STAYING THE INVESTMENT COURSE WITH A WARREN BUFFETT–STYLE APPROACH

The tables have turned. During the late 1990s, funds following a strictly growth approach could do no wrong, and value-based funds languished.

Over the last year, however, with the overall markets in bear territory, value-based approaches have proven their worth.

One fund that has done particularly well sticking to its guns is the Vontobel U.S. Value Fund. Over the last 10 years the fund has averaged a 17.7% annual return (through year-end), compared to 16.8% for the average growth fund, yet with less volatility relative to the S&P 500. For the last year (through March 30), the fund was up 35.2% compared to a loss of 8.4% for the average growth fund.

Currently, the fund has about $132 million in total assets.

In early April, portfolio manager Edwin Walczak discussed the management of the fund with Maria Crawford Scott.

FUND FACTS

VONTOBEL U.S. VALUE (VUSVX)

CATEGORY:
Growth

PERFORMANCE (thru 3/30/31)

Compound Annual Return (%)	Fund	Category
1 year	35.2	–8.4
3 years	6.0	3.6
5 years	14.6	12.4

RISK
Average

TOTAL ASSETS: (as of 3/30/01)
$132 million

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What is the basic objective and investment philosophy of the fund?

Even though the fund looks nothing like the S&P 500 index, we have to be compared to something, so over the theoretical long run, the objective is to beat the index—and we have done that on a 10-year basis. The last three years were rather poor because value investing was out of favor, but over 10 years we're about a percent ahead of the S&P after expenses and fees.

The investment philosophy is straightforward—it's a derivation of Warren Buffett's philosophy. It's all bottom-up stock picking, which basically means we're trying to buy companies that we think have some element of a franchise dealing in high-quality goods, that have reasonably predictable earnings, and that are selling at a discount to what we think they're really worth. It's not really deep value investing, like buying highly cyclical stocks when they're out of favor. It's really more what others would call GARP—growth at a reasonable price.

It also results in a concentrated portfolio because there aren't many companies that meet our criteria, and for those that do, it's hard to get them at the right price. Our investment universe is only about 100 companies—maybe 150 if we really try to get liberal. But at any one point in time, we'll have maybe 20 to 25 names in the portfolio. And since it is strictly bottom-up, we do not place any emphasis on industry weightings, so for instance right now we have no tech or oil stocks, and roughly 50% is in financials.

How do you arrive at your universe of around 100 stocks?

There's no magic number, but if you look back historically in the broad U.S. market, and you look for only companies that have delivered reasonably predictable earnings and have had reasonably high returns on capital, it happens to work out to be that number. For example, when we first started we looked at Value Line, and we only came up with 60 companies. With so few companies, we decided to try to be more liberal and expand it a little bit to include Microsoft and Intel, even though we've never owned them, just for the sake of following them, and . . . you never know. And those are the companies that, if they get mispriced for whatever reason, we'd like to buy.

How do you define "reasonably predictable earnings"?

We look back over a 10-year history, and we don't want to see things like a drop of 20% in one year. For instance, here's an example of a boring little company, but it delivered the goods—Torchmark, which is an insurance

company in Birmingham, Alabama. One year they'll earn 10%, the next year 18%, sometimes they were at 11%, but you never see them down 20%. We're not requiring them to grow 30%, and in fact we don't really have any minimum earnings growth requirement. We'd rather see reasonable consistency, even if it's at a modest rate.

Do you exclude companies that have had down years?

Not necessarily, because sometimes there are cycles in these businesses. And we don't necessarily require that earnings every year be greater than the prior year. We're willing to look through those kinds of situations if we think the longer-term path basically is one of reasonable consistency and predictability.

Does the predictability requirement lead you to companies that are larger in terms of market capitalization?

If you had talked to us in 1997 when we had Disney, Gillette, Coca-Cola, and Wells Fargo, we were categorized as a large-cap value fund. But at the end of '98, we couldn't find many things to buy, and it was difficult for us to get into technology stocks because it's so reasonably unpredictable. Therefore, we had about 30% in cash for awhile as we searched for something to buy, and we ended up finding a lot of insurance companies. It just happens that many insurance companies are mid-caps, so now we're categorized as a multi-cap value fund. In that sense we've changed, but we never really look at market capitalization as a criteria.

What kinds of valuations do you look for?

We try to use some element of a discounted cash flow to estimate a firm's intrinsic value: We forecast an earnings growth rate and discount the future stream of earnings to the present using today's long-term bond rate. If the stock is selling well below that, it is a candidate for purchase. We won't necessarily purchase it, but at least it's a candidate. So, our valuations have nothing to do with things like price-earnings ratios or price-to-book, although by coincidence—and coincidence only—the fund's average P/E and price-to-book is well below the market most of the time.

In this particular market environment, then, you've been finding a lot of insurance companies based on that cash flow analysis?

We really started getting into them in '99, and most of them kept going down in '99. Then last year they went up. The irony is that we had a horrible year in 1999, a tremendous year last year, and we're doing okay this year, but the portfolio has hardly changed at all.

When you find a company that meets your valuation prospects, do you normally know the reason why the market is undervaluing it?

Most of the time. We do use screens, but the more I get involved in this, the more I realize the screen basically tells me what's on the front page of the newspaper. When the market hated banks in 1990, all the banks showed up on our screen first. Or when Clinton was elected and Hillary was trying to change health care—front page news—and all the health stocks showed up. Most screens really capture the fear and show what's unpopular. Right now, we're looking at tech stocks. We haven't done anything, but it's kind of obvious what the issues are and no surprise that a lot of these companies are showing up on various screens saying, 'look at me.'

What kind of screening do you do to exclude companies that really don't deserve higher valuations?

That's where the qualitative assessment comes into the analysis. There's no one criteria that would make us pull the trigger on a stock either pro or con. In any company there are always risks and problems. So the way we do it in the portfolio is that we hold different percentages of our holdings based on how confident we are in the business and how undervalued we think that business is. For instance, Fannie Mae is 10% of the fund, but then another little company called IPC Holdings is only 2%. If we are very confident in a company and it's really undervalued, we'll go up to 10%, but with a less-trustworthy company, like IPC Holdings, even if it were 50% undervalued, we'd only go to a 2% position. But we won't hold much less than 2%, because it really has no impact on the fund.

The qualitative factors you look for are things like how strong of a franchise a given company has?

Yes, and how long it can be perpetuated—things to do with the economics of the business. We don't use anything that has never been thought of before, but it's hard to find all those attributes in one company. That's why when we get one, we really make sure we try to have a significant weighting in it, or in that area of the market.

How do you decide within an industry which companies you are going to hold? For instance, you have a large number of insurance holdings—do all of those have their own franchises?

Yes. Even though they're under the general rubric of insurance, there are really three or four sub-segments. For instance, Mercury General in California is an automobile insurance company, and their main advantage is that they're a low-cost provider of automobile insurance in California—even lower than Buffett's Geico. I like the fact that the guy who runs it is a self-made billionaire, and he's got 90% of his assets in the stock. That company has been around a long time, and there was just an insurance war in California and these guys still are quite profitable. So that's their advantage.

Now let's take a different insurance company—Chubb,

a name most people probably have heard of. They are more of a conglomerate, but even though one-third of their business is a commodity, two-thirds of their business is kind of a specialty business, like insuring homes and art for very wealthy people, and they charge a lot for that. So, the profitability of two-thirds of the business is great. So that's their little niche, and it's different from Mercury General's niche.

What would cause you to sell a holding?

Well, that's an easy one. Two things would prompt a sale: One is that we're wrong, and the fundamentals deteriorate. That would be the worst reason. The more happy reason would be that the stock gets fairly valued or it goes above our estimate of its fair value. And that's a slight difference between Buffett and us—when something gets to a fair value we tend to sell, whereas Buffett frequently holds on, thinking that the value of the company will grow again the next year and the next year. Our tendency is to be chicken, or risk reverse, so whenever something gets to be more or less fairly valued or a little bit above it, it's been reduced to a diminished position by virtue of our having trimmed and trimmed and trimmed.

By the way, the turnover in the fund is high, but the irony is that the names we own don't change that much. Because the market fluctuates so much, what we tend to do is to add and subtract from our existing holdings. For instance, if we bought a stock at $50 thinking it should be at $100, and it immediately shot up to $70, we typically would start to scale back as it approaches its fair value. But if it goes down again, we will add to it.

Some people would look at the fund and the concentrations, and think it's a highly risky fund. Do you view it as a riskier fund?

No, actually I think the fund is risk reverse, and that's why it's concentrated. And that gets into an important difference—risk versus volatility. And it gets back to what I said earlier about the kind of businesses we want to buy. We stress long-term consistency, and then we buy at the right price. That's really a risk-averse investment approach. In the short run, because we look nothing like the index most of the time, we can be much more volatile up or down relative to the index. But we don't care about that because that's volatility relative only to the market, not risk. Risk is when you lose money.

The fund didn't do so well in '99. What happened?

Ninety-nine was a horrible year for all the value funds. We lagged the averages by a significant amount, 10% or more, although we did well for value managers.

In '99, we had no technology, because it's very difficult for us to get to those stocks given our investment criteria. Who had a durable franchise? Can we understand it? Do they generate free cash flow? And we haven't even gotten to the valuation question. So it was never a function of valuation, it was always a function of whether these companies are investable to us at any price. And that's what kept us out of technology.

In the meantime, we had a lot of insurance stocks where the fundamentals were deteriorating in 1999, but they looked cheap on a long-term basis. We also had holdings that did well on an earnings basis, but the stocks went down anyway, like Fannie Mae and Freddie Mac. I think one went down 15%, the other went down 20%, although both of them enjoyed double-digit earnings growth in '99. So we just kept adding more on our way down.

Was that frustrating?

That was the worst year ever. We were basically prepared to go out of business or be fired. People lose faith and you begin to wonder yourself. Hopefully, I won't have to live through that again in the next 25 years.

We thought about whether we were crazy and whether we were dinosaurs. At one point I asked: "What's wrong with us? Everyone has a Nokia cell phone, but we can't own Nokia?" You have to go through periods of trying to improve your style and think about how you can do things better, and we do that even now. But we never were convinced that we were wrong, and so I didn't look at technology. And that served us well the following year.

With our approach, basically we have to be prepared to go into the gutter because we are going to stick with our discipline no matter what, and we're frequently doing things that are unpopular.

And yet today, when all the headlines are trumpeting a bear market, for you it must be like a piece of cake.

The funny thing is, people—like my mother—ask me: "Why are you happy when the market went down 300 points?" The reason is this: The market is much more deliberate and rational now, and I think it will be much more of a stock picker's market going forward. In the late '90s, I don't know if you want to call it a bubble or not, but basically the tide lifted all the boats. Because everything was going up so rapidly, it was extremely hard to beat the index, and then there was a bubble on top of that. Now it has deflated, and I think tech has corrected, value has risen, and it's a much more level and deliberate playing field. If we get a boring 5% return for the next 10 years, I couldn't be more happy.

There's actually a much broader spectrum of things that are worthy of investigation now than there has been in the past two years, which is a good thing.

And I think there is a chance for active stock pickers to do better relative to the index. ✦