Bill Ackman on What Makes a Great Investment

By John Heins
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In addition to commenting on his high-profile current investments, Pershing Square Capital's Bill Ackman in a recent interview with Value Investor Insight describes the general company traits he looks for in both active and passive investments, why a high public profile is an important element of his strategy, whether his thesis on J.C. Penney has evolved, what lessons he's learned from a few prominent mistakes, and why his short conviction on Herbalife is as high as ever.

Starting at a basic level, how would you characterize your investing strategy?

We rely on concentrated research to identify great businesses that are trading at highly discounted valuations because investors have overreacted to negative macro or company-specific events. That's the time-arbitrage part of the strategy, taking advantage when the market reacts to short-term factors that have little impact on long-term intrinsic values. Our greatest competitive advantage, though, comes from using our stake in a company to intervene in the decision-making, strategy, management or structure of the business. We don't like waiting for the market to be a catalyst.

Why is Warren Buffett willing to pay 20% above the highest price at which H.J. Heinz stock has ever traded, even after it's had 20 quarters of great results? The answer is that control is very valuable. Not just for the bragging rights, but because you can change strategy, you can redo the cost structure, you can change the tax structure, you can sell off underperforming assets or hidden assets. The control premium is really telling you that the current management team and board are not optimizing the value of the business. For a financial buyer, which is essentially what Buffett is in this case, you're buying it be- cause it's a great business and because you believe you can make the price paid end up looking cheap.

That's very similar to what we try to do: Buy high-quality businesses at a price that is not reflective of the intrinsic value of the business as it is, and certainly not reflective of what the intrinsic value would be if it were run better. That allows us to capture a double discount. That's a benefit we can have over private equity. They can buy a company and run it better to extract incremental value, but they're typically paying the highest price in a competitive auction, so they don't get that first discount. We don't get full control, but because we have a track record of making money for other investors, we can often exert enough control to make an impact. With Canadian Pacific Railway [CP], we won a proxy contest and with our 14% stake were able to appoint 8 of the 14 directors and recruited one of the best rail- road executives of all time, Hunter Harrison, to be CEO. That has created a lot of value.

How do you define a great business?

We like simple, predictable, free-cash-flow generative, resilient and sustainable businesses with strong profit-growth opportunities and/or scarcity value. The type of business Warren Buffett would say has a moat around it.

We've done almost nothing in energy or other cyclical businesses. We avoid healthcare because of all the regulatory uncertainty. We've done nothing active in financial services, except on the short side with MBIA. When you're putting 8%, 12% or 15% of your money in something, it's not a day trade. You have to focus first and foremost on high-quality businesses that can't blow up and should grow in value over time.

Like Procter & Gamble [PG]?

P&G is a perfect example. It's a global leader in many of the most-attractive consumer-goods categories, which have structurally high profit margins, strong customer loyalty, and excellent growth opportunities in emerging markets, where P&G has nearly 40% of its sales. Its brands, including Pampers, Tide, Gillette and Olay, are among the strongest in the world. Despite all that, in the second quarter of last year we were able to buy into the stock at a modest multiple on depressed earnings. The company had for three years underperformed its peers on many levels, innovation had been weak, and an already-high overhead cost structure had become even more bloated. With the stock at $60, we thought there was an extremely low probability we'd lose money, and that with more effective leadership P&G could return to historically attractive levels of revenue and earnings growth and the stock would respond accordingly. So, a great business, at a cheap price, with an understanding of what can be done to make it more valuable. That's a classic Pershing Square investment.

Beam [BEAM] would be another example of quality. The spirits business is highly attractive, where brand leaders have significant pricing power, strong barriers to entry, high margins, and attractive growth both domestically and internationally. Beam is now the world's only pure-play, publicly traded global spirits company that is not family controlled or influenced, making it a very scarce asset. We think in an industry that is very likely to see significant consolidation over the next several years, they have many interesting strategic alternatives available.

What about something like Burger King [BKW]? Is that a great business?

This is a 60-year-old brand that for much of its recent history has been managed horribly, but it still exists, which is a good indicator of a good business. It's the world's second-largest fast-food hamburger restaurant chain, with over 12,500 restaurants in 80 countries, and has made enormous progress on several strategic initiatives since it was bought in 2010 by 3G, the same group Warren Buffett is partnering with on Heinz. They're refranchising substantially all company-operated units, have overhauled the menu and marketing strategy, and have accelerated a lower-cost store-renovation program. All of that is paying off in significant and ongoing growth in free cash flow. That type of turnaround is usually only possible when the core business is a good one.

Is it typical for you to delegate activism, as you seem to have done in this case?

We're generally averse to making investments in controlled companies, but we consider 3G's controlling ownership of Burger King to be a positive. We 100% believe in it, the strategy and the management team. Someone else can be the catalyst from time to time.

Describe how you construct your portfolio with both active and passive investments?

We think having 8 to 12 core positions at a time provides an adequate degree of diversification, while allowing us to concentrate in a handful of ideas that we know very well and believe have highly favorable risk/reward characteristics. If our capital base were permanent, we'd probably only do active investments. But it isn't, so the fact that I don't ever want to be forced to sell an active investment in the course of an engagement means we also need to hold passive positions. Historically, around 55% of our portfolio has been in active investments, 15% or so has been in cash, and the balance has been passive.

What has tended to perform better, active or passive?

The 55% of our capital in activist investments has produced more than 90% of our returns. One primary reason we're working hard to increase the amount of permanent capital we have is to devote as much of the portfolio as possible to active positions. Doing that should enable us to earn higher returns over time.

Why maintain the 15% or so average holding in cash?

That's just what it's been on average, the level can be much higher or lower. We don't believe in leverage, so cash serves as liquidity for potential future opportunities, the size and availability of which can vary. We earn a high enough return on capital that we can afford the dilution of cash.

Maintaining a high public profile appears to be important to the execution of your strategy. Why is that?

The press is a necessary element of the strategy. Look at something like Procter & Gamble. We haven't run a proxy contest. We haven't made a public presentation. All we did is buy some stock. That became publicly known and immediately the press was all over the company and what they were or weren't doing right. That saved us a lot of time and energy. On solid, high-profile boards of companies that are underperforming, sometimes the directors just need a little bit of a push. One of the best pushes is a reputational push, which a press spotlight can administer.

That spotlight can be particularly important in our shorts. We don't short on valuation, but in situations where we believe a company is violating the law, or has misleading or inaccurate accounting, or has a potential regulatory problem. In these cases the attention really matters. If you're a regulator with any sort of oversight of Herbalife [HLF], how can you ignore it when a reputable investor who has spent 18 months researching it says it is a certainty that the company is a pyramid scheme? Imagine if I'm right and they've done nothing on a company that's in the paper everyday.

In taking such public positions, do you risk being so committed that you're less apt to recognize evolving flaws in your thesis?

One of the keys to this business is having conviction based on your work that you're right and the rest of the world is wrong. If you don't have that confidence, you'll never buy anything because there's always something that can go wrong. Everyone thought the idea of buying stock in General Growth Properties right before it went bankrupt in the middle of the financial crisis was the stupidest idea they've ever heard of, and plenty of people said so. The stock was at 35 cents a share, down from $63, and we bought 25% of the company. You can't get much more contrarian than that.

There's obviously a balance to maintain between confidence and humility. You have to be humble enough to recognize when you're wrong. I'm willing to look silly. With General Growth, we could have looked very silly. But even if things hadn't worked out, I still think it would have been a good investment. It was probabilistic, where we thought the upside was high enough and likely enough that we were willing to take the risk of the stock going to $0.

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