

## Chuck Akre on the Akre Focus Fund

By Robert Huebscher

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*Chuck Akre is the Managing Member and Chief Executive Officer of Akre Capital Management, which he founded in 1989. For a time, his firm operated as part of Friedman, Billings, Ramsey & Co. (FBR), and Akre was the manager of the FBR Focus Fund (FBRVX). He has a track record of above-average performance over the last 20-plus years managing mutual funds, separately managed accounts and partnerships.*



*He launched a new fund, the Akre Focus Fund (AKREX), in September of 2009. We spoke with Akre on January 27.*

**I'm familiar with your "three-legged" investment process: choosing companies that earn high rates of return, have management teams with proven track records of upholding their shareholders' best interests, and can reinvest capital at high rates of return. How have you adjusted those principles over the last year and a half and, in particular, have you embraced the "new normal" paradigm and lowered your return thresholds as a result?**

Quite frankly, over the last several years, I have reduced my expectations of return. That's been pretty consistent with what has been going in the world.

For many years we have been looking at business where the return on the owners' capital [equity] was north of 20%. For the last several years we have looked at businesses in the upper teens and higher. We are still looking for those businesses, and we are still finding those businesses where we think that expectation is likely to unfold. All of that is predicated on what amount of owners' capital there is. Understanding the balance sheet of these businesses is important. The really good businesses have very strong balance sheets, where the majority of their capital is the owners' capital and not debt capital.

**You have a fairly concentrated portfolio of 10 holdings, a limited track record with your new fund, and approximately \$166 million under management. What is your universe of investment candidates? US versus non-US? Across all style boxes? Debt as well as equity?**



We've disclosed our top 10 holdings and we have more than 10, but not 20 holdings. We are approximately 45% invested.

We have no boundaries on where we will go. It's a matter of both familiarity and our enterprising nature. In the past in our funds, we've held businesses domiciled outside the US – in Canada, Mexico and Europe. We have not owned any businesses that were domiciled in Asia. We remain interested in businesses anywhere that we can understand the accounting and the culture. That becomes easier as time goes on because of international accounting standards. Cultural issues have a lot to do with how companies present their information.

In our fund now, we have several businesses that earn revenue outside the US. The most prominent is our largest holding, American Tower [Ed.'s Note: see a discussion of this holding [here](#)], which provides infrastructure (towers) for cell phone, video, and data antennas. They earn 9% of their revenue in Mexico, 4% in Brazil and a little less than 4% in India.

Other names we own that have some business outside the US are gaming manufacturers. Overall, we don't have a significant amount of non-US-based revenue.

We are not constrained in a style box. We are interested in all parts of the capital structure.

**One of your holdings is the insurance company Markel. Can you talk about how this fits into your three-legged stool paradigm and how you expect it to earn your required rates of return?**

In the property and casualty insurance industry, any company has two kinds of capital: owners' capital and policy holders' capital. They have two ways to earn money: from investments (to be able to pay claims from policy holders) and on the underwriting of business. They measure the profitability of that underwriting with the "combined ratio." A combined ratio of 100% means that they write their business at break-even.

A combined ratio below 100% means they write business at a profit. We've learned from Warren Buffett that it means your cost-of-capital is negative. If you have a combined ratio of 97% means it is -3%. A combined ratio of 103% means your cost-of-capital is 3%.

The industry, for most of its existence, typically has had a combined ratio north of 100%, although that has not been the case in the last several years. The industry operated their businesses at a loss.



### **Why would they do that?**

Because they could make it up on the investment side. They are going to hold their investments over a long period of time to overcome the costs of underwriting. It's a losing proposition unless you could overcome that with your investment portfolio.

A couple of things have happened now. We are in a very modest interest rate environment – a zero Fed Funds Rate. Driving your business on investment income is much harder these days.

Furthermore, we have always been attracted to businesses that had the discipline to be underwriting their business at a profit. That eliminates most companies in the industry.

### **How is Markel different?**

Markel has been public for 25 years. Across that time, we've studied their reserve development. When an insurance company reports its profits for the year, it is a function of their management's estimates. They put a dollar of premium on the books and they say they have reserved "x" cents against future claims – that's an estimate. What they say are their earnings are really just an estimate of what they are likely to be.

In the industry, for many years there has been company after company that every four or five years has had to make a "one-time" adjustment to its earnings. If there was a pattern – and indeed there was – that means they were stupid or untruthful about what their loss reserves ought to be. They would report these good earnings and periodically adjust them because their losses were coming in greater than that. They would call that a "one-time addition to reserves," and continue this fallacy that the amount they were reserving and the amount they were showing as earnings were accurate.

Markel is one of a small group of companies that has, over a long period of years, written their business at an underwriting profit, by and large. They say in their literature that they set their reserves so that they are more likely to be redundant (they had more reserves than they paid out) than deficient. When you look at their last 25 years and make an adjustment for their company doubling through their acquisition of Terra Nova in 2000, you will see that their reserves have been redundant almost the entire time.

Furthermore, they have a tail in their business that is about four and a half years. If you look over a four- to five-year period – and there is a whole host of those periods over the last 25 years – you see that they have continued to be



redundant over that period of time, which means they have been honest in their evaluation of what their reserves ought to be.

Number two, their history of redundant reserves gives them the latitude to be more venturesome in their investments. They don't have to keep everything in liquid cash to pay reserves. They can take a portion of their shareholders' capital and invest it for longer terms and higher returns in the equity market. They have done that. With insurance company accounting, if their portfolio goes from 100 to 200 and they don't sell anything, that change in value is not reflected in their income statement. On top of all that, Markel has much greater leverage, in terms of the size of its investment portfolio relative to its book value, than almost any other company.

**If you combine all of those things, what is the real gain in economic value per share for Markel?**

I've concluded it is the change in book value per share.

The two components of earnings are underwriting gains and losses and the change in book value per share (for the investment component). The investment portfolio is more than three times the size of the shareholders' capital and all of the operating costs are distributed to the operating insurance company subsidiaries (there are no operating costs at the parent level). The parent only has the costs of taxes on its income and interest on its debt; we exclude those. If they were able to earn a 5% after-tax return on their portfolio and the portfolio was leveraged 3x (\$3 of investment for every dollar of shareholder capital) you could see that they had a 15% return on their capital. For many years it was actually 4x, so it was a 20% return. Part of their investment portfolio is made up of equities instead of debt, so the opportunity to get to 4% to 5% after tax over time increases.

Unrelated to underwriting, Markel in a reasonable environment might have a 12-16% return on shareholder capital as measured by the change in book value per share just based on their investment portfolio. If you add in \$1.8 billion in earned premium and 3 points of underwriting profit on that pre-tax, that is \$55 million, taxed at 35%, and you have approximately \$40 million of additional income. Markel is geared to having returns on the owners' capital as I think about it, of the mid-teens.

**What can upset that?**

A terrible year in the stock market, as in 2008. Or the last four years in the property and casualty business, where we have seen declines in prices in the various lines of business. Their premiums written have gone from \$2 to \$1.8



billion. Those things take away from the experience, but over the years the odds are way better than even that this is a business that can compound the shareholders' capital at a number in the mid-teens or maybe higher.

It has a history of people who think about their business properly and honestly and share those honest views with their shareholders in the way write their material, conduct their conference calls, and communicate in person. It's a business that, like so many businesses, has reinvestment opportunities, is based on writing more business, can make acquisitions and can add to their investment portfolio, all of which have the ability to compound our capital at these above-average rates.

**You also have a fairly high concentration in financial services, including TD Ameritrade, Factset, and MSCI. There are a number of factors, such as uncertainty in the regulatory environment, contraction in the hedge fund industry, and ongoing deleveraging that will impede growth in this sector. What makes those holdings stand out?**

Let's start with TD Ameritrade. It is one of the modern ways of delivering brokerage services to the public, in an electronic model. Unlike E-Trade and some others, it did not wander off the reservation with its investment portfolio and invest in mortgage securities. It kept its investment portfolio pristine.

TD Ameritrade is the smallest of the three brokerage firms (behind Fidelity and Schwab), but it is growing its market share off a very small base from their advisor network. As more and more of the world's business goes to advisors, we think that is an interesting opportunity.

They get almost nothing from the cash on their balance sheet now, but have the opportunity to get a nice boost to their economics as interest rates rise. They have that rate arbitrage for these businesses.

At the end of the day, it's just not very expensive from our point of view. We look at free-cash-flow per share in the period ending September of \$1.45, and the stock is \$17.70 today. The valuation is modest – 12x this year and 10x next year. It's conservatively run, its offering is easy to use, it's growing in the advisor channel, it has the opportunity to have a big kick if we come to a period of higher interest rates, and the valuation is very modest. Its balance sheet is conservative and has no net debt. We think it has the perfectly reasonable opportunity to grow those earnings, as in the past five years, at 14-15%. If I can own that business at 10x or 12x, my experience tells me I am going to have pretty good experience.



### **What about MSCI?**

There are risks that relate to the ETF business, but there are also opportunities. MSCI is a royalty business, from the use of the indices it creates for clients that have assets advised or investments outside the US. It's a global brand name. It doesn't take a lot of capital to support that.

Their November 2010 earnings are about \$1.25, and the stock is at \$29.70, so it's certainly more expensive [than TD Ameritrade], but it's a great royalty business from our perspective with maybe bigger opportunities than TD Ameritrade. Next year, we think that number will be around \$1.45, so it's 20x. It's probably the most expensive name in our portfolio, but we think the opportunity is in the mid-teens. It's a unique brand name. I'm always interested in trying to capture the effect of brands that don't take a lot of capital. It's not without risk, but it's a pretty interesting business.

### **And Factset?**

Factset is research tool. I have it on my desk alongside my Bloomberg, and we are trying to figure out which we really want to have.

Factset is like TD Ameritrade – the number three name behind Bloomberg and Thomson/Reuters. The people I talk to in our business, from a research point-of-view, say it is better than Bloomberg and Thomson. In terms of business models, information management and distribution is a good place to be in the 21<sup>st</sup> century. It is delivered electronically – as are TD Ameritrade and MSCI. In the year ending in August 2010, we think Factset will earn around \$3.35, and the stock is about \$64, so its 19x this year. Our August 2011 number is around \$3.70, so it's around 17.25x next year.

These are information management and distribution businesses. This kind of business gets a higher multiple than old-fashioned click-and-brick businesses. We have relatively small positions in both MSCI and Factset, and we think we have an interesting opportunity.

**Let's turn to the macro environment. I recognize that you are a value-based bottom-up stock picker and investor. What elements of the macro environment concern you most? What is your biggest fear?**

You've characterized us correctly. In the last week and a half, I've given two talks to groups of advisors around the country. At the end the talks I've said, "What are we concerned about these days?"



We are cautious. That's why we are 45% invested. We are cautious because our domestic economy continues to be driven 70% by the consumer. The consumer is confronting a lot of issues. We are north of 17% in underemployment. One quarter of all mortgages are underwater. A trillion and a half dollars have been removed from credit card and consumer lines of credit. The notion of home equity lines and refinancing are things of the past. We have 20% of income in the form of transfer payments. We have deficits in excess of a trillion dollars and likely will as far as we can see. We have 14.5% of all mortgages either at least one payment behind or already in the foreclosure process.

We have a host of headwinds for the consumer that makes it unlikely that the next decade is going to look much like the last one. Do I believe we are in a bubble? Not particularly – certainly not like we faced in 2007. We have entitlement programs in place (and the prospect of another one) that in and of themselves have the ability to nearly bankrupt the federal government.

We certainly face the prospect of higher taxes. All of those create significant headwinds.

Add to that the possibility of higher interest rates, which any reasonable person will say is at least an even-odds probability. We may be in a death spiral like Japan has been in for at more a decade, with deflation. But the other possibility is that our ability to pay back our debt is going to be influenced by devaluing the dollar. If we have higher interest rates, I just have to think back to what valuations were in the late 1970s and early 1980s. Top-quality names were selling at 5x and 6x. If you own something now at 19x, 15x or even 12x, they become vulnerable if you face that possibility.

We remain cautious and will try to pick our spots. Brokerage firms and investment management firms will shrink and the amount of money that is invested worldwide will shrink if we have big declines in the market. If they don't, then they will continue to grow.

**Is the fact that you are 45% invested a reflection of your macro outlook or a lack of attractive investment candidates?**

It is a reflection of our macro outlook. When the money came into the new fund, we chose not to duplicate the fund we just quit managing (FBRVX), because there were a number of investments in that fund that were less attractive because of where the economy was, in my mind. I would be interested in some of those at much lower valuations, and there are some I probably wouldn't be interested in.



If we talked a month ago, we would have been 25% invested. We are putting money to work deliberately and cautiously. We had a market that went up 60% off the March low. Everything is not as rosy as the market projects.

Mohammed El-Erian has said that stock market was on a “sugar high.” That is something that resonates with us. Last week, and even this week, reinforce the notion that the market is running out of steam here.

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