It's More Than a Matter of Style

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Often we are asked, "what kind of investment manager are you?" We're inclined to reply, "a very good one, of course!" But the question relates to what *style* of investing we employ.

Unfortunately, as in US politics, there are only two commonly recognized philosophies at either end of the investment style spectrum: "Value" and "Growth". Having just two style choices from which to describe your investment approach makes it challenging to explain your process for building portfolios. Luckily, unlike most political discourse these days, a discussion of investment style doesn't run the risk of immediately offending anyone! As a practical matter, we think investors and consultants put far too much emphasis on achieving style diversification. Our view has always been that growth and value considerations are really two sides of the same valuation exercise.

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Very broadly, the working definition of the Value approach describes portfolios comprised of stocks with low price multiples of sundry denominators such as earnings, dividends, cash flow and assets. Often, the earnings of companies in a Value portfolio are in decline or even negative. At the other end of the spectrum, managers who employ a Growth style look for companies with rapidly growing earnings that in the long run should drive their stock price much higher. These managers expect to pay higher multiples of the same denominators for the promise of earnings that compound at a healthy clip.

Growth at the "Right" Price?

In practice, most investment managers fall somewhere in the middle – (between Value and Growth, regardless of their political affiliation!). Unfortunately, this catchall category bears a description that really doesn't lend any additional clarity to a conversation about investment style since it sounds so darn commonsensical! It's referred to as "Growth at the Right Price" or "GARP," for short.

"If pursuing a GARP approach were as easy and breezy as the notion is bandied about in such conversations, why wouldn't everyone want to be a GARP investor, after all?!"

People new to the topic of investment styles might look for an actual distinction within the difference. Really, shouldn't Growth investors care even a little what price they pay for a company with a compelling story? (Certainly between 1995 – 2000 exorbitant valuations didn't deter Growth investors.) Or, do Value investors care so much about

finding stocks with the most depressed valuation metrics they're willing to overlook potentially large fundamental risks in their portfolios? If pursuing a GARP approach were as easy and breezy as the notion is bandied about in such conversations, why wouldn't everyone want to be a GARP investor, after all?! To believe "Growth at the Right Price" is its own opportunity set – compared to a Value or Growth style – is a little like expecting to be in fabulous shape for doing the least amount of exercise possible (alas, we know too well *this* approach doesn't work!).

"...in the context of managing real money for real clients, we view risk as the potential to suffer a permanent loss of capital."

As it turns out, if an investor had to choose between Growth and Value, all things being equal (and in this case, that's quite an unrealistic assumption), he or she would be better off over time adhering to a strict Value discipline. Many studies have shown over the years that by simply dividing stocks into quintiles by price/earnings ratios each year and buying the "cheapest" 20%, an investor earned significantly and consistently higher total returns than the most expensive quintile. These results suggest investors drive stock prices too low in the face of bad news or uncertainty, and systematically pay too much for the promise of growth in an exciting company story. In the aggregate, Value stocks subsequently perform well off their depressed levels; but stocks valued richly for their rosy outlook typically can't live up to expectations and move lower as investor enthusiasm wanes.

Volatility Does NOT = "Risk"

Many of these studies also conclude this kind of Value strategy is less "risky" -- which, in the academic context of the results, means less *volatile*. However, in the context of managing *real* money for *real* clients, we view risk as the potential to suffer a permanent loss of capital. Most stocks that look statistically cheap deserve their low valuations due to their poor competitive and financial positions, which make them fundamentally much *riskier*.

"Market commentators and investment managers who glibly refer to "growth" and "value" styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component - usually a plus, sometimes a minus - in the value equation."

- Warren Buffett

What Warren, and we, are saying is that it's not "growth" per se, but the elements of a company's profitability and capital efficiency that determine whether a company's growth adds to (or subtracts from) the value of a company's stock.

It Takes Money to Make Money

Capital efficiency is simply a measure of how many dollars of new assets a company requires to produce an additional dollar of revenue[1]. Corporations can't attract capital for free. Capital for new investment comes at a cost: shareholders and bondholders

[1] In accounting parlance, this is referred to as "asset turns."

(and banks) expect a return on the money they provide a company. So, given the capital costs companies bear to build out their balance sheets, we prefer to invest in companies with low capital intensity -- that is, those that require relatively fewer assets to produce each dollar of revenue.

No Margin, No Profits

Generally, all of the qualitative aspects of a company's business and competitive position can be effectively rolled up into one metric: "Return on Assets" (ROA)[2]. ROA is a broad measure of what a company is managing to return on its investments – which are essentially all of the assets on its balance sheet. If a company is in the position to make additional investments with attractive returns -- rates of return above whatever the additional capital costs them -- then investing more in the business produces increasing profits that are really *worth* something. On the other hand, if a company struggles to earn decent returns, investing additional expensive capital into a low-return business is much like throwing good money after bad. Rather than make new investments, these companies should *return* capital to their investors -- maintaining a balance sheet just large enough to sustain whatever truly profitable operations the company might have.

That's the theory anyway. Unfortunately, most of the time corporate managements aren't anywhere near this disciplined in how they allocate their shareholders' capital. Bigger balance sheets can support higher revenues even if they do not produce any true "profits", as we just discussed. And bigger revenues often play into the calculation for larger executive compensation!

'AA' Big Loser

To illustrate what we're talking about we'll pick on the venerable Alcoa, Inc., one of our favorite examples of shareholder value destruction! [Please see Chart 1 on next page.] Over the last ten years Alcoa ballooned its balance sheet by 40%, adding $11 billion of net new assets; but, after all Alcoa's capital expenditures, net cash from operations was virtually nil over the entire *decade*. However, what made these new, ill-advised growth investments so costly for Alcoa shareholders is the fact that the company earned a meager 2.4% on its ever-growing assets over the period - a rate of return far below our preferred minimum ROA of 8% and nowhere near what all this additional capital really cost the company. In the process, Alcoa's capital efficiency fell significantly, down 25%. From our perspective, Alcoa 'cost' their shareholders about $1.9 billion a year on the company's investments over the last decade.

[2] There are many other ratios to measure "profitability"; we look at several. But, ROA is a good, bottom-line measure of what an enterprise earns on its book (accounting) assets – and is intuitively easy to compare against the "cost" of what it takes to attract additional capital.

Unfortunately for them, Alcoa's shareholders suffered more than a large opportunity cost. During this time, the total market value of Alcoa stock declined from $32 billion to $11 billion today; and the stock price has gone from $38 to $9! However, Alcoa's management fared considerably better than their shareholders. For this horrendous management and value destruction of the highest order, just last year Alcoa's CEO took home a compensation package worth around $14 million. In theory, Alcoa should liquidate itself, pay off its debts and distribute what's left over to the shareholders so they can invest the proceeds in a *good* company!

Alcoa, although perhaps an extreme example, is not the exception. Unlike the Lake Wobegon Stock Market -- where all the companies are "above-average"! -- most companies earn a pretty darn average return on their assets (see Chart 2). This means truly profitable, consistent growth can be hard for a company to come by. Only those companies with some true competitive advantage are able to sustain profit margins high enough to earn a positive spread over what their capital costs.[3]

In fact, the data show only about 300 companies, or about 20% of our universe, are probably earning ROAs competitive with our H.M. Payson range of "hurdle rates" (8% - 12%). Fully 68% of the companies in our universe are earning something less than this range.

Chart 1

Alcoa
(Symbol:AA)
Dec 2001 - Dec 2011

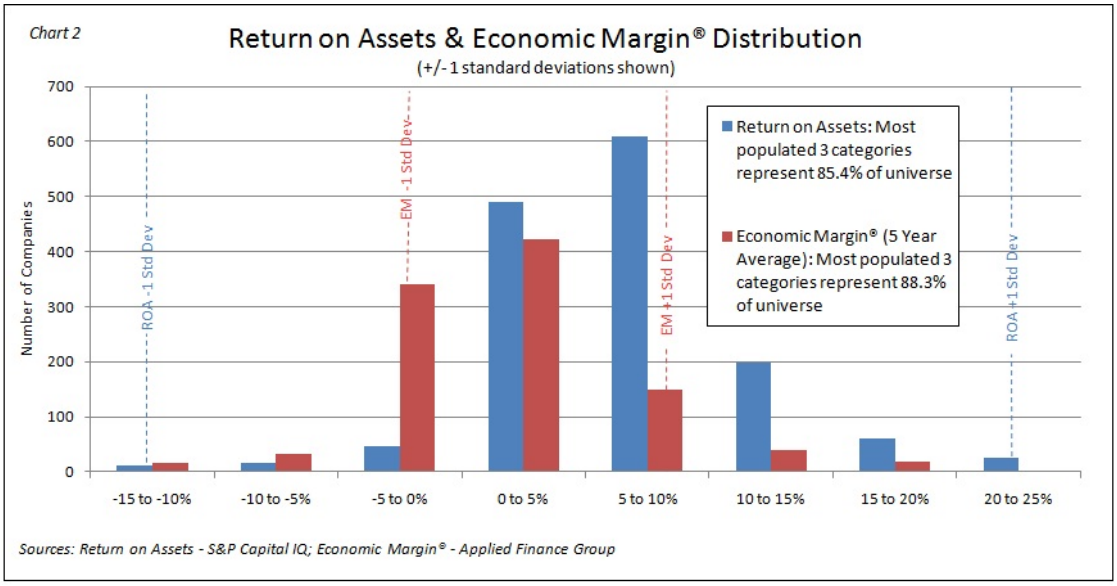
Beginning Net Assets	$28,355
Ending Net Assets	$40,120
Average Net Assets	**$34,238**
Actual 10y Cumulative Earnings	8,353
Average ROA	**2.4%**
"HMP Required ROA"	**8.0%**
Capital Efficiency	25% decline
Total stock market value:	$32B down to 11B (a 65% decline)
Stock price:	$38 → $9
CEO Total Compensation in 2011:	$14 million

Alcoa "under-earned" our cost of capital by 5.6% per year for ten years!

Source: S&P Capital IQ

[3] There are many approaches to calculating what a theoretical cost of *equity capital* is to a company -- most of them steeped in finance theory and quite arcane. We simply apply a subjective "opportunity cost" to the equity of companies we analyze as a proxy for what an investor might earn by simply owning the whole S&P 500 -- adjusted higher the more qualitative risk we assign to any particular company.

As another way to relate profit margins to a company's balance sheet, we subscribe to and adapt a model developed by a terrific outfit in Chicago called Applied Finance Group (AFG). Their model modifies a company's reported financial statements to arrive at an "Economic Margin®"which better reflects the company's true profitability after accounting for, among other things, a 'charge' for the capital it employs. Taking capital costs into account this model suggests that among the companies in our broad survey there is a much narrower distribution of "real-life" profitability than even the ROA statistics suggest (*see red bars on Chart 2*).



Why do most companies earn uninspiring returns on their investment, and why are most companies somewhere around the average for the universe? In theory and practice, high profit margins will attract competitors who will invest enough additional capital into an industry until everyone competing in that industry earns only a "breakeven" return. That is, *unless* any one competitor in the industry has a true competitive advantage which, as the data shows, is the exception and is typically pretty narrow.

Linking Value and Growth

In the context of profit margins and capital efficiency, here is how we view the continuum between Value and Growth. There are approximately 1,700 US stocks with a total market value greater than $500 million from which we exclude about 500 stocks with low or negative ROAs [4]. Broadly we break the entire universe into five parts: Deep Value, Slow Growth, Rapid Growth, Intangible Growth and 'Everything in Between', which is where *we* invest.

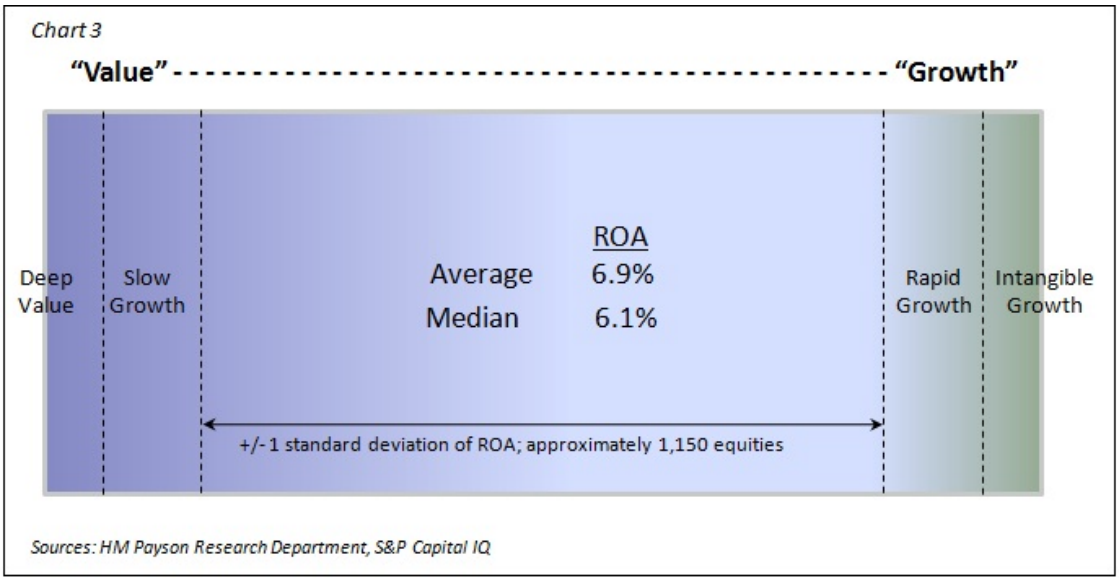
[4] Additionally, we exclude financial stocks from this universe since they typically generate very low ROAs, combined with high leverage to produce Returns on Equity (ROE's) only comparable to the median operating companies in our investable universe. In many respects we treat the analysis of financial stocks in the context of their own set of metrics.

'Deep Value' companies are often labor *and* capital intensive, possessed of dramatically underperforming assets. Many of these companies could theoretically be worth more dead than alive for the assets on their balance sheets. These stocks are statistically cheap for many good reasons. Typically they operate in 'commodity' businesses such as airlines, paper, chemicals, steel, etc. These companies are "price-takers": they have zero pricing power. These are the biggest "value destroyers" in our universe. (We put Alcoa squarely in the middle of this class).

'**Slow Growth'** companies barely earn their cost of capital and provide low sustainable growth, if any, and also tend to be capital-intensive. Utilities, many heavy manufacturing companies, grocery stores, etc. are well represented in this segment of the universe. They deserve their low price-to-revenues and price-to-assets, and only provide decent investment returns when bought (and sold) at the right prices.

At the other end of the spectrum**, 'Rapid Growth'** companies appear to have high profit margins (even if unsustainable in the long-term), whose lofty valuations embody high expectations of future growth. Often these companies are able to finance their own rapid growth given their high margins and low-capital intensity. This segment is typically populated with biotech and niche technology companies, etc. More often than not, their growth flames out and the stocks come down to Earth, costing investors money.

Finally, **'Intangible Growth'** companies may have yet to generate little if any *revenue*. Their assets are typically a mix of goodwill, patents and other intellectual property. Usually they burn through lots of cash and constantly issue new stock to meet their cash needs just to keep the lights on. These companies have virtually no operating metrics upon which to base a valuation, so the market for their stocks is extremely speculative.



We define 'Everything in Between' as the group of stocks that lies roughly within plus-or-minus one standard deviation of the average profit margin for the entire universe. Simply put, this group accounts for about 70% of all the companies in our universe. Therefore, we have a broad opportunity set among large and small companies operating in many different industries. We need to find only 20 - 30 good ideas at a time (which, it turns out, is a little harder than it sounds!) to build a strong portfolio. This means we can focus on companies rather than where the overall market might be trading. We believe virtually every market environment yields ample opportunities.

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Today's Cash Flow is More Valuable Than Future Growth

The art and science of our approach is less about putting a value on earnings *growth*, but more about focusing on a company's prospects of generating a *sustainable* level of truly profitable cash flows. We begin with the company's balance sheet, gauging its strength and flexibility and the efficacy with which management has deployed the assets. In this sense our roots run deep in the Value investing philosophy. However, we're not interested to own stocks of companies that are simply statistically attractive in their valuations. Rather, we are looking for opportunities to own shares of companies that can earn attractive returns on their assets and generate strong free cash flows[5].

Free Cash Flow Drives Returns

Free cash flow can be put to many good uses in the hands of the right management. Hopefully, the company will put some of that cash flow into *our* hands by way of paying out large and growing dividends! Dividends are our preferred use of a company's free cash flow. But, at a low enough share price we also like to see managements retire shares of their company by opportunistically buying their stock in the open market - thereby increasing the share of a company's profits (and dividends) available to the remaining shares outstanding.

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Sensible share repurchases can provide a significant component of *per share* growth. Unfortunately, too often we see managements undertake a share repurchase plan at indiscriminate prices. This increases the likelihood such expenditures will end up being dilutive, rather than accretive, to the shareholders. (Obviously, we take a dim view of this lack of capital discipline on managements' part). Free cash flow can also be used to pay down a company's debt

[5] Free cash flow is cash generated by the business *after* the company makes all the necessary ongoing investments to maintain its operations.

(but at current interest rates, we almost prefer that they don't), or stockpiled on the balance sheet to improve its overall liquidity.

Finding True Growth

Finally, there's the issue of (profitable) growth. If a company has the opportunity to make additional investments at attractive rates of return, free cash flow can be used along with other forms of capital to grow the company. Stocks of companies with high margins and generating free cash flow are rarely statistically "cheap" - but they often trade at prices we consider very attractive relative to the free cash flows they generate (before *and* after we apply our 'capital charge').

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In the spirit of Graham and Dodd's notion of 'Earnings Power', when we talk about our valuation "discipline" we are referring to the high hurdles of return we require of a stock even without considering its growth prospects. Our approach affords us a measurable 'margin of safety' in keeping with Graham's philosophy - and it helps us avoid paying too much, if anything, for a company's future growth. Still, we own stocks of many companies that have done a good job of compounding their shareholders' capital (*see chart 4*). These companies grow into their large market capitalizations for a reason: they consistently outperform their competition and the average company in earning high returns on their assets.

Chart 4

Capital Efficiency x Profitability = "ROA"

Company	Sales/Assets	Net Margin	Return on Assets
Apple Inc.	1.1	22.3%	**24.6%**
Cummins Inc.	1.6	7.4%	**11.6%**
Google Inc.	0.6	19.2%	**11.0%**
Microsoft Corporation	0.6	23.7%	**15.2%**
CSX Corp.	0.4	18.5%	**7.5%**
Exxon Mobil Corporati	1.3	7.1%	**9.5%**
Pepsico, Inc.	0.9	9.3%	**8.4%**
McDonald's Corp.	0.8	19.1%	**15.9%**
Abbott Laboratories	0.6	13.6%	**8.7%**
General Dynamics Cor	0.9	7.5%	**7.1%**
S&P 500 Index	0.4	8.5%	**3.3%**

Source: S&P Capital IQ

The Power of Compound Growth

A fabulous example of a true growth stock is Exxon. Most would consider Exxon a *value* stock for its humble valuation: you can buy the stock of this amazing franchise today for

less than 12x earnings. At its current price Exxon has a total market value of around $400 billion and is the second largest stock in the S&P 500 behind Apple.

What makes the Exxon story all the more impressive is the enormous base of assets upon which it has compounded profitable earnings growth for its shareholders over decades. Over the last ten years, Exxon's capital efficiency has remained steady - assets *and* revenues have grown about 8.8% per year; and its average ROA over this period was an impressive 11%, well above any reasonable measure of its cost of capital. The energy business is notoriously capital-intensive. Indeed, Exxon made investments of over $180 billion. But, even net of these investments Exxon generated cash from operations totaling an enormous $250 *billion*, of which Exxon paid out every single dime to shareholders in the form of dividends and stock repurchases. By reducing its shares outstanding by 3.6% each year, Exxon's *per share* earnings increased 12% annually; and, after accounting for our 'capital charge', Exxon produced $110 billion of true, economic profit. Altogether, Exxon has turned in an All-Star performance! Given Exxon's impeccable record of capital discipline we see no reason why the company can't continue to grow, and profitably.

"...we think we do a good job of valuing cash flows and understanding the value elements of profitability and growth."

Our tale of two companies has a predictable ending: Over the decade ending in 2011, Exxon, the kind of value creator we look to own for our clients, provided its shareholders a 169% return – beating the S&P 500 by 135%! Alcoa, a value destroyer, lost 70% of its value, losing to the S&P500 by 100%.

Conclusion

Investors simply put too much emphasis on investment styles, especially when it is defined in terms of valuation metrics - which is the common approach to differentiate them. Value stocks are cheap because they are poor businesses, usually in a compromised competitive and/or financial condition. Growth stocks typically present unnecessary price risk since most of their market value derives from the calculation of future growth that may or may not materialize.

In our competitive world, high sustainable margins and profitable growth are the exceptions - so we are wary about what we might be prepared to pay for it. Yes, we're conservative; and many of our own clients would introduce us as a Value manager. Rather, we think we do a good job of valuing cash flows and understanding the value elements of profitability and growth. We look to add a margin of *fundamental* safety beyond just investing at conservative valuations.

Combining these perspectives is how we build portfolios of fundamentally strong companies at valuations which embody little, if any, expectation of the growth potential we might see in them.

Market Log- August 31, 2012

S&P 500: 1,406.58
10 year T-Note: 1.56%
Crude Oil: $98.09
Gold: $1,692.60

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