A SEARCH FOR GOOD BUSINESSES SELLING AT ATTRACTIVE PRICES

FUND FACTS

OAK VALUE FUND (OAKVX)

CATEGORY:
Growth

PERFORMANCE: (thru 6/30/01)

	Fund	Category
Compound Annual Return (%)		
1 year	22.8	0.0
3 years	6.4	6.1
5 years	17.8	13.2

RISK:
Average

TOTAL ASSETS: (as of 7/31/01)
$350 million

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Value-based investment styles continue to be the leading cars in the current roller-coaster market. And despite the S&P 500's one year of red ink, a number of stock funds have managed to turn in some impressive one-year returns.

One fund that has done well over the last year, as well as over the long term, is the Oak Value Fund, following a Benjamin Graham-Warren Buffett approach that focuses on buying good growth businesses at reasonable prices. The fund was among the top 25% of all growth funds over the last year and last five years.

As of the end of July, the fund had $350 million in total assets.

In early August, portfolio managers George W. Brumley III and David R. Carr Jr. discussed the management of the fund with Maria Crawford Scott.

Can you describe the investment philosophy and basic objective of the fund?

George W. Brumley III: We want to buy good businesses, with good management, at attractive prices. It is a Warren Buffet, Benjamin Graham-infused value methodology of treating investments as businesses, knowing as much as you can about those businesses and then trying to buy them for less than they're worth because, for whatever reason, the stock market periodically puts them on sale.

Our goal is to get a reasonable return over time. And a reasonable return over time means you can't lose lots of capital.

What's your investment universe?

David R. Carr Jr.: We're all-cap people. However, we have to have liquidity because we typically only own 25 to 35 names at any one point in time, so given our size we want some liquidity to be able to move in and out. When a company's market capitalization gets below a billion dollars, we become even more demanding.

Apart from that, we'll look at almost the entire universe of firms. What we're looking for is companies that tend to have high returns on capital, high returns on assets, that have good business models, and that are growing.

Do you run screens for these characteristics?

David R. Carr Jr.: We've been doing research for 20 years and it helps to have that history. We will use screening at times to see if there's something out there that's currently out of favor that we should be looking at. We may look at the new lows list in this time of turbulence and volatility, to see if we can find something that on any given day is being thrown out the back door.

But typically what we find is that any kind of quantitative method, such as a screen or a new lows list, is only going to generate an idea or a name that we probably already know a fair bit about or have already done some research on. The fly-fishermen around here say: "If you're in the water a lot, you're more likely to catch fish."

George W. Brumley III: We look intensively at our portfolio companies—we look at their competitors, suppliers and customers. And some of our research leads us in directions that we may not have thought we were going in to begin with. A good example of that occurred several years ago. Berkshire Hathaway is one of our largest holdings, and Berkshire owns several retail jewelry chains. In the course of our research, and in trying to understand the jewelry business, we visited Tiffany. When we did, we very quickly came to understand that

Tiffany was really a very different business—it was not all that similar to the retail chains that Berkshire owned, and it had some very unique business characteristics. We actually added Tiffany to our portfolio after that in-depth research process. So it got into the portfolio in a circuitous manner, as we were trying to understand a portfolio company better by looking at a competitor.

Your list of prospective stocks, then, is not so much a product of any kind of screening process?

David R. Carr Jr.: It primarily comes down to a huge amount of research. We'll visit face-to-face with managements of probably close to 200 companies this year. That work is done to look at core companies we hold and see how they're doing, to look at potential prospects and evaluate whether they meet our parameters, to look at competitors, suppliers, or just do additional work on an industry we think might have some interest in.

A lot of work is done on an ongoing basis to put us in a position such that, when some promising company gets cheap enough for us to buy, we have all the requisite information and knowledge, and can move very quickly.

George W. Brumley III: Basically, we spend all of our time trying to figure out what businesses are worth. We want to understand the businesses, the managements, and we want to understand what the prospects are. Once we have that information, we continue to update it with the hope that we might get an opportunistic chance in the market to buy it at something significantly below what it's worth. That's the trick. It's simple to describe, but it takes a lot of discipline to execute.

What are the attributes that you particularly like in a company?

David R. Carr Jr.: We want to know how the company creates its product or service and what the cost pressures are—we like companies that have some unique characteristic that allows them to price for a greater profit margin. We want it to be in a business that, over time, will grow revenues in some fashion. We like to see something that is a growth driver to the business.

We also focus heavily on management. We want a management who is open to explaining what the business is and what it does so that investors can make reasonable, intelligent decisions about the value. In other words, we want them to be shareholder-oriented. They must treat us fairly and view us as owners of the business, and understand that they are stewards of the capital of the shareholders.

That's less easy to find than it used to be. It used to be that was very common. Today, with all the stock options and other things, a lot of managements see public companies as a means to increase their own personal net worth.

Of course, we do want management to be rewarded if they do a good job. But only if they do a good job. We don't think they should be rewarded for being asleep at the wheel.

There are cases when we've found companies that are truly wonderful businesses, but the board of directors and management put in options programs that were excessive. We owned Moody's, which was bought out by Dunn & Bradstreet, and it truly is one of the best businesses in the world. But in the spinout, the board and management put in an options program that we thought was excessive. Early on, they transferred almost 4% of the company to management; and then on an ongoing basis, they transferred about 2% of the company each year. The problem was, when we started plugging in the numbers and saw what it was going to take to buy back those options and to account for that transfer of wealth, it had a fairly dramatic effect on the value of the company. We didn't feel we were being treated fairly as shareholders and we left what we felt was truly a good business. But it does demonstrate how quickly, with the stroke of the pen, management who doesn't view us as owners of the business can affect the playing field.

What else do you look for in management?

George W. Brumley III: We spend a lot of resources and time with company management to understand how they view the business, and how they allocate the capital. We want to know their long-term, five-year and 10-year goals. As Wayne Gretzky said about playing hockey, he knows where the puck's going to be, not where it is. We go where the valuable companies are, and a valuable company has the ability to generate long-term free cash flow. We want to know what management is doing to make the business better and how that business model is going to increase the value of the company over time and whether that is reflected in the current stock price.

How do you value a company?

David R. Carr Jr.: The primary model we use is discounted cash flow, because we think the cash flow of a firm is key. However, we adapt it based on the industry. And we will look at other values as well—liquidation values and private market values.

But basically, we try to project the terminal value—our understanding and belief of what the business will be worth based on our independent analysis of the business model and how it will perform in the next five or so years. And then that terminal value is discounted to a present value.

We want to buy a stock that is at a discount to that intrinsic value. The discounts we look for vary by industry. For certain industries we're willing to accept a smaller discount, for certain industries we require a much larger discount. Companies that generate higher predictable cash flows will allow us to take a somewhat smaller discount. We refer to that—as did Benjamin Graham—as our margin of safety.

What our goal is, on a long-term basis, is to not lose capital. For a Tiffany's, where you really have a phenom-

enal brand name and good long-term growth and awesome management, our discount demanded is a little bit less. But typically, we look for a 25% to 35% discount to what we consider to be the intrinsic value.

You tend to own a lesser number of stocks in your portfolio than other funds. Why?

David R. Carr Jr.: We have around 28 companies in the portfolio right now, although we'd like to have 35 and we're certainly trying to work to find them.

We love diversification because if we knew we'd be absolutely right on one stock, we could buy one stock and sit back and that would be easy. I think we probably have more diversification in the portfolio now than in a long time, and that's a function of more stocks getting cheap.

But as you go beyond 35 names, you begin to get complete diversification and you then mirror the market. If you're going to do that, you might as well sit home and not do research. We have created our long-term competitive advantage and a long-term average return that is above many indexes by doing research and by owning a portfolio where we know our companies, we know our businesses, and we do a huge amount of work to minimize the chances of being wrong.

George W. Brumley III: We feel that knowing a lot about the businesses and doing the right kind of evaluation and the right analysis on competition is the best sort of risk control we can come up with.

What would be reasons to sell a stock, both on the upside and on the downside?

George W. Brumley III: To be completely eliminated from our portfolio, it must be at absolutely full value, in a positive instance.

On the downside, we would eliminate a stock if we decided we were wrong and made an error on some assumption about the business model, or the management did something that changed the model. In the case of Moody's, it was the board of directors and management together with the stroke of a pen, which changed the relationship between shareholders and the owners and operators of the business. We had to leave.

However, it's much more common that we trim positions, because the intrinsic value number that we work with is a range. I don't know if a stock is worth, for instance, $65.30 or $65.40. As a stock's price comes closer to the intrinsic value's range and the discount closes, we tend to take capital out and deploy it somewhere else.

In Tiffany's case, we bought the stock and it went up 200%, so we sold huge amounts and we made lots of money. On the other hand, it never reached the absolute top of our range, and we think it's still a good long-term business, and so we kept some. And we keep looking for an opportunity to buy more.

There are other companies recently that have reached the upper parts of their valuation ranges and we're probably more likely to sell today and trim than we were in the past.

Now why don't we just sell all, when it gets any kind of move? For the most part we hate taxes and we also don't like getting rid of companies where we think management really is doing a good job and the business has more room to grow. Buffet said many years ago, 'we don't want to cut our flowers and water our weeds.' When we have great companies that we think still have room to grow, we try to hold them, but we very well may change our percentage holding based on the discount to intrinsic value.

Was it difficult to hold on to the value portion of your approach over the last few years when the pure-growth stocks were so dominant?

David R. Carr Jr.: If you look at the way in which things were being priced, it really was a no-brainer for us. For example, one client couldn't understand why we couldn't find any tech stocks to buy in what he felt was the new paradigm. 'At least buy Cisco,' he said, 'There's no risk in that.' At the time, it was trading at a $400 billion dollar market cap, and my response was that if you take some very simplistic assumptions and have this stock double every five years—which is not at all what the market was expecting; the market was expecting more like a 40+% annual growth rate—but even if it only doubled it was going to be worth $800 billion in five years and $1.6 trillion in 10 years. That's just crazy.

George W. Brumley III: However, we never ignored technology. Actually, we spent a lot of time and effort learning about the tech business, for several reasons. First, because it absolutely was changing the economy and we believe it will continue to change the economy. Second, it has an impact on some of the old economy businesses, both in and outside of our portfolio. But most importantly, there are some very good businesses in the tech field.

Now that the landscape has changed and valuations have changed, we are able to sift through the wreckage and find some companies that meet our parameters and that now meet our price targets.

Although the S&P 500 is down for the year, many value fund managers, including you, are up and doing quite well.

David R. Carr Jr.: We come into work every day now and things are getting cheaper. We can allocate capital to where opportunities are.

For us, it is a perfect time. We think the markets may stay tough for some time still, and we think there are a lot of issues and a lot of problems out there. But it's a kind of world that we like. There are more opportunities in this kind of environment, when people are lamenting that everything is terrible. In our view, that's the ground in which future returns are planted. ❖