Charles de Vaulx: "We Have Never Been as Cautiously Positioned"

By Robert Huebscher
September 17, 2013

Charles de Vaulx joined International Value Advisers, LLC (IVA) in May 2008 as a partner and portfolio manager. He now serves as chief investment officer and portfolio manager. Until March 2007, Charles was portfolio manager of the First Eagle Global, Overseas, U.S. Value, Gold and Variable funds, together with a number of separately managed institutional accounts. In addition to sharing Morningstar's International Stock Manager of the Year award in 2001 with his co-manager, Charles was runner-up for the same award in 2006.

I spoke with Charles on Sept. 9.

Your former partner, Jean-Marie Eveillard, once said he would rather lose half his clients than half his clients' money. Is that also your business philosophy?

Yes, of course. Most of my team worked with me at First Eagle and we are trying to follow the same investment process and philosophy that we had at First Eagle and at the SoGen funds before that. Even though we are long only and invest predominantly in equities, we've been very clear about the fact that we are a lot more absolute-return oriented than we are interested in beating a benchmark. To be more precise, we are willing to try to beat the benchmark, but only in the long run, over a full economic cycle, and not on an annual basis.

Yes, we are willing to do certain things that, short-term, may not appeal to our clients, even though, especially, if it would be to help protect their capital. We have never ever been as cautiously positioned as we are today. At the end of July, the IVA Worldwide Fund had 29% in cash, but then we also had short-dated bonds in Singapore dollars and former high-yield corporate bonds that are of very short duration.. So at the end of July, we had only 53.3% in equities. We are willing to be significantly underweight equities if we believe that is the right thing to do for our clients, even if they may not perceive it that way at this time.

Another way we try to protect our clients - and not risk losing half our clients' money - is to be mindful of our capacity. Two and a half years ago, in February of 2011, we closed our Funds to new investors. For us to remain multi-cap investors and to retain the ability to roam and, at times, buy into large stocks or at other times into smaller stocks, and for us to remain able to buy into high-yield corporate bonds that may not be the most liquid, it is important not to get too big. We have acted upon this by closing our Funds to new investors. As a result, today we manage $18 billion, and we are comfortable with that amount. We would not be comfortable managing $50 billion; it would become very difficult for us to invest in smaller, less liquid securities. So in a sense, by closing, we have “lost” half the clients we may have gotten had we not closed our Funds.

Let’s talk about the composition of your portfolio. You’re not alone among value investors who favor Genting Malaysia. Can you walk us through the value case for that company?

It is a company that we have known for a long time. In 1988, over 25 years ago, at SoGen funds we owned the parent company of that stock. The bulk of the value lies with a casino they own and operate in Malaysia. In fact, it is the only casino in Malaysia, and it is a money machine. It generates tremendous amounts of free cash flow. The only reason why, in the past, the stock has been undervalued is because of a feeling among investors that the management does not give enough of its free cash flow back to shareholders in the form of dividends. They have basically let the cash pile up on the balance sheet, as opposed to paying higher dividends or aggressively buying back their own shares.

Over the past two or three years, they have been buying back a little bit of their shares, and we wish they would have done more of that previously. A few years ago, they bought some casino operations from a sister company in the U.K. and London. Those acquisitions have been good for the company, but it still remains small. The bulk of their value lies in their assets in Malaysia.

You have very few financial stocks in your portfolio - why? You do own a small position in Goldman Sachs. Why do you favor that one?

During the financial bubble from 2003 to 2007 — at my previous firm — we owned no financials to speak of, because we felt that most banks and insurance companies had become grossly undercapitalized and were also engaging in riskier and riskier activities. There is a central tenet of value investing, which is: “It is not enough for a stock to be cheap. It has to be ‘safe and cheap’,” to use the expression coined by Marty Whitman at Third Avenue.

After the financial crisis burst in 2008, many American banks were quickly recapitalized in late 2008 and early 2009. When that happened, their stock prices bounced back with a vengeance and were not cheap enough for us. I am talking about Citigroup, J.P. Morgan and Wells Fargo in the U.S. Conversely, in Europe, we found that most banks remain undercapitalized. There have been some exceptions, which was why two years ago now we bought stock in UBS, which we felt was adequately capitalized, especially since most of its value lies in its wealth management business, both in the US and in Europe.

But today, the banks – be they in Spain, Italy, Germany, like Deutsche Bank, or France – are undercapitalized. The stocks look cheap, and many of them trade at a big discount to book value. But these balance sheets have to strengthen, and additional rights issues will be needed for these banks to be adequately capitalized.

We invested in Goldman Sachs a year and half ago, in the spring of 2012, because the stock was trading at a pretty big discount to its book value. We bought it at around $114 per share. It had an interesting mix of businesses, including advising companies on M&A deals and wealth management, which is a pretty valuable business. We thought that over time, their capital markets activities would be able to earn good returns on capital going forward and, because of the unique culture of the firm and the global nature of its activities, Goldman Sachs would be a survivor. Many of its competitors would quit certain lines of businesses, and capacity would shrink in some parts of the businesses, and they would become highly profitable again.

Today, the stock trades at a slight premium to its tangible book value. It's barely above book value. And we think, for such a superb global franchise, we still are eager to remain shareholders in Goldman Sachs.

Additionally, we bought a Bank of America preferred stock in the summer of 2011, just before Buffet made his investment and that position has worked well for us. We sold more than half the position a few months back when it was yielding around 6-6.5%.

Emerging markets has been very weak year-to-date, not only the stocks, but also the underlying currencies, including the Brazilian real. We have been buying stock in a Brazilian bank called Itau Unibanco. When banks are adequately capitalized on a price-to-book basis, and when the valuation is compelling, we are willing to buy into financials.

Right now, the Indian stock market has been very weak, and we are doing some research into banks there.

You have not held much exposure to emerging markets, so congratulations on that call. On a cyclically adjusted basis, price-to-earnings ratios in the emerging markets are starting to look inexpensive. What, if anything, is wrong with that valuation metric? What would need to happen to turn you more bullish on emerging markets?

You're right that, in terms of multiples-of-earnings, many emerging market stocks seem reasonably priced. But unfortunately, the underlying earnings of many of these companies remain very high. Yet many of these countries – Brazil, India, Indonesia, South Africa –

have experienced credit bubbles, the biggest being China, where there has been a big credit boom over the past six or seven years. The question now becomes: to what extent will earnings decline over the next few years as the economies slow down and interest rates go back up?

Value investing is not about low price-to-earnings stocks. If these are cyclical earnings, oftentimes you're better off buying at a high multiple of depressed earnings rather than at a low multiple of peak earnings. People did not pay enough attention to the fact that some of the biggest stocks in emerging markets have little to do with the underlying economic growth in those countries. If you think about Samsung Electronics in South Korea, Petro China in China or Petrobras in Brazil, these are plays on the global economy. In the case of the two oil companies, it is a play on the price of oil rather than on the economy in China or Brazil. The global economy is weak, and that is a big headwind against some of these large emerging markets stocks.

Emerging markets stocks have done so poorly this year, while equities have done so well in the U.S., Japan or even Europe. Now is the time for value investors, such as ourselves, to start doing a little more research, nibbling and hopefully find a few opportunities in emerging markets stocks.

In an interview last year, you mentioned that your first investment at age 14 was a gold coin and that you bought your first stock the following year, in 1976. Over the long term, which was the better investment?

I kept both for five years or so. I was able to sell my gold coin at the height of the "gold mania", late 1979 or early 1980. The stock you talked about was Club Med. At the time, the company's earnings were depressed. In 1976, we had a very deep economic downturn following a crisis in 1974-1975 after the oil embargo. The stock of Club Med was very depressed, and what piqued my curiosity then was the company had what I felt would be. irreplaceable assets. It owned outright – and did not lease – wonderful sites around the world. It seemed to me that the irreplaceable nature of the company's assets would help them going forward.

The answer to your question is of course gold. But we do not view gold as an investment. Gold, for us, is more akin to money. In fact, gold was used as money for centuries in the world. Money is not supposed to compound at 8% a year. If you look at stocks in the U.S. going back 80 years, they have compounded at roughly 8% annually, including dividends. Ideally, as a long-term investor you want to own, first and foremost, stocks. Over the past 80 years, gold has compounded at only 4%. I say that, tongue-in-cheek, because 4% was what was needed to offset inflation.

Gold has been able to maintain its purchasing power over the past 80 years. Many stocks have done better than that. Ideally you want to own mostly stocks, assuming you can buy them at reasonable prices. But sometimes you want to own a little bit of gold. Right now, we have 3.9% of the IVA Worldwide Fund in gold bullion, not gold mining stocks.

At times, gold is inversely correlated to stocks. I will give you two recent examples. In 2008, when the financial crisis hit, gold bullion finished the calendar year 2008 up 7%, while stocks, bonds and commodities were taking a beating. More recently, in July and August of 2011, when global equity markets fell sharply, there were major worries about the Eurozone and stocks fell sharply. But gold went from $1,200 to $1,900 an ounce – briefly, mind you – in early September 2011.

In a portfolio or a mutual fund, to be able to have some assets that “zig” when the other parts of the portfolio “zag’ is very powerful. We have an investment approach that is very different from the traditional approach of most mutual funds, we try to deliver returns that are as absolute as possible. We are long only; we cannot short, and we would not want to do that. One of the tools we use to minimize drawdowns at the portfolio level is gold. Gold can act as a great hedge in a portfolio, especially against extreme outcomes, like inflation and deflation.

The reality of human nature is that many individuals cannot tolerate portfolio volatility on the downside. That also happens to be our own psychological makeup. We use as many tools as we can, including gold, to mitigate downside volatility.

We have been very careful over the past few years to own mostly, if not overwhelmingly, gold bullion and avoid gold mining shares like the plague. That has been great call, because their production costs have gone through the roof. The share price performance of most gold mining stocks has been awful, while the price of gold bullion has gone up over the past few years.

What would have to happen to the mining shares in order to make them attractive to you today?

Some gold mining shares have become cheap. The problem is that the production costs of most miners now are around $1,100 to $1,300 an ounce, which is very close to the current price of gold. It makes those stocks extremely speculative. Of course, if you have very high production costs and in the next two months the price of gold rises 20%, these stocks would do exceedingly well. But I view them as way too risky, in light of their high production costs.

I would need to see production costs be lowered significantly for me to consider using gold mining stocks in lieu of gold bullion.

I said that we owned a lot of cash – about 29% of the Worldwide Fund as of July 31. Being underinvested year-to-date and having all that cash has not hurt our performance too much. If you look at the IVA Worldwide Fund, Class A (IVWAX) is up 10.19% year-to-date through September 6, while the MSCI All Country World Index is up 11.16%. We are trailing the Index by barely 1%, yet we have been less than 60% invested in equities throughout the year-to-date

Many advisors – and I am not saying whether it is right or wrong – typically do not want to show cash in their client's account. They will use different funds – bond, equity, and even value or international funds – but typically will be reluctant to hold cash.

We believe that cash is a legitimate asset class and we are happy to hold cash for them. We may be better equipped than some advisors to decide when to redeploy that cash. Many advisors – or at least those who invest with us do not resent us, at times, holding cash. They understand and respect that we are absolute-return oriented investors and understand when we need to be in cash.

You recently stated that U.S. dollar cash assets and Treasury bonds, especially long-duration bonds, are a great way to "grow poor." I realize your process is bottom-up and that cash is a residual of the investment process, when you cannot find enough good investment opportunities, not an attempt to time the market. With that said, since you do not run a concentrated portfolio, can an argument be made for employing cash in names that you do like?

Stock markets around the world have bounced back since the lows of March2009, and as a result of that, we find it very hard today to find that many cheap stocks around the world. When some of the stocks we own go up in price – good examples recently were the The Washington Post and Berkshire Hathaway – and as a result, the discount between their stock price and their underlying intrinsic value shrinks, the proper self-discipline is to trim the position. That is what we have been doing.

The answer to your question is "no." It would be wrong for us to double up some of the individual positions we own. It's one thing to be comfortable having, say, 3% of the Fund in Berkshire Hathaway; I can sleep at night knowing that. I would not be comfortable, at today's share price, having 6% of the Fund in Berkshire Hathaway. The same thing applies to The Washington Post, whose stock price has done very well.

Today, cash will give you a dollar-based return that is less than the inflation rate. 10-year Treasury yields have gone up a lot over the past few months. They yield around 2.8-2.9%, which is slightly in excess of inflation, but no one knows what the inflation rate may be three, four or five years down the road.

In light of the fact that equities are probably the best house in a bad neighborhood, relative to cash and high-quality bonds, equities probably would do better. The reason we are not willing to increase our allocation to equities is because that remains a relative argument. Advisors who use our Funds do so, overwhelmingly, because of our ability to be absolute-return oriented and be very resilient in down markets. Hopefully, if markets keep going up, our stock picking will be good enough – as has been the case this year – to offset the dilution from cash.

What's very difficult about investing in stocks is that we are living in an environment where corporate profit margins have never been as high as they are today. In the U.S., margins are higher today, in many instances, than they were in 2006-2007, before the bursting of the financial bubble. We are in a world with ultrahigh corporate profits and ultralow interest rates, with many of those rates being manipulated in the U.S., the U.K. and now Japan, with their quantitative easing. Yet, despite those ultralow interest rates, there are some still significant imbalances in the world.

I spoke earlier about the debt China has accumulated. There have been credit bubbles in South Korea, Brazil, Indonesia, and even in India. Even though stocks do not seem to trade at high multiples of earnings, we believe that it is a bit of an optical illusion. There is high risk that earnings will go down for many companies around the world and then up in the next two or three years.

How is your outlook on the global economy reflected in your assessment of market valuations?

Today, the U.S. is perceived in the world as the strongest economy. Yet, as the employment data showed late last week, despite our recovery here, we are not growing fast enough to generate enough jobs. Europe seems to be doing a little better. Yet Mario Draghi, the head of the European Central Bank (ECB), last week said, "I am very, very cautious about the recovery." He meant the European recovery. I share his lack of enthusiasm.

China is still a big question mark. There are big signs that things may not degenerate into a hard landing, but that battle has not been won yet. There are many emerging economies that are decelerating. The global economic outlook remains very uncertain. Valuations for stocks are high, because of the record-high profit margins and ultra low interest rates, so there is very little margin of safety.

Most stocks and bonds today are priced for perfection. When you are as absolute-return oriented as we are, it gives us a very queasy feeling when stocks and bonds are so highly priced.

Let me ask you about one other economy that you did not touch on in that list, which is Japan. You have a relatively large exposure to small-cap stocks in Japan. Does their high debt-to-GDP ratio concern you? What will be the impact of Japan's aggressive attempt to devalue the yen – "Abenomics" – on your positions? Are you concerned about the effects the unwinding of emerging markets in general could have on Japan and its currency?

Some people, including Kyle Bass, have expressed tremendous concern about the extent of the debt-to-GDP ratio in Japan. But they have looked primarily at the government debt-to-GDP. In fact, a lot of the government debt in Japan is held by the government itself, so you have to look at the net government debt as opposed to the gross government debt. You also have to be aware that both households and especially corporations are huge savers. A lot of the excesses at the government level, in terms of debt, are offset by the fact that corporations are huge savers.

In the long run, one should be worried because the demography in Japan is not good. Unless they start making more babies going forward or they're willing to allow more immigrants, in 20 or 40 years they will have a bit of a problem.

Japan now exports more to China than it does to the U.S., and if the Chinese economy does experience a hard landing, short-term that will hurt Japan. But we feel, despite the rally in Japanese equities that has taken place over the last nine months, they are still cheap enough and companies in Japan are so strong financially – many of them are flush with cash – that they will still do well relative to emerging market stocks, if things get worse for many emerging economies. And because so many companies in Japan have excess cash, we would like to see them improve capital allocation (increase dividends and share buybacks). We think this is what would rerate Japanese equities over the long-term.

A lot of the stocks that we own in Japan today tend to be smaller, more domestic, less export-oriented companies. We own Yahoo! Japan, a subsidiary of Yahoo! It's a pure Japanese business. We own Temp Holdings, which is a temporary staffing business in Japan; it is not an export company like Canon.

We have mitigated the risk of the yen weakening further by being 50% hedged on the currency. If the yen weakens we are only hit to the tune of 50%.

You have a relatively large exposure to French stocks. How do you handicap the policies of France's government? Is the relatively narrow spread of French to German debt justified?

Regarding your second question, France still has a big problem with the size of its government debt and associated budget deficits, and unlike Japan, it is not as if the private sector saves enough to offset the excesses at the government level. I am surprised that French debt does not trade at a higher spread versus German debt.

In terms of the French companies themselves, many of which we own, many of them are global companies. We own Sodexo; it is a food catering company, and 40% of its earnings are right here in America. Many years ago, they bought Marriott Services. They have a significant presence in Brazil and they have some operations in India. We own a tiny little company in France called Robertet. They make flavors and fragrances. Even though it is a tiny French company – family-controlled, by the way – 35% of its sales are right here in America.

So far, the socialist government in France has not done things that are too adverse to these French companies. As long as the stocks are cheap enough, we are happy to own them.

Another example of a French company that we own is Teleperformance. It is the leading call center operator in the world, and 85% of its earnings are right here in America. In fact, the founder of the company lives mostly in Florida, so from many standpoints that company should not even be listed in France.

We would ideally like to own more stocks in Germany. We own Siemens, for instance. But if you look at the industrial fabric of Germany, you will notice that most companies in Germany are privately held or family-owned. They are not available in the public stock market. We know that Germany is a strong economy and it has some wonderful businesses, but unfortunately, most of them are not available in the stock market.

You are a student of the Austrian school of economics. What do you see as the effects of zero-interest-rate policies and quantitative easing? What are they doing to economies and the market? Specifically, how do you adjust your investment process to deal with those policies?

There's a school of thought, to which we subscribe, that believes that a lot of the excesses that took place in emerging markets were the result of those ultra-loose monetary policies. Ultra-low interest rates have helped create many or bigger bubbles, such as those in China, Indonesia and elsewhere. If you artificially manipulate interest rates, that has consequences and leads to bad capital allocation.

Another consequence of those policies is that you set up interest rates that are lower than inflation. Financial repression is the equivalent of a tax on savers. Many older people in the United States rely on income to live and enjoy their retirement. Now that interest rates are less than inflation rates, they are in a pickle. Understanding the side effects of quantitative easing is very important, and the big debate is, how successful has it been?

There are signs of the economy stabilizing in Spain right now. The U.K. is doing a little better. But it begs the question of whether countries are better off accepting some pain, as opposed to postponing and delaying things by too much quantitative easing.

Given the amount of sovereign debt that is outstanding, aren't the consequences of raising interest rates almost as unthinkable as keeping them low forever?

That is why policymakers, especially in the U.S., do not seem eager to raise rates. But if interest rates are not raised, if and when they have to be, it will be interesting to see what happens in many emerging countries. You will run the risk of inflation. In a way, if inflation is the end result of all those policies, owning equities is the best thing to do, except that these equities are so much more expensive than, say, they were in 1970s.

What question should investment advisors be asking themselves at this time?

Advisors should respect the fact that we will be in a very-low-return world for a long time and they should be able to convey that to their clients, which is not an easy conversation. Some individuals do not want to amend their lifestyle (i.e. save more and consume less) and may not want to be told that at best, the return on their financial assets may be 3% to 5% in the next 10 years, and even less once you adjust for inflation.

Advisors should remember history and understand that sometimes there are 20-, 30- and 40-year cycles, during which interest rates go down as they did from 1982 until recently. But then there are 20-, 30- and 40-year cycles during which inflation rears its ugly head and interest rates go back up. They should be mindful of that and understand the consequences and effect it has on different asset classes.

For the past three or four years, we have tried to be very vocal and remind people that you cannot just equate high economic growth to good stock market performance, particularly with respect to emerging markets. It is more complex than that. High economic growth in China does not necessarily mean that Chinese stocks will offer good performance. One has almost has nothing to do with the other. Conversely, just because Japan has stopped being less relevant in the world economy, one should not refrain from investing in Japan.

Advisors should avoid simple generalizations. They should understand that the devil is in the details, and that oftentimes you have to do what hurts. Today, interest rates are low, so everybody is chasing yield. They want to own REITs, MLPs and emerging-market debt funds.

Investing is about having the fortitude to resist the temptation of these things. Investing properly is often psychologically painful.

Thank you very much.