SUSTAINABLE GROWTH AT A DISCOUNT USING A BUSINESSMAN'S VIEW OF COMPANY VALUE

Last year proved to be a stellar year for growth and aggressive growth funds. But that didn't mean you had to follow a strictly growth philosophy to achieve lofty returns. A number of funds that are often considered to be "value investors" achieved returns comparable to or exceeding their "growth investor" counterparts.

One example is the Weitz Series Value Fund, which follows a Benjamin Graham style value approach. Last year, the fund was among the top 10 growth funds, and it has performed above its peers over the last three and five years, as well.

In early March, portfolio manager WallaceWeitz discussed the management of the fund with Maria Crawford Scott.

FUND FACTS

WEITZ SERIES VALUE FUND

CATEGORY:
Growth

PERFORMANCE: (thru 1/1/98)

Compound Annual Return (%)	Fund	Category
1 Year	38.9	26.2
3 Years	31.6	25.9
5 Years	19.8	17.4

RISK: (relative to category)
Low

TOTAL ASSETS: (as of 3/98)
$400 million

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What is the investment philosophy used in managing the Series Value Fund?

What I try to do is understand the value of the underlying business behind the stock. I'm looking for understandable, well-managed, cash-generating businesses, and I try to figure out the value that an informed, intelligent, business buyer would pay for it. And then I want to buy it at a big discount to that business value—preferably a 50% discount.

When I talk about business value, though, I'm going beyond just looking for a low price-earnings ratio or price-to-book-value ratio, which some textbooks would use to define a value investor. I'm willing to consider under-utilized assets, or assets in the ground in the case of a natural resources company, where the earnings might be totally depressed and the stated book value might not reflect the value of those assets.

I'm also willing to buy companies that, based on general accounting principles, don't have high, or in some cases, don't have any reported earnings, but that have very high discretionary cash flows. A company such as a cable television or cellular telephone firm, that may spend literally billions of dollars up front to build a network before it gets any revenue, has huge depreciation and amortization charges that from an accounting point of view wipes out reported earnings. But it might have very high cash flow over which management has complete discretion. That is sort of a pure version of value investing, but when people look at the statistical profile of the portfolio, it doesn't tend to look like a traditional value portfolio.

The method you use to value a stock, then, depends on the type of business it is in, and will differ from stock to stock?

Exactly. Different kinds of businesses use assets in different ways. The TV broadcaster that has a license for one of the network stations really requires very little capital. They put up a tower and they have a little bit of an investment, but they're basically passing on other people's programs, and they are charging advertising dollars for it. So they generate cash that isn't really needed [to be reinvested] in the business. That has a very high value relative to its stated book value.

When you are looking at a prospective stock, how do you decide which evaluation method to use. Is it obvious?

I ask: If I owned this business, what would be the variables that would really matter? If I want to be in the TV business but I don't have a license, I don't have a business. So, you know the book value is not particularly important. If it's a company such as a bank, whose assets are primarily liquid securities and

cash, then you know the book value does have some meaning and reported earnings may have some meaning. And yet, the bank may have made some acquisitions and have a lot of goodwill on the books, which is an intangible asset—say they bought a bank may have had a $100 million of book value, but they paid $300 million for it because it was a very good bank and generated a lot of cash earnings. That extra $200 million would have to be written off, and that would be an offset to reported earnings year by year, but there was really no diminishing of value. So, I might add back to reported earnings the depreciation charges or the goodwill amortization charge to get cash earnings.

Since you can't screen on any one particular valuation approach, how do you find companies that look promising for further analysis?

The ideas come from all over the place. Friends in the business swapping ideas informally might trigger an idea. There are six of us here that do investment research, and the six of us all read many different things, including trade journals and other kinds of esoteric things that are probably pretty boring to most people.

Management is such a key factor that, if I read an interview with somebody who sounds really sharp and has the right approach, I might look further into the firm. Sometimes, we look at the new low list, or we look at stocks that have gotten hammered for some reason—we don't do a lot of distressed company buying, but it is a place to look anyway.

But we hardly ever just go to a stock database and have it spit out a list of stocks that have a price-earnings ratio under such and such. We make so many adjustments to earnings, it would be a wild goose chase.

Is a 50% discount to your valuation estimate a requirement for purchase?

Well, 50% is sort of a handy number to use, but we aren't rigid about that. A lot depends on how certain we are of our valuations. If there is a well-managed bank that's profitable, and that has had a good history of making quality loans and seems to have adequate loan reserves and that sort of thing, we would need a smaller discount than for a more volatile business, where valuations are less certain.

It's what Ben Graham called a "margin of safety": If you are wrong about your valuation, or the valuation deteriorates, or if it takes an extra five or 10 years before anybody notices or cares about the company, then at least you still have a reasonable investment. But if you buy at 100 cents on the dollar and something goes wrong, then you don't.

What non-financial characteristics do you look for in a company?

We'd like to have a business that has some control over its destiny. In the case of TV or cable, there is a license that gives it a quasi-monopoly. In the case of a company like Valassis, which makes books of coupons that they stick in the Sunday newspaper, there is just one other competitor—it is a nice, cozy duopoly with very high margins. Valassis will generate about $2.40 per share in cash earnings—reported earnings plus a little bit of goodwill amortization—and they need virtually none of that to be plowed back in the business.

What would cause you to sell a stock?

Three things. One is if I find out my valuation was wrong—I missed a negative or I miscalculated something and found out that it really wasn't as good of a business as I thought. Or if I find out the management was unethical—managerial ethics is a major issue because you want them to treat you as a partner. In any case, if I find out I'm wrong for some reason, then I'd sell and move on.

Outside of that, if we've bought a stock at 50 cents on the dollar, and we start to find the price at 80%, 100% or 120% of the value, all of a sudden the risk/reward has shifted badly against us, and I would probably sell in that neighborhood of full valuation.

Lastly, if there are more "better ideas" than there is money in the portfolio, I might sell a stock a bit earlier—maybe at 75% of our estimated valuation. That has happened occasionally—the fall of '87, the summer of '82, and the fall of 1990.

In today's market, I've been selling stocks sooner than I had thought, and for the most part I've not found enough replacements, so I've let cash build up to about maybe 25% of the portfolio. There is so much money chasing so few stocks that many things are too expensive for me to be very interested. Somehow that imbalance has to be corrected. I'm not sure what the scenario is, but this 15% to 18% a year return that people have gotten used to is probably unrealistic.

But you don't try to time the market?

No, although some people would say by definition that that is market timing. I would just say that I try to put all the possible investments in an array from most-attractive to least-attractive and that Treasury bills are higher on the list than usual right now. The reason I am more in Treasury bills now is that I'm more attracted to them relative to other stock alternatives, and not because I am predicting that the market is going to go down. But that may be splitting hairs to some people.

How high in cash would you go?

25% seems pretty high to me. I wouldn't promise not to go a little higher, but I'd rather not make a really extreme bet.

What about investing some of that cash in existing stocks?

I've done some of that, but there are limits. The Value Fund is a diversified fund, so I can't have more than 75% of the fund in positions of 5% or more. And I don't want to be overly concentrated in any one industry—cable grew to be over 30% of the portfolio, and I got very uncomfortable with that on general principle even though I was pretty comfortable with the stocks, so I cut that back down to about 20%.

On the other hand, I don't mind concentrating to some extent—I think concentrating on your best ideas and not having 200 to 300 stocks makes sense, assuming you know how to distinguish your best from your worst. The Value Fund has tended to have 40% or 45% of the fund in its top 10 stocks the last few years. I'd say that's relatively concentrated by mutual fund standards. We have a total of about 45 different stocks in the fund.

We have classified you as a mid-cap fund, but do you have any limitations on the size of companies you consider?

No, the mid-cap classification is based on a snapshot of our portfolio, but not something that comes out of our charter. I would love to own huge companies so that liquidity was never an issue, but I'm also willing to own very small companies. I have lots of patience accumulating positions in thinly traded stocks, and I'm willing to own them a long time, so I don't have to worry about bouncing in and out of them.

We are also sometimes classified as a value fund, but that doesn't mean I'm not interested in growth. I would love to have companies that grow fast if I really trusted the earnings predictability. But to value a business, I'm trying to figure out the present value of the future cash flows, and for a lot of very fast-growing businesses, that future is just not predictable enough for my comfort. If something is growing 25% to 50% a year, mathematically they can't keep it up, and it also attracts competitors.

I'm interested in business growth at a sustainable, predictable rate, and so if by chance some of the faster-growing companies came to be cheap by my standards, maybe we would be classified as a growth fund.

We have been in five or six of the Morningstar style and size boxes over the years, but the portfolio just doesn't change that much. The common thread that you would always see in our portfolio going back 10 years and going ahead 10 years would be the price sensitivity relative to the business value.

Your portfolio turnover rate is relatively low—typically, how long would you hold on to a stock?

I would love to hold a stock for 20 years. It's expensive to change both in terms of transaction costs—commissions and the buy-sell spread—and in terms of the tax consequences. Warren Buffett says his favorite holding period is forever. That might be overstating it a little bit, but I would like to hold for long periods.

Occasionally, there'll be a stock that I think is mispriced and quite possibly could move up 20% to 30% in a short period of time just because of some special factor—I'm not above owning that. That might occur when some company is breaking itself up or liquidating, a merger that's already approved, or a piece of news that's misunderstood. But generally speaking, I would like to hold for a long time.

Speaking of Buffett, one of your holdings is in Berkshire Hathaway.

I've owned that one since the late '70s—it's been there 20 years.

It's been a good investment?

It's been a fabulous investment. Warren is the best, I think, at many things, and when I bought the stock, I thought I was paying a reasonable price. At one time, it traded at a discount to its tangible assets, and you got Warren for free. Since then, it has come to trade at a premium—there is a Warren premium in there, I think, and it is very hard for me to justify. I've let it get to be a much smaller position by letting other things grow up around it.

Your philosophy is very similar to his—how much do your holdings overlap?

They overlap some—they overlapped more in earlier years. Warren describes himself as a Ben Graham follower, being price sensitive, and seeking a margin of safety and that sort of thing, but he also places a higher value on certain business characteristics. In other words, he recognizes there would be a big premium for certain characteristics like predictability and free-cash generation and market clout of the kind that the Coca-Colas of the world have. So, he would say that he wants to buy at a big discount to value, but he would come up with a higher value today then he would have 10 or 20 years ago. Also, he needs to buy very large positions to be able to make a difference in his portfolio because Berkshire Hathaway now has $50 billion or $60 billion in assets. So, his universe has gotten to be a little limited in a way that mine certainly hasn't. ◆