Compounding Interest
Recognizing a company’s competitive advantage is much easier than making a call on how long it lasts. Making such calls is Chris Davis’ stock-in-trade.

Few investment firms have a more storied history than Davis Advisors. Founded by Shelby M.C. Davis in 1969 to offer to outside clients the approach honed by his father, Shelby Cullom Davis, the firm now manages $35 billion, more than $2 billion of which is Davis-family money. Its flagship New York Venture Fund has earned over its 46-year history a net annualized 11.8%, vs. 10.0% for the S&P 500.

Such outperformance has been elusive of late, but current CEO Christopher Davis sees no need for alarm. “We’ve had periods like this before,” he says. “We don’t believe the basic laws of value investing have been repealed.” With co-portfolio manager Danton Goei, he’s finding opportunity today in such areas as energy, cement, banking and healthcare services.

Crème de la Crème
Whether collecting art or portfolio companies, Francois Rochon seeks buys that will one day be deemed “masterpieces.” His eye so far has proven sharp.

While Francois Rochon dabbled with various renditions of the value investing art early on, he arrived at the invest-in-quality end of the spectrum relatively quickly. “The way I’m wired is to invest in outstanding businesses,” he says.

Such wiring has paid off nicely for his Giverny Capital investors since the Montreal firm’s founding in late 1998. Since then his core portfolio – investing mostly in the U.S. but also in Canada – has earned an annualized 10.1%, vs. 3.8% for the S&P 500 (in Canadian dollars and after fees).

Finding opportunity in “great companies trading at fair prices,” Rochon sees upside today in such areas as used-car retailing, trucking, aftermarket auto parts and metal and electrical components.
Investor Insight: Davis Advisors

Davis Advisors’ Chris Davis and Danton Goei describe what they believe sets true “compounding machines” apart from pretenders, their hoped-for value-add in assessing management, the soul searching they’ve done after a relative-performance swoon, and why they see mispriced value in Lafarge, Wells Fargo, Encana, Ultra Petroleum and Express Scripts.

You’ve said your research process starts with asking, “What kind of businesses do we want to own?” What’s the general answer to that question?

Christopher Davis: We’re looking for businesses with high or improving returns on capital that are run by first-class management teams and that have the financial strength to weather difficult environments. Equally important is the sustainability of those returns, supported by things like strong brands, intellectual property, low costs, distribution advantages, growing end markets and limited risk of technological obsolescence. We’ll often find opportunity because the market doesn’t look out far enough to correctly value durable competitive advantages. Sometimes we’ll just perceive a business as being great that the market doesn’t – my grandfather called them “growth stocks in disguise.”

Two examples we’ve owned for a long time – related in the news of late because the nature of their relationship changed – would be Costco [COST] and American Express [AXP]. Both have produced excellent returns on equity over long periods. Both have quantifiable competitive advantages: Amex cards generate more than three times the amount of spend per card of the competition, while Costco has roughly twice the sales per square foot of other major warehouse chains. The business models are obviously different – for Amex it’s about brand, security and service, for Costco it’s about scale, low costs and low prices – but similarly durable.

The appeal of these types of businesses is their ability to compound value. If you’re going to own a company for a long time, the earnings it generates today will be a small component of the eventual return. Much more important will be how those earnings can be reinvested over time to build value. When companies with positive compounding characteristics become available at really attractive prices, we’ll hope to take advantage.

You mention the importance of first-class management. What is your – or any investor’s – value-add in judging that?

CD: There is a risk of the halo effect, where if the business has done well, everybody assumes management must be good. We try to differentiate ourselves in judging management around this idea of understanding reinvestment. You often see companies invest at increasingly lower rates of return simply to get bigger. CEOs of bigger companies, by and large, make more money, so they’ll reinvest in growth even if the incremental returns are low.

That’s exactly what we don’t want to see. We want there to be a clear understanding of incremental returns on capital and that returns matter more than size. That gets to the heart of a company’s culture, along with things like how management communicates, how they pay themselves and the accounting choices they make. What constitutes great management isn’t as universally held as you might think, and to figure it out takes quite a bit more insight than just analyzing trailing financial results.

How would you handicap the management of portfolio holding Google [GOOG]?

CD: The fact that Google has a spectacular business was obviously the result of a stunning insight by the founders, and the fact they’ve been able to capitalize on it as they have is a demonstration of good management. But what will define Google as a successful investment over the next 10 to 20 years will be how they reinvest the profits made from this extraordinarily good business they have today. We have to have insight into their ability to invest to create value over time.

Joint Effort

Though he’s known for holding what he considers “compounding machines” indefinitely, certain events give Chris Davis particular pause about even his highest conviction positions. For example, he says, “The risk increases when we see a management transition.”

His firm went through a transition of its own at the start of 2014, when Danton Goei replaced 20-year Davis Advisors’ veteran Ken Feinberg as the co-manager with Davis of the firm’s flagship New York Venture and Selected American Shares funds. With the large-cap funds’ mired in a relative-performance slump, Davis decided the risk of inaction warranted rocking the boat.

Why not take the reins alone? “The funds have been run mostly with co-managers since my father started them,” says Davis. “I prefer that because so many risks in investing are behavioral and having the right partner can help mitigate those types of risks. It requires an enormous amount of trust and the willingness to challenge each other, and Danton and I share full responsibility for every decision. We enjoy working like that and fully believe it’s in the best interest of our investors – of which my family is the largest.”
On the plus side, we very much like their long-term focus on building a durable business, not just maximizing today’s profits and revenues. They have invested to protect the moat around the search business and there’s data to indicate thoughtful reinvestment in M&A, research and development and infrastructure. Things that seemed odd at the time – acquiring YouTube for $1.65 billion, or DoubleClick for $3.1 billion, or even Android for $50 million – make a lot of sense now. We also admire that Larry Page and Sergey Brin take virtually no compensation and don’t annually load themselves up with additional stock options, which often happens in technology companies.

On the other hand, we’re not fond of the two-tier stock system and the overall disregard for shareholder input. We’re concerned, for example, by the large compensation packages granted to non-technical executives. Is that really necessary? In many areas being at Google is probably much easier than the comparable position would be at, say, General Motors. Given the strength of Google’s cash flow and balance sheet the company should also be returning capital to shareholders. So it’s not a perfect management record, but the positives outweigh the negatives.

What’s typically going on that makes quality businesses mispriced?

CD: I don’t know that there’s a “typical” situation, but opportunities do fall in some common buckets. We often look where there’s complex accounting that may cause misunderstanding about the quality of the business. We are attracted to management changes – particularly when we know well the person or people coming in – which generate uncertainty and can be a result of recent or even chronic underperformance.

We pay attention when industries are under a cloud or transforming, a classic example being the managed-care business a few years ago when everyone was scared about the introduction of the Affordable Care Act and we could buy something like UnitedHealth [UNH] at 10x earnings even though we saw it thriving long-term in almost any plausible regulatory scenario. We also try to take advantage of cyclical-ity and earnings volatility, but around a rising long-term trend rather than a stagnant one or worse.

We find sometimes that the market doesn’t recognize how scalable companies with proven records of success can be.

ON AIRLINES:
Our view is that this is still a capital-intensive, commodity business where barriers to entry are not that high.

It’s now more reflected in the stock, but a good example we own is Costco [COST] as it has transformed itself from a domestic company to more of an international one. If you earn a 15% return on capital and a 13% return on opening new stores and the saturation point is expected to be five years, the valuation changes dramatically when that saturation point because of global growth moves out to 20 years. In a similar way, investors were slow to appreciate the global potential of a number of U.S.-based Internet companies.

Spinouts continue to provide opportunity. Late last year we bought shares of Citizens Financial [CFG], the U.S. regional bank spun off by Royal Bank of Scotland. You had a large foreign bank being forced by regulators to divest its U.S. business at a time when very few U.S. banks were in a position to do acquisitions. The CEO was relatively unknown, coming over from the CFO position at RBS, and Citizens had no track record as a public company. There was 25-30% more capital in the business than it needed. All that to us indicated this was a good place to look.

Are there industries you tend to avoid out of hand?

CD: When you write off an industry because everybody knows it’s been so bad for so long, that’s often the time you should be looking. Think of energy in the late 1990s when oil was at $12 and it had been a lousy business since 1981, or of railroads until the last decade or so. The willingness to keep an open mind and take a fresh look is something we challenge ourselves to do all the time, but it never comes easily.

Speaking of long-considered-lousy businesses, have you taken a fresh look at U.S. airlines?

Danton Goei: We have, and certainly missed the run in their stocks to date as consolidation has had a very positive impact. Our view, though, is that this is still a tough, capital-intensive, commodity business where barriers to entry are not that high. We’re not convinced today’s positive dynamics will persist over time.

CD: We think the comparison here with railroads is being made a bit lightly. Airline consolidation has been powerful, but one big difference with railroads is that they own the track. Airlines’ control over routes and gates is less certain. In addition, while there are scale advantages, upstart airline competitors will likely still have the ability to cream off a route or two at a time, or they’ll start with a new fleet of planes and capitalize on the fuel-cost advantage. We’re not sure things are really as different this time as the market seems to believe.

DG: Given how we invest, it’s critical that we always challenge the assumption that a business model is carved in stone, good or bad. Our biggest sale over the past year or so has been Bed Bath & Beyond [BBBY], which we had owned for a long time. Warren Buffett has said that 20% of the S&P 500 will earn less in five years than they earn today, and the changed competitive dynamics in Bed Bath & Beyond’s business leads us to believe it very well may fall in that category. We have only the highest regard for the company and its management, but their hand has just gotten much tougher to play.
Describe your valuation discipline and its emphasis on “owner earnings.”

DG: We value companies based on normalized free cash flow, where we strip out the quirks of generally accepted accounting principles to arrive at the excess cash a business generates – or could generate – after reinvesting enough to maintain current capacity and competitive advantages, but before investing in growth. That can result in any number of adjustments, relating to things like extraordinary items, differences between maintenance capital spending and depreciation, pension assumptions or the cost of stock options.

We look out three to five years, targeting a 10% owner-earnings yield on the current stock price at some point over that period. If we believe at the point it hits 10% that the business will still have durable competitive advantages and that capital will be invested at high incremental rates, the current price can be a great starting point for us.

CD: For most companies, GAAP reporting reflects accounting policies that maximize current reportable income, say by capitalizing things that ought to be expensed, or by using depreciation schedules that are unrealistically long. For those companies our calculation of owner earnings will be less than the earnings reported. The companies we want to own, on the other hand, are those with owner earnings that are the same or higher than GAAP earnings. That’s a smaller universe, with companies that might appear optically expensive but that we consider actually quite cheap. The accounting choices made also give us insight into the management and culture.

Your large-cap portfolios hold around 60 positions. Why is that?

CD: The simple answer is that we like the benefits of concentration and focus, but we like the benefits of diversification too. Our top-20 holdings make up close to half of the portfolio, so our best ideas can make a real difference. At the same time, we’re leery of outsized positions. As a general rule, we don’t want our top five positions to exceed 25% of the portfolio.

What is your typical holding period?

DG: Annual turnover averages 15-20% over time. In the last five to six years it’s been closer to 10%. What’s going to drive our performance over time is maintaining core holdings of compounders, not from trading in and out of positions.

Have the recent travails at American Express sparked any action?

CD: To give you some color on how we think about things, American Express was founded by three people in 1852, two of whom, Mr. Wells and Mr. Fargo, a couple years later started a bank you may have heard of. Amex is a company that has shown enormous resiliency and adaptability for the past 163 years.

We don’t believe the short-term issues impacting the stock, like Costco finding another credit-card partner, take away from American Express’ core strengths and ability to compound long-term value for shareholders. What we worry more about are challenges in the future from technological change. So far the company has mostly been a beneficiary of that change as credit and debit cards take share from cash and checks, which has only been amplified as commerce shifts online. We expect the business to be as resilient and adaptable to future challenges as it has been to past ones.

DG: To your question of whether we’ve traded in the stock on the recent weakness, the answer is no. It was already a large position and remains a large position. None of this is to say we won’t sell into strength and buy into weakness. As Costco’s owner-earnings yield has fallen as low as 4%, for example, we still own it but have reduced our position. On the other hand, we’ve added to our position in Las Vegas Sands [LVS], the casino company whose shares have been hit hard.
by a sharp decline in its Macau business. We’ve concluded that while the near-term outlook in Macau overall is bad, the company still makes good money there and is less exposed to the junket-driven and VIP businesses that have fallen off a cliff. That leaves it well positioned in a high-barrier market that over time should benefit from powerful secular trends. While we wait for that to play out, we’re earning a dividend yield on the current price of over 4.5%.

Turning to specific ideas, what do you think the market is missing in cement and aggregates company Lafarge [LG:FP]?

CD: We have a long history investing in these types of companies in the U.S., having been large holders at times in both Martin Marietta Materials [MLM] and Vulcan Materials [VMC]. We like the dynamics of the business, as permitting restrictions and high transportation costs relative to the end product’s value tend to favor established players and limit competition in local markets. We’ve watched such businesses create considerable value over long periods.

Lafarge, based in France, is the world’s largest producer of cement, aggregates and concrete, with cement accounting for roughly 60% of revenue and about 80% of operating profit. The company has a poor track record of capital allocation, but one positive from excessively priced acquisitions is that it now generates roughly two-thirds of its business in emerging markets, where modernizing economies will drive strong infrastructure spending for decades to come.

We think there are a number of things helping to create the investment opportunity here. The company is merging with Holcim – the #2 to Lafarge’s #1 globally – which has engendered both controversy and uncertainty. While the U.S. recovery in cement and aggregates is underway, the business in Europe and emerging markets is cyclically weak. There’s also the legacy of lousy capital discipline, particularly on the Lafarge side.

We don’t believe the market is recognizing the potential synergies from the merger. While it’s true that scale economies don’t mean much across an entire geographic portfolio, there are plenty of centralized costs to cut and in local markets, particularly in Europe, the combination with Holcim should take out excess capacity and have a positive impact on pricing power over time. We’ve seen that happen after consolidation in the U.S.

We also think corporate governance has and will continue to improve now that around one-third of the combined business will be owned by two shareholders with long track records of smart capital allocation: Nassef Sawaris, who built competitor Orascom prior to selling out to Lafarge, and GBL, the second-largest listed holding company in Europe. There was some drama over who should run the combined company, but while we expect the new CEO to do a fine job, we think board oversight is what will really matter in the end. Having Nassef Sawaris and GBL weighing in at the board level helps reduce the execution risk.

Finally, if you believe a rebound in infrastructure spending eventually happens across a number of challenged markets, the upside is even more interesting.

How interesting relative to today’s share price of around €63?

DG: We think the cyclical improvement in the relevant developed and emerging markets gets us to an 8.5% owner earnings yield on today’s price within a couple years. When we build in the cost and other
benefits of the merger over that period, the earnings yield looks more like 12-13%. At that point we expect to own a business with attractive returns and above-average, if cyclical, growth potential.

The Holcim shareholder vote to approve the merger is on May 8. Is there risk it doesn’t go through?

DG: The benefits of the deal are considerable, so we’d be surprised if it’s voted down. A bigger risk is that to get final regulatory approval they have to make divestments beyond what has already been announced. There’s some uncertainty there, but again, if the U.S. experience is a guide, there will be plenty of opportunity to improve the competitive dynamics across a very large portfolio of businesses.

You’ve been branded, not always favorably, as a fan of big banks. Explain your enthusiasm today for Wells Fargo [WFC].

CD: I wouldn’t say we have any particularly high regard for financial stocks in general. For example, the idea to me of investing in a financial-services ETF has zero appeal. But banking today has many of the characteristics we look for. It can be complicated to analyze and there’s some subjectivity in how results are presented. Banks are difficult to make obsolete and if they’re good, they can grow for a long time without saturation.

We also like that a company’s culture, which doesn’t show up in a computer screen, can be a defining competitive advantage. Well-run banks regularly surprise on the upside, with their reserves constantly proving redundant, or their credit quality constantly better than the allowances for losses. That can make for an extremely durable business, yet there’s still a perception because of the financial crisis that it’s a very risky one to own. That provides in certain cases the last piece of the puzzle today, an attractive share price.

Wells Fargo is an excellent example of all that. If you looked at its return on equity over the past 40 years, you’d see it in the double digits probably 90% of the time, averaging 15% and never negative. Benchmark that against a quality consumer-products or pharmaceutical company, and you’d expect it to trade today at a 20x P/E, not 13x on below-normal earnings.

What in your view makes Wells unique?

CD: We basically expect its owner earnings to be more predictable and durable. That’s partly a function of its culture, which is one of focus, pragmatism and execution. Its business model is narrower than other big banks, so it has less funding risk, less capital-markets exposure and lower regulatory risk. They know what they do well and they stick to it.

Wells also benefits considerably from its size. Its market share of new loans being generated across its lending categories is almost uniformly higher than its market share of existing loans. People whose mortgages are coming due, for example, have fewer choices than they’ve historically had, so Wells is able to take share. We also pay a lot of attention to deposit density, because banks with top deposit shares in individual markets typically take a disproportionate share of the profits in those markets. Wells is #1 in deposits in...
more U.S. metropolitan statistical areas than any other large bank.

How cheap do you consider the shares at today’s $55.50?

DG: We’re expecting about $4.20 per share of owner earnings this year, resulting in a current earnings yield of 7.6%. We think that’s a great starting point for a business of this quality, which while it may be overearning a bit on credit is underearning in other areas such as net interest margin. Within two or three years we expect normal earnings of around $5.50 per share, at which point our owner-earnings yield rises to 10%.

One risk would seem to be if Wells’ return-on-equity history turns out not to be applicable to the environment going forward for banks. How do you assess that?

CD: It is true that if banks have to hold more capital, all things being equal, their returns on capital will be lower. That would depress valuation. But we believe offsetting that is that there is likely to be less competition, which should incrementally benefit returns of the biggest and best banks like Wells. We expect its incremental ROE to be 12-14%, maybe a bit below historical levels but still satisfactory. The higher capital requirements also make banks far safer investments, which should support higher valuations.

I come back to my earlier point: Compared to the average American business, Wells has well-above-average resiliency and durability, reasonable earnings-per-share growth potential and below-average risk of competitive erosion, but its stock trades at a below-average valuation. It’s really hard for me to imagine a U.S. large-cap manager who owns 40 to 50 positions not having a good-sized stake in Wells.

The dislocation in energy has attracted your interest. Why does something like Encana [ECA] go to the head of the class?

CD: The market from time to time gives us the opportunity to buy businesses that may not fit the profile of a classic compounding machine, but are so out of favor that you can see value compounding very well nonetheless. That’s true today in energy, where our focus has been on companies that due to the nature of their assets can reinvest over long periods at predictable rates of return, subject only to the energy price. That description fits Encana to a tee.

DG: The company has largely finished a transformation started in mid-2013 when Doug Suttles took over as CEO. It’s gone from a top-heavy, do-everything company focused on volumes and reserves to a leaner, highly focused one focused on incremental returns and profitability. Selling, general and administrative costs have been cut in half. Nearly 30 asset plays have been reduced to seven, including properties in the highly productive Montney and Duvernay in Canada and Eagle Ford and Permian in the U.S. Oil production is growing 20-25% annually, but natural gas currently accounts for 80% of total production.

CD: What’s transformational about shale resources is the predictability of costs and

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**INVESTMENT SNAPSHOT**

| **Encana**  
| (NYSE: ECA) |
| **Business:** Development, exploration, production and marketing of natural gas, oil and natural gas liquids from properties located in the United States and Canada. |
| **Share Information**  
| (@4/29/15): |
| Price | 14.20 |
| 52-Week Range | 10.53 – 24.83 |
| Dividend Yield | 2.3% |
| Market Cap | $10.53 billion |
| **Financials**  
| (TTM): |
| Revenue | $8.02 billion |
| Operating Profit Margin | 29.5% |
| Net Profit Margin | 42.3% |
| **Valuation Metrics**  
| (@4/29/15): |
| ECA  
| S&P 500 |
| P/E (TTM) | 2.8  
| Forward P/E (Est.) | n/a  
| **Largest Institutional Owners**  
| (@12/31/14): |
| Company | % Owned |
| Davis Advisors | 5.3% |
| RBC Global Asset Mgmt | 4.7% |
| Caisse de Depot et Placement | 3.3% |
| Manning & Napier | 3.0% |
| TD Asset Mgmt | 2.7% |
| **Short Interest**  
| (as of 4/15/15): |
| Shares Short/Float | 2.0% |

**ECA PRICE HISTORY**

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**THE BOTTOM LINE**

Given the quality, nature and size of its reserve base, the company can continue to reinvest cash flow at 20% returns on equity for a long time, says Chris Davis, driving long-term profit growth that isn’t reflected in the current share price. On the normalized $1.50 in EPS he expects within five years, the shares today trade at an earnings yield of 10.5%.

Sources: Company reports, other publicly available information

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April 30, 2015  
www.valueinvestorinsight.com  
Value Investor Insight  
7
the ability to turn on and off production spending based on prevailing energy prices. Just those four plays Danton mentioned represent about 8,000 drilling sites, in proven formations, which is about 20 years of activity at the current run rate. So in our analysis we can have high conviction on both the production levels and costs, and then just swing prices around to understand sensitivities.

The transformation effort included two poorly timed acquisitions of U.S. assets last year. Didn’t that give you pause?

CD: There’s no question they bought at the wrong time, which became doubly negative when they had to raise equity capital because the debt they put on at higher oil prices became riskier at lower oil prices. That’s a real black mark, but it’s been outweighed in our minds by the asset quality, the long-lived reserves, the predictable rates of return and the strength of the operational execution.

With the shares at a recent $14.20, how are you looking at valuation?

CD: If we use $4 gas and $60 oil, we estimate owner earnings two to three years out at around $1.05 per share. At the longer-term market-clearing prices we expect of closer to $5 gas and $75 oil, that EPS number goes to over $1.50.

So the way we look at it, the earnings yield on today’s price is unlikely to go much under 7% and is more likely to be 11-13% five years out. So we have plenty of staying power on the downside and what we think is a nice option on the upside. With proven reserves in proven fields with proven infrastructure, we think they can continue reinvesting cash flow at 20% returns on equity for a long time.

Is your thesis for Ultra Petroleum [UPL] similar?

CD: Ultra is basically a more concentrated version of Encana. The strategy is even more narrow, focused almost exclusively on gas and on one field, 47,600 acres in the Pinedale in southwestern Wyoming. The field is low-cost – returns at $4 gas are over 30% on the capital they need to deploy – is hooked up to great infrastructure, and is only about 35% developed. That means that like Encana, Ultra has many, many years of profitable and predictable production growth ahead.

DG: We didn’t mention this earlier, but we don’t ascribe to the conventional wisdom that natural gas is forever doomed to stay at current prices. The supply side continues to correct sharply, and while it will be slower, we believe demand for natural gas will materially increase as well. We own shares of OCI N.V. [OCI:NA], a Netherlands-based fertilizer company that has spent heavily to build capacity in the U.S. to take advantage of low prices for natural gas, its primary input. You see that type of thing happening in a variety of industries and we believe will help drive North American gas prices higher long-term.

So we’re particularly interested in producers that are still profitable at low prices and have the greatest upside in a higher-price environment. The market is less likely to pay up for that when “everyone knows” natural gas is in oversupply.
Is Ultra’s stock, now $16.35, cheaper or more dear than Encana’s?

CD: Ultra is a bit higher risk, with higher debt and very little resource diversification. We believe the incremental returns are higher as well so we’d probably pay a higher valuation, but we don’t need to.

Using the same base estimates of $4 gas and $60 oil, two to three years’ out we estimate per-share owner earnings at around $1.35. That would give us an 8.3% earnings yield on today’s price, but we could imagine that at 12% within five years and then doubling from there over the next five years. That’s what can happen with 30% incremental returns on invested capital.

Describe your investment thesis for Express Scripts [ESRX].

DG: Our healthcare exposure historically was mostly through large-cap pharma, where we liked the research intensity, the intellectual property and, of course, the growing demand both from aging populations and developing countries. But in recent years we’ve concluded the opportunity as a healthcare investor will be more in companies focused on helping control costs. In the U.S., healthcare spending accounts for nearly 18% of GDP, a huge gap over Europe at 10-11% and developing countries in the 5-6% range. Firms that benefit from and contribute to cost control in the system – including big managed-care organizations, third-party lab operators and pharmacy benefit managers [PBMs] – should be well positioned.

PBMs manage the drug benefits offered by managed-care organizations, large corporations and government payers. That involves any number of policy-setting and administrative tasks, but also means negotiating supply agreements and prices paid to drug manufacturers, distributors and pharmacies. Scale in such a business is extremely important both in terms of cost efficiency and buying power, and Express Scripts is the biggest U.S. player in a market in which the top three – CVS Caremark and UnitedHealth are the others – control around 70% of the business.

CD: I would emphasize that we like investing in companies that take cost out of the system in ways that don’t feel offensive to the end user. There are sometimes sensitivities around things like pushing a generic substitution, but by and large the efforts a PBM like Express Scripts makes to save money for its customers and their end users are considered win-wins. If getting your prescription filled through the mail under Express Scripts’ direction saves money and everyone shares in that, that’s not overly controversial.

This is also a good example of a business that is able to grow without spending that much capital. Earnings for several years have compounded at more than 20% per year, but the company at the same time is returning a significant amount of cash to shareholders. Over the last four years it has bought back 7-8% of its shares each year.

The shares, now around $85, have doubled since the height of the healthcare-reform fears in 2011. What upside do you see from here?

DG: We estimate 2015 owner earnings at around $5.40, so the stock trades today.
at a below-market P/E of less than 16x. If EPS grows as we expect over the next two to three years at 12% or so annually, we'll get to an earnings yield on today's price of around 7.5%. While that's not remarkably cheap, we consider it attractive for a market leader in a non-obsoletable business where size matters and where it should benefit from secular tailwinds for many years to come. This is the type of compounder we could see holding onto for a long time.

When we first spoke [VII, May 31, 2007] you were proud of your flagship large-cap fund beating the S&P 500 in every 10-year rolling period since 1969. Talk about the soul searching that's gone on as that winning streak has been broken.

CD: We've always had two goals, protect our shareholders’ capital by producing positive absolute returns, while also providing above-market returns on average over time. Over the past four or five years we've done a great job with the first goal, but haven't lived up to our standards on the second.

The first point I'd make is that having excellent absolute results and lagging relative results is neither a new or particularly uncomfortable position for us. We operate in a world where given the choice of producing a 4% return when the index earns 3% or producing a 12% return when the index earns 14%, most managers would probably choose the first one. Their goal is to get a lot of assets under management and to do so you want to beat the benchmark. We absolutely expect over time to beat the benchmark, but would much prefer in any given year to earn the higher return for our clients.

Against the benchmark we've been hurt more by what we've chosen not to own doing well than by what we've owned doing poorly. We have generally steered clear of companies with high leverage ratios, which have benefited from low interest rates but risk significant problems if the environment changes. We have avoided companies with high dividend yields because of their below-average growth rates and above-average valuations as the market irrationally overpays for yield. As is often the case in longer bull markets, we rarely own the market darlings because we question the long-term durability of their competitive advantages.

What would greatly concern me is if we owned too many things that destroyed value. But that hasn't been the problem, it's been not owning enough of the things that have done well for what our analysis, judgment and discipline tell us are temporary reasons.

History gives us comfort here. Since 1969 the Davis New York Venture Fund has underperformed in 30% of all five-year periods. But in the five years that followed these disappointing periods, the fund beat the market by an average of 6.8% per year. We're don't assume the current environment is the permanent state of affairs.

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The Reviews Are In...

“I learned the investment business largely from the work and thinking of other investors. *The Art of Value Investing* is a thoughtfully organized compilation of some of the best investment insights I have ever read. Read this book with care. It will be one of the highest-return investments you will ever make.”

William A. Ackman, Pershing Square Capital Management

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Leon G. Cooperman, Omega Advisors

“I often judge a book by how many times I get my highlighter out and dog-ear pages. On that metric, this book is wonderful – simply packed with insight from some of the best long-term investors. Everyone will learn something from this book.”

James Montier, GMO

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Investor Insight: Francois Rochon

Francois Rochon of Giverny Capital explains how he tries to keep his investing process relatively simple, how he’s responded to making too many errors of omission, the “rules” he tells investors to help them maintain perspective, and what he thinks the market is missing in Precision Castparts, CarMax, LKQ Corp., Knight Transportation and Ametek.

You’ve described your circle of competence as “not that large.” Explain why.

Francois Rochon: I quote all the time the Warren Buffett saying, “If a company has a lousy past and a great future, we’ll miss it.” We start with companies that are highly profitable, have sustainable competitive advantages and are run by honest, competent and shareholder-focused managers. We look for simple businesses that we can understand and where we believe the companies ten years from now will be selling the same basic products and services they are today. We also believe they have the potential to grow earnings and intrinsic value at twice the rate of the average company over the next five years. You can imagine that results in a fairly narrow opportunity set.

To give some examples, we’ve owned O’Reilly Automotive [ORLY] for more than ten years, and while it has almost quadrupled its number of stores over that time, it’s basically the same auto-parts business now that it was then. CarMax [KMX] sells used cars in almost exactly the same way it did when we bought it eight years ago, but it has almost tripled its revenues. I’m not saying the products and services are unsophisticated or easy to provide. Precision Castparts [PCP] sells very sophisticated products to world-class manufacturers, for example, but it’s relatively easy to understand what they do and whether they have a competitive advantage or not.

What we try to avoid is everything that is commodity in nature, particularly related to natural resources. We don’t like things that are overly regulated by the government, so we avoid utilities and certain types of healthcare businesses. We will invest in technology, but we avoid companies that are difficult to value because they have to reinvent themselves all the time.

Can you elaborate on that last point? What type of technology business qualifies and what doesn’t?

FR: We own Google [GOOG], for instance, because we consider it mostly an advertising company that is by and large in the same business today that it was 15 years ago. Compare that to Apple, which of course has been a phenomenal success, but its revenue mix and product makeup are much different today than they were five or ten years ago. It was very hard ten years ago to predict how well Apple would do, and it’s still hard to predict where it will be ten years from now. The prospect of rapid change is not something we embrace as investors.

We’ve historically shied away from software companies for that reason, but in recent years as the sector has matured, we’ve increasingly found companies to own with what we believe are stable product lines and durable competitive advantages. The most recent example is a Toronto company called Constellation Software [CSU:CN]. It was founded in 1995 and has been very disciplined in assembling, primarily through acquisition, a number of specialized software products with high market shares serving a variety of vertical markets. We also consider its CEO, Mark Leonard, a truly exceptional businessman. Even in going for the first time through Constellation’s financials and investor communications you’re struck by the transparency, the focus, the humility and the authenticity. We’re not being sold, but are treated like partners.

How did you arrive at your focus on incremental growth potential?

FR: Since I started managing my own portfolio, the return has been roughly 5% higher than the S&P 500 on an annual basis. That’s almost entirely because the
companies we’ve owned have grown their earnings at 5% per year better than the average S&P 500 company. Rather than trying to time the market or to predict economic or political trends, that’s how we’ve chosen to try to meet our performance objectives. It sounds simple to say, but of course isn’t so simple to do.

Focusing on incremental growth was just the most natural way for me, probably since I first read Warren Buffett’s annual letters and Philip Fisher’s Common Stocks and Uncommon Profits more than 20 years ago. I’ve also been influenced in that regard by Peter Lynch, who always emphasized understanding what makes a great business over what constitutes a great stock price. My capitalist antennae are always up for special businesses that have enduring qualities.

Strong growth can be a result of cyclical or operating turnarounds. Does that type of growth potential attract your interest?

FR: Typically not. We focus more on companies that can combine healthy organic or acquisition-related top-line growth with operating leverage. We also don’t like to count on P/E-multiple expansion to meet our return objectives. If the growth is more a function of “getting back to normal,” the earnings may rise, but chances are the P/E will be lower, taking away from our return. Part of our success rests on judging correctly which companies will keep their P/E because they deserve to.

Despite your living in Montreal, you have tended to invest mostly in the U.S. Why is that?

FR: Part of it is proximity, making it easy for us to experience first-hand what a company does and why it might be unique. I would also say that the U.S. is just the best environment for capitalism and entrepreneurialism in general. We often look at simple and boring businesses, but even in those there’s a constant drive to improve and innovate and create value. That should be common everywhere, but it isn’t.

Last time we spoke [VII, August 27, 2010], you made the case for a giant company like Disney [DIS] as well as relative pipsqueaks like MTY Food Group [MTY:CN] and Bank of the Ozarks [OZRK]. Do you have a cap-size sweet spot?

FR: We will look at every size company, but I would say our focus is probably in the $2 to $12 billion market-cap range. They’re big enough to have well proven their business model, but still have plenty of room to grow and, hopefully, haven’t yet gotten stodgy and bureaucratic.

When do you consider a stock attractively priced?

FR: Our valuation discipline is simple. We estimate what we believe a company can earn in five years and then apply the P/E we think the market should give it. If the resulting price is at least double the current share price – which would give us a 15% annual return – we’re willing to buy.

As I mentioned, while we look to avoid cases where the P/E might contract, we’re rarely counting on P/E expansion either. The P/E ratio of our portfolio is very similar to the P/E ratio of the S&P 500. Since we believe we own superior companies with enduring superior growth prospects, that to us means they’re undervalued.

We assume you’re not a particularly active trader of your portfolio.

FR: We typically hold 20 to 25 positions and our average holding period is close to seven years. While we’ll cut back on a position that gets over 10%, for the most part our position sizing is a Darwinian process. We usually let our winners run, creating bigger positions, while those that are disappointing become relatively smaller. You mentioned earlier Disney, MTY Food and Bank of the Ozarks, all of which have done extremely well over the past five years and that we still own. Disney and Bank of the Ozarks are now top-five positions because we have kept most of our shares over the years.

When a company’s fundamentals deteriorate, I rarely sell right away, but I also don’t add more money. IBM [IBM] would be an example. We bought a stake a few years ago and results have been disappointing, particularly last year. We’ve kept our shares because the stock seems very cheap and we believe IBM can get back on at least a moderate growth path and will buy back a lot of shares. But we haven’t bought on weakness. As Peter Lynch says, you won’t improve results by pulling out the flowers and watering the weeds.

Our average holding period is actually increasing. I’d like to think that’s because we’ve improved our selection process and we’ve been a little more right than we used to be about identifying great businesses with enduring business models. If that’s true, it pays to be patient. I mentioned O’Reilly Automotive earlier, which we first bought in August of 2004. Four years later the stock had gone nowhere, but eventually it started to reflect the significantly higher earnings power of the business. This is one we’ve trimmed over the years, but since our first purchase the stock price is up more than 10 times.

You’re always fully invested. Why?

FR: One reason is that we’re always finding enough to buy that we like. The other main reason is more philosophical. We want to own producing assets and stocks have been a winning strategy for doing that in the long run. The S&P 500 trades at 17-18x, depending on what you’re using for earnings this year. That’s close to the historical norm. So if earnings grow 6-7% on average per year in the future as they have over the last 50 years, that plus 2% in dividends would result in an
INVESTOR INSIGHT: Francois Rochon

8-9% average annual return for the S&P. That’s OK, and certainly better than what you might expect from some other asset classes. If we continue to find companies that we believe can do five percentage points better than that on an annualized basis over many years, why would we hold cash?

What do you think the market is missing in Precision Castparts [PCP]?

FR: Precision Castparts manufactures complex components used in aerospace, power, energy and other industrial applications that require those components meet strict tolerances and perform under harsh conditions. Around two-thirds of the business is in aerospace, where its products are throughout the aircraft, in door frames, wing beams, stabilizer parts and particularly in engines. This is a market in which reliability and product performance is extremely highly valued, so once you’re established with a Boeing or a Rolls Royce or a GE, it’s very hard to be displaced. One of our investors told us his son, who works for an engine maker, often says it’s a bit difficult negotiating with Precision Castparts because it doesn’t budge on pricing and his firm has to accept that since there aren’t many alternatives. That of course is music to our ears, and explains why the company is able to generate net margins in the high-teens, very high for an industrial company.

The stock is now trading at a low historical P/E, primarily because 15% or so of the business is tied to energy-infrastructure spending that is expected to be down considerably this year. We believe that’s a short-term issue and that the long-term fundamentals for the overall business remain quite strong. The aerospace industry should continue to grow at above-GDP rates, and the constant drive for more-efficient engines and high-performance aircraft plays to the company’s strengths in providing high-end product solutions. Management also has proven to be very smart in making acquisitions to enhance or broaden the product portfolio, an opportunity we consider ongoing.

How inexpensive do you consider the shares at a recent $207?

FR: The stock trades today at 15.6x our $13.30 EPS estimate for this year, the lowest multiple it’s had since the financial crisis. While we’re not counting on the 20% annual earnings growth the company has had over the past ten years, we believe through organic growth and acquisitions that 12% or so is achievable. In five years that would result in close to $24 per share in earnings. It’s often not the case, but here we also expect the P/E ratio to go higher, as a company of this quality should not trade at a below-market multiple. If the multiple gets back to 18x, we’d have in five years a share price around $430.

You’ve been a long-time holder of CarMax [KMX]. Why do you still like its investment prospects?

FR: We talk about trying to find unique businesses, and this is one that has really revolutionized the used-car industry. In an industry where brand reputation was almost non-existent, CarMax created a national brand known for offering fair

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INVESTMENT SNAPSHOT

Precision Castparts (NYSE: PCP)

Business: Global manufacturer of complex metal composite parts sold to OEMs serving primarily the aerospace, power-generation and energy-infrastructure industries.

Share Information (@4/29/15):

- Price: 206.95
- 52-Week Range: 186.17 – 275.09
- Dividend Yield: 0.1%
- Market Cap: $29.34 billion

Financials (TTM):

- Revenue: $10.10 billion
- Operating Profit Margin: 28.2%
- Net Profit Margin: 18.6%

Valuation Metrics (@4/29/15):

<table>
<thead>
<tr>
<th>PCP</th>
<th>S&amp;P 500</th>
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<tbody>
<tr>
<td>P/E (TTM)</td>
<td>16.0</td>
</tr>
<tr>
<td>Forward P/E (Est.)</td>
<td>16.3</td>
</tr>
</tbody>
</table>

Largest Institutional Owners (@12/31/14):

- Capital Research & Mgmt: 1.8%
- T. Rowe Price: 8.4%
- Vanguard Group: 5.3%
- State Street: 4.2%
- BlackRock: 3.9%

Short Interest (as of 4/15/15):

- Shares Short/Float: 2.5%

PCP PRICE HISTORY

THE BOTTOM LINE

Though its stock has been hurt by modest exposure to energy-infrastructure spending, Francois Rochon believes the company is capable through organic growth and acquisitions of increasing profit at a 12% or so annual clip over the next five years. At 18x his 2020 EPS estimate of $24, the shares would trade at more than double today’s price.

Sources: Company reports, other publicly available information
prices on trade-ins, fair, no-haggle prices on sales, valuable warranties and superior customer service. That model has proven to be very hard to replicate.

We think the story only gets better over time. When I first bought into the company in 2007 it had roughly 2% of the market. After eight years of strong growth it should have maybe 160 stores by the end of the year and that market-share number will be pushing 5%. Clearly there is still much more share to grab.

At the same time, as CarMax gets bigger, its availability of cars improves and it is able to invest gains in operating efficiency both in lower prices to consumers and further building the brand. People buying or selling cars want to deal with people they trust, and every year that goes by should establish CarMax further as the trusted industry brand. It’s not that easy to find a company that you believe can grow 15% per year for at least the next decade.

How do they achieve that level of growth?

FR: The current plan is to open something like 15 stores per year, which should produce 8-9% annual top-line growth. As existing stores gain further traction, we’re expecting 4-5% annual growth in same-store sales. Add in a little margin improvement and we arrive at 15% growth in EPS per year.

At today’s share price of just under $69, are you paying a rich price for that kind of potential?

FR: The stock trades at around 23x our 2015 EPS estimate of $3.03. That’s almost exactly the same multiple at which we bought it eight years ago, when we also thought earnings per share would grow 15% a year. We think the P/E is fair, and if the company does as well as we expect over the next five years, that same P/E will be fair five years from now. That would mean we’d benefit as shareholders from the full extent of the earnings growth.

Does cyclicality worry you here?

FR: The stock price didn’t reflect this at the time, but CarMax’s business was actually pretty resilient during the financial crisis. It makes sense in many ways, as you’d expect used-car sellers to gain market share in bad economic times, but it was nonetheless very reassuring for me to see how the company fared in the recession.

This has provided a good lesson in sticking with your conviction when the market’s short-term view challenges it. We’ve made three and half times our money on our first CarMax purchases, but had at one point, in late 2008, to live through a 70% drop in the share price. Thankfully that type of thing doesn’t happen often, but when it does you have to be able to bear it.

Do you see similar upside potential for auto-parts supplier LKQ Corp. [LKQ]?

FR: This is also a unique company that in many ways has revolutionized its industry. LKQ means “like kind and quality,” which refers to the refurbished and aftermarket auto parts the company provides to auto-body shops providing collision and mechanical repair. It buys used and salvage vehicles and strips them for parts

**INVESTMENT SNAPSHOT**

<table>
<thead>
<tr>
<th>CarMax</th>
<th>Valuation Metrics (@4/29/15):</th>
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</thead>
<tbody>
<tr>
<td>(NYSE: KMX)</td>
<td>KMX</td>
</tr>
<tr>
<td><strong>Business:</strong> Retailer and wholesaler of used vehicles, operating through 146 stores in 74 markets throughout the U.S.; selling emphasis on “low, no-haggle prices.”</td>
<td><strong>P/E (TTM):</strong> 25.2</td>
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<tr>
<td><strong>Share Information (@4/29/15):</strong></td>
<td><strong>Forward P/E (Est.):</strong> 22.8</td>
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<td><strong>Price:</strong> 68.76</td>
<td><strong>Largest Institutional Owners (@12/31/14):</strong></td>
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<tr>
<td>52-Week Range: 43.00 – 75.40</td>
<td><strong>Company</strong></td>
</tr>
<tr>
<td>Dividend Yield: 0.0%</td>
<td>T. Rowe Price</td>
</tr>
<tr>
<td>Market Cap: $14.36 billion</td>
<td>Vanguard Group</td>
</tr>
<tr>
<td><strong>Financials (TTM):</strong></td>
<td>Primecap Mgmt</td>
</tr>
<tr>
<td>Revenue: $14.27 billion</td>
<td>Davis Advisors</td>
</tr>
<tr>
<td>Operating Profit Margin: 6.8%</td>
<td>State Street</td>
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<tr>
<td>Net Profit Margin: 4.2%</td>
<td><strong>Short Interest (as of 4/15/15):</strong></td>
</tr>
<tr>
<td><strong>KMX PRICE HISTORY</strong></td>
<td>Shares Short/Float: 6.0%</td>
</tr>
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</table>

**THE BOTTOM LINE**

While its innovative operating model has allowed it to create an unsurpassed national brand, the company still has a long runway for profitable growth in a highly fragmented market, says Francois Rochon. Assuming the stock earns the same P/E in five years as today, he expects earnings growth to lead to a doubling of the share price over that time.
it can recycle and refurbish. It also buys and resells parts from non-OEM suppliers in Asia. Prices vary, but LKQ’s parts often sell at 25-60% lower than the comparable OEM versions.

Insurance companies, who pay for most collision repairs, love them and LKQ has used its price leadership and an aggressive acquisition plan over time to become the only player in the U.S. with a national network. That’s a significant barrier to entry in a market where parts availability is so important.

Over the few last years LKQ has extended its proven model outside the U.S., expanding primarily in Europe through acquisitions in the U.K., Belgium, France and the Netherlands. Those markets were for the most part even more fragmented than in the U.S. and the company has gained traction relatively quickly, to the point where non-U.S. revenues today account for around one-third of the total.

**Why do you consider the stock attractive at today’s price of $25.25?**

**FR:** The stock has been relatively weak lately for two main reasons. One, given the large non-U.S. presence, is the impact of the strong dollar. The second is a sharp decline this year in scrap prices, which has an effect because roughly 10% of revenues come from selling material left over as scrap.

Those two things may limit earnings growth somewhat this year – we’re estimating $1.42 per share in EPS, up 12% from last year – but we don’t believe diminish the potential for at least 15% annual growth over the next five years, primarily driven by the international side of the business. If the multiple stays at today’s 18x, we’ll meet our return goals if growth comes in as we expect. While we’re not counting on it, there is potential for the P/E to expand again once the short-term issues pass.

We saw LKQ’s CEO quoted in an article about driverless cars and how their success could one day put a crimp in the company’s accident-reliant business model. Is that a concern?

**FR:** Given the time frames involved for something like that to have an impact, I can sleep OK at night with that risk. This has proven to be a pretty stable business over time and I don’t expect that to change anytime soon.

From auto parts to trucking services, describe your investment case for Knight Transportation [KNX].

**FR:** Knight is generally regarded as the best-in-class trucker in the United States. It focuses on more-profitable short and medium-length hauls, has among the most modern and competitive fleets, and is a clear leader in efficiency and cost control. Its operating ratio – operating expenses as a percentage of revenues – has averaged 83% over the past ten years, well below most competitors and resulting in company net margins that are roughly twice the industry norm.

We had owned this before, but got interested again in January when the company named its president, David Jackson, to be CEO. It didn’t signal a dramatic shift in strategy or execution, but we just believe...
he has a particularly well-articulated view of the company’s path forward and how to get there. It’s actually quite interesting that he took the place of Kevin Knight, one of four cousins who control around 25% of the stock and who will remain as chairman of the board and now focus in an operating role on strategic growth. He basically concluded that David Jackson would be a better CEO and stepped aside to take advantage of that. You don’t see that very often.

We wouldn’t think you’d find the trucking industry overly attractive.

FR: I’m not the biggest fan of the industry in general, given the high fixed costs, significant price competition and relatively high cyclicality. But even such industries can have leading players that do such a good job that they can make for successful investments – I refer to them as oases in the desert. Knight was hurt in the most-recent recession, but earnings only went down something like 10% in 2008 and another 10% in 2009. They keep costs low and the balance sheet strong, which generally allows them to improve their long-term position when there are short-term headwinds.

That said, we particularly like David Jackson’s emphasis on diversifying in less-cyclical but related areas such as logistics, strongholds of companies like C.H. Robinson and Expeditors International. He wants to deliver the best complete solution to customers, even when Knight may not be a viable choice every step of the way. That’s an unusual and we think smart way of looking at things. Logistics services now makes up almost 25% of revenues, but we think it one day can be 50% of the total.

I should probably mention that lower fuel prices – which incrementally benefit truckers over railroads – isn’t a big part of our thesis. It may have some short-term impact, as it probably did in a very positive first quarter, but it’s not something that we’re counting on as a longer-term benefit.

At just under $30, the stock trades at 20x this year’s $1.50 consensus EPS estimate. Are you again counting on growth to make that look cheap?

FR: It’s sounding a bit repetitive, but we think earnings can grow here as well at 15% per year over the next five years. That’s from 4-6% annual growth in trucking and 20%-plus annual growth in logistics. The current multiple is pretty much in line with where it’s been historically, so if we’re right on earnings, we’re willing to assume the multiple will at least be the same five years from now.

Trucking companies have been dealing with a driver shortage and more-restrictive hours-of-service regulations. Could either or both of those throw Knight off track longer term?

FR: Both are important because they can put pressure on productivity. Knight is probably less impacted because its shorter routes make it more attractive to drivers for lifestyle reasons as well as less likely to run up against new hours-of-service limits. We’ll keep an eye on them, but we don’t consider these big barriers to success going forward.
INVESTOR INSIGHT: Francois Rochon

Ametek [AME] is one of the bigger market-cap companies – more than $12.5 billion – we’ve heard almost nothing about. Is that part of its appeal?

FR: When we find companies we consider undervalued, it’s typically due to short-term worries we believe are temporary. Sometimes, though, it’s more because the business isn’t very exciting and the company isn’t very well followed. Ametek is an example of that.

The company sells a wide range of products, many of which are used to monitor, test, measure and power any number of industrial processes. It has dozens of divisions, which often have leading positions in niches where there aren’t a large number of competitors and switching costs are high. The portfolio is well diversified by industry as well as geographically, with 55% of revenues coming from outside the U.S. In important ways it’s a bit like Danaher [DHR], though smaller and a bit more focused.

Explain more the Danaher comparison.

FR: One would be Ametek’s focus on operating effectiveness, evidenced by its variety of Six-Sigma-type approaches to streamline manufacturing, speed up product development and generally increase margins. In 2014 the company says it realized $100 million in cost savings from various “operational excellence” initiatives, particularly involving global sourcing and procurement. It expects to take out another $110 million in costs from similar initiatives in 2015.

Ametek is also like Danaher in counting on a disciplined acquisition plan to help fuel growth. In 2014 it spent $575 million to acquire five businesses that added $285 million in new revenue. But it’s not just an acquisition machine. Last year it also invested more than $200 million in R&D. Products launched within the previous three years accounted for 23% of total 2014 revenues.

Overall results have been quite impressive. The return on equity is close to 20%. Net margins have increased from 10% to nearly 15% over the past ten years, and we believe they could get as high as 20% over time. Management expects to double revenues and profits in the next five years, which we believe is plausible from organic growth, acquisitions and continued margin improvement.

Doubling profits over the next five years would – surprise, surprise – reflect 15% annual EPS growth. Is the multiple at today’s $52.40 share price at a level where you’d expect all that upside to translate to the stock?

FR: The shares currently trade at less than 19x our $2.80 estimate for earnings per share this year, which adds back some intangibles amortization. We believe a 19x multiple makes sense today for a company with this level of profitability and growth profile. We can’t be sure it will make sense in five years, but we believe it will. They can execute on this plan for many years to come.

You dedicate a section of each of your annual letters to mistakes, often citing those of omission rather than commission. Why is that?
FR: Even though they don’t show up on our statements, errors from not buying something are often much more costly than errors on something we bought. Maybe an error of commission results in a stock that’s down 20-30%. Most of the errors of omission I cite are cases where I didn’t pull the trigger and missed a 400-500% run or even more.

Give an example.

FR: I could have cited Stericycle [SRCL] as a mistake every year for the past 12. When I first heard about it in 2002 from a portfolio-manager friend of mine, it struck me as just my kind of thing. It collected medical waste, a messy and unexciting business that tended not to attract competition and wasn’t overly affected by technological change. The problem was the stock traded at 29x forward earnings, which was higher than I wanted to pay, even though I thought it could grow at a very high rate for a very long time. So what happened? Earnings have grown at an annualized 18% rate since, the multiple today is still 29x, and the stock has gone from $16 to $134. I never did, but had I purchased it at just about any time in the last 12 years, I would have been happy.

Everyone has stories like that and you can’t beat yourself up over them. I would say, though, that having had that happen a few too many times, I’m now probably willing to pay a bit higher price for a company I believe is exceptional and has a particularly promising future outlook. I don’t at all throw caution to the wind, but a willingness to pay from time to time a slight premium to where the average company trades has helped me avoid some costly mistakes.

On the subject of adversity, you have detailed a “Rule of Three” for your investors. What does that consist of?

FR: We tell this to investors to help them maintain perspective, but it’s good for us to keep in mind as well. The first rule is to expect markets to go down 10% at least once every three years. The second rule is to expect one stock out of three that we purchase not to work as well as expected. The third rule is to expect us, even if we’re very good, to underperform the index at least once every three years. So far, those rules have proven to be pretty much right.

The point is to accept that things are not always going to go your way. So when they don’t, you can more easily ignore the pressure to change your strategy toward whatever’s working at the moment.

Another thing I took from Peter Lynch was the importance of being pragmatic and humble. When things didn’t work out for him, it wasn’t the end of the world. He wasn’t obsessed with proving he was right and just sold and bought something else. There’s a lot of wisdom in that.
Lease to Own

Value investors have a hard time coping with success, itching to sell when a stock has been on a glorious run. For the second time in five years, Andrew Wellington argues why that would be a mistake in AerCap Holdings.

When Andrew Wellington of Lyrical Asset Management last made the case for AerCap Holdings [VII, March 31, 2010], shares in the aircraft-leasing company had nearly quadrupled since he bought them during the financial crisis. Yet he was confident that high demand for the company’s growing fleet of mostly narrow-body, fuel-efficient planes would drive earnings and the share price higher. Investors scared away by the stock’s big move, he said, “are missing a great opportunity.”

Bingo. Fueled by a continued secular shift by airlines toward leasing, high demand from developing markets, an overall economic recovery and the purchase of AIG’s International Lease Finance Corp. – “the most-accretive acquisition I’ve ever seen,” says Wellington – AerCap’s stock continues to fly high, quadrupling again over the last five years to a recent $46.75.

Is it time for investors to be scared? Not at all, he says. AerCap is now the industry leader with a fleet of 1,300 planes and another 380 on order, and along with GE Aviation Services it controls roughly half the global aircraft-leasing market. With a fleet larger than most airlines have, AerCap’s buying power allows it to pay lower prices for planes, a benefit it shares to make leasing a more viable option. And customers continue to take that option: 40% of the global commercial airline fleet is now leased, a number that has inexorably grown over more than 30 years.

The composition of AerCap’s fleet and the company’s expertise in managing it are also competitive advantages, Wellington says. It has the most-modern planes, attracting incremental demand as airlines pursue better fuel efficiency even as fuel costs have dropped in recent months. Newer planes also better hold their value, and AerCap has proven skilled in selling off aircraft to maximize residual value. It typically reports gains when it sells its planes, having depreciated their value below what buyers will pay.

The quality of AerCap’s fleet significantly mitigates risk as well. Credit losses have been very low, as in-demand planes that even in the worst case have to be repossessed can often be quickly re-released at good prices. “Done well, leasing airplanes to airlines isn’t as scary as you might think,” Wellington says.

Although there’s little sign of it on the immediate horizon, rising interest rates could pose a challenge for AerCap, increasing funding costs that have been at generational lows. While obviously a risk to be managed carefully, Wellington says that most of the company’s leasing contracts allow the pass-through of higher interest rates, putting more of the risk on lessees.

Despite the company’s many virtues, he argues that the crux of the investment case today rests on valuation. AerCap shares trade at only 9.2x consensus 2015 earnings estimates of $5.10 per share. That makes no sense, he says, for a company earning 15% returns on equity and that he believes through moderate top-line growth, operating leverage and share buybacks can increase earnings per share over the medium term at 10% annually. Based on his discounted-cash-flow valuation, he believes the shares are worth $75.
It’s fair to say that Brady Corp. doesn’t initially leap off the screen as a pulse quickening investment idea. Founded in 1914, the Milwaukee-based firm sells a wide variety of labels, signs, printing systems and safety devices used in workplaces worldwide. Think employee IDs, identification labels for wiring in airplanes, warning signs in manufacturing plants. Its website touts the appearance of Brady signs in the movie Jurassic Park, which premiered in 1993.

Brady's common shareholders have no voting rights – those are held by two descendants of founder W.H. Brady – and the stock is barely followed by Wall Street. That’s not particularly surprising given the share-price trajectory: over the past ten years, a period in which the S&P 500 is up 77%, Brady shares have actually declined, from just over $30 to today’s $27.

So why is Eric Heyman, co-portfolio manager of the Olstein Strategic Opportunities Fund, high on Brady’s prospects? There’s no exciting new product or bold-stroke strategic initiative, just a much-needed corporate reset underway that he expects to pay off handsomely for investors. “Sometimes the quiet turnaround is all you need,” he says.

Brady starting in the mid-2000s went on a buying binge, making 24 acquisitions from 2006 through 2013. The purchases typically made sense in solidifying a market position or expanding in a new geography, but the financial payoffs were slow in coming because integrating the new operations took a back seat to making the next deal. While overall operating margins started to decline, the company at the end of 2012 made its first blatantly bad deal, paying $300 million for Precision Dynamics Corp., a maker of ID products for the healthcare sector. In its fiscal year ending last July, Brady took nearly $150 million in impairment charges related to PDC.

The accumulating bad news led to the naming of Molex Inc.-alum Michael Nau- man as CEO last August, and his message has been straight from the back-to-basics playbook: consolidate manufacturing facilities, better manage working capital, reduce overhead costs, prioritize research and development spending, increase customer service and solidify the balance sheet. The firm’s dedicated deal team – “in my experience, not a good idea,” says Heyman – has been retired.

Not surprisingly, the market has been slow to assume the best when it comes to Brady. Heyman pegs the stock’s fair value today at $37, 18.5x his $2 per share estimate of normalized free cash flow, which adds back excess depreciation relative to actual capital-spending needs. The real upside, however, will come if CEO Nau- man is successful in increasing operating margins from less than 10% today to the 13-14% level achieved prior to the acquisition binge. “That’s not a stretch goal at all,” says Heyman, “making it a nice free option to have on the upside.”

**INVESTMENT SNAPSHOT**

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<tr>
<td><strong>Business:</strong> Provider of identification and safety products used in the industrial, construction, education and medical-services sectors.</td>
<td><strong>BRC</strong></td>
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<tr>
<td><strong>Price</strong></td>
<td>27.08</td>
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<tr>
<td>52-Week Range</td>
<td>20.98 – 30.86</td>
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<tr>
<td>Dividend Yield</td>
<td>2.9%</td>
</tr>
<tr>
<td>Market Cap</td>
<td>$1.39 billion</td>
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<tr>
<td><strong>Financials</strong> (TTM):</td>
<td><strong>Largest Institutional Owners</strong> (@12/31/14):</td>
</tr>
<tr>
<td>Revenue</td>
<td>$1.22 billion</td>
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<tr>
<td>Operating Profit Margin</td>
<td>9.9%</td>
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<tr>
<td>Net Profit Margin</td>
<td>(-5.0%)</td>
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**Short Interest** (as of 4/15/15): Shares Short/Float 3.4%

**BRC PRICE HISTORY**

**THE BOTTOM LINE**

After years focused more on completing acquisitions than actually making them work, the company’s current back-to-basics approach is both necessary and welcome, says Eric Heyman. He pegs the shares’ current fair value at $37, without assuming the significant benefit he expects over time as operating margins return to pre-acquisition-binge levels.

Sources: Company reports, other publicly available information
Tidying Up

The Life-Changing Magic of Tidying Up by Japanese decluttering expert Marie Kondo surely wasn’t written with investors in mind. A global publishing phenomenon that one reviewer calls “a mystical manifesto on letting go of the stuff we don’t need,” Kondo’s book offers a variety of specific advice on how, literally, to put and then keep your house in order. It’s typically better to fold your clothes than hang them, for example. Socks and stockings should be treated with respect and “never, ever” balled up. Her rule of thumb on accumulated papers: “discard everything.”

Beyond the how-to details, however, Kondo also offers more strategic and even philosophical guidance around lightening the load of your many possessions. One key, she writes, is to make the purging process a special event, not a little-bit-every-day occurrence:

When people revert to clutter no matter how much they tidy, it is not their room or their belongings but their way of thinking that is at fault. Even if they are initially inspired, they can’t stay motivated and their efforts peter out. The root cause lies in the fact that they can’t see the results or feel the effects. This is precisely why success depends on experiencing tangible results immediately. If you use the right method and concentrate your efforts on eliminating clutter thoroughly and completely within a short span of time, you’ll see instant results that will empower you to keep your space in order ever after.

In contemplating what stays and goes, the author counsels keeping things simple:

The best way to choose what to keep and what to throw away is to take each item in one’s hand and ask: “Does this spark joy?” If it does, keep it. If not, dispose of it. This is not only the simplest but also the most accurate yardstick by which to judge.

When coming across something difficult to discard, she suggests assessing anew the role it plays in your life:

If, for example, you have some clothes that you bought but never wear, examine them one at a time. Where did you buy that particular outfit and why? If you bought it because you thought it looked cool in the shop, it has fulfilled the function of giving you a thrill when you bought it. Then why did you never wear it? Was it because you realized that it didn’t suit you when you tried it on at home? If so, and if you no longer buy clothes of the same style or color, it has fulfilled another important function – it has taught you what doesn’t suit you.

In fact, that particular article of clothing has already completed its role in your life, and you are free to say, “Thank you for giving me joy when I bought you,” or “Thank you for teaching me what doesn’t suit me,” and let it go. You’ll be surprised at how many of the things you possess have already fulfilled their role.

Replace words like “space” and “item” with “portfolio” and “stock” and we’d suggest there’s some wisdom in there for investors. With a decluttering mindset, maybe you’ll avoid making that next less-than-well-considered buy, or holding on to a loser longer than you should. All in the name of turning a tidy profit …
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