John Heins and Whitney Tilson

The Art of Value Investing

November 21st, 2014

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All Sensible Investing is Value Investing

"Our entire process is rooted in Ben Graham's simple philosophical framework for investing. He believed there were two values for every stock, the first being the current market price, and the second what the share would be worth if the entire company were acquired by a knowledgeable buyer or if the assets were liquidated, the liabilities paid off and the proceeds paid to stockholders. He called that the intrinsic value and argued that the time to buy was when there was a large spread between the current price and that value, and the time to sell was when that spread was narrow.

Over time we've developed different ways of applying that – by valuing income streams rather than just assets, by calculating private market values, by investing internationally – but the essence of what we do has remained consistent. Our work every day is essentially directed at valuing what businesses are worth."

–Will Browne, Tweedy, Browne Co.

Circle of Competence

"A baseball player never really gets paid, no matter how many homeruns he hits or what his batting average is, unless he gets to the big leagues. Then he's guaranteed to make a lot of money. But in the fund business you can find a minor league where you can hit for a better average, because that's what you're paid on.

I remember one of our guys taking us into Korea in the early 1990s, and the market was so inefficient that it was a gold mine if you knew what you were doing. My point is that to be successful in this business, you don't have to be better than everybody everywhere, just better than everybody in the league in which you play. It's maybe today more difficult to find those inefficient areas, but it's not impossible."

–Julian Robertson, Tiger Management

Playing the Odds

"The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory. There is no such thing as 'liking' a horse to win a race, only an attractive discrepancy between his chances and his price."

–Steven Crist, Daily Racing Form

Deficient Market Hypothesis

"We believe the market often misprices stocks due to neglect, emotion, misinterpretation or myopia, so our value−add comes from bottom−up stock selection. We're trying to buy at low prices relative to our current estimate of intrinsic value and we want to believe that intrinsic value will grow."

–Steve Morrow, New South Capital

Deficient Market Hypothesis

"Investment markets follow a pendulum−like swing between euphoria and depression, between celebrating positive developments and obsessing over negatives, and thus between overpriced and underpriced.

There are a few things of which we can be sure, and this is one: Extreme market behavior will reverse. Those who believe the pendulum will move in one direction forever – or reside at an extreme forever – eventually will lose huge sums. Those who understand the pendulum's behavior can benefit enormously."

–Howard Marks, Oaktree Capital

Fertile Ground

“Two kinds of events create volatility, which creates opportunity. The first revolve around individual companies, such as earnings misses, unexpected news, M&A activity, restructurings and legal issues – things that can make prices and valuations change relatively quickly. We want to understand what made the price change and then figure out whether the facts have changed as much as the price. To the extent they haven’t, that can be an opportunity.

The other major source of volatility is when a macro event or trend causes markets to move. The market reflects at any moment what investors think XYZ’s business is worth, so if macroeconomic factors force people to buy and sell its securities but we believe those factors have nothing to do with the underlying fundamentals of the company – or less to do with the fundamentals than is being reflected in the share price – that can also be an opportunity.”

–Jon Jacobson, Highfields Capital

What Could Go Wrong?

"The very first thing we do when we start to analyze a company is to ask ourselves how far the stock price would fall if we were wrong. It's not some back-of-the-envelope calculation, but a full assessment looking at liquidation asset values and stressing the business model and valuation levels under any number of bad scenarios. If the downside is more than 30% from today's price, it's unlikely we'll invest, regardless of the upside potential. If we can't establish a concrete downside number – which probably means it isn't far from 100 percent – we absolutely won't buy the stock.

Going through this first sets the tone we want to set in our research. Rather than start out looking to convince ourselves why we should buy something, we start out trying to prove why we shouldn't buy it. We try to keep that level of skepticism alive throughout the process."

–Ragen Stienke, Westwood Management

Patience as a Virtue

"As Graham, Dodd, and Buffett have all said, you should always remember that you don't have to swing at every pitch. You can wait for opportunities that fit your criteria and if you don't find them, patiently wait. Deciding not to panic is still a decision."

– Seth Klarman, The Baupost Group

"I honestly don't feel any of the emotional ups and downs from the market's day-to-day activity. I just don't worry about short-term volatility."

– Ed Wachenheim, Greenhaven Associates

Be Ever So Humble

"You obviously need to develop strong opinions and to have the conviction to stick with them when you believe you're right, even when everybody else may think you're an idiot. But where I've seen ego get in the way is by not always being open to questions and to input that could change your mind. If you can't ever admit you're wrong, you're more likely to hang on to your losers and sell your winners, which is not a recipe for success."

–Kyle Bass, Hayman Advisors

A Google Skeptic Eats Crow – And Thoughts on the Stock Today

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My Worst Call Ever (1)

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- In a column published on The Motley Fool website on July 30, 2004 entitled *The Tech Stock Opportunity*, I wrote:
  - **Fertile ground**

    Despite my reservations about the tech sector, I actually think that it is -- or at least should be -- fertile ground for value investors for the simple reason that most of the investors in the sector are irrational, momentum-driven speculators. Thus, the sector is characterized by wild mood (and therefore price) swings, as investors overreact to favorable or unfavorable developments. While overvaluation has been the more common state of affairs during the past decade or so, there have been a few points -- October 2002 most recently and, to a lesser extent, March 2003 -- when tech investors panicked and all sorts of tech stocks were downright cheap…

    Not only does the tech sector offer occasional opportunities to buy 50-cent dollars, but when it returns to favor, one can sometimes sell such dollars for $2, $3, or more... Now *that's* a way to make real money!

My Worst Call Ever (2)

KASE CAPITAL

- However, of Google I wrote: :
  - **Dell vs. Google vs. McDonald's**

    Regarding the former, there's a huge difference between, say, Dell and Google. While both are lumped into the tech sector, I would argue that Dell is primarily a manufacturing/assembling, sales and service business, not a technology company. Dell doesn't really care which hardware and software products win the technology wars -- it simply buys, assembles, sells, and supports whatever its customers want. In short, I think the odds are very high -- say, 80%-90% -- that Dell is a major computer company in 20 years. (This is not to say that I recommend buying Dell stock -- as much as I admire the company, I wouldn't buy it at half of today's price.)

    Google, in contrast, is a more typical tech company -- one that must invest heavily to remain on the cutting edge or its customers will quickly and easily flock to competitors. Just as Google came out of nowhere to unseat Yahoo! as the leading search engine, so might another company do this to Google. I admire Google and what it has accomplished -- and I'm a happy user -- but I am quite certain that there is only a fairly shallow, narrow moat around its business.

    [continued]

My Worst Call Ever (3)

KASE CAPITAL

Think about it. What are the odds that it is the leading search engine in five years (much less 20)? 50/50 at best, I suspect, and I'd wager that odds are at least 90% that its profit margins and growth rate will be materially lower five years from now. Yet investors appear ready to value this company at as much as $36 billion, nearly 200 times trailing earnings! Google with the same market cap of McDonald's (a stock I own)?! HA! I believe that it is virtually certain that Google's stock will be highly disappointing to investors foolish enough to participate in its overhyped offering -- you can hold me to that.

I Was Right That Margins Would Decline…

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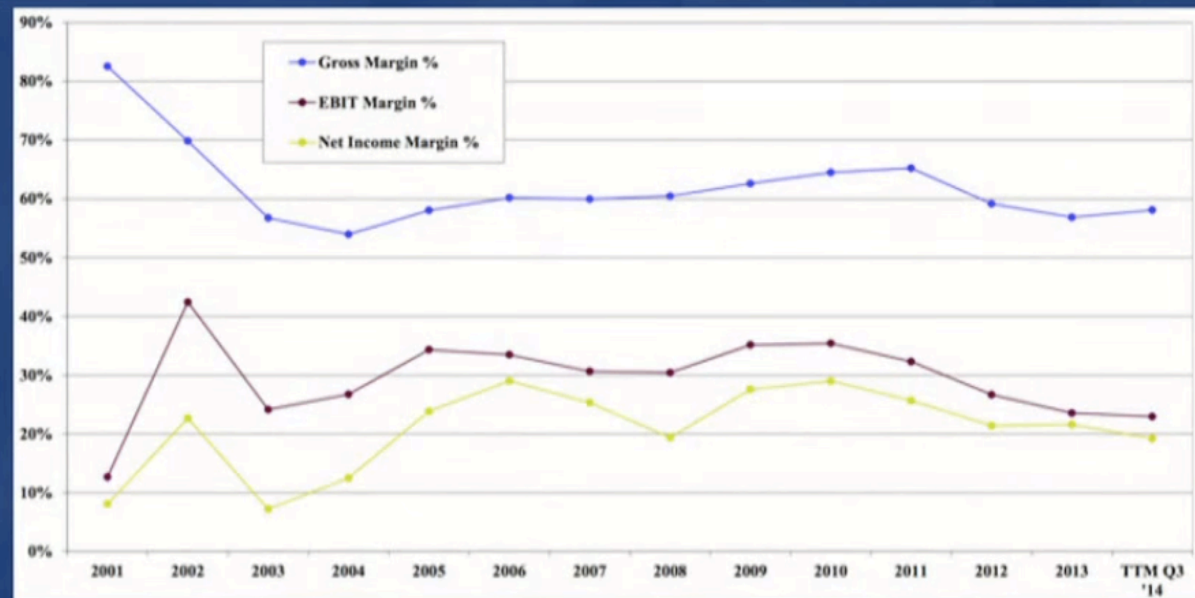
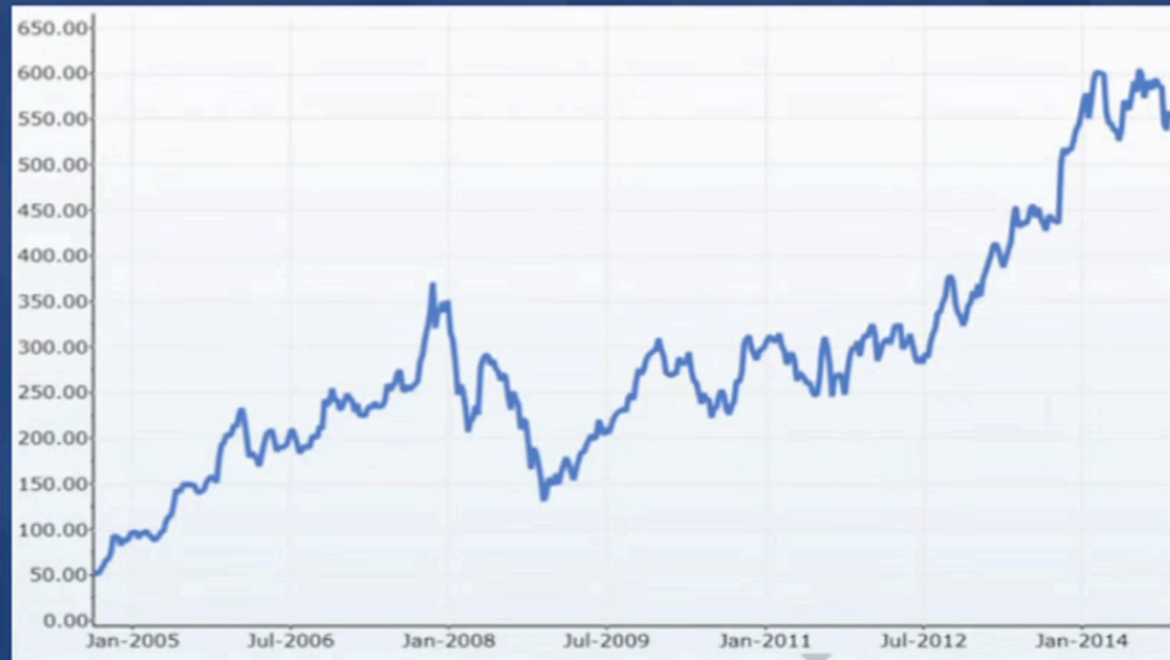


Google's Stock Has Increased By More Than 10x Since My Misguided Call



What Did I Miss?

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- I was completely wrong that Google has "only a fairly shallow, narrow moat around its business"
- Google has a very powerful virtuous cycle at work:

Valuation of the Stock Today

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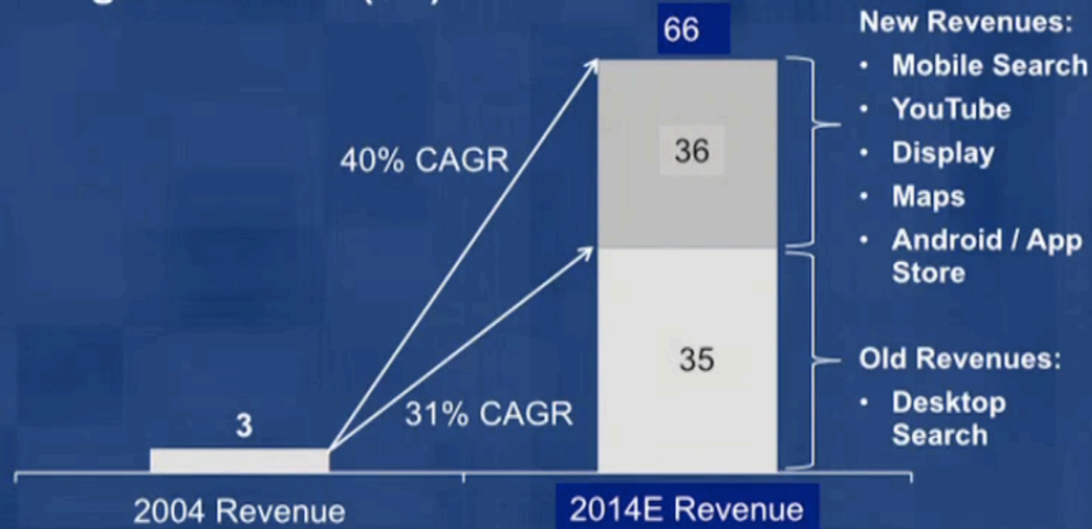
- Stock price (11/18/14 close): $535.03
- Market cap: $368 billion
- Cash & STI: $59 billion
- Debt: $7 billion
- Enterprise value: $316 billion
- 2014 est. EPS: $20.19 (includes stock-based comp)
- 2015 est. EPS: $25.19 (includes stock-based comp)
- 2014 est. EBITDA: $26.0 billion
- 2015 est. EBITDA: $30.9 billion
- P/E (2014): 26.5x
- P/E (2015): 21.2
- EV/EBITDA (2014): 12.2x
- EV/EBITDA (2015): 10.2x

Last Quarter's Results

- Revenue grew 20% YOY
- But expenses rose 28% (GAAP) (or 22% (non-GAAP))
- So operating margin declined from 27% to 23% (GAAP) (or 34% to 32% (non-GAAP))
- Resulting in EPS from continuing operations declining 6.4% from $4.66 to $4.36 (or rising 12.8% from $5.63 to $6.35 (non-GAAP))
- Net cash provided by operating activities rose 17.9% from $5.1 billion to $6.0 billion and free cash flow rose 28.0% from $2.8 billion to $3.6 billion
- The key questions going forward:
  1. Will revenue continue to grow at a ~20% rate?
  2. Will margins at least stabilize (and ideally improve)?

The Bull Case: New Platforms Continue to Create New Revenue Streams



How Google's Stock Could Double in the Next Four Years

Drivers:

- Grow search ~10% annually
- Grow display ads ~25% annually
- Grow YouTube ~30% annually
- Grow new products (Google Play, etc.) ~40% annually

Valuation in Four Years:

- Revenue growth of ~20%
- Maintain margins
- P/E multiple remains constant ~20x
- Results in the stock doubling over four years

Note: Slides 12, 15 & 16 are from the presentation of a friend who wishes to remain anonymous.

Talks
at
Google