ADVISOR PERSPECTIVES

Bruce Greenwald on Positioning First Eagle's Funds

By Robert Huebscher
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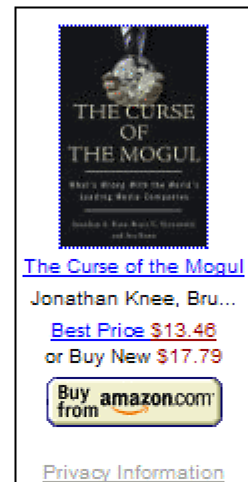

Bruce Greenwald is a recognized expert on value investing. A professor of finance at Columbia University and Director of Research at First Eagle Funds, he is the author of the books "Value Investing: from Graham to Buffett and Beyond," "Competition Demystified: A Radically Simplified Approach to Business Strategy," and "Globalization: The Irrational Fear that Someone in China will Take Your Job." His latest book, "The Curse of the Mogul: What's Wrong with the World's Leading Media Companies," is available via the link below..

We spoke with Greenwald on November 4. This is part two of that interview. In part one, which we published last week, we spoke with Greenwald about his views on the structural problems in the economy and his forecast for higher unemployment rates.

Has the way you practice value investing changed as a result of the financial crisis?

We changed our focus on risk management. Many other value managers did as well, because they were blindsided.

There are three principles that I believe good risk managers and value managers should pursue to protect themselves from permanent impairment of capital and variance.

The first principle is that the quickest way to permanently impair your capital is to overpay for something. So you always want to have a margin of safety.

The second issue is that, you go wrong with your margin of safety because your intrinsic value is wrong. Something happens that surprises you. That is almost always – if it's a permanent impairment of capital – a company problem, where a product doesn't work or a competitor comes in, or an industry problem, like newspapers, where they get destroyed. Sometimes it's a particular national problem, like in Venezuela. But those risks tend to be diversifiable. So the value investors who had always been very concentrated, like Glen Greenberg, who is a wonderful investor, got burned. He had five to seven positions.

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For the sake of risk management, you've got to have at least 20 to 30 globally diversified positions. This second lesson of diversification applies because the risk of permanent impairment of capital tends to be unsystematic and specific to impairment of capital management and to variance management. We were very diversified.

The third rule is that, even within a diversified portfolio, if you have if you have a total loss that affects 3% to 4% of your portfolio, you are asking for trouble. The thing that will convert temporary impairments, which are the macro fluctuations, to permanent impairments is leverage. We've always been extremely careful when it comes to leverage.

I think the value community has learned this lesson. The guys like Marty Whitman who got burned were in financial services, where there were enormous amounts of leverage. We've learned that if you want to do a stub, which is a highly leveraged position, you want a five- to six-times upside, because the downside is zero. You've got to start thinking in those terms. People have learned to think about leverage differently and to be warier of leverage, and only be willing to do it in a restricted part of a diversified portfolio.

The fourth thing we've learned is that when you build your portfolio you have to think about macro risks in terms of scenarios. Basically it comes down to two scenarios: You can have stagnation and deflation and a recession for extended periods with inadequate demand, or you can have inflation. You have to know, holding by holding, what your vulnerability is. For example, real assets – real estate, natural resources, and things like that – are going to do very well in an inflationary environment but are going to get killed in a deflationary environment. Fixed income is going to do very well in a deflationary environment and is going to get killed in an inflationary environment.

Which assets give you the best overall protection?

The assets that are most attractive are the franchise businesses that have pricing power, because you can pass along inflationary price increases and you are not subject to competition from excess capacity, the way you are in industries like autos and steel. You have much more control on the downside.

When you have a set of positions, you are looking for a discount to intrinsic value, but after you've built that portfolio you want to know that it is reasonably balanced. Fortunately, at the moment, the best bargains are in franchise businesses. You are getting 8% to 11% and in some cases 13% to 14% sustainable earnings returns. With no growth at all, you have a safe asset with really attractive returns in selective areas.

People have learned to look at their portfolios with this degree of balance as a result of this experience. Realistically, I don't believe in inflation in this environment, but nobody

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can be absolutely confident of what will happen with respect to price expectations and inflation.

We've learned about diversification, the cost of leverage, looking at our portfolios from a macro perspective, and looking for balance in our exposure. The other thing we did inadvertently, when our macro exposure looks to be too much for the balance of our portfolio, is to think about buying hedges. The hedge that we've had is gold, which has protected us. The attractive thing about gold is that it has no industrial uses. It's strictly something that, when everything goes wrong, it's going to do really well. I think people have learned to appreciate that.

The other great way to hedge is to recognize that when the risks are the biggest is when nobody thinks there are any risks at all. When that's the case, the implied volatilities in derivatives are going up, and you get really good prices on deep out-of-the money puts on overvalued indices like the Russell in the summer of 2007, and you get really good prices on credit default swaps. You can buy credit default swaps that are trading at four basis points, which implies one default in 2,500 years – in the most volatile region on Earth or on the most volatile commodity. Mutual funds really can't use this strategy, but good value funds are thinking about hedges, which are really forms of insurance. For the last several months, hedges have been extremely expensive, but they are finally coming down in price.

In our mutual fund, gold is the primary hedge. We have some cash, which is clearly a safe asset carrying a low yield. Most of our risk management is that we are consciously moving our portfolio – because that's where the bargains are – to the areas where we believe the macro risks are considerably more attenuated.

What surprised you in this environment?

The biggest surprise, in a funny way, is the way that franchise companies, like Deere, have weathered this period in terms of their profit performance. The auto companies got slaughtered, but Deere, which typically would have gone from making money to losing money, is maybe down 35% in earnings.

These companies increasingly make their money on services. The part of the package you need from Deere, if you own a Deere tractor, is service. If it breaks down, you need it fixed. Deere has a dense network of dealers with lots of parts availability and lots of capacity. You're going to get much better service and you are going to get a higher price for that. That's a competitive advantage that protects them against price competition. As the package of what these manufacturers offers moves in the direction of service, they are going to have more local monopoly power in different areas, because the services are locally produced and consumed.

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Some of the stocks you own, like Microsoft and American Express, don't fit the traditional mold of value stocks – ugly, cheap, beaten-down, and boring. What makes these stocks attractive?

American Express is unbelievable. It has sustainable earnings of a minimum of $3/share. If they manage their costs at all – and that could happen if Ken Chenault leaves the company – they could easily make another $2.50/share pre-tax by cutting costs. You're talking about making $5/share after-tax in sustainable earnings. When the price is $10, that's two times earnings – a 50% earnings return.

If you think it is $3 or $3.50 with a potential of $5.00, you're talking about an earnings return on American Express that's 10% and up. They've got some organic growth because they earn 1.1 % on their billings [through merchant fees] without any significant impact on receivables. Rich people are clearly doing better than poor people, as they have for the last 40 years. The surprise is that these stocks, which you would not think are ugly or obscure, are this cheap. People have just gotten scared.

Microsoft is going to rule, because you need an operating system. They have pricing power. I don't know why their stock was at $17, which I believe is where we bought it. They generate huge amounts of cash. Their stupidity seems to have stopped for the moment. They are not doing X-box or dumb things for Yahoo any more.

There must be some risks in these stocks.

The thing that makes us most nervous is that these incredible franchise stocks are available at prices that seem to be very attractive based on conservative assumptions. I think it's because there is this phenomenon that when people want absolute certainty, a little bit of risk scares them and they won't look at it.

How do you get people to accept bizarre choices? You say here you can get "x" for free, or you can have "x" plus "n" with one chance in a thousand of an outcome of minus a hundred. People will choose "x" for free all the time. I believe that's what's going on, and why we worry about these franchise businesses.

American Express has a huge ability to manage costs, which is the cost cutting I mentioned earlier. They've done a lot of it, and have basically gotten rid of $2 billion of costs, but they may spend about $800 million of that back, which is a crime. You've got tremendous cost control on the downside and perfect inflation protection, because they just collect a fraction of the billings. Yet it was selling at a ridiculous price and is still selling at a slightly ridiculous price.

I know you own Berkshire Hathaway, so I have to ask you what you think about Buffett's purchase of Burlington Northern.

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It's a crazy deal. It's an insane deal. We looked at Burlington Northern at $75 and I'll give you the exact calculation we did. You don't have a high earnings return. They are paying 18 times earnings, but it's really much worse than that. They report maintenance cap-ex very carefully. They report depreciation and amortization, and they report only about 70% of the maintenance cap-ex. So they are under-depreciating, and their profit numbers are lower than the true profit numbers – and in a bad way, because the tax shield for the depreciation is undergone too. Their profitability is much lower than it looks.

Buffett's paying 18-times [at $100/share] and at $75 he was paying 16-times. Our calculation is he was paying 21-times.

Secondly, there are two kinds of assets. There are the rights-of-way, which you can't get rid of. So there's no issue about having to earn a return on them because you have to keep it in the business, and because there's nothing they can do with those rights-of-way. If you look at the asset value of the non-right-of-way equipment, and you write it up because it's more expensive than it was originally, you get an asset value that's very close to the earnings power value. We didn't see a lot franchise value or hidden asset value.

The other thing is that if you try to calculate sustainable earnings, you have to cope with the fact that earnings are up enormously since 2003, when oil went up. There is a simple calculation you can do, which compares the cost-per-ton-mile for freight for a truck versus a railroad. If you build the increase in the price of diesel fuel into the post-2003 experience, when revenues suddenly start to grow, what you see is that the entire growth of the revenue is accounted for by the energy advantage that the railroads have and therefore how much business they can capture from the truckers, and how much pricing they can get because the competition is now more expensive.

There is nothing special about the railroads. It's entirely an energy play.

If you look at what their margins should have gone up by, given the energy efficiency, the margins go up by only about half of that. So you don't have a good aggressive management over these five years producing outsized returns.

We looked back at when they did the merger with Santa Fe, because then they did increase margins. But they got bored with it, and margins started to come down. The same thing happened recently. We don't see a lot of hidden profitability in the culture of the company.

It looked to us like an oil play. He has a history of making bad oil play decisions. And that was at $75/share, we thought there were better oil plays. At $100/share we think he has lost his mind.

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You've co-authored a book on the media industry [see link at the beginning of this article], which challenges a lot of conventional wisdom about some of the problems that have plagued that industry. Have your views on this industry led to any investments?

When you look at the media business, there are three parts to it. There are the content providers (who never made any money), which are the production houses in the movies and the imprints in the record houses. There are no barriers to entry there. If you look at the last 20 years, everything went right for the movies. First they got VCRs, then cable, then DVDs, then good foreign distribution. Revenues grew by about 8.5%. Costs per movie grew by about 9.8% and the number of movies grew by 1.2% annually. There are going to be good years and bad years. So, when everyone says content is king, remember that content production is not king.

The second part of the business is the aggregators. The movie companies and the record companies used to do the aggregating. For example, the record companies pressed the records and shipped them to the stores in bulk. What kept their advantage, and why there were four majors, was because it's expensive to do that. It's hard for an entrant to do that. That went away with electronic distribution.

Once you can do that electronically, that advantage is gone, and they got killed. If you think about the aggregation of newspapers, the same thing happened. They had to put the news together, print it, and so on. Electronic news distribution destroyed their business model.

The aggregation profits now are in the cable networks. To do a cable network, you need a full slate of programming. If you dominate a specialty niche, like Discovery does, it's hard for others to pay for that programming. If you have the best distribution for that kind of programming, you get the best prices and all the advantages of economies of scale.

But if that model evolves to where you have all the content on a web site, such as the Discovery Channel web site, everyone just picks and chooses, and all of a sudden that barrier to entry is way down We're very leery of these businesses. We want high returns – much higher than the NBC-Universal deal – on the aggregators, because the history has been that the aggregators can go away, just as continuous content has gone away. It used to be that nightly news or the soaps were a big thing that you had to do every day, and they were hard to produce. Now people can make one-off soaps.

Is there any part of the media industry that is attractive economically?

The content business was never very profitable and the aggregation business went away with electronic distribution, so you are left with the final distribution – the pipelines. They ought to get correspondingly more valuable. They are Comcast and Verizon.

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They have local monopolies. Nobody is going to build infrastructure to compete with them. The issue is whether they can get along on price with the Telcos.

The one that we like best, even though they break our hearts with their stupidity, is Comcast, which is trading at a 13% earnings return because they are way over-depreciating. We think they ought to have huge pricing power. To do that, they've got to get along with the Telcos, but they are doing everything in their power to alienate them by going after small businesses, which has always been in the bailiwick of the Telcos. Hopefully, just like Coke and Pepsi, they will learn to cooperate.

What will happen is that you will have a cable wire into your house, and then everything will be wirelessly distributed. In that world, their costs go to nothing. If they keep their prices up – and they can probably charge $300/month, because it will cover your cell phone, regular phone, internet access, and on-demand programming – and they collaborate, they can charge a lot and make a ton of money.

The only reason we are seeing the opportunity to buy them is because of Brian Roberts, who has 100,000 people and a lot of costs. If he wants to indulge himself and waste a couple of billion dollars buying this wasting asset, Universal, and pay for it by cutting $3 billion in costs we are going to be happy.

That's where we have the best value and, surprisingly, the best inflation protection. People do not pull out their wires in recessions, so it is also a safe asset. The market seems to understand the risks, but they seem to be shying away from it.

Is it reasonable to look at an index like the S&P from a value investing perspective and decide whether it is cheap?

I believe the answer is obviously yes. To say whether the S&P is cheap, you've got to compare it to something like earnings power or book value. You have to be very careful about sustainable earnings and real book value, and to adjust for over- or under-depreciating.

In March, life was sweet if you had the cash, but it's not so cheap now. If you're a global fund, you've got to start looking at national markets to see where the bargains are. For a while they were in India, but they are not any more. Nor are they in China.

You are buying in Japan.

We've made a judgment that everyone hates Japan because of its long-term stagnation, which we don't think is going to change. Our holdings in Japan include Shimano, Fanuc, and some of the insurance companies. These are companies with global franchises.

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You always must ask, "Why did God make these bargains apparent only to me?" When we look at their global earnings power, they have clearly been tarred with the Japanese disease. We are buying a business that is a global non-Japanese business at a depressed value, because people think of it as a Japanese business. We are buying a ton of cash in the Yen. In this environment, the Yen is probably not going to appreciate, but it's probably not going to suffer long-run depreciation given the dollar deficit.

For you to ultimately reap rewards on those investments, doesn't it require that other investors see the same value you are seeing?

In some sense the answer is yes, and in some sense the answer is no. To really pay off and make up the discounts we are seeing that is true. When we make these investments, we are increasingly looking at earnings returns. We are getting returns on those businesses, after the cash, of 8% to 10% or even as high as 12%. We'll take that all day long.

Now – and this is where you are right – we have a lot our investment sitting in cash, which is not very attractive. We are assuming ultimately investors will recognize the value of the cash. But those are also the investments with the least downside risk.

Everyone knows the governance problems in Japan. We are buying these global businesses at a really good price, we think we are getting increased earnings, and we are reasonably happy to sit on them, because we think value is accruing.

What is your greatest fear?

The killer would be inflation. Normally, for inflation to take off you need expectations, which there are, and you need wage pressures, which I don't see. But if inflation takes off, policy is going to be emasculated. The view that output demand can be stabilized by government policy is not going to be true any more. It's going to be painful. The nice thing is that our natural-resource and franchise businesses can really do well in that environment.

But, in terms of a macro fear, that's really going to be painful. If you get stagflation at these levels of unemployment, watch out.

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