An interview with Robert E. Torray, portfolio manager, The Torray Fund

A Search for Quality Companies Among Firms That Are Out-of-Favor

The market's five-year performance has reached impressive heights—almost 20% annually for the period ending June 30. While the average stock fund has not kept pace, a number of diversified funds have managed to outpace that level without taking too much extra risk.

One such fund is the Torray Fund, a growth fund that started operations at the end of 1990 (although, because of the fund's size, it has only recently been carried in AAII's mutual fund database). The fund, which tends to invest in large, well-known companies, has been among the top 25% of growth funds for the last year, three years, and five years. For the five years through June 30, the fund returned 21.1% annually, compared to the S&P's 19.7% and 17.7% for the average growth fund; over the last three years the fund returned 31.2% compared to 28.8% for the S&P 500 index and 22.8% for the average growth fund; and for the last year, it returned 34.9% compared to 34.6% for the S&P 500 index and 24.9% for the average growth fund.

Currently, it has about $420 million in total assets.

In early August, portfolio manager Robert E. Torray, who is also president of The Torray Corp., discussed the management of the fund with Maria Crawford Scott.

What is the basic objective of the fund?

To make money—as much as possible. More seriously, we have established a long-term goal of making 15% a year in total return. And we do that by buying and holding top-notch companies. We don't trade, and we don't make that many changes. We look for maybe two or three investments a year.

Many of your holdings are fairly well-known, so you're buying names that a lot of people are familiar with. Do you prefer larger companies?

I definitely prefer large, substantial companies. I'm not interested in obscure firms that nobody has ever heard of.

I think the larger firms are better investments because the likelihood that they'll work out is far greater. When you get into secondary companies, small businesses, you can get a spectacular result, but on average the odds are stacked against you. Whereas with large, critical mass companies, the certainty of the outcome is much greater, and that's what I'm interested in.

What's your definition of a top-notch company?

A company that has very strong economic characteristics, which would include a strong competitive position and substantial market share, sales growth, earnings growth, and good and honest management.

How do you judge management?

It's hard. A successful business with a rising share price is usually associated with successful management. The kinds of managements I like are the ones that think long term—five to 10 years out—and don't run a business simply to produce quarterly results that will impress Wall Street and move the stock. I prefer managements that focus on the business, and if the business itself is the objective of management's attention and the stewardship of the business is conducted properly, the shares will take care of themselves.

What kinds of growth rates are you looking for?

We don't look for any specific rates, and it depends, too, on what the price of the business is in the market. We would be willing to accept a somewhat lower rate of growth if the price reflected that. The ideal situation would be the highest growth rate you could find, but ordinarily that coincides with a very high price, and in general we avoid that type of situation.

Usually we buy in at a time when there is disagreement about a particular company's long-term outlook. Typically, the consensus is that the outlook is dim, and the shares will have fallen a lot in price. We try to analyze the business and come to a conclusion about whether the consensus opinion is correct or not. And I find very often that it isn't. Often, the source of the discontent is temporary, and within a year or two, the situation changes and share prices recover.

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Is a falling share price a flag that draws you to a company for further examination?

Absolutely. It could be either a decline relative to the market, or due to a general market decline. But it creates the potential for you to acquire a very, very good company at a fair or low valuation.

You mentioned that you look for companies with favorable economic characteristics, but don't many of the companies whose prices have fallen have less favorable economic characteristics?

They do sometimes at the inflection point where we're investigating them. For example, IBM, which is one of our bigger investments, has quadrupled since we invested in it. At the point where it had fallen severely in price—I think it went from $170-something down to around $45 on the pre-split shares—the popular view was that mainframes were dead and that the competition was just sort of eating IBM for lunch. As things have unfolded, that view has been discredited, the shares have risen radically, the earnings are up, the cash flow's up.

Our view was, and is, that IBM is a business that has critical mass and a dominant position, and there are big installations of IBM computers all over the world in large institutions that really couldn't have afforded to remove the installations and go with a competitor. And a lot of the competitors were trading in single digits. So it just seemed unrealistic to me that that group was going to put a permanent dent in IBM. And that's the way it's turned out.

AT&T is our biggest investment today and I think it's in a somewhat similar situation. The view there is that MCI, Sprint and others are potentially going to put AT&T out of business. I just don't buy that scenario. As it turns out, their long-distance business grew 9% in the last quarter, and the valuation of the shares is very conservative. We've been buying it for nine months to a year; I think the high this year was $42, the low was $32 and it's back to about $40 right now. In any event, it's a double-A balance sheet, it's got tremendous cash flow, it's one of the five best brand names in the world, it's a service that's cheap, it works, and the company has a hard-core business clientele that I don't think is going anywhere. And if you look at the way the market has priced AT&T and compare it to the price that British Telecom paid for MCI, AT&T would be $75 if it were trading on a comparable basis. I don't think MCI is even a shadow of AT&T. Of course, not everything works out, but that's the thought process.

So, you are looking for favorable economic characteristics that others don't necessarily see?

I just see to my own satisfaction in certain businesses things that the general population doesn't agree with, and our job is to figure out whether they're right. I find that most of the time they're wrong. Much of this is a function of the way the institutional money manager business, including mutual funds, works. The competition to gather assets is just so intense, and the fund companies believe they can't afford to fall behind their competition or the market for very long. And that thought process leads to the view that they can't afford to own anything that's going down, because falling shares detract from results. I find very often that when a company stumbles, even just for temporary reasons, the share price immediately starts to go down, and then there's a piling-on effect where one portfolio manager after the other dumps the shares, and prices fall below the point where I would think they would under other circumstances.

It's in that arena where we're looking for investments. And large, successful powerful companies like AT&T, IBM, always come back.

What about a company like a Woolworth's or Montgomery Ward? They were large, and their share prices fell.

I never buy those kinds of things. When I was younger, I did, and I learned that they don't work out.

They're very weak franchises. I view Kmart as being that kind of a situation. And there are a lot of "value buyers" that I suspect have moved into a Kmart type of investment—the shares go from $40 to $30 to $13, then they're $8. There's a permanent group of comeback investors in the market and they tend to move into those types of situations. My feeling is the market rarely prices them low enough to reflect how bad they are. They were better when the economy and competition was different, but in today's environment, the deck is stacked against that type of a situation, and the odds against those businesses coming back have become increasingly long.

You don't see any growth potential?

You have to distinguish between growth of the business and growth of the stock. I don't see much potential for the business, but it's possible and probably likely that if the enterprise remains in business long enough and the shares fall to a low enough price, the price is eventually going to rise—it's only a matter of time. There are people who invest on that basis, and I don't have any problem with it, I just don't like it myself. These would be stocks that one would buy for the purpose of selling it at a higher price to another person, and I never invest in anything with the idea I'm going to sell it. I haven't sold a stock personally in 10 years—I just keep buying more. And that's the same mode that we're in with the mutual fund.

Aside from the franchises, are there other industries or businesses that you tend to avoid?

In general, we don't invest in cyclical companies. At the present time, and this has been true for five or six years, financial companies have been the largest component of the portfolio. We also have larger holdings in communications, entertainment, satellite broadcasting, and cable television—those are the kinds of businesses we're in right now.

You have a very low portfolio turnover, but you do occasionally sell. What would prompt you to sell shares?

Usually the business has disappointed us, and the analysis that we made that led to a positive conclusion doesn't add up. If the business just is not performing up to our expectations and we find another investment, we'll sell one to buy the other.

What about a company that has done very well—at what point do you sell?

We're not buying shares with the idea that at some target price we're going to sell. It think that's just a complete waste of time, and keeps investors constantly in motion, which can have the effect of raising your tax bill, increasing your costs because of commissions, and exposing you to more mistakes. I would rather have a concentrated portfolio of good businesses that I know a lot about and that I'm not thinking about selling.

Will you prune back if it becomes too large of a holding?

Not really. EDS (Electronic Data Systems) has been about 7% of our portfolio. Our top five holdings are 30%. And the top 10 is nearly 50%. I like a very concentrated portfolio. We own 44 stocks. And we have a lot of cash flow. If I want to change the amount that one stock or industry bears to the whole portfolio, I just stop buying it. We have a number of stocks in which we have made a lot of money in the last six years, and we stopped buying them and started putting money in our other stocks that have been flat to declining against the market. And now those are the big weightings, and the ones on which we made money are much lower weightings. I guess that leads to the question—why don't we just sell them? Well, we don't need to sell them, because if we do sell it's going to create a capital gains tax for the shareholders. But because the holdings are smaller, it won't affect shareholders as much if they fall. And those would be the holdings that, if we didn't have the cash flow and we found a company that we wanted to invest in, we'd sell those bottom holdings. The capital gains wouldn't be too big because the percentage in the stocks is relatively small.

Why do you prefer to have fairly substantial holdings in the firms you own?

If I'm not willing to put at least 2% or 3% in a stock, then I'm not going to buy it at all. And of course, if we're going to do that, we have to be very confident about the outcome. We have to feel that there's no chance of losing money.

What is the biggest risk an investor faces in your fund?

Well, there is stock market risk. But really, if there is real risk, it would emanate from the mindset of the shareholder and not from anything we're doing. If the market starts to go down, the fund's price is going to drop—no question about it. And if unfavorable news were to surface on three of our five biggest holdings and they dropped precipitously, you could have a fair decline in our share price in one day. Now, if the shareholder is one who finds that alarming and then sells our stock, that's a risk to them. But that has nothing to do with the relative riskiness of the businesses that we have investments in. To my mind, the fluctuation risk in stocks and in portfolios is totally irrelevant. The real risk is in the nature of the companies that are contained in the portfolio, and if the portfolio is a repository for weak businesses and turnaround situations, I would say that's a very risky portfolio. If it's one comprised as ours is—Kimberly-Clark, IBM, AT&T— I see very little risk. They all don't have to turn out for us to get a good result.

The year 1995 was a big one for you. What accounted for the success?

Everything we had went up, and they went up a lot. The pharmaceuticals were extremely strong. We had large investments in a number of major pharmaceuticals—Eli Lilly, American Home Products, Pfizer, and so on—that we had bought during a period of time when the administration was trying to restructure the healthcare industry. The major pharmaceutical and healthcare stocks fell at least in half as a result of that and we loaded up on them. They are now up four to five times in price. We have not bought any more shares. We bought Eli Lilly at 22 on shares that are now 117. It was 11 times earnings, with a yield of around 5.4%. Now the multiplier's 30, and the yield is infinitesimal. Well, you're not going to find that type of situation everyday, but Eli Lilly has a triple-A balance sheet, as does American Home Products. And there are only about 10 or 12 American companies left with a triple-A balance sheet. This was an example of an industry characterized by great economic characteristics, high-quality balance sheets, very good managements, and an endless supply of customers worldwide. Yet, the view was the government was going to put a clamp on them so they couldn't raise prices, there was nothing in the pipeline in terms of promising new drugs, and all of that turned out to be totally wrong. And I don't know one analyst on Wall Street that did not voice the popular opinion that these were things you wanted get out of.

How do you view he market now?

I wrote to our shareholders in our most recent report about our view, which is that stocks are extraordinarily high. I'm not interested in bargains, but there are not a lot of stocks that are even fairly priced. My opinion is that the market is overvalued by about a third. But we are still finding opportunities to invest in—like Tele-Comm, which missed the entire rise, and EDS, which traded much higher when GM spun it out.