Fund focuses on valuing a company as a "rational businessman" would if he were buying the firm as a private business venture.

A Value Approach That Analyzes Stock As If Buying the Business

An interview with Harold J. Levy, portfolio manager, First Eagle Fund of America

As the stock market continues its upward trend, different types of funds prosper at different times.

One fund that has done particularly well recently is the First Eagle Fund of America. The fund was up 9.4% for the first quarter of 1996 compared to 5.3% for the S&P 500, and 38.0% for the year ended March 31, compared to 32.0% for the S&P 500. The fund fared well in 1995, but it slightly underperformed the S&P 500, with a return of 36.3% compared to 37.5% for the S&P 500. Nonetheless, its long-term track record has been strong, outperforming the S&P 500 both over the last three years and the last five years. In addition, the fund was among the top 25% of all funds in the growth category for the last year, three years and five years (for years ending March 31).

Currently, the fund has about $160 million in assets.

In early June, portfolio manager Harold J. Levy discussed the management of the fund with Maria Crawford Scott.

What are the investment objectives of the fund?

The basic objective is to create long-term capital gains and to earn above-average returns through equity investing.

Then would you classify your fund as a growth fund?

I have a hard time putting myself in a category because we'll do whatever we think makes sense that's consistent with our strategy, and consistent with getting paid for the risk we take to make money. We're basically a value fund, but that doesn't mean we don't buy growth stocks if we think that they're values.

What strategies do you use to pick stocks?

We believe that the market is very efficient and very egalitarian—everyone gets the same information, everyone goes to the same meetings, and everyone can run the same screens. What we try to do is to focus on companies that are undergoing some kind of fundamental change, because we think the market does not know how to price 'change.' In other words, the market doesn't deal as well with dynamic change as it does with, say, marginal change. If people decided that Coke's growth rate is going to go from 15% to 16%, all the valuation models in the world will tell you what that would do to the stock's price. But when Allied Signal gets a new chairman, how do you analyze that? It requires a lot more creativity, and that's where we think we can get an edge over our very smart and very competitive competitors.

How do you find stocks that might be subject to change?

As simple as it sounds, the things we look for really are reports in the paper, whether it's a management change, an acquisition or divestiture, a new strategy—those things generally get reported right in front of our faces every morning. The key is to figure out what's significant and what we should spend our time on. That's the real issue.

Do you look for change within industries, as well?

Generally we look for individual companies, but you'll find oftentimes what's driving the change of a particular company is not an internal event, but is a result of industry conditions. We definitely use a bottom-up approach, but it may lead us to certain industries.

How do you value a company that is undergoing change?

Well, let's say you have a new management at a company, and one of their businesses has been losing money for three years, to which the market has been imputing negative value. If management sells that business, maybe they can turn that into an asset—you don't have any losses anymore, and you have capital to invest in your good business. Those are things that require an understanding of the nature of earnings and what's reasonable or unreasonable to expect. And of course new management is key. We get ourselves familiar with management, visiting every company

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that we invest in. We understand that people are the ones who create value.

Why are you able to evaluate changes differently than, say, other analysts?

We tend to look at things very differently than the typical analyst. My background, for instance, is in venture capital. We look at a company as if we were buying the business—the way a rational businessman would who's willing to pay a price for that business. You've got to earn a return from that price, so we say: Does it make sense to own this business at this price? We don't pay a lot of attention to things like discounts to market multiples, although we do try to understand that part of the market.

Do you try to buy companies at a discount?

Oftentimes in a turnaround or with a new management, the actual value is not obvious, and you have to make some assumptions about the future direction of the company. We may feel that it is worth a lot more [than the current market price] if those moves are carried out.

That said, we also tend to be skeptical and we don't like to be wrong. We're willing to pass on things where we think there are huge risks.

What do you look for when trying to put a price on the business?

The first thing that we want to do is understand the managers—how they get paid, what motivates them, why they are doing what they are doing. Remember, these managers [of the firms we are analyzing] are basically saying they are going do something—buy back their shares, for instance, or split the company up in two businesses. So there's a reason why they're doing this, and we want to make sure we understand what the reason is.

The second thing we really try to understand is the actual implicit price that we're paying for the business. This means you've got to look at the debt structure, you've got to look at liabilities both on and off the balance sheet, you've got to look at assets, and you've got to look at the fact that a non-performing business may be losing money to which you might ascribe negative value—those kinds of things.

The third thing we need to understand is the cash-generating capabilities of the business. Wall Street focuses on earnings, and I'm not saying that's wrong, but it's a lot better to understand cash flows rather than earnings. So we go through the profit and loss statement to distinguish real earnings from those items that have very little to do with real economic earnings, such as depreciation. So that's our price-earnings ratio—what we are paying for those businesses versus their ability to generate cash flow.

All those things are judgments we have to gather in order to reach our conclusions about what the real economic value of the business is.

So, although you are value investors, it isn't quite the same as, say, a Ben Graham value approach?

I would say the difference is that he was much more focused on working capital and the company selling at discounts to net working capital so that if you liquidate the company, you make money. We're much more focused on franchise value. In other words, we understand that Coca-Cola has negligible book value, but value isn't meaningful for Coca-Cola. Coca-Cola is just an example of a phenomenon that companies have value beyond the balance sheet. When we say we're value investors, those are the values that we focus on.

Do you ever examine what the market is thinking of a particular stock?

We're definitely cognizant of what the market thinks. We don't intend to be contrarians. We're not interested in being the only person out there who likes something. Generally, the market's right.

What kind of return are you seeking?

We go into a stock seeking to make at least 50% in one to two years. Now, sometimes we do, and sometimes we don't.

Do you set a price target?

I wouldn't describe it as a target—the world is too dynamic to have a target. The moment you buy something, information comes out and all the prices change. We have a guidepost.

Once or twice a week we'll go through and make minor adjustments to the portfolio to take into account what's happening in the marketplace.

What would cause you to sell a stock?

We buy a stock for a reason, and if that reason turns out to be wrong, we would sell. For instance, if we bought a stock because management was going to buy back their stock because they have free cash flow, and it turns out that they really want to buy it back to hold the price at a certain level because they're afraid of being taken over—that's not a good reason to be buying back stock. So, we would sell it.

The other reason we'd sell is if we're right. For instance, if we bought Bank of Boston two or three years ago because we thought that their real estate problems were overblown and they were going to survive and prosper, and that view becomes reality, with the stock reflecting that, then we'd sell. Of course, more often than not the changes are incremental. The market just doesn't in one day recognize Bank of Boston, it happens over a period of time, and as the stock goes up we generally scale out, assuming we've found something that we like more.

There must be times when you have made a right decision but the market takes a long time recognizing it.

I think we were very early with some defense companies—for instance, McDonnell Douglas took a long time to really work big. The company offered two major opportunities. One was a turnaround in the C-17 program and the other was to make money on Douglas aircraft. In the meantime, they were generating a lot of cash and buying back stock, and it took a while for the stock to work. But it finally did. The fundamentals just get better.

If the stock doesn't appreciate, we don't sell it. Generally, the market is very savvy, but sometimes it's slow. If something's not working, we try to figure out why.

Do you have any size restrictions for the stocks that you seek?

No, capitalization is really a default function. It doesn't have a big role in our decision making with the exception that we want to make sure that we're able to sell something if it works. So we like companies that are sizable enough for us to buy and sell. Having said that, we do like access to management, so it's better to have companies that are less well-followed than very well-followed, which means that our bread and butter investment is in the $1 billion to $5 billion dollar range. But we will buy a duPont or an IBM or Citicorp if we see something the rest of the world doesn't see.

You are classified as a non-diversified fund?

Right. We think that the more flexibility we have, the better. Most of the time we would probably meet the diversification rules. If you look at our reports over the last couple of years, you'll see that we don't make huge bets on individual companies because we understand that we can be wrong.

But certainly some of the sectors you are invested in are pretty sizably weighted.

Yes, although I would look at the "defense" sector and I would say that the things that are driving McDonnell Douglas are very different than what's driving General Dynamics. Granted, they're both defense, but they are very different stories, very different businesses. If you assume the defense budget is limited, you could argue that maybe both can't prosper. I disagree with that. One could prosper while the other may not. With banks, you could argue that banks are all interest rate–sensitive. I think the market overstates interest rate sensitivity. The Bank of Boston is quite different from Mellon, which has a mutual fund business. On the other hand, we try to make sure that even though we have industry positions, we're not making a 20% bet on one event happening.

But you tend simultaneously to stay out of the hot industries. Is that a result of your selection techniques?

Absolutely. We look for things where we think we can make reasonable or very good returns taking minimal business risk, and hot areas have a lot of business risks.

You've got very flexible criteria as far as your investments in equities, bonds and cash are concerned. Do you ever vary the mix by much?

We're an equity fund. We have the ability to do lots of things, but basically we are a plain-vanilla equity fund that makes its money by buying stocks that go up, so we tend to stay fully invested in equities.

Would you ever move to a heavy cash position?

We have in the past and, sometimes when you try to avoid near-term pain it costs you long-term pain.

The things we own we think are worth owning in any environment, or most. So if we're worried about the stock market overall, whether we are right or wrong [about the market], over time we're going to make money. And if we're right about the stocks, we're better off having been invested, and I think long-term investors would probably agree that thinking about the market's not beneficial.

You have a small number of holdings in restricted securities. What are those?

I started in venture capital, and for a small number of positions, I'm comfortable giving up liquidity as long as we can get it back in price. So we've done a couple of deals that I think are going to work out pretty well. We're taking risks there, but we're buying businesses at a much cheaper valuation than the stock market overall. Most are in the form of preferred stock. Often in venture capital deals, the investors get preferred stock and the management gets common stock. And when they go public, the preferred converts to common.

And have any of those gone public for you?

Yes, Abbott went public three or four months ago, which was a nice deal for us.

Recently, your returns were close to the S&P 500, and this year, you've been able to outperform it. What's accounted for the performance recently?

I think it's the type of market. Last year was, to me, a growth stock market. When all stocks go up, we're not going to be the ones who pay highest dollar to get the last dollar return. This year the market has been somewhat more restrained.

Another reason is that, when you have an event-oriented portfolio and you don't get big events, you may not perform well for a while. And then all of a sudden you get two positions that are bought out and have big appreciations simultaneously, and we benefited from that recently.