

## Choose Wisely, and Wait

*Warren Buffett counseled Tom Russo's M.B.A. class in 1984 to invest in what you know and stand by your convictions. Russo has learned those lessons well.*

Track Tom Russo's daily activities and you'll see a whirl of activity – visiting management, speaking with investors, attending conferences. Track his portfolio trading and the activity level falls off a cliff. “We tend to let management do a lot of our work for us,” he says.

Russo's hands-off approach has paid off handsomely for investors. A partner at Lancaster, Pennsylvania's Gardner Russo & Gardner, he manages some \$4 billion and the flagship Semper Vic Partners fund he started in 1984 has earned a net annualized 14.6%, vs. 9.9% for the S&P 500.

Focused on companies with global brands and extensive reinvestment opportunities, he sees upside today in such areas as wine and spirits, beer, consumer packaged goods and banking. [See page 2](#)

### INVESTOR INSIGHT



**Thomas Russo**  
Gardner Russo & Gardner

**Investment Focus:** Seeks companies with global brands and a high capacity for reinvestment, run by management with a well-developed “capacity to suffer.”

## Serve and Protect

*In life, paying up for quality is often a reasonable approach. In investing, as Kevin Bernzott's record would attest, buying quality at a bargain price is even better.*

### INVESTOR INSIGHT



**Bernzott Capital Advisors**

(l to r) Scott Larson, Kevin Bernzott, Thomas Derse

**Investment Focus:** Seek companies with unassailable business models when their share prices reflect temporary market, industry or company-specific stress.

Run a red light in Camarillo, California and there's a chance Kevin Bernzott will pull you over. The founder of Bernzott Capital Advisors is a sworn deputy sheriff, on patrol two nights a week. “It's my way to give back to the community,” he says. “They pay me \$1 per year and tell me I'm worth every penny.”

Bernzott has also more than earned his keep in his day job. Since his firm's founding in 1994, it has earned a net annualized 13.1% for investors, vs. 9.7% for the Russell 2000 Value index.

Applying a quality-first approach to small-cap investing, he and fellow managers Scott Larson and Thomas Derse see opportunity in such varied areas as pet supply, vacation rentals, medical technology, credit scoring and consumer staples. [See page 11](#)

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# Investor Insight: Thomas Russo

Thomas Russo of Gardner Russo & Gardner describes why he has no qualms about investing in multiple companies in the same industry, what management trait he values above all others, how his “never sell anything ever” profile has evolved, and why he sees unrecognized value in Pernod Ricard, Anheuser-Busch InBev, Unilever and Wells Fargo.

You’ve defined for yourself a rather narrow circle of competence. Describe the ideal business you typically pursue today.

**Thomas Russo:** My ideal business typically owns strong brands which address the needs and wants of developing-market consumers who are growing rapidly in number and in purchasing power. Those brands create the impression in consumers that there is not an adequate substitute, which makes them aspirational and affords their owners valuable pricing power.

I’m a value investor, which says I want to buy 50-cent dollars, but given my firm’s predilection for serving the needs of taxable investors, I also want that dollar to tax-efficiently compound in value over long periods of time. That means the businesses must have great capacity to reinvest, which is not all that common. I own Nestle [NESN:VX] rather than Kraft, for example, because Nestle historically planted seeds for its brands in hundreds of countries that now can absorb immense amounts of capital spending to build infrastructure and to invest in marketing to activate those brands. Kraft, with its much more U.S.-centric past, does not have the same capacity for reinvestment. I want our money to work for us – in essence, I am passing through to our portfolio-company management much of my obligation to reinvest.

In addition to the capacity to invest behind growth, it’s equally vital that corporate leadership has the will to do so even when such investments burden current reported profits. Jean-Marie Eveillard used to talk about the importance for investors to have the “capacity to suffer,” and I’d argue that same capacity to accept short-term pain for long-term gain is critical in management. The market often doesn’t like any burden on

reported profits, so adequate levels of investment often invite scorn and ridicule that leaders have to be able and willing to endure.

**Do you find that willingness in short supply today?**

**TR:** It has never been particularly abundant. I often find it in family-controlled companies, where management is far more likely to think generationally rather than focus on how to deliver results within some finite period to maximize the value of their stock options. It doesn’t require family ownership to find managers who care about their company’s future beyond them, but it is even more rare without it.

I think about the efforts of spirits company Pernod Ricard [RI:FP] in China. In the early 2000s competitors were pulling back in the country because the economy was going through a rough patch and the markets for premium imported whiskey and cognac were painfully slow to develop. Patrick Ricard saw it as an opportunity to invest in developing both the marketing profile and distribution of the company’s Chivas Regal and Martell brands, a path that proved very unprofitable in the early years. Today China is Pernod’s third-largest market, accounting for some 15% of profits and growing 18-20% per year. There was nothing pre-ordained about this success – the company made investments necessary to build a category that tapped into an increasing sensibility among Chinese with rising disposable incomes to show standing and status through the brands they consumed. If Pernod had not been there early, and endured the pain of being early, they would not have the position they have today.

On a different note, during the depths of the 2008 crisis, one of the most extraordinary conference calls I heard



Thomas Russo

## Who Says?

As an undergraduate history major at Dartmouth in the 1970s Tom Russo remembers being particularly interested in historiography, which he describes as the study of how historians interpret history. “It’s the study of ‘Who says?’ – how different people interpret actual events based on their knowledge, preferences and biases,” he says. “Sensitivity to that has been very valuable to me as an investor.”

Russo’s own history sheds considerable light on the development of his investing strategy. His grandfather’s travails investing in energy stocks helped form an ongoing aversion to commodity-related bets. His first job as a bond analyst as interest rates rose in the mid-1970s made him highly wary of inflation’s corrosive effects. A Warren Buffett talk to his Stanford business-school Investments class in 1984 drove home the importance of focusing on what you know and stretching your investing horizon to allow for companies to compound value. Those lessons were reinforced after graduate school during four years as an analyst at the Sequoia Fund, where deep-dive primary research was all that mattered. Says Russo today: “You don’t have to rediscover lessons that have been well made by others before you.”

was that of Johann Rupert, the longtime chairman and large shareholder of another of my holdings, Swiss luxury-goods company Richemont [CFR:VX]. He started talking directly to company operating managers who were on the call, reassuring them that the reason the company held billions of euros in cash was to allow it to survive difficult periods and continue to build its brand franchises through them. He went on to describe where the company was planning to invest heavily, such as China and Russia, as well as where it would stop investing, primarily Japan. The tenor of the conversation was much different than what you typically heard at the time. I found it all to be a dramatic statement of how to prudently shepherd assets.

**When we last spoke [VII, June 30, 2006], you were almost exclusively focused on four businesses: food, beverages, tobacco and ad-supported media. Has that changed?**

**TR:** Until I get more thoughtful about companies such as Google or Apple – the replacements for the media businesses that once had such a lock on consumer communications – you can lop off that last leg.

One of the lessons I took from Warren Buffett years ago was to define the areas you're comfortable with and stick to them. Branded consumer businesses are those for which I have a natural affinity and that I think I understand. While I would have a hard time on the weekend observing what DRAM chip is in the cell phone of the person walking next to me, I pay a lot of attention to – and think I learn a lot from – what people are wearing, or eating, or smoking or drinking. Of course these are also all businesses that lend themselves to the types of global growth opportunities I most value.

**The share of your portfolio in U.S. companies continues to decline. Why?**

**TR:** We probably held 35-40% in non-U.S. stocks five years ago and that number today – counting Philip Morris

International [PM] as non-U.S. because all of its operations are overseas – is closer to 70%. One practical reason is that my foreign investments have worked better than those in the U.S., but I have also actively swapped out of U.S. companies that didn't have adequate global reinvestment opportunities and into European holdings that did. Most of that is a result of company-by-company assessment, but I will admit to casting an eye toward history and wondering if today's U.S.-cen-

## ON EUROPE:

**It has been masked by broader economic woes, but Europe is becoming a more amenable place to do business.**

tric investor isn't like the similarly positioned British investor in the early 1900s who would have left a lot of money unearned as a result of his nation losing economic relevance due to progress elsewhere while he or she stayed invested only domestically.

**Isn't that sentiment a bit inconsistent with your finding opportunity in old-world Europe instead?**

**TR:** The opportunity is less about Europe and more about European companies, that as a result of historical accident or conscious effort have established profound footholds in the fastest-growing parts of the world for their celebrated and long-nurtured brands. Unilever [UN], for example, has been imbedded in India through its Hindustan Lever subsidiary since long before India's economy became more open and hundreds of millions of people started to enjoy incomes above a subsistence level. The aspirational appeal of so many European brands – think Cartier watches, Chivas Regal scotch, even Heineken beer – has been cemented in consumers' minds and is a powerful driver of demand as rising incomes in many parts of the world take

those brands from unattainable to affordable.

As a value investor, companies in Europe hold even greater appeal today. We have never really had to wrestle with excessive valuations there because it has always been deemed a slow-moving region, but investors are now actively frightened away. In addition, I think another unrecognized result of the economic crisis has been that European companies are increasingly able to operate their businesses as dictated by competition rather than regulatory fiat. Just one example: Nestle struggled for years after buying Perrier because the French government wouldn't let it rationalize local production, which was orders of magnitude less efficient than in Nestle's comparable San Pellegrino operation. That changed two years ago and Nestle has done what it needed to do to make Perrier more competitive, while freeing up capital to invest in growth. As a result, the Perrier business has grown 30% over the past two years. In general, while it has been masked by broader economic woes, Europe is becoming a more amenable place to do business.

**You mentioned swapping out of certain U.S. companies. Describe your thought process behind an example or two.**

**TR:** I did a substantial amount of selling in 2008 and redeployed capital into stocks I already owned, such as Pernod Ricard, Richemont and SABMiller [SAB:LN], that were down 50-60% because the global economy was so stressed and companies connected to emerging markets were particularly hard hit. Shares in Dr Pepper Snapple, a domestic soft drink company with little historical ability to grow outside our shores, were sold. Kraft Foods, domestic focus, sold. International Speedway, the parent company of NASCAR which had run out of rope in expanding in the U.S. but was still attempting to do so, sold. H&R Block was cheap and trying to work through serious diversification errors, but its lack of reinvestment opportunities kept it from making the cut.

**What about newspaper company McClatchy, one of your last, painful media holdouts?**

**TR:** With every company I own there is always the question of sustainability, that a transformation in its industry will leave it behind. Five years from now you may ask me the same question about the tobacco companies I own and why I continued to hold them in the face of changing user preferences, regulatory hurdles and litigation risks. You may ask me the same question about Nestle and why I didn't see the extent of its vulnerability to competition from private-label brands. McClatchy was losing to the disruptive forces of technology in its industry and my mistake was in believing its franchise would hold up better and longer than it did. It's that simple.

This process in 2008 was really quite profound for me as an investor. It increased my resolve to hold only companies I deeply believe in because you never quite know when forces outside of your control set off a tidal wave across markets that shakes everything to its foundation. During a crisis, the less conviction you have about something, the more likely you are to handle it poorly and the more likely the company in question is vulnerable. After 2008, I am more concentrated even than usual, with nearly 75% of the portfolio in my top ten holdings.

Having sold as much as I did also put forever to rest my longstanding profile of never selling anything ever. I am over that. One outcome of this exercise has been to more pointedly question the enduring nature of the status quo and to not hesitate in reducing portfolio holdings when the uncertainty is too high.

**You mentioned tobacco stocks, of which you own Philip Morris, Altria [MO] and British American Tobacco [BTI]. What's behind your conviction about their future?**

**TR:** The world knows all of the vices of tobacco and the risks inherent in investing in tobacco stocks, all of which is incorporated in their share prices. But we

also know the business has a high degree of brand loyalty, is still growing in the developing world, is enormously cash-generative and is increasingly controlled by fewer large competitors who are likely to be sensible about the significant pricing power their brands command.

So using Altria as an example, they pay out 80% of cash flow in dividends [providing a 6% yield at current prices] and still have plenty to invest in maintaining their brands' strength and in making

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**ON SELLING:**

**After 2008 . . . I put forever to rest my longstanding profile of never selling anything ever. I am over that.**

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selective acquisitions. They bought UST, the leading smokeless tobacco company, which also owned a domestic wine business. They also acquired the John Middleton cigar company. Also important to me is that as a result of the sale of Miller Brewing many years ago, the company now owns \$15 billion worth of SABMiller shares, a global beer company we find attractive and hold on its own.

**How many new ideas do you add to your portfolio in any given year?**

**TR:** We've added two new portfolio companies over the past year, Anheuser-Busch InBev [BUD] and MasterCard [MA]. We wait for breaks in prices in companies we would like to own, and both of these came under pressure for U.S.-specific reasons at a time when their appeal to me is almost entirely due to their businesses outside the U.S.

MasterCard had intrigued me since it came public in 2006, but it quickly became a darling of the investment world and I missed the opportunity. It came back to earth last year when increasing fears that post-crisis regulation in the U.S. would limit debit-card fees and profitability sent the shares below \$200. At the

time it looked like the company would earn in 2012 something like \$24 per share, so we were able to pay 8x that earnings number for a company that had really seen no change in its long-term opportunity set and whose new CEO, Ajay Banga, was to my mind one of the most impressive international finance executives in the world.

While it's not a food, beverage or tobacco company, MasterCard fits all my criteria: a heavily branded consumer product that has extraordinary potential globally due to the substitution of commerce for subsistence, and the migration within commerce toward payment systems other than cash. This is also a case where I believe the business is enhanced rather than threatened by technology, resulting in innovative ways to pay by credit that will hasten the shift away from paying by cash. [Note: MA shares recently closed at \$359.]

I will talk later about A-B Inbev, but there the break in the share price had more to do with a quarterly shortfall in domestic shipments of core U.S. brands like Budweiser. In addition to being overdone, the market's reaction was doubly ill-considered because the shortfall in large part was due to a strategic decision to raise prices on lower-end products, to lessen people's incentive to trade down in price. Steps to improve long-term brand equity over time caused short-term problems – just the type of capacity to suffer I like to see.

**How do you think about valuation?**

**TR:** I wouldn't say I'm overly precise when it comes to valuation. Most of the companies we're speaking about today trade at around 13x earnings and I am comfortable holding the right companies with P/E multiples up to the mid-teens. Nestle, for example, trades at maybe 15x estimated earnings, but less than that if you back out the burden of \$2.5 billion in investment spending on emerging markets this year, up from \$1 billion last year. Those transformative types of investments impact earnings because you're developing capacity that does not yet

have full scale advantages. But the company will likely earn at least 20% on that committed capital, adding on the order of \$500 million in annual operating income five years out. Overall, I believe it can grow earnings at least 7-10% annually over the next five to ten years, which with dividends should result in a double-digit annual return on my shareholding, which is my general aspiration for the portfolio.

**You mentioned selling in 2008, but what have you sold more recently and why?**

**TR:** In 2010 we started the year with Richemont at about 7.5% of the portfolio. The stock went up 75% and it ended the year at about 7.5% of the portfolio because we sold shares as it became less undervalued and the weighting became higher than I considered appropriate. That is just part of the ongoing process to adjust position sizes based on price movements, but I'm always mindful of Warren Buffett's caveat not to cut flowers and water weeds. Some of the proceeds from selling Richemont went to buy more Wells Fargo [WFC], to rebuild a position size after the stock had fallen in price. There is always the risk in such cases that Wells could be a value trap, while Richemont's great leap forward only presaged a great next few years' of earnings growth. I am mindful of that, but I would not have been comfortable with Richemont at 13% of the portfolio.

**You appear to have materially cut your Comcast [CMCSA] stake recently. Why?**

**TR:** My concern is over the impact of technology on its core business. The company says that if everyone starts using Apple TV or Google TV, what they have to pay extra as a result to Comcast for Internet access and using so much more bandwidth will compensate for whatever they no longer pay on the cable side. That may turn out to be true, but the outcome is very uncertain. The government may limit price increases. Consumers may balk at increases coming from monopoly providers. I am not comfortable that cable providers have done enough in managing

their governmental and consumer relationships for the best outcomes to occur.

**Describe your more detailed investment case for Pernod Ricard.**

**TR:** Pernod over the past 20 years has taken its business from the sale of pastis, a declining liquor sold primarily in France, to marshaling a broad portfolio of iconic global spirits brands such as Chivas Regal scotch, Martell cognac, Beefeater gin and Absolut vodka. The business model has been to add brands through acquisition and integrate them into direct local distribution systems that have been built carefully over many years at great expense. As more brands are directed through that dedicated distribution, revenue synergies are realized,

cost efficiency goes up and the system itself provides even greater competitive advantage.

The financial model has been to leverage up to make the acquisitions, run the businesses better and then extract cash from them to pay down debt rather quickly. That got derailed a bit by the poorly timed purchase that brought them Absolut in 2008, which ended up requiring some asset sales and a rights offering to restore the balance sheet. To the company's credit, financing issues didn't keep it from investing in the Absolut brand, an 11-million-case-per-year brand when they bought it that they believe can sell 20 million cases annually. That will come from selling it more forcefully in 25 markets where Absolut was already the leading premium vodka, but where the category

**INVESTMENT SNAPSHOT**

**Pernod Ricard**  
(Paris: RI:FP)

**Business:** Global marketer of spirits, wine and champagne, under brand names including Absolut, Chivas Regal, Jameson, Beefeater, Martell and Perrier-Jouet.

**Share Information**

(@11/28/11, Exchange Rate: \$1 = €0.751):

<b>Price</b>	<b>€67.97</b>
52-Week Range	€56.09 – €72.78
Dividend Yield	2.1%
Market Cap	€18.00 billion

**Financials (FY2011):**

Revenue	€ 7.64 billion
Operating Margin	25.0%
Net Profit Margin	13.7%

**Valuation Metrics**

(Current Price vs. TTM):

	<b>RI</b>	<b>S&amp;P 500</b>
P/E	17.1	13.4

**RI PRICE HISTORY**



**THE BOTTOM LINE**

Having long invested in local distribution, the company is well positioned to capitalize on developing-market consumers' increased appetite for its status-confirming brands, says Tom Russo. With further multiple compression unlikely, he believes share returns should at least match his expectation for low-double-digit annual net income growth.

Sources: Company reports, other publicly available information

was not fully developed because the agents representing the brand did not own it. That shows the power of the dedicated global system Pernod has.

**Is Pernod's success in China typical of the upside you see for the company in emerging markets?**

**TR:** The scale obviously differs by country, but another example would be India. Over the past decade Pernod has sown the seeds of success by establishing a profitable niche for premium scotch whiskey in the country, which commands a tiny share of the market today. As that share grows along with disposable incomes, the growth potential for the company is dramatic. To give you a sense of the scale, current worldwide annual demand for premium scotch whiskey is 70 million cases. The overall market for "scotch whiskey" made in India – most of it today from low-quality brands – is 125 million cases per year.

Another engine fueling this type of business is that wealthy Chinese and Indians and Brazilians are increasingly traveling the world, developing a taste for the stature-confirming brands they find there. One company we are close to owns the billboard concession in the Shanghai airport. They contracted for the business when it had 23 million passengers three years ago, but this year it will handle 70 million passengers, the vast majority of which are Chinese traveling the world and potentially developing Western preferences. That's a powerful force behind the Pernod Ricard story.

**How much of a problem will exposure to Europe and North America be?**

**TR:** Developing and emerging markets account for maybe 40% of the business, with Western Europe roughly one-third and North America around 25%. I don't spend a lot of time trying to handicap how the debt crisis plays out and its near-term effect on the economy, but I do believe Europeans and Americans will continue to indulge in small luxuries with relatively small price points like those

Pernod sells. The risk is if retailers panic as they did in 2008 and pull sharply back on inventories. Barring that, any developed-market sluggishness should be more than offset by emerging-market growth.

**With the shares trading at a recent €68, how are you looking at valuation?**

**TR:** The stock trades at about 14x next year's estimated earnings, for a company I believe can grow net income at low dou-

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## ON THE DOLLAR:

**Over time the dollar has been declining in value – I am happy to maintain our natural exposure to other currencies.**

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ble-digit rates for several years. Given the overhang from concerns about Europe, I would argue that any further multiple compression is unlikely and believe the multiple should actually expand if growth comes in as I expect and as potential in places like India is better recognized. Even if the share price just rises with earnings growth, we expect to be perfectly happy.

**Do you hedge currency exposure here?**

**TR:** No, which is true as a general rule. I looked back at the impact currency has had on my returns since 1991 and found it has added an incremental 0.5% per annum. It has followed a volatile path, but over time the dollar has been declining in value, a dynamic I would expect to continue given seismic movements in global economic power. Given that, I am happy to maintain our natural exposure to currencies other than the dollar.

**Moving along the adult-beverage spectrum, describe the upside you see in Anheuser-Busch InBev.**

**TR:** I have been a long-time investor in the global beer market for many of the

same reasons I like the spirits business. Brands when properly handled convey stature and standing, making them aspirational. This creates vast opportunity when aspirational consumers are increasingly able to afford the product.

But I had never been a big fan of either Anheuser-Busch or the company that bought it in 2008, InBev. With A-B, I wasn't convinced management was sufficiently focused on building long-term brand and shareholder value. With InBev, my concern was that its famous penchant for cost cutting risked hollowing out the institution and its brands over time.

I took a closer look as the integration of the two businesses got underway. This is a scale business, in which high market shares translate into marketing advantages, distribution advantages and operating-cost savings. The merged company was ideally suited to capitalize on its scale, as it now controlled 20%-plus of a global market that has become far more consolidated.

I have since gained an appreciation for management as much more than mere cost cutters. I saw it first in the way it creatively re-positioned Stella Artois from a bargain-basement brand to one celebrating more of a high-end, fashion-setting image and competing head on worldwide with other European brands such as Heineken and Peroni. I heard it in how they talked about Anheuser-Busch's legacy marketing focusing too much on the clever and cute and not enough on actually building long-term brand loyalty. Their execution of large-scale and high-cost marketing partnerships with soccer's World Cup and the National Football League has illustrated both global marketing brawn and local marketing sophistication.

Which is not to say they don't know how to run a tight ship. For example, in North America since the acquisition management has taken out costs across the board, been more strategic with advertising and marketing spending, and raised prices on low-end brands. Operating margins for the North American Anheuser-Busch business have gone from the mid-20s to now pushing 40%.

**What are they doing to revitalize the faded Budweiser brand?**

TR: As much as we may have enjoyed the “What’s up?” commercials or those with chirping frogs, the reality was that those types of campaigns had much more talk value than Budweiser brand value. That led over time to the hollowing out of the brand and a big decline in market share, a void that luckily for the company was more than filled by the rise of Bud Light.

Management does not believe Budweiser should be allowed to languish further, so has relaunched the brand to early success in the U.S. by celebrating its

American heritage and the notion that it is a beer that rewards hard work. They’ve also done something I would not have thought possible, which is turn Budweiser into a premium growth brand outside the U.S. By playing up its iconic association with American values, Bud is expanding rapidly in places like China, Brazil and Russia, where the premium ends of the market are small but growing rapidly.

In China, for example, Budweiser already has 35% of the premium import market, which accounts for maybe 4% of the 550 million barrels of beer sold each year. Management believes over the next decade the overall Chinese market will hit

one billion barrels per year and that the premium piece will go to 15%, comparable to most developed markets. Back-of-the-envelope math would indicate that if Bud can maintain its share of premium beer sales in China, its operating profit in the market could go over the decade from around \$200 million to \$3 billion. That is just one brand in one admittedly giant market, but shows the kind of global opportunity the company has.

**How cheap are the shares, now at \$58.20?**

TR: The valuation today is quite modest at just over 13x 2012 consensus earnings estimates. The market seems to be concerned in the near term about rising input costs and doesn’t yet grasp the potential in developing markets. We believe there is a clear path through reinvestment and continued cost synergies from the A-B acquisition for the company’s bottom line to grow at a low- to mid-teens annual rate for some time – with the stock price at least following suit. The market seems leery of management’s ability to execute, a concern I find completely unfounded.

**What’s behind your interest in consumer-products giant Unilever [UN]?**

TR: The basic premise here is that the company has the highest relative exposure to fast-growing developing markets, while at the same time has been the least well-run of the large global consumer-goods companies. As it hits its full stride, the upside potential is quite high.

Unilever’s heritage has been a mixed blessing. It was early in building out its global footprint, so that a relatively high 55% of revenues today come from developing and emerging markets. It has long-established and thriving businesses in places like India and Brazil, giving it a leg up in the parts of the world that should grow the fastest.

On the other hand, an overly complex and duplicative organizational structure left it with excessive fixed costs, a lack of decentralized accountability for results, inconsistent brand-building efforts, inadequate information systems and a muted

**INVESTMENT SNAPSHOT**

**Anheuser-Busch InBev**  
(NYSE: BUD)

**Business:** Largest global brewer with 14 of its brands – including Stella Artois, Beck’s, Budweiser and Michelob – generating annual sales in excess of \$1 billion.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>58.22</b>
52-Week Range	49.05 – 64.53
Dividend Yield	1.7%
Market Cap	\$92.82 billion

**Financials (TTM):**

Revenue	\$38.64 billion
Operating Profit Margin	30.9%
Net Profit Margin	12.9%

**Valuation Metrics**

(@11/28/11):

	<b>BUD</b>	<b>S&amp;P 500</b>
Trailing P/E	18.9	13.4
Forward P/E Est.	13.7	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Clearbridge Adv	0.3%
KeyBank	0.3%
Gardner Russo & Gardner	0.2%
Wellington Mgmt	0.2%
Brown Brothers Harriman	0.2%

**Short Interest** (as of 10/31/11):

Shares Short/Float n/a

**BUD PRICE HISTORY**



**THE BOTTOM LINE**

With unmatched global scale in a scale business and management that appears as adept at brand building as it is at cost cutting, Tom Russo believes the company’s earnings can growth at a low- to mid-teens annual rate for some time – with the stock price, now trading at a “modest” 13x forward earnings, at least following suit.

Sources: Company reports, other publicly available information

sense of urgency. Up against companies like Procter & Gamble, Nestle, Colgate-Palmolive and Reckitt Benckiser, that put them at a competitive disadvantage that has been a challenge to overcome.

Much of our bet is that Paul Polman, who took over as CEO in 2009 from Nestle, will successfully complete the cultural transformation started under previous CEO Patrick Cescau. It's a monumental task, but he is rooting out organizational inefficiency and inefficient manufacturing utilization. He is investing in management information systems like those he championed at Nestle, which promote localized decision-making sup-

ported by company-wide best practices and information. He is more consistently nourishing brands with the proper amount of advertising and marketing support. All told, he still has 200 to 300 operating-margin basis points to go to get to the minimum mid-teens level a business like this should have.

One concern I have is that the company may have moved too quickly on the acquisition front, buying the personal-care business of Sara Lee in 2009 and then Alberto Culver about a year ago. Those businesses have been slow to integrate, complicating the broader transformation and slowing it down.

**What upside do you see in the U.S. ADR, now at \$32.40?**

**TR:** At a 14x forward multiple, the shares trade at a discount to peers. The company owns publicly traded subsidiaries in India and Indonesia, which trade at much higher multiples and if backed out make the rest of the business that much cheaper. I could do clever things like short out the subsidiary exposures to isolate the core business, but I'm content to win from them delivering on relatively modest expectations from an unchallenging valuation.

You have 55% of the business in markets that are typically growing at an annual rate of 10-15%. With operating leverage and the margin improvements coming through, that should sustain bottom-line growth in excess of 10% per year. If that happens and we get some multiple expansion on top of that, we'll do well.

This is still a show-me idea. But the model of P&G under A.J. Lafley and Reckitt Benckiser under Bart Becht – when those firms delivered enormous shareholder value during similar periods of transformation – leads me to believe the payoff here could be well worth the wait.

**Your position in Wells Fargo would appear to be a strategic departure. Is it?**

**TR:** Wells is a company whose shares I have owned for almost 20 years. While not a perfect match with the rest of my portfolio, it has a long and successful history in nurturing and taking advantage of its first-class consumer brand. It has evidenced significant capacity to reinvest, and management has shown the willingness time and again to focus on building long-term value at the expense of short-term criticism.

I consider the stock today a 50-cent dollar, in large part because of the market's profound concern about the banking sector in general. Just a few weeks ago the stock fell 5-6% after an analyst report highlighted how American banks were exposed to trouble in Europe. The reality is that Wells is not that exposed to

**INVESTMENT SNAPSHOT**

**Unilever**  
(NYSE: UN)

**Business:** Manufactures, markets and sells consumer packaged goods in more than 180 countries; brands include Knorr, Lipton, Dove, Vaseline, Axe and Brylcreem.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>32.40</b>
52-Week Range	28.20 – 35.17
Dividend Yield	3.3%
Market Cap	\$92.21 billion

**Financials (TTM):**

Revenue	\$59.74 billion
Operating Profit Margin	13.3%
Net Profit Margin	9.8%

**Valuation Metrics**

(@11/28/11):

	<b>UN</b>	<b>S&amp;P 500</b>
Trailing P/E	16.0	13.4
Forward P/E Est.	14.0	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Wellington Mgmt	1.5%
Invesco	1.1%
Fisher Inv	0.9%
Capital World Inv	0.8%
BlackRock	0.6%

**Short Interest** (as of 10/31/11):

Shares Short/Float	n/a
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**UN PRICE HISTORY**



**THE BOTTOM LINE**

The company's operational and cultural transformation under CEO Paul Polman is a "monumental task," says Tom Russo, but he believes the resulting margin gains coupled with strong developing-market growth will fuel 10%-plus bottom line growth. Multiple expansion on top of that, he says, would make "the payoff well worth the wait."

Sources: Company reports, other publicly available information

Europe's problems, but its stock goes along for the bumpy ride with the rest of the industry.

**What sets Wells apart in your mind?**

**TR:** It starts with a clear focus on retail banking and a culture oriented toward driving customer involvement with a broad range of products. They recognize that just by staying close to home they can leverage the returns that accrue from increasing the number of products and services – from checking, to credit cards, to wealth management – sold per household. That's how employees in the branch are incented. This focus has kept Wells from having to rely on wholesale money, derivatives and sophisticated financial instruments to generate profits. They do things the old-fashioned way, lending money and offering financial services.

The ongoing opportunity – and challenge – for Wells today is to successfully transmit its culture to the Wachovia business it purchased at the height of the financial crisis. Wachovia had essentially the same footprint as Wells in terms of branches and total assets, but it sold far fewer products per customer, relied much less on core retail deposits, was more involved in reckless mortgage lending and had gone further afield in investment and corporate banking. That cost it its independence and allowed Wells to buy it – in a splendid capacity-to-reinvest moment – at roughly 10% of what Wells was worth at the time.

The process of making acquired Wachovia more Wells-like has burdened the income statement since the merger, as have crisis-related expenses that will not last forever. Duplicate integration expenses have run at well over \$1 billion per year since the acquisition. There are also significant costs attached to managing through troubled real estate loan portfolios and in dealing with unprecedented refinancing activity. As these costs continue to go away and the Wachovia business starts to operate according to new metrics more consistent with those of Wells, you should see a dramatic increase in the company's earnings power.

On top of that is the earnings benefit that will come from the eventual return of a more normal yield curve. I cannot tell you when the world becomes safe enough for capital that we will once again have a yield curve that makes sense, but I am quite confident it will happen, and it will relieve some of the massive pressure on net interest margin that comes from investing non-loaned money at rates painfully close to what's being paid for core deposits.

**What does "normal" look like here and how do you see it impacting the share price, now at \$24.15?**

**TR:** I have a high degree of comfort that profits should approach \$4-plus per share by 2014. If that happens, I don't know what the multiple will be, but it will likely be significantly higher than today's 6x that normal earnings level. In the meantime I am comforted by a balance sheet that isn't pledged with instruments I can't understand and by a retail franchise that is secure and offers enormous value to consumers who use it.

**What could go wrong?**

**TR:** The world remains troubled from a capital standpoint, so it's likely that Wells

**INVESTMENT SNAPSHOT**

**Wells Fargo**  
(NYSE: WFC)

**Business:** With \$1.3 trillion in total assets, provides banking, insurance, investments and mortgage products and services through 9,000 offices primarily in the U.S.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>24.15</b>
52-Week Range	22.58 – 34.25
Dividend Yield	2.0%
Market Cap	\$127.36 billion

**Financials (TTM):**

Revenue	\$72.87 billion
Operating Profit Margin	35.6%
Net Profit Margin	20.8%

**Valuation Metrics**

(@11/28/11):

	<b>WFC</b>	<b>S&amp;P 500</b>
Trailing P/E	8.9	13.4
Forward P/E Est.	7.4	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Berkshire Hathaway	6.8%
Fidelity Mgmt & Research	3.8%
Vanguard Group	3.7%
State Street	3.6%
Capital World Inv	2.9%

**Short Interest** (as of 10/31/11):

Shares Short/Float	1.0%
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**WFC PRICE HISTORY**



**THE BOTTOM LINE**

As integration expenses from its acquisition of Wachovia go away and the acquired business achieves metrics more consistent with its own, the company's earnings power should increase sharply, says Tom Russo. That, he says, would warrant a "significantly higher" multiple than the current 6x his \$4-plus estimate of normal per-share earnings.

Sources: Company reports, other publicly available information

will be required to tie up more capital than it needs. That may limit its flexibility in buying back shares, which at today's prices would likely be highly accretive to shareholder value.

There is also always a risk that the company is no longer content with being the best retail bank and deploys capital elsewhere, say into the investment-bank and brokerage businesses acquired from Wachovia that can have a way of siphoning off investment. I do not believe that will happen, but it's worth watching.

**While Wells is your only bank, you obviously have no hesitation owning multiple companies in the same industry. Why?**

TR: There are not that many great businesses in the world, so to the extent I can have multiple exposures in them, I am lucky. Pernod is one of three spirits companies I currently own, the others being Brown-Forman [BF-B] and Diageo [DEO]. In addition to AB-InBev in beer, I

have owned Heineken [HEIO:NA] since 1989 and SABMiller since 2008. We also spoke about tobacco. In general, it seems artificial to me to force myself to buy the best steel mill, for example, because I

**ON SECTOR INVESTING:  
It seems artificial to force myself to buy a steel mill because I have filled my allotment for spirits companies.**

have already filled my one allotment for a global spirits company. Where it gets a bit awkward is when I'm expecting companies in the same industry to expand share in the same key countries, but given the overall growth potential in those countries and the admiration I have for the companies' franchises and management, I

don't consider that an overly risky position to take.

**You seem more or less unperturbed by the market turbulence we've experienced in recent years. Any secret to that?**

TR: I've been lucky enough to have trained at the Sequoia Fund and to have invested in Berkshire Hathaway for the past 28 years, so I've tried to learn from those who take a patient posture and have had such robust success.

Recent commentary around Bill Miller's retirement suggested that investing today is a new game requiring a new set of tools. I believe pronouncements of a new era will prove to be as misplaced going forward as they have been in the past. The work Bill did over his career – identifying great businesses trading at fair prices and lengthening out the time horizon to investors' profit – should remain a rewarding game going forward. That is the game I attempt to play as well. VII

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# Investor Insight: Bernzott Capital

Kevin Bernzott, Scott Larson and Thomas Derse of Bernzott Capital Advisors explain why even the best companies fall from favor, why they emphasize the sustainable over the cyclical, why they'll at times invest in what the market considers a value trap, and why they believe PetSmart, Interval Leisure, Equifax, Teleflex and Energizer are mispriced.

Your basic strategy is to invest in high-quality companies at attractive prices. Is there anything unusual about how you assess quality?

**Kevin Bernzott:** Quality to us probably means what it does to most investors. We focus on companies with \$500 million to \$5 billion in market cap, where we believe we're most likely to uncover mispriced opportunities. From there we winnow down the opportunity set based on any number of quality measures: significant market share, high industry barriers to entry, recurring revenues, high margins, high returns on capital, low capital-spending intensity, reasonable leverage, strong management teams, proven shareholder friendliness.

We regularly track our portfolio companies against companies in the Russell 2000 Value index. Today, for example, our 30 or so companies have an average operating margin of 17%, vs. 8.5% for the index. The average return on equity over the past five years is 20%, vs. less than 7% for the index. The interest-expense coverage is higher, earnings growth is higher and growth in dividends is higher, but the P/E on trailing earnings is lower. That pretty well sums up what we're trying to do.

We're essentially looking for companies that can reinvest in their businesses at good rates of return, which allows value to compound over time. A lot of people invest based on specific catalysts they see happening over the next 12 to 18 months, where if you're right you make a lot of money and if you're wrong, you take your lumps and move on. That can certainly work, but that's not our going-in strategy.

**Scott Larson:** I'd highlight the importance we put on recurring revenue. That can come from selling products con-

sumers use every day, like PetSmart [PETM] selling pet food, from subscription-type businesses, like Liberty Starz [LSTZA] with its premium movie channels, or in industries with high switching costs, such as providing core processing for banks like Jack Henry [JKHY] does, or renting and cleaning uniforms like Cintas [CTAS] does. The more reliable the revenue stream, the more confidence we have in our ability to predict future cash flows and the more protection we have against unexpected risks and against basic economic cyclicalities.

Jack Henry is a good example of what we're looking for. The core-processing industry is an oligopoly with rational competitors. Switching costs are high, so at least 80% of Jack Henry's revenues recur from existing customers. Debt leverage is low. Operating margins are in the low-20s and management has proven to be solid operators and adept at making acquisitions to grow. This is the type of company we'll have on our wish list of stocks to own that meet our criteria for quality. Then it's just a function of patience and waiting for the right price. We don't believe that there's ever a bad time to buy a quality company if the price makes sense.

**What typically happens to produce prices that make sense?**

**KB:** Many times it's just a bad quarter or two that whacks the stock price and we believe we understand what the problem is – and more importantly, management understands what the problem is – and it's temporary and fixable.

We try not to invest in cyclical companies, but the market at times can treat almost anything as if it's highly cyclical – certainly the case in late 2008, early 2009. Unemployment was going up, so Cintas' business was perceived to be in



Scott Larson, Kevin Bernzott, Thomas Derse

## On the Beat

There are less-traveled paths to an investment career and then there is Kevin Bernzott's. After four years as a policeman in Southern California, in 1979 he became the security director for a real estate developer then building the San Fernando Valley's Sherman Oaks Galleria, later made famous in the movie *Fast Times at Ridgemont High*. He parlayed that into a long stint as a real estate operations manager, developer and investor, earning a law degree along the way.

An avid equity investor on his own, he started Bernzott Capital Advisors in 1994. "It became clear to me that I enjoyed securities management far more than beating my head against the wall with planning commissions," he says. Now with some \$400 million in assets under management, he shares portfolio responsibilities with Scott Larson, who joined the firm after ten years in private equity, and Thomas Derse, a former accounting-firm partner.

"Having come to this later in life with some varied experiences I think helps me avoid getting lost in the details," says Bernzott. "Figuring out what's most important is often more than half the battle."

trouble. The banking sector was under siege, so Jack Henry was considered highly vulnerable. It's not that the concerns are unfounded, just that they can be significantly overdone relative to the true long-term impact. Revenues may be stickier than expected. Management may have more levers to adjust expenses than people think. And then when the business once again improves, the companies we want to own are typically poised to benefit more than most. When there's a 20% impact on the market value that should have been more like 2-3%, that can create opportunity for us.

**SL:** Companies transforming themselves also increases the potential for misunderstanding. We own Ascent Capital [ASCMA], for example, which originally was a media production company inside Discovery Communications. After splitting off as a public company it has totally remade itself through the acquisition of Monitronics, a residential security-monitoring company. That's a business we know well, with strong, stable cash flows and high margins, so late last year when the market was confused about what the company was and management wasn't going out of its way to tell its story, we had the chance to get in at a compelling price.

Lexmark [LXK] is another current example. The company is getting out of the consumer side of the printer-and-ink business, and declines there are masking strong results on the commercial side of the business on which it's now focusing. The stock over the summer traded as low as 5-6x free cash flow, which we thought significantly undervalued the ongoing business – 50% of which comes from outside the U.S. – and gave them no credit for roughly \$1 billion in excess cash that was available to buy back stock and initiate a dividend, both of which they have done.

**What tend to be deal-killers today when deciding whether or not to buy?**

**KB:** Number one is probably high leverage, particularly when there's a constant need for open access to capital to keep the

business running. That's a primary reason we're almost entirely out of financial services at a time when the sector accounts for more than 30% of our benchmark. That's not a top-down call, but an outcome of our process and desire to avoid leverage risk.

**Thomas Derse:** We've also been very careful around companies that rely too heavily on government spending. A lot of defense-related firms are showing up on our screens, for example, with attractive

## ON RED FLAGS:

**We've been careful around companies that rely too heavily on government spending – they don't control their destiny.**

margins, nice market shares and low valuations. But our concern is that they don't control their own destiny and there's more risk to the downside for them than there is opportunity to the upside.

**SL:** Earlier this month we were all lined up to start buying PerkinElmer [PKI], which sells instruments, consumables and services with medical and environmental applications. One area of focus in our research was capital allocation, particularly the company's mixed record with acquisitions. We had overcome that concern, but the day before we planned to start buying the stock they announced they were making a \$600 million acquisition (of Caliper Life Sciences) at more than 4x revenues. It's still on our watch list, but the acquisition brought our concerns about capital allocation enough to the fore that we decided to hold off on buying.

**Describe your general valuation process.**

**SL:** We're traditional discounted-cash-flow investors. We're well aware of the pitfalls in building models where a tweak of this long-term growth assumption or

that margin assumption can have a huge impact on the estimate of intrinsic value. We try to counteract that by layering in conservative assumptions and by focusing on companies where revenue growth, while important, is not the primary driver of the investment. We also make an effort to calculate each company's actual weighted average cost of capital and then use something 100 to 200 basis points higher in our calculations. Today we're typically using 10-11%.

We're looking to pay no more than 60-70% of our estimate of fair value. For companies with stronger track records and more unassailable business models, a 30% discount may be perfectly fine. We don't think we're ever taking big fliers on anything, but the less confident we can be in our forecasts, the higher the discount we require.

**One could question the unassailability of the models for a couple of your holdings, such as Valassis Communications [VCI] or Coinstar [CSTR]. Describe how they fit what you do.**

**SL:** Valassis is a transformation like those I spoke about earlier. A core business, selling promotional space in free-standing newspaper inserts, is clearly in decline. One key attraction for us is that it is transitioning those customers into its shared-mail products, primarily the Red Plum mailers that go out stuffed with coupons and advertising flyers. Because the incremental profitability of adding new advertisers to each mailing is very high, we're betting that margins and the bottom line expand as that transition proceeds.

You could also question the long-term viability of the company's shared-mail product. Our view is that consumer-products companies will continue to use coupons as a way to increase sales and defend market share. In the last few years we've actually seen record coupon issuance and redemptions, which indicates the business still works. As for Internet-based competition, digital coupon products – which Valassis also provides – make up a microscopic share of redeemed coupons, and the Groupings

and Living Socials of the world are serving an entirely different customer. There is certainly risk in how it all plays out for Valassis, but we think the concerns are more than in the stock price at less than 6x free cash flow.

Coinstar is somewhat different from our typical holding in that we've traded a bit more around it as it goes in and out of favor. Current financial results have been awesome, driven by growth in the RedBox DVD-kiosk business. The company recognizes that business eventually will be threatened by widespread Internet distribution of movies, but their view – which we share – is that the day of reckoning is many years away. In the meantime, management can use the excellent cash flow it generates to reinvest in existing or new businesses or to return money to shareholders.

The company enjoys a valuable relationship with retailers and is looking at a variety of kiosk-type opportunities with strong potential. Just because they see something coming doesn't mean they'll be prepared when it happens, but at today's valuation – 11x estimated 2012 EPS – we still believe surprise is more likely to be to the upside. It's obviously something we're watching closely, however.

Describe your investment case for PetSmart [PETM].

TD: With approximately 1,200 stores, PetSmart is the largest retailer of pet supplies and services in North America. It has diverse sources of revenue, roughly half coming from consumables like pet food, a third from hard goods like leashes and toys, and most of the rest from services, including grooming, training and boarding.

The company's market is large, growing and still fragmented. Nearly \$50 billion will be spent on pet products and services this year, up 5% from last year, which is on the low end of the expected longer-term growth trend. Pet ownership is still rising, as is spending per pet as owners increasingly humanize their pets, making the demand for PetSmart's wares nicely inelastic. One recent relevant

example: U.S. pet owners just spent an estimated \$42 million on Halloween costumes for their dogs, at an average ticket price of \$10.

PetSmart accounts for 14% of industry pet-products revenue and 15% of the services market. That leaves it ample room to increase market share, while often picking off the higher-end customer. Their typical customer is affluent, spending nearly 80% more per year on their pets than the market average. All these positive trends have fed consistent growth even in difficult times – company same-store sales have risen for more than 20 straight quarters.

Isn't the health of the market attracting plenty of competition?

TD: No question. Broad-based retailers like Wal-Mart, Target and the grocery chains have been expanding their pet-related offers, and even places like Home Depot and Old Navy are getting in on the act. While none of that can be taken lightly, our basic view is that PetSmart's product variety, unique service offerings and well-trained, pet-loving sales personnel will continue to stand out for the customer who views his or her pet as a member of the family. The company has also been focused on making its product

INVESTMENT SNAPSHOT

**PetSmart**  
(Nasdaq: PETM)

**Business:** Leading specialty retailer with more than 1,200 North American stores offering an extensive range of pet-related consumables, hardgoods and services.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>46.74</b>
52-Week Range	37.63 – 49.04
Dividend Yield	1.2%
Market Cap	\$5.22 billion

**Financials** (TTM):

Revenue	\$6.00 billion
Operating Profit Margin	8.1%
Net Profit Margin	4.6%

**Valuation Metrics**

(@11/28/11):

	<b>PETM</b>	<b>S&amp;P 500</b>
Trailing P/E	19.3	13.4
Forward P/E Est.	15.6	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Longview Asset Mgmt	6.1%
Goldman Sachs	5.0%
Vanguard Group	4.2%
CI Investments	4.1%
State Street	3.0%

**Short Interest** (as of 10/31/11):

Shares Short/Float	3.4%
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**PETM PRICE HISTORY**



**THE BOTTOM LINE**

Bolstered by its leading position in serving a growing and still-fragmented market for pet products and services, Thomas Derse believes the company can increase earnings at least 10% annually. His discounted-cash-flow model on its shares, assuming mid-single-digit sales growth and modest operating leverage, yields a \$69 fair-value estimate.

Sources: Company reports, other publicly available information

mix even more unique by launching more private-label items and partnering with well-known brands, such as Martha Stewart, to offer exclusive product lines.

This also is a category not as susceptible to online competition. Heavy, awkward-sized items like bags of pet food are typically more efficiently sold through retail.

**PetSmart has scaled back its growth ambitions. Is that a positive or negative?**

**SL:** We consider it a positive. Historically the company has grown square footage 8% or more annually, but that's been cut to around 3% as it opens fewer, smaller new stores and focuses on optimizing overall operating performance and driving free cash flow. We expect that to result in more capital being returned to shareholders in the form of dividends and stock buybacks.

**With the shares now at around \$46.75, how are you looking at valuation?**

**TD:** We're comfortable with management's goal to consistently deliver double-digit annual earnings growth. On estimated EBITDA of \$815 million and EPS of \$2.90 for the fiscal year ending in January 2013, the stock currently trades at an EV/EBITDA multiple of 6.9x and a P/E of about 16.5x.

For a company with 25% returns on capital and with a leadership position in a growing market with inelastic demand, we don't consider that at all expensive. Assuming revenue growth in the mid-single digits, some modest margin expansion and a weighted-average cost of capital of 10%, our DCF model puts fair value at \$69 per share.

**What's behind your interest in Interval Leisure Group [ILG]?**

**SL:** The company's primary business is a vacation-time-share exchange network, in which 1.8 million members can trade time at a property they own for time at properties owned by other members.

Interval earns revenue through annual membership fees of at least \$90 – paid by timeshare developers or individual owners, who collectively renew at roughly 90% annual rates – and through transaction fees of around \$160 each time an exchange is made.

In addition to liking the recurring nature of the revenue, another particular appeal of the business is that it's essentially a duopoly, with Interval the #2 player behind Wyndham Worldwide's RCI. Interval is widely credited with having the higher-quality network, with a more diverse and higher-end variety of resorts offered. Because Wyndham itself is a

major time-share developer, other players such as Four Seasons, Sheraton, Starwood and Westin have resisted having their properties listed with RCI. The overall network effect for Interval is highly positive: the more available options, the more members who then add new properties to the network.

**The timeshare business hasn't exactly been thriving.**

**SL:** That has been a headwind for Interval, as demand for timeshares has lagged with the soft economy. While Interval has done a good job in driving up

**INVESTMENT SNAPSHOT**

**Interval Leisure Group**  
(Nasdaq: ILLG)

**Business:** Operator of second-largest timeshare exchange network, with 1.8 million members who own property in 2,600 resorts in more than 75 countries.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>13.37</b>
52-Week Range	10.19 – 17.94
Dividend Yield	0.0%
Market Cap	\$748.9 million

**Financials** (TTM):

Revenue	\$422.8 million
Operating Profit Margin	22.8%
Net Profit Margin	9.1%

**Valuation Metrics**

(@11/28/11):

	<b>ILG</b>	<b>Russell 2000</b>
Trailing P/E	20.5	42.2
Forward P/E Est.	17.4	19.9

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Gates Capital Mgmt	5.4%
Macquarie Group	4.9%
Wallace R. Weitz & Co	4.4%
Van Berkorn & Assoc	3.7%
Vanguard Group	3.7%

**Short Interest** (as of 10/31/11):

Shares Short/Float	3.7%
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**ILG PRICE HISTORY**



**THE BOTTOM LINE**

Cyclical industry headwinds are causing the market to misprice the company's high-quality core business, which benefits from highly recurring revenues and significant barriers to entry, says Scott Larson. Assuming modest industry growth resumes by 2014, he estimates the fair value of the company's shares today at around \$20.

Sources: Company reports, other publicly available information

revenue per member, its membership base is down 10% from a pre-crisis peak of 2 million. That's far more stability than timeshare developers have experienced, but it has made growth for Interval difficult to come by.

Our feeling is that the value proposition for timeshares is still attractive, excess inventory will be worked off and that the growth that everyone seems to think is gone forever will return. It won't be the double-digit annual gains of the two decades prior to 2008, but it doesn't have to be in order for Interval's membership base and revenues to start expanding again. We expect the overall market to be flat over the next two years, but that it can grow at least 3% annually thereafter.

**Interval is expanding its hotel management business. Does that make sense?**

**SL:** The company now provides management services to more than 25 resorts and hotels, mostly in Hawaii. We don't love that the business is more cyclical and has lower margins, but it's a reasonable avenue for expansion and the rebound in it today has been offsetting weakness in the core exchange business. It's still a very small part of what makes the company go from a cash flow perspective.

**What fair value do you ascribe to the shares, now around \$13.40?**

**SL:** For our DCF calculation we assume 3% annual revenue growth starting in 2014, a 10% cost of capital, and operating margins expanding at 30 basis points per year to just over 25% in 2020. Margins have been higher than that in the past and there's plenty of inherent operating leverage, but we're trying to be conservative. With all that we arrive at a fair value of \$20 per share.

One additional positive is that John Malone's Liberty Media owns nearly 30% of Interval and has two people on the board. I have no idea if Liberty sees this as a core holding, but it has been an active shareholder and is the type of investor we like to have on our side.

**What do you think the market is missing in Equifax [EFX]?**

**SL:** Equifax is known primarily as one of the three big credit bureaus in the United States, along with Experian and TransUnion. But it also augments that core information with a wide variety of income, wealth, demographic and employment information so that it can provide to customers what it calls a 360-degree view of the consumer. Buyers use it to improve their own profitability through better risk underwriting, more precise targeting of potential customers and more focused marketing messages.

The company has been collecting data and building its database of more than 300 million records over 100 years, providing it with a competitive advantage that any new entrant to the business would find hard to overcome. Revenue is highly recurring because the data and analytics Equifax provides are often built into customers' daily operations, say as part of the computer system a bank loan officer would use in processing applications. There's a nice network effect here also, as customers not only seek information from Equifax, but they also provide it with information, further enriching the database.

**INVESTMENT SNAPSHOT**

**Equifax**  
(NYSE: EFX)

**Business:** Provider of individual financial and demographic information that corporate and government customers use in a variety of sales and marketing applications.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>34.80</b>
52-Week Range	28.59 – 39.90
Dividend Yield	1.9%
Market Cap	\$4.21 billion

**Financials** (TTM):

Revenue	\$1.93 billion
Operating Profit Margin	23.5%
Net Profit Margin	11.4%

**Valuation Metrics**

(@11/28/11):

	<b>EFX</b>	<b>S&amp;P 500</b>
Trailing P/E	19.5	13.4
Forward P/E Est.	12.7	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Bank of NY Mellon	5.8%
Vanguard Group	5.3%
Fidelity Mgmt & Research	5.1%
Artisan Partners	5.0%
State Street	4.7%

**Short Interest** (as of 10/31/11):

Shares Short/Float	1.5%
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**EFX PRICE HISTORY**



**THE BOTTOM LINE**

Scott Larson believes the market isn't recognizing the extent to which the company is diversifying its product line and geographic footprint to compensate for sluggishness in traditional areas. Even without assuming a rebound in U.S. consumer-credit demand, he estimates the current fair value of the company's shares at more than \$50.

Sources: Company reports, other publicly available information

**How would you characterize the competitive environment with Experian and TransUnion?**

SL: It's an oligopoly in which the companies tend not to compete on price. They often provide joint services to banks and other lenders, for example, which pull data from more than one firm to assess a customer's creditworthiness. That price competition is not particularly cutthroat is evidenced by the fact that Equifax's operating margins have historically been in the mid-20% range.

**How troubling has the pullback in consumer credit activity been for Equifax?**

SL: With more than 40% of revenues coming from providers of financial services and mortgages, it's clearly had an effect. But the company has done an excellent job of launching new products in new markets and new geographies to more than offset that impact. Overall revenue grew 7% in 2010 and the company is targeting 6-9% annual growth (including acquisitions) going forward. Non-U.S. growth is a particular area of focus – international revenues now make up about a quarter of the total, but credit scoring is still in its infancy in most developing markets.

**At just under \$35, how inexpensive do you consider the stock?**

SL: The shares currently trade at 8.5x trailing EBITDA, versus 11x for Experian and the 11.7x Madison Dearborn is seeking for its stake in TransUnion. At 11.7x, Equifax would trade at around \$51.

That's almost exactly the value we get from our discounted-cash-flow model that assumes annual revenue growth of 4.5% and margin expansion of 20 basis points per year. Were the mortgage and consumer-credit markets to perk up, that would provide additional upside we're not betting on.

**Given the sensitivity of the information Equifax sells, is there risk that privacy concerns drive increased regulation?**

SL: The company is already heavily regulated by the Federal Trade Commission and has a good record of operating within all regulatory guidelines. The scrutiny of what they do has been constant, but at least for the time being we don't see it increasing.

**Teleflex [TFX] would appear to be a company-undergoing-transformation type of idea.**

SL: When we first started looking at Teleflex it was in three completely disparate businesses. We started to get more interested as it concluded it wanted to

focus solely on its medical-technology business, which it has now done after agreeing to sell both its industrial aerospace and marine divisions. We think that greatly simplifies the story and will highlight how attractive the healthcare-related business is.

The company sells mostly single-use medical supplies and devices to hospitals, with 50% of its business coming from overseas. The products include things like sutures, catheters and access ports, for which there is consistent and relatively sticky demand. Well-established brands like those Teleflex provides matter, and doctors and nurses are slow to

**INVESTMENT SNAPSHOT**

**Teleflex**  
(NYSE: TFX)

**Business:** Following the divestiture of two unrelated business units, now focused on the development, manufacture and sale of single-use medical supplies and devices.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>58.60</b>
52-Week Range	49.40 – 64.56
Dividend Yield	2.4%
Market Cap	\$2.39 billion

**Financials (TTM):**

Revenue	\$1.87 billion
Operating Profit Margin	14.4%
Net Profit Margin	12.6%

**Valuation Metrics**

(@11/28/11):

	<b>TFX</b>	<b>Russell 2000</b>
Trailing P/E	10.1	42.2
Forward P/E Est.	12.6	19.9

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Franklin Resources	7.9%
Parnassus Inv	7.5%
Vanguard Group	4.6%
Allianz Global Inv	4.0%
Ameriprise Financial	3.7%

**Short Interest** (as of 10/31/11):

Shares Short/Float	3.1%
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**TFX PRICE HISTORY**



**THE BOTTOM LINE**

After finally selling off disparate operating divisions, the company is now focused on a top-to-bottom operational improvement in its core medical technology business, says Scott Larson. Assuming annual revenue growth of 4.5% and operating margins improving to 21%, he believes the stock today is worth more than \$105 per share.

Sources: Company reports, other publicly available information

switch from products they trust and are comfortable using.

A big part of the story is the naming as CEO earlier this year of Benson Smith, a board member who had been President and COO of much-larger competitor C.R. Bard. He's gone through the business with a fine-toothed comb and is pursuing several pricing and operational initiatives that we expect to result in improved profitability. The operating margin today is around 17%, but the company's goal is to increase that by 150 to 200 basis points per year, eventually hitting 25%.

**How vulnerable is the company to regulatory obstacles in the future?**

SL: Most of their products are not particularly complex and sell for less than \$100, which are not typically the types of things for which the FDA mandates the use of alternatives or for which Medicare is seeking price cuts. That doesn't mean they're immune to cost pressures, but those pressures should be manageable.

**What upside do you see in the shares from today's roughly \$58.50?**

SL: We're assuming a long-term revenue growth rate of around 4.5% per year, which we don't consider aggressive given the demographic tailwinds to the business, high growth outside the U.S., and the potential for accretive tuck-in acquisitions. We're not as optimistic as management is on operating margins, but do expect them to hit nearly 21% by the end of our forecast period. Using a 10% cost of capital, our per-share fair value today is \$107.

Now that Teleflex is a pure-play medical-supply business, there's a good chance it could be attractive to a larger, acquisitive competitor such as Covidien or C.R. Bard. We'd expect them to try to improve the business first, but a buyout is certainly a potential ultimate outcome.

**From medical products to consumer products, describe the potential you see in Energizer Holdings [ENR].**

TD: The company is best known as the manufacturer of Energizer and Eveready batteries, but sells a diverse portfolio of consumer products that also includes Schick razors and blades, Hawaiian Tropic suntan lotions, Playtex tampons, Wet Ones sanitary wipes and the Diaper Genie. Roughly 50% of the business comes from batteries and lighting, 30% from shaving, 10% from skin care and the rest split evenly between feminine care and infant care. The brands tend to be #1 or #2 in their markets, and produce fairly predictable and recurring revenues, 50% of which now comes from outside the U.S.

The problem child today is batteries, a business in long-term secular decline because of the increasing sale and use of rechargeables. On top of that the industry is highly price-competitive, as all the big players – also including P&G with Duracell and Spectrum Brands with Rayovac – fight for market share. As if that weren't enough, input costs for things like zinc have been rising, putting even further pressure on battery margins.

Our view isn't that the battery business is poised to rebound, but that concerns about it are excessively built into the stock price and are overwhelming the positive efforts the company is making to

**INVESTMENT SNAPSHOT**

**Energizer**  
(NYSE: ENR)

**Business:** Global manufacturer and marketer of branded consumer products, including Energizer batteries, Schick shaving products and Hawaiian Tropic lotions.

**Share Information**  
(@11/28/11):

<b>Price</b>	<b>70.56</b>
52-Week Range	61.60 – 84.94
Dividend Yield	0.0%
Market Cap	\$4.72 billion

**Financials** (TTM):

Revenue	\$4.65 billion
Operating Profit Margin	14.6%
Net Profit Margin	5.6%

**Valuation Metrics**

(@11/28/11):

	<b>ENR</b>	<b>S&amp;P 500</b>
Trailing P/E	19.0	13.4
Forward P/E Est.	10.1	11.7

**Largest Institutional Owners**

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Lazard Asset Mgmt	5.5%
Vanguard Group	4.2%
Bank of NY Mellon	4.1%
UBS	3.1%
State Street	3.0%

**Short Interest** (as of 10/31/11):

Shares Short/Float	3.6%
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**ENR PRICE HISTORY**



**THE BOTTOM LINE**

The company's battery business is challenged, but Thomas Derse believes concerns about it are overly built into the stock price and are overwhelming positive efforts the company is making to more than compensate. His DCF model, assuming 5% annual revenue growth and margins expanding to 15%, yields a fair share value of \$107.

Sources: Company reports, other publicly available information

decrease its dependence on batteries and reinvest in other parts of the business to more than compensate.

**Give an example of the type of reinvestment effort you expect to pay off.**

**TD:** The best one is probably in shaving, where the company launched the Schick Hydro platform in 2010 and committed \$150 million in marketing support over five years to make it a success. The launch has gone well and we expect it to result in share gains for the company in the wet-shave market. Energizer also recently acquired American Safety Razor, which owns the Wilkinson brand, building out its low-end product offer and allowing it to rationalize manufacturing capacity and increase shaving margins.

**With the stock now at \$70.50, what expectations are you building into your estimate of fair value?**

**TD:** We actually expect battery-related free cash flow to increase over the next few years as the company rationalizes that business. Combined with solid organic growth in most other divisions, we estimate free cash flow will increase from around \$5.70 per share in the fiscal year ending in September to more than \$7.40 in fiscal 2013. On that estimate, the shares trade today at a 9.5x multiple. The EV/EBITDA multiple on 2013 estimates is 7.3x, a roughly 30% discount to where P&G trades.

In our discounted-cash-flow model we're assuming long-term annual revenue growth of approximately 5% and margin expansion through operating leverage of roughly 10 basis points per year, up to a normalized level of around 15%. That results in a fair value of around \$107 per share.

**Your biggest concerns?**

**TD:** We obviously have to pay careful attention to how well the decline of the battery business is managed. There's also always the risk of an over-reaching acquisition, but management so far has made

smart additions to the portfolio and hasn't overpaid.

We're encouraged by the fact that management has been reaching out more productively to shareholders in articulating their plans. Actions obviously speak louder than words, but the company has historically been less than warm in its communication with shareholders and we're happy to see that changing.

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## ON FOCUS:

**I've never gotten the fascination with investment pornography, like the latest thing Jim Cramer is talking about.**

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**Say you've been right on an investment. When do you know it's time to sell?**

**TD:** We have an updated sell price for everything we own and start to sell when the market price is 90% of that. We usually don't sell the entire position right away, partly because we may be reevaluating our fair value, but also because we've observed over time that stock prices can go well beyond our conservatively held fair value. We try not to get too cute with that, however. Much of what we've sold recently – such as Church & Dwight [CHD] and McCormick [MKC] – has been valuation-related. They're excellent companies, but there always comes a time to say goodbye.

**How about some less-happy examples?**

**SL:** A year or so ago we sold our position in Lender Processing Services, which provides processing and data-management systems for mortgage lenders, out of concern that scandals over the widespread mishandling of mortgage-loan relationships – even though LPS hadn't been implicated – would result in industry structural and regulatory changes that meant things would never return to normal. That's still to play out, but while we lost money on the position, we did avoid

another 40-50% drop in the stock price since then.

**SL:** Going a bit further back to something we didn't exit quickly enough, we watched fast-food operator Sonic go a few years ago from 20 quarters in a row of increasing same-store sales to a company that couldn't seem to get out of its own way. Management would lower guidance and the stock would fall enough that the valuation still looked compelling based on the new guidance. But they never hit their numbers, so the low valuation meant nothing. One lesson there is to be extremely wary when management keeps lowering guidance. Another is that when they start blaming declining sales on the weather, it's probably time to move on.

**It what ways are you incorporating macro views into your analysis today?**

**SL:** If the global economy struggles, we think by the nature of the conservative assumptions we build into our models that we're covered. Because we don't tend to own particularly cyclical companies, we're not that reliant on things returning to "normal" for the investments to work out. That's one of the virtues of our emphasis on predictable cash flows, which means some level of stability in most any economic environment. That's not to say the businesses and stocks won't respond even better to economic revival, but if we're buying right on conservative assumptions, we're not paying for that.

**KB:** We try not to spend much time worrying about things outside our control, and market pricing on any given day is one of those things. Historically, because of the types of companies we own and the prices we've paid for them, we capture most but not all of the upside in buoyant markets and more than hold our own in down markets. I've never understood the fascination with what I call investment pornography, like the latest thing Jim Cramer is talking about on television. We just try to stick to our knitting and the results should take care of themselves. **VII**

# Battle Planning

Never a glass-is-half-full kind of investor, James Montier sees plenty to worry about as he traverses the world in search of attractive potential returns. “I certainly wouldn’t want to be fully invested right now,” he says.

## INVESTOR INSIGHT



**James Montier**  
GMO

**On allocating assets:** “What else am I going to do?” is not the most compelling reason for doing something. If there’s nothing to do, do nothing.”

*Editors’ Note:* As a sell-side equity strategist prior to the financial crisis, James Montier was a consistently creative, provocative and contrarian critic of financial-market excesses and investor irrationality. Now a portfolio manager on the asset allocation team at Jeremy Grantham’s GMO, Montier maintains a somewhat lower public profile but his insights on investor behavior and market inefficiencies remain as razor-sharp as ever. We spoke with him recently from his office in London.

You’ve changed jobs since we last spoke [VII, October 31, 2008]. Any surprises in making the shift from the sell-side to the buy-side?

**James Montier:** It became apparent to me after 20-odd years on the sell-side that there weren’t that many places where my deep-value philosophy fit. There would be long periods in which I couldn’t find much of anything to be excited about, which always grates on the big houses. On top of that the analysts spent so much time trying to predict the next quarter’s earnings that actually trying to think like

a long-term investor was somewhat of a lonely proposition.

At GMO I’m surrounded by people who actually want to talk about investment, which is refreshing, and who are willing to take positions that might take a fair amount of time to play out even if that costs us clients in the meantime. I’m a member of the team charged with asset-allocation strategy, both long and short. We drill the asset classes down as far as we can, but hand specific securities selection over to other internal groups charged with populating the portfolios with the best in class.

Is it different for you having actual client money on the line?

**JM:** I don’t think it’s wrought particular havoc on my psyche or been much different than I expected. The feeling I get when a call results in bad performance is no worse than it was before, for example. I’m probably helped by the nature of GMO’s relationship with its clients. [Baupost Group’s] Seth Klarman always talks about the importance of having clients who understand what you’re trying to do and that it may not work every second of every day. On days when the market is down heavily, you should be focused on the opportunities that may present instead of on the phone with clients who ring up asking, “What’s going on?”

Three years ago you admitted experiencing some feelings of “incipient bullishness” about stocks. How would you rate the investing opportunity set today?

**JM:** When asked about the impact of the financial crisis on investor behavior, Jeremy Grantham had a lovely quote saying that history would suggest people would learn a lot in the short term, a little in the medium term and nothing in the long term. What has surprised me is that

people seem to have learned pretty much nothing the whole way through, reverting almost immediately to bad old habits.

Why do you say that?

**JM:** Because U.S. equities in the aggregate, for example, are still quite expensive. Because of the shockingly short-term focus of most market participants. Because of the obsession with relative returns, which always seems to happen when the market has been going up. Those kinds of bad behaviors keep coming back time and again and it never ceases to amaze me how little we actually learn from experience.

Look at bond markets worldwide. You mostly see record low yields, which I struggle to reconcile with central banks’ willingness to be so accommodative when it comes to liquidity creation. Bond investors are for the most part investing with no margin of safety.

Why do you think that is?

**JM:** I can only imagine that it’s some yearning for stability and safety in a risky and volatile world. But how safe and stable is it really to lend the U.S. government money for 10 years in return for a nominal 2% yield? I don’t get it.

Other sources of enthusiasm for bonds may have nothing to do with the true assessment of risk and return. I recently spoke with a number of corporate pension-fund managers who said they were being driven into fixed income in order to minimize volatility in their portfolios. Their CFOs didn’t want to have to explain why quarterly profits were being impacted by big moves in the pension fund, so the result is that accounting rules end up impacting fixed-income supply and demand. And I always thought pension funds were run for the benefit of the beneficiaries!

### How are you acting on your view that bonds have no margin of safety?

**JM:** We've been establishing short positions against government bonds, particularly those of Japan, the U.S. and Germany. We're partially hedging that exposure in duration terms, because we didn't want to be running naked short duration in an environment where concerns about economic growth are so prominent. It's perfectly possible over the next year or so that we'll see a significant global economic slowdown – being fully short duration into that would not be the world's best idea.

What we're doing then is buying reasonably valued insurance, which today includes longer-term Australian and New Zealand bonds. We're expressing the view that we don't like bonds that pay 2% or below, but we don't mind those paying the 5.5% we were able to get earlier this year in Australia and New Zealand.

### We take it you're not pounding the table for equities just because bonds are so expensive.

**JM:** I'm amazed at how common the relative valuation argument is. But you shouldn't forget that all that argument may be telling you is that bonds suck, not that equities are great. It's like going to Cinderella's house and meeting the two ugly stepsisters and being told you should be happy to date one of them. Personally, I'd rather wait for Cinderella.

None of that stops people who want you to buy equities from talking about how much better they are today than bonds. "What else am I going to do?" is not the most compelling reason for doing something. If there's nothing to do, do nothing. It's not that difficult.

Absolute standards of valuation get you away from the idea that you have to be doing something, which goes all the way back to Ben Graham. He was looking at all elements of the capital structure in a very unconstrained fashion, but was fully prepared to hold cash when there were no opportunities. Today with the

rise of specialist mandates and passive indexing, so many people want to be fully invested all the time. I'd argue that has caused our industry a lot of problems.

### What are absolute standards of valuation telling you about equities today?

**JM:** Our 7-year asset-class return forecasts are largely valuation driven and today show that no equity class is particularly cheap. Some, such as international

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## ON EUROPE:

### We believe this is the point at which one should begin to think about accumulating positions in Europe.

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large caps, emerging markets and U.S. high quality, are at what we would consider fair value, offering 5.5% to 6.5% real annual returns. That's not great, but it does allow us things to buy at a time when equities and equity-like instruments make up about 50% of our portfolio.

Our biggest allocation – roughly 20% of the portfolio – is in high-quality companies in three primary sectors: consumer staples, healthcare and big tech. Examples would be Procter & Gamble [PG], Johnson & Johnson [JNJ] and Microsoft [MSFT], all of which have high and stable profitability and low leverage.

The next-biggest allocations are 10% of the portfolio to Europe and around 8% to emerging markets. The percentage in European stocks has been increasing in recent weeks, and the cheapest things – other than financials, which we don't own – are the big telecoms and the integrated oil companies like Royal Dutch Shell [RDS-A], Total [TOT] and Eni [E].

Though we're finding things to buy, I certainly wouldn't want to be fully invested because of the chance we'll before too long be able to put capital to work at more attractive expected rates of return. The pendulum does swing backward as well as forward, so while we want some

risk assets – mostly in the form of the fairly valued equities we can find around the world – we want to keep plenty of dry powder. Our typical unconstrained asset-allocation fund is running with around 35% cash. Back in the summer we were as high as 55% cash.

### How does your new-found interest in Europe reflect your views on the ongoing debt crisis?

**JM:** I gave a speech on this recently in which I borrowed [Oaktree Capital Chairman] Howard Marks' concept of the "I know" vs. the "I don't know" investor.

The "I know" investor thinks knowledge of the future direction of economies, interest rates and markets is essential for investment success and is confident not only that he can have such knowledge, but that he'll have it first as well. These are people who are quite popular at dinner parties.

The "I don't know" investor doesn't believe that you need to know the future or even that you can, so spends most of his or her time on how big the margin of safety is and in assessing what risks can result in the permanent impairment of capital. This tends to be a contrarian lot and they aren't hugely popular at dinner parties.

That got me thinking about how the "I don't know" investor would approach Europe today. He'd first assess how big the margin of safety is, i.e. how cheap European equities are. It's a mixed bag, but in general when you look across European markets, while they're not once-in-a-lifetime bargains, the valuations are not bad and mostly at the low end of historical ranges. So you've got a degree of margin of safety here for sure.

The next step is to assess the risk of permanent capital impairment. I'd argue that outside of financials and other companies that are excessively leveraged, in many cases it's hard to construct scenarios in which assets over time so fundamentally deteriorate in value that capital is permanently impaired. Take Eni, the Italian oil and gas company, as an example.

Assume a really bad outcome, that Italy gets thrown out of the Euro zone. Does that really matter to Eni? The answer is probably not. It's a global integrated oil company that makes its money in dollars. It has exposure to Italy, but it's not that big a piece of its overall operations.

So from an "I don't know" perspective, we believe this is the point at which one should begin to think about accumulating positions in Europe. When babies and bathwater are thrown out together, that creates opportunity.

#### **You're not finding such "babies" among European financials?**

**JM:** With financials you can build a fairly easy case for permanent impairment. You have a stack of assets and a tiny sliver of equity, so it takes very little asset impairment to completely eradicate the shareholder – as we saw not long ago in U.S. and U.K. banks during the financial crisis. That makes me very nervous.

**Many find comfort in assuming that growth in places like China, India and Brazil will compensate for economic problems in the U.S., Europe and Japan. Do you?**

**JM:** People always overestimate the degree of independence world economies have. Emerging markets are slightly less export-driven than they used to be, but their growth is still largely dependent on what happens in the developed world. So it's kind of hard to argue for decoupling, which just never seems to materialize. That doesn't really auger for the hope that emerging economies are going to lead us out of the mess.

There's also I believe an inadequate recognition of the potentially severe bumps in the road to emerging-market growth. My colleague Edward Chancellor, for example, has written extensively on potential problems in China, particularly relating to a housing market that he argues is in the same sort of bubble that existed in the U.S. and U.K. That itself poses a significant threat to the intermediate growth prospects for China, and even

for the global demand for commodities. One has to be cautious.

All that said, from a valuation perspective emerging markets as a class are OK, with an expected 5.6% annual return in our 7-year forecast. They're not bargain-basement cheap, but nothing is. They deserve a reasonable representation in one's portfolio.

#### **Talk a bit more about how GMO arrives at its 7-year asset-class return forecasts.**

**JM:** Let's use equities as an example. There are four ways you can make money from buying an equity: revenue can grow, margins can increase, the P/E can go up, and dividends. My group spends its time thinking about how each of those is likely to move.

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### **ON MISTAKES:**

**It's easy to learn a specific lesson that isn't very helpful – you won't find yourself in exactly that situation again.**

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For example, as of October 31 our annual return expectation for the S&P 500 over seven years is 1.8%. On the plus side we see modest upside from revenue growth – based on mean reversion given that growth fell below trend during the financial crisis and hasn't yet recovered – and from dividends. We see a small negative impact from a change in P/Es, but the main drag on returns is most likely to be declining margins. It scares me that analysts by and large are expecting profit margins to go up even more over the next few years, which is one of the least likely outcomes I can imagine.

We effectively build mean reversion into our forecasts, that things will go back to normal after seven years. We don't necessarily expect to end up at fair value in seven years, but it's as good a bet as any over a seven-year horizon. Though I certainly have them, we try not to bet views, keeping it all empirically based and

reacting to the opportunity set we're presented with at any point in time.

**Turning to more of a behavioral-finance issue, we've noticed a mini-boom in articles and books about the virtues of making mistakes and how best to learn from them. Many investors talk a better game on this front than they actually play. How do you try to learn from your mistakes?**

**JM:** We have a deliberate process to at least once a year sit down and look at the mistakes we've made. If you do it too often you probably don't achieve much at all because you're constantly looking over things before the mistake is actually clear.

We try to focus more on process errors we can control than just on what went wrong in terms of outcomes. In my case, for example, that might mean finding and correcting the gaps in our process that led me to ignore certain aspects of our 7-year forecast in constructing a portfolio. It's also important to make sure you learn the right lessons – it's very easy to learn a specific lesson that isn't very helpful because you won't find yourself in exactly that specific situation again. You want to learn the most general lesson you can from the mistakes you make.

#### **Give an example.**

**JM:** We have a good-sized position in dividend swaps, which are popular in Europe. They allow you to separate the dividends a company pays from the multiple the market puts on the stock. We own dividend swaps on the Euro Stoxx 50, for example, which pass through the dividends paid by the 50 largest European companies. There's a futures markets that goes out to 2020 and at times the term structure can be extraordinarily downward sloping, to the extent that those dividends can be priced expecting a 40% fall by 2014 and to never grow again.

What has caught us off guard is the extreme volatility of this asset, the result of it being a favored vehicle for the flightier of the hedge-fund set. The general lesson is that you always have to think about who else is invested in your trades

– you may not want to be at the mercy of the madness of others.

**What can you imagine the risk-on, risk-off market driver is two years from now?**

**JM:** Debt today is the topic of concern globally, and I'm inclined to believe that won't have changed two years from now. Deleveraging is a slow and arduous process.

As Churchill said about Americans, politicians can usually be trusted to do the right thing when they've exhausted every other possibility. So only in the most heated part of a crisis can we actually expect policy makers to be vaguely sensible. The rest of the time they play politics, which doesn't bode well for addressing long-term debt issues. Politicians are unfortunately subject to exactly the same short-term preferences and desire for instantaneous gratification that most of us are.

**Does that mean we should get used to the type of volatility we've been seeing in equity markets?**

**JM:** The only time we've seen sustained really high volatility was during the Great Depression. When you look at a situation like Europe's, one can certainly make the case that sustained high volatility is going to be with us for some time – we're just so desperately at the mercy of politicians playing headline roulette. I saw a joke e-mail the other day with two mock Bloomberg headlines, the first saying, "EU Finance Ministers Finally Agree on Dinner Menu," and then the second warned, "Italy and France Deadlocked over Wine Selection." That sums up the risk of investing in Europe, which is likely to go from good news to bad news to good news at a fairly rapid clip.

The opportunity that creates is that it tends to scare people off and lead to lower prices, which is kind of what I live for as an investor. People always confuse temporary impairment, which is just price volatility, with permanent impairment. That's why you get price anomalies on which to capitalize. I'm perfectly happy to live with high volatility for a while because I suspect it will give us the opportunity to get some more capital invested.

**How do you avoid getting caught up in the day-to-day turmoil?**

**JM:** Just turning off the screens is usually a good start. It's the bias of the information age that people feel isolated when they're not in touch with what's going on. To me it's a good discipline to often say, "I don't really care what goes on in the market today." When you do that you can actually get something useful done. Even something simple like saying you'll only answer e-mails in the morning, at lunch and at the end of the day sometimes can go a long way toward avoiding unhelpful distractions that tend to arise.

We're very big on what we call battle plans, in which we map out how we'll behave at various price points in the market. John Templeton used to talk often about taking that kind of pre-commitment down to the level of individual securities. Because you've already decided what you should be doing, it allows you to focus your attention in a very useful way when the market is falling to pieces. **VII**

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# No Respect

*Aspen Insurance has objectively been a business success, but it's been a colossal dud in the stock market. Scott Barbee of Aegis Value Fund believes the market's pessimism has been well overdone.*

By almost all accounts, Aspen Insurance has been an outstanding success since its founding in Bermuda in 2002. Focused on writing a broad range of property and casualty and specialty insurance and reinsurance, the company has grown its assets eight-fold over that time, to \$9.4 billion. It earned net income of \$152 million in 2003 – the year its stock started trading – a number that rose to an average of more than \$350 million for the five years ending in 2010. Its fully diluted book value per share of \$38.27 as of September 30 is up from just under \$22 at the end of 2006.

Where Aspen has not succeeded, however, is in the stock market. Trading tightly between \$20 and \$30, the stock at a recent \$25.25 is up a whopping 75 cents since it began trading in 2003. The shares today trade at only 66% of book value.

Scott Barbee of the Aegis Value Fund thinks the pessimism for Aspen has been well overdone. The company's shares, he says, suffer today from two primary factors, one industry-wide and the other company-specific. The first is the chronic over-capitalization of the global insurance business, which has resulted in a uniquely long period of weak pricing. The second is Aspen's bad catastrophe-loss experience this year from a variety of sources, including earthquakes in New Zealand, the earthquake and tsunami in Japan and tornados in the United States. Company catastrophe losses this year are expected to be around \$450 million, \$275 million more than what it considers its normal load.

While Aspen's no-respect share price might be valid if its underwriting experience this year was a sign of chronic recklessness or if one believed the insurance pricing cycle would never turn, Barbee considers both of those highly unlikely. The company has a solid underwriting history and has been conservative both in managing its investment portfolio and

reserving for future policy losses, he says. He respects, for example, that management has been sharply reducing the duration risk in its fixed-income portfolio, even at the expense of current earnings. In addition, even after a bad year, underwriting loss reserves on Aspen's books are still \$360 million, or \$7 per share, above what the company considers its best estimate of what actual losses will be.

“This is a solid company with good management that happens to have had a bad year and is possibly at the bottom of

the underwriting cycle,” says Barbee. “We keep looking for the bogeyman and can't find it.” He sees no reason why Aspen shares shouldn't at least be worth stated book value – Aegis Value portfolio company Penn Millers Holding Corp. recently agreed to be acquired by Ace Ltd. for 108% of diluted book – and even more if that \$7 per share in potentially excess reserves turn out to actually be so. In that case, Aspen's book value today is more than \$45 per share, nearly 80% above the current share price. **VII**

## INVESTMENT SNAPSHOT

### Aspen Insurance (NYSE: AHL)

**Business:** Provider of property and casualty reinsurance and specialty and surplus insurance primarily in the U.S. and Europe.

### Share Information (@11/28/11):

<b>Price</b>	<b>25.26</b>
52-Week Range	21.99 – 31.57
Dividend Yield	2.4%
Market Cap	\$1.78 billion

### Financials (TTM):

Revenue	\$2.10 billion
Operating Profit Margin	0.1%
Net Profit Margin	(-1.3%)

### Valuation Metrics

(@11/28/11):

	<b>AHL</b>	<b>Russell 2000</b>
Trailing P/E	n/a	42.2
Forward P/E Est.	8.2	19.9

### Largest Institutional Owners

(@9/30/11):

<b>Company</b>	<b>% Owned</b>
Greenlight Capital	5.8%
Royce & Assoc	4.3%
Vanguard Group	3.9%

### Short Interest (as of 10/31/11):

Shares Short/Float	3.1%
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### AHL PRICE HISTORY



### THE BOTTOM LINE

The company's shares – at 56% of book value plus estimated excess reserves – are priced as if 2011 underwriting woes will be chronic and as if the insurance pricing cycle will never turn up, says Scott Barbee, both of which he considers highly unlikely.

Sources: Company reports, other publicly available information

# “The volatility is good for you”

**Thoughtful investors can** certainly be overwhelmed by an unending stream of information and commentary about markets and stocks, much of it centered today on the macroeconomic forces that have sent markets atwitter since the financial crisis reared its ugly head in 2008. Seemingly everyone – Wall Street analysts, mutual fund managers, regional-bank market strategists, Main Street brokers, your Uncle Ed at Thanksgiving dinner – has an opinion about the investing impact of things like the European Central Bank's next move, whether there's a bubble in Chinese real estate, or what the U.S. Federal Reserve has planned.

It's difficult not to feel compelled to invest with an eye toward understanding the various macroeconomic forces that are clearly driving short-term equity prices. We ourselves will admit to questioning traditional value-investing orthodoxy that argues such efforts are inevitably fruitless and a patent waste of time. But at a time when questioning that

orthodoxy is commonplace, it's probably a good idea to revisit its root origins. To that end, we offer the following insights from a trio of unsurpassed investors:

*Peter Lynch, from One Up on Wall Street:* “Since the stock market is in some way related to the general economy, one way that people try to outguess the market is to predict inflation and recessions, booms and busts, and the direction of interest rates. True, there is a wonderful correlation between interest rates and the stock market, but who can foretell interest rates with any bankable regularity? There are 60,000 economists in the U.S., many of them employed full-time trying to forecast recessions and interest rates, and if they could do it successfully twice in a row, they'd all be millionaires by now. They'd have retired to Bimini where they could drink rum and fish for marlin. But as far as I know, most of them are still gainfully employed, which ought to tell us something. As some perceptive person once said, if all the economists in the world were laid end to end, it wouldn't be a bad thing.”

*John Templeton, as quoted in Forbes:* “I never ask if the market is going to go up or down because I don't know, and besides it doesn't matter. I search nation after nation for stocks, asking: 'Where is the one that is lowest-priced in relation to what I believe it's worth?' Forty years of experience have taught me you can make money without ever knowing which way the market is going.”

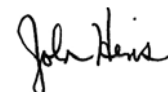
*Warren Buffett, earlier this month on CNBC:* “I wouldn't worry about headline risk unless I was investing with leverage. If I own a good business privately, am I worried about what the headlines are tomorrow? If I've got the best auto-repair shop in town, I'm not worried about the headlines tomorrow, I'm worried about taking care of my customers. I don't know what the stock market is going to

do, but nobody else does either. Forget about it. Just own good assets, run by decent and honest people. The volatility is good for you. Stocks overreact all the time and that's why a guy who can keep his senses about him can get very rich.”

## Lions in Wait

Using imagery from the wild, Francois Parenteau of Defiance Capital [VII, July 31, 2008] described the importance of patience in the value investor's skill set: “We think of ourselves a bit like a lion lying in wait. There are plenty of gazelle running around, but we can't run after them all, so we wait for one to get within 125 feet before we go. Not 150 feet or 200 feet, but no more than 125. Sometimes the market offers up those great kills and we try our best to be ready and to take advantage when they come along.”

Market volatility offered up plenty of potential bargains in this year's third quarter, as a drumbeat of macroeconomic fears left the quarter's low on the Russell 3000 index at nearly 20% below its high. On what did the best investors in the business pounce? As described in the new issue of *SuperInvestor Insight* – published later this week – their collective buys included technology stalwarts such as Google and Apple, high-moat global powerhouses such as Visa and even once-proud outcasts like Sprint Nextel. For actionable insight on what star investors such as Seth Klarman, David Einhorn and Bill Ackman are buying and selling through the market's turbulence, don't miss the new issue of *SuperInvestor Insight*. To subscribe, please visit [www.superinvestorinsight.com/subscribe](http://www.superinvestorinsight.com/subscribe).



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