash? It doesn't have a brand that it can take around the world and deploy capital behind its future growth.

"In my portfolio, 60-65% of the assets are in non-U.S. companies. But what you have not seen is many non-U.S., emerging market companies. One of the reasons is due to reinvestment risk."

Cultural values are also very important. In developing markets, the people who are driving these arguably faster growing businesses are sometimes willing to cut corners. For example, speaking of the local dairy market in China, every few months you read newspaper

articles about children dying from toxic chemicals in the milk. That just should not happen with Nestle. Nestle cannot afford the risk of using questionable inputs for their products because their reputation is of paramount importance. I can evaluate the ability of some global firms to reach local cultures because I can see the backgrounds of management and their capacity to reach various cultures. For local firms however, it is much harder to evaluate management culture.

GD: Can you talk about your thesis for Martin Marietta and the offer for Vulcan?

TR: Martin Marietta's business, stone quarrying, tends toward natural monopolies. It is very expensive to haul stone on a truck and stone isn't valuable enough to allow it to recoup shipping costs. Within 25 miles is about the only distance that you can draw from to get stone. In most urban areas, that 25 mile radius is an area where it is not likely that new quarries will be zoned. So if you own a quarry in an urban region, you have a very valuable asset. That is what interested me in the business a long time ago. Of course, like so many things in this business, this awareness wasn't a piece of independent inspiration. I was working at the Sequoia Fund in 1984, and I happened to look at a research report

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lying around the office from a few years earlier that dealt with a crushed stone company, Vulcan Materials. My colleagues at Sequoia said that they used to have an analyst that loved the business and who did research on every quarry that Vulcan owned. It was a family controlled business, and I liked the fact that they would be careful with the way they deployed the capital. The work the analyst did showed most of the quarries were free from competition and the company clearly made a lot of money. Once clued into the business' unusual economics, I then wondered if there were companies other than Vulcan in the business. After reading that report and doing a lot of research myself, I subsequently invested in four or five related companies in the crushed stone business. The work others had already done at the Sequoia Fund provided the base for my investment thesis in Martin Marietta, and then my contribution to my investors was to try and find other smaller companies both here and abroad, trading at even lower valuations because they were not as well known. Overtime I bought shares of Ready Mix Concrete, which was located in Ireland. I also bought shares in a French company that was in the same business.

G&D: Pricing for Martin Marietta is still likely driven by macro concerns. How

do you think about such exogenous drivers for a business? Similarly, how do you think about other commodity-related companies like BHP that have significant scale in certain markets?

TR: For Martin Marietta, it has been amazing how the post-08 trauma has affected its business in a way that has never surfaced before in its history. There are three legs to this business: commercial building, residential building, and infrastructure. They kind of follow different cycles. We have been going through a terrible funk in terms of job growth, but during this downturn the government has still never released the extraordinary appropriation intended for roads, so the infrastructure industry has been starved. This would typically be the kind of business that one would expect to have "Keynesian leverage" during a national downturn. Similarly, the commercial construction industry is dead - more than dead, really - because so much of the business was dependent on people who overstated their businesses' vitality during the run-up to the collapse. They were building buildings that weren't sufficiently leased by using easy money that made these businesses appear to be much better than they actually were. Of course, the market reversed and these companies fell. Residential construction has not come back. Their stone quarrying businesses as a

result operate with their high fixed costs at a fraction of their scale. Pricing has

"For Martin Marietta, it has been amazing how the post-08 trauma has affected its business in a way that has never surfaced before in its history... This would typically be the kind of business that one would expect to have 'Keynesian leverage' during a national downturn."

actually not gone down in the face of this due to Martin Marietta's pricing discipline and the fact that price elasticity for their stone is very low. Volumes have just come down by virtue of the fact that the three sources of demand for their product are soft at the same time.

Regarding other extractive industries, such as Newmont, BHP and Anglo-American - those are really based more on global markets for commodities.

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Stone provides somewhat of a natural monopoly which protects the pricing a little bit but most industrial commodities are priced on the

“Now Vulcan finds itself flat on its back both due to the extreme leverage it took on when it acquired Florida Rock at the peak of the market, and due to its heavy exposure to the Florida and California markets which turned down particularly sharply beginning in 2008.”

margin. While I recognize the scarcity that can be driven by emerging market demand met by fixed scale, I have chosen not to risk an investment in these businesses, because commodity prices are notorious for being unsustainable.

G&D: *What is your view on the offer by Martin Marietta to buy Vulcan?*

TR: According to all of the

merger-related documents, the thought behind the acquisition of Vulcan was Vulcan’s initially. But now Vulcan finds itself flat on its back both due to the extreme leverage it took on when it acquired Florida Rock at the peak of the market, and due to its heavy exposure to the Florida and California markets which turned down particularly sharply beginning in 2008. Martin Marietta has now proposed merger with Vulcan under their terms and it has become a big fight. The difficulty with such a merger is something that Vulcan discovered following its acquisition of Florida Rock. The process of putting Vulcan and Florida Rock together generated much lower profits than initially hoped for due to the Justice Department’s demands that Vulcan quickly sell certain operations to a bona fide competitor. Instead of controlling more of the market where they had picked up additional exposure through Florida Rock, Vulcan was forced to sell to somebody else who wanted to stay in or even enter the business.

When Vulcan approached Martin, they had initially thought that any divestiture could be spun-out into a new leveraged entity which would be a price-taker in those markets. In a sense, a joint venture would have allowed them to gain more scale in the combined Vulcan/Martin markets. When Vulcan first proposed merging with Martin Marietta,

they hoped for a loose Justice Department, which would have allowed them to shift some operations to a third party trust that would have been accommodating from a pricing standpoint. What’s clear today is that Justice Department has taken a very strong turn against approving such transactions. A joint ven-

“When Vulcan first proposed merging with Martin Marietta, they hoped for a loose Justice Department, which would have allowed them to shift some operations to a third party trust that would have been accommodating from a pricing standpoint.”

ture now seems dead on arrival.

Vulcan is now arguing that if the acquisition of Vulcan were to move forward, Justice would require massive divestitures in arms-length transactions with a third

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party over a very short compliance time period. Vulcan believes this will effectively provide the business foundation for a new player in their own very consolidated markets. This could disrupt the term structure of the existing industry and create margin-destroying competition in what are already quite agreeable markets from a pricing standpoint. The markets wherein Martin and Vulcan compete today tend to be duopolies with very fine structures. This was the reason that Vulcan provided for not having approved the deal.

Several of Martin's and Vulcan's large shareholders, most notably Mason Hawkins of Longleaf Partners, have come forward to express support for Martin and its offer. It is not clear to me that this threat from market disintermediation through Justice Department sales of assets to a new competitor will not threaten to disrupt the structure of the industry. In my opinion, it's probably worthwhile for Vulcan shareholders to wait on giving approval to the deal until they see what the Justice Department will require.

G&D: What is the thesis behind your investment in Brown-Forman?

TR: Brown-Forman is a family controlled, very long term minded company which owns a portfolio of brands that enjoy increas-

ingly global consumer loyalties. Jack Daniels is a terrific brand and the company has been run by a shareholder minded family. In 1987, I was surprised to see Brown-Forman shares plunge 40% because a brand called California Cooler that they had earlier acquired had seen at that time an

“[In Brown-Forman] I saw a core business that was still very strong and a company that had dropped a lot in value. At this time, early 1997, I did a lot of research on the company and realized that investors were unfairly discounting Brown-Forman due to a misperception about the state of its whiskey business.”

unexpected decline in shipments. What the market

had completely forgotten about for the moment was that the company still had very solid brands in Jack Daniels and Southern Comfort. So I saw a core business that was still very strong and a company that had dropped a lot in value. At this time, early 1997, I did a lot of research on the company and realized that investors were unfairly discounting Brown-Forman due to a misperception about the state of its whiskey business. For a while, a certain segment of the population (mostly around Wall Street) had moved away from bourbon and moved towards wine spritzers and those sorts of things. But the fact was that the rest of the population in the United States had not moved away from bourbon. It seemed that Wall Street analysts had extrapolated their tastes to the rest of the world. So as I mentioned, Brown-Forman's stock price collapsed following management's efforts to diversify the business by buying California Cooler. Missed in all of this was that Brown-Forman still sold around four million cases of Jack Daniels annually in the US, which alone I thought justified an intrinsic value worth twice the share price. Moreover, the company sold an additional half a million cases internationally.

As I was analyzing the company in 1987, the management described plans that would reorient the company

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Pictured: Tom Russo at CSIMA Conference in February 2011.

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to expand internationally, which would cost them money and negatively im-

segmented their brand and created different price points for Jack Daniels. But

“Importantly, Brown-Forman had the “capacity to suffer” in this manner because it was family controlled via A and B shares which allowed the Brown family control.”



Pictured: Tom Russo and Jean-Marie Eveillard, at a CSIMA conference in February 2011.

pact near-term reported earnings. Importantly, Brown-Forman had the “capacity to suffer” in this manner because it was family controlled via A and B shares which allowed the Brown family control. Folks at Brown-Forman realized that around 4 million cases of bourbon sold in North America was a great business, but it wasn’t going to get much better. There was however a very large opportunity abroad. In 1987, Brown-Forman was in four markets and the company resolved to invest internationally to drive growth in its worldwide business. It was at this moment that I invested in Brown-Forman. Fast-forward to today -- they still sell about four and a half million cases of Jack Daniels in North America, but this business is probably more profitable today than it was because they have

the real story is that they now sell over five million cases of Jack Daniels internationally. When they started this journey, they only operated in four large international markets including England, Australia and Germany. Now they’re in 18 markets wherein they sell over 100,000 cases each year. They were one of the first companies in which I invested that believed in the concept of suffering through some burdens on currently reported profits in pursuit of future success and growth for the company. Additionally, they realized that they could do this without the risk of losing the company due to the family’s controlling stake.

G&D: Was the “ability to suffer” also behind your thesis in investing in E.W. Scripps?

TR: That was certainly the case with E.W. Scripps. E.W. Scripps Company developed Scripps Network Interactive, a subsidiary it spun off about four years ago. Nearly 15 years ago, Scripps’ parent company considered developing a new network. The family that controlled the company bought into the vision of a network that combined home and garden channel. This was something that had not been successfully done before but they believed that it could be done and were willing to tolerate up to \$150 million of cumulative reported operating losses to make it happen. So Frank Gardner and Ken Lowe, two superb executives of the company, began to pursue this vision of a new network with \$150 million in operating expenses at their disposal. They spent maybe \$2 million in the first year, about \$15 million the next year on hiring people, etc. The third year, their operation was even more fully developed as they began the production process in earnest, so they invested even more fully in the business. In the meantime, the new network hadn’t yet generated any revenues! E.W. Scripps, thanks to its separate newspaper and television businesses which had been generating about \$350 million a year, was still making a profit – albeit reporting a declining one – as invest-

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 ment in the network grew. Though earnings declined in the early stages, Gardner and Lowe ultimately spent the right amount and now Scripps Network Interactive, the company they built, earns over \$500 million in EBITDA and is worth over \$7 billion. If a corporate raider had come along during the early stages of the build-out and sold this Home and Garden Network because it would have probably increased near term reported profits but it would have surely destroyed all of what was, at the time, a positive NPV business.

G&D: In the past, when we have heard you discuss the spirits business or other businesses, you have frequently stressed the importance and power of brands. In the case of this nascent network, however, where a brand did not yet exist, how did you gain comfort that those early investments by Gardner and Lowe would not destroy value and would in fact add value?

TR: That was the hardest part of my whole evaluation of the company. Along the way, we did start to see some early indications of this being a promising investment for E.W. Scripps, such as some buzz being generated about the new brand. Indications like these still don't mean success is a certainty. What was certain was the family's and management's collective willing-

ness to suffer through that period of reported profit declines in pursuit of a business that they were willing to "build to last."

G&D: During your career, you have been very consistent in uncovering and in-

"I've been very fortunate in having been provided the capacity to wait and take my time in earning returns.

The problem with short-selling is that it is terribly event-driven. To be really successful at short-selling, one typically would place a bet based on analysis of a soon-to-be

relevant problem...To get short selling right, it is very time specific."

vesting in high quality companies. Have you ever considered launching a hedge

fund through which you could short some of those companies that you have determined to be of low quality?

TR: I've been very fortunate in having been provided the capacity to wait and take my time in earning returns. The problem with short-selling is that it is terribly event-driven. To be really successful at short-selling, one typically would place a bet based on analysis of a soon-to-be relevant problem. For example, a short seller may believe a company is going to reveal a problem with their receivables accounting when they report their quarterly numbers. It creates an urgency that is different than the kind of duration I can enjoy with the businesses that we own. To get short-selling right, it is very time specific. Moreover, the structure of shorting is such that the risk of being squeezed is so intense that you can't put too much money into any given short. For a hypothetical example, if I'm thinking of using a short position to hedge Nestle, I would have to establish a very large number of positions, given our large long position in Nestle. So you have to significantly and frequently worry about timing if you want to establish a meaningful short position.

Here's another example of a similar dilemma inherent to shorting. I probably would

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“All of Freddie Mac’s moves were done to meet the market’s near term, management-created growth expectations for the company.”

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not have gotten the timing of shorting Diamond Foods right. I met the management of Diamond Foods when they were very small. I felt that they had a good story but I just got a funny, uncomfortable feeling about the people running the company. This was when it was \$17 a share. Then the stock went from \$17 to \$90! That would have been a painful short, even though the shares ultimately did decline precipitously.

Thinking about that uncomfortable “feeling” I got from meeting a management team reminds me of a profound point that Charlie Munger made at a Wesco annual meeting about six or seven years ago. Charlie talked about the value of beliefs versus the conviction of knowledge. Someone during that meeting asked Charlie why he had sold Freddie Mac because shares of Freddie had really rallied since Wesco’s sale. Charlie looked at him for a long moment and said, “Because we felt like it.”

Charlie then mentioned a friend of his who owned a large private business which had a director of marketing who had done a better job for the company than anyone ever had. The owner called this director one morning and told him what a great job he had been doing and how terrific an employee he was. But the owner also told the Director that there was something about him that made

the owner uncomfortable to the point that he was actually losing his sleep and appetite. The owner decided to fire this Director, despite all of his successes at the company, because as the owner told him, he was “too old and too rich” to be losing sleep and appetite over anything. Charlie then explained to the person who asked the question that he was just uncomfortable with owning Freddie Mac and it wasn’t worth their worry. He explained that with scale and time, the growth Freddie had demonstrated in recent history would basically no longer be available and that Freddie had begun to accumulate more mortgages on its balance sheet in lieu of securitizing them. According to Charlie, management had also inappropriately denied recent purchases of high yield junk bonds of a tobacco company. All of Freddie Mac’s moves were done to meet the market’s near term, management-created growth expectations for the company. Charlie explained that he just couldn’t invest in a company with a management team that was corrupting an otherwise good business and was not honest and frank about its moves.

My sense about the people at Diamond Foods couldn’t be modeled or quantified, but I stored it away without immediately acting on that hunch. Feelings like these, enhanced by years of ex-

perience and lessons learned, are to be respected rather than ignored simply because you cannot quantify them.

G&D: When you spoke to the value investing class at Columbia, you spoke about the important nuances between Kraft and Nestle. Could you describe some of the nuances for the benefit of the readers?

TR: When I discussed Kraft last year, I expressed my observation of the challenges and constraints that they face. Their three core businesses – domestic crackers, domestic cheese, and domestic meat – happen to be the grocery categories most exposed to private label competition in the US market. Cheese is cheese. The consumer belief that there is no adequate substitute for cheddar cheese isn’t high enough to support pricing over the commodity costs. The same is true for the cracker and meat businesses. So Kraft tends to be more commodity-oriented. There are nevertheless still a number of other products within the company that are valuable, such as Chrystal Light. It’s not that the shares won’t perform relatively well, it’s just that there’s an omnipresent domestic pressure on the three key pillars of Kraft’s business. The solution as they saw it was to expand offshore and diversify their

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business beyond those three major domestic pillars. They've finally done that with the massive restructuring of the business, whereby the costs they've taken out may point to higher returns on those commodity-oriented segments. They further believe that the businesses they have acquired in the international markets will power up reinvestment. This remains to be seen as it can be challenging to merge cultures when a company tries to buy growth.

G&D: When Kraft splits into the separate publicly traded North American-focused and globally focused companies, will you take a look at either of the shares?

TR: It's a bit of a hodge-podge, especially if I care a lot about culture. There are a series of leaps of faith that are required of one for this investment. I'll probably take a look at both of the stocks and would be delighted to be positively surprised...

Warren Buffett outlined his own frustration with the Kraft situation a couple of years back. His frustration was in part specifically related to Kraft's selling of what was believed to be one of their crown jewels, DiGiorno, to Nestle. The CEO of Kraft claimed that Kraft had received a very high exit EBITDA multiple. But this was backward looking. The selling price also didn't account for taxes

Kraft owned. So the sale

"I am intrigued by Pepsi although I don't think that the carbonated drinks industry has come to terms with its sugary past and present. There are an increasing number of places that charge soft drink taxes and try to limit consumer intake of sugary drinks. I think that there are other shoes to drop on the carbonated soft drinks category and so I have avoided owning the company, though this is from someone who owns tobacco companies and spirits companies!"

price received was based on historical earnings before considering the tax affects on the sales proceeds. Warren made a comment at the time that Kraft had in fact sold the business for something like 6x operating income. My investors by contrast effectively bought the DiGiorno business through our stake in Nestle. We were provided with that opportunity because somebody was desperate for a strategic reason to consummate an acquisition and sacrifice valuation for the DiGiorno brand.

G&D: What are your thoughts on Pepsi?

TR: I am intrigued by Pepsi although I don't think that the carbonated drinks industry has come to terms with its sugary past and present. There are an increasing number of places that charge soft drink taxes and try to limit consumer intake of sugary drinks. I think that there are other shoes to drop on the carbonated soft drinks category and so I have avoided owning the company, though this is from someone who owns tobacco companies and spir-its companies! However, if we were to see a spin-off of Frito-Lay from Pepsico, that could be quite interesting. I went to a Pepsi meeting a few weeks ago and I was struck by the ongoing reality that there is no peer competitor in Frito-Lay's market. It's in a league

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of its own. To the extent that a category competition was developing in the form of Diamond Foods, that's gone by the wayside. Aside from that, Frito-Lay's route system, its innovations and the continued consumer demand for its products are a powerful force in the US and abroad.

As an aside, if you're going to be a high conviction investor who intends to hold positions for a very long time, you should be sure to get out and see the business. By doing so, when the market panics, you can fall back on the confidence you gained from witnessing firsthand how the company is building out its business in key growth markets. Along these lines, I was in Angola to investigate the expansion of SAB-Miller's distribution there and in a modest out of the way community, a small bodega was selling Johnson & Johnson, Marlboro, Nestle and, sure enough, Frito-Lay branded products. Frito-Lay is quite a franchise.

G&D: What do you think about Pepsi's collaboration with Senomyx to focus on the discovery, development, and commercialization of sweet-enhancers and natural high-potency sweeteners with the intent to bring to the marketplace a lower-calorie drink?

TR: I am not sure the battle over CSD market share will be over by sweetener selection. Senomyx has

whiz-kid scientists in flavor and technology, specifically in the area of taste receptors. They say that the mouth has 17 taste receptors for bitter and only two for sweet. This is because humans have to survive, and things that are bitter are things that kill you while things that are sweet don't or rather do so more slowly. What Senomyx tries to do is override the requirement to get sweet by deactivating taste receptors, so you can meet your desire for sweet at much lower doses. Foods can then contain fewer calories without losing any of their taste. The problem is that Senomyx gets to learn at Pepsi's expense. What Senomyx does for Pepsi in terms of compounds developed, is proprietary, but what Senomyx scientists learn is not proprietary and hence over time shared, ingredient-based competitive advantage will likely remain short-lived.

G&D: Given your interest in Cadbury, is Mars a company that you would own if it ever became public?

TR: Absolutely! Mars would be an interesting company if it were publicly traded as it fits right into my wheel-house. They have businesses in pet food, global confectionary, ice cream treats, rice, etc. The company is family-owned, however Mars has not been as well run as possible over most recent time. I cele-

brate the "capacity to suffer" and the ability to take the long view. However, in some cases, the fully private nature of some companies may mean that mistakes can get buried because there is no publication. Within a public company, if you go out and say you are going to come out with a brand new product and it flops, people within your company have to address it, come to terms with it, and learn from that experience. When decisions at a fully family-controlled private company are made and they fail, I don't think the institutions learn as well from those experiences. Mars is not nearly the company it could be, and arguably should be, given what they started with 40 years ago – premium pet food, premium confectionary products, ice cream novelties, etc.

G&D: What are your thoughts on Danone and the yogurt category?

TR: I love the yogurt category. However, I have found as an investor that Danone has been more expensive than Nestle for most of the time that I've been investing. Danone has done a great job with the yogurt category. I like that with CEO Frank Riboud, the company has become very entrepreneurial. However, the company has a feeling of having a more personality-dependent future vs. Nestle, where the culture of innova-

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"If you're going to be a high conviction investor who intends to hold positions for a very long time, you should be sure to get out and see the business."

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“What has kept me away from the cosmetics companies has been their route to market. Historically this has been a department store-driven business, which has been an increasingly difficult place to be. Declining foot traffic into department stores reduces opportunity to market.”

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tion is more institutionalized. Within Danone there is a huge tribute to the vision of one man. I don't think it's a given that they will be able to find a successor with similar vision or charisma to succeed that one man. Reckitt Benckiser was very well run for a decade but its charismatic, driven and talented CEO recently left and Reckitt's shares have since languished.

G&D: Have you ever been interested in owning companies in the cosmetics sector?

TR: My investors indirectly own a third of L'Oreal through Nestle. I've never owned any of these companies directly. What has kept me away from the cosmetics companies has been their route to market. Historically this has been a department store driven business, which has been an increasingly difficult place to be. Declining foot traffic into department stores reduces opportunity to market. Other store-based concepts are emerging like Sephora. The internet is now an emerging channel. For instance, Birchbox is a new startup in this category that could be disruptive – people pay a fee to sign up and get monthly deliveries of sample products delivered to their door. The problem with the old model is that people now don't go to the department store as often and I'm unsure of the

rents that are going to be asked of cosmetics companies as we move forward. Do I think beauty matters? You bet. There's a lot of money to be made in related products. Unilever makes gobs of money through the sale of Axe, a body spray that males start using at an early age because they think it will help them do better with young ladies. As an investor, something like this is great – it is something that people will spray on every day with hope!

G&D: You have been a long time investor in Heineken. Have you ever been interested in Carlsberg?

TR: I have invested in Heineken shares since the early 1990s. I have had no investments in Carlsberg. As much as I like family ownership because it gives a management team the “capacity to suffer,” Carlsberg is owned by a foundation, which is not an ownership structure I have embraced. It is a very different beast. The kinds of demands and standards that come from a foundation versus a family-owned company versus a public company are very different. The brand Carlsberg exists in many developed and emerging markets, but in no market are they the commanding story, except Russia. The company's market share in Russia is so big, that there is a lot of country-specific risk. Russia recently went nuclear with new taxes on the beer busi-

ness, and Carlsberg has felt the effects of this. Carlsberg's new management has done a fine job ... it's more the corporate structure that has concerned me.

G&D: You are one of the most celebrated value investors, but you did not start out at Columbia Business School. How did you first get exposed to value investing?

TR: Despite the obvious shortcoming of not having the full value investing immersion offered at Columbia and spearheaded by Professor Bruce Greenwald, I was fortunate to have taken Jack McDonald's class at Stanford Business School. Professor McDonald was a lone voice at Stanford in value investing. The other “finance” classes were all concerned with greek letters and “provable certainties” that I do not believe to be reliable. A very influential event in my life was Warren Buffett's visit to Professor McDonald's class in the early 1980s. Today, I am quite fortunate and privileged to serve on the Advisory Board of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School and have been quite fortunate to have been so affiliated with the school. In addition, in recent years, I have been assisted in my efforts by excellent work from one of Professor Bruce Greenwald's program's

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“The concept of turning down noise of Wall Street is something that I appreciate by the training I received at the Sequoia Fund. The absolute detachment from Wall Street there was amazing...I never saw a salesman come through the door. If you have 16 Wall Street analysts coming through your door each day, what is that going to do to your capacity to stay the course with a company?”

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graduates, T. Charlie Quinn.

G&D: What is the best piece of advice you have ever received?

TR: Most of the good advice I’ve heard over the years has emanated from Buffett. “Do what you like to do because you will be better at it” is something he says often that I’ve taken to heart. Another good piece of advice of his that I’ve followed is “pick your heroes.” While Warren is my “uber hero” for investing, within my operating company teams I’ve picked Peter Brabeck who was CEO and is now Chairman of Nestle. Here is a guy who has reformed the culture and expectations of an already great company into something that is better. Another good piece of advice of Buffett is to stay within your circle of competence. Lastly, he has said “you can’t make a good deal with a dishonest person.” I don’t think that the people in corporate America are dishonest, but they are driven by incentives that make them less owner-minded. You have seen Buffett focus more on private businesses, many of these being family companies, as these people haven’t yet developed bad habits. It all comes down to people. At the end of the TV show “The Apprentice,” Donald Trump, when he’s about to boot somebody, always says: “nothing personal, it’s only business.” I think many people misinter-

pret this to mean that business isn’t personal. I think it’s just the opposite. The best businesses are very personal. It’s all about the culture, the people, and the leaders.

G&D: What are some things that you think have contributed to your amazing success?

TR: I think the fact that Warren Buffett and his partner Charlie Munger exist has been so valuable for the investors who seek to invest for the long term. Had they never existed, the concept of buying great businesses for the long term, and staying the course through thick and thin kind of investing would have been ravaged by efficient market theorists. You would not be able to find patient capital to pursue this style of investing. Due in large part to Buffett, people know it is possible because it has been done. This has allowed me and others who do what I do to have the privilege to striving to follow similar goals and objectives. My clients have been an extremely important part of my success. They have been willing to give me the “capacity to suffer,” which is exactly what I ask from the managers of the companies we own.

G&D: Mason Hawkins talks about how being located outside of New York has helped him think independently of the Street.

How important has being outside of New York been for you?

TR: The concept of turning down noise of Wall Street is something that I appreciate by the training I received at the Sequoia Fund. The absolute detachment from Wall Street there was amazing. Our offices were at 56th and 6th Avenue in New York, but it could have been Topeka, Kansas for how little contact we had with the Street. I never saw a salesman come through the door. If you are located in New York and you have 16 Wall Street analysts coming through your door each day, what is that going to do to your capacity to stay the course with a company? You would have an eroding stream of banter that you would have to steel yourself against. That was what Sequoia fund offered. To see patient investing actually succeed was proof that this way of doing things could work. They accomplished this in New York, not Tennessee. So future investors should realize that it is more about maintaining a detached frame of reference than it about the specific place where you choose to work.

G&D: It was a pleasure speaking with you, Mr. Russo. Thank you very much.

Alex Roepers



Alex Roepers

“My official title was Director of Corporate Development but I was basically Mr. Divestiture. Every time I showed up at a subsidiary company, the employees knew their company was for sale.”

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G&D: Following your time at Harvard Business School, you worked for Thyssen-Bornemisza Group, an industrial conglomerate. What triggered that decision?

AR: While still at Harvard Business School, I spent my summer interning at Dover Corporation, a publicly listed conglomerate where I was involved in mergers & acquisitions analysis. I really became intrigued by what it took to buy a company from the perspective of a business owner. So, during my second year of business school, I focused on any classes related to buying and selling companies – tax factors and business decisions, real estate, corporate finance and others.

I immediately looked for a career opportunity where I could do the same thing. My boss at Dover had previously worked at Europe-based Thyssen-Bornemisza Group, which was a larger company than Dover but privately held. My background was quite suitable for Thyssen-Bornemisza. They had offices in Monaco, Amsterdam and New York. I wanted to work in New York but I would also be able to use my Dutch, French, German and English. Dover was operating highly efficiently whereas Thyssen-Bornemisza was twice the size of Dover but had a more complex portfolio. Thyssen-Bornemisza owned

80 different companies that operated in 40 different industries on two continents. I arrived at Thyssen-Bornemisza and spent four years helping the top management in Monaco rationalize its portfolio of companies. My official title was Director of Corporate Development but I was basically Mr. Divestiture. Every time I showed up at a subsidiary company, the employees knew their company was for sale. I was involved in a lot of transactions where we were selling companies in order to pay down debt and streamline the company. I held that role during the bull market of 1984 to 1988, which was a period of a tremendous number of IPOs and corporate activity. Specifically, private equity activity also increased greatly during these years. Thyssen-Bornemisza was basically a large private equity portfolio that was selling its portfolio companies into a favorable market. I learned a lot about valuing companies but I also learned to dislike a few things. For example, when we bought companies, we had to pay a premium for control. Further, one has to consider that financial buyers typically add significant financial leverage to a company, on top of introducing an illiquidity factor and are more likely to buy in at the “high point” of the cycle regarding valuation. This is because banks lend procyclically and are unlikely to extend loans at an eco-

nomous trough. This formula really didn’t appeal to me. Additionally, as I knew well from my experience with divestitures, once you own a company it takes a long time, usually a year, to sell it. These were two things – high entry valuation multiples and the difficulty to exit – that I really didn’t like about the private equity business.

G&D: Did these experiences shape your decision to move to the investment business?

AR: Beginning in about ’86 or ’87, I started to present ideas outside of my normal areas of divestitures and acquisitions of entire companies for the portfolio. I started to present ideas about taking smaller, “toehold” interests – two to five percent positions – in much larger publicly traded companies that I identified as being very attractively valued. In these situations, we wouldn’t have to pay a control premium and we wouldn’t have the illiquidity that came from being a majority shareholder. Further, we also didn’t lever the positions. I presented 26 of those ideas over two years. The market crashed in ’87 and eventually 10 of the 26 companies were acquired by other companies. They indeed had very attractive sum-of-the-parts characteristics whereby a private equity firm or another corpo-

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rate buyer could acquire the companies and profitably break them into smaller pieces. So I demonstrated that even in the public markets, I was able to identify companies that represented solid value. Additionally, the other 16 companies which were not taken over performed quite well as many had specific identifiable catalysts ahead of them.

I measured my pro forma record from the 26 companies I had recommended, which was good enough such that it allowed me to go out and raise some money at the age of 28. Raising money after the crash in '87 was like trying to raise money in 2009. It was very hard, particularly as I didn't have much money of my own and no record other than this pro forma record with the 26 stocks. I did, however, get backing from the CEO of Thyssen-Bornemisza. In addition, my former manager at Thyssen moved to Geneva and became the head deal-maker for Carlo de Benedetti, who was the equivalent of Carl Icahn at that time. That led to additional funding. After convincing a Dutch bank to provide backing, I officially launched Atlantic Investment Management. I raised eight million dollars in total, which wasn't a lot, but still felt like quite a success and was certainly enough to get going. My stated approach was to invest in a limited part of the universe of pub-

licly traded stocks -- in a very concentrated manner, with position sizes equivalent to two to five percent

“My stated approach was to invest in a limited part of the universe of publicly traded stocks -- in a very concentrated manner, with position sizes equivalent to two to five percent ownership-- in companies that specifically demonstrated features that would be attractive to private equity firms or strategic buyers. To put some generic labels on the strategy, the goal was to be a really concentrated, value-oriented stock picker in the mid-cap arena.”

ownership-- in companies that specifically demonstrated features that would be attractive to private equity firms or strategic buy-

ers. To put some generic labels on the strategy, the goal was to be a really concentrated, value-oriented stock picker in the mid-cap arena. The portfolio was fully up and running in the middle of 1989.

Fairly quickly after officially launching the fund, the junk bond market collapsed and Drexel-Burnham went into bankruptcy. The fuel for private equity disappeared and investor interest in mid-cap, “LBO-able” companies dissipated. So my portfolio went quickly out of favor in late 1989 and money rotated into defensive names like Phillip-Morris and Proctor and Gamble. It was a prelude to what was coming. 1990 was an economic disaster: we had the Savings and Loan Crisis, a huge recession, a 30-40% decline in the housing market, followed by an oil shock and the Iraq War. It was several years of misery leading into 1992 and people became disillusioned with equities. That set up a 200% rally in the S&P and a phenomenal five year period of activism, takeovers, and corporate action. My approach did very well from 1992 to 1997. In fact, the conditions today seem quite similar to those of 1992. I believe that 2012 to 2017 could be another phenomenal period for the equity markets, for activism, takeovers and corporate action because we have had, similarly, several years of misery since late

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2007.

G&D: What about macro concerns such as the historically high debt levels for the major sovereigns? Could something like this provide a strong enough overhang to impede a potential bull market?

AR: It certainly is an issue. Let's not forget, though, that we have historically very low interest rates. So if you look at the total debt service burden in relation to GDP, it's not much different than it was in 1982. The market is staring at the debt to GDP figure a bit too much. The aggregate amount of debt is certainly a concern. I'm all in favor of politicians who try to reduce spending and bring the budget in line. This is an issue, but it's primarily an issue for people who hold bonds. Eventually, it does become an issue for all asset classes if it spirals out of control. That is an assessment we have to make. I do not think however that a major problem like the events of 2008 is likely in the foreseeable future.

If you look at the European sovereign debt situation, it's primarily an issue for the bond holders in those countries as well as the banks and insurance companies that hold the bonds. From day one – I learned this in the '80s – we have not invested in levered entities that lack transparency, which include banks, brokerage firms and

insurance companies. What you really have to watch for is if there's a tsunami effect that could result from failures related to sovereign debt that will affect the

“From day one – I learned this in the '80s – we have not invested in levered entities that lack transparency, which include banks, brokerage firms and insurance companies. What you really have to watch for is if there's a tsunami effect that could result from failures related to sovereign debt that will affect the economy and corporate earnings via a credit crunch.”

economy and corporate earnings via a credit crunch. We monitor these issues daily. From our perspective, however, we are investing in very solid companies that are always profitable, even though they can be im-

pacted during particularly fearful periods. I've dealt with a fair number of market conditions over the past 23 years and in our main fund, we've returned 9x the S&P 500 returns, net of fees, with a long-only portfolio of US stocks. This performance was achieved without tech companies, IPOs, over-levered companies or any pure commodity oriented exposure, but just with companies that you and I can understand.

G&D: Do you still form the core of your portfolio with a keen eye toward takeover targets or has that shifted a bit over time?

AR: A primary determinant of which stocks become a core holding in the portfolio and receive a higher capital allocation are the predictability and reliability of the company's cash flows. A lot of qualitative thinking goes into our stock selection process, including a thorough understanding of what the company does, how many customers they have, how many regions, how many products, what kind of products and whether or not the product has a revenue stream derived from a large installed base. For example, if you sell an elevator, you have a contract to maintain the elevator. A mature elevator company gets 75% of its earnings from the installed elevators that operate whether the

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Pictured: John Spears of Tweedy, Browne Company at CSIMA Conference in February 2011.

“A primary determinant of which stocks become a core holding in the portfolio and receive a higher capital allocation are the predictability and reliability of the company's cash flows.”

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Alex Roepers

“The first part of our investment philosophy, which is very important, is concentration of capital in high conviction ideas. A lot of people pay lip service to that and end up having portfolios with 100 stocks, with the top 10 each representing maybe 4% of the portfolio. In our case, the core activity is typically 6 stocks, with a range of 5 – 8 stocks.”

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building is half empty or not. So I'd much rather invest in an elevator company than in an office furniture maker, which doesn't have a revenue stream derived from an installed base. If we find companies trading at a low valuation on predictable and reliable cash flows, with a strong balance sheet, it will become a large percentage of our portfolio. Then we're looking for multiple catalysts. An elevator company that we like, Schindler Elevator, is insider controlled so it's not a takeover candidate and therefore becomes a smaller percentage of the portfolio. At present, Schindler is too expensive for our valuation metrics, but we constantly monitor it should it become cheap enough. In general, nine out of ten companies that we own have no insider control and as such they're more likely to be taken over if they stay at a low valuation for an extended period of time. Thus passage of time at a low valuation, assuming reliable cash flows and a durable franchise, ranks as an important catalyst. However, we look for other catalysts as well, including asset divestitures, smart synergistic acquisitions, share buyback programs, dividend initiations, analyst upgrades, insider buying, judicious capacity expansion in growth markets and others - the more catalysts the better.

G&D: You broadly out-

lined the types of companies that you like and the ones you avoid. Could you talk a little more about your investment philosophy and how you construct your portfolio?

AR: The first part of our investment philosophy, which is very important, is concentration of capital in high conviction ideas. A lot of people pay lip service to that and end up having portfolios with 100 stocks, with the top 10 each representing maybe 4% of the portfolio. In our case, the core activity is typically 6 stocks, with a range of 5 – 8 stocks. We understand that such concentration is often perceived as being “too risky” for many investors. However, we feel that it is actually less risky because we know our portfolio inside and out. Six stocks require a tremendous amount of focus and research, as well as universe definition and discipline to avoid the risk that comes with concentrating capital. Therefore, we avoid roughly 80% of the public stock universe by excluding financials and high tech, high product liability-related companies, small companies due to the liquidity risk issues, and the very large companies because we don't have any significant edge. Our edge and our ability to do due diligence is really concentrated in this well-defined universe of companies with a \$1 to \$30bn market cap.

Concentration is a core aspect of our philosophy, and very important to out-performance over time. Quite often we have 20 good ideas but we believe that we're going to do better with the top five than the next 15. Our flagship Cambrian Fund typically holds six stocks. That certainly restricts the amount of capital we can manage, but we are comfortable with that; in fact, we've had to close our funds to new capital in the past. We are most focused on compounding capital over time, making money for our clients, and we are working to create a 30+ year record that will establish a legacy that can stand up well against the great investment track records out there.

G&D: How does your philosophy differ on the short side?

AR: We have a long / short fund called AJR, which is our other US product. The fund has been around for 18 years and has compounded at 13% vs. 8% for the S&P since inception. In this fund we have 15-16 long positions and 25 - 30 short positions. The 15 long positions are 80-100% of capital, with no leverage used, and the top 6 of those companies are the same 6 holdings in our long only Cambrian product. The other 9-10 long names are value-oriented ideas that we like

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Alex Roepers

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but which didn't make it into the core long group because they're either not as diversified, they have significant insider ownership or they have enough financial leverage such that we are not comfortable making it a core position.

On the short side, we are diversified and the portfolio is actively traded. We find short ideas from our long universe. While doing peer analysis, we will find companies that are over-levered, poorly run, overpaid for a poor acquisition or ran up to the high end of their valuation range. Sometimes they are pair trades and sometimes they're stand-alone ideas that come from the analysis of our long ideas. These positions are actively traded, with a stop-loss to ensure appropriate risk management and with a typical position size of one to two percent. While on the long side we're concentrated with a one to two year time horizon, on the short side we're diversified with a time horizon of two weeks to two months.

G&D: You mentioned Cambrian and your US-focused hedge fund AJR. Could you talk more about how your firm developed and the various funds that you offer?

AR: The strategy has been the same since day one. I started the firm with a sharp focus on US stocks because that's all I was able to focus

on at the time. I was basically by myself and then I added one analyst and then another. The late 1990s tech bubble was a challenging period for our funds. I had clients telling me that they didn't understand why our fund was flat, so I had to ask them if they knew what they were invested in. I remember asking them if they thought it was a good idea that Cisco was trading at 25x revenues. I've saved a lot of clients a lot of money by asking them to simply relate the market capitalization of the companies they were investing in to the revenues of those companies. I would point out that IBM has traded between 1-3x revenues for the past 20 years. They could see that an investment in Cisco at that time was merely speculation, not a sound investing strategy. I engaged in these discussions with clients partially to justify why I was severely underperforming and partially to warn them about the companies in which they were investing. In '99, we actually managed to do surprisingly well and even made some money on our shorts. In fact, we were rated number one by Nelson's ranking of money managers.

The inflection point came in March of 2000. It's very important to understand that when there is a commodity boom or a technology boom it draws the wind out of other market segments; in this case value

stocks. The NASDAQ was up 25% in the first three months of 2000 and we were down 10%, so we had underperformed by 35% against this index. By the end of the year, we were up 55% and the NASDAQ was down 40%. In the last nine months of 2000, our out-performance was massive, and our strong performance continued into 2001 and 2002. That really helped launch our business. We grew from \$100M AUM in 2000 to \$1.5B AUM by mid-2003. We closed our U.S. funds in July 2003. Soon after, I hopped on a plane to Asia with one of my analysts. I had never been there before but knew it was important to understand the significance of China. By late 2004 we started a fund to focus on Japanese and European companies. Within six months we had raised \$1.5B in AUM for this new fund.

G&D: Can we talk a bit about the 2008 downturn and how you positioned the fund at that time?

AR: We foresaw many of the issues that caused the crisis, though we never envisioned it was going to be as vicious as it was. We were early in betting against Fannie Mae and Freddie Mac, as we started these short positions in 2003. These companies lacked transparency and had only 1.5% equity against a giant pile of mortgages. Addition-

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ally, the implicit government guarantee was for mortgage holders, not the equity holders. While we had these positions right and were short all the way to the bottom, our long-bias in mid-cap companies obviously hurt us in the late 2008 and early 2009 period. Money was coming out of the market and whatever stayed in the market rotated to the largest of large caps. We had disproportionate underperformance as this occurred, but then disproportionate out-performance as we came out of it. The one thing that we learned after the crisis was that we could better manage our exposure. When volatility in the form of the VIX is high, it creates a lot of opportunities, whereby one can buy good companies at cheap prices. During the 2008-09 crisis, the S&P was down 40%, but the top 30 stocks, which make up roughly one-third of the market cap of the index, were only down 18%. The rest of the S&P was down on average over 50%. A lot of people were gun-shy going into 2009. We ended up with a defensive portfolio coming out of the crisis. Everything came down so hard and indiscriminately that we were able to buy great companies cheaply at that time. We bought Smuckers and Thermo-Fisher Scientific – these are companies that hold their own very well even in a bad economy. We were able to buy these companies for 6-7x EBIT while they were still growing

earnings in a down economy. 2009 favored highly levered, deep cyclical companies. Companies like Caterpillar were up 140% from March to September 2009, but more defensive companies were flat. Nonetheless, we were up 60% in 2009 with our concentrated long only fund and we did it with a more defensive portfolio. This allowed us to outperform in 2010. Over the past three years, our concentrated long-only fund has compounded at 38%.

G&D: Can we talk about a few of your current investments?

AR: One of our larger holdings today is Joy Global. It is a Milwaukee-based company that makes high productivity coal-mining and surface mining equipment. Coal is not everyone's favorite fuel, but it provides 40% to 50% of the fuel for electricity generation in this country. Right now there is weakness in the U.S. coal market because we had a mild winter and natural gas prices are super-low thanks to the shale boom and the advancement of hydraulic fracturing. As a result, utilities are switching from coal to natural gas when it's possible. However, coal will continue to be a very important fuel not only in the United States but globally. According to BP, coal accounts for 30% of global energy consumed (including transportation) and it will continue to take share over

the next few years as global electrical demand grows, particularly in emerging economies such as China and India. Peabody Energy says that global coal demand will grow by 1.3 billion tonnes over the next five years, which is more coal than the United States produces in a year. China is a big part of the story, as 70% of its electricity needs come from coal. China has gone from being a net exporter to a net importer of coal. Also, Joy Global's earnings were flat in the 'Great Recession.' It's hard to find another capital goods company that weathered the storm this well. That is because Joy generates about 60% of its revenues from an installed base worth tens of billions of dollars. That equipment operates in extreme conditions and has wear and tear and constantly needs to be rebuilt with strong, recurring spare parts demand. Joy also has thousands of employees around the globe supporting the equipment of the BHPs and Peabodys, among others. Joy Global makes sure the equipment is up and running but they don't take on the risk of operating it. All the company needs to grow EPS is for worldwide coal production to continue to increase. Finally, Joy Global has a strong competitive position with enormous barriers to entry. Two Milwaukee-based companies, the other being Caterpillar subsidiary Bucyrus International, con-

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“We foresaw many of the issues that caused the crisis, though we never envisioned it was going to be as vicious as it was. We were early in betting against Fannie Mae and Freddie Mac, as we started these short positions in 2003. These companies lacked transparency and had only 1.5% equity against a giant pile of mortgages. Additionally, the implicit government guarantee was for mortgage holders, not the equity holders.”

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trol the market – it's a duopoly. No one else in the world can make these pieces of equipment. At Joy's factory, in order to support the stamping equipment used to construct the equipment, JOY has a 200 feet deep concrete foundation beneath their machines. Regulators will not provide approval today for a plant requiring 200 feet of concrete.

G&D: In a recent interview for *Graham & Doddsville*, Jim Chanos talked about his negative view of the coal industry due to fracking. How do you respond?

AR: I would say that he is very focused on the U.S. I have great respect for Jim Chanos but I do believe natural gas prices will not stay low forever. Additionally, there is a ton of U.S. electricity production that is tied to coal and there will continue to be a large amount of coal production to support this. The U.S. is also exporting much of its coal production. While Joy Global's U.S. business is down, its total business is up because its international side is strong. I think people overestimate the impact of the warm winter and extrapolate low natural gas prices into perpetuity, which I see as the primary reason for lower coal production. Natural gas production can change very quickly. For starters, there is a lot of environmental

backlash against fracking. Any significant legislation (although none is expected until after the November 2012 election at the earliest) could impact the price of natural gas. Second, natural gas trades for several multiples of the US price in markets such as Europe and Asia. It will take time for this arbitrage to close.

G&D: How much of Joy Global's sales and earnings are tied to China?

AR: Direct China sales are only 15% of the Joy Global story at this point. The China real estate boom is an issue for investors in real estate companies and developers, and for those companies making wheel loaders and other products directly tied into Chinese construction. China's electricity need is un-mistakenly tied to GDP, growth in its total population, a rising middle class and salary inflation, which allows people to buy more things like air conditioners that require a lot of energy. Electricity use in China overtime will go up, therefore coal production and use of coal will go up. Coal production is an issue in China because the government has decided to go from 11,000 mines to 4,000 mines by 2015, by shutting the least productive and most dangerous mines that lacked proper structural support. The remaining top tier mines need the automated equipment that Joy Global and Bucyrus supply.

Joy is also supplying mid tier mines with equipment from a China based company it recently acquired. Caterpillar, incidentally, agreed to buy Bucyrus for 10x forward EBITDA vs. the 6x EBITDA multiple that JOY trades at today. In our view, it would make strategic sense for a company like Komatsu to buy Joy, or perhaps later on for Joy to buy Komatsu. It's a chicken and egg game that will go on for the next few years as Joy works to become bigger than Komatsu in terms of market cap. Of course, it's hard for a non-Japanese company to buy a Japanese company, but they want to stay out of the hands of Komatsu. Komatsu would be smart to pay attention to the current weakness in Joy's share price. Joy is not insider controlled. We have seen the industry consolidate in the past few years. Terex, a company out of Westport, was involved with heavy equipment and had become a big competitor to Caterpillar in some areas.

Terex got into some trouble due to high leverage and put its hydraulic excavator unit on the market. Caterpillar looked at it, Joy looked at it, and Bucyrus ended up buying this prized Terex unit. At that point, we invested in Bucyrus, sensing that eventually Caterpillar could acquire Bucyrus. Now Joy remains standing as the only pure

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"I think people overestimate the impact of the warm winter and extrapolate low natural gas prices into perpetuity, which I see as the primary reason for lower coal production. Natural gas production can change very quickly."

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“Now Joy remains standing as the only pure play mining equipment business that is a perfect fit for Komatsu or one or two other strategic buyers. Joy should have \$1.4 billion in operating profit for FY 2013 and the company is valued at \$9.5 billion or 6.8x EBIT. This is a very attractive valuation for this franchise. Bucyrus was bought for more than 12x EBIT.”

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play mining equipment business that is a perfect fit for Komatsu or one or two other strategic buyers. Joy should have \$1.4 billion in operating profit for FY 2013 and the company is valued at \$9.5 billion or 6.8x EBIT. This is a very attractive valuation for this franchise. Bucyrus was bought for more than 12x EBIT.

GD: So assuming there's no strategic buyer, what do you think the market is missing in this story?

AR: People are expecting that earnings will come down for the cyclical (not secular) challenges Mr. Chanos mentioned. For the bears, Joy's shares are pricing in peak earnings per share of \$7 or \$8, so it's trading at 10x peak earnings. But, in our view, these are not peak earnings. We see Joy's earnings trending up over time. They had one flat year in earnings in the Great Recession. Caterpillar earnings were down 60%. Sales were down nearly 40% at Caterpillar, while sales at Joy were flat.

GD: Is there another company you could tell us about?

AR: Owens Illinois is another large holding that we've had for awhile. They are the largest maker of glass bottles in the world. It is a very unique franchise

and a take out candidate. The most likely buyer for this company would be someone like Berkshire Hathaway. OI owns 81 glass plants. The glass bottle is used for food, beer and wine and other high end drinks. Everyone agrees glass is the preferred packaging for consumers. Glass is used to package something like 98% of wine, 80% of liquor, and 50% of beer in mature markets. These numbers switch around a bit depending on the economic environment, but the changes are relatively minor. Depending on where you build it, it can take up to \$200 million to build a new plant. You can't ship glass more than 300 miles because it's prohibitively expensive, so geographical coverage and distribution are quintessential. Owens Illinois has 19 plants in the U.S., 30% market share globally and 40% to 100% market share in key markets.

GD: Hasn't there been any secular decline in glass usage?

AR: Yes – it has been massive. There were advances in plastic bottling technology in the 1980s which led to a surplus of glass bottlers in the market at that time, and industry consolidated from 20 suppliers to 3 that control more than 90% of the US market. Volumes are pretty stable now, however. In wine for example, you aren't going to switch to

plastic. Even 'new age' drinks are in glass, because glass has a premium feel. Overall glass packaging usage trends are very favorable in emerging markets and stable in developed markets. Pira, a consultant, projects that glass packaging will grow more rapidly than beverage cans or metal packaging through 2015. The industry's pricing power is solid and it has high EBITDA margins.

It's a matter of good execution and smart acquisitions, and it helps to have the winds of a strong economy at your back. We have invested in OI four times over the past 20 years, and we have made money every time on it. This stock cratered during the financial crisis and we invested in the stock at \$13, after which it ran to \$38. We are now one of the largest shareholders of the company. It has had a tough run recently, but that's why it's one of our largest holdings again. If you look at earnings now, this company is getting treated as if it's an airline stock that is going from high profits to massive losses. This company has always been profitable. Currently, it is making more than \$800 million in EBIT and that can go to \$1.2 billion annually. The problem in 2011 was that they finally saw higher volumes, yet were caught with having a reduced manufacturing footprint and inventory. As a

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result, they were forced to ship glass over greater distances, which increased shipping costs significantly and really damaged the second quarter of 2011. This did not change our thesis at all. Their earnings were \$2.37 per share last year. I think they will have \$3.00 in earnings in 2012 and we see this company getting \$3.40 in earnings the next year. The company has more than \$4 in earnings power and it's share price could potentially double in the next year.

GD: So you think the market is singularly focused on current earnings and not its future potential?

AR: I think there are few people who appreciate this unique franchise as we do. It's not a growth business, but it's a great moneymaker. We try to evaluate high quality companies with strong franchises that make money in any kind of environment, and I believe Owens Illinois and Joy are two examples of that.

GD: You've seen a number of different market cycles. What advice do you have for younger analysts?

AR: The four letter word that messes up households, governments, and companies is "debt". If you can stay away from debt you will be much better off. Of course, there are some situations where it makes

sense to take on a reasonable level of debt. For example, a fixed rate mortgage

“Overall glass packaging usage trends are very favorable in emerging markets and stable in developed markets. Pira, a consultant, projects that glass packaging will grow more rapidly than beverage cans or metal packaging through 2015.”

that costs no more than 25% of your income, to buy your first house makes sense. But many of the financial problems in the world have been due to entities taking on way too much debt. In terms of managing money, don't use margin debt. The companies that we own have very manageable debt, if any. I always look closely at the interest costs on the debt related to EBITDA. Many refer to this as the interest coverage ratio. Our companies must have at least 4x EBITDA as compared with net interest expense, and most have a far greater cushion than that.

GD: What kind of qualities do you look for in your analysts?

AR: I always look for honest people who enjoy the research process. In fact, we have six Columbia MBAs on our team. I think Columbia Business School does a nice job training its students. There is a strong focus on value investing that breeds strong analysts. I am always looking for an analyst that has a private equity investment mentality on publicly traded companies. We do intense research and get to know the customers, the plants and everything else we can before we buy shares in a company. In order to get conviction on an investment idea, you need to do a lot of work. So I look for people that really want to do this work and who are intellectually curious about this.

GD: Any parting words of wisdom for our readers?

AR: Do something that you really enjoy, and be honest, hardworking, and trustworthy, and things should work out very well for you. You should do something you love to do, because you're much more likely to succeed at it. There's nothing like having a spring in your step on your way to work because you like what you're doing.

G&D: Thank you very much.

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Julian Robertson



Julian Robertson
“But what really made me was the realization that I could hire really good young people. When we started Tiger Management, I did that. One of them John Griffin used to teach a security analysis course at Columbia Business School and now guest-lectures there...”

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investment philosophy?

JR: Well it started with my father, who was an interesting guy. He was a very authoritarian figure, but he wanted me to learn a number of different things. He showed me how the stock tables worked in the paper, and I got interested in an early age and we worked on a few stocks together. He was in the textile business but he was a really good investor. I joined the Navy after college, as I had been in the ROTC in college. Prior to the Navy, I never really had any sort of responsibility. But upon joining the Navy, I literally had 700 million pounds of TNT and an atomic bomb under my command. I enjoyed the responsibility. After the Navy, my father wanted me to get some training in New York before I went to a brokerage firm down south. That was 55 years ago, and I'm still here. I've adored New York, and if I could force everybody to do it, I'd force them to grow up in a small town in North Carolina and then eventually come to New York.

G&D: What do you think explains your incredible success?

JR: Well I started at the

right age, certainly. But what really made me was the realization that I could hire really good young people. When we started Tiger Management, I did that. One of them, John Griffin, used to teach a security analysis course at Columbia Business School and now guest-lectures there. John and I are still great friends. There was a big age difference between us but we're still close. When he left to go on his own, I didn't handle it particularly well. If I had been smart I would have taken a piece of his action. We're probably better friends now though than we've ever been. He's going to host my 80th birthday day in June. His son and my grandson are great friends. I was talking to John the other day about how we've never really given anyone too much too soon that they couldn't handle. But I said, the trouble was, I tried to rehabilitate a lot of people who, for one reason or another, didn't have it. So I've made some mistakes on that. But our young people were really great. And good ones begat even better ones – even today, we still do! So I'd say the success really belongs to the young people who worked here. John Griffin, Andreas Halvorson, Lee Ainslie, and probably the

greatest analyst of all time, Steve Mandel.

G&D: So many of the people that worked at Tiger Management have gone on to be extremely successful investors in their own right. What was the process and the training like here for young analysts?

JR: It was sort of a melting pot. I was so much older than they were, so they had to have a father-like opinion of me. They thought I had a unique touch or something, so they would put me on a plane with one of them, who would act like a camp counselor to keep me from getting in trouble and we'd go to Japan and see what we could learn. We were buying a stock in Korea, and things were so new about it that the paper called the broker and asked who was buying that stock. And the broker told them about us and said that since Tiger was buying so much that he was too. So they didn't really know what was going on over there either! It was just a gold mine.

G&D: If someone brings an idea to you, what are the first few things you want to know?

JR: The first thing is, is the

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Julian Robertson

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management decent and honest? A lot of people don't really care about that. The way to look into that is to do some diligence. Are they actively involved in their community? You should try and find folks who know them and see what they think. Of course, you also want to investigate the growth possibilities. We had fantastic analysts and I found I could count on their earnings projections. So I sort of turned from a cheap skate investor, one who was focused on low multiple stocks, to one interested in real growth stocks. Today, in my opinion, the world's cheapest stock is Apple (editors note: the interview was conducted when Apple traded at \$450). If that company had existed in the 1970s, it would be trading at 5x what it currently is.

For years I've had a fund that I've put money into in case of a real crisis. I've put TIPS into that portfolio and I'm convinced now that they're a disaster. There's just no yield at all. You're taxed on the yield. So I'm thinking very seriously of shifting all of my TIPS into something like Apple or Google. Apple is

just an extraordinary company. They just have ideas. They don't have any factories. They just have great ideas and then outsource all

“The first thing is, is the management decent and honest? A lot of people don't really care about that. The way to look into that is to do some diligence. Are they actively involved in their community? You should try and find folks who know them and see what they think. Of course, you also want to investigate the growth possibilities.”

their manufacturing so that they really don't take too much operating risk.

G&D: When would you sell Apple?

JR: Well, there will be a time to sell the stock, of course. But right now,

they're trading at 12x earnings for a company with amazing products. This year will see the Apple television set. I'm almost sure of that. But when the stock skids, it likely won't be a massacre because they have so much cash.

G&D: Could you give us a general sense of what you think an analyst should look at first and what should get one most excited about a particular stock?

JR: I'd say if you have an idea that company management is comprised of really great people, you should look hard at that stock. But keep in mind that people can change too. For example, Steve Jobs was not a great person in many respects before he was fired, according to his biography.

G&D: Aside from honesty and other important core analytical attributes, what do you look for in an analyst when you decide to seed their fund?

JR: Competitiveness. Is he a competitor? Does he get into the batter's box and crowd the plate to intimidate the pitcher? I use that as an analogy but I believe that athletics actually do

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“We had fantastic analysts and I found I could count on their earnings projections. So I sort of turned from a cheap skate investor, one who was focused on low multiple stocks, to one interested in real growth stocks.”

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mean a lot. For instance, Mandel is a fabulous athlete and particularly strong in tennis and squash. He picked up golf and now he's good at that too. Griffin plays everything. Really all of those analysts I mentioned earlier have been good athletes during their lives. But there are certainly exceptions to that too. A whole bunch of funds have been successful with no jocks involved.

I should also mention that all of those guys have a real interest in making this world a better place. Mandel is on the National Board of Directors for Teach For America. Griffin is a founder and Board Chairman for something called iMentor, which is a huge mentoring organization here in New York. Lee Ainslie has done a lot and Andreas is getting into it in a big way. That's another interesting aspect to those who have been successful investors. Look at George Soros. He's quite a philanthropist.

G&D: In addition to a competitive spirit, how do you decide which analysts are good enough for backing from your fund?

JR: Well it's based on who has given you the good ideas

and you have to keep track of that. We're going to back a new fund and I think you'll hear about it in two or three months. This fund will be managed by a team of people who we've vetted and who we think are very good. We've had some losers along the way.

Something else we do, by and large, is that we test most of the people who come to work here. This is a psychological test that lasts for about three hours. If the results of that test aren't consistent with how successful managers would think about and respond to the questions asked, then we feel we're doing a bad job with those people who have come to work for us. We've had flops take it and great managers take it, so we've been able to extract a lot of useful information about our people from that test. It's something that helps prevent us from seeding a fund run by someone who wouldn't be all that good. The test tries to assess whether a person is thoroughly honest or if they're trying to game the test. The questions are worded in such a way that they help us do that.

G&D: Of the "Tiger Cubs" that you've mentioned, is there one that you feel is

most similar to you in terms of investment style?

JR: I think a lot of those guys gravitated toward Tiger Management because they had similar investment philosophies. I would say that there are many more similarities than there are differences between all of us. I would say, though, that some writers out there will try to determine a correlation between the portfolios of the various "Tiger Cubs" or Tiger Seeds. We can show you figures that just blow that right out of the water. On the other hand, I think almost all "Tigers" had sensational 2007s and reasonably good 2008s but not very good 2009s and 2010s. You could say there's obviously some correlation but it's not that. It's just that our fundamental risk parameters were similar.

G&D: Analysts are bombarded with so much information today, what do you think they should focus on to most effectively allocate their time?

JR: I would say that hedge fund investing is, in another sense, the antithesis of baseball. You can hit .400 and not make much money if you're not playing in the big leagues. But if you play in

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"Is he a competitor? Does he get into the batter's box and crowd the plate to intimidate the pitcher? I use that as an analogy but I believe that athletics actually do mean a lot."

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the big leagues and you hit .400, you're going to make big money. With hedge fund investing, you get paid on your batting average irrespective of the "league" in which you're playing. So go where the pitching is the worst. Go to the minor leagues; go to Korea and China now. There are 1,000 fraudulent companies and 1,000 fabulous stocks! I once found somebody to whom I gave this pitch who said, "Gosh, I should go to China!" Then I reminded him about his family. He replied that he was about to get married to a Vietnamese woman who would love to live in China. So we backed his fund in China. I think our Chinese fund, which should officially launch in May will be a good one because we have a manager on the ground there who's talented and loves the business.

G&D: What is your view of the current macro situation and how is it shaping your investment strategies today?

JR: I'm the only person in America, outside of Stan Druckenmiller, who has some worries about the US printing money. Europe also scares me. The print-

ing of money is scary, but that is what they are doing to get out of it.

"...I would say that hedge fund investing is, in another sense, the antithesis of baseball. You can hit .400 and not make much money if you're not playing in the big leagues. But if you play in the big leagues and you hit .400, you're going to make big money. With hedge fund investing, you get paid on your batting average irrespective of the "league" in which you're playing. So go where the pitching is the worst. Go to the minor leagues; go to Korea and China now."

G&D: Besides Apple and

perhaps Google, are there any other stocks or industries that you find particularly appealing today?

JR: I love WuXi (pronounced WOO-shee; ticker: WX) which is a Chinese-based employment agency for PhDs, primarily in the drug industry. Pharmaceutical companies can employ a Chinese PhD living in China for about one fifth of what a US PhD would cost. So I think its business of somewhat disintermediating the pharmaceutical-focused PhD market is a good one. The company's earnings are certainly increasing beautifully at about 20% a year and it still sells at 10x earnings. It was ushered to the IPO phase by probably the best venture capital firm in the world, General Atlantic.

G&D: Can you talk a little about your investment philosophy?

JR: I believe that the best way to manage money is to go long and short stocks. My theory is that if the 50 best stocks you can come up with don't outperform the 50 worst stocks you can come up with, you should be in another business. That being said, there are

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Pictured: Professor Roger Murray and investor Robert Heilbrunn with their wives, Agnes Murray and Harriet Heilbrunn.

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Julian Robertson

“For my shorts, I look for a bad management team, and a wildly overvalued company in an industry that is declining or misunderstood. For instance I think REITs are jokes. People look at them for yield, which in a sense they provide. But, I think about this like I think about printing money. As long as people keep printing things go alright until something blows up. The REITs are the worst because they pay high dividends and when they don’t earn enough to cover the dividend they issue stock.”

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long periods of times where the 50 worst companies will outperform the 50 best.

Always of particular importance to me at any company is the quality of people at the company. Still, this is not an infallible way of looking at companies. I am reading the Steve Jobs biography right now and am at the point where he got fired from Apple. One takeaway I have is what a difficult person Steve Jobs was when he was a young guy. He seemed to have changed dramatically as he got older.

G&D: What advice do you have for young analysts and business school students?

JR: Peter Lynch’s books have some great insights would be great for anyone to read. Here’s a ‘small-world’ story for you. My neighbor who lived across the street from me in Salisbury, North Carolina went to Columbia Business School. He roomed with Warren Buffett when he was there. The reason I bring this up is that Warren is just so disciplined, smart, and sound – these factors are really what makes him great. People should look at some of the things he’s done in his career and try to emulate him. I’m actually going to the Berkshire

Hathaway annual meeting for the first time this year.

G&D: What do you look for in your shorts?

JR: For my shorts, I look for a bad management team, and a wildly overvalued company in an industry that is declining or misunderstood. For instance I think REITs are jokes. People look at them for yield, which in a sense they provide. But, I think about this like I think about printing money. As long as people keep printing, things go alright until something blows up. The REITs are the worst because they pay high dividends and when they don’t earn enough to cover the dividend they issue stock.

G&D: Many think that the hedge fund industry is changed dramatically over the last few years in terms of the difficulty in raising money now, as compared to five to ten years ago, as the industry has become more institutionalized. What are your thoughts?

JR: I think this is true, but it is nonsense on the part of the buyers. They act as if you have to have \$100 million in assets under management to be brilliant. The truth of the matter is that if

you did your work you would be better off investing in a \$25 million hedge fund. It’s much easier to turn \$25 million into \$100 million than it is \$100 million into \$400 million, and it’s a lot easier to turn \$100 million into \$400 million than it is to turn \$1 billion into \$4 billion. I think the focus on large, institutionalized funds is a temporary phenomenon. The good people will be looking for smaller funds.

When I was managing money I felt that if we could keep enough people, and that the caliber of our people was good, then it didn’t matter how much money we managed. But the truth of the matter was, when we were finishing, we had nearly \$40 billion (\$20 billion in assets under management levered 2-for-1) to invest. Even if we had 400 positions, we would have had to put \$100 million in each position. It’s hard to find that many \$100 million positions that you really want to invest in and that you can get into and out of. It’s tougher the bigger you get.

G&D: Thank you very much Mr. Robertson.

Robert Luciano

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Luciano is a CFA Charterholder and a Fellow of the Financial Services Institute of Australasia.

G&D: Could you talk a little bit about the background of VGI Partners?

RL: VGI was founded in early 2008 at what turned out to be the early stages of the global financial crisis. As one of my good friends said at the time, we couldn't have chosen a better time or a worse time to start an investment management firm. We started managing money for wealthy families and individuals and that remains our client base. Our focus is on concentrating our capital in our best ideas. We had some attributes that we wanted to incorporate from our experience over the last 10-15 years in the investment management industry and take some of the positives and learn from the negatives, and really go back to the basics of what absolute return investing is all about. We wanted to ensure that we as principals had close alignment with our investors, so we invested in the same funds or vehicles that they were. We also wanted a structure that was skewed toward performance and not on maximizing management fees. We are focused on returns, and on the alignment of interest between the manager and the client. That's the crux of what VGI is about, and what its modus operandi has been from day

one. We assembled a group of highly focused, highly talented people who, along with me, are equity partners in the firm and have a very substantial amount of their own and their families' net worth invested in VGI and the Fund. This creates a very unique alignment of interest, which is so important and yet so few people have it these days. It's one thing to have money invested in the funds that you manage; it's another thing to have the vast proportion of your net worth invested in the funds that you manage. That focuses your attention very substantially and it causes you to focus on preserving capital first and foremost, and then secondly, on generating returns on a risk adjusted basis. So it ensures that you think about Ben Graham's great concept of margin of safety all the time. For example, we don't allow personal trading at VGI, which means that everyone here focuses exclusively on what we're doing. We are looking for high quality companies and high quality investments. We limit the amount of capital we raise, aiming to manage money only for people who share our time horizon and investment philosophy. That's wonderful for us because it means we have an excellent client base that understands our style of investing, and when there is volatility, we are not worried that we'll have upset investors. That's a key issue these days, when

many fund managers have money under management that can cause them to embark upon what Warren Buffett calls "the institutional imperative". It is important to have the right

"When you manage billions of dollars, the incremental capital that you raise can become lower quality and is more difficult to manage. Every incremental billion becomes harder and harder to manage as size is an anchor on performance"

people and infrastructure, the right investment philosophy and alignment of interest, which goes hand in hand with the right compensation policy, and the right capital meaning the right investor base. That's difficult for many managers to put in place and particularly as they continue to grow, it becomes very complicated.

G&D: A lot of fund managers we speak with often say that finding patient capital is one of the biggest challenges in investment management. What is your secret sauce?



Robert Luciano

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RL: Part of it is simply that we manage just under \$300 million and have grown organically and via client referral. When you manage billions of dollars, the incremental capital that you raise can become lower quality and is more difficult to manage. Every incremental billion becomes harder and harder to manage as size is an anchor on performance. We have decided to close to new investors when we reach around \$1 billion under management, and the reason for that is that we like to invest 50% of our capital in our top 5 ideas. So with \$1 billion, an average core position size is going to be around \$100 million, and for some small to mid-size companies it becomes difficult to invest more than this due to liquidity constraints and other factors.

G&D: Would you explain the reasons why you prefer to run a very concentrated portfolio?

RL: We subscribe to the Buffett and Munger philosophy, where one of the key tenets is concentration of capital in your best ideas, and we believe in concentrating in our best ideas for a number of reasons. For instance, we can only analyze and know so many companies in detail at a single point in time. Also, by concentrating our capital in our key ideas we are hopefully able to optimize our return on capital. Concentration allows us to

focus all of our research and continuous learning efforts on a relatively small number of great businesses. We have six people on our investment team, so we can harness a large amount of resource and focus on a number of companies, so we can build up knowledge on specific companies very rapidly. As time goes by your knowledge on these companies increases and this improves your understanding on how the business makes money, its sustainable competitive advantage, the industry structure, the company's financial statements and its future earnings power. It allows you to bring a lot of things together and that's particularly helpful during times of volatility when share prices can fall sharply, and the rest of the market is fearful, you have the courage of your convictions and because you've done your work and your analysis, you can buy more. That's one of the key Graham tenets - that you need to understand the business, to back your conviction and your analysis, and even if the market disagrees with you for a period of time, allocate your capital accordingly. If you don't know the companies well, it's very difficult to gain the conviction to buy more when the price falls sharply. We realize that we have finite capital, so to optimize our return on capital we allocate our efforts and our capital towards our best ideas. We are not going to spread the portfolio across 50 or 100

stocks because we don't think it makes any sense. We want to concentrate capital in our best ideas, and we think over time this will give us a superior return to the market or a portfolio that has a high degree of diversification. Most importantly, that superior return will be achieved with lower risk, because we understand the companies in depth and we have selected them one by one. We think we reduce the risk in our portfolio by ensuring that we only invest in high quality businesses and we define risk as the permanent loss of capital, not as standard deviation of return.

G&D: Would you explain a little more about your investment criteria?

RL: A great investment is one you'd never have to sell. It's an asset that you bought at a reasonable price and which continues to deliver a return that you are pleased with. Its return exceeds your hurdle rate, whether that's a property, a private business or a listed security. When it comes to stocks, what we're looking for are companies that we can understand that have relatively simple and straightforward business models and attractive industry structures. We don't like complexity in terms of conglomerates or opaque financial institutions. We then narrow this list to find companies with a truly sus-

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“A great investment is one you’d never have to sell. It’s an asset that you bought at a reasonable price and which continues to deliver a return that you are pleased with. Its return exceeds your hurdle rate, whether that’s a property, a private business or a listed security.”

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“Investing is one of those wonderful careers where the more time goes by, the better you get, unlike an athlete that has a finite career.”

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sustainable competitive advantage. I think you can only ascertain whether the competitive advantage is truly sustainable by understanding the business model and industry structure. If you can find a company that has a sustainable competitive advantage and you can buy it at a reasonable price, then you're on your way to a successful investment.

G&D: But wouldn't those companies be priced at an appropriately high valuation?

RL: In a normalized market environment, yes, this is usually the case, particularly if it is a well known stock. However in the past few years, you have been able to buy some of the best companies in the world at significantly marked-down prices. One of our largest positions is The Coca-Cola Company which was trading in the low \$40s in late '08, early '09, and that stock until only just recently has been trading at a considerable discount to intrinsic value. Coca-Cola is one of the greatest businesses in the world that epitomizes sustainable competitive advantage. Our job is to find companies that have these characteristics and buy them at a reasonable price. So for our investments, we look for companies that are relatively easy to understand which often means avoiding some companies whose businesses are extremely vulnerable to tech-

nological innovation. Sustainable competitive advantage is very important, and the key is to buy it at the right price. If you overpay for a wonderful business, you can generate low or even negative returns for a very long time. Investors in Coca-Cola would have experienced this if they paid around 50x earnings in the late 1990s. You could have bought Coke stock then and made no money for over 10 years. I guess this perfectly highlights Warren Buffett's point about "paying a high price for a cheery consensus."

G&D: Where have you typically found your best ideas? Do you run screens?

RL: There are a variety of ways we come across our best ideas. A lot of it is comes through general knowledge and combined experience. I've been looking at public securities since 1996 and reading hundreds of annual reports, as well as Outstanding Investor Digest, *Graham & Doddsville* and other investing publications. So our knowledge of securities has accumulated over time. Investing is one of those wonderful careers where the more time goes by, the better you get, unlike an athlete that has a finite career. Charlie Munger and Warren Buffett are a testament to this. They have gotten better as they've gotten older. So I guess it's collective learning – we have a short list of

businesses we'd like to own, and sometimes price gets in the way of that. Sometimes it's our own fault where we don't want to pay up for a great business and the stock just keeps going up or we simply miss it. Sometimes we find them through screening, other times we find them from speaking with other companies. We typically conduct more than 350 company meetings a year either through company visits, conference calls, or one-on-one meetings at conferences. We regularly ask companies who their key competitors are and who in the industry they recommend that we speak to. We ask management who they respect and admire and which other companies we should be speaking to. So there is no single approach, there is no single technique. Sometimes we may have an idea for a long time, for example Colgate-Palmolive which we have in the portfolio. We have been long-term admirers of the company, and for whatever reason didn't buy it during the financial crisis. The stock got quite expensive at one point, and then there was an opportunity to purchase Colgate in August 2010 when there was some concern over what we thought was not a serious matter. There was the devaluation of currency in Venezuela and also threat of competition from P&G which we assessed to be temporary and not material

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to valuation so this gave us an opportunity to buy the stock at very attractive levels. This is an example of a company that we had on our watch-list, we missed an initial opportunity, but we continued to watch it, and when the stock was sold off it was a very quick decision to build a substantial position in Colgate. It's important to keep watching great businesses because invariably you get these opportunities over time.

G&D: Are there any industries that you find yourself investing more than others?

RL: We avoid certain industries and therefore, by doing that, we tend to focus on what's left. We avoid banks and insurers because of their complexity and opaqueness that makes it difficult to forecast the earnings power of these businesses and to ascertain what their true intrinsic value is. We don't feel we have any adequate edge to price those securities with the amount of information available in the public filings. We also tend to avoid resource companies because we find it difficult to value them due to the uncertainty of longer-term commodity prices. It is one thing to have a sense of volume; it is another thing entirely to try to ascertain what the longer-term price of a commodity will be. We currently do have a focus on business service software that has

recurring revenue at the core of the business model. We like recurring revenue businesses in general, whether it's in software, in financial services, in media or in healthcare. We don't tend to do top-down analysis, but rather focus on bottom-up analysis - we focus more on companies than industries per se. Having said that, we are very mindful of longer term trends, so for instance an ageing demographic is a very powerful longer-trend trend in many Western countries. So we're mindful of secular trends or shifts in terms of industries or sectors that we can invest in, and I think it is important to be mindful of these types of secular changes that are going on, but we don't invest based solely on those criteria.

G&D: Could you talk about some current ideas?

RL: One of our key positions is Oracle Corporation. We think Oracle is an excellent business, and particularly attractive at these prices. It's a stock that is out of favor with the market. We've owned it from the high teens and it's about \$30 at the moment. Oracle dominates the industry in relational database software. It has evolved substantially in the last 15 years from selling software on a one-off basis to selling software with a recurring revenue stream attached to it in the form of Update & Support fees. So effectively the Up-

date & Support fee has evolved to being the biggest component of Oracle's revenue. The Update & Support revenue for Oracle is linked to the initial purchase price of the software, and is about 22% of the purchase price per annum and indexed to inflation. Roughly 96-97% of Update & Support contracts are renewed annually; the small amount that is lost is usually due to M&A and bankruptcy. So what they've done is built up this recurring revenue stream. In 2001, recurring revenues were \$3.5 billion while one-off revenues were \$4.5 billion. In FY 2011, the recurring revenues were \$14.8 billion and new software fees were \$9.2 billion. The delta between \$3.5 and \$14.8 billion has a gross profit margin of about 90% and the incremental gross profit margin is even higher.

G&D: So what is the market most concerned about in pricing this stock?

RL: We like Oracle along with SAP because they're both mission critical software businesses that have established a very strong recurring revenue base. They are must-haves for large global corporations and it's very hard to dislodge Oracle or SAP once they have been installed. The market is likely focused on some weakness in new software license sales for Oracle, as it can be a driver

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 of near term results, but if you're looking at it on a longer term basis, the recurring revenue stream and its growth are far more apparent. Oracle recently acquired Sun Microsystems, and the market initially was concerned about this acquisition because Oracle was effectively buying a hardware company that was not making any money. The market was worried that the company was "deworsifying" but it turned out that the company ended up reducing cost, cutting out unprofitable revenue and ended up acquiring Sun for what looks like less than 2.5x EBIT which is a very attractive acquisition price. That concern faded away, but another concern may be that the management team is shrinking the revenue base of Sun as it gets rid of non-essential revenue lines and low margin products. It appears to concern people that the hardware revenue is shrinking, and I think there's a broader concern that the arrival of cloud computing would dislocate Oracle's dominance in relational databases. What we're focused on is this remarkable increase in the recurring revenue stream, which has only accelerated post the financial crisis. The recurring revenue was \$8.3 billion in 2007 and grew to \$14.8 billion in 2011, and we're looking for a number of around \$16 billion in 2012. That's a staggering growth rate on a revenue line that has a gross profit margin of over 90%. Even if

we assume that the company no longer grows its 2011 free cash flow in perpetuity you'd still get a valuation that is around the current stock price. We think that is remarkable, because you don't

"What sometimes can happen is that analysts can become stuck in a certain way of analyzing a company, and the same analysts cover the same names for many years, and they sometimes just don't pick up gradual shifts in business models. They focus on the data that they have populated their models with and they miss the new data."

get that type of margin of safety in many stocks today. We read a 120 page report on Oracle from the sell-side a while back that had no mention of the recurring revenues! I don't understand how such a large revenue base with such a high gross

profit margin goes unnoticed in a 120 page report. It reminds me of McDonald's, how the market was obsessed about food prices a few years ago while forgetting that McDonald's was one of the most diversified property owners in the world. The high food prices were somewhat relevant as they would affect the franchisees, but to be obsessed with them didn't make much sense. What sometimes can happen is that analysts can become stuck in a certain way of analyzing a company, and the same analysts cover the same names for many years, and they sometimes just don't pick up gradual shifts in business models. They focus on the data that they have populated their models with and they miss the new data.

G&D: *Is there another name that you are currently excited about?*

RL: WD40 is a global consumer products and brand management company. The vast majority of WD40's revenue is generated from selling cans of the world famous WD40 branded industrial lubricant (G&D: WD40 stands for Water Displacement, 40th attempt which was the laboratory name used by the chemist who developed the product in 1953).

WD40 manufactures the WD40 concentrate internally to protect its secret

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formula. WD40 ships this concentrate to external ‘aerosol fillers’ and outsources the majority of the manufacturing of its product to third parties. As a result WD40 has only two employees in its manufacturing operations. This asset-light business model enables WD40 to operate with very little capital and only 334 employees.

WD40 generates greater than US\$1,000,000 in revenue and US\$171,000 in EBIT per employee. These metrics are particularly high for an industrial company and highlight how management operates the business. WD40’s outsourced-manufacture business model means that it has lower fixed operating costs than a typical manufacturing company. This allows WD40 to shut down production rapidly when there is a sudden drop in demand, as we saw in 2008/2009, which helps protect WD40’s profit margins. WD40’s dividend payout ratio is around 50% which we think is impressive and it is now embarking on substantial share buybacks. Last year, WDFC bought back \$41 million of stock on top of paying dividends, for a total return of capital to shareholders of \$60 million, which we think is extraordinary. The stock at these levels is still undervalued at a 7% free cash flow yield for a company with such high quality characteristics. At this point, you’re not paying any-

thing for a takeout premium, and we think this mono-line business with no debt and high cash flows is a standout candidate to be taken private.

G&D: You started VGI Partners in Sydney initially, given your background. How did you decide to open a NY office?

RL: We have primarily focused on equities outside of Australia since our founding in 2008 because the opportunities internationally have been so substantial. As we became better known to investors, we have had more interest from outside of Australia and we came to the realization that we needed to have a base in either the US or Europe to help us grow and allow easier access to companies and management teams. We had a choice between New York and London and we decided to work closely with a large investor in New York. New York is a great place to be and we also get terrific access to first class graduates who can potentially join us and help us grow VGI Partners.

G&D: Any advice for students thinking about entering the investment industry?

RL: I think that this profession largely chooses you. Most people who I think have become successful in investing have shown character traits at an early age that suggested that they

would be successful in investing or in business. I don’t think that this is a career that you can force upon yourself, because it is something that you have to be genuinely interested in. My advice would be to learn from Charlie Munger and Warren Buffett, read all their speeches, and read all the original Buffett Partnership and Berkshire Hathaway letters. I would also highly recommend reading Phil Fisher’s “Common Stocks and Uncommon Profits.” That would be a very good place to start. The teachings of Ben Graham go hand in hand with the teachings of Warren Buffett, and the “Intelligent Investor” is a must-read. I would also spend as much time as possible studying accounting. It is something that I feel a lot of modern finance courses underestimate. One of the keys to being a successful analyst is understanding accounting and financial statement analysis, and that is vastly underappreciated. I was trained as an accountant; some of our team members were trained as accountants too and four of the Investment team, including myself, have completed the CFA program which puts a lot of emphasis on financial statement analysis. Finally, don’t focus on the monetary outcome, if you are a good analyst the monetary outcome will find you.

G&D: Thank you very much, Mr. Luciano.

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