

# A SEARCH FOR UNDERVALUED FIRMS IN A STRONG GROWTH MARKET

## FUND FACTS

### LONGBLEAF PARTNERS FUND—(LLPFX)

#### CATEGORY:

Growth

#### PERFORMANCE: (thru 3/31/00)

	Fund	Category
Compound Annual Return (%)		
1 Year	-9.0	26.3
3 Years	11.5	22.5
5 Years	14.4	21.7

#### RISK: (relative to category)

Average

#### TOTAL ASSETS: (as of 5/30/00)

\$3.3 billion

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*The most recent market cycle has been rough for value-based investors, particularly in comparison with growth investors who have had several years of exceptionally high returns. But it has provided a test of value managers' ability to stick to their convictions.*

*Today's lists of top performers, even for longer time periods, are dominated by funds that focus on growth approaches. However, in the mid-1990s when growth and value approaches were running more evenly, one value fund that consistently ranked above its peers in terms of long-term performance was the Longleaf Partners Fund. Currently, the fund is lagging its growth category peers. However, the portfolio managers are steadfastly sticking with their style.*

*The fund had been closed, but recently reopened its doors to new investors. As of the beginning of June, it had \$3.3 billion in total assets.*

*Three portfolio managers run the fund using a team approach. In late May, portfolio manager Mason Hawkins discussed the management of the fund with Maria Crawford Scott.*

### ***What is the investment philosophy of the Partners Fund?***

The fund seeks long-term capital growth by investing primarily in a limited number of mid- to large-cap companies that are financially strong, well-managed and that sell at market prices that are 60% of our assessment of their business value.

It's a simple process that gets down to businesses, people and price. If you want to think of it schematically, you would draw three circles. One circle is good business, one is good people and one is good price; we want to be where those three circles intersect.

### ***What is a good business?***

It needs to have a competitive advantage so that the slings and arrows of capitalism don't impinge on our invested capital. It needs to be competitively entrenched, with pricing power to protect its position. It needs to have a strong balance sheet. It needs to produce real cash earnings relative to the capital that's required to keep the business competitive. Finally, we need to have a basic belief in the company's ability to grow those real cash earnings over the next three or four years.

### ***What about good management?***

We want to know, just like you would investing in any private business, whether the top managers are trustworthy and capable. A lot of that, of course, can be known by studying past business practices, but we also talk to the managers themselves. First, we want to know how well the managers can execute every aspect of the business plan—how will they grow the revenues, how will they handle pricing, how will they keep costs down, basically how will they produce free cash flow?

Second, we want to know about the managers' capital allocation skills. It's not enough just to produce cash earnings out of a business. You also have to have enough intelligence to reemploy that cash stream to an area that's going to add more value for us.

It is also very important to us to know the kinds of incentives these people

are given. Basically, we want owner-operators at the corporate helm. Over time, we've had tremendous success with owner-operators. Hired hands are more problematic.

***Your third requirement is that the stock be priced at 60% of your valuation of the firm. What methods do you use to value a business?***

We value businesses three ways. The first is to determine the present value of the company's future free cash flows. We take the gross cash flow (net income plus all non-cash charges, depreciation, depletion, amortization and deferred taxes) and subtract out required capital spending, financing needs and maintenance capital expenditure requirements to keep the operation up and efficient. What's left over is free cash flow—we consider that the coupon of the business. Basically, it is net earnings that would be distributable to private owners, or it's available for public shareholders to be reinvested in the operations, used to repurchase shares, make acquisitions, pay dividends or put into T-bills. We spend lots of time working on the current free cash. We then project that free cash flow stream out seven or eight years at a growth rate that we think is conservative, add a terminal value on in the eighth year and discount it all back to the present with a discount rate that is a premium to the long-term treasury. So we get a discounted present value of the company's future cash production.

The second valuation method is to look at the balance sheet and ask what the company would be worth in liquidation—we simply total up the economic assets, take out the economic liabilities and divide it by the number of shares outstanding.

The third valuation method is to compare our liquidation values or our discounted free cash flow values to sales of similar businesses. We maintain a very extensive historical databank of comparable business trades.

So, those are our three methods of appraisal—actually, it is really two methods and one check on the other two. If our first two valuation methods come in higher than the comparable sales yardstick, we would use the lower of the two.

***Do you first find companies that you want to invest in and then wait until they come down to your target price, or do you first look for companies that are selling more cheaply than what you would value them at?***

Both. We have a wish list of good businesses that we would like to own, and when something gets below 70 cents it's on our radar screen, and we just hope that it drops the last 10% to give us a shot. But we also look at the new low list every day, and we have other methods of scanning for companies that may be undervalued.

***Looking at your top 10 holdings, some of them are as much as 10% of total assets.***

When we find one of those rare qualifiers, we're willing

to bet substantially on it. We believe that it is important to have a significant amount of our assets invested so that it makes a difference when the market comes round to properly valuing our firms.

Waste Management is a good example. We made a lot of money in Waste Management the first go around, when there were some questionable accounting and other issues that we thought were temporary and would get solved. Then we had a second bite at the apple when the CEO became very ill and the company was put in disarray. We understood the business well, felt that it had the best assets in the industry and thought that the problems were easily solvable. In that particular case we were willing to put a more significant amount of money into that particular company because of our conviction about the business and ultimately about the management.

***When you purchase an undervalued company, is it usually reasonably obvious where you and the market disagree in terms of valuations?***

Usually, the difference has to do with time horizon more than anything. When you find undervaluations, it is often because the market has been disappointed for ephemeral reasons. And many times not only are the problems temporary, but they may in fact strengthen the long-term competitive position of the company.

If a company misses its quarterly earnings by a couple of cents, does that really matter? Not at all. But it seems to drive the market crazy. If someone decides they don't want to be a shareholder for the next 30 days and they sell it off, we don't mind at all trying to take advantage of that, even if it takes awhile to fix the problem. But many times it can be just as simple as a company saying they need to spend more capital on a particular area of the company in order to catch a business opportunity or to reduce costs or to roll out a new product. That's a perfect situation for us.

***Your approach clearly leads you to overweight certain industries and avoid others. Is that a risk?***

We feel it's OK to not participate in industries excluded by our approach for two reasons: first, we can't understand them, and second, even if we could the companies are probably overvalued. There are going to be periods when worlds we don't understand do well and maybe our relative performance will not be the hottest in the world. But those things have a way of changing.

We couldn't tell you who is going to have the next successful semiconductor. We can't tell you who is going to have the next and best cholesterol-reducing drug. We know that semiconductors are great for society and we know that certain drugs keep you from having heart attacks and are wonderful for people. But if you have to know which company is going to get to those products first, and those that don't are going to go out of business—that's a pretty high-risk proposition.

***On the other hand, some of your value stocks have clearly benefited from technology—for instance, Federal Express. Does that enter into your equation?***

In our annual report we talk about how we intend to benefit from what we think truly is a technological revolution in this country. There are four ways that we outline. The first is to own great business franchises that have tremendous opportunities to benefit from the use of technology, not the ownership—Marriott International and Hilton Hotels are good examples that we own. In these instances, great reservation computer systems bring them more business, and also possibly cut out a travel agent, where savings can either be given to the customer or kept.

The second way that we've exploited this whole technological revolution is to own a great service provider to technology companies. FedEx, as you noted, is a great example. FedEx picks up keyboards and hard disk drives and everything else for Dell around the world.

The third way is to buy technology for free. When we bought a massive position in Philips Electronics, we bought it in the mid-30s and we were getting one of the leading semiconductor companies for very little or almost nothing. Of course, they had other operating businesses that we could understand.

The fourth way that we've benefited from technology is through the direct ownership of technology. Examples we would give were our major foray into MediaOne and prior to that 360° Communications where we owned tremendous broad-band cable and fiber-optic networks that traditionally had been used for home cable TV, but which we believed would be the great backbone for the Internet and for carrying telephone signals. In that particular case, we thought we understood the technology. We're not opposed to technology, but we are opposed to anything we can't understand, can't value and can't buy at a discount.

***When would you sell a stock?***

There are primarily two reasons. The first is when the stock price reaches our appraisal of value, we sell it because there's no longer a margin of safety.

The second major reason we sell is when we can improve our position by 100%. For instance, if a stock we own rises to 80 cents on the dollar (of our appraisal) and we can buy another company that's at 40% of our appraisal, then that warrants a change.

There are other reasons, but they happen only rarely. One is if the business runs into a competitive threat that we didn't envision, and we think it's going to be permanent, then we need to reassess our position. The other is if we run into a management that we think is really not what we thought they were at the outset.

***Value approaches are usually considered to have lower risk than growth approaches. Is your approach lower risk?***

Understanding the dynamics of compounding is helpful in understanding the advantage of our approach. If you have a

business that you buy at 50% of its real value, and if the value goes up 12% a year and the price rises to reflect that value, in the fifth year you compound capital at 29%. Two-thirds of the return comes from the closing gap between price and value; one-third comes from the business value growing.

We go back to what Ben Graham taught us. The gap between price and value provides a margin of safety, and it's important to have a large gap for two reasons. First, it protects your capital. If we make an appraisal error of 5% or 10%, we still have a lot of value over what we paid. But the margin of safety principle is also very important for offensive reasons. If you buy a dollar for 50 cents and the dollar grows to \$1.20, your return potential has just gone through the roof.

***That assumes that the market eventually comes around to agree with you.***

We believe that, in the long run, the market properly weighs businesses. And it always has for a couple hundred years of free-market capitalism.

***But many value companies have been in the dumps for a relatively long period of time. Has that been frustrating for you?***

We just go back to what our goals are. Our first goal is not to lose money. Our second goal is to beat inflation plus 10%, which is our baseline objective. Our third goal is to compound wealth over any period of time. We'd say that we're very happy that we've reached all three of those goals, and we've taken a minimum amount of business and market risk to do so.

There are two sides to the investment equation—what kind of risk you subject your capital to and, secondly, what kind of return you make. We're not willing to take on the risk that some of the growth-oriented investors took on. In particular, we won't invest in businesses that we can't understand. If you can't quantify what the value is, you can't quantify the discount and you don't have that margin of safety. If somebody pays 48 times earnings for a company and it goes to 60 times earnings and they make a higher return than we do, that's fine with us.

There have always been periods when people chase what is working for the simple reason that it is going up. We think these periods come and go, and we think they went March 10. We don't believe the reweighing of realities has ended. In the long run, businesses have to have customers, they have to have revenues that produce profits to justify a value, and clearly, there's been a major wake-up call in that regard.

Disciplined investors who understand what economic values are all about aren't concerned if someone else is making money and it's not on their terms. It gets down to whether you have the discipline to execute your own approach and, of course, whether your approach is sound. ♦