
Fund seeks companies with a high return on tangible assets, that throw off large amounts of cash and that are shareholder-oriented.

A Search for Profitable Businesses With Shares Selling at a Discount

An interview with Donald Yacktman, president & portfolio manager, The Yacktman Fund

New mutual funds obviously don't have much of a track record. But a number of funds have been started by portfolio managers with impressive track records elsewhere, who decided to set up shop on their own. One such portfolio manager is Donald Yacktman, who built a reputation managing the Selected American Shares Fund. In 1992, Mr. Yacktman left Selected American to set up his own fund.

The Yacktman Fund now has a 3½-year performance record. It got off to a bad start, with a loss of 6.5% in 1993 compared to a gain of 10.0% for the S&P 500 and 13.8% for the average growth fund. However, it has outpaced the S&P 500 and been among the top 25% of growth funds for the first half of 1996 (up 12.5% compared to 10.0% for the S&P and 9.7% for the average growth fund), and for the last year (26.9% compared to 25.9% for the S&P and 22.6% for the average growth fund) and last three years (18.5% compared to 17.2% for the S&P 500 and 15.0% for the average growth fund) for periods ending June 30, 1996.

The fund currently has about \$650 million in assets.

In late August, Mr. Yacktman discussed his approach with Maria Crawford Scott.

What is the investment objective of the fund?

Our objective is to have the highest possible return while taking a minimal amount of risk through investment in the stock market. And as a derivative of that approach, what you end up with is a portfolio where the growth rates are above those of the S&P 500 and the price-earnings ratio is below the S&P.

What kinds of stocks do you look for?

We think of it as a triangle. We look for good businesses, and we define a good business as one that has a high return on tangible assets. If you looked at the profile of our businesses, you'd find that their returns on assets are probably 2½ times those of average corporate America—

The Yacktman Fund is managed by Yacktman Asset Management Co., 303 West Madison St., Suite 1925, Chicago, Illinois 60606; 800/525-8258.

they're very profitable businesses. Conceptually, you could think of it as owning a bunch of high-coupon bonds yielding 20% in a 10% bond market, or something like that.

These businesses throw off enormous amounts of cash and because of that, we also want a firm that has shareholder-oriented managers—that's the second leg of our triangle. In other words, we want a management that can take the cash flows that those assets are generating and reinvest them at high rates. We have a very long time horizon and we would be willing to own a stock as far as the eye can see as long as it didn't become overvalued or the business didn't change dramatically. And by the way, a good business tends to attract the better managers, and they tend to have a lot of their personal wealth at stake.

A manager can use the cash in five different ways. First, he can reinvest it in the business, for research and development, marketing, cost reductions—things that will enhance or further develop the existing resources he has. Our businesses typically have a lot of cash left over even after doing that. The other things a manager can do with the cash are: make an acquisition; buy back stock; pay down debt or build up cash; or pay a dividend. We're not enamored with dividends, and most individuals who are taxpayers should not be either. We would rather have the management do something more creative with the cash flow that will result in long-term price appreciation.

The bottom part of the triangle is a low purchase price. What I mean by that is that there is a big gap between the private market value and the public market value of the firm. We don't have any mechanical ground rules for this, but if the gap is significant, that's when we buy; if it goes lower, we'll add to it. Conversely, if the stock price gets too close to private market value, that's when we start to let some of it go.

Do you screen a universe of stocks?

We've basically built a list of businesses that we invest in. We started with a list that was developed from historical experience, and we've gradually either whittled away or added to it, depending on the circumstances. We have roughly 100 companies that we feel are really super-

profitable, and I would say that between 85% to 90% are over \$100 million in size; the rest tend to be smaller companies.

So, you follow these 100 companies, and when the price reaches a certain level, then you would buy?

Right, and typically about 12 of them will be between 55% and 60% of our holdings; the mutual fund has around 33 holdings.

Do you put a private market value then on all of those 100 companies?

Yes.

What goes into that valuation?

We value them very similarly to what you'd do if you were to value a building or any privately-held business—you look at the cash flows and their predictability, and the multiples that are being paid for businesses similar to that in a private market transaction. From that, you derive a multiple to the cash flows and then you capitalize them. And what we look for is a share price that is a significant discount to this private market value.

What would cause you to purchase a stock, then—a significant price drop?

Almost any decline in price of any consequence should be a sign that you at least take a look at it, look at your assumptions and start to evaluate it. Usually you get a decline in price for one of three reasons. One, the overall market goes down—an example is the drop of 10% we had earlier this year, which is the first one we'd had since 1990. Two, there is a perceived threat to the cash flow—now, this may not happen in actuality, but it's perceived. The classic example of this would be Philip Morris, which is our largest holding, where psychologically, people are worried about lawsuits and everything else and yet, on the business side, the company is just humming—I mean it is really on all pistons. Three, there's a small problem that the market perceives as internal and that's relatively easy to correct. Fruit of the Loom had some errors they'd made and they're basically dealing with correcting them. So, they're at least attacking the problems and the stock has popped quite a bit since then.

Do you buy the stock all at once?

Typically, we're gradual buyers, and I'd say half our turnover is of the same companies we are buying at different price levels. I mentioned Fruit of the Loom—in the fourth quarter last year it went from 21½ to 16½ and back to 25½, or something like that, all in a three-month period. And in that three-month period, we showed a net sale of 100,000 shares in our quarterly report, yet early in the quarter when the stock was down, we had bought 600,000 shares and then

later in the quarter when it was up, we'd sold 700,000 shares. So that's an example.

What would cause you to sell a stock?

Well, typically they've run up in price, and then we're starting to get concerned about how close it is to private market value. So gradually, we're peeling away—we tend not to do anything abruptly. Also, if we bought something when it was depressed and we overbought it, then we would start to chip away when it runs up. For instance, we bought a lot of Reebok when it was down in the mid-20s, and when it ran up, we tried to cut it back so that we didn't own over 5%.

Are there times when you have had to totally drop a stock because either management changed or you just decided it was no longer a "good business"?

Very rarely. What more typically happens is the stock or the company is not as good as it once was, or it becomes popular, and then something else that is better becomes less popular—the relative valuations indicate that you should shift from one to the other, and we'll do that. The ground rule here is that you always try to have as much upside potential as you can with as little downside risk as possible. We're constantly looking for that combination.

Many of your companies are large, well-known names, yet dividends are not something that you are seeking. Why then do you invest in the large-cap market?

We focus on where we can find value, and it's just a matter of where we have found it. Conceptually, we're trying to squeeze all the risk out. Take a company like Quaker Oats, which is not having a stellar period right now. The reality is that Quaker Oats has ready-to-eat cereal, grocery products, Gatorade, Snapple—they have several distinct pieces to them. It's almost like buying a portfolio of businesses, whereas if you buy Barefoot Lawn Co., you're buying a lawn care company, and that's all it does. We think that that is an added risk because they're more vulnerable when that particular business is in a downturn. That doesn't mean we won't buy it [Barefoot is a fund holding], but we would expect more from it.

What about smaller companies that you invest in—do you look for the same characteristics?

Yes, we are looking for the same thing. But we don't use market cap to define large and small. What we do use is earnings, and the smallest company we have would probably be Barefoot and the largest would probably be Philip Morris. Barefoot probably has a market cap of in the neighborhood of \$60 million, so it's a pretty small company.

The prospectus mentions that the fund can switch to fixed-income at times that you feel that the market is relatively fully valued. Have there been occasions where you've gone

heavily into fixed-income?

Since we've started, we've had no more than 15% in cash, other than initially when we had a lot of money come in and we were gradually investing it. Right now we have about 12½%, which is high. We'd rather have nothing in cash, and in the middle of 1993, when things were dirt cheap, we had a ⅓ of 1% cash.

One of your large holdings is United Asset Management, a mutual fund company.

They have everything we want. It has a very high return on assets. They generate enormous amounts of excess cash flow—they generated something like \$180 million in cash after taxes. Between \$35 million and \$40 million of that comes out in dividends, so the rest is left over for acquisitions, paying debt, etc. That's the kind of thing that's attractive.

Your approach tends to put you into stocks with common characteristics, while avoiding other groups. For instance, you don't have any technology stocks. I take it you view that as a positive?

I do. Most technology companies are not the kinds of businesses we invest in, and they have been priced very highly recently. The third thing is that there are a lot of Roman candles. I remember when, maybe less than 15 years ago, Apple was the darling of Wall Street and today it's trash. In the technology business, very few stand the test of time.

Doesn't that approach make the fund vulnerable at certain stages of an economy?

Yes. I would say that there are two times when we would look bad. One is if you have a capital goods boom in the early stages coming out of a recession, and I think 1993 was an example—we looked pretty bad if you looked at the first half of 1993. From then on, we've looked great. The other time we wouldn't look so great would be during a re-spike in the bull market, like last year. Interestingly, if you take the June to June years—June of 1993 to 1994, 1994 to 1995, 1995 to 1996—in each one of those 12-month periods, we've beaten the S&P 500. But if you look at the

calendar years, last year we did not beat the S&P. That's typical of our strategy because it's very defensive-oriented. We will struggle in periods when the market roars up, because we'll be getting more and more defensive. We're not going to be in the speculative-type things. But then, during the period this year when the market went down 10%, we were down only half of that. We really open the gap in a period like that.

Overall, what would be the major risk to an investor in the fund?

A lot of people have pointed to the fact that we have over 10% of the fund in tobacco issues, and they're very controversial. People are very fearful of lawsuits, and anytime you create uncertainty, people hate it. They'd rather spend a lot of money in things that they view as certain. Our contention is that, conceptually, Philip Morris is like a beach ball being pushed underwater and the water level is rising and somebody's trying to pull the plug out of the bottom of the tub, so to speak.

You've managed to keep the expense ratio very low—0.89% in 1995—and the prospectus mentions that you are able to do this by outsourcing. What is this?

We were anxious to try to bring the expense ratio below 1.00%, which was a goal that we achieved last year. We've really tried to look at this seriously. We're not trying to develop a big marketing organization or a big family of funds. We're just trying to implement an equity-oriented strategy that anyone can invest in. Because of that, we farmed out everything else we possibly could on the mutual fund so we could focus our efforts on just managing the assets. So the 800 number, sending out our prospectuses, daily pricing, the transfer agency, all of that has been farmed out.

One thing the expense ratio does not reflect is that one of the advantages of working with firms like Schwab and Fidelity is you can use some trades with them as a way of paying for part of the services they provide, so in effect you get to lower your expense ratios. If you take that into account, the net cost to the shareholder last year was 0.91%. Now, we don't do enough brokerage to keep the expense ratio that low perpetually, but we have brought it below 1.00%. 