Signal vs. Noise
The best investors adhere to fundamental principles while always learning new things, a combination readily apparent in Markel Corp.’s Tom Gayner.

Tom Gayner’s tasteful office in suburban Richmond, Virginia betrays few of the trappings of a big-time money manager. He’s co-CEO of Markel Corp., responsible for its roughly $18 billion investment portfolio, but the phone rarely rings. His work area is piled with reading material such as the latest Statistical Abstract of the United States. There’s not a scrolling market ticker in sight.

Such calm has proven a consistent environment for investment success. Over the past ten years Gayner’s equity portfolio has earned a weighted average annual return of 11.2%, nearly 500 basis points better than the S&P 500. While typically cautious, he sees opportunity today in such areas as entertainment media, asset management, food and alcoholic beverages.

On Point
Investors often run into trouble when they stray from what they know well. That’s unlikely to be an issue for John Day and his KDI Capital Partners.

Aversion to risk was ingrained early in John Day when he joined the parent of the Golden Corral restaurant chain in 1990, initially to make restaurant-company investments. “The founder’s mantra was that it’s hard to make this money, so don’t lose it,” Day says. “If something wasn’t working, I’d hear about how many meals we had to serve and dishes we had to wash to make up for the loss.”

Nicely balancing risk and reward, Day’s KDI Capital Partners flagship portfolio has earned a net annualized 11.1% since it opened broadly to outside money in 1998, vs. 5.7% for S&P 500. Targeting specific areas of expertise, he’s finding upside in such areas as drug distribution, industrial-products distribution, home-improvement retail and digital advertising.

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Investor Insight: Thomas Gayner

Thomas Gayner of Markel Corp. describes two key ways in which his strategy has evolved, how he’s able to “tune out the noise and focus on what’s really important,” why the energy sector didn’t attract his interest in its latest swoon, and why Walt Disney, Brookfield Asset Management, Diageo and Nestle so nicely fit his profile for compelling investments.

It’s been ten years since we first spoke [VII, May 26, 2006]. Would you describe today how you invest any differently from how you did then?

Thomas Gayner: I wouldn’t change a word in describing the four investment principles we follow. We’re looking for profitable businesses with good returns on capital at modest leverage, that have honest and talented management, that have reinvestment opportunities and capital discipline, and that have shares trading at fair prices.

One thing that has changed is a point of emphasis. I’m an accountant by training, and when I first started out I was most comfortable looking at financial statements and arriving at a point-in-time assessment of what I thought something was worth today relative to what it was selling for. That’s what card-carrying members of the value investing union do. But what has become more important to me is not the snapshot, but the movie. What do the characteristics of the business say about what happens next? That’s caused me to put primary emphasis on item #3, reinvestment opportunities. Business is so dynamic today that you’re either getting better or you’re getting worse. I’ve learned through painful experience that without ample reinvestment prospects, you’re generally looking at a rotting asset.

Of course it’s much more fun to buy great companies with bright prospects, so the main reason not to would be because they often cost too much. I am still very attuned to that, but at the margin I have become more willing to pay up for the good stuff.

How does your setup within Markel influence your strategy and process?

TG: I’m married to a successful insurance company that keeps putting money in its account month after month after month, and in the 25-plus years I’ve been here has never asked for a penny of it back. That allows me to invest with a far longer time frame than most, so it makes sense for me to put emphasis on durable and consistent businesses that get better over time and compound the capital we’ve invested in a tax-efficient way for the corporation. If I’m directionally correct more often than not, things should work out pretty well.

I’d also add that as part of Markel it’s easier for me to tune out the noise and focus on what’s really important to any given investment thesis. I’m not sure whether markets have gotten more volatile or not, but it sure feels that way when you have a 24-hour news cycle and stuff coming at you all the time. Couple that with the fact that most money managers are critiqued every quarter or even month on their performance and you can see why people trade a lot and time horizons keep getting shorter. I don’t have to get bogged down in any of that.

Since we first spoke, my analyst staff has gone from zero to one to the hiring of Dan Gertner probably six years ago. People ask me how I keep track of things doing so much by myself, and my response is to ask what keeping track of things means. Does it mean knowing what the March sales receipts were at Disney World and how that compared to March a year ago? For how we invest, those aren’t really the things that matter.

You’ve said that you had more portfolio turnover last year – in absolute dollars and as a percentage of the total – than you’ve ever had. Does that signal any other evolution in your thinking?

TG: That’s a very good question that requires a fairly in-depth answer. Five, ten or fifteen years ago I would have said I was not very interested in or good at investing in technology. Product cycles were too short and things in the tech world were too hit or miss for me to commit the capital we had with the time horizons we wanted. After a great deal of soul-searching, however, I concluded that technology was so fundamental to the economy that I was no longer allowed to say I wasn’t a technology investor. I needed to better figure out how to think about it in a way that worked for us.

With respect to technology we can put companies in three basic categories. At one end of the spectrum are those for which technology shouldn’t disrupt their basic economics. Here I’d put firms like Diageo [DEO], Nestle [NSRGY] or Uni-lever [UL], consumer-products businesses selling things like whisky or ice cream or soap that aren’t particularly impacted by the Internet or technological change. In the second category would be companies that are impacted meaningfully by technology, with positive and negative effects. Wal-Mart [WMT] is a good example. It’s not a technology business, per se, but on the plus side it has long benefitted from its sophisticated information-management systems, and on the negative side it faces a strong challenge from online retailers like Amazon [AMZN]. The third category would be companies where technology is both critical to their success and would appear to confer dramatic advantages going forward. The best examples: Google [GOOG], Amazon and Facebook [FB].

Coming back to the question of portfolio turnover, in the first category – the Diageos and Unilevers of the world – we didn’t change much. These companies operate in wonderful product categories that can generate solid and durable growth far into the future. This has always been a fertile area for us and remains so.

We were buyers in the third category, and at the end of the year owned core
positions in Alphabet, Amazon and Facebook. Ten years ago I wouldn’t have owned any of them, but given the winner-take-all elements of their businesses you can credibly think about how durable the franchises are and how much runway they have ahead. At the end of last year Alphabet had $73 billion of cash on its balance sheet. People say, “Oh, but a lot of that is trapped overseas,” to which I say, so what? It’s $73 billion! This is an immense cash-generating machine at the top of the food chain in the world of data, which as everything becomes more and more digital becomes more and more valuable over time. I’d also add that each of these companies has young, founder visionaries who have already demonstrated remarkable success. That fits very well with how we invest.

It’s in the second category where I became more concerned that, as Yogi Berra once said, the future ain’t what it used to be. Wal-Mart has been an incredibly well run business, but there’s no getting around the fact that Amazon has made its future course less attractive. Wal-Mart will continue to spend a lot of time, effort and money on trying to compete with Amazon online and I just don’t believe they can do it. I also think the sad truth of growing income dispersion in the U.S. doesn’t bode well for an important segment of Wal-Mart’s customer base. So while I have all the respect in the world for the company, it’s playing a tougher hand today than it used to. In thinking about the highest and best use of capital, I decided to fight the battle elsewhere.

**ON ENERGY:**

*Up to this point I would have said each cycle top would be better than the previous one. I question that today.*

I’ve followed Walgreens for as long as I’ve invested. The story has changed from when it was just growing by rolling out stores in the U.S., but we think it can play an important role in delivering healthcare at a more reasonable cost, has significant non-U.S. growth opportunities now that it’s combined with Boots, and is still a growth business in the U.S. driven by demographics. I’m not smart enough to judge which pharmaceutical companies will succeed with which drugs, but the good news with Walgreens – and CVS [CVS], which we also own – is that that doesn’t matter. I may not make as much money as I would with a “win” bet on a drug company, but I think a “show” bet on a distributor can work out perfectly well.

**What’s an example of something you sold last year that wasn’t tied to technology?**

TG: I also have tremendous respect for this company, but we closed our position in Anheuser-Busch InBev [BUD]. We’ve owned it successfully more than once, but concluded this time that the combination of, one, having to proffer some very good businesses to regulators in order to buy SABMiller, two, the continued rise of craft beer, and, three, the fact that much of any potential savings has already been wrung out of the cost structure, made the future, again, not what it used to be.

**You’ve been slow to reinvest some proceeds from last year’s sales. Why?**

TG: After setting aside money in fixed income to cover our expected future claims, we have just under $8 billion in assets for which I can make an investment decision. Since I’ve been here we’ve essentially taken that discretionary number and multiplied it by 50% to 80% to arrive at our equity allocation. If the opportunity set is attractive with lots of good ideas at great prices, we’ll be closer to 80%. If equity prices are relatively high and good ideas are relatively scarce, we’ll be closer to 50%, staying conservative and keeping some powder dry. The allocation is also impacted by what’s going on in the insurance business – the better it is the more likely we are to allocate to equities. Right now, all things considered, we’re running about 53% in equities. Getting to that has meant more selling than buying.

**Have you been at all active in energy?**

TG: Energy is something I’ve never considered an area of expertise and it tends to boom and bust more than we like. You need to have more of a trader’s mentality to be good at it, and I know that’s not my strong suit. That said, we do own some energy at the very tippy top of the quality scale, primarily Exxon Mobil [XOM] and Schlumberger [SLM], and we have not been averse to buying in the sector when things seem particularly out of favor. This time around we have not done that.

**Why?**

TG: For all of my life up to this point I would have said that despite the booms and busts, each cycle top would be better than the previous one. I know enough to know I’m probably wrong on the timing, but I question how much longer that can be the case as we start to turn the curve in figuring out alternatives to fossil fuels. I’ve been accused of being a wimp for thinking such things out loud and I may be way too soon, but that’s driving how we’ve responded to volatility in the sector so far.

**Turning to another beaten-down sector, are you finding financials of interest?**

TG: Going back to my earliest days as an investor, I invested in not one, not two, but three banks whose stocks had fallen dra-
matically and I thought I was catching the bottom, only to have them all go to zero. So I’ve always probably had less than my fair share invested in banks. That worked out pretty well during the financial crisis, but you can overlearn lessons sometimes. Just in the past few days I read Jamie Dimon’s latest JPMorgan Chase [JPM] annual letter. It’s quite an impressive letter, touching on how the company navigated the financial crisis and is positioned going forward. We have a small stake, but given how inexpensive the stock is, there’s a case to be made we should own more.

Has the market done a good job of assessing the value of Markel [MKL] over time?

TG: They’ve gotten it directionally right. When I started in 1990 the shares were below $9. Now it’s 100x that, so that sounds good to me. By any metric for Markel on a per share basis – revenue, book value, cash flow, investments per share – they have largely followed roughly the same path over 25 years that the stock price has.

It’s been 10 years since you started Markel Ventures, the division that buys ownership stakes in non-insurance businesses. How would you grade that effort so far?

TG: I’d say it’s coming into its own. Last year it reached $1 billion in revenues and it now provides a base load of cash flow to be reinvested in ways not tied to the insurance or securities markets. We haven’t gotten them all right, for the same reasons we don’t always get our public equity investments right. The world changes in ways we did not anticipate. Sometimes the people don’t turn out to be what we expected. In aggregate it has worked pretty well and we continue to learn and improve.

I believe the Ventures business helps provide a structural advantage for the corporation. If reinvestment of capital is the single biggest determinant of how well the Markel Corporation performs financially over time, it’s a positive that we have a full range of choices for that reinvestment. We can invest in a business we’re already in, run by people who have proven over long periods they know what they’re doing. We can acquire new businesses that are complementary to what we do or allow us to enter areas we believe have attractive prospects. We can buy publicly traded equity or fixed income securities. If it makes sense, we can buy back our own stock. That sort of 360-degree view is a valuable attribute.

ON VALUATION:
What I want to avoid is being directionally right about intrinsic-value growth but still making a bad investment.

You mentioned earlier a willingness to “pay up for the good stuff.” Describe for your equity ideas how you think about what you’re willing to pay.

TG: I want to pay a multiple that does not expose me to a high risk of multiple compression. Said another way, I consider a fair price today one that allows us over time to realize on our investment the same level of compound annual growth we expect in the intrinsic value of the business itself. In more normal times I’d probably say I needed at least a 10% annual return in order to commit capital. Given the level of interest rates today, for the highest quality business like a Nestle or a Unilever I might be willing to accept 8% or so.

What I clearly want to avoid is paying a price at which I can be directionally right about the intrinsic-value growth but still make a bad investment. I noticed ten years ago we spoke in our interview about General Electric, which was a case where I didn’t do a bad job of assessing how the business could perform over time, but I just paid too much for it on day one. The multiple had fallen from 40x to 25x so it felt like I was getting a deal. I obviously wasn’t.

Describe why Walt Disney [DIS] today fits your profile for a compelling investment.

TG: The primary reason is that the company is a creativity machine, operating in entertainment and media businesses that help people occupy their free time. The global demand for what it produces has been growing strongly for as long as I’ve been alive and I believe Disney is the world’s best at producing it. I don’t expect either of those things to change. Warren Buffett many years ago described the company as being like an oil well where the oil keeps seeping back in. Its ability to create intellectual property and capitalize on it over long periods of time is unparalleled.

It feels like Disney has been firing on all cylinders for years. Don’t your contrarian instincts signal caution?

TG: Yes, I have the same natural reaction. But I remember thinking that a year ago, and two years ago, and five years ago, and more than thirty years ago when I was in college. Yet somehow or another they continue to make it work. There comes a point when maybe you have to say the business is very good and these people know what they’re doing.

There are always things to worry about. There is concern about ESPN in a brave new over-the-top world in which the traditional pay-TV bundle is under threat. The bear case is well known and has key elements that are directionally correct. But I also believe ESPN will figure out what people want to watch, and that the nature of live sports and ESPN’s market position means that its economics will remain as good or better than before. It may not be a straight line up, but I like the long-term trend. And, by the way, there are movies and amusement parks and interactive games on which people will be spending increased free time and disposable income to Disney’s disproportionate benefit.

More recently people have been wringing their hands over who will replace Bob Iger as CEO when and if he steps down in the next couple of years. To show you how promising I was as an investor early on, in one of my classes at the University of Virginia we had to chose a company and prepare a detailed investment report
on it. I chose Walt Disney and I remember concluding that even though it was going through one of its periodic lulls, it wasn’t the right time to invest. I ended with something like, “Asking the successors of the Walt Disney Company to recreate the magic of Walt Disney himself would be like asking the children of Beethoven to write the 10th, 11th and 12th symphonies.” Great line, right, but just stupid and immensely wrong. This was right before Michael Eisner took the reins and had one hell of a run in charge of the company. Someone’s going to get the job who I suspect will be very talented and very good at what they do. If for some reason it doesn’t work out, they’ll fix it.

How are you looking at valuation with the shares at a recent $104?

TG: The stock today trades at a less than 18x P/E on estimated 2016 numbers and below 17x on 2017 numbers. Our view is that population growth and growth in worldwide affluence will increase overall demand for Disney products, and that the company will grow at an even higher rate than that because it operates at the top of the food chain.

From today’s level I expect the stock over five to ten years to double its current price – purely from the performance of the business, with no assumption of multiple expansion. If that happens in five years, we’ll make 15% per year. If it happens in ten years, we’ll earn closer to 7%. We’d obviously prefer the former, but in this interest-rate environment, considering our degree of confidence it will happen, the latter wouldn’t be so bad either.

If we remember correctly, you have long ties to your next idea, Brookfield Asset Management [BAM].

TG: Our relationship with Brookfield goes back more than 30 years. When Steve Markel, Tony Markel and Alan Kirshner bought out the second generation of the family in a leveraged buyout of Markel Corp., a predecessor company of Brookfield lent them money. The person who made that loan is still there and one of the senior officers of the entire company. Brookfield is what I’d call a hands-on asset management company. My dad had a partner and friend when I was growing up who started out as a mason, became a masonry contractor and then started buying real estate, usually small buildings that had something wrong with them. He knew how to fix them, either by himself or using his network of experts in the trades. It wasn’t some guy manipulating a spreadsheet in an office somewhere. That’s how I think about Brookfield, which has 70,000 people around the world who know how to run office buildings, hydroelectric dams, container ports, toll roads and any of the other assets they own and manage. They combine the intellectual firepower in determining what might be cheap with the operating capability to actually run it.

This is one of those shape-shifting companies that goes where it sees opportunity. If you look at some of the deals it has announced this year, they include buying a majority stake in a power-generation company in Colombia, taking private a shopping-mall company in the U.S. and partnering to develop a $1 billion office tower in Dubai. They have particular expertise...
in distressed investing. You asked about energy – while I’m not buying, the people at Brookfield are, know a lot more about it than I do, and are better at finding the right place in the capital structure to play.

_Barron’s_ not long ago wrote a critical piece on the company over how it marked some of its assets to market. Is that a concern?

TG: People go after Brookfield from time to time for things like that. But the company is just doing what it’s required to do under International Financial Reporting Standards, which it follows. Is there variability and uncertainty and lack of precision in the values it places on its investments? Yes, there is for any company like this. I accept that. We’ve owned the stock for 15 years and the compound annual return over that time is more than 15%. If you’re playing fast and loose with your numbers, I don’t think you can keep that going for 15 years.

How are you looking at upside with the shares currently trading just above $34?

TG: I rank order opportunities based on our expected rate of return over medium- and long-term horizons. Here the stock trades at 15x trailing earnings and I believe my rate of return on it can be a double-digit number for a long time. That seems like a reasonable price to pay for a company that has demonstrably performed and meets our four investment principles so well.

You’ve been a long-time fan of spirits maker Diageo [DEO]. Why do you consider it an attractive investment today?

TG: For all of the reasons I’ve considered it an attractive investment for a long time. My Dad was a country businessman and one of his businesses was a liquor store, where I used to help out as a kid. It’s a consistent, durable business: Johnnie Walker scotch has been around since 1820 and think about what’s happened in the world since then. Forget the rise of the Internet, that was before electricity, the automobile and the telephone! But the Johnnie Walker brand endures and still makes sense.

I talked about the importance of reinvestment opportunities and they’re plentiful for Diageo. It already has the manufacturing, distribution and marketing benefits that come from being the leading global producer of branded premium spirits, but outside of the very biggest firms the market is still fragmented and the company has plenty of opportunity through M&A to fill out its product line and further take advantage of its scale. It also is very well positioned to benefit as rising affluence around the world drives demand for what is an affordable luxury for aspirational consumers. They have an excellent history of capital allocation, going back to when its then parent company merged with Guinness twenty years ago and eventually decided to sell off businesses like Pillsbury and Burger King and double down on spirits and beer. That was a pretty good decision.

Are the U.S.-traded ADRs cheap at a recent price of $109?

TG: The shares trade at around 20x forward earnings, which isn’t necessar-
INVESTOR INSIGHT: Thomas Gayner

Diageo (US ADR: DEO)

Business: Production and distribution of alcoholic beverages worldwide under such brand names as Johnnie Walker, Smirnoff, Captain Morgan, Tanqueray and Guinness.

Share Information (@4/28/16):
- Price: 109.07
- 52-Week Range: 100.12 – 122.23
- Dividend Yield: 2.3%
- Market Cap: $68.36 billion

Financials (TTM):
- Revenue: $15.06 billion
- Operating Profit Margin: 27.8%
- Net Profit Margin: 23.5%

Valuation Metrics (@4/28/16):
- P/E (TTM): 19.4
- Forward P/E (Est.): 19.4

Largest Institutional Owners (@12/31/15):
- Harris Assoc: 0.9%
- Brown Brothers Harriman: 0.7%
- Wellington Mgmt: 0.6%
- UBS Fin Serv: 0.4%
- Columbia Mgmt: 0.3%

THE BOTTOM LINE
The company enjoys the scale benefits of being the leading global producer of branded premium spirits, says Tom Gayner, but should continue to fill out its product line and further capitalize on secular demand growth for its “affordable luxury” products. From earnings growth and dividends he expects a roughly 10% compound return on the stock.

Sources: Company reports, other publicly available information

DEO PRICE HISTORY

THE TOPIC LINES
The company enjoys the scale benefits of being the leading global producer of branded premium spirits, says Tom Gayner, but should continue to fill out its product line and further capitalize on secular demand growth for its “affordable luxury” products. From earnings growth and dividends he expects a roughly 10% compound return on the stock.

Sources: Company reports, other publicly available information

ily cheap, but also isn’t expensive in this interest rate environment for a company that can grow 6-7-8% per year for what may be decades. On top of that you have a current 2.3% dividend yield. We’ll be perfectly happy if we can compound our money in a tax-efficient manner at those sorts of rates.

Are the elements of your thesis similar for Nestle [NSRGY]?

TG: Yes. This is a company that has been around for more than 150 years and is now the largest food and beverage company in the world, operating in something like 200 countries. It has a diverse product portfolio and more than 20 of its brands – including Nestle, Nescafe, KitKat, Perrier and Purina – generate in excess of 1 billion Swiss francs [$1.03 billion] in annual revenues.

Rising living standards don’t just mean people start buying more whiskey or BMWs, a lot of it is about buying a nicer brand of ice cream or coffee, or buying baby formula for the first time. With the company’s global distribution network, its well-known brands and its financial strength to invest, it’s likely to get more than its fair share of upside from both organic growth and M&A. Like Diageo, we see it with a high degree of confidence as at least a 7-8% annual compounder.

The knock on many big food companies is that they’re out of step with the changing tastes and eating habits of a younger generation. Is that a worry for Nestle?

TG: It’s certainly a legitimate general concern, but I’d argue Nestle hasn’t been overly susceptible to that particular criticism because it’s been fairly forward-looking in adapting existing products as well as its product portfolio to broadly changing tastes and consumer wants. For example, while I don’t know if it will produce moonshot successes, the company for many years through its Health Science business has been at the forefront of advancing the role of nutrition in overall health management. That’s part of the culture of the company and I think makes it more attuned to what’s coming next.

The ADR, now at $74.35, has barely budged over the past couple of years. Are you counting on any particular catalyst to change that?

TG: I’m not overly attuned to catalysts, nor do I think I’m very good at figuring out what they are. Things do weigh on the stock from time to time. Last year there was a food-safety issue with the company’s extremely popular Maggi instant noodles in India, in which a regulator’s report said that some noodle packs contained excess levels of lead. People also worry about the impact of the stronger Swiss franc on Nestle’s reported results. These types of things fall for us in the category of temporary issues that won’t have an impact on how well our investment does over our time horizon. If they impact the share price temporarily, we’ll likely benefit because we’re in the market every month with new cash to invest in our core holdings, so we can dollar cost average into better prices.

It’s no secret that Nestle is a really good business, so the shares trade at 21x estimated 2016 earnings. We think at that
level we can realize over time roughly the intrinsic-value growth we see in the business, which would result in an 8-10% compounded annual return. For a business like this, we’ll take that all day in this market.

Given the large fixed income portfolio you also manage, do you have a strong view on interest rates?

TG: Interest rates for me fall in the category of incredibly important but also largely unknowable. Without suggesting I can forecast this to any reasonable degree, I’m comfortable concluding that interest rates are very low and I am uninterested in taking on long-duration assets at these prices. That said, for the past couple of years we kept the duration of our bond portfolio shorter than the duration of our insurance liabilities because I was worried about interest rates going up. I have since concluded that interest rates are likely to stay low for a longer period than I would have thought, so those durations are now basically in balance.

On the equity side, the level of interest rates is one factor in our having only 53% of the investable portfolio in stocks. If interest rates go up, I suspect equities will get cheaper and we want to have the money to buy them. There’s some opportunity cost in that, but that’s okay. You have to be thoughtful about it and recognize your ability to predict is limited, but you should also be responsive to price signals, and those tell us there’s a lot more room for interest rates to go up than down.

Do you think much about the U.S. presidential campaign?

TG: I try not to, it gives me a headache. But we’ve made it through not very good presidents before and I assume we’ll be able to do so again. I read a book not long ago about Millard Fillmore, who has not been highly regarded in the pantheon of presidents, but one particular thing that struck me was the description of the 1856 campaign and some of the tenets of the American Party, which nominated Fillmore. It was also known as the Know-Nothing party, and if you read what its platform said about trade, immigrants and religious groups, you’d be surprised at the parallels to today. So what’s going on now is not at all unprecedented. We’ll get past it.

You mentioned earlier that being part of Markel made it somewhat easier for you to reflect, tune out the noise and focus on what’s important. Do you have any other advice on how to do that?

TG: Generally speaking, that’s my temperament, which is helpful. It’s also very important in your life to have people who you respect and know have your best interests at heart who will bluntly speak truth to you and you’ll listen. I have to be able to communicate well what I’m thinking and doing, and if I’ve done that and someone close to me thinks I’m wrong, I have to give that a full and fair hearing. I’d argue that one of the key roles Charlie Munger has played in Warren Buffett’s life is to bluntly speak truth to him. Having that helps a great deal in zeroing in on what’s important and in actually being right about it.
Investor Insight: KDI Capital

KDI Capital Partners’ John Day, Sheldon Fox, Colin Kelly, Mitchell Scott and Todd Young explain why their opportunity set doesn’t stray from three basic business models, a key lesson learned from one very bad year, how they use options to mitigate risk, and why they see upside in McKesson, BMC Stock Holdings, Lawson Products, Lowe’s and Rubicon.

We haven’t yet come across a firm that started out as a division of a restaurant company. Explain how that happened with KDI Capital Partners.

John Day: I joined the parent company of the Golden Corral restaurant chain in 1990. My background was in securities research and investment banking and the idea was to look at potential restaurant-company acquisitions. Before long the company founder, James Maynard, suggested that if we saw public restaurant companies that offered big upside with little risk, we should invest in those too. We had success doing that and over time started taking in outside money and very deliberately broadening where we looked for opportunity. In 1998 we made money management a stand-alone business and in 2007 we renamed it KDI Capital Partners to reflect our key investment principles of knowledge, discipline and integrity.

Describe the broadening over time of your opportunity set.

JD: With an emphasis on not losing money, we thought the two keys to achieving that goal were knowledge and price. If we kept our focus narrow and knew as much or more than anyone else about a particular investment opportunity, there was a higher likelihood our judgment on it would be right. If we got a really good price, our risk of loss was likely lower.

In tracking restaurants we learned a lot about the distributors that served them, which has evolved into a broader focus on distribution in general. We consider it an advantaged business model, in which returns on capital can be very high for companies with scale efficiencies in industries where distribution adds more value because there are lots of buyers and lots of sellers. It tends to be defensive, especially in less-cyclical sectors like food or health-care. It’s also one of the few types of businesses in which acquisitions tend to work well and are accretive to value.

Our second area of emphasis we call multi-unit businesses, starting with restaurants but since expanding into retail and other sectors where you can look at the unit economics and the addressable market and make informed projections about the evolution of the business. The operating leverage in these businesses as they grow is very high, resulting in good returns on capital and strong cash flow.

The third focus, which we’ve recently started to develop, is in recurring-revenue business models. A software or technology service provider would be a traditional example, but we’re also interested in areas like asset management. These can be relatively predictable, high-return and low-capital-intensity businesses. If we can buy the right ones when they’re under a cloud or before their potential is more fully recognized, they should offer excellent long-term upside with diminished risk.

Sheldon Fox: We run a concentrated portfolio with around 20 stocks. So we want to spend all our time, first, on finding good businesses – predictable, growing, earning high returns on capital and run by leaders with integrity who allocate capital well – and second, that are in areas in which we’ve developed deep expertise and relevant contacts. You’re always tempted to stray, but if it’s not a very good business or it’s not in an area in which we specialize, we are going to pass.

What tends to be going on that lets you buy into any of these businesses at “a really good price”?

SF: Each analyst heading up our three areas of focus covers around 35 stocks. So we’ve typically already identified the companies that meet our criteria for quality and have established the price at which we’d be willing to buy. Then we wait for the opportunity.

The opportunities, of course, arise for a variety of reasons. For example, we have long followed Ecolab [ECL], which supplies cleaning and sanitation products to industrial and commercial enterprises. It’s kind of goes across our categories, with elements of a distribution business, with high recurring revenues, and with target customers including a number of multi-unit businesses like hospitals, restaurants and hotels. The stock six months ago started to lag due to concerns about the company’s exposure to energy and to some adverse foreign-exchange trends. Neither of those current issues dramatically impacts what we believe the business is worth over time, so as the gap grew between our estimate of value and the share price, we established a new position.

We also often respond when there’s a shadow over a sector, as there has been generally in healthcare tied to the public discussion of drug prices and the troubles at Valeant Pharmaceuticals. We already had positions, but that has contributed to something like CVS Health [CVS], the pharmacy and pharmacy benefits management company, or Mednax [MD], which runs specialized physician practices, becoming even more attractively priced.

Mednax was an idea highlighted in our latest issue [VII, March 31, 2016]. How does it fit into your areas of focus?

Todd Young: Mednax is a multi-unit business not dissimilar to a retailer in that its acquisition of a new physician practice in neonatal care or anesthesiology is similar to the opening of a new store. It reports comp sales like you’d see at a retailer or a restaurant. There’s an obvious demographic tailwind, and we think the company can continue to show profitable
growth because its value proposition remains attractive both for doctors and for its customer hospitals and other healthcare providers. Despite all that, from mid-October to early this month the shares fell 25% for reasons that we thought had little to do with the fundamental business. That gave us the chance to add to our position.

JD: I’d mention two other reasons target companies can become attractively priced. One is simply when the company stumbles of its own volition and the market punishes it and moves on. That was the case a few years ago with Lawson Products [LAWS], a small distributor of maintenance and repair products, which after a variety of ill-advised moves by prior management had to take significant writedowns and reset itself under a new CEO. The underlying business is very durable, so when we could buy the shares at around book value – after big writedowns – we took advantage. We’ll talk more about it later, because this is one we still consider mispriced.

From time to time we also find cases, especially in small caps, where the market doesn’t appear to understand a company’s business. That’s our view with Rubicon Project [RUBI], which provides the underlying technology that facilitates a significant amount of the buying and selling of digital advertising. Many putative competitors are trying to compete by buying ad inventory and repackaging it in some way to sell. Rubicon doesn’t do that, but instead powers a wide variety of platforms that match buyers and sellers, taking a small cut of each transaction. It doesn’t take the same kind of inventory risk and is agnostic about the algorithms used to make the ad-purchase decisions. We believe its business model is unique, superior and more scalable, but the market seems just to lump it in with everybody else.

Describe how you arrive at what you believe a company is worth.

SF: We use an LBO-type valuation model in which we forecast seven years of operations through all three financial statements, and then we put a terminal value on the company based on the EBIT multiple we believe a financial buyer would pay to do an LBO at that point. We then discount that value back to the present at different discount rates to arrive at current prices where we’re a buyer and where we’re a seller.

ON MODELING:
Our discipline tries to take as much emotion as possible out of arriving at what we think something is worth.

The process of going through all this forces us to truly understand whether we’re looking at a good business or not. We have to know the drivers of the business to forecast cash flows and profitability, and we have to fully understand the financing and capital needs to support growth. Stock prices always reflect emotion – sometimes positive and sometimes negative – and we’re trying through this modeling discipline to take as much emotion as possible out of arriving at what we think something is worth.

Our terminal value depends on our assessment of business quality and risk. For a large cap like Wal-Mart, for example, the terminal value would assume that the equity slice of an LBO would require a 15% compound return. For a small company like Lawson Products, that equity holder target could be 30%.

You use call options to mitigate portfolio risk. Describe how you do that and why.

SF: We will use calls in a couple of ways. One is to hedge downside risk when a position is getting close to our target price. For example, when volatility was high earlier this year, we were able to sell options in CVS at a strike price of $105 when the stock was in the mid-$90s. Our target price is around $110, so we were giving up little upside because if the shares rise, the strike price plus the $4-5 we got for selling the call would make us indifferent. But at the same time the option premium gave us 5% protection on the downside. We think this helps us protect capital, and sometimes allows us to stretch out holding periods on positions that haven’t yet qualified for long-term capital gains treatment.

We also use options to get the entry price we want on a particular stock. We wanted to own MasterCard [MA], but even in the correction in February the stock didn’t get down to our $80 buy price. But at that time we were able to sell a $90 call option into early 2017 on the stock and collect almost $7 per share in premium. So we could buy the shares, in effect, at a net price of around $77. Our upside was capped at $90 plus any dividends received in the interim, which would give us a high-teens return over 12 months. We’ll be fine with that and at the same time have protected ourselves on the downside.

Describe the investment case for a large-cap distribution idea, McKesson [MCK].

Mitchell Scott: McKesson, which distributes drugs and medical supplies to pharmacies and healthcare providers, fits the profile of what we like about distribution companies. It’s a top-three player in an already consolidated market in which those three control almost 90% of the market. Its scale provides it with a durable competitive advantage and it has minimal capital spending needs and high inventory turns, which allows the business to generate strong returns on invested capital.

A key growth driver for the company is the increase in its addressable market, as the U.S. 65-and-over population starts to grow around 3.5% a year. In addition, more specialty drugs are coming on market and drugs in general, because they are often the lowest-cost treatment, should continue to take share in the healthcare value chain. The company has also successfully used M&A to drive growth, most recently outside the U.S. In late 2014 it acquired Celesio, Europe’s largest drug distributor and second-largest retail pharmacy chain, and earlier this year it announced it was buying Rexall Health, Canada’s #2 retail
pharmacy. Both of those lay a solid foundation for future growth.

Three key issues have been weighing on the stock. One is the end of an abnormal period of generic-drug price inflation, which had been a nice tailwind over the past two years. Deflation is the more typical pattern, so inflating generic prices isn’t something we count on long term.

The company has also lost some large contracts, which together can take about $1 out of earnings per share. All were driven by customer consolidation – for example, the expectation McKesson will lose Rite-Aid after it’s acquired by Walgreens Boots, and losing Omnicare when it was bought by CVS – but we consider these more bad luck than reflective of McKesson’s service or value proposition. Any further rounds of consolidation are just as likely to work in their favor.

The final issue is the negative sentiment around drug pricing that Sheldon referred to earlier. There may have been some bad actors and the industry is certainly an easy target for politicians running for office, but it’s hard for us to imagine such an important and vibrant industry being meaningfully harmed by politicians on a sustained basis.

The shares, now just under $170, are off 30% from their 52-week high. How are you looking at upside?

MS: The company has an earnings hole to fill due to contract losses, but through a combination of organic growth, operating leverage, recent M&A and share repurchases we believe it can increase EPS at a low double-digit rate over the next few years. Based on our valuation model, we arrive at a fair price today of $225. At the current price, given our methodology, we’d expect to earn 14% per year on the stock over our investment horizon.

On a forward P/E basis the stock for many years has traded at a market multiple. On estimated calendar 2016 earnings, that number today is 13x, which is just 75% of the market multiple. For a non-cyclical company with long-term tailwinds and a solid industry structure, we think that’s just too cheap.

In such a scale business, what do you find interesting about small industrial-products distributor Lawson?

MS: Lawson distributes items such as fasteners, cutting tools and various industrial supplies that are used in maintenance, repair and operations [MRO] applications. These are low-value-add components of inventory, so tend not to get much attention from an on-site inventory-management perspective. Lawson addresses that issue by managing the inventory for its customers – which include industrial accounts like Schlumberger down to the local auto-body shop – on an outsourced basis. The value proposition is that for a small cost the customer avoids the headache of keeping track of everything and the downtime and expense of not having what they need when they need it.

The company competes within the broader MRO market served by giant distributors such as Fastenal and W.W. Grainger. Lawson defines its vendor-managed-inventory niche at about $2.5 billion in annual revenue, and it’s one of the bigger players, with around $280 million in sales. It’s a very fragmented market.
Michael DeCata has done a great job since taking over as CEO in 2012 of cutting costs and fixing operational problems, many of which were tied to a disastrous SAP installation. The company is now in growth mode and since the start of 2014 has added 135 sales reps to a base of just under 800. It typically takes three to four years for a rep to go from zero to managing the corporate average of $400,000 worth of business. As that incremental business kicks in margins should increase – the company has excess capacity to get up to $400 million in annual sales without having to incur meaningful capex.

Is M&A in the cards?

MS: Management has rightly argued the company should go slow. They’ve done two really small deals, and as they develop a consistent and repeatable process for deal integration we expect the company in such a fragmented market to get more aggressive on the M&A front.

How cheap do you consider the shares at today’s $20.25?

MS: Direct and indirect exposure to energy end markets has hurt the financial results of late, but we believe over time Lawson just through new-rep additions and increased rep productivity can generate high-single-digit top-line growth. Management also has a multi-year target of 10% EBITDA margins, which we believe is attainable within the next few years, up from today’s level of 5%. All in, our LBO fair value is $27 per share. That assumes very little in the way of general industrial production growth in North America and assumes no incremental benefit from M&A. Either of those would add meaningfully to the upside.

This isn’t necessarily something we count on, but we could imagine Lawson one day having considerable strategic value to an acquisitive larger distributor. At the EV/EBITDA multiples at which deals have been done in the industry, if the company is successful in meeting its margin goals, the resulting share price would be well in excess of our current estimate of fair value.

Turning to yet another distributor, describe your interest in BMC Stock Holdings [STCK].

MS: BMC Stock is the product of the merger last December of industry peers Stock Building Supply Holdings and Building Materials Holding, both of which distribute building products like doors, windows, cabinets and lumber that are used to build homes. It operates in 17 states throughout the Southeast and West, in areas that represent at least 60% of the single-family building permits issued in the U.S.

This is a case where we believe each merger partner brings something special to the combined company. Building Materials had been a leader with its Ready-Frame initiative, which delivers precut lumber to builders based on particular job specifications. Customers are willing to pay the premium price involved because it can reduce the time it takes to put up a house by 20% to 40%, saving on labor and shortening the time to market. This is especially valuable in today’s environment, where we hear a lot about labor
shortages in the building trades. As BMC offers Ready-Frame products across its entire geographic footprint, the company overall should incrementally benefit.

On the other side, Stock Building Supply has been a pioneer with its e-business initiative, providing a variety of online services that help improve procurement and logistics management so as to lower sales costs and improve service. Again, extending those capabilities to the full company should add overall value.

Are you making any bet here on home-building?

MS: This is definitely a cyclical business but we like where we are in the cycle. The 715,000 single-family housing starts in the U.S. in 2015 were still 30% short of the 30-year average. The fundamentals appear positive, with consumer health fairly strong and significantly fewer underwater mortgages weighing the industry down. Overall, we think there’s a lot of runway left for housing.

How attractive are the shares at $17.60?

MS: The stock sold off pretty hard this winter, in large part due to the company’s exposure to Texas, which accounts for about 30% of sales. The fear, of course, is that lower oil prices are having a negative impact on the housing market as well. While that’s not an idle fear, the Texas economy outside of places like Houston remains fairly strong. In any event, we believe the housing-start news in Texas over the long term will likely be more positive than negative.

Price weakness in lumber has also been an issue, given that it’s about 30% of what the company sells. We accept that these prices will go through cycles, but from today’s levels mean reversion would argue for an increase in pricing. We also think the Ready-Frame products, which are higher priced and more profitable than selling straight lumber, will help offset some of the exposure to low lumber prices.

Our LBO fair value for the stock is around $26. That assumes medium-term top-line growth of 10% per year and that the EBITDA margin within the next couple of years can reach 8%, which would mean the company meets its synergy targets from the merger.

Is home-improvement retailer Lowe’s [LOW] also a play on housing?

TY: That’s part of it. An increase in housing starts would certainly benefit Lowe’s. I’d also note that private residential fixed investment as a percentage of GDP is still about 25% less than its long-run average. Just people spending on their homes at the rate they have in the past would provide a significant tailwind.

What we think is probably less appreciated by the market is the margin-expansion opportunity the company has. You could describe its competitive market more broadly, but the reality is that when it comes to big-box home-improvement retailers there is essentially a duopoly with Lowe’s and Home Depot. The barriers to entry are very high and the online threat is low, but the market is also fairly saturated so value growth at this point will come primarily from same-store sales, operating leverage and intelligent capital allocation.
The company says it expects 25 to 30 basis points in margin improvement for each point in same-store sales growth above 1%. We assume near the low end of that guidance, so with the 4% increase in annual comp-store sales we’re modeling over the next couple of years, that would result in 80 basis points in margin improvement per year and an 11% operating margin by 2017. Assuming an additional 0.5% in top-line growth from new stores and a continuation of share-buyback initiatives, that would translate into annual growth in earnings per share of 17-20% over the next two years.

How are you looking at valuation with the shares trading today at $75.40?

TY: The stock on next year’s consensus estimates trades at a 16x P/E. So one way to look at it is that for a market multiple you’re buying into a company growing earnings at a much faster rate than the market. Lowe’s earnings are also likely to grow faster than Home Depot’s, whose stock goes for nearly 19x next year’s estimated earnings.

Our sell price, or fair value, on Lowe’s is around $93 per share. That’s after haircutting management’s formula on operating leverage in the out years. If the formula actually continues to hold, all the better.

Now for something completely different, describe in more detail your thesis for Rubicon Project.

Colin Kelly: As John mentioned earlier, the company provides a platform and tools for buying and selling digital advertising. It runs its own public exchange and also white-labels private exchanges both for publishers who want more control of their inventory and for demand-side service providers who tout their expertise in figuring out what to buy. Rubicon itself is very much a technology service provider – it doesn’t care how people decide to buy, just that they buy using its platform. Taking a small piece of every transaction, the company generated over the past year close to $250 million in revenue.

The secular story is around advertising spending continuing to move from traditional to online media. There is still a big mismatch between dollars spent on digital media and time spent by consumers on digital media. That should continue to close over time, especially as marketers improve how they use data to better target their spending and make it more efficient and effective.

You prize business durability and predictability. What makes you believe Rubicon’s place in the ecosystem is secure?

CK: Google is the gorilla in the industry, but from all our conversations with publishers and advertisers it’s clear they also want third-party exchanges where they can conduct business and not be totally reliant on Google, which can be a competitor for revenue and traffic. The best third-party exchanges will be those with a critical mass of buyers and sellers, which Rubicon has developed. It has more than 400 demand-side partners, and on the supply side it already partners with 70 of the 100 largest digital publishers. Its platforms also have an excellent reputation for the quality of the inventory offered, an important attribute as advertis-
ers increasingly worry about click-fraud and viewability. All this attracts buyers, which attracts more sellers, and so on. As the network effect plays out, we think that greatly supports the sustainability of the business.

What upside do you see in the shares from today’s $19.40 price?

CK: This is more of an open-ended growth story than many of our typical ideas. Over our model period we believe revenues can grow at close to 20% per year and that operating margins will eventually approach 20%. Given the greater uncertainty, we assume a 2.5% cost of equity to reach our terminal value. With those key inputs we arrive at a fair value today of around $25 per share.

Is that enough upside for an idea like this?

CK: The stock has run up quite a bit from our entry price. We’ve tried to be conservative in scaling organic revenue growth down to 15% or so by year four and in assuming 20% operating margins, when more mature financial-exchange businesses can earn 60%–plus margins. We’ll be disappointed if it doesn’t work out better than our model. In the meantime, we don’t feel overly exposed on the downside given that the business generates strong cash flow returns on invested capital and that there’s $117 million in net cash on the balance sheet, more than 12% of the current market cap.

Can you describe a mistake in the relatively recent past that informed a change in how you do things?

JD: Given that growth is important to our typical investment case, getting the growth prospects wrong really hurts us. We felt that acutely last year with Whole Foods [WFM], where we misjudged how the company would be impacted by increased competition from traditional grocers like Kroger. We bought into management’s ambitious plans for growth and the reality very quickly lagged the ambition. It’s not that that type of thing hasn’t happened before and won’t again, but we’ve redoubled our efforts to fully vet management plans with independent sources within the industry. We’re devoting more resources and time to making new contacts and using them to more fully understand what’s really going on in the competitive set. We expect that to pay off in fewer mistakes, which to our way of thinking is more than half the battle when it comes to investing.

While your long-term record is excellent, your 10-year performance isn’t quite as good because of a relatively lousy 2007. Any lessons from that?

JD: As a matter of fact, yes. I had made the decision late the previous year to manage the portfolio with a committee-decision structure, and it was a disaster. Nobody was responsible for failures and everybody took credit for successes, which led to a lot of bad decisions. You have to have one or two people carrying the keys who have full responsibility and are waking up in the middle of the night worried about risk. We limited the damage to one year, but it was a hard lesson learned.
Clear and Present

Investors with long records of success have a way of describing what they do in straightforward terms that make it seem deceptively easy. Ed Wachenheim, a newly published author at age 78, is a perfect example.

Ed Wachenheim
Greenhaven Associates

“The key problem most investors have is that they with some regularity let behavior interfere with reason.”

Editor’s Note: Operating far from publicity’s glare, Ed Wachenheim has had a remarkable investing career. A Williams College liberal-arts major with a Harvard MBA, he joined paper-products company Central National-Gottesman Corp. – owned and operated by his wife’s family – in the late 1960s, working his way up to head its investment-management division in 1979. The division, since renamed Greenhaven Associates, started accepting outside money in 1991 and due to Wachenheim’s investing prowess, rather than his marketing flair, now manages around $5.5 billion.

At 78, Wachenheim is as engaged and energetic as ever and shows no signs of slowing down. As he put it when we last spoke [VII, December 31, 2012]: “I am a poor dancer, but if I were a good one, as Warren Buffett says, I would be taping-dancing to work every day.” We caught up with him recently from his suburban-New York City office, where he works with a small team including his son, to discuss his just published book – Common Stocks and Common Sense – lessons learned in a long career, how he’s navigating today’s investing environment, and why he can’t imagine ever hanging up his spurs.

You’ve operated pretty much under the radar over a long and successful investing career. What prompted you to write a book?

Ed Wachenheim: For nearly 50 years I have thought long and hard about the investment process, and a few years ago I starting thinking about sharing those thoughts with others. As I tried to put my thoughts and experiences on paper in a logical and organized fashion it proved quite a challenge, much more so than I expected. I enjoy challenges and got a great deal of satisfaction from taking the project from start to finish.

Who do you see as the primary audience for the book?

EW: I’d like to believe that inexperienced investors will be interested in how a professional investor approaches the investment process, just as experienced investors will be interested in how another experienced investor thinks and acts. There are a lot of ways to skin the cat when it comes to investing, and it’s always been interesting and informative for me to learn how other professional investors research and analyze companies and arrive at investment decisions.

You chose to tell much of the story through case studies of specific investments, with lots of historical detail on each company and on how you developed your thesis. Why do it that way?

EW: While many people might believe the basic principles of value investing can be explained in a “how-to” textbook, I’ve always considered value investing to be situational. By using the case method to explain actual investments we’ve made, I was able to place them in real-life context, with all the unknowns, uncertainties, unforeseen changes and emotions that often affect outcomes. To my mind, that’s far more instructive. Hopefully the reader will think about and critique my thought processes and the actions I took, and will gain something from that thinking and critiquing.

One chapter covers your investment made 15 years ago in homebuilder Centex. What insight would you expect readers to take away from that?

EW: I tried to write the case studies in such a way that they contained a number of lessons. With Centex, one lesson would be that new ideas often are offshoots of old ideas; as a shareholder of U.S. Home we noticed that public homebuilders were starting to grow rapidly, which led us to work through a number of questions that ultimately resulted in our buying shares of Centex. A second lesson is that you have to continually be objective and avoid getting caught up in fads. I’d characterize the homebuilding boom in 2004-2005 as a fad, which we recognized simply because there wasn’t the need for as many homes as were being built.

A third lesson is that you shouldn’t count on management to recognize that a fad or cycle isn’t permanent. This certainly became the case with Centex’s CEO, who went to great lengths to deny that excesses were building in the market. Finally, we saw more generally around the housing crisis that the government and general public will often seek scapegoats to blame for a problem. The root cause of the collapse and subsequent financial crisis was that homebuyers bid up the prices of houses and took on excessive debt in the process. Any number of players enabled them, but that was the root cause. In the end, though, it seems as if the government put almost full blame for the crisis on the banks. The lesson is that life can be unfair and that expediency and politics often over-rule reason and truth.
In case studies on IBM and Boeing, to cite two examples, you go through a lot of historical detail before getting to your investment analysis. How does that historical perspective make you a better investor?

EW: I typically find that knowing the history of a company often aids in understanding its culture, its fundamentals and the durability of its products and services. The way I look at it, the holdings in our portfolio are my career’s family members – I’d never agree to marry without first learning about my potential mate’s background and meeting her parents.

When we made our initial investment in IBM, for example, understanding how the company lost its way and became bloated with far too many employees helped me understand how critical it was for the company to dramatically reduce headcount, and how that could drive earnings growth and a much higher stock price. With Boeing, learning how the company evolved from the day in 1914 when William Boeing caught the aviation bug at an Independence Day flying demonstration in Seattle gave me some insight on its ability to work through a number of problems four or five years ago in the rollout of its more fuel-efficient 787 Dreamliner. There was more to the investment case than that, but knowing the history gave me a richer perspective than I believe I would have had otherwise.

Let’s walk through a real-time case study, Goldman Sachs [GS]. What sparked your most recent interest in it?

EW: About two years ago I picked up a copy of Bloomberg magazine with a cover story on the three co-heads of Goldman Sachs’ investment banking business. One was John Weinberg, whose family I know very well. I am friends with his mother, used to know his deceased father, and when I was at Goldman in the 1960s worked on a project with his grandfather, Sidney Weinberg. That sparked my interest in the story, which was basically about the strength and success of Goldman. That led me to look at the stock, which was then trading at only a small premium to tangible book value. A business of this quality selling at a slight premium to book value is an adrenaline rush for a value investor, so I decided to look into it further.

What aspects of Goldman’s history are most relevant to gaining insight about its future?

EW: Goldman has been and remains the gold standard in investment banking. It attracts many of the brightest and most motivated graduates. It may sound old fashioned given prevailing views, but in an industry where greed and selfishness can lead to fractures in a firm, I believe Goldman’s culture of emphasizing sharing, teamwork and ethics continues to drive employees to work for the good of the firm and its clients. Any firm will have bad actors, of course, but in general the culture fosters happy, hardworking and successful employees.

Is being the gold standard in investment banking as interesting as it once was?

EW: Since the financial crisis most large financial-services companies have been...
relegated to the doghouse by investors, who have been concerned about adverse litigation and over-regulation. We believe most of the major litigation stemming from decisions made before the financial crisis has already been settled or will be in the near future. And while tougher regulation may leave financial institutions over-capitalized, we think there's a silver lining for premier players like Goldman.

Based on our calculations, in 2015 the company only earned a 6.5% to 7% after-tax return in its Institutional Client Services segment, which makes markets in fixed-income securities, commodities, currencies and equities. By all accounts these market-making operations – which are the most affected by increased capital requirements – are among the most profitable and efficient in the world, so our logic is that if Goldman can only earn a 6.5% to 7% return here, many of its competitors are likely doing much worse than that, which explains why they’re pulling back. In recent months a number of other firms have announced substantial reductions in their trading staffs. As competitors withdraw, Goldman should enjoy higher market shares and, importantly, wider spreads and much higher profits.

Do you have to have a view on how the regulatory environment evolves?

EW: It is possible that unreasonably high capital requirements will lead to systemic low returns. But the Fed and other government officials must be concerned that high capital requirements will reduce liquidity in the market-making system, with the result that there could be high volatility and even dislocations in markets at times when there is major positive or negative news. That could trigger liquidity problems for investors and financial institutions – and remember, the 2008-2009 financial crisis was more of a crisis of liquidity than a crisis of solvency. It would be ironic and obviously ill advised if the Federal Reserve, in attempting to reduce the chances of another crisis, actually triggered one. My general assessment is that there is a high probability that the Fed will not turn the screws too tight and that the environment will be one in which Goldman can prosper.

What upside do you see in the shares from today’s $164 price?

EW: The company earns very high after-tax returns on its Investment Banking and Investment Management segments, which we estimate at around 200% of capital employed in Investment Banking and 50% in Investment Management. So if it can earn a 10% after-tax return on its market making, we believe the entire company can earn on a normal basis a 15% return on its tangible book value. We project that Goldman’s tangible book value will increase to about $187 per share by mid-2018, from $163 currently. Using our return expectation, that would translate into normal earnings power in two years of roughly $28 per share.

Based on its quality and growth potential, I certainly believe Goldman is worth materially more than 10x earnings, but because of the perceived volatility and risks in financial services, it’s likely worth less than the average market multiple of 16x. If I settle somewhere in the middle, say 12.5x to 13.5x earnings, the shares on our 2018 estimates would be worth $350 to $380.

So if our analysis is correct, the shares should be a home run. If our projections are only partially correct, the shares still could provide a high return. It’s rare as an investor to find the shares of a high-quality, growing company trading at less than its tangible book value, which is now the case for Goldman. This strikes us as a highly unusual opportunity.

You articulate an approach that sounds disarmingly straightforward. Why in fact is investing so difficult for most people?

EW: I do believe in simplicity, and that one’s investment process should be simple. It should not be difficult to understand a company’s fundamentals and prospects to a sufficient degree of accuracy. It should not be difficult to see past short-term issues and focus on long-term potential.

The key problem most investors have is that they with some regularity let behavior interfere with reason. They become emotional in periods of stress and let emotions dictate their decisions. Or they aren’t contrarian and fall in line with the herd. Why do experienced investors continue to make behavioral errors? My conclusion is that behavioral traits tend to be hard-wired and habitual. Seth Klarman once said that “people don’t consciously choose to invest with emotion – they simply can’t help it.” I agree. That’s what makes investing so difficult for most people.

Do you feel you’ve gotten better at investing with age?

EW: I have certainly become more knowledgeable about more industries and companies, which is a positive. I have been concerned, though, that as I become older and more financially secure I will become too risk averse. But I’m aware of this and actively try to avoid becoming too conservative. On balance, I believe my investment skills have improved a bit over time.

Will you ever step away from the game?

EW: For me, investing is an enjoyable hobby that I’ll do as long as my health permits. I enjoy the creative aspects of the business and still get as much of a kick out of finding a new idea as I ever have. I have wanted to plan for succession and provide opportunities for my younger associates, so I have turned over accounts for them to manage and will continue to do so, likely at an accelerated pace. But I don’t intend to step away because I would sorely miss the creativity, fun and excitement.
Common Stocks and Common Sense

In these excerpts from Common Stocks and Common Sense, Ed Wachenheim summarizes his straightforward recipe for success, offers a colorful description of margin of safety, and explains how he battles both decision regret and mediocrity.

STRATEGY TO OUTPERFORM

While the stock market itself is attractive, my goal, hope, and prayers are to materially outperform the stock market over time. My specific objective is to achieve average annual returns of 15% to 20% without subjecting our portfolios to large risks of permanent loss. Happily, we have achieved these goals. Over the past 25 years, accounts that we manage have achieved average annual returns of very close to 19%. I attribute a material part of this success to a strategy that I developed in the early 1980s. The strategy is to try to purchase deeply undervalued securities of strong and growing companies that hopefully will appreciate sharply as the result of positive developments that have not already been largely discounted into the prices of the securities. Our reasoning is that the undervaluation, growth and strength should provide the protection we cherish against permanent loss, while the undervaluation, strength, growth and positive developments should present the opportunity to earn high returns.

We typically purchase shares in a company in anticipation that one or more positive developments will drive the shares within the next few years, and we then sell the shares after the positive development (or developments) has occurred and has substantially discounted into the price of the shares. Positive developments can include a cyclical upturn in an industry, the development of an exciting new product or service, the sale of a company to another company, the replacement of a poor management with a good one, the initiation of a major cost-reduction program, or the initiation of a major share repurchase program. Importantly, the positive developments we predict should not already have been predicted by a large number of other investors. We need to be creative and well ahead of the curve. If we are not early, there is the likelihood that the future positive developments already largely will have been discounted into the price of the shares.

But what if we are wrong about a stock and the predicted positive development fails to occur? Then, the undervaluation, strength and growth of the stock still provide the opportunity to earn a reasonable return. If we cannot have the icing, we can at least have the cake.

ON TIME HORIZON:

I disagree that the shares of wonderful businesses can be held forever. Such businesses become less wonderful.

The above strategy of predicting positive changes makes common sense. At any one time, the price of a stock reflects the weighted opinion of the majority of investors. In order to earn outsized returns, we need to hold opinions about the future that are different and more accurate than those of the majority of other investors. In fact, it can be said that successful investing is all about predicting the future more accurately than the majority of other investors.

MARGIN OF SAFETY

The concept of a margin of safety is that an investor should purchase a security at a price sufficiently below his estimate of its intrinsic value that he will have protection against permanent loss even if his estimate proves somewhat optimistic. An analogy is an investor standing on the 10th floor of a building, waiting for an elevator to carry him to the lobby. The elevator door opens. The investor notices that the elevator is rated for 600 pounds. There already are two relatively obese men in the eleva-
er would sell. But our ambitions lead us to seek shares that are temporarily deeply undervalued and then sell the shares when they become fully valued. This is an approach to investing that is less relaxing and that requires considerable effort and time, but that has worked for us.

CONFIDENCE

Investment decisions seldom are clear. The information an investor receives about the fundamentals of a company usually is incomplete and often is conflicting. Every company has present or potential problems as well as present or future strengths. One cannot be sure about the future demand for a company’s products or services, about the success of any new products or services introduced by competitors, about future inflationary cost increases, or about dozens of other relevant variables. So investment outcomes are uncertain. However, when making decisions, an investor often can assess the probabilities of certain outcomes occurring and then make his decisions based on the probabilities. Investing is probabilistic.

Reaching rational decisions in a probabilistic world requires confidence. I have observed that investors who lack confidence often delay making decisions in quest of additional information that supports their views. Sometimes the delays become permanent and opportunities are lost. Warren Buffett says that investors do not have to swing at every pitch. But an investor who lets too many good pitches go by because he possesses the confidence to swing only at particularly “fat” pitches may be called out on strikes before he ever sees a particularly fat pitch.

During my career, I purchased many stocks that I should not have and failed to purchase other stocks that I should have. I often have been asked how I can maintain my investment confidence in light of the many decisions that did not turn out as predicted. I have an answer. To maintain my confidence and to guard against decision regret – becoming distraught over opportunities that were missed or over purchases that were unsuccessful – I draw a large distinction between the correctness of my decisions and the outcomes of my decisions. If I carefully analyze a security and if my analysis is based on sufficiently large quantities of accurate information, I always will be making a correct decision. Granted, the outcome of the decision might not be as I had wanted, but I know that decisions always are probabilistic and that subsequent unpredictable changes or events can alter outcomes.

Thus, I do my best to make decisions that make sense given everything I know, and I do not worry about the outcomes. An analogy might be my putting game in golf. Before putting, I carefully try to assess the contours and speed of the green. I take a few practice strokes. I aim the putter to the desired line. I then putt and hope for the best. Sometimes the ball goes into the hole, but most often it misses. I do not worry about missing or the misses. By removing worry from the decision-making process in golf and in investing, I can think more rationally and act more confidently – and therefore make better decisions, especially when investment decisions are counter to the conventional wisdom or otherwise are difficult. And I can sleep at night!

ON SETTLING

I believe that ambition, tempered by reason, permits a person to succeed and feel rewarded, and that, in a competitive world, settling for mediocrity often leads to failure. Yes, investing $5 billion at a time when the stock market is relatively fully valued is a challenge. But there are two disparate mind-sets to the word challenge. One is the frustration of encountering an apparently impenetrable wall. The other is the thrill and satisfaction of climbing the wall. To each his own, but I relish the latter. And I say hogwash to “settling” for lower returns in the future.

Excerpted from Common Stocks and Common Sense, by Edgar Wachenheim III, ©2016 John Wiley & Sons

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Light Sabre?

A quick glance at its stock chart since its IPO two years ago would indicate little turbulence ahead for travel-booking company Sabre Corp. Spruce Point Capital’s Ben Axler would argue that looks can be deceiving.

It’s been a smooth flight for Sabre Corp. investors since the company’s IPO in April 2014, seven years after its pre-crisis leveraged buyout. From an offering price of $16, the shares in the travel-booking company have dramatically outpaced the market and now trade around $29. Of 14 analysts currently following the stock, 13 are bullish and the other ranks it a “hold.”

Don’t count Spruce Point Capital’s Ben Axler among Sabre’s fans. Earlier this month he issued a detailed report on the company outlining his bear case for the stock, suggesting a price target of $12 to $17. “I’m attracted on the short side to situations that seem too good to be true,” he says. “This is an excellent example.”

Sabre’s main business, generating 71% of 2015 revenues, is a platform that presents inventory, prices and availability from an array of travel suppliers to buyers such as travel agents and corporate travel departments. Central to Axler’s thesis is the secular threat to that middleman role as buyers look to circumvent its costly platform. Two ominous signs: German airline Lufthansa last fall put a surcharge on flights booked through Sabre in an effort to incent buyers to book directly with it. Increased competition is also likely from Google, which in 2010 paid $700 million for flight-shopping company ITA Software but has been limited under a consent decree with the Justice Department in how aggressively it builds that business. That’s expected to change when the decree expires in October.

Axler also argues that in key respects Sabre’s financials paint a misleading picture of its vibrancy. The company capitalizes cash incentives paid to entice and retain customers, which he says masks the fact that such costs are increasing and fueling a decline in revenue per transaction. Backing out the purchase last year of the 65% of Singapore-based competitor Abacus International that it didn’t already own, he says Sabre’s core business grew no more than 1%, at a time when management touts it as a 4-6% top-line grower. In addition, a “tax receivable agreement,” which will result in nearly $390 million in payments to the firm’s LBO backers, is to be classified by Sabre as a “financing activity,” while Axler believes such payments would more accurately reduce operating cash flow. “On the underlying cash-flow economics, the business is at best stagnant since its pre-IPO days and not worthy of its current valuation,” he says.

In arriving at his target price range, Axler uses 2016 consensus analyst estimates, adjusted only by flowing all paid upfront incentives through EBITDA, reducing that estimate by $65 million. The 6.5x to 8.0x EV/EBITDA range he uses is what investment bankers suggested for a terminal multiple in their fairness opinions on Sabre’s 2007 LBO. “Why use a higher multiple when the business hasn’t improved, the headwinds are stronger and the terminal case is closer,” he says.  

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**INVESTMENT SNAPSHOT**

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<tr>
<th>Sabre</th>
<th>Valuation Metrics (@4/28/16):</th>
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<tbody>
<tr>
<td>Business: Operator of a global technology platform used primarily by travel agents to book airline travel for their clients.</td>
<td>SABR</td>
</tr>
<tr>
<td>Price</td>
<td>28.93</td>
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<tr>
<td>52-Week Range</td>
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<td>Dividend Yield</td>
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<tr>
<td>Market Cap</td>
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<tr>
<td>Financials (TTM):</td>
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<tr>
<td>Revenue</td>
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<td>Operating Profit Margin</td>
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<td>Net Profit Margin</td>
<td>18.4%</td>
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**SABR PRICE HISTORY**

**THE BOTTOM LINE**

By digging deeply into the company’s financial statements, Ben Axler believes its performance reflects chronic competitive challenges that he thinks will threaten the stock’s valuation. Making one adjustment to estimated EBITDA for upfront incentive payments and applying a 6.5x to 8x EV/EBITDA multiple, he believes the shares are worth $12-17.

Sources: Company reports, other publicly available information
Stop and Smell the Data

In his seminal 2012 book *The Signal and the Noise*, statistician Nate Silver describes what he calls the failures of prediction that accompanied the financial crisis and the common thread they shared:

The confidence that homeowners had about housing prices may have stemmed from the fact that there had not been a substantial decline in U.S. housing prices in the recent past. However, there had never before been such a widespread increase in U.S. housing prices like the one that preceded the collapse.

The confidence that the banks had in Moody’s and S&P’s ability to rate mortgage-backed securities may have been based on the fact that the agencies had generally performed competently in rating other types of financial assets. However, the ratings agencies had never before rated securities as novel and complex as credit default options.

The confidence that economists had in the ability of the financial system to withstand a housing crisis may have arisen because housing price fluctuations had generally not had large effects on the financial system in the past. However, the financial system had probably never been so highly leveraged, and it had certainly never made so many side bets on housing before.

The confidence that policy makers had in the ability of the economy to recover quickly from the financial crisis may have come from their experience of recent recessions, most of which had been associated with rapid, “V-shaped” recoveries. However, those recessions had not been associated with financial crises, and financial crises are different.

In the vernacular, the events being forecasted were “out of sample,” meaning the sample size of comparable events was actually very small, making past experience far less relevant to the future. As Silver writes: “When there is a major failure of prediction, this problem usually has its fingerprints all over the crime scene.”

How to avoid out-of-sample forecasting mistakes is relevant to value investors, who spend considerable time predicting whether a company’s current travails are temporary and fixable or permanent and beyond repair. Key to making those predictions well is recognizing how the current situation is unique – or not – from what’s transpired in the past.

Silver offers two key pieces of advice. One is to make every effort to expand your sample size of possible precedents. While the U.S. had never had such a housing crash before, other countries like Japan had, the study of which might have better informed what was in store here.

Also critical is truly having a probabilistic mindset when thinking about the future. This makes logical sense to most people but isn’t common practice because, as Silver points out, in many walks of life expressions of uncertainty are mistaken for admissions of weakness. That’s shortsighted at best, he says:

We have big brains, but we live in an incomprehensively large universe. The virtue in thinking probabilistically is that you will force yourself to stop and smell the data – to slow down and consider the imperfections in your thinking. Over time, you should find this makes your decision making better. 

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