Letter to Clients
June, 2011

Cheap Tricks

"A nickel ain't worth a dime anymore."

Yogi Berra

An article of faith among value-oriented investors is that, to paraphrase Warren Buffett, price is what you pay; value is what you get. According to the faithful, if a stock is purchased at a price that is less than what an intelligent investor calculates it is actually worth, that investor is then likely to make money when the stock trades at (or at least closer to) its proper valuation. Embedded in this concept – which we embrace – are a series of assumptions that we'd like to examine: first, that stock market participants, in the aggregate, are more likely to be swayed by emotion or misjudgments than are at least some of those who purport to determine intrinsic "value"; second, that intrinsic value can be ascertained with some degree of accuracy; and finally that, over time, price will come to reflect that value.

At the heart of these issues is the uncoupling of the concepts of price and value. Most economists would take exception to such a separation. They would tell you that price reflects actual value in that it represents an appraisal by actual buyers and sellers who enter into transactions where they willingly trade goods and services for cash. In the aggregate, such "votes" about value determine price. Accordingly, price is a real reflection of the value intrinsic to whatever is being bought and sold. Intrinsic value, by this measure, is by definition the value assigned to a good or service by the market. By contrast, most of those same economists would cast a skeptical eye on a valuation that was based on a model or analysis rather than on the real world exchange of money. According to them, the market as a whole has a better idea of what, for example, an apple is worth than does a guy sitting in an office running an abstract valuation model. One of the reasons for such skepticism is the lack of precision inherent in any valuation model. The advantage of deferring to price in the matter of value is that it is a "real" output rather than a purely conceptual one[1].

[1] In this regard, value investors face an interesting dilemma in deciding whether to accept as gospel (and to prefer over more traditional methods) the results of mark-to-market accounting. Believing in their own models, value investors, often correctly, disbelieve in the models of others. Faith in mark-to-market is easily taken to an illogical extreme, as when the debt of a troubled company, or even of an untroubled company during chaotic times in the fixed income markets, is reduced in value on the balance sheet, thereby "increasing" shareholders' equity.

We would argue, however, that when it comes to certain kinds of transactions, price is less likely to be a function of a series of rational decisions about the utility of a purchase or sale and more likely to be plagued by less rational considerations. In such cases, well-constructed models can usefully bound what that purchase is objectively (or at least rationally) worth. The purchase of shares of stock is a case in point. When you buy an apple, you generally intend to eat it immediately, or at least within the near future. You care about its size and appearance, freshness, source, and perhaps variety. But you don't worry about what it will be worth in the future. Even in the case of something you intend to use over time, such as a car, you have a pretty good sense of what it's worth to you now and over time, and you know that if you take reasonably good care of it, you can likely sell it in the future for a price you can more or less anticipate. When you buy a share of stock, on the other hand, you need to have a belief about what the company, of which that share represents a quantum of ownership, is worth. And to have an idea about what that company is worth, you need to have some idea not only about what that company is worth right now but what it is likely to be worth into the indefinite future. Even if you buy stock in order to trade it reasonably soon, you need to have some belief about what it's likely to trade for in the future. These kinds of judgments are far more difficult to make, and more to the point, far easier to get wrong.

Because these kinds of assessments are so fraught with uncertainty, irrational judgments and emotions like hope and fear are much more likely to influence them and, by extension, the pricing process itself. This helps explain why momentum can play such a big role in the short-term price fluctuations of a stock. Because market participants find it difficult independently to assign a value to a stock, they are far more likely to be influenced by what others think about it and also more inclined to follow the crowd by pushing a stock up when it's been going up and down when it's been going down. This is also why "sensational" information about a company often overshadows more mundane news about the firm. The screaming headlines decrying **Goldman Sachs** of late (all of the news bad, only some of it relevant) are a good illustration. High emotion in the wake of the economic crisis, coupled with the lack of clarity with respect to important policy matters like capital standards exacerbate the natural tendency to react emotionally to a stock. Indeed, the murkier the outlook for a company, the larger the role fear, on the one hand, and hope, on the other, seem to play in the pricing of a stock. It is instructive that, while "bubbles" can occur in the marketplace for goods (typically goods that for reasons of real or perceived scarcity come to be seen as investments, such as Dutch tulips in 1637), asset bubbles in the investment arena (and here we include housing, because that bubble was fueled in large part by the belief in housing as an investment) are an all too frequent occurrence.

But why should a process that ignores the aggregated "votes" of thousands of market participants have greater legitimacy in discerning intrinsic value? The crowd is obviously far better at pinpointing the value it places on an apple than is some guy with a sharp pencil. Certainly, one palpable lesson from the economic experiments of the twentieth century is that command economies function far less well than do market economies, both in establishing appropriate pricing and in producing goods and services that market participants actually want. In the case of the stock market, the participants, collectively, have access to a vast array of information that no single participant can possess. While this would seem at first blush to further handicap the sharp-penciled analyst, we believe that with a combination of clarity of thinking, emotional restraint, and a well- (i.e., conservatively-) designed model, thoughtful analysis has the capacity to overcome the informational disadvantage. Such analysis can produce results that more closely bound the actual "value" than can the moment-by-moment vote of the (easily misdirected) crowd.

A company is really nothing more than a bundle of income-producing hard and soft assets harnessed to produce a good or service that is sold to customers who are willing to pay something for that which the company produces or provides. A company has limited choices as to what to do with the money it makes off these assets: it can reinvest in the business (both to support its legacy operations and also for growth, either organic or through acquisitions) or it can return money to shareholders, either through dividends or share repurchases. The owner of a share of stock is simply the owner of a fractional interest in the shareholders' equity in the firm, plus the future stream of cash flows of the company, as allocated in the above ways. While analysts employ a number of different techniques to estimate the value of a company, including determining its breakup or private sale value (when a corporation acquires another company, it obviously engages in a valuation process that dictates how much it is willing to pay for the target firm), we believe that the best way to value most companies[2] is to focus on what the future stream of cash it will produce is worth. In essence, we look at the free cash flow we expect the company to generate in the future and discount that back to the present, taking into account such factors as incremental fixed and working capital that will be needed to support ongoing operations, the likely margins and growth rates for the business, and amounts to be paid in interest and taxes. The key here is to understand that every input into our model represents nothing more than an educated guess and that the output of the model is the sum of those guesses. This does not yield a point estimate of value – not even close. But it does give us a range of likely values based on a series of intentionally conservative assumptions. Indeed, increased complexity in the model not only does not yield increased precision, but in fact enhances the likelihood of distortions arising from too many guesses, albeit educated ones.

In order to avoid the same pitfalls into which other market participants fall when they buy and sell shares, we attempt to make explicit any biases, fears, enthusiasms or other sources of misjudgment that could color our perspective.

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[2] We use a different valuation method for financial and highly cyclical companies, keyed off of book value and using return and capital allocation assumptions. We do this to minimize the importance of recent revenue as a starting point, as revenue can fluctuate widely for such companies.

Because we work hard not to be swayed by such emotions and biases and because we tend not to be deterred by uncertainty if we have reasonable confidence that certain outcomes are much more likely than others, we believe that we can take a view that is far more objective than that of the market. We also stress test our assumptions to understand how the valuation changes with different inputs, thereby affording us comfort within a fairly broad range of possible outcomes.

It is also critically important that we not make the mistake of thinking that our valuations are precise. While we exercise extreme price discipline, what this means in practice is that we designate a "continuum" of intrinsic value and then pay at least 20% below the reasonable low estimate within that continuum. Our discipline manifests in our unwillingness to pay above that 20% discount (or often more, if the stock is new to us or there are other reasons, such as a big pending lawsuit the outcome of which could be material, that cause us to want a larger margin of safety).

We are asked with some frequency why we're often early in a stock that we believe is undervalued – why we don't wait until the stock has turned around before taking a position in it. The answer is that while we don't relish being early in a stock, it's virtually impossible to time things exactly right. So long as we are confident that we have a wide margin of safety, we would prefer being early to missing an otherwise good buy. One thing that a margin of safety affords is a buffer to absorb the shock of something actually going wrong, and we're willing to take the safety that affords us in exchange for having an investment that might move sideways or even down in the short term. Moreover, because stock prices embody expectations (good or bad, correct or incorrect), they typically respond to information (again: good or bad, correct or incorrect) well in advance of actual events.

Note that the fact that market pricing is not reliable does not mean that it is always wrong. In fact, if it were always wrong, we couldn't do what we do, since it is explicitly our expectation that, over time, pricing will eventually approach intrinsic value, thereby justifying our purchase at a discount. As noted above, the market is an information aggregator of sorts – but an aggregator without much control over its limbic system. The catalyst to closing in on intrinsic value tends to be the clearing up of uncertainty within the universe of this aggregated information, whether it be regulatory uncertainty (as is currently plaguing **Wells Fargo** and **US Bancorp**), litigation risk (as demonstrated by Goldman Sachs and **Moody's**), the timing of a turn in the economic cycle (**Martin Marietta Materials** and **Vulcan Materials**), or when and to what extent insurance pricing might start to harden (**Fairfax** and **Brown & Brown**). Each of these companies remains under the spell of greater than average uncertainty in the minds of most market participants, and the fear that coexists with such uncertainty tends on the margin to determine stock price. Once the future becomes clearer, we believe (and history shows) that the stock prices of these companies will move closer to their intrinsic value.

The lack of precision surrounding valuation also has implications for when we sell a stock. Market prices don't only undershoot intrinsic value, they also overshoot it. At some level of overvaluation, there is a substantial likelihood that the price will recede to intrinsic value rather than continue to climb. Because we are intentionally conservative in our valuations, we also understand that fairly consistently our valuations under- rather than overstate the intrinsic value of a stock. Therefore, a small overpricing tends to fall within the "continuum" of valuation that we establish. It is only where there is a fairly substantial overvaluation that we have some degree of confidence that the stock is more likely to fall than to continue its ascent.

And, finally, a cautionary note on valuation-driven approaches: in 2008, the Russell Value Index was down 36%. It was a tough year for all investors, and value-oriented investors were not exempt. How could they have gotten it so very wrong? The answer lies in the fact that valuation divorced from an in-depth analysis of the resilience of the business, the quality of management and the appropriateness of the corporate culture is misleading at best. Any estimation of intrinsic value must, especially since it is forward-looking in nature, take into account the qualitative aspects of a company that are an integral part of that company's ability to create (or destroy) value over time. If a company fails the basic tests of good business, good management and good culture, intrinsic value must reflect that, since the quality of a company has a direct impact on its ability to earn economic rents, to grow and thrive, and to generate healthy cash flow over time. Those who walked into the "value trap" in 2008 thinking that they held a ten cent nickel by owning companies like Bear, Stearns, Washington Mutual and Lehman Brothers – or even Citigroup or Bank of America – learned that lesson the hard way.

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