

The Art of Value Investing

By John Heins and Whitney Tilson

Article Highlights

- Insights from renown value investors on investing in turnarounds, selling and avoiding overconfidence.
- Turnarounds require new corporate management, and it can be prudent to wait for tangible signs of improvement.
- Sell a stock as it reaches or exceeds fair value or if your investment thesis is proven to be wrong.

Though successful value investors may share core principles, how they execute their strategies can differ on any number of fronts.

Our hope is that mining the diversity of opinion can help novice and expert investors alike refine their own investing strategies and processes. It should also help those looking for others to manage their money determine which are the right questions to ask, as well as what answers are worthy of their respect and attention.

In this article, we are excerpting sections of our book, “The Art of Value Investing” (John Wiley & Sons, 2013), which assembles primarily from first-person interviews the opinions of the best investors in the business on a wide range of investing topics. Here, they explain their thinking on investing in turnarounds, how they approach selling and how they’ve learned the hard way that ego can be an enemy of returns.

Anticipating the Turn

The bad news that typically precipitates the need for an operating turnaround, as well as the ongoing uncertainty that revolves around management’s turnaround effort, can wreak the kind of havoc on stock prices that value investors are keen to capitalize upon.

That a company is in turnaround mode, of course, doesn’t mean the turnaround will be successful. This fact makes the ability to distinguish eventual winners from losers



in the turnaround game an essential—if decidedly non-trivial—skill in any contrarian investor’s toolkit.

“My best ideas, by far, have been in situations where a new CEO takes over an undermanaged franchise. If we only focused on one thing, that would be it. The market just does not pick up on the ramifications of change quickly enough.

The big question after identifying a CEO you have confidence in is getting the timing right. You can’t wait for the CEO to come out with his restructuring plan in front of 250 analysts. The best thing is when you already know the person and the business and can act very quickly after the new CEO is named.”

—Kenneth Feinberg, *Davis Advisors*

“We’re looking for businesses that are going through some kind of transition—in management, in the business mix, in the industry. Often a previous management team overextended and overleveraged the company and somebody new has been brought in to straighten it all out, by cutting costs, selling assets or paying down debt. A good business that happens to have a bad balance sheet is much easier to fix than the opposite.”

—James Rooney, *Avenir Corp.*

“Just because a company is capable of throwing off lots of cash doesn’t mean they’re doing so at any given moment or that they’re using the cash correctly. We’re value investors

first, so we're looking for depressed stock prices. Often what causes a depressed stock price is a misallocation of free cash flow, through ill-timed or ill-conceived acquisitions, pouring money into bad businesses or any number of wrong capital-allocation decisions. But those tend to be fixable problems, which is a lot easier to do when the core business is intrinsically healthy."

—Andrew Jones, *North Star Partners*

"Three-year to five-year turnarounds almost always require a deep infusion of outside management talent, a change in culture, an overhaul of the cost structure and some fairly dramatic shifts in operational execution. We want to identify these potential turnarounds early, but it's often only after a year or so of careful study that we're ready to act. Depending on the situation, we want to see tangible evidence—say, an increase in gross margins, declining inventory levels or reduced operating expenses—that the turnaround is working.

If we believe the shares can double or triple if we're right—which isn't a stretch if earnings and valuations are starting from particularly depressed levels—we have no problem leaving the first bump in the stock price on the table. We're helped by the fact that once the market has given up on a company, it can be quite slow to embrace it again."

—Lloyd Khaner, *Khaner Capital*

"More than anything, we're looking for inflections in businesses where some sort of structural change will drive returns on invested capital to be materially higher. In our conversations with companies, their competitors and their suppliers, we're trying to identify structural changes that we can get ahead of and will result in better returns on capital.

I'd say at least half the time it has to do with new leadership changing how things are done. For example, we love when management or a board changes compensation systems to move from a grow-grow-grow, earnings-per-share-driven culture to one focused on returns on invested capital."

—Joe Wolf, *RS Investments*

"What will get me excited is when one of our analysts comes to me with a story like this: 'Preston, I've been following this stock for two years but haven't found a good reason to write it up. It used to be kind of a high-flier, but the stock chart now looks like death warmed over. The shares were at \$40, had a big drop and have been trading between \$15 and \$18 for months and nobody cares. The company is likely to have some big write-offs this year to clean up the balance sheet. And, by the way, two months ago the board fired the CEO and the new guy is someone I know from a previous company where he did a great job. He's not even talking to the Street for six months as he gets a handle on things.'"

—Preston Athey, *T. Rowe Price*

"Getting turnarounds right is very tough. It takes a tremendous amount of research effort, the turnarounds almost always take longer than you expect and it's just easy to get it wrong. That doesn't scare us away, but we're very cognizant of the risks. We're unlikely to act until we see tangible signs of the turnaround happening or some clear positive sentiment from the industry or management."

—Scott Hood, *First Wilshire Securities*

"I was tempted in my youth by turnaround stories or betting on new product or service offers, where you could hit the ball out of the park if things got fixed or the new product took off. But I've had enough failures pursuing those types of ideas that I've, for the most part, lost the stomach for them. From a performance standpoint, I'm more focused on what something is than what it can be."

—Thomas Gayner, *Markel Corp.*

"We don't do turnarounds. What attracts us to the whole concept of value investing is the idea of having a margin of safety, in terms of value over price. That margin of safety only exists if values are stable and it only improves if value increases. With turnarounds, you're making a bet—maybe a very intelligent

one, but still a bet—that something broken can be fixed. Even in the best case, you may be looking at years when value declines or stagnates. Our experience is that we're better off investing in a good business that is constantly compounding value from the beginning of our ownership, without what to us is the unacceptable risk that the turnaround doesn't work. We just don't think we need to take that kind of risk to earn strong returns."

—C.T. Fitzpatrick, *Vulcan Value Partners*

"Not to be flip, but all we count on in a number of our investments is just for things to return to normal. There's a lot less risk in wanting that to happen than looking for some huge transformation in a company's business."

—Christopher Grisanti, *Grisanti Capital Management*

Saying Goodbye to Investments

In contemplating selling, investors are dealing with the good, the bad and the ugly in their portfolios. While that can make generalizations difficult, leading investors are typically clear-headed and thoroughly unsentimental about why any given position should be headed for the chopping block.

"We sell for four primary reasons: when the price reaches our appraised value; when the portfolio's risk/return profile can be significantly improved, for example, by selling a business at 80% of its worth for an equally attractive one selling at only 40% of its value; when the future earnings power is impaired by competitive or other threats to the business; or when we were wrong on management and changing the leadership would be too costly or problematic."

—Mason Hawkins, *Southeastern Asset Management*

"Warren Buffett talks about a company's value moving through innovation, imitation and then idiocy phases. We're most comfortable in the early stages when we think we're kind of writing the intellectual property. That's not to say

What Does It Mean to Be a Value Investor?

We couldn't agree more with the characteristically concise conclusion by Berkshire Hathaway's Vice Chairman Charlie Munger that "all sensible investing is value investing." But what exactly does it mean to be a value investor? At its most basic level it means seeking out stocks that you believe are worth considerably more than you have to pay for them. But all investors try to do that. Value investing to us is both a mindset as well as a rigorous discipline, the fundamental characteristics of which we've distilled down to a baker's dozen.

Value investors typically:

- Focus on intrinsic value, what a company is really worth: buying when convinced there is a substantial margin of safety between the company's share price and its intrinsic value, and selling when the margin of safety is gone. This means not trying to guess where the herd will send the stock price next.
- Have a clearly defined sense of where they'll prospect for ideas, based on their competence and the perceived opportunity set rather than artificial style-box limitations.
- Pride themselves on conducting in-depth, proprietary and fundamental research and analysis rather than relying on tips or paying attention to superficial, minute-to-minute, cable-news-style analysis.
- Spend far more time analyzing and understanding micro factors, such as a company's competitive advantages and its growth prospects, instead of trying to make
- macro calls on things like interest rates, oil prices and the economy.
- Understand and profit from the concept that business cycles and company performance often revert to the mean, rather than assuming that the immediate past best informs the indefinite future.
- Act only when able to draw conclusions at variance to conventional wisdom, resulting in buying stocks that are out-of-favor rather than popular.
- Conduct their analysis and invest with a multi-year time horizon rather than focusing on the month or quarter ahead.
- Consider truly great investment ideas to be rare, often resulting in portfolios with fewer, but larger, positions than is the norm.
- Understand that beating the market requires assembling a portfolio that looks quite different from the market, not one that hides behind the safety of closet indexing.
- Focus on avoiding permanent losses rather than minimizing the risk of stock-price volatility.
- Focus on absolute returns, not on relative performance versus a benchmark.
- Consider stock investing to be a marathon, with winners and losers among its practitioners best identified over periods of several years, not months.
- Admit their mistakes and actively seek to learn from them, rather than taking credit only for successes and attributing failures to bad luck.

—John Heins and Whitney Tilson

there's not a lot of money to be made in the imitation and even idiocy phases, but it's not our native ground. If we're saying the same thing as the consensus and something is no longer misunderstood, chances are we're selling."

—Adam Weiss, *Scout Capital*

"Psychological issues can come into play, but selling strikes me as fairly straightforward. We'll sell any time we conclude our thesis is flawed or risk factors have emerged that make us doubt the probability of return. In ideas that are working out, if we believe the fair value of a stock that is a 5% position and trading at \$80 is \$100, we start staging out as the position size gets larger and the stock price gets closer to fair value.

So we might start selling at \$90 and be out by \$105. We try not to make it much more complicated than that.

We have a friend who keeps sending us emails about all the stocks we sold too soon. But you know what? It's OK to give up the risky profit. We kick ourselves when we turn out to be too conservative by selling at the midpoint of our fair value range. But we can live with that. We specialize in getting the low-risk profits. It's OK with us if other people make money on the high-risk profits."

—Zeke Ashton, *Centaur Capital*

"In general, we own a stock because we have a thesis that we don't believe is widely recognized. Once that thesis

is widely recognized, there's no reason for us to own the stock. We hope the stock is selling at a certain level at that point, but sometimes it's higher than we expect and sometimes it's lower. But it's not the price that matters, it's whether the thesis is widely known. If it is, we should be selling regardless of the price."

—Ed Wachenheim, *Greenhaven Associates*

"We are fully aware when valuations are getting stretched, which often coincides with a position getting outsized in the portfolio. In those cases, we will likely take money off the table by managing the position size down."

—Chuck Akre, *Akre Capital Management*

"When we worked for Boone

Pickens, he taught us that the most successful wildcat oilmen were not the ones who hit the most gushers, but the ones who knew when to plug a dry hole. I think we're disciplined about ignoring sunk costs. We mark our investments to market every day and say, 'OK, we bought this at \$25 and it's now at \$12, what does the upside look like with this new investment at \$12?' If it meets our targets, we'll still own it. If it doesn't, we'll get out. People are afraid to admit to clients that something is a bust, but we're pretty good at just taking our lumps and moving on."

—*Ralph Whitworth, Relational Investors*

"We try not to have many investing rules, but there is one that has served us well: If we decide we were wrong about something, in terms of why we did it, we exit, period. We never invent new reasons to continue with a position when the original reasons are no longer available."

—*David Einhorn, Greenlight Capital*

"We are prone to the classic value-investor mistake of being stubborn about selling even when the thesis starts to break down. We try to apply a couple basic tests to avoid that mistake. One is to be sensitive that when something is taking up an inordinate amount of mental bandwidth, that's almost always a bad sign. We spent way too much time trying to grapple with AIG in 2008, for example, as the bottom was falling out. Also, probably the best question we ask ourselves when contemplating selling is, 'If we didn't own it, would we be buying it today?'"

—*Daniel Bubis, Tetrem Capital*

"Based on our research, investors who sell winners and hold losers because they expect the losers to outperform the winners in the future are, on average, mistaken."

—*Terence Odean, University of California, Berkeley*

"Once we take ownership of an idea—whether it's related to politics or sports or investing—a lot of changes

take place. We probably fall in love with the idea more than we should. We value it for more than it's worth. And quite often, we have trouble letting go of it because we can't stand the idea of its loss. What are you left with then? A rigid and unyielding ideology that can be quite detrimental to clear thought."

—*Dan Ariely, Duke University*

"When management really makes us angry, we put the file in a drawer for a while and just don't do anything. We try not to sell just because we're angry. If you sell when you're angry, you can imagine everybody else who sells that way reaches the point of exasperation at exactly the same time. That's the kind of thing that creates at least a trading bottom. Better to sit on it for some time, and even if you still hate what the company's doing, you're probably going to get a better chance to get out."

—*David Einhorn, Greenlight Capital*

"Buying bargains is the sweet spot for value investors, although how small a discount one might accept can be subject to debate. Selling is more difficult because it involves securities that are closer to fully priced. As with buying, investors need a discipline for selling. First, sell targets, once set, should be regularly adjusted to reflect all currently available information. Second, individual investors must consider tax consequences. Third, whether or not an investor is fully invested may influence the urgency of raising cash from a stockholding as it approaches full valuation. The availability of better bargains might also make one a more eager seller. Finally, value investors should completely exit a security by the time it reaches full value; owning overvalued securities is the realm of speculators."

—*Seth Klarman, The Baupost Group*

Be Ever So Humble

There's no question confidence in one's abilities is critical to successful investing. To commit one's own and others' hard-earned capital requires

conviction, and conviction requires confidence.

But as with fine scotch or pepperoni pizza, too much of a good thing can be problematic. It can at times be difficult to see, but quite often even the most accomplished money managers exhibit a level of humility about their craft that, far from a sign of weakness, is often a prerequisite to long-term success.

"It is much harder psychologically to be unsure than to be sure; certainty builds confidence, and confidence reinforces certainty. Yet being overly certain in an uncertain, protean and ultimately unknowable world is hazardous for investors. To be sure, uncertainty breeds doubt, which can be paralyzing. But uncertainty also motivates diligence, as one pursues the unattainable goal of eliminating all doubt. Unlike premature or false certainty, which induces flawed analysis and failed judgments, a healthy uncertainty drives the quest for justifiable conviction."

—*Seth Klarman, The Baupost Group*

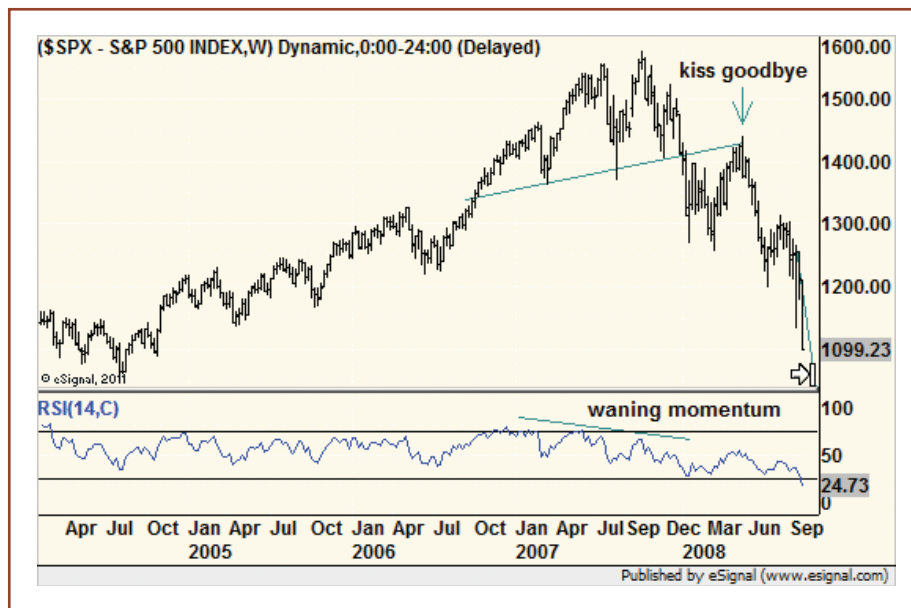
"You obviously need to develop strong opinions and to have the conviction to stick with them when you believe you're right, even when everybody else may think you're an idiot. But where I've seen ego get in the way is by not always being open to question and to input that could change your mind. If you can't ever admit you're wrong, you're more likely to hang on to your losers and sell your winners, which is not a recipe for success."

—*Kyle Bass, Hayman Advisors*

"Attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year, and through discipline to have highly superior relative results in bad times, is: (1) less likely to produce extreme volatility; (2) less likely to produce huge losses which can't be recouped and (3) most importantly, more likely to work."

—*Howard Marks, Oaktree Capital*
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Figure 4. S&P 500 Index



out that bottoms, such as the end of the bear market in 2009, are usually “events,” while tops are usually “processes.” Evidence that a bull market is ending builds gradually as more stocks and sectors start to change for the worse.

The first blow for the bulls was the initial news of the sub-prime mortgage crisis in August 2007. The stock market plunged and, although it recovered quickly, broke the string of higher highs

and higher lows that mark a bull trend. Something had changed, although at the time the fundamentals, aside from the mortgage market, were still good.

The market moved back to new high ground but it did not last. Prices once again dipped back to the previous low—now called support—to signify more aggressive behavior by the bears. The balance of power, and supply and demand, shifted.

When the index sliced through its previous lows one more time, the technical sell signal was given. As I’ve come to expect, signals are never this clean and easy. After a 10% drop from support and a similar-sized recovery, the index touched that former support level one more time. It was the same kiss goodbye that occurred with Apple above but on a large, market-wide scale. The bear market raged for months thereafter.

An important point to remember is that the kiss goodbye occurred at the same price level for the S&P 500 that was seen in late 2006. The same price but with a different trend. One place was a buy signal, the other was a sell signal and it paid, quite literally, to know the difference.

Combine Charts and Fundamentals

Many investors use charts exclusively to make sell decisions, but most are likely more comfortable letting changing fundamentals tell them when it is time.

However, using charts in conjunction with other analyses can provide early warning for market changes so you can take profits and move either to other stocks or into cash to sit out market turmoil that may be on the way. ▲

Michael Kahn CMT, writes the twice-weekly *Getting Technical* column for *Barron’s Online* (www.barrons.com) and the daily *Quick Takes Pro* newsletter (www.quicktakespro.com). Find out more at www.aaii.com/authors/michael-kahn. Kahn will be speaking at the AAI Investor Conference this fall; go to www.aaii.com/conference for more details.

Stock Strategies

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“When I worked for New York City, I met an old-time surveyor in my department who had gone broke betting on horses. The first time he had gone to the racetrack he decided to bet on a horse named Surveyor, and the worst possible thing happened—the horse won. This

guy figured it was easy money and over the next 20 years he proceeded to lose just about everything he had.

People forget it all the time, but it’s important as investors to differentiate between luck and skill. Over short periods of time, you can do the wrong thing and make a lot of money and do

the right thing and look like an idiot. We try to stick to what we do well and not get too caught up in what’s working at any given moment. In the long run, that sort of discipline will keep you from blowing up. It’s a lesson a lot of smarter guys than us have obviously forgotten.”

—Phil Goldstein, *Bulldog Investors* ▲

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