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Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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Craig Effron

Craig Effron of Scoggin Capital Management

Craig Effron is the co-portfolio manager of Scoggin Capital Management, which he founded with partner Curtis Schenker in 1988. With approximately \$1.75 billion in assets under management, Scoggin is a global, opportunistic, multi-strategy event-driven fund. Scoggin focuses on identifying fundamental long/short investments through three primary strategies including event driven equities with a catalyst, special situations, and distressed credit. Mr. Effron began his career as a floor trader on the New York Mercantile Exchange and New York Commodity Exchange. Mr. Effron received a BS in Economics from the

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Jeff Gramm

Jeff Gramm '03 of Bandera Partners

Jeff Gramm manages Bandera Partners, a value hedge fund based in New York City. He teaches Applied Value Investing at Columbia Business School and wrote the upcoming book "Dear

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Shane Parrish

Shane Parrish of Farnam Street

Shane Parrish is the curator for the popular Farnam Street Blog, an intellectual hub of curated interestingness that covers topics like human misjudgment,

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Jon Salinas

Jon Salinas '08 of Plymouth Lane Capital Management

Jonathan Salinas founded Plymouth Lane in April 2013 and acts as sole portfolio manager to the Fund. Prior to founding Plymouth Lane, Jonathan worked as an analyst at Marble Arch Investments, a long/short hedge fund manager. Before joining Marble Arch, Jonathan served as a consultant at ZBI Equities, a long/short hedge fund manager operated by Ziff Brothers Investments. Prior to ZBI, he was an analyst at Festina Lente Investment Management, a concentrated, value-oriented investment manager, and worked as an analyst in capital markets and research divisions at UBS AG.

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Welcome to Graham & Doddsville



Meredith Trivedi, the Heilbrunn Center Director. Meredith skillfully leads the Center, cultivating strong relationships with some of the world's most experienced value investors, and creating numerous learning opportunities for students interested in value investing. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.



Professor Bruce Greenwald, the Faculty Co-Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.

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We are pleased to bring you the 26th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

In this issue, we were fortunate to speak with three investors and the founder of the popular blog Farnam Street.

Craig Effron of Scoggin Capital Management discusses the evolution of his firm and his investment approach from commodities to the stock market. Craig offers insights into his risk management mentality, challenges facing the investment management community, and creative ways to express investment theses while managing against downside risk. He shares recent case studies in the event-driven space and opportunities he currently see in distressed credits in Puerto Rico and energy.

Jeff Gramm '03 of Bandera Partners discusses his book on activism "Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism" and

walks through current ideas including Famous Dave's (DAVE) and Star Gas Partners (SGU).

Shane Parrish discusses the origination of Farnam Street and his focus on becoming a better learner, as epitomized by Warren Buffett and Charlie Munger. Shane explains how these learnings apply to becoming a better investor and shares his hopes for Farnam Street and its readership.

Jonathan Salinas '08 of Plymouth Lane Capital discusses his experiences with varied investment approaches and mentors and how his background leading up to founding Plymouth Lane has contributed to the firm's world view and how he seeks to invest. Jonathan also shares current ideas DHX Media (DHXM) and Sequential Brands Group (SQBG).

This issue also highlights photos from the 25th Annual Graham & Dodd Breakfast, held on October 9th, 2015 at the Pierre Hotel in New York. This event brings together alumni, students, scholars, and practitioners for a forum on current insights and approaches to

investing. This year's breakfast featured a conversation with Philippe Laffont of Coatue Management moderated by Professor Bruce Greenwald of Columbia Business School.

Lastly, we are proud to bring you pitches from current students at CBS. We feature finalists from the Darden at Virginia Investing Competition, Columbia Business School's inaugural CSIMA Stock Pitch Challenge, and Alpha Challenge at UNC Kenan-Flagler.

The three finalist ideas from our classmates include: Marc Grow '17, Benjamin Ostrow '17, and Evan Zehnal '17 — Dexcom Inc. (DXCM) Short; Nielsen Fields '17, Joanna Vu '17, and Adam Xiao '17 — Quest Diagnostics (DGX) Short; and Justin Hong '17, Zachary Rieger '17, and Cristóbal Silva '17 — XPO Logistics (XPO) Long.

As always, we thank our interviewees for contributing their time and insights not only to us, but to the investment community as a whole, and we thank you for reading.

- G&Dsville Editors



Keynote speaker Philippe Laffont addresses attendees at the 25th Annual Graham & Dodd Breakfast



Attendees gather at the 25th Annual Graham & Dodd Breakfast

25th Annual Graham & Dodd Breakfast— October 9, 2015 at The Pierre Hotel



**Mario Gabelli '67 at the Graham & Dodd Breakfast with
keynote speaker Philippe Laffont**



**Professor Bruce Greenwald with Philippe Laffont at the
Graham & Dodd Breakfast**

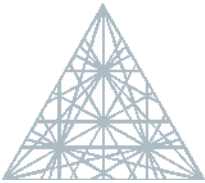


**Sid and Helaine Lerner speak with Heilbrunn advisory
board member Tom Russo**



**Heilbrunn advisory board members David Greenspan '00,
William von Mueffling '95, and Jenny Wallace '94**





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www.grahamanddodd.com

Craig Effron

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Craig Effron

Wharton School of Business of the University of Pennsylvania.

Graham & Doddsville (G&D): Could you tell us about your background and how you came to investing?

Craig Effron (CE): It's important, because I am not the traditional hedge fund story. I didn't work two years in investment banking and then go to Harvard Business School. I went to Wharton for undergrad. I did not get into NYU Law, but I got into Duke. I went down to Duke for a weekend with my parents and everybody there was 6'4" and blonde. I said, "I'm not going to do very well here. Socially, I cannot go here." My parents said, "I tell you what, take a year off, defer, and then reapply to NYU a year later and hopefully get in."

During that year, I met up with two buddies for a card game at Penn. They were playing for stakes that I had never even known existed. I said, "What do you guys do for a living?" One said, "We trade commodities. On the floor, we buy and sell gold and silver. It's really fun and you should come check it out."

I had been working at EF Hutton, which was big in everything, but they went bankrupt in the '80s. I had gotten a job there right after school and worked there for a few months. But, then I played in this card game and, afterward, went down to the floor with my friends. I thought, "Wow, this looks like a lot of fun." Somehow, I convinced my parents to lend me forty thousand dollars to

try my hand at trading commodities. I said that if I didn't do well, I would go to law school a year later. I did well. I learned a lot about life and about commodities and trading. And I was fairly good at it.

The problem with commodities trading is that it ends at 2:30 in the afternoon. When you're 24 years old you can get into a lot of trouble if you're done at 2:30pm unless you have something to do. I decided to start learning the stock market. I had gone to Wharton for undergrad and somewhat thought I knew what I was doing, but I didn't really know how to invest. About five years into trading on the COMEX, I started doing risk arbitrage.

That was the heyday of Mike Milken. I thought I was a genius because every time there was a deal announced, automatically—within a week—there would be a topping bid. Then there would be a third bid; it was crazy. Everyone on the floor knew about my success trading stocks. They all gave me their money, as my friends, to run for free. I did that for a year and it was fun. I had about 30 accounts and I was doing it for free.

Paul Tudor Jones, who stood next to me in the ring, was a good buddy of mine and said, "You know what? Run my money, as well. But one caveat: I want you to charge me a fee." I asked, "Why do you want me to charge you a fee?" And, being as smart as Paul is, he said, "Because if you charge me a fee, you will pay attention to my account first." He was dead

right.

After about a year of managing Paul's money and these other accounts, I realized that I liked doing this more than trading commodities. I left and told everybody I was going to put together a fund called Scoggin with my partner Curtis Schenker, who is still my partner.

Here's a key element of our partnership and how Curtis and I complement each other—it's an important fact about Scoggin. Curtis was my best friend before we started Scoggin. He's my best friend still. Curtis and I keep each other grounded. We realize we caught a 30 year bull market. We weren't that smart. We happened to have money under management, and it worked out. Curtis and I don't take ourselves too seriously. He has always been Mr. Naysayer, and I'm Mr. It's-Always-Bullish.

He's the guy who kept us in business a lot because I would've been a lot more aggressive during the technology bubble. He said, "Craig, leave it alone. This is not what we do. We don't know what that means. We're not doing that." And of course later technology blows up. That's why it works, and that's why we're still best friends and still partners.

Part of this Scoggin charm, if you want to call it that, is that we still are friends first and partners second. I think it sort of flows through the whole office. The average tenure of my analysts here is 10 to 12 years. There are a few new guys who are two or three

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Craig Effron

years but basically I have 12 analysts, and six or eight of them have been here since before 2000. It's a very nice feeling to know that I can go on vacation and know that I'm not going to have someone blow me up.

Incidentally, the name "Scoggin" comes from a camp that Curtis and I went to in Maine. I met him there and we reunited at Penn. We started Scoggin together with these 30 accounts, Curtis's money, and my money. It was about \$3 million in total and that was how we started in 1988. To put it in perspective, as a hedge fund with \$3 million in 1988, we were not even the smallest, while the biggest fund was about \$80 million.

G&D: At that point, were you just focused on risk arbitrage?

CE: Yes, that's all we were doing at that point. We were up a lot of money in '89 and in September of '89 the biggest deal in history was United Airlines. The deal blew up and everybody in my world went out of business. We went from up 65% to up 20%, which is a big draw down, but still up 20%. Before this, I had been competing to attract the best talent, but I couldn't afford to hire many of them. Now, they were working for free because they were all out of work. I hired a restructuring analyst, a long/short analyst, and others whom I could never have afforded before that.

That is when Scoggin was really born because we could now do things besides just get lucky with Mike Milken doing topping bids. We could still do risk arbitrage, but now we

could get involved in distressed credit, spin-offs, and restructuring—anything that has an event. We went from running \$3 million to running \$3 billion by the late 2000s. We sort of stopped raising money because I liked my life and I didn't want to be a manager of people; I wanted to be a manager of money. And, mostly, I wanted it to be my own money.

Then '08 happened. We had no losing years until 2008. We had twenty years where every year we made money. At that point we were up 17.5% net to investors. 2008 occurs and,

"I realized how fleeting success can be in a market, whether it's a stock market or a commodities market. My whole perspective on investing has been, and hopefully will continue to be, not to lose."

depending on which fund you look at, we lost between 20% and 30%. To my investors, I was known as a "Jewish T-bill." This is a very bad thing to be known as—not the "Jewish" part but the "T-bill" part. Because when you then have a losing year, they say, "Oh my God, it's not a T-bill." Then they start to realize, "Wait a minute, he's got risk after all. We thought you were really safe. We thought you couldn't

lose." I had to go through this whole process for my investors explaining why they shouldn't pull their money out. A lot of them did a year later. We blew up after redemption dates so the investors had to wait to redeem. We made most of the money back in 2009, but they were all so stunned about what had happened that we lost about 25% of our capital through redemptions in 2009. That was a learning experience for me. You don't ever want to have people think you are what you are not. Then the Madoff thing happened the same year, so they started saying, "Wait a minute. Madoff didn't lose money for 20 years either." I actually had to explain why I'm not Madoff to my big investors. They knew I wasn't, yet they had to check the boxes to make sure I wasn't actually Madoff.

G&D: Were they institutions?

CE: Yes, they're my big guys, and they were worried that they were going to be fired from their jobs. Imagine having another fraud that you invested in. A lot of institutions were invested with Madoff.

The reality is that a lot of the fund is my money and Curtis's money. If you do the math, we can do much better making good returns on our own money than with management fees. Except, this year we are losing money. It's the second time we're losing money since 2008. We are down about 10%. It's really nauseating because we have done a good job to be down 10%—that's what's scary. We've done very few things wrong, but those things we have done wrong

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Craig Effron



Matthew Baredes '17, Matheus Romariz '16, and Nicholas Turchetta '17 volunteer at the Graham & Dodd Breakfast

have been fatal in 2015.

G&D: Could you talk about how you think about managing the downside in your portfolio?

CE: Let's go back to the floor experience. Managers you've spoken to in the past and with whom you will speak in the future are probably "traditional analysts." They come from good schools, they learn at Morgan Stanley or Centerview Partners how to be an analyst. They start becoming investors and that's their thing. I am totally different. I am a trader. I am a risk manager. I was very successful on the floor because I didn't go out of business.

I remember when I was 23 or 24, there were the "Michael Jordans" and the "Tom Bradys" of the floor. They were famous. They were the big traders who traded hundreds of lots. I'm there for about six to nine months and I'm a little baby trader at this point. I get tapped on the shoulder by a veteran trader. He was one of the biggest traders in gold. He taps me on the shoulder one day and says, "Hey, can I talk to you? I'm wondering if I could borrow some money from you. I had a little problem: I was short gold." Gold went crazy and he went out of business.

I said, "I don't have any money to lend you—I'm 23 years old—but I appreciate that thought." I said to myself, "Wow this guy was a millionaire." He was looking for money because he went out of business. I realized how fleeting success can be in a market, whether it's a stock market or a commodities

market. My whole perspective on investing has been, and hopefully will continue to be, not to lose.

Relatively speaking, making money is easy. It's avoiding losing that's important and much more difficult. This 10% down year is going to cost me two years of money. I can tell you next year will be a very

"I've learned that people tend to give you a one-year grace period. They realize that the S&P is flat for the year but the real market is not. There are 327 stocks down this year out of 500 in the S&P with a handful outperforming."

difficult year as well. In fact, if we fight back to even in two years I will be happy. The key to our business, I've learned, is this: don't go down. It's fatal to a lot of firms. The average age of a hedge fund that goes out of business is seven years. We're on our 27th year. That's not by accident. We had 20 years of never losing. We had 2008, we also lost 3% in 2011, and now this year: three losing years out of 27. That's how you stay in business.

A lot of very good investors have blown up. Some have

come back from it, but not typically. You're given one chance to go out of business and that's it in our industry. You can't redo it. 2008 was different. People gave you a free pass in 2008. Otherwise, if you lose money of any real size, you're out of business pretty quickly. There's another smart guy down the street who has done really well and he will take your money.

G&D: How much more competitive is the hedge fund industry now compared with when you started?

CE: Here is a crazy stat: when I started business there were 300 hedge funds in the world. There are now over 10,000. We were the 165th biggest in 1990 with maybe \$30 million, 155th in 2000 at around \$1 billion, and we were 177th in 2008 at \$3 billion. No matter how big we got, we never got any bigger relatively. It's symptomatic of the issues we're having now in our business. There's too much money in it.

The business was an amazing business when no one knew what it was. In my world, at your age, mediocrity in my business made you very wealthy. People wanted to be invested in hedge funds. They didn't care if you were the best. They wanted to be in a hedge fund; that was the cool thing to be in the '90s. If you were just mediocre, making 8% a year, people were delighted because they were doing it in a hedge fund as opposed to doing it in a mutual fund. Now you're in a position where it's not good to be a hedge fund unless you're really good at it.

Craig Effron

People that were terrible were making tons of money on management fees. That all changed in 2008; they went out of business. Now, in our business, if you're not in the top 20%, you don't make any money, and that's the way it should be. Like any business, you should be required to be in the top percentile of performers to remain in business. That's the new dynamic, the new normal in my world. If you aren't good at it, you actually are out of business. Every year, I've got to be good again because there are many options out there. Whether it's another hedge fund or a quant fund, there are so many options that people say, "Look, we love you as a person, but you're making no money for me."

Now for 2015, we are down between 10% and 11% at this point, and we have had very few redemptions. I've learned that people tend to give you a one-year grace period. They realize that the S&P is flat for the year but the real market is not. There are 327 stocks down this year out of 500 in the S&P with a handful outperforming.

G&D: Those are companies like Google and Amazon?

CE: Out of those stocks that are up, it's about six that make a difference. That's not what I do. I don't trade Google (GOOG) and Amazon (AMZN). If I did, I wouldn't need to be in this business. I'm doing things that are "tricky" or "clever," and not so much this year, obviously. It's not just me. Because, as you know, my world is getting destroyed. We are trading on events that

theoretically have catalysts, and that has been a horrible business this year.

G&D: Did the catalysts not come through or did the catalysts not matter much?

CE: Some didn't come through and some came through and ended up with bad results. I'll give you a case in point which I find amazing. Starwood Hotels (HOT) went up for sale in June. The stock at the time was at \$80/share. Everybody had a break-up value of somewhere between \$90 and \$105. On June 15th, when Starwood announced that the company was up for sale, the stock was up a little bit that day. Then the market

"There are a lot of things out there that are scaring me. But, I'm paid to play, and that's what I do. But I don't play with leverage."

blew up and the stock was down into the \$60s. By the time the market came back about a month later, the stock was at \$75.

In the first week of November management announced there were three buyers. One is a Chinese buyer who owns The Waldorf; one is Hyatt Hotels (H); and one was an undisclosed name. The stock goes from \$75 to \$78 because it's going to be an awfully good

deal. Five days later they announce a deal with Marriott (MAR) at \$70: a take-under. I had not seen that in 25 years.

Now obviously there's more to the story. Maybe it's because something is going on in the company that I don't know about. We thought, "There are three buyers. We are going to make a lot of money." We lost 10% overnight on that trade. That's just one example of what is going on this year.

Also, Mylan (MYL) was trying to buy Perrigo (PRGO) this year. It was a big deal. Mylan came in hostilely and Perrigo had no defenses. They went down to the last week, where they needed 50.1% of the votes to vote "yes" for the deal from Mylan. If you vote "yes," you make \$20; it's that simple. If you vote "no," the stock will go down and you lose \$15. There's a \$35 differential. In the history of the world, I've never seen people vote without their pocketbooks under consideration. Not only did it not go through, but also the deal lost by a lot.

What I learned was that people like making money, but there are things they like more. In this case, they liked the CEO of Perrigo so much that they felt badly for him. They said, "Let this guy try to make it." They hated Mylan's guy. I'm not saying I loved him, but he was offering me \$20 more than where the stock was trading. They chose not to take the \$20 and lose \$15 instead. I thought it was a no-brainer. It was the biggest position on the street and people got destroyed. Who

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would think that people would throw off \$20 and take a \$15 loss? But, that's what we're reading now.

G&D: Did they think there would be additional bidders?

CE: No, we were already past that. We thought initially there would be. Now it is the last day; it's over. Either you take the \$20 or you table it. In all my years doing this business, I've never seen people not take the money. It was a big difference. Not like it was a \$2 premium. It was \$20 on a \$140 stock. When things like that happen in my world, it's hard to make money. I'd make that bet every day of my life. It's just how it goes.

G&D: Do you know anything about the make-up of the votes?

CE: It was every arbitrageur, representing about 25% of the float. They voted "yes," obviously. The indexers ended up voting "yes," which had been a big issue. When I heard the indexers were going to be voting "yes," I said, "This is going to be a no-brainer." Every plain vanilla or Fidelity of the world had a one-on-one with the CEO on that Thursday of the vote. And that guy pleaded. He said, "Guys, you are going to end up owning Mylan stock. He's a criminal; he does terrible things. Perrigo has real brands. Give me a year to make this up to you. Just give me that year and, if I don't do something in that year, I'll get another buyer." They bought into it. All the institutions, which are the main voters, all voted his way, and all turned on the day before the vote. We all had

thought they would take the money, because everyone takes the money.

That's what I'm dealing with this year. The events space has been a disaster, an unequivocal disaster. Unless you're long Amazon and Netflix (NFLX) and the Jim Cramer FANG stocks, you're having a really lousy year. If you're an energy-related guy, you're out of business. Things are bad in retail, too. Macy's (M) is the gold standard and it is down 50% this year. Hospitals and HMOs were obliterated the last two months, I don't know why. If you're in the wrong sectors, you think it is a bear market like 2008 versus the market being very quietly up 1%.

"Don't be so big where your eyes are bleeding and you've got to get out. Size your positions so that you can withstand what happens if you are wrong."

G&D: You don't use a lot of leverage. Was that a product of 2008 or have you always been more conservative?

CE: No, it was a product of me being on the trading floor and realizing what can happen. Leverage is a two-edged sword. It's wonderful when the trade is going up, but you're out of business quickly when it goes the other way. I have

friends, and they're brilliant guys, who have four or five-times leverage now, and I always wonder, "How do they sleep at night?" If, God forbid, something happens out of the blue, the next day they're losing something like 15% or 20%. But look, that's how they were brought up. I was brought up a different way because I was a commodities trader where leverage was a bad thing. You could get blown away by being too big.

For the last five years, it has been fine because the Fed had your back. It's been a very easy market until this year. Once the Fed stopped QE the market became difficult. So what it really shows is that most of us have just been gliding along because of the QE wind at our backs. And now that QE's done, that's why the market has been flat. QE is over and now we have the prospect of higher rates. There are a lot of things out there that are scaring me. But, I'm paid to play, and that's what I do. But I don't play with leverage. Now, we do use a modicum of leverage, maybe 120% gross, but not 300% gross.

G&D: Could you go into a bit more detail?

CE: Our average exposure is about 120%. Our net is about 45% long. That's where we usually run. We go as low as 80% gross and 20% long. We're always long. You guys should know one thing: the markets go up over time. That's just how it is. If you try to play the short game at the wrong time, you'll lose money.

You don't want to be short

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Craig Effron

markets over a long period of time. We all watched the ten-year period from 2000 to 2010. That was a flat period. I had never seen that before. Remember, I saw gigantic periods. The '90s grew at around 20% a year, the '80s averaged 10% or 15% a year. So 2000 to 2010 was an interesting period. But, yes, we're low-leverage guys.

G&D: Building on the topic of risk management, let's consider a situation like Perrigo where what you thought would happen did not occur. Can you talk about how you think about the next steps?

CE: I've learned over my many years doing this that you never sell the first day of a bad event. That is for amateurs because there are guys that are so big that their eyes are bleeding and they have to get out. If you look at where the stock is on day one versus day 30, 99% of the time every sale you made was bad. You wait a month and then you can reassess. Perrigo is no different. Perrigo opened at \$135. I closed my eyes, I didn't do a thing. It's now \$150. Now we're getting out. We made our \$15 back. So now we broke even on the trade, but we lost the \$20 we would have made.

People that sold on day one and day two and three, are kicking themselves. Last year, AbbVie blew up the big deal with Shire. Shire went down \$100. If you waited one year, it was higher than the bid.

G&D: Is that because of the tax inversion?

CE: That's what it was—it was

the tax inversion. It was because AbbVie was scared of getting yelled at by Obama. So they blew it up. They traded from \$250 to \$150. Settled around \$180 for the next two or three months, then went back to \$260. Now it's back to \$220. What we have learned here is, "Don't be so big where your eyes are bleeding and you've got to get out." Size your positions so that you can withstand what happens if you are wrong. In Perrigo, we only lost 50 basis points on that break, because I knew I didn't want to be selling it badly.

Normally, if we'd been up for the year we probably would have risked 1.5% on that trade, that's how good I thought it was. It was an overnight binary bet. That is not a big bet if it was 1.5%. But it is when you're making a bet on red or black.

G&D: How concentrated are your positions?

CE: We have about 20, maybe 30, positions, and our biggest are between 5% and 7%. We have nothing smaller than 1.5% or 2%, and we average probably 4%. We're very focused on protecting against the downside, and that drives our risk management approach and portfolio construction. People have this view of hedge fund guys, that they are like magicians and that there is voodoo going on. There is no voodoo. You guys are as good as I am at this. Your opinion is as valid as mine is. I've been doing it longer; that is the difference. I've seen the examples of ideas from your classes. There are brilliant people. My analysts are not any more brilliant than you; they just have experience doing it.

What students miss a lot is the practical matter of the stock. For some of the short ideas, I ask, "Do you realize the short interest in this thing?" They realize there's not just a downside of losing X amount in an upside case. When you and the whole world are short a stock, you go out of business too many times. People your age often don't understand technical aspects of the market. They understand that a stock is not worth \$20—it's only worth \$10. Okay, that doesn't mean it's going to \$10. It could go to \$50 before it goes to \$10 and does that mean you made a good decision or not?

Some people will say in interviews that their best idea was long Apple. I ask, "Ok, when did you buy it and for what price did you buy it? Ok, \$220. Did it go up or down first?" They usually say, "Well, it went down first." I say, "Oh, okay. Where did it go to?" If he says, "To \$85 or \$90," that guy is not getting hired because he thinks that is okay. He lost half his money on the way to making three times his money. Well he's out of business at that point. There is no more company. It's easy to say, "Yeah, I owned Apple at \$200." But there is a middle chapter there. It went to \$80 first, when Jobs was dying, then \$600. I don't look at a good investor as a guy who has lost half my money first; that's terrible. It's very important to understand that every idea might be worth five times at some point, but if you lose half first, it doesn't really matter. Hedge fund managers that are good understand that and they have stop-losses where they don't let that happen. Some

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people go out of business because they say, "Well, it's worth \$200. It is trading now at \$120. I'm not getting out here. It was just \$150." Then it goes to \$90, then the next crash comes, and then you're out of business. So we have a pretty hard stop on things here.

When one of my analysts comes up with an idea I say, "First of all, one to ten, how much do you like it?" If it's not at least a seven, I don't do it. If it's a nine or a ten I say, "Okay, I want to know right now at what price you're selling it and at what price you're admitting you're wrong." I want to do this when we are unemotional. Investors have a tendency, and so do I, to marry positions. You think a stock is your wife, your girlfriend. It's not. Stocks don't know you own them. They really don't. But when you own a stock, it's like your girlfriend, you can't get rid of that stock. It's true, and that is an emotional response that we all have.

If I said on day one, "Hey, you like this stock ABC? Our target is \$70, it's trading at \$40. Where are you admitting you're wrong?" I want to know. There's no discussion that way. If it goes down that amount, whatever it is that they say, I get the message, and at that moment I'm getting out because I don't want to think, "Well, stay with it because, they're wrong. The market is getting it wrong." I hate that comment, "the market is wrong here." The market is never wrong. I learned it in the commodities business and re-learned it in the stock market. When you own a stock that you think is

worth X and is trading half of X, you're wrong. Something is missing. You find out later what it was. The market is always right and it tells you it is right. Once in a while, you're smarter than the market. Not much. So my analysts all realize they need to have a stop point because if they don't, they'll get married to it.

I will revisit something after I've got out of it, because you find, when you have sold a

***"If I can't trade
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position, whether it's been good or it's been bad, that you have a liberated feeling. You can look at it objectively. You are no longer married to it. But when hope becomes a strategy, you're lost.

This year, the times that we lost, it hasn't been one name. That's the crazy thing. It's been a menu of things that have gone wrong. So, I can't say I've been killed in one name. I lost 80bps here, 60bps here, and all of a sudden we're down 10%. And the hedging has been

killing us.

G&D: When you generate high returns do you typically have a few big winners?

CE: Out of our 30 positions, ten are meaningful, and of the ten we hope to have three or four that are home runs. A home run means up 50% to 100%. Year to date, three out of our top five positions are down 50%. We didn't ride it all the way down, but that's where they're down now. Micron Technology was at \$36. It's trading at \$15. YPF is an oil company in Argentina, down from \$27 to \$15. The last one, Applied Materials, was an arbitrage deal that blew up. Three of our biggest positions got destroyed. That's never happened to me during all my years of investing.

G&D: What do you think went wrong with the Micron investment? Was it increased competition?

CE: Micron is crazy. We owned it two years ago. We have owned it for a long time. We bought it at \$15; we sold half at \$30 and kept half. Up until three years ago, there were many players in this space. They always competed on price, and they always blew everybody up. It got down to three: Samsung, Micron, and Tsinghua Unigroup. We said, "Finally. Price rationality. There's no way they're going to break price. They're having a great run here. They'll just keep price and it'll be good." Then Samsung ruined it for everybody. Once Samsung started a price war everybody joined in and now prices in MRAM and DRAM have gone down by half. We figured,

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"Finally, three rational pricers." We were wrong. There are only two. That was a big problem for us.

G&D: How do you decide when to sell? You mentioned asking analysts for stop losses.

CE: Micron is a good example. We bought one- and two-year LEAPS in 2013, because it was very volatile stock. We had already bought shares before at \$7 and it was up 100%. The LEAPS that we paid \$3 for were trading at like \$17 or \$18. We sold the LEAPS and bought short term options struck at \$25. So we use options a lot to limit our risk when they're priced appropriately.

When the VIX is trading at 11 or 12 for the general market, you can do tons of wonderful things with options. When it is trading at 19 like it is today, a lot less so. It's hard. If I can't trade options and limit my losses, I've got to bring my gross down because I don't want to get caught in being long common stock that can go down a lot more than the options can. Options are wonderful vehicles.

I took courses in Wharton on options pricing. I learned all the theoretical models. That's not what I'm talking about. I'm talking about actually understanding what they mean. In 2008, Bank of America had traded down to \$4/share, like it was going to go bankrupt. They had calls that were trading at one hundred vol, which is humongous. The \$5 call was trading at one hundred vol. That meant, instead of paying \$0.38 I was paying \$0.48. People were thanking me for putting in an order to

buy those options because I was paying way too much for them, a dime more than they're worth. A dime on \$0.38 is a gigantic move. But I'm playing for dollars here. So, I bought thousands and thousands of Bank of America, \$4 or \$5 calls, while the stock was trading at \$4. Then luckily, a month later, Bank of America went from \$4 to \$7 overnight. All the calls at \$0.48, which were worth only \$0.38, were now trading at \$3, and the guys who gave them to me got destroyed. Options are always mispriced to some people who don't understand optionality.

Another good example, SunEdison is in the news right now. We bought a boatload of \$3.00 and \$3.50 calls last week. The bet was very simple: half the world is betting it is going to go bankrupt, while half is betting it isn't. The short interest in it was forty percent. I might be wrong here, but I'm saying the option is mispriced. I can buy calls that look really expensive, trading at one hundred vol again. And, again, they're a dime more than they should have been. So we bought a boatload and just sold about half of them for about \$1.00 profit on a \$0.40 call.

It's a great risk/reward. We were risking \$0.40 to make \$1 versus paying \$3.20 for the stock and maybe losing \$3. Now one hundred vol is really high, but they still did not understand that if it didn't go bankrupt it was going to be a long term option now on SunEdison.

G&D: Do you use options a lot in the event-driven space because option pricing cannot effectively price a future event?

CE: Yes, all the time. For example, in SunEdison, people did not understand the ramifications of this deal. If SunEdison does not go bankrupt, it means they're going to be okay. They may have a 10 or 20 year life now. The stock is a long term option. It is worth much more than they think it is worth. Today, Sun Edison changed the deal with Blackstone on its debt, so the stock is up \$1.00. Options players didn't appreciate that this is no longer a candidate for bankruptcy. When that happens all the calls are long term options and they should be priced higher.

I have a lot of notional exposure sometimes, but I'm only risking X. When we are invested in a stock that has vols in the high teens or low twenties, we will almost always use an in-the-money call. If we get a terrorist attack one night and DuPont goes from \$70 to \$60, we are in the money \$5. I know what I'm risking and I'm still controlling all the shares because there is about ninety percent delta to the stock. It gives you a lot of sleeping ability. I don't need to go out and hedge my book when I know all I can risk is \$5, but I have an upside of infinity if DuPont does well. Mega-cap stocks have very low vols. Another crazy thing regarding options: where in the world, as a value of an asset goes higher, does insurance cost go lower? If your house doubles in value, they require double the insurance payment to insure your house. In the S&P, and stock markets in general, as prices go higher, vols go lower and the price of options get cheaper. It's totally counter-

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Attendees at the Graham & Dodd Breakfast

intuitive.

So, my Nirvana was during 2012 – 2014 when the market was going up slowly every day. Vol was 11, I could go long all the stuff I liked and buy protection on the market for cheaper than it was a year earlier when the market was lower. It's insane. How can the market be less risky at today's price than it was 20% lower?

That's how I made all my money, by getting very long in stuff that I loved, and being short the market an equal amount through very cheap puts because they were mispriced. What happens to vol when the market goes down?

G&D: It goes up.

CE: A lot. So you get the vol expansion and the delta expansion by the market going down making your puts more worthwhile. It's like a triple whammy in your favor, and yet it happens.

G&D: Maybe if it was a situation where earnings were growing more quickly than the market was appreciating? But that wasn't the case in 2012 and 2013.

CE: Even if that's the case, I don't care. The minute the market blows up, for whatever reason, delta expands and vol expands. You have a 2x reason why it works. Your puts, which were at 12 VIX go to 22 VIX. That alone is a home run. Plus you have it working because the market is going down. When the market blew up in August that was the prime example. We were long a ton of puts for August expiration,

which we do all the time, and that saved our month. We didn't lose any money in August because we had puts that went from \$1 to \$20 from both the volatility aspect and the price aspect. That hadn't

“Another crazy thing regarding options: where in the world, as a value of an asset goes higher, does insurance cost go lower? If your house doubles in value, they require double the insurance payment to insure your house. In the S&P, and stock markets in general, as prices go higher, vols go lower and the price of options get cheaper. It's totally counter-intuitive.”

happened to us since 2008. Remember that insurance is cheaper as the market goes higher, not more expensive, which is a wonderful thing.

G&D: With respect to incentives, people get paid on a yearly basis, so managers only look out on a yearly basis. Do you think that creates an even more skewed incentive structure for LEAPS, so that

they're even less appropriately priced? We were talking about how options are priced, but LEAPS are multi-year.

CE: LEAPS are a wonderful vehicle. The problem that guys in my world have is liquidity, quarterly or annually. What you have to be careful of is having a mismatch of what you own versus your liquidity terms. Long-term, locked-up money doesn't really exist much in my world anymore. Also, LEAPS have different taxes. There's a dirty little secret about our business. You should ask managers what their after-tax returns are. For example, if I talk about making 17% net, I'm a fraud. I made 17%, but it was almost all short-term in those days. Now, Joel Greenblatt was always an after-tax guy. He traded LEAPS all the time because he said, "I'm not paying taxes at short-term rates." He made more than I did because he was paying 20% and I was paying 50%.

G&D: His stated number in his book is 40%.

CE: You're right, and he's the best there ever was. It was 40% on a long-term basis. The guy's a tax genius. He was a Wharton five-year guy and he learned about accounting. I said, "Oh, making money is great." I was a dumb guy, and he always said to me, "You're not tax efficient." I just wasn't thinking because I was making these very good headline numbers.

When you play in my world, which is event-driven, if there's a takeover tomorrow I can't be long-term. It's over. What am I going to do about it? A lot

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of what I did wasn't my decision. I'm not a stock picker, remember. I'm an event picker. We've done more stock picking in the last few years because it's been the place to be. But, generally, our holding period, unless it is distressed, is less than a year. Lately we're about 70% short-term, 30% long-term which is about as good as I can get.

G&D: Is there anything else you find challenging in this environment?

CE: Before 2008, the risk-free rate was 5%. That's a fair risk-free rate and we were making about 15% net. We were three times risk-free net and I was considered a hero. What's risk-free rate now, you think? Call it 1%? If I make 8%, I'm eight times the risk-free rate, and I'm getting yelled at. What it means is that we are doing things that are much riskier now than it was before 2008 to get eight times. Investors don't get that. Guys making 15% are either highly leveraged, or crazy lucky and good.

But sometimes you've got to accept the fact there's no money out there. There are times to reap and sow. This is not a reaping time; this is a crying time. We see the markets doing what they're doing now because of the Federal Reserve and Europe, Japan, and China taking on the mantle of the US Fed. It's very scary.

I'll tell you what's going on here: asset inflation, whether it's bonds, or real estate, even more so. Residential real estate is trading at one caps in New York. A one cap! The

world is beyond what I understand now, but I know one thing: there's going to be an end to this. I thought it might've been this past fall, but I was wrong. It is going to be ugly.

G&D: How does that factor into your and your investors' risk appetite?

I'm at a point now in my life where my investors are all risk averse. None of them need to get rich; their goal is to stay rich. It's a big difference. Business school students can afford to be risky, do what I did, play options, and live to make money. Once someone turns 40 or 50, has kids, and a house, they need to make a nice living and avoid going backwards, and I did the wrong thing going backwards this year.

G&D: Have you considered pursuing something similar to Pershing Square, where you establish a permanent capital vehicle so you can have more flexibility or take a longer term view?

CE: There are only a few Bill Ackmans out there. I cannot do that. Dan Loeb did it, Bill did it, and David Einhorn did it. Those are the three guys that created permanent capital. They deserved it. We don't deserve it. Bill is the smartest guy I've ever met. There is nobody smarter in this world, in my opinion, in what we do. There is nobody more impressive to hear a story from. He's the best presenter I've ever met. He deserves permanent capital because, over time, he will make a lot of money. David Einhorn is also very impressive—different

than Bill, but equally impressive. Dan is a great guy who has done extremely well. But permanent capital would be a great thing for me because I would have a much longer term view of the world.

G&D: Would you consider creating your own family office?

CE: One day that may end up happening. For instance, there are bonds out in the distressed world that are literally unbelievable, but I can't buy them because they were unbelievable a week and a half ago and now they are three points lower. I don't have the luxury of being down 6% in a month trying to make my money next year. Firms like Oaktree and Apollo with longer term money are buying hand over fist right now. They're all suffering near term losses because energy bonds have gone down considerably, and continue reaching new lows, but they know that over time, over their investment horizon, it's going to be fine. My horizon is quarterly or yearly, so I don't have that ability, I have to be more on top of things and hope I can catch the bottom. That can be difficult.

G&D: Do you have the ability to set up separate portfolios?

CE: Some of our larger investors have set up separate accounts, and in those we're buying. The accounts are longer term, lower fee, but there's a two year lock-up, and in those we are buying. In those accounts we're interested in oil and Puerto Rico bonds. They have long

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tails to them, and we believe they are smart investments. It's great for all of us. That's why I don't really mind charging a lower fee. There are things out there that are being misunderstood and being thrown out with the bath water.

G&D: Any examples you'd be willing to share?

CE: A good example is Vantage Drilling (VTDG). They own the newest deep water fleet in the country. There are a hundred deep water drilling platforms in the world. They own seven of them. They're the seven newest and they have a 30-year life. They were built from 2012 – 2013 at a cost of \$800 million each. The company is going through bankruptcy and the bonds, which we are buying now in the high 20s to low 30s, are valuing these drilling platforms at \$180 million each. In the depths of the 2008 oil depression, platforms traded at \$300 million. These platforms are three years old. They are the most efficient, and they are platforms people want to own and lease. If you believe oil will not be \$37 forever, which I tend to believe, at least in 27 years, this is not only money-good, but they're also turning into equity, and could be a ten bagger. These bonds were 105 on April 1st this year; they're now 30, going to be bankrupt, and we're getting the equity. That's an example of what's being given. We have bought a position of about 4%. We cannot go any larger. We started buying at 44, they're now 28, 27, and I can't buy anymore.

G&D: Is there a big cost

advantage to the new rigs?

CE: Yes. That's exactly why we love them. We can buy these bonds knowing they're worth at least double what we're buying them for today. We will probably see a bottom soon. Oil is probably near bottom too. It's trading at \$37. Could it go to \$30? Yes, but remember last year, at this time, it was \$67. I thought that was cheap, and then, before that, it was \$107. It's down 70%. That's a big move. All you have to do is shut the spigots off, have production cuts, and

"I think having a sounding board is an important thing. You have an opinion and you start believing it, because it's your opinion. But, if you have a good partner who's your friend, and loves you and tells you, "Hey, here's what you're missing," and does so in a nice way, it's a very good thing. And you have to be willing to do the same for him or her."

you'll get a \$20 rally overnight, and it'll come soon enough because, I think, Saudi Arabia is starting to feel pressure

internally. They are running out of reserves to support themselves. Their currency is begging to be de-pegged. They can't have that, so they've got to do something.

G&D: What do you think about Iran's supply coming on now?

CE: Well, the market is oversupplied by a million barrels right now. That'll be another million, so it'll be two million oversupplied. That's bad news. On the flip side, Putin is now very involved in the Middle East, and he and Saudi Arabia are now allies. Putin's country is going bankrupt because it is oil-based. He is probably negotiating with the Saudis, offering to go after ISIS if they elevate the price of oil. Saudi Arabia holds the keys here. They can be the balancer, and that's all it takes. Russia is going out of business. It's worse than Brazil. The whole economy is oil, so I'm sure Putin is making a very hard plea, hoping to get oil back to the \$50s. My suspicion is you're going to see a surprise OPEC meeting in February and they'll raise the price about \$20. We're long oil now, actually, having bought it the last few days.

An oversupply of two million barrels is not significant either on 90 or 100 million barrels, with frackers stopping production. By the second quarter, we can have it where we're undersupplied by two million—it wouldn't be surprising. That's what we're thinking.

G&D: We would love to get

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into your process for idea generation and also hear about your process for deciding when to put on a position.

CE: Let me correct a misperception. Most funds don't author many of their own ideas, and we're one of them. We have an idea or two that we generate ourselves, especially in credit, but most are in *The Wall Street Journal*, or they come up in discussions at dinner with friends of mine. The idea that we're sitting in a room, and then are suddenly all like "I got it! Let's buy XYZ." That's not how it works. Bill Ackman is a different guy. Bill does do that and he's unique. John Griffin does that as well, especially in Japan. Generally, though, we all talk to each other and share ideas. Ideas are not generated out of thin air. They come to me from *Barron's*, *The Wall Street Journal*, *Financial Times*, idea dinners, brokers, etc. That's how they come.

The differences inside each fund is how they take the information, and we do it very simply. Before 2000, I was the sole generator, with Curtis, of every idea. I didn't use any of the analysts' ideas. I was the guy who gave all the ideas and they would generate the numbers, but they were my thoughts.

Now the division of labor is probably one-third my ideas and two-thirds theirs. They're much better than I am now and I'm not as good as I once was. They're smarter than I am and a lot of ideas are theirs. When they come to me and say, "I love this idea" we rank it one to ten, then we discuss. My job is to decide how big to

make it, how to express it, the time frame, and other details. We start discussing whether it should be a pair trade against a comp, options, bonds, CDS, or any number of ways.

I'm the risk manager; I put the trades on. I can tell you every position we own, the number of shares, and why we own it; but, I may not know the math behind it. I know the thesis. I am the guy who does the sizing and the risk, and I also know when positions start getting too big. I can sell at any time without consulting the analyst. They know that I have one rule, don't get mad at me if I sell your idea one day, because we may buy it back.

There's a very good amount of money to be made by trading, what I call, around the edges. If you're long a company at 5% and it rallies more quickly than you thought it was going to rally, if we sold 1% of that 5% on a rally, hoping to buy it back, it's a win-win. If I'm wrong and it goes higher, that's okay. If I'm right, I can buy it back, and create a little alpha and nothing bad has happened.

I've taught my analysts that if things happen quicker than we expect, take some money off the table and look to buy it back. Things don't go in a straight line. That's been a good lesson. There's a gentleman named Bernard Baruch, whom you may have heard of, who famously responded to the question, "How'd you get so rich, Bernard? By selling too soon." It's a great line, and I am the quintessential sell-too-soon guy. I was long Valeant, and I was selling the stock when it

was at \$200. While I don't feel that bad now, I felt bad at \$250, but that was me getting out early. I had bought it at \$140, and I made \$60, which looks good now. I never got back in, and I never shorted it either, but that was selling too soon.

Another adage to keep in mind is that you can't like a stock as much at \$100 as you did at \$20. I don't care what it's earning. It's just the way it is. Look at Apple. Apple went from \$200 to \$700 back to \$300. That's just what happens. I'm not saying to go to zero, in position and size, but you can't like it as much as you once did. Instead, an option may be to keep the same position the same size. If it's 3%, keep it 3% don't make it 12% because it's rallied; that's just dumb, and that's how you go out of business. You have to "feed the ducks when they're quacking," and that's what I do because I know when I want to sell to them, they're not going to be there for me. You have to sell when you can, not when you have to. Some very smart, large managers ended up forced sellers of things they love. Why? Because they received redemptions and had to sell. What a horrible thing, selling things you love at the bottom because you have to sell.

G&D: Any other recommendations?

CE: I recommend partnerships, even though most managers like to be lone managers. I think having a sounding board is an important thing. You have an opinion and

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you start believing it, because it's your opinion. But, if you have a good partner who's your friend, and loves you and tells you, "Hey, here's what you're missing," and does so in a nice way, it's a very good thing. And you have to be willing to do the same for him or her.

Lastly, we are unusual. I am an old school investor from the '80s, and there are only ten investors left doing this with funds the same age as ours. There are only ten guys still around from the '80s from the 300 people I started with, and the rest have all gone out of business, because as I mentioned, the average fund folds every seven years.

G&D: Joel Greenblatt talks about how the stock market doubles and halves every seven years, or thereabout. Is that part of it, is it just part of that cycle, when everyone goes out of business?

CE: People start believing they're really good at it because they have a good run. They forget that a large part of it is luck. We're lucky to be in this world, where people buy stocks for no reason. The market is fragile. We've taken our book down dramatically. We are focusing on credit, which I think is more interesting, and that's our bet. I can't play a stock market that I think is destined to be a debacle. The S&P might very easily be overvalued by 25%. Energy is important, but retail, semiconductor, hospitals, I don't know what's keeping them up. They are going to blow up, mark my words. It is going to be ugly when it starts to hit Facebook (FB) and

Amazon. People never get out on the way up. They get out when they have to and not when they want to.

G&D: Do you think value will have its day soon?

CE: I hope so. I'm not an Amazon player. Value has its time but it's always less than what you think it's going to be.

G&D: Has the crisis and its aftermath changed your perspective at all?

CE: I have this little program every year for college sophomores going to be juniors, and my opening salvo always says, "Do not confuse happiness with money." I know more unhappy billionaires than

"Do not confuse happiness with money [...] You need to find happiness by loving what you're doing, and a lot of folks don't love what they're doing."

I can count on all my hands. Having money's a great thing, and I would never not want to have it—I'm not saying that—but it does not make you happy. It takes away one element of problems: how are you going to eat, are you going to be able to go on vacation, or put your kids in private school?

It doesn't create happiness. I see more happy kindergarten

teachers than I see hedge fund managers. Hedge fund managers have a habit of being very competitive. They're all alpha people. They would rather be flat and have their competition down 10% than everybody be up 10%. It's a crazy world.

Don't be like that. Understand there's room for everybody to make money, number one, and number two, when you make that money, don't say, "I should be happy, but I'm not." It's not a happiness factor. It means you can do things. That's all it means. You need to find happiness by loving what you're doing, and a lot of folks don't love what they're doing. They hate competition. It's a very stressful business. I get yelled at a lot. This year I'm getting phone calls from an investor I've had for 20 years yelling at me. I never get calls when I'm doing well, that say "Great going."

If you get into this business—and I don't recommend it right now—the government has really made it difficult. Young investors can't open a fund. You have to go to a place and spend a lot of time learning how to do it, and maybe you get good at it and maybe with that expertise, you can go and open a fund when you're in your 30s. I did it when I was 28 because there was no barrier to entry. You didn't have any compliance officers; you didn't need to have big, heavy-duty accounting groups. Now, if you run \$500 million dollars, day one, you can't be in business. Why? You can't get the right people. You can't have a robust back office to make your investors comfortable, and you can't get the

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compliance people you need.

They've made the business either get big or get out, and that's what we see happening. There's nobody left in the hundreds of millions of AUM anymore. It's sad, because there's real value there. If you're running \$500 million, it's much easier than running \$5 billion.

G&D: Do you have any advice for Columbia students?

CE: I don't want to say you shouldn't enter the industry. I'm just saying have your eyes wide open. I would pursue private equity at this point. Private equity is one place where they give you hope that you can still make money, and they can't pull their money out. An investor can see three cycles in an eight year period. Over that eight year period, investors are going to have one chance to pull their money. For hedge funds you have eight months. If you start a hedge fund and lose 10% your first year, you're out of business. In a private equity firm, if you lose 10% on paper your first year, you've got seven years to figure it out. I like that model better now. Long term assets are much better.

G&D: Thank you for your time, Mr. Effron

CE: I have enjoyed this immensely. I don't want to tell you not to be in this business. It's a great business, but I'm worried that it's not what I remember anymore. Maybe it'll become more normalized, but throughout there will be hurdles.

Jeff Gramm

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Jeff Gramm '03

Chairman: Boardroom Battles and the Rise of Shareholder Activism published by HarperBusiness.

It is a riveting history of shareholder activism that has garnered advance praise from Arthur Levitt, Alan Greenspan, Fred Smith, Charles Schwab and Tyler Cowen. The book features an appendix with original, never-before-published letters written by Warren Buffett, Benjamin Graham, Ross Perot, Carl Icahn, and Daniel Loeb.

Graham & Doddsville

(G&D): Could you provide some background on your journey and how you came to investing?

Jeff Gramm (JG): I really learned about investing at Columbia. I went to the University of Chicago for undergrad. I played music after college, so I was a career-transitioner when I got to Columbia Business School. That was before the whole value investing program, so Joel Greenblatt just taught a regular Security Analysis section. I was lucky enough that his class was the one that fit my schedule and I just felt like it clicked for me. Instantly, the whole thing resonated with me and I got extremely interested in investing.

Before my first year core classes, I had never really known about accounting, I had barely even heard of Warren Buffett and so I came to the whole thing fresh. After Joel's class, I just began to consume everything I could.

G&D: Was there a time in Security Analysis where you realized that value investing, that orientation, was right for you?

JG: I remember Greenblatt did an in-class case study of Munsingwear and I remember getting it very quickly. I'm sure that I didn't know what the hell I was doing back then, but the case clicked in a way that made me think I could be good at value investing. I wasn't especially confident in business school. I stuttered badly, I didn't have any business experience, I was very unpolished, and then along comes this class where I felt I really was getting it faster than many of my classmates. That was really important for me at an important time in my life.

G&D: Who besides Joel Greenblatt would you say were major influences on you and developing your style of investing?

JG: Definitely my boss Greg Shrock. He gave me all of the Berkshire letters and the Munger speeches and that kind of stuff. Also, Bruce Greenwald's Economics of Strategic Behavior class. It really helped me understand competitive advantages and how to think about business strategy.

G&D: How did you decide to launch your fund?

JG: My first job out of business school was at HBV Capital. It was a multi-strategy hedge fund owned by Mellon Bank. I worked on their distressed fund from 2002 to 2004. It was a billion dollar fund, but at the same time it was pretty

unstructured.

The analysts had a lot of leeway in what they looked at and what we got to do. Pretty quickly I got to do this activist campaign on Denny's. We were bond holders, then we bought the distressed equity and I wrote a 13D protesting the company's rumored plan to equitize the debt. Then we led a PIPE to recapitalize the company. It was a fun and exciting time in the business.

G&D: No new management though?

JG: No new management. The management at that time was good for a turnaround but had a hard time after the turnaround. There have been several new CEOs since then.

At HBV, I was lucky enough to have a very good mentor. The head of research, Greg Shrock, had been an M&A lawyer with Wachtell Lipton for many years and then a bankruptcy lawyer at Milbank. He and I left to launch a long/short distressed fund called Arklow Capital where I was the junior partner. We were seeded by Protégé Partners in 2004.

I left Arklow to form Bandera in 2006 with my current partner Greg Bylinsky. It's a much more traditional value fund: highly concentrated, long biased. I got away from long/short diversified and distressed investing.

G&D: Why were those the right decisions for you?

JG: I was always interested in concentrating in my best ideas. I've always thought that was the best approach for getting

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good returns. I didn't enjoy being a part of a long/short fund with a two man team. The short side is extremely labor intensive. Greg Shrock was very keen on shorting the subprime bubble. It ended up working out incredibly well for him, but having a short book was a lot of work and it didn't leave a lot of time for doing what I wanted to do.

I also didn't love distressed investing, and especially during those years, there weren't a lot of actual workouts. There weren't that many distressed bonds even. Everyone was looking at the same opportunities. I've always thought distressed investing is an industry where there are lots of economies of scale and I thought it was hard to be a little guy in the space. Big, established firms have lots of advantages in deal flow and trading, that aren't as prevalent in more classic value investing.

G&D: You say that Bandera is extremely long biased, that you're concentrated. Do you have any sort of structural advantages that allow you to do that, which maybe other people don't?

JG: We are very lucky to have a good capital base of long-term investors that have been in the fund a long time and have seen us in good years and bad years.

G&D: They're all high net worth individuals?

JG: Yes. They know what we are doing and how we think, so to the extent that we have any kind of edge, I think it's our investor base. I think I'm good at what I do. I think I

have a dispositional fit for this business. I think I have a few areas of expertise, but ultimately, there are a lot of people out there that are doing exactly what I do and what Bandera does.

When you go to the Berkshire Hathaway meeting, you meet dozens of other smart people that are doing exactly the same thing. It always gives you pause. It's easy to talk about your hedge fund's process and your edge. But ultimately, I think a lot of that is overstated and that value investing is mostly about keeping sane and using good judgment.

"It's easy to talk about your hedge fund's process and your edge. But ultimately, I think a lot of that is overstated and that value investing is mostly about keeping sane and using good judgment."

G&D: What was it like launching in late 2006 right before the crash?

JG: I'm not going to lie, it was exciting but also very scary. In some senses the sky actually was falling in 2008, but we had two incredible strokes of good luck. A contingent of our investors are high frequency traders and that was an extremely good period for

them, so they added capital at the lowest points. That helped us a lot. We also had a large hands-on investor that was a former bank owner who kept us very honest when we looked at financial stocks.

Launching a fund is very difficult, and it's easy to make mistakes right at the beginning as you are trying to build a portfolio. If the market is going up, as it was in 2007, there's a tremendous amount of psychological pressure to get your cash invested.

There were lots of investors with great reputations that were pounding the table and saying things like, "Fannie Mae (FNMA) or Freddie Mac (FMCC) is the best idea that I've ever seen in my entire career." It's hard to be a young fund manager and hear Rich Pzena and Bill Miller, or industry experts like Tom Brown pound the table, and then watch Lampert pile into Citigroup (C), and not follow.

G&D: Were you seeing opportunities where stocks were just selling off for uneconomical reasons and you were able to make the best of that opportunity?

JG: Of course. It was an amazing period. I think my biggest mistake in that period was passing on the extremely good businesses we always knew we'd want to buy whenever the market tanked. We looked at Costco (COST) and Google and other great companies and we passed.

G&D: You own Google now though, correct?

JG: We do. We have owned

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Google since 2011. But during the crisis we mostly bought cash-at-a-discount type stocks. We bought Hilltop Holdings (HTH) at a huge discount to cash. We bought the Hilltop preferred which was a money-good preferred at a huge discount. We bought into a company called Peerless Systems (PRLS) at very big discount to cash. We joined the board and pushed the company to return capital to shareholders. We viewed all of those as very low-risk investments with a lot of upside. We did buy a few operating companies, including Popeyes (PLKI), which we had been closely following and was in the early stages of a turnaround.

G&D: You're still involved with most of the stuff you were buying in 2008 and 2009?

JG: Not all of them, but we still hold many. Of our top five holdings today, we owned four of them, Star Gas, Tandy Leather (TLF), Hilltop Holdings and Popeyes, in 2009. The financial crisis, for any fund manager, was an incredible learning experience, but also a test of what you do when markets get scary. I think we passed the test, but I certainly don't think we got an 'A.'

G&D: You mentioned one of the lessons that you learned from starting your own fund was don't push to invest everything right away. Is there anything else you would recommend?

JG: The big thing is to try to stay rational that first year, because there is a tremendous pressure to out-perform early in the life of the fund. The

other thing that I regret is not establishing our back office operations. I think it was last year at the Columbia conference where Seth Klarman talked about the importance of getting good operations people and a good CFO to be sure that you can concentrate on your investing. We definitely took the opposite approach. We had a

"[2008 and 2009] was an amazing period. I think my biggest mistake in that period was passing on the extremely good businesses we always knew we'd want to buy whenever the market tanked. We looked at Costco and Google and other great companies and we passed."

short-term lease and we ran a bare bones operation.

I think there are lots of sensible reasons to do that, but I do wish that we had hired a CFO from the bat. We ultimately over-complicated things for ourselves operationally.

The early years of a fund are hard. Having business partners is hard. We're a 50/50 business partnership. Learning how to manage a portfolio where there's no boss is a real learning experience. Then you

throw the financial crisis in there!

G&D: Can you talk a little bit more about your process? Idea generation, then the investment process, specifically having a co-portfolio manager model? Last year we interviewed Jay Petschek and Steve Major at Corsair. We heard from them about their processes as co-managers.

JG: Idea generation is the least process-driven thing we do. There are always ideas floating across your desk; I think the most important thing is having a good two-to-three minute internal filter to help you decide which ideas to dig deeper into. As for our co-portfolio manager model, we require written investment write-ups. We each have our own research process, and then we pitch our ideas to each other both in person and then with a written memo. It's harder to cut corners in writing.

G&D: What do you look for in that process because there are a lot of good ideas that might not fit within your strategy? If someone pitched you Amazon, two years ago you probably wouldn't have been interested.

JG: I first try to understand if it's a good business. Then, if I don't understand the business, can I do the work to understand it? Those are the key things that we think about first. If you can get there, even if the valuation looks not that great, it might be worth a look.

It's funny, in the class I teach at Columbia, we no longer teach idea generation. I feel like one

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of the goals of my class is to improve your quick filter. I want the class to teach you how to think about businesses and then how to value them. That's really about it.

G&D: Switching topics to your upcoming book, "Dear Chairman," could you start with an overview of the book and how you came up with the idea in the first place?

JG: When I teach I'll always get a few students that ask me for book recommendations. I'll tell them I like the Greenblatt book. I'll send them an email with a bunch of the Buffett letters, the Buffett articles, the Munger speeches, Klarman letters, you know, just the classic value investing stuff that everyone passes around. And I always include a bunch of 13D letters. I've always enjoyed them. I came of age in the industry at a time when there were a lot public 13D letters. We swapped them like bootleg tapes, so I still have a lot that I share with my students. At some point I thought, "there must be a book that collects these things."

I looked for it and there wasn't one. I thought, "I can do that. That will be pretty easy." I had that idea for a few years and at some point, I decided to write Buffett to ask for the letter he wrote to American Express (AXP) in 1964.

I got to work one day and it was in the mail and I said, "Holy cow! I should probably do this book now." It makes you understand the power that Buffett has over all of his CEOs. I felt this compulsion to write the book and to do a good job with it. It took about

a year, a miserable sleepless year. The initial idea for the book was to collect a bunch of "Dear Chairman" letters with short explanatory introductions. This evolved into a more narrative book about the history of shareholder activism.

G&D: You did a great job of categorizing the shift in attitudes and approaches of all these activist investors. What do you think are the main drivers of these changes? Where do you see it going from here?

JG: I think one of the most powerful forces in activism has been the change in the shareholder bases of public companies. Activist investors are ultimately just a group of economic actors out to make a buck. It's the evolution of passive investors behind the scenes that has changed the attitudes and approaches of activists.

The book begins with Benjamin Graham in the 1920s, when, except for the big railroads, most public companies had very concentrated ownership. Ben Graham had to go directly to the Rockefeller Foundation, a 30% owner, to plead his case that Northern Pipeline needed to distribute its liquid assets to shareholders. By the 1950s many concentrated public company owners had passed away, and their stakes had been sold off. Companies had very diffuse shareholder ownership which was exploited by the "Proxyteers." They ran entertaining proxy campaigns to win public support, and that allowed them to infiltrate the boardrooms of a lot of big, established

companies. But since then share ownership has re-concentrated into the hands of fiduciary investors like pension funds.

G&D: In the introduction to "Dear Chairman" you talk about how so many documents have been lost. You had to write to Buffett direct to get a copy of that letter. Do you think that's beginning to change with more SEC disclosure and the fact that all the SEC filings are online?

JG: I was surprised at how hard it is to find old business documents, like annual reports from small companies. I think that will change not just because of EDGAR, but also because people care more about business history. I credit Warren Buffett with that. Look at how popular Thorndike's "The Outsiders" CEO book is! Many of the CEOs profiled in that book were completely under the radar even at the height of their powers. Now there are eager young students reading a book about them.

G&D: Going back to the 1950s and the "Proxyteers," we were struck by Robert Young's fight against New York Central and how involved both sides were in the popular media. It seems really interesting given the limited number of channels that were available at the time. Can you talk about the strategy for choosing those channels and how they were able to get so much access when, today, some important fights are rarely discussed in the media?

JG: In 1954 the ownership of the New York Central was extremely diffuse. There were

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basically no large holders, so both sides were forced to advertise in the newspaper to win proxies. You had to get the votes of the “Aunt Janes,” as Young called them. It was a dynamic that you never see today. If you’re trying to win a proxy fight now you’re usually courting 15 to 20 key shareholders and trying to get those votes.

This difference in ownership structure also played out in the campaigns’ messaging. Activists used extremely populist rhetoric to collect votes. It was essentially a political campaign and that’s the reason the battles were so entertaining. Back then, the PR representative was an important person. You had to get the best people to write your copy, now your PR is usually an afterthought.

G&D: Young was also skilled at getting organized labor on his side. Is there a chance to do that going forward?

JG: Could organized labor flex its muscle? Well obviously the public pension funds have been very active investors. You could even argue that some of the largest public pensions funds are downright progressive as far as shareholder activism is concerned.

G&D: Thinking about labor in general, let’s consider an activist fight where a pension plan for labor in an entirely different industry is a major shareholder. They are unrelated, but is there any solidarity with labor that would get in the way of activism?

JG: They have a fiduciary duty to shoot for the best financial outcome. People have long been concerned that entities like CalSTRS and CalPERS could begin to operate in a way that is pro-labor. Peter Drucker even wrote that the United States is the first socialist country because of the control that the labor force has over industry through pension funds. That’s always been a thing some people are concerned about, but it hasn’t really played out. The only case I remember was when CalPERS ran a proxy fight against Safeway shortly after the company had a labor dispute and strike. The CalPERS’ chairman was quickly removed because of fiduciary conflicts.

G&D: Why did you choose to include the Robert Young activist campaign against New York Central in “Dear Chairman”?

JG: I picked Robert Young versus New York Central because it best depicted the “Proxyteer” movement and Young was probably the most famous of all the “Proxyteers.” But there were lots of other interesting proxy fights that I could have chosen. I talk about Ben Heineman in the book as well. There’s also Louis Wolfson who was extremely charismatic; he was a lot more colorful than Young was, but I ultimately felt that I had to go with the most important battle.

G&D: In your research, did the activist campaigns mostly lead to positive results or negative results?

JG: It was interesting, it was

quite hard to find a real disaster outside of BKF Capital. The two most famous disasters are BKF and JCPenney (JCP), and I’d argue that the intervention at JCP wasn’t as bad as people make it out to be. It’s easy to point to the failure and blame Ackman, but he helped the board lure one of the industry’s biggest stars to be the company’s CEO. That’s what boards are supposed to do.

G&D: Potentially Target?

JG: Not really. Target (TGT) was a disaster just because [Ackman] bought LEAPS, but the actual activism there didn’t hurt the company.

When I started doing research, I thought that I would find something really black and white. Like an activist investor calling for Apple (AAPL) to liquidate when the stock was at \$8. I didn’t find too many cases of blatantly misguided activism. Activism can fail long-term shareholders when companies are sold at the wrong time, but those cases don’t make for good drama like BKF or JCPenney.

G&D: Michael Dell did say that that’s what he would have done if he had been the CEO of Apple at that time, but he didn’t go activist.

JG: Yes. I thought there would have been that kind of a smoking gun from someone reputable and there really wasn’t. The majority of the cases that I looked at did tend to work out for the activist and shareholders, with a few blunders here and there. In the book, there’s BKF Capital

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which was an unmitigated disaster. New York Central was in trouble anyway, it's not like their problems were caused by activism.

G&D: You can maybe even say the GM one, because Ross Perot didn't really get what he wanted. He got a lot of money, but he didn't change the company.

JG: You have to wonder what would have happened if he had actually been installed as the CEO. It's a tantalizing thought. Ross Perot's letter to Roger Smith is the best thing in the book.

Also, GM (GM) played a key role because they basically invented the modern pension fund. Then they proceeded to run their company into the ground for 35 years until the pension funds revolted.

G&D: How did you end up deciding which cases to include?

JG: There were some that were obvious, like Benjamin Graham, Ross Perot, and Warren Buffett. There were some where I had to depict movements like the "Proxyteers," the corporate raiders, and modern hedge fund activists.

For the corporate raider era, I picked Carl Icahn's battle with Phillips Petroleum because I thought that it had a lot of important elements. It had a very early poison pill. It had the first highly confident letter. It had Icahn and Milken and Boone Pickens, all in peak form.

For the hedge fund activism

chapter I wanted a classic angry I3D letter, so I had to go with Dan Loeb. Star Gas is not the best case, but I think it is the best letter. It's really over-the-top, calling out the CEO's mother and stuff like that. In "Dear Chairman" the original letters are all included in the appendix. If I were reading the book, I would start by devouring the original letters.

G&D: How has researching and writing "Dear Chairman" shaped you as an investor?

"I was surprised at how hard it is to find old business documents, like annual reports from small companies. I think that will change not just because of EDGAR, but also because people care more about business history. I credit Warren Buffett with that."

What have you learned and how has that affected your investments?

JG: It really drove home the big career risks that many of these guys took. They all were in comfortable positions, but proceeded to take massive career risks.

G&D: Just because if it did go poorly, they had big positions in their funds or do you mean the public nature of the campaigns?

JG: No, I mean actual material personal financial and career risk. Look at Carl Icahn: he leveraged up to do those early deals. He had fifteen deals in a row where each new deal used a large portion of his capital. And they all worked out! It was also interesting to learn more about the 1990s hedge fund era. It certainly drove home that the glory days were a little bit before my time. You had guys like Carlo Cannell that had a billion dollar fund. I'm not sure that would happen now. He deserves it. He's a great investor, but he's definitely an outsider. The industry is much more institutionalized and mature now.

I also found writing a book to be an incredible exercise in learning to be more productive. I have a full-time job, I was teaching, I have two little kids. So to make time to write a book and to have it come out well taught me a lot about how much you can get done if you turn off your phone and your email.

G&D: We had Bill Ackman in an issue last year. He talked about his evolution and now for almost every position he wants it to involve some elements of activism. It doesn't seem like you necessarily want all of your investments to be activist positions. Is that correct?

JG: I think that's a dispositional thing for me. I don't enjoy activism that much. I definitely

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think it works. If you're right that a stock is undervalued, activism is a great way to improve your IRRs by having it play out more quickly. Ackman is good at activism. I think he enjoys it.

I'm not that good at it and I don't enjoy it that much. I think I'm a decent investor, but it takes a particular mindset to be able to go onto a board and tell hardworking, usually honest people, who in some cases dedicate every waking hour to the company, that they're wrong. That's just hard to do. I've had to do it when my back was against the wall, but it's not pleasant at all.

G&D: How do you think activism plays out in general for shareholders in the long term? Have you come across anything that convinced you one way or the other that activism is actually in the best interest of shareholders for the long term as well? That activism is not, as some people criticize the industry or the practice, just to chase short-term returns?

JG: If every company were well-governed, and all activist campaigns did was to force a company sale to take advantage of the disconnect between the market valuation and the valuation in the sale, then I think that you would have to argue activism would be a negative, because ultimately you are giving up your long-term value—or a portion of it—to the buyer. But the dirty truth is that governance is terrible, and there's a huge opportunity out there to shake up public company boards. If you're correct on valuation and you

can improve the operations or the capital allocation, activism is very powerful.

I think activism is a good thing overall for passive shareholders, because a lot of these boards need to be shaken up. It's incredibly frustrating to be invested in an undervalued, poorly-managed, and poorly-governed company which allocates its capital badly. To the extent activism, or the threat of activism improves that dynamic, it is a great thing for investors. Activism fails when it forces good companies to sell themselves at the wrong time. And now, as activism has evolved, you are seeing shareholders who are more and more focused on tinkering with operations. So we'll probably see a few more failed interventions in the coming years that look like JCPenney. We should be willing to live with those if it improves overall governance.

G&D: Talk about passive investing and indexing versus pension funds and the shifts in shareholder bases. What impact will that have for governance and activism broadly? Can you speak about pay packages and say-on-pay votes? As companies get bigger, it seems like management teams get paid more and they're all getting paid the 75th percentile of all their peers and pay keeps escalating.

JG: Those are two huge topics—executive compensation and the growth in passive investing—that I do not cover as much as I'd like to in the book. They are tough issues. A great CEO is incredibly valuable and can

create a lot of value for shareholders. If they're paid according to the value that they create, it will be a scary looking number that's hard for the public to digest. On the other hand, a lot of CEOs are simply not that good and don't deserve mammoth paychecks. It is a very hard thing to reconcile.

This is something that activism has not really solved. Activism sometimes rids companies of underperforming CEOs, but activists usually give the new CEO a pretty good package. Remember, many of the shareholders who become arbiters in these situations are overpaid as well. I'd love to see more creative approaches to executive comp. One unfortunate side-effect of the Valeant debacle is that Pearson's comp package got a lot of criticism. But I really liked how it was structured. I liked that he had to risk his money, and I like that the board installed an interesting, atypical compensation scheme.

Regarding the shift to indexing and ETFs, it is completely fascinating from a governance standpoint. These votes matter, and you have to worry if the right incentives are in place to make sure these big passive institutions vote wisely.

Vanguard is taking an active role in the governance debate and they are dedicating meaningful resources into their proxy voting. But you have to worry about how much power is accruing to these places. It's a little scary if you think too hard about it.

The industry tried to deal with this problem by creating ISS.

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But ISS has devolved into one big best practices checklist. You need to have good judgment and that's the danger of the checklist. I wrote about some classic examples in the book, including ISS's recommendation that Coca-Cola shareholders withhold their vote from Buffett because he owned Dairy Queen. That is totally insane. If you're an actual shareholder of Coke, would you vote for Buffett on your board? Of course you would.

G&D: Who is your primary audience for "Dear Chairman"?

JG: I really wrote the book that I would want to read. So I think the people that would get the most out of it are value investing fund managers, which is a pretty small target audience. But ultimately, I wrote the book for fun and because I wanted to. If you're an investor, if you're into value investing, if you're interested in governance, I think you will enjoy it. Beyond that I don't know, it does get a bit nerdy in parts.

G&D: One other character that's really important to the development of activism is Marty Lipton. Can you talk a bit about his role and how your view of him has changed, if at all?

JG: I always understood the poison pill and I've always thought that in the right circumstance, the poison pill can be effective in protecting shareholder value. Ultimately, if you are a value investor, then you understand that markets can be very inefficient. So if you believe that to be the

case, then it is possible to perform an aggressive takeover of a company that screws the shareholders. If the pill is put in for the right reasons, and not to protect a bad management team, then it can actually protect shareholder value.

You have to acknowledge that, as a device, it's not inherently evil. Lipton obviously has a reputation as a defender of corporations and he has a business that is built around that. So he always takes the anti-activism side, but I think Marty's a smart guy and if you

"... The dirty truth is that governance is terrible, and there's a huge opportunity out there to shake up public company boards. If you're correct on valuation and you can improve the operations or the capital allocation, activism is very powerful."

get him off the record he obviously knows there are bad boards out there and bad CEOs.

Marty Lipton and Joseph Flom are very important figures in the development of corporate defenses so they're key parts of the story.

G&D: Carl Icahn recently did

an interview where he suggested that there could be bad managers and bad boards, but that they're not necessarily bad people who are deliberately negligent; rather they could benefit from working with them. Have you taken a view as to the evolution of activism and where it might be going—perhaps to "shareholder advocate" instead of "activist," to work with management teams to make the companies better and to keep these men and women in their jobs?

JG: First of all, when I say "a bad CEO" or "a bad board," I'm not saying that they're bad people. The power of incentives are at play here. When your livelihood is on the line, it's easy to convince yourself of the rectitude of a position that happens to support your personal employment and enrichment. It's not that all these people are bad.

Could activism evolve into a more constructive, positive engagement? I think that the threat of activism, as pervasive as it is now, is resulting in companies beginning to be more conscious of their weak spots. They are forced to play defense before they're even attacked, which is a good thing. Managers are being mindful of the areas where their companies struggle, and they communicate better with shareholders about it. That's a good development.

But in terms of constructive engagement, when the battle lines are drawn constructive activism will only get you so far. Often, replacing the CEO and changing the board is a lot

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more effective than trying to compel them to do what you want to do. When companies play defense, they usually do the bare minimum required to keep shareholders happy. It's better than nothing, but it often doesn't go far enough.

G&D: One of the themes in investing is the democratization of information. People have more access to information now, so that's led markets to be more efficient. Given the threat of activism and people finding information more easily, would that drive managers to be more short-term in nature just to avoid an activist campaign?

JG: I'd question your premise that because of all this information markets are becoming more efficient. We still have tremendous lapses in collective judgment. I'm not sure that the extra information helps. If markets have gotten more efficient, it's probably because so many smart, motivated people are becoming professional investors.

But to the rest of your question, everyone is paying attention to shareholders now because they know the threats of activism. Companies are going to try keep their shareholders happy. If the shareholders are short-term oriented, does that lead to short-term decision making? It certainly can. It's the job of shareholders and the board to put management in a situation where they can make the right operational decisions, even if it's painful in the short-term. This is always going to be a challenge for any management team in an era with or without

activism.

True long-term decision making is hard, both for shareholders and for management teams. No one wants to sit through two or three poor years for the promise of something better.

G&D: Are there any investment ideas that excite you and you want to share?

JG: We have an investment in Star Gas Partners (SGU). It's a heating oil distributor; they deliver heating oil to 450,000 households in the Northeast. Heating oil distribution is a mature, declining yet surprisingly good business. It's true there are low costs of switching and it's easy to change your dealer, but good heating oil companies have consistently generated quality returns on capital. Every time I meet someone who runs a small, private heating oil dealer, they are rich.

At times, the market seems to misunderstand the quality of the business, maybe because the few public companies that distribute heating oil have been disasters. This includes the old Star Gas, Heating Oil Partners, and Superior Plus, a Canadian propane company that overpaid for some US heating oil assets several years ago. But the truth is that heating oil distribution can be a very good business if you operate well.

G&D: Why have there been disasters if the underlying business is so strong and there is quality return on capital?

JG: It's a volatile business, sometimes in the Northeast we just don't get a real winter.

Yet the bigger public players used a lot of leverage and basically marketed themselves to investors as utility-like, dividend paying companies. The original Star Gas was a financial roll-up run by an investment banker named Irik Sevin, who's in my book because of his battle with Dan Loeb. Sevin rolled up a bunch of heating oil dealers, accumulated a lot of debt, and tried to centralize the business as if it were a propane distributor. But, heating oil distribution is a service-oriented business, Star Gas pissed off their customers, and the company was overleveraged. When things got ugly, management began to make some directional bets on the price of oil that went against them.

A private equity fund, Yorktown Energy Partners took control in 2006. Yorktown founded a heating oil company in 1981 that it ran very successfully until selling out to Star Gas in 2000. They generated a fantastic return with Meenan by doing what Star Gas is doing now, allocating capital extremely well into acquisitions and opportunistic share repurchases. So here we have a deceptively good business controlled by extremely good capital allocators. The company has bought back 25% of the stock since Yorktown took control in 2006 and it's still cheap at a very low multiple of its normalized earnings power. The market values Star Gas as if it is in a death spiral. Its enterprise value is about \$400 million, in a normal weather year the company should make about \$100 million in pre-tax

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operating income (backing out its amortization of acquired customer lists). Earnings are volatile. Last year Star Gas made \$160 million pre-tax; in 2012, when there was basically no winter, it made \$66 million. But the stock is entirely too cheap. Since we've owned SGU, they've bought back \$85 million worth of shares and paid \$130 million in dividends.

G&D: For Star Gas, can you talk about the corporate structure and shareholder rights?

JG: SGU is a Master Limited Partnership, but it's kind of a weird, vestigial MLP. All of the assets of the business are held at the C-corp level. If they could easily unwind the MLP structure then they would, as it serves no purpose and has higher administrative costs. Plus, it's a pain for investors. Regarding governance, the investors could technically replace the general partner if they wanted to, but it's a very well run company, so that is not something that we would like to see.

G&D: What are the big risks to the business? Are changes to interest rates or the price of oil big drivers?

JG: The big driver for them in the long-term is the speed of conversion to natural gas for heating. It's basically been 1% to 2% for a long time, and that could accelerate to a higher level. Over time, conversions have been pretty stable, but various external forces could change that, such as new regulations, government incentives to convert, changes in the relative value of natural gas versus heating oil, et

cetera.

And, the availability of acquisitions is important. When you talk about the valuation, Star Gas trades at 4x the normalized pre-tax earnings power, but that's misleading because it is a declining business if there is no ability to make acquisitions. Every so often some clown will waltz into the space and overpay for heating oil dealers. That really hurts us, because Star Gas is the natural acquirer in the industry. Over the past five years, they've grown their customer base by 10% through acquisitions. If you take their pre-tax operating income and subtract the cost of the acquisitions, they're generating \$60 to \$80 million a year. So it really trades at 5x to 7x pre-tax if you adjust for acquisitions.

G&D: What does the balance sheet look like?

JG: They have a \$100 million term loan offset by about that much in cash.

G&D: We were talking earlier about doing some Graham and Dodd investing and buying cash at a discount. How do you think about the downside here?

JG: SGU is working capital-intensive business so you have to normalize the working capital for seasonality. There are times in the year where it seems like SGU has a mountain of available cash, but it's not really freely available cash. Ultimately, Star Gas is going to keep on doing acquisitions. They're going to continue to operate the business. It's not that useful to look at the

liquidation value because they're not going to liquidate. If the industry goes away, then we're hosed because there are no assets there aside from trucks. That's actually why Star Gas is a good business; it is a very low CapEx business. They generate a lot of cash, but there's no asset protection if the business deteriorates.

G&D: You mentioned short selling is not a big part of Bandera's strategy, but it seems like the short of Famous Dave's worked really well. Could you talk more about that?

JG: We will short opportunistically, but it's quite rare. We usually only do it if we know the company exceptionally well. Famous Dave's (DAVE) was our only short position this year. We used to be the largest shareholder in 2010 and 2011. We got to know the board and management very well.

A succession of activists investors rolled into Dave's, and the market got extremely excited about the future prospects of the business in a way that we thought made no sense. We sold our position to the activists on the way up. It is hard to short a company like that, where there's a lot of optimism, a lot of smart people involved, and they are repurchasing a lot of shares. I have a very high opinion of Patrick Walsh, one of the first activists to get involved, but the valuation just got too crazy and we shorted about 5% of the company. Even without obvious catalysts, you had a struggling brand and a shrinking company suffering nine years in a row of declining

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Jeff Gramm

traffic. Yes, they are buying back shares. Yes, there's optimism about the future. But the market's valuation was totally disconnected with the reality of the situation. We knew the situation extremely well, having been the biggest holder for several years. It was a painful short for a while, but we knew that no one would buy the business at \$35 a share. *[Editor's note: Famous Dave's has since fallen to under \$6 per share and Bandera filed a 13D disclosing a new position in the company in January.]*

G&D: Do you have any advice for students trying to start careers in investment management?

JG: If you want to work at a hedge fund, you need to be creative about your job search. A lot of the funds that might possibly hire you don't actually know that they might hire you! Most hedge funds I know do not have a system for hiring, so you need to be as creative about the process as you would be in your investment research.

I'll get these e-mails that read, "Dear fund manager. I want to work at your fund." You have to do better than that. You have to decide who you want to work for and then target them. Most hedge fund holdings are publicly available and you can figure out which funds invest in the type of companies that interest you. It's easy to find out who runs the fund, but don't just send a generic email with a resume.

If you have identified the fund manager you want to work for, then think, "Okay, how can I get my stuff onto his or her

desk?" I tell students to write a cover letter that's very short and include an investment write-up. Put it on fancy paper. Either drop it in the mail or courier it to them.

If your research is on a position in their portfolio, they'll probably read it. If you're looking at ten funds, it's a lot of work to do a report on ten different companies, but if that's what it takes to get a

"Most hedge funds I know do not have a system for hiring, so you need to be as creative about the process as you would be in your investment research."

great job, you should try to do it. If I get a write-up on my desk about Star Gas, I've got to read it.

You have to put yourself in a position for people to pay attention to you. It also helps if your write-up includes actual research you have performed rather than just opinions. It sounds harsh, but I find that students often overvalue their own judgment.

At your first job outside of business school, even if you do great work and you're extremely smart, don't underestimate the fact that you're also there just to perform work. Don't overvalue your own judgment.

Your judgment is important, and if you do good work it will get better. But at your first job in the industry, your boss really wants you to gather information and to work hard.

I think a lot of the standard clichés about performing at work, get there first, stuff like that, are true. You'd be surprised at how few people actually do it.

G&D: Jeff, thank you for your time!

Shane Parrish

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Shane Parrish

decision making, strategy, and philosophy. Shane is a strategist for both individuals and organizations, and is dedicated to mastering the best of what other people have already figured out.

Graham & Doddsville

(G&D): Can you discuss your background and the origins of Farnam Street?

Shane Parrish (SP): Farnam Street started as a byproduct of my MBA. As I was going through that program it became evident that we were being taught to regurgitate material in a way that made marking easier. We weren't honing our critical thinking skills or integrating multiple disciplines. We couldn't challenge anything. Eventually, I got frustrated. I didn't give up on the MBA, but I did start using the time that I was previously investing in homework and started to focus on my own learning and development. At first it was mostly academic. I started going back to the original Kahneman and Tversky papers, and other material that was journal based, because I figured I'd probably never have access to such a wealth of journals again outside of school.

So I started the website and it was really just for me, not for anybody else. The original url of the website was the zipcode for Berkshire Hathaway. I didn't think anyone would find it. It eventually grew into a community of people interested in continuous learning, applying different models to certain problems, and developing ways to improve our minds in a

practical way. The strong reception surprised me at first, but now the community has become very large, stimulating, and encouraging. I should point out that I don't come up with anything original myself—I'm just trying to master the best of what other people like Buffett, Kaufman, Bevelin, and Munger have already figured out. In fact, that's our tagline. It reminds me of something Munger said once when asked what he learned from Einstein, and he replied, only half-jokingly, "Well he taught me relativity. I wasn't smart enough to figure that out on my own." That seems like a bit of a wiseass remark, but there's some untapped wisdom there.

G&D: What are your motivations for Farnam Street?

SP: I want to embrace the opportunity I have, which has been created largely through luck, and I want to give readers and subscribers enormous value in three ways.

First, I want to help them make better decisions. To do our best to figure out how the world really works. Second, I want to help people discover new interests and connections across disciplines. Finally, I want to help people explore what it means to live a good life and how we should live. I hope by sharing my intellectual and personal journey I can help people better navigate theirs.

G&D: It seems pretty clear that you have a profound admiration for investors. Farnam Street is the street Berkshire Hathaway is located on, and you discuss Charlie Munger's views quite a bit.

What appeals to you about investing?

SP: For Munger and Buffett specifically, it's not necessarily that they're just investors, it is that they've modeled a path of life that resonates with me. I also appreciate the values that are associated with their investment success. I think what they've done is they've taken other people's ideas, stood on the shoulders of giants, so to speak, and applied those ideas in better ways than the people who came up with the ideas. For example, with regards to psychological biases and Kahneman's work, Munger and Buffett have found a way to institutionalize this to a point where they can actually avoid most of these biases.

Kahneman himself says something along the lines of, "I've studied biases all my life, but I'm not better." Yet, these two guys from Omaha actually figured out how to be better.

It's not just Kahneman and human biases. Munger and Buffett have done it in a variety of disciplines like Michael Porter's work on Competitive Strategy. They separately derived the same basic ideas, except in a way that gives them an enormous investing advantage. To my knowledge, Michael Porter has not done that. Of course, he may not have been trying to do so. Another great example is Ben Graham. He provided the bedrock that Warren Buffett built his brain on, but if you really think about it, Buffett was and is a much better investor. And lastly, regarding Munger, in my opinion his method of organizing practical psychology is a lot better than

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the actual residents of that discipline, even the people who “taught” him the ideas through books.

Returning to investing, the field resonates with me because investors have skin in the game. Investors have clear accountability and measurable performance. That contrasts with many other types of organizations. For the most part, investors are searching for the truth and constantly looking for ways they could be wrong and that they could be fooling themselves. There’s a pretty clear scoreboard.

G&D: Are you an investor yourself?

SP: Yes. I used to be involved with a small registered investment advisor based in Massachusetts. I still invest personally and hope to return more of my focus to investing in the future. Right now I’m focused on Farnam Street, which I see as the biggest opportunity ahead of me and the opportunity that I’m most excited about. There’s a lot to do.

G&D: Can you talk about what you have planned for Farnam Street?

SP: I just hired somebody to help out at Farnam Street for the first time. His name is Jeff Annello. He’s amazing. It’s become more of a sustainable business. We are developing products. We have two courses coming out next year that we’re incredibly excited about. I think we have put over a year’s effort into one of the products, and we’re just starting the other one

right now which will be released next fall.

We are launching “How to Read a Book” early in the year. That course is aimed at adapting Mortimer Adler’s theory of reading to the modern age, and giving people a structured way of going about learning from books, as opposed to simply reading them. Seems simple, but most of us never really pick it up.

Today we are bombarded constantly with information, and we often read all types of material in the same way. But that’s pretty ineffective. We don’t have to read everything the same way. Adapting your

“Adapting your reading style to consider the type of material you are reading and why you are reading it makes you much more effective at skimming, understanding, synthesizing, and connecting ideas.”

reading style to consider the type of material you are reading and why you are reading it makes you much more effective at skimming, understanding, synthesizing, and connecting ideas. If you take the same approach to reading everything, you will end up tired and frustrated.

G&D: Reading is something you seem to know quite a lot about, but in a recent post, you discussed that you are purposefully reading fewer books. What is your thinking around that decision?

SP: I fell into a trap with reading. It almost became a personal challenge that you can easily get wrapped up in. In 2014, I was basically reading a book every few days. I think I ended the year with over 140 books read, but I must have started at least 300. I realized I was reading just to finish the book. That meant I wasn’t getting as much out of it as I should. I ended up wasting a lot of time using that approach and it also impacted what I read. You have these subtle pressures to read smaller books and to digest things in a really quick way. I wasn’t spending enough time synthesizing material with what I already knew and honing my understanding of an idea.

It’s not about how many books you read but what you get out of the books you read. One great book, read thoroughly and understood deeply, can have a more profound impact on your life than reading 300 books without really understanding the ideas in depth and having them available for practical problem solving.

G&D: Can you discuss some of your techniques for absorbing and synthesizing as much information as possible?

SP: There is a lot that can be done after simply finishing a chapter. I like to summarize the chapter in my own words. I also like to apply any

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learnings from the chapter to my life, either by looking backward to see where concepts may have applied, or by looking forward to see if it might make sense to incorporate something into my daily routine. I think the reason to do that is twofold. One is to give me a better understanding of that learning, and two is really a check and balance, and a feedback loop. Have you ever watched TV and somebody comes in on a commercial and says, “What are you watching,” and you’re like, “I have no idea,” but you’ve been sitting there 20 minutes? Well, we can do that with books, too. You’ll start reading, and paragraphs will fly by, and then you’ll have no idea what you were reading. It’s fine if you’re reading for entertainment, you might be able to catch up later, but if you’re reading for understanding, that’s something you want to avoid.

Part of what I want to do is develop a feedback process to make sure that I’m not doing that.

I try to make extensive use of book covers for notes about areas to revisit, potential connections to other concepts, and outlining the structure of the author’s argument. After I’ve finished a book, I usually put it on my desk for a week or two, let it sit, and then I come back to it. I reread all of my margin notes, my underlines, and highlights. Then I apply a different level of filtering to it and make a decision about what I want to do with the information now.

G&D: You also talk about the Feynman technique in some of your posts.

SP: Yes, the Feynman technique is essentially explaining a concept or idea to yourself, on a piece of paper, as if you were teaching it to someone else with little background knowledge. When you’re learning something new, it’s all about going back and

“The Feynman technique is essentially explaining a concept or idea to yourself, on a piece of paper, as if you were teaching it to someone else with little background knowledge. When you’re learning something new, it’s all about going back and making sure you understand it.”

making sure you understand it. Can you explain it in simple, jargon free, language? Can you explain it in a way that is complete and demonstrates understanding? Can you take an idea and apply it to a problem outside of the original domain? Take out a piece of paper and find out. I think that being able to do this at the end of a book is really important, especially if it’s a new subject for you. The

process of doing that shows you where your gaps are; this is important feedback. If you have a gap in your understanding, you can circle back to the book to better understand that point. If you can’t explain it to somebody else, then you probably don’t understand it as well as you think you do. It doesn’t mean you don’t understand it, but the inability to articulate it is definitely a flag that it’s something you need to circle back to, or pay more attention to.

G&D: It seems like feedback mechanisms are a key part of your approach.

SP: I think at the heart of it, you want to be an active reader. You want to selectively be an active reader, and not a passive reader. These types of activities make sure that you’re reading actively. Writing notes in a book, for example, is really just a way to pound what you’re reading into your brain. You need engagement.

G&D: In a recent post, you brought up Peter Thiel’s concept of a “secret”. Essentially, what important truth do very few people agree with you on? I’d be really curious if you have something in mind that would fit this concept.

SP: Ever since I came across this question I’ve been toying with it over and over in my head. I’m not sure I have a decent answer, but I’ll offer one of the things that I run into a lot but couldn’t really describe until Peter Kaufman pointed me to a quote by Andy Benoit, who wrote a piece in *Sports Illustrated* a while back.

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Shane Parrish



Student volunteers enjoy themselves at the Graham & Dodd Breakfast

Benoit said “Most geniuses—especially those who lead others—prosper not by deconstructing intricate complexities but by exploiting unrecognized simplicities.” I think he nailed it. This explains Berkshire Hathaway, the New England Patriots, Costco, Glenair, and a host of amazing organizations. I’ve long had a feeling about this but couldn’t really pull it out of my subconscious into my conscious mind before. Benoit gave me the words. I think we generally believe that things need to be complicated but in essence there is great value into getting the simple things right and then sticking with them, and that takes discipline. As military folks know, great discipline can beat great brainpower.

I know of many companies that invest millions of dollars into complicated leadership development programs, but they fail to treat their people right so the return on this investment isn’t even positive it’s negative, because it fosters cynicism. Or consider companies that focus on complicated incentive plans—they never work. It’s very simple. If you relentlessly focus on the basics and develop a good corporate culture—like the one Ken Iverson mentions in his book *Plain Talk*—you surpass people who focus on the complex. Where I might disagree with Benoit a little is that I don’t think these are unrecognized as much as under-appreciated. People think the catechism has to be more complicated.

G&D: You discuss the power of multidisciplinary learning. Do you have any example

where the multidisciplinary learning has been especially powerful for you? Munger has a number of examples of him arriving at a solution faster than an expert in a field as a virtue of Munger using concepts from other fields.

SP: If you were a carpenter you wouldn’t want to show up for a job with an empty toolbox or only a hammer. No, you’d want to have as many different tools at your disposal as possible.

Furthermore, you’d want to know how to use them. You can’t build a house with only a hammer. And there is no point in having a saw in your toolbox if you don’t know how to use it. In this sense we’re all carpenters. Only, our tools are the big ideas from multiple academic disciplines. If we have a lot of mental tools and the knowledge of how to wield them properly, we can start to think rationally about the world.

These tools allow us to make better initial decisions, help us better scramble out of bad situations, and think critically about what other people are telling us. You can’t over-estimate the value of making good initial decisions. Nothing sucks up your time like poor decisions and yet, perversely, we often reward people for solving the very problems they should have avoided in the first place. It’s a little weird, but in some organizations you’re better off screwing up and fixing it then making a simple, correct, decision the first time. Think about portfolio managers trumpeting how they’ve “smartly sold” a stock at a loss of 20%, saving them a

loss of 50%, but which a wiser person never would have purchased in the first place. The sale looks smart, but the easier decision would have been avoiding misery from the get-go. That kind of thing happens all over the place.

Multidisciplinary thinking also helps with cognitive diversity. In our annual workshop on decision making, *Re:Think Decision Making*, we talk about the importance of looking at a problem in multiple dimensions to better understand reality and identify the variables that will govern the situation—whether its incentives, adaptation, or proximity effects. But the only way you’re going to get to this level of understanding is to hold up the problem and look at it through the lens of multiple disciplines. These models represent how the world really works. Why wouldn’t you use them?

One important thing, for example, we can learn from ecology, is second order thinking—“and then what?” I think that a lot of people forget that there’s a next phase to your thinking, and there’s a second and third order effect. I’ve been in a lot of meetings where decisions are made and very few people think to the second level. They get an idea that sounds good and they simply stop thinking. The brain shuts down. For example, we change classification systems or incentive systems in a way that addresses the available problems, but we rarely anticipate the new problems that will arise. It’s not easy. This is hard work.

Shane Parrish

Another example is when a salesman comes into a company and offers you some software program he claims is going to lower your operating costs and increase your profits. He's got all these charts on how much more competitive you'll be and how it will improve everything. You think this is great. You're sold. Well the second order thinking is to ask, how much of those cost savings are going to go to you and how much will be passed on to the customer? Well to a large extent that depends on the business you're in. However, you can be damn sure the salesman is now knocking on your competitors' door and telling them you just bought their product.

We know thanks to people like Garrett Hardin, Howard Marks, and disciplines like Ecology that there are second and third order effects. This is how the world really works.

Munger's got a brain that I don't have. I have to deal with what I've got. I'm not trying to come up with the fastest solution to a problem. It's great to have a 30 second mind, but it's not a race. Part of the issue I see over and over again is not that people don't have the cognitive tools, but rather they don't have time to actually think about a problem in a three dimensional way. If you think you're going to come up with good solutions to complicated problems in 30 seconds and your name is not Charlie Munger, I wish you luck. The rest of us should learn to say "I don't know" or "Let me think about it" about ten times more frequently than we do.

G&D: It makes sense that second-order and third-order effects are underappreciated.

SP: I think a lot of people get incentives wrong and it has disastrous implications on corporate culture. Let's look at it from another angle – how would you intentionally design an incentive system that functioned horribly? You'd make it so complicated that few people understood it. You'd make everyone measured on individual and not team success. You'd have different variables and clauses and sub-clauses. No one would understand how their work impacts someone else. To make it even worse, you'd

"If you think you're going to come up with good solutions to complicated problems in 30 seconds and your name is not Charlie Munger, I wish you luck. The rest of us should learn to say 'I don't know' or 'Let me think about it' about ten times more frequently than we do."

offer infrequent and small rewards. You'd offer a yearly bonus of maybe 5% of salary or something. And of course, you'd allow the people in it to game the system and the

people running it to turn it into politics. I think we can all agree those are not desired outcomes and yet that is how many incentive systems work.

G&D: Do you have any thoughts on particularly powerful concepts or process implementations that can help investment organizations pursue investment excellence?

SP: I think it's important to focus on getting better at making decisions over time. It is about making the process slightly better than it was last time. These improvements compound like money. You really have to flip it on its head. What's likely to not work well?

Generally speaking, analysts tend to have a focused view of the world and they stay in their lane. Specialization certainly helps develop specific knowledge, but it also makes it hard to learn from the guy or girl next to you who has knowledge in a different industry, so you're not improving your intuition as much as you'd probably want. It's like chess. People once thought great chess players were great thinkers, but they're not any better at general problem-solving than the rest of us. They're just great chess players. Investment analysis is often the same way, especially if you're siloed in some industry analyst position. It's probably not making you a great thinker, but you are learning more about your industry.

In order to have the organization learn and get better, we need to expose our decision making process to others. One way to do this is

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to highlight the variables we think are relevant. Start making clear why we made our decisions and the range of outcomes we thought were possible. It needs to be done in advance. A lot of people do this through a decision journal. Some accomplish this through a discussion that flushes out which variables you think will dominate the outcome and most importantly, why. Not only does that facilitate an environment where others can challenge your thought process, but over time it enables them to get a good feel for what you think are the key variables in that particular industry. That helps me expand my circle of competence. You don't want an organization where the automobile analyst knows nothing about banking and the chemicals guy knows little about consumer products, and then a portfolio manager with a little surface knowledge of everything is pulling the trigger. I have never seen that work, but I've seen a lot of people try. The "everyone's a generalist" approach has its own limitations, like a crippling lack of specialized knowledge.

So, obviously, any investment organization has to find a middle ground. How could it be otherwise? You must start with this basic and obvious truth to solve the problem.

Another challenge in the investment world is dealing with the sheer volume of the information. I get questions from portfolio managers all the time about how best to keep up with the information flow. They say "I get 500 emails a day. I have researchers' work come to me at all hours. I have

thousands of pages of material to read."

Clearly Berkshire Hathaway has done a really good job with this, with basically two guys doing all of the information processing—two really smart guys, but only two.

How do they do that? Well, part of the reason is that Buffett and Munger are continuously learning about companies that do not change rapidly. They're learning about companies that change slowly. That in and of itself is a major advantage. They also are operating in industries in which they know the key variables of determining an organization's success or failure, and more importantly, ignoring the industries where they don't. It's a huge step to be able say to yourself "Look, I'm going to miss some enormous winners that were incredibly hard to see ahead of time. I'm OK with that." Buffett and Munger can do it, but most struggle. So they stretch and invest in things where they really cannot accurately predict the odds of success or failure, all forces considered. Probabilities being what they are, if you consistently invest in things with middling odds, you'll have middling results. Again, how could it be otherwise? The key is knowing the difference between an obviously attractive situation and a difficult-to-predict one and being able to act on the former and sit on the latter. Of course, I'm over-simplifying a bit, but you can't get around the fact that reality is reality. You have to find a way. And this will help you solve your information flow problem,

because you'll be tossing a lot of ideas out very quickly.

G&D: It seems like you would prefer the Buffett and Munger model over the approach of the average hedge fund with specialists?

SP: If my job is being a neurosurgeon, I need to keep up-to-date with all the latest neurosurgery papers, academic articles, books, and talks because I'm very specialized in that one particular area and it's relevant to my job and relevant to my livelihood.

If you look at investing holistically you can't do that for every company in every industry. In my understanding, part of the reasons Buffett and Munger have accumulated so much knowledge is that they focus on learning things that change slowly. That makes it easier to identify potential outcomes and determine the relevant variables.

David Foster Wallace had this great quote, "Bees have to move fast to stay very still." And that's what most of us do. We move a lot to stay in the same place. Buffett and Munger are getting further ahead each day.

Unless physics changes, for example, it's unlikely that we'll see the development of more efficient way to move bulk freight. It doesn't seem subject to technological disruption, but instead will likely be aided by technology. Technology helps improve the management of your rail network, but it's not going to replace the entire network anytime soon. I think that Berkshire is actually moving away from

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uncertainty by pursuing companies like this. If you don't know the range of outcomes, you will have a hard time assessing probabilities. One of the things that decision journals help identify is outcomes outside of what we expected. That's a very humbling experience. After identifying possible outcomes and applying confidence levels, it's humbling to get it so wrong.

G&D: You have also studied an investment firm that's probably as different from Berkshire Hathaway as possible with your most recent podcast with Chris Dixon of Andreessen Horowitz. What are your thoughts on good decision making as applied in the venture capital world and how is it different than Berkshire Hathaway?

SP: Chris was an excellent guest to have on The Knowledge Project. He operates in Venture Capital—a world I don't get much exposure to. He has insight on things I know very little about: venture funding, how to structure a venture capital firm so that you are adding value, etc. And they've been very successful.

I think we're largely operating in unprecedented territory given the magnitude of private valuations. In past decades, companies IPO'd at much lower valuations so public market investors could more easily participate in their success. I don't know how this plays out, but talking to Chris was fascinating.

Andreessen Horowitz has a very different operational approach as compared to

Berkshire Hathaway. As I understood it, they are trying to add value to the entrepreneurs. Also, they've moved away from a business or idea based sourcing process to one that is almost exclusively focused on the entrepreneur. That directly contradicts some of Buffett's thoughts on the relative importance of a management team versus the underlying business.

It makes sense that they would have different approaches. I think it's important to understand that there are things that we want to have in our mental tool box. But part of being an effective craftsman is knowing when they work and when they don't. You can't just pull our random tools and expect them to work.

In 2013, I did some consulting work on improving innovation in organizations and the most common thing that people were doing at the time to solve the innovation problem was copying Google's 20% of time spent on independent innovative ideas.

I found this interesting for a number of reasons. It surprised me that every executive had it on the tip of their tongue, but there's no large sample size for a successful innovation like this 20% idea. Google and, I think, 3M are the two most prominent examples. Google, at the time, I think they had only been around for 15 years. That's a pretty small sample size for continuous innovation. Also, you need to understand how that fits with the company culture, and why it works even if you're seeing it work. Why

does it work at Google? Is it because of how it fits in the overall culture? The problem I see is that people are taking one piece of a large puzzle and thinking that it's going to solve their problem. It might help. It might not. It's just a tool. It reminds me of the group of blind people touching the different parts of the elephant. Also, some of these innovation projects get done for the wrong reasons, and with the wrong incentives. If my boss asks me for ideas to help the company innovate and I give him an idea that sounds good, one that subconsciously reminds him of an article he read in Fortune about innovation, isn't that basically good enough for me as an employee? Does it even matter if it works? In most organizations, am I really going to be held responsible for the success or failure of my innovation prescription? The organization might suffer, but will I suffer personally? Probably not. My lack of ability to think the problem through will probably be forgotten in time if the idea sounded good and relevant at the time. If it was defensible via Powerpoint. This is one reason hiring consultants rarely works as well as hoped.

So, we copy Google's twenty percent innovation time. They're an innovative company; they're hip; they're cool; we're going to copy them. Okay, well, we can do that. It's a good story. What gets lost is a potentially useful discussion like, "Maybe we should remove the things in our environment that take away from natural innovation, like all these meetings." That's a much tougher conversation,

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but just like taking away sugar works better than adding broccoli to your diet, taking things out of the corporate culture is often a better solution than adding new stuff. Munger has us paying attention to incentives because they really are driving the train. You have to get it right.

G&D: One big theme for you is the concept of life-long learning. What is your motivation to pursue it? Munger has called it a moral duty. Do you have similar feelings?

SP: I wish I were as eloquent as him. I've always had to work harder. You just have to keep getting better everyday. You have to keep learning. If you're going to accomplish what you want to accomplish, it's probably not through going home and watching Netflix every night, right? You have to learn how the world works. We have a huge statistical sample size of things aren't changing. There is an excellent letter by Chris Begg at East Coast Asset Management that discusses Peter Kaufman's thoughts on this. Physics, math, and biology are things that change very, very slowly, if at all. Learning things in those disciplines is good. It's practical, because that's how the world works. Those are things that don't change over time.

I think that, for me, it's just become "How can I pass people that are smarter than me?" I think if I can get incrementally better every day, compounding will kick in and over a long enough time, I'm going to achieve the things that I want in life.

What could be better than constantly learning new things and discovering that you're still curious? Most of us forget what it's like to be six years old and asking "why?" all the time and trying to understand why things operate the way they do. It's hard to still do that, but you can still carry that wonder with you into life and try to understand why things are happening and why success or failure happens.

"Avoiding stupidity is better than seeking brilliance. But that by itself is suboptimal. You also want to copy models of success. We don't necessarily have to come up with all of this stuff ourselves. We can see a better model and adopt it, or the parts of it that will help us along."

Avoiding stupidity is better than seeking brilliance. But that by itself is suboptimal. You also want to copy models of success. We don't necessarily have to come up with all of this stuff ourselves. We can see a better model and adopt it or, the parts of it that will help us along. Giving up on holding on to our own ideas is really important.

I don't come up with almost anything that's original. I aggregate and synthesize other people's thoughts and put it into context for people. I think that those are things that I like to focus on, I have a passion for doing that. I'm doing it anyway because I get a lot of value out of reading, learning, and exploring the world, and I share that with people.

G&D: With regard to Mental Models, you spend a lot of time discussing their importance, but you also highlight their shortcomings. Can you discuss your view of the value of mental models?

SP: It's important to understand how we are likely to fool ourselves. Aside from the psychological factors, which Munger and Bevelin talk about extensively, there are other ways.

For example, we run organizations based on dashboards and metrics and we make decisions based on these numbers. Investors look at financial reports to make investment decisions.

We think that those numbers tell a story and, to some extent, they do. However, they don't tell the full story. They are limited. For example, a strike-out can be a good thing in baseball. Players who suck statistically in one system can thrive as a part of another – the whole "Moneyball" idea lives here, and the Patriots have been extremely successful with a wide variety of talent. In business, reported depreciation can be widely off. The accounting could be gamed. A tailwind could be

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benefitting a business temporarily, soon to dissipate. Many companies look their absolute best, on historical figures, just before the big denouement.

There is a great quote by George Box who said “All models are false but some are useful.” Practically speaking, we have to work with reductions—like maps. A map with a scale of one foot to one foot wouldn’t be useful, would it? Knowing that we’re working with reductions of reality, not reality itself, should give us pause. We recently wrote a piece on Farnam Street called “The Map is Not the Territory,” which is a more in-depth exploration of the nuances behind this.

Knowing how to dig in and understand these maps and their limitations is important. A lot of models are core – they don’t change very much. Social proof is real. Incentives do drive human behavior, financial and otherwise. The margin of safety approach from engineering works across many, many practical areas of life. Those are the types of huge, important models you want to focus on as a part of becoming a generally wise person. You need to learn them and learn how to synthesize with them. From there, you layer in the models that are specific to your job or your area of desired expertise. If you’re a bank investor, you’re going to look to attain a deep fluency in bank accounting that a neurosurgeon wouldn’t need. But both the analyst and the surgeon can understand and use the margin of safety idea practically and profitably.

G&D: Essentially, they can be powerful if used correctly, but we can also over apply them in some ways?

SP: They work sometimes and not other times. You need to be aware of limitations. The point here is just to be cautious—the map is not the terrain. It doesn’t tell the full story.

G&D: Do you have any other investors or companies outside of Berkshire Hathaway that really have some profound thinking or you really love reading their shareholder letters or you’ve learned a lot from? Anything like that that we can talk about?

SP: Berkshire has an incredibly unique model of writing to shareholders, and frankly no one else is as good. One that’s slightly off the beaten path, although it’s become a lot better known over the past few years, is a Canadian company called Constellation Software (CSU). The CEO there is truly doing God’s work as far as how he reports to shareholders. Very clear presentation of the financial performance of the business, and a lucid and honest discussion of what’s going on.

There are two key components to reporting to shareholders well, as I see it. One is presenting, in as clear a way as possible, the results in the prior periods. Presented consistently and honestly over time. The second is being extremely forthcoming about why these figures came out the way they did; good or bad, warts and all. When Blue Chip Stamps was still a reporting company, Munger would write

about See’s Candy. What did his summary table show every year? Pounds of candy sold, stores open, total revenue, total profits. The key variables. Then he explained in clear language why See’s was a good business and what had occurred in the most recent period, and if possible, what he foresaw in general for the following year. That’s what we need more of: give investors an updated report of the major drivers and then tell us what happened. Leave out the fluff. You don’t need to write essays like Buffett. Just help us understand the business and what’s going on.

G&D: This has been great, Shane. Thanks so much for your time.

Jon Salinas

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Jon Salinas '08

Jonathan earned an MBA from Columbia Business School. While at Columbia, he completed the Value Investing Program administered by the Heilbrunn Center for Graham & Dodd Investing. He received a BA with a degree in Political Science from Rutgers College, where he graduated with high honors and was elected to Phi Beta Kappa. Jonathan is currently an adjunct professor at Columbia Business School where he teaches Applied Security Analysis and has previously taught Distress Investing.

Graham & Doddsville (G&D): Could you start off by telling us about your background?

Jon Salinas (JS): I started off in a rotational capital markets program at UBS where I got a broad-based background in equity, credit, and derivatives, which has influenced the way I invest in that it allows me to look for investments across the capital structure. I also met a lot of people who had different approaches to investing, both modern and old-school, and learned the hard and soft skills of investing. After UBS, I attended Columbia Business School and was a part of the Value Investing Program. I met a number of incredible influencers there including Professors Bruce Greenwald, Joel Greenblatt, and the other adjuncts. David Rabinowitz and Eddie Ramsden taught my Applied Value Investing section. They were concentrated, special situation oriented investors. Both

professors were passionate about special situation investing, helpful, and thoughtful. They were really inspiring early mentors that motivated me to stay involved in the program.

The seminal experiences I had were studying under Bruce Greenwald as well as a seminar at Blue Ridge Capital taught by John Griffin and David Greenspan. In Bruce Greenwald's classes, I learned the "economics of strategic behavior" and how to truly analyze competitive dynamics of a business.

"The seminal experiences I had were studying under Bruce Greenwald as well as a seminar at Blue Ridge Capital taught by John Griffin and David Greenspan."

In the Blue Ridge seminar, it was the first time I was exposed to a really phenomenal process for conducting primary research as well as investing in a really differentiated way. We also learned about short selling as well as the behavioral aspects of investing. I studied philosophy, political science, economics, and psychology in college, so the behavioral aspects of investing and markets dynamics have always intrigued me. It was nice to see that overlay. I think the

behavioral aspects of investing are really important for thinking about investing on both sides, but they are particularly important on the short side.

After business school I went to work at Festina Lente for David Berkowitz, who had run Gotham Partners with Bill Ackman. It was a very concentrated long-only fund that had about six investments in total. They focused on very high quality, durable businesses with great management teams and capital allocation strategies. This experience taught me how to think about concentration, and what does and doesn't work. It was also 2008, so I got to see the financial markets collapse. Being in a concentrated long-only fund during that period was definitely a learning experience in terms of how you think about the impact of market de-leveraging.

From there I went to work at Ziff Brothers where I worked with Yen Liow. Yen's a very thoughtful investor who is very focused on framework-oriented investing. This involves thinking through certain qualitative processes and pattern recognition associated with great investments, both long and short. I spent some of my time there focusing on energy which was helpful to get a base understanding of how all companies are impacted by commodities. I realized it was an area where you had to be specialized so we avoid investing in energy. As a generalist, I think it's important to understand which areas require some real expertise.

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After spending some time at Ziff Brothers, I joined Marble Arch, which was a Tiger-oriented fund seeded by Julian Robertson. The two founders were from Tiger Management and Hound Partners. I joined Marble Arch in 2009 as a generalist when it was a young organization, about a year and a half into its life. It was a small team, and we had a really great run in the four years that I spent there, and we were able to grow the organization. They were very opportunistic, investing both long and short, with the ability to look at distressed credit when it offered more attractive risk-adjusted returns. They were very dedicated to absolute returns on the short side. It was where I was able to really expand my skillset as a short seller.

The generalist approach is one that I gravitated toward because I enjoy being able to always look at new opportunities. Now, I'd say most generalists end up specializing in some way. For me, I specialize to some degree within TMT and consumer, but I'm also willing to look at financials and industrials. I'm willing to look at any business in which I can truly break down the business, assess the durability of the moat, and the quality of the business. I'm also open to evaluating special situations where it's easy to analyze the assets and liabilities. In some cases, there might be complexities associated with the situation, which is leading to the inefficiency. The ability to break down the inefficiency and understand it while also thinking through the margin of safety and the intrinsic value is

really how I tend to filter the world.

G&D: Can you walk us through your decision to launch Plymouth Lane?

JS: I launched Plymouth Lane in May 2013. I had always wanted to try and express my style and my voice. I thought I could have success investing in a concentrated manner, both long and short, focusing on very high quality businesses that would compound for many years, and evaluating special situations that could offer attractive risk-adjusted returns whether it was through distressed credit, spin-offs, or some other subset of special situation investing. I was really driven to achieve high returns on a standalone basis, to try to build a high quality team, and to qualitatively embrace certain things like volatility and concentration that most investors don't typically embrace.

G&D: What have you done for your capital structure to enable you to embrace volatility?

JS: One lesson I learned along the way from investors was that if one is going to invest in a concentrated manner, you have to build the business structure to allow for volatility. As a result, we primarily focus on partnering with very long-term oriented investors, those that think about investing out over multiple year time horizons. The majority of our capital is under multi-year commitments, which lets us think about the long-term, and not necessarily focus on short term volatility. We've also

been very upfront with our investors about concentration and the by-product of volatility, which I think helps filter for an investor base comfortable with volatility, understanding that it is often a byproduct of differentiated, high absolute returns over time. It's very hard for an investment manager to reduce volatility and still get abnormal returns. I'd say having those types of conversations with investors have been very helpful.

We've also tried to spend a lot of time helping investors learn about us, our team, and our process. We think that type of transparency has given our investors comfort along the way. We also try to align interest. For example, in return for a multi-year commitment, we earn our incentive fee over a multi-year period. If we're not generating returns over the long term, we're not getting paid, which I think is a little bit different than how most tend to structure their business in the industry.

We felt like we were building a business for the partners. Our structuring was very partner friendly. The underlying thought I have is that duration of capital is very helpful for investing and outperforming over time. We try to be thoughtful in structuring our capital base as long duration as possible. It makes the job of generating returns easier if you have a longer time horizon to invest.

G&D: One of your big investments that allowed you to break into the industry was a credit investment, but not

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many long/short managers spend that much time on credit. Why do you think credit is interesting and what are you seeing today?

JS: When I was entering business school, I wanted to understand the bankruptcy process, which is a critical area of traditional value investing. Some of the best investments have tended to result from a bankruptcy process. I also like that it creates a catalyst for value realization, and there is a certain amount of complexity involved. Because of my background in the social sciences, I had an interest in understanding the law in the overlapping business implications. I started learning under Harvey Miller at Columbia Law School. At CBS, I studied under Dan Krueger '02 and worked at Schultze Asset Management, which is run by another Columbia alumnus.

I met Mark Kronfield, one of my partners at Plymouth Lane, while he was a Senior Analyst and I was an intern at Schultze Asset Management. He taught me a lot about distressed investing. Distressed investing is a great way to invest in special situations, like complex litigations. For example, some of the energy investments we are invested in now are situations where we are thinking about how cash will be distributed and the inefficiencies that may exist.

Distressed investing is also a way to invest in really high quality businesses during periods of financial distress. The investment I think you alluded to in your question is General Growth Properties

(GGP), one of the largest regional mall REITs that existed at the time. It had been funded using short term debt to reduce its overall interest expense. That was a positive while the debt markets remained open but created a problem when debt markets seized after Lehman collapsed and they could not rollover their short maturity debt. GGP was in a strange limbo for a few months after it had defaulted on its debt but not yet filed for bankruptcy. It was about a four or five month period where no one was willing to foreclose or force a bankruptcy on the company.

“[GGP] had three companies that had been combined in a REIT structure, with an incredibly complex capital and corporate structure. It had over 100 different properties, each with its own debt and profitability. I think that complexity created an opportunity.”

There was a lot of preparation that was done ahead of time by Weil, Gotshal & Manges, run by Harvey Miller, who was representing the debtor. I started doing an analysis of the

business and began to understand that regional malls tend to be pretty high quality businesses. Regional malls own some of the premier Class A commercial real estate across the United States. It's very hard to construct a regional mall. There are real “NIMBY” factors in that malls tend to be massive structures, so it's very difficult in a town or a city to add a new mall. Therefore, if you own a regional mall, you have a bit of a regional monopoly.

G&D: In 2008, ecommerce penetration was much lower than it is today, right?

JS: It was low and it was starting to increase slightly, but what was interesting was GGP had an incredibly diversified portfolio, so no tenant accounted for more than 2% of revenue. They were incredibly diversified with very high occupancy rates, and remained very stable after 2008, so you saw really no degradation in occupancy at all for the business. The operating performance never really deteriorated.

What was interesting was their complex corporate structure. GGP had acquired Rouse Co. about a decade prior to the bankruptcy. Before that, Rouse had acquired the Howard Hughes Corporation, which was another commercial real estate and mall operator. You had three companies that had been combined in a REIT structure, with an incredibly complex capital and corporate structure. It had over 100 different properties, each with its own debt and profitability. I think that complexity created an opportunity. The value-

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added research task was sitting down and taking every property and trying to estimate what the profitability of each property was and thinking through its private market value.

Using very conservative multiples on the profitability of each property and then subtracting the debt you could get a sense of the equity value. The sum of the positive equity in the properties was what GGP was worth. You had to overlay the corporate structure in the appropriate way. Doing that analysis took a lot of work. It was very tedious but it allowed me to get comfortable under conservative assumptions that I could walk away with a 50-60 cent recovery with the portion of the debt I was focused on. The exchangeable notes were trading at 10-20 cents on the dollar at the time, suggesting a 3x to 5x return in conservative scenarios. If things worked out reasonably well, it was very easy to envision a recovery to par, which would be 5x to 10x return, which is what happened and happened very quickly.

I felt even if you liquidated the company under very, very conservative cap rates in the low teens, you could walk away with a multi-bagger outcome. I was using low teen cap rates even though historically they had never gone that high. What ultimately happened was shortly into the bankruptcy process, liquidity began to improve for commercial real estate. Then Simon and Brookfield got into a bidding war for the asset, and Brookfield ultimately

purchased it.

G&D: Was that a situation where you had an appetite for distressed credit but you hadn't spent a lot of time in commercial real estate and as a generalist you were able to recognize the mental model as a situation you'd seen before, and then figure out the business model?

JS: Exactly. I think that's a perfect example how you attack this and how you think about value. The big inefficiency was everyone was thinking about the consolidated profitability and slapping a cap rate on that to value the enterprise, and then subtracting the debt to arrive at the equity. With that method, the selection of the cap rate impacted how recoveries flowed through the debt structure, which is the wrong way to think about it because in a bankruptcy you tear apart the corporate structure and you really build the value from the bottom up. You don't think about consolidated profitability unless it's deemed that that's necessary. That was one risk to try and evaluate because this was different businesses that had been pieced together. I felt like it was highly unlikely they would do that unless it was to the benefit of the entire entity, which likely implied a pretty robust recovery.

G&D: You've had a long bias towards media and content over the years. Are there any businesses that are ownable in your mind given the hard-to-answer questions around cord cutting and changes in the industry landscape?

JS: Historically we entered media investments with an assumption that cord cutting was exaggerated or not necessarily evidenced. I'd say that's still the case in that aggregated cord cutting numbers are not accelerating dramatically. That being said, we think cord cutting is a reality that impacts the economics of the business in that it gives content providers less leverage than they've had historically.

Our favorite investment in the media content space at the moment is DHX Media (DHXM). It's a really interesting investment opportunity. DHXM is a \$700 million market cap in the U.S. and about a billion in Canada. It's Canadian and U.S. dual-listed but primarily trades in Canada. As a Canadian-listed and domiciled entity it has a structural advantage. Canada has significant dedicated media funds and tax incentives for production and creation of content within its borders. It's very important culturally for Canadians to remain leaders in producing video content and it's a real niche they've carved out. For players like DHX, these subsidies allow them to produce new content while taking less risk than they would outside of Canada. Often they can have 75-100% of content cost covered from government funding or some private dedicated media funds, which allows DHX to put less capital at risk when starting a project.

They've also been very smart in that they've focused on doing only one thing and trying to do that one thing very well, and that's producing content for children. If you study the

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world and the way things are changing, as we move from linear television to an over-the-top format for video distribution, kids' content is very much subjected to disruption because kids prefer on demand viewing. Children like repetitive viewing, and they don't really care about the freshness of content so you could potentially repurpose older content. This would be very disruptive for legacy players with scale economics like Nickelodeon, Disney, and others.

DHX has been a low cost disrupter. They built up a very cheap library of kids' content. They figured out early on what translated well in an over-the-top video environment. They can license this content to Netflix, Hulu, Amazon, and others very cheaply and generate attractive returns on the library content that they acquired, which is very disruptive for other players. Content in their library includes Caillou, Yo Gabba!, Teletubbies, and Degrassi. They have no real ties to the traditional linear television ecosystem. Most of the distribution is monetized over-the-top, positioning them really well for how the industry landscape is changing. They're growing that business line organically at approximately 20-30%.

They're also a very large player in Advertising Video On Demand (AVOD), which universally is primarily YouTube. About 10% of their distribution revenue actually comes from YouTube which is one of the larger concentrations of any player that I know.

Also, interestingly, they pursued vertical integration in Canada. They cheaply purchased the Family Channel which is the number one kids and family-oriented linear television channel in Canada. Historically it had been the Disney channel in Canada. They actually let the contract with Disney expire and they pushed their own library content while also licensing content from Hit Entertainment, which is owned by Mattel and DreamWorks.

“From my perspective, the DHX Media thesis is very similar to the Lions Gate thesis, but may represent a better way to express the theme.”

So essentially they rebuilt this linear television channel in a cheap way, passed on some of the cost savings to distributors to keep DHX in a really strong position, and they get an additional benefit in that they can monetize new content that they produce first via Canadian linear television before distributing it over-the-top in other regions.

They also have a merchandising and licensing business. Merchandising and licensing is a great business. They basically take the kids content and partner with a toy distributor and toy manufacturer. When toys are sold, they receive a share of

the revenue. They own their own production studio in Canada so they produce all their own events and they also do third party production which helps them utilize their capacity better.

G&D: *It sounds like you like the business units. What makes it especially interesting to you today?*

JS: John Malone has been very vocal about the importance of content to serve as a differentiating factor for distributors on a go-forward basis. He's demonstrated this thesis with his movement to invest in Lions Gate. From my perspective, the DHX Media thesis is very similar to the Lions Gate thesis but may represent a better way to express the theme.

With DHX, you avoid the concentration and cliff risk of the Hunger Games franchise. You have a clean business model focused only on kids' content, which is incredibly important in an over-the-top world. Most of our diligence suggests that 30% of SVOD viewing is kids' content, if not more. Any SVOD operator that I've talked to continually highlights the importance of kids' content. I also think there is greater optionality on a takeout. If you think about this business, it is so small relative to the value it can offer to a distributor, we think it is the type of thing that can easily be purchased at some point.

Lions Gate tends to trade at 2x the valuation multiple of DHX Media despite DHX having higher organic growth. We think high organic growth can persist as well. DHX just

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signed a deal with DreamWorks to co-produce 130 new episodes of kids-oriented animation over the next five years. They've partnered with all the main SVOD players globally without having too much revenue concentration to any single SVOD player.

On our numbers, it trades at 10-12x earnings on a 12 month forward basis and a high single digit multiple of EBITDA. We tend to focus on EPS or cash EPS, so I think it's really attractive to own this business at a high single digit to low teens yield when it's growing organically 15-20% with a ton of optionality on a takeout or Teletubbies growth.

It's underfollowed as it is only covered by Credit Suisse and a few Canadian banks. I think it's really interesting.

G&D: Can you describe the option value on Teletubbies?

JS: DHX purchased Teletubbies very cheaply and they've just relaunched it. Teletubbies is preschool content with no real spoken words, so it translates really well internationally. This is a benefit I learned about with Discovery. When content can be easily re-dubbed and distributed globally, you can earn really high returns on content investment. Teletubbies is even distributed in China, which is pretty big because China is pretty restrictive in terms of Western content that they're willing to distribute domestically. In November, DHX partnered with the BBC to re-launch the series. BBC was the original producer and distributor. Early

signs are very positive. It's taken about two-thirds share of the 0-3 age demographic on CBeebies, which is BBC kids, and it's taken about a one-third share of the 3-6 age demographic. It's going to launch in Canada in January and then in the US.

At its peak in the late '90s Teletubbies had the largest annual sales of all kids-oriented merchandise. It sold almost \$2 billion in retail merchandise in the late '90s in a single year, not over a multi-year period. If you adjust that for today's dollars and you assume even a fraction of that success, it will be very significant. DHX on a standalone basis in Canadian dollars is a 100-120 million CAD EBITDA company. It's very easy to envision a scenario where Teletubbies can increase EBITDA by 25%-100%.

G&D: Do you have thoughts on management?

JS: Michael Donovan and Steve DeNure are the two founders. They are chairman and COO, respectively, and they effectively run the company. They've both been involved in kids' content, and content production overall, for many years. They basically were in a strong position a few years ago to slowly build the company, and build the company for today's environment, so they have no legacy economics they've needed to sustain.

DHX has been a pretty smart acquirer of content. They've purchased library content typically at about 5x EBITDA and they've historically traded at a multiple that is twice as high, creating value.

G&D: You mentioned a concentrated portfolio, and this seems like a very compelling idea. How big would something like this be?

JS: Our larger positions tend to be about 10-15% of capital. This is one of our larger positions so it is in that range.

G&D: Could you tell us about how you think about portfolio construction? Do you have exposure targets? How do you think about shorting?

JS: We try to do exactly that. Our net exposure tends to be between 40-60% and that flows from the bottom up. We cap our largest shorts at about 3-4% of capital. We focus on a few different buckets on the short side.

We look for really challenged businesses where there may be really negative competitive dynamics. Competition short is the typical name for that framework. It's the classic Greenwald-style analysis where the company may have a first mover advantage that is unsustainable and the research process involves understanding how new competitors are going to attack the business, undercut pricing, and capture market share. Reduced profitability is a key focus area for us. Also, we focus on frauds, fads, or businesses that we think are overearning and unsustainable. Separately we look for credit bubbles—for businesses that have experienced some type of enormous debt-driven growth where leverage will be reduced or impaired in some ways. In these situations, you can have a real asymmetric downside in the equity.

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G&D: You mentioned earlier that you also invest in derivatives. Can you share how you think about using derivatives?

JS: On the long side, options can be an interesting way to use non-recourse leverage to protect capital at risk but augment returns. It's basically non-recourse leverage that you can use. On the short side, we focus on terminal shorts—businesses that we think could be worth zero. In the later stages of a terminal short, volatility and squeeze risk become quite high, so we may use puts to protect our capital at risk while still being able to participate in the downside if there is a terminal outcome. The last thing we use options for is to hedge volatility or squeeze risk in some of our later stage terminal shorts. In these positions, we may short the equity and buy a small amount of short duration call options that protect us from upside risk. This lets us augment positions at higher prices and use squeezes to our advantage.

G&D: Any other ideas you'd like to talk about, long or short?

JS: An interesting special situation right now is Sequential Brands Group (SQBG). We came to SQBG through our special situation investment in Martha Stewart Living Omnimedia (MSO), as SQBG recently closed on MSO a few weeks ago. MSO was a classic special situation where consolidated profitability did not appropriately reflect the true economic value.

Martha Stewart can be thought of as a combination of a good business and a bad business. It has a publishing business with premier titles like Martha Stewart Living, which is one of the preeminent female publications, and Martha Stewart Weddings. The publishing business is challenging because it is facing macro headwinds. In addition to publishing, MSO owned a licensing business which is incredibly strong and highly profitable. I am attracted to licensing businesses because they are high margin, capital light, and tend to be strong consumer businesses overall.

Corporate overhead was high because it was a founder-owned company. Martha Stewart had gone through a number of CEOs over a very short period of time but failed to effectuate a turnaround. Then in late 2013, a restructuring executive, Dan Dienst, was brought in. He had previously restructured a scrap metal business. We thought the fact that Martha Stewart had brought in a scrap metal restructuring advisor to run her business was a really interesting development and that she was serious about the turnaround.

Martha Stewart owned 25% of the business and a little more than 50% of the voting control. There was a founder share class with super voting rights. In our view we thought it was really interesting because we assumed she likely wanted to turn around the business, improve profitability, and ultimately sell the business. She is in her early 70s so we thought it was reasonable to think about a sale as a catalyst.

Also, it was under the radar with a sub \$200 million market cap, almost \$50 million of cash and no debt at the time, which was also interesting. The licensing business did almost \$40 million in EBITDA and most of that was offset by publishing and corporate overhead. We felt if you could just move publishing to break even you could unlock \$20-25 million in operating profit from the licensing business for a business that had about \$150 million enterprise value at the time.

Martha Stewart branded products are the number one selling item in Macy's for their wedding registries, and Macy's has the largest wedding registry business in the US. Martha Stewart historically has been one of their top selling products. MSO has a number of other licensing deals: a deal for Martha Stewart Pet Products with PetSmart, a deal with JC Penney, a deal with Home Depot for Martha Stewart Furniture, and there's now Martha Stewart Office Products licensed with Staples. We thought there were opportunities to expand licensing. Interestingly there are no food products, so there's an opportunity to develop Martha Stewart brand food items. International was also a whole new opportunity as nothing was being done internationally.

The first move to trim corporate overhead and reduce losses in the publishing business was successful. They cut a deal with Meredith Corporation where Meredith effectively took over the publishing business and then turned it into a revenue share

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agreement. This reduced most of the losses associated with publishing and started to unlock the profitability of licensing and merchandising. Then what ultimately happened was there was a bidding war for the asset and SQBG won the bidding war and just closed the transactions a couple of weeks ago.

SQGB is run by Bill Sweedler, who has been involved in licensing businesses for many years. Bill Sweedler originally sold Joe Boxer to Iconix and has been involved in a bunch of other brands. At SQGB, they own a portfolio of licenses: Avia; And I; Ellen Tracy, which is pretty prominent female brand; Jessica Simpson's business; and William Rast, which they bought from Justin Timberlake.

They're one of the largest distributors for Walmart. What's interesting to understand is their athletics business in Walmart with Avia and And I. Most street-oriented shoe companies won't sell in Walmart because they don't want to cannibalize pricing in other channels. This puts Avia and And I in an enviable position because they have brand cachet but can sell lower priced products that they replicate from more expensive sneaker providers like NIKE, Reebok, and Adidas.

They can be a low cost provider within Walmart. Obviously, this gives them a huge base to sell and distribute to. They'll partner with a manufacturer and collect a licensing fee. With the Martha Stewart acquisition, they will have a whole new homes and lifestyle vertical. She's going to

remain the chief creative officer for the business. We think since Martha Stewart had really no research coverage and no following, that it's very under the radar. People don't realize how profitable that licensing business was, how powerful the international opportunity can be, and all of that will unfold within SQGB.

"I think [investment management] is a great industry, but a challenging industry, and I think you have to really enjoy the job of analyzing businesses and thinking about what makes a great business and a bad business."

On our math, it's very conservative to estimate, on pro forma basis, that SQBG could earn \$0.80-\$1 per share. The stock trades under \$8, so you can buy SQBG at 8-10x earnings with upside optionality from a pretty durable licensing business. It has about 4x net leverage, but will de-lever quite quickly. It's Carlyle and Blackstone-backed so they have real investor backing. SQBG has a \$500 million dollar market cap and \$1 billion enterprise value, so they have little bit more research coverage, but it is still an underfollowed situation.

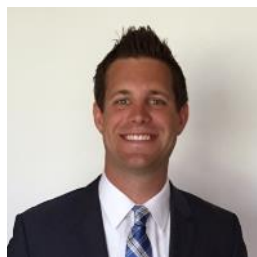
G&D: Do you have any advice for students looking to get into the industry?

JS: I think it's a great industry, but a challenging industry, and I think you have to really enjoy the job of analyzing businesses and thinking about what makes a great business and a bad business. If you enjoy doing that, then I think it will be a really great career. My advice would be to spend as much time as you can studying different types of businesses, analyzing different ideas, and doing different case studies. You should be trying to understand why certain longs or shorts have worked well as well as understanding how great management teams have acted and created value over time. Pay attention to Greenwald's teachings on what are the characteristics of a great businesses. Seek out as many mentors as possible, try and learn as much as you can from other investors and from people who are willing to just spend some time chatting with students. That's my advice.

G&D: Great, and take your class, right?

JS: Yes, definitely. Take my class, and spend some time on short selling.

G&D: This has been really great. Thank you.



Marc Grow '17

Marc is a first-year MBA student in Columbia Business School. Prior to CBS, Marc worked as the CFO of a family office after spending two years as an equity analyst at a value-oriented hedge fund. He holds a BA in Accounting from Whitworth University.



Benjamin Ostrow '17

Benjamin is a first-year MBA student at Columbia Business School. Prior to CBS, Ben worked as an Investment Analyst at Stadium Capital Management for four years. He holds a BS in Commerce from the University of Virginia McIntire School of Commerce.



Evan Zehnal '17

Evan is a current first year student at Columbia Business School. Prior to CBS, Evan worked within the opportunistic credit investment team at Canada Pension Plan Investment Board and in investment banking at TD. Evan graduated from McMaster University with a Bachelor of Commerce.

Dexcom, Inc. (NYSE: DXCM) - Short 2015 Darden at Virginia Investing Competition - First Prize

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Executive Summary

- Wall Street darling with misunderstood competitive dynamics provides skewed 4.1x upside to downside ratio
- Primary research supports thesis that perceived patient benefit is higher than actual
- Overestimation of total addressable market
- Insiders have been selling the entire way up – last purchase was in Q1 2013 around \$15 per share
- Short interest of 2.5% with 50bps cost of borrow

Capitalization		Financials										
Share Price:	\$81.79											
Shares O/S:	81											
Market Cap:	\$6,649											
Cash:	\$113											
Debt:	\$0											
Enterprise Value:	\$6,536											
		2010	2011	2012	2013	2014	LTM	2015E	2016E	2017E	2018E	
Revenue:		49	76	100	160	259	356	372	460	529	547	
Growth:		63.8%	56.8%	31.0%	60.2%	62.0%	56.9%	43.5%	23.7%	15.0%	3.4%	
Op Inc:		-45	-45	-55	-26	-22	-56	6	47	76	84	
Margin:		-93.1%	-58.8%	-55.5%	-16.5%	-8.3%	-15.9%	1.6%	10.3%	14.4%	15.3%	
Net Income:		-55	-45	-55	-30	-22	-58	6	47	76	54	
EPS		(0.97)	(0.68)	(0.79)	(0.42)	(0.30)	(0.72)	0.07	0.58	0.93	0.67	
		Consensus EPS:										
		(0.29) (0.00) 0.53 1.13										
Key Stats		Share Price & Valuation										
52 Week High:	\$103.29											
52 Week Low:	\$55.60											
Short Interest:	2.5%											
Avg Daily Vol:	0.91											
EV/EBITDA:	350x											
P/Sales:	19x											
Price Target:	\$20.00											
Return:	76%											

Investment Thesis

Dexcom is a short today for three reasons. The market is underestimating the competitive dynamics within the industry along with overestimating the patient benefit associated with using the product. These aggressive assumptions have translated into the perception that CGM devices will have widespread adoption among the entire diabetes population, which dramatically overvalues the TAM for this product. This combination has materialized into an extremely aggressive valuation. Competition is moving towards an integrated device and longer life sensors, which means market share and pricing pressure for pure-play CGM provider Dexcom.

Company Overview

Dexcom designs and develops continuous glucose monitoring systems for patients with diabetes. Currently 29m people in the US are affected by diabetes but CGMs are primarily used for patients with Type 1 or Juvenile Diabetes, which only represents approximately 5% of the diabetic population. CGM systems are made up of three components: sensors, transmitters, and a display device. The sensor is inserted into the skin and remits glucose data back to the display device. Patients use this data along with data from finger pricks in order to dose their insulin therapy. This is a razor/razorblade model as the hardware lasts for years but the sensors have an FDA approved life of 7 days. Each sensor costs approximately \$70. It's important to note that the utilization of sensors is actually much longer. Primary research suggests the average life of current sensors is actually double the FDA recommendation. The sensors get smarter the longer you wear them; patient feedback indicates the most accurate days were 5 through 14.

	Medtronic	Abbott	Senseonics	Dexcom
Current Product:	Minimed 530G	In EU only	Applied for CE Mark	Dexcom G5 Mobile
Next Generation:	Minimed 640G	Freestyle Libre	Senseonics CGM System	Dexcom G6
US Release:	Early 2016	Mid 2016	2017	2017
Annual Cost:	\$3,000	\$1,800	?	\$3,500
Sensor Life:	6 days	14 days	90 days	7 days



Dexcom, Inc. (DXCM) - Short (Continued from previous page)

Market View	Variant View
Type 2 diabetes market represents larger and faster growing opportunity	Primary research suggests this is largely overdone. A very small percentage of T2 patients even monitor their glucose levels like T1. There could be some initial benefit to monitoring in early stage of T2 diagnosis but the revenue/customer profile would be a fraction of T1.
Historical market share gains translates into future market share success	Given Medtronic's market share in pumps and their salesforce size, an integrated device that combines CGM & pump technology with a single insertion site is likely to become the industry standard.
Revenue growth is the key value driver	Q3 was the first quarter in three years where SG&A growth outpaced year-over-year revenue growth, suggesting the cost to acquire new customers is accelerating and the low-hanging fruit has been picked.

Valuation & Scenario Analysis

The model was constructed with a top-down approach. The total addressable market was developed and then market share assumptions were made along with pricing in order to construct a revenue profile. The base case assumes: market adoption of CGM technology of 51%, DXCM achieves 50% of the market, and revenue/customer remains flat at \$2,500. High gross margins were sustained but industry operating margins of 25% were assumed as DXCM matures. A discount rate of 8% and terminal growth of 3% achieves a price target of \$20.00.

Key Assumptions	Base Case	Bull Case	Bear Case	Primary Research
Type 1 Adoption:	51%	75%	75%	More than 25 Type 1 diabetics
DXCM Market Share:	50%	70%	25%	Former employee of Dexcom & Medtronic
Annual Pricing:	Flat	5%	-3%	Two Nurse Educators with T1 ID & Elementary School Nurse
Operating Margins:	Industry Peers	Industry Peers	Industry Peers	VC Investor & former board member of DXCM
				Diabetes Educator & Program Coordinator for medical center
				Healthcare IP & medical device royalty investors
Price Target:	\$20.00	\$100.00	\$5.00	
<i>Return:</i>	76%	-22%	94%	Attended JDRF TypeOneNation Summit 11/7/2015

Catalysts:

Innovation: There is a tremendous amount of innovation in the product pipeline with regards to therapy for patients with diabetes. Specifically, Medtronic's integrated device that combines CGM technology along with pump therapy with a single insertion site along with companies like Senseonics that have an implantable sensor with a 90-day life spell trouble for pure-play CGM player DXCM.

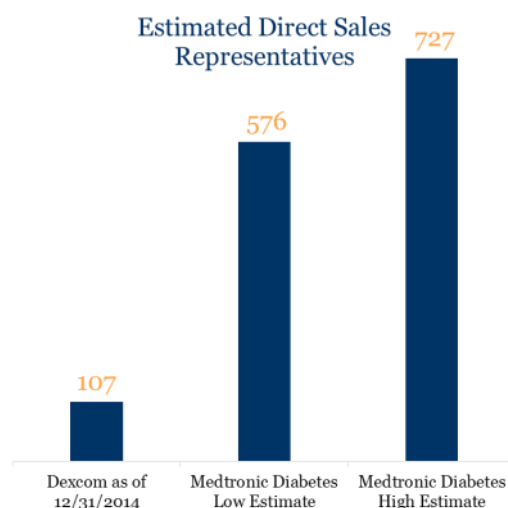
Revenue Miss: Management has kept their revenue targets consistently low but acceleration in SG&A spend suggests customer acquisition cost is accelerating. Next generation sensors coming out in 2016 also extend sensor life by 3 days; fewer sensors = less revenue/customer. The market is clearly not valuing this business on earnings or cash flow but rather market opportunity, so we see this as the key catalyst.

Risks:

DXCM realizes price increases over time: It's more likely that Dexcom could maintain current prices on sensors but sensor life continues to improve; further reducing annual spend per customer. Management commentary suggests pricing pressure over time, especially if they want to increase adoption.

Greater adoption of CGM technology: Base case assumes 51% adoption which is greater than current adoption of insulin pumps. Primary research suggests meaningful price concessions would need to be made in order to achieve more significant adoption.

DXCM gets bought out: Likely player would be a larger pump company. But Medtronic has 65% market share in pumps. DXCM has been public since 2005 so there has been plenty of opportunity for a takeover. Major competitors are developing their own technology.



TAM	Value	Formula
Total US Type 1 Patients	1.25mm	A
Annual CGM Cost	\$2,500	B
Current CGM Adoption	17%	C
Current Annual Sales	\$531	D=A*B*C
DXCM 2015E Sales	\$372	E
DXCM Market Share	70%	F=E/D
Base Case Adoption	50%	G
Base Case 2015 TAM	\$1,563	H=A*B*G
100% Adoption TAM	\$3,125	I=A*B

**Nielsen Fields '17**

Nielsen is a first-year MBA student at Columbia Business School. Prior to CBS, Nielsen was a Co-Portfolio Manager and Senior Analyst at Summit Global Management, a long biased hedge fund.

**Joanna Vu '17**

Joanna Vu is a first-year MBA student at Columbia Business School. Prior to CBS Joanna was an associate at Colony American Finance.

**Adam Xiao '17**

Adam Xiao is a first-year MBA student at Columbia Business School. Prior to CBS, Adam was an equity research associate at Dodge & Cox.

Quest Diagnostics (NYSE: DGX) - Short 2015 CSIMA Stock Pitch Challenge (Columbia Business School) - First Prize

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Recommendation

Quest Diagnostics represents an opportunity to short the independent diagnostic testing lab market which we believe is facing secular pressure due to commoditization of service, unfavorable regulation, and increased buyer bargaining power resulting in persistent pricing and volume pressure. Quest Diagnostics, in addition, has experienced cost inflation in its high labor-intensive and fixed-cost structure, which the company has failed to fully offset through its "Invigorate Cost Savings Program". Quest has been disguising the revenue and cost pressures by making \$1.5B of acquisitions, which have only served to offset the profit decline and should be considered a form of maintenance capital expenditure. After adjusting free cash flow, we believe a truer picture of free cash flow is significantly below consensus expectations and arrive at value using a DCF methodology of \$35 per share, which represents ~50% downside from DGX's current price.

Capitalization		Other Metrics	
Current Share Price	\$67.42	Short Interest	5.16%
Shares Outstanding	143.35	52-Week Low/High	\$60.07 / \$89.00
Market Cap	\$9,682		
Less: Cash	\$123	EV/FY'15 EBITDA	8.8x
Plus: Debt	\$3,731	EV/FY'16 EBITDA	8.5x
Enterprise Value	\$13,290	Price/FY'15 Earnings	14.2x
		Price/FY'16 Earnings	13.3x

Business Description

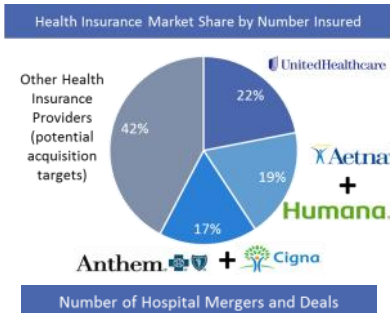
Quest Diagnostics provides diagnostic testing services such as routine testing, esoteric testing, and drug testing through its national infrastructure of approximately 2,200 patient testing centers, 3,000 courier vehicles and 20 aircrafts that collectively make tens of thousands of stops daily. The company serves one in three adult Americans and about half of the physicians and hospitals in the United States. Consensus view is that Quest operates in a duopoly structure with competitor LabCorp, both of which have built moats of national scale in a highly fragmented industry that has seen steady consolidation of smaller independent regional labs. However this duopoly represents just 25% of the total diagnostic testing industry if hospitals are considered as part of the market.

Investment Thesis

1) Pricing & Volume Pressure

Visiting hospitals and via conversations with hospital staff, we found there was little differentiation independent labs offered in routine testing. The only dimension that labs truly compete on is price. Based on our research, we foresee pricing, which has already been a significant headwind, as a greater issue in the future. As more baby boomers enter retirement, Medicare's bargaining power as a customer increases. The Protecting Access to Medicare Act (PAMA) takes effect in 2017 and will lower reimbursement of diagnostic tests by enforcing market-based pricing – potentially leading to pricing cuts of up to 10% per annum – and potentially much more after 2019.

	2017E	2018E	2019E	2020E
Maximum PAMA Cuts	10%	10%	10%	15%
Out Estimated PAMA Cuts	5.0%	5.0%	5.0%	7.5%
DGX Resulting Rev Decline	0.71%	0.71%	0.71%	1.07%



In addition to this, non-Medicare insurers who decide which lab vendors to reimburse have been consolidating over recent years with 2015 being a banner year as the big five providers will become the big three – covering nearly 60% of the US population. We believe regional players covering the remaining population will likely continue to merge to remain competitive under the Affordable Care Act (ACA). As private insurers become larger, their bargaining power with service providers increases which limits Quest's ability to raise prices.

Quest does recognize that price will continue be a headwind and in 2012 launched a new strategy to grow esoteric test revenue which commands a higher margin. Since that time however we have seen no evidence of growth in esoteric revenue. In fact, esoteric revenue decreased by 11% and increased by just 1% in 2013 and 2014 respectively. In general we believe the strategy to grow esoteric revenue to be flawed as growth is driven by external factors out of Quest's control such as testing equipment capabilities and the physicians' decisions to order these uncommon tests.

In addition to pricing pressures, Quest has been and will continue to face volume pressure. Just as ACA has decreased profitability for insurance providers, physicians and hospitals are experiencing the same effect. Several physicians explained to us that because of ACA they find it difficult to remain profitable independently and are joining hospitals. In addition to hospitals gaining diagnostic testing volume through the acquisition of private practices, hospitals are merging thereby gaining regional scale and will have enough testing volume to profitably insource testing rather than outsource to Quest.

In addition to losing volume to hospitals, Quest has lost testing volume to their biggest competitor, Labcorp. Although organic growth in revenue has declined for both companies, organic growth in volume has increased for LabCorp and declined

Quest Diagnostics (DGX) - Short (Continued from previous page)

for Quest, which suggests that Quest has lost volume to LabCorp. Through personal interviews, physicians indicated that they prefer sending tests to LabCorp because pick up times are better, test results are provided within 24 hours, and are easier to view online.

2) Failed Cost Savings

Beyond Quest experiencing downward pressure on revenue the company is also experiencing rising cost pressure. In 2012 Quest initiated a cost savings program with a target of \$1.3 billion in run rate savings by 2017 and claims to have hit \$700M run-rate cost savings thus far. However upon closer inspection, we find that after accounting for acquired costs, there is a cost gap of \$343. The gap implies there is cost inflation and that the savings program is simply a way to keep operations at steady state. This is a classic case of the "Red Queen" syndrome as Quest has to run as fast as they can to stay where they are. To run faster, Quest continues to acquire and invest in a troubled diagnostic industry, an industry that LabCorp is diversifying away from with the \$5.6b acquisition of Covance, a company which operates as a contract research organization.

3) Overstated Free Cash Flow

Over the past 5 years Quest has spent over \$1.5b in net acquisitions (including sales of nearly \$800m), however both sales and NOPAT have changed very little over that timeframe. We believe acquisitions have been used to fill the hole created by a declining core routine testing business. Capital IQ's stated unlevered FCF fails to exclude \$250m in stock based compensation expense, which we consider a real expense, and over \$400m in restructuring and acquisition integration charges, items we also consider to be ongoing as Quest will continually have to restructure operations to offset ongoing cost inflation and acquire new volumes through lab acquisitions to offset price and volume declines in its core business.

This is an important point regarding Quest's need to pursue acquisitions. Quest buys smaller regional labs for the book of lab testing business, not the fixed assets. The majority of the purchase price, some 85%, is booked as either goodwill or intangible assets and therefore rarely hits the income statement as D&A.

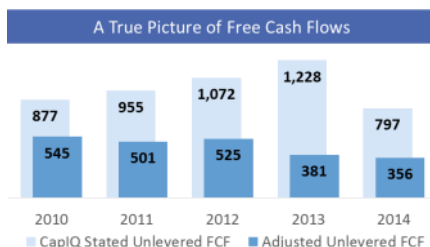
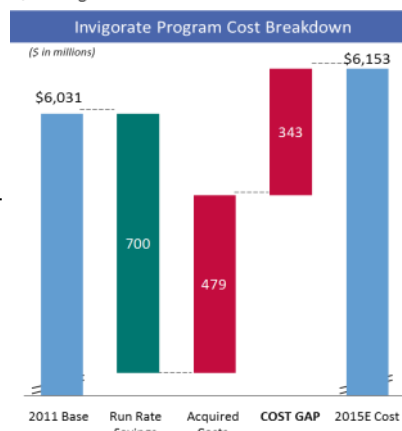
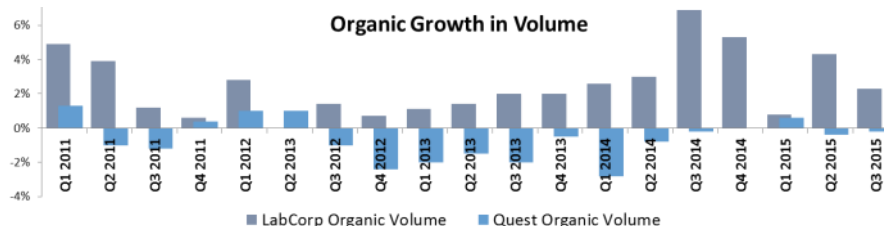
These maintenance acquisitions can be thought of as customer acquisition costs incurred in order to maintain current levels of revenue and NOPAT. These costs are essentially capitalized on the balance sheet but never depreciated over time — we make the correction of subtracting the acquisition costs from free cash flow. These acquisitions come with diminishing levels of potency which is evidenced by the declining return on net operating assets over the period, falling from nearly 12% to ~8.5%, driven by a growing asset base yet a stagnant level of NOPAT.

Valuation

We believe the appropriate methodology to value Quest is by discounting our adjusted free cash flows. Our base case valuation of \$35 assumes flat revenue over the ensuing five year period driven by half the allowable PAMA cuts to Medicare and Medicaid reimbursement rates. We do not model pricing pressure from private health insurers despite evidence that suggests otherwise. We believe we are being conservative in these estimations. We estimate lost volume similar to the prior five year period in which Quest faced similar pricing pressure that was offset by acquisitions to keep revenue flat over the period. We assume that similar cost inflation of 1.4% experienced in the prior five years is more than offset by savings from Quest's Invigorate program which peak in 2018. At a nearly a 14x unlevered FCF multiple, which incorporates an 8.25% WACC and 1% terminal growth rate, and is in line with the average multiple DGX traded at over the prior 5 year period, we arrive at a value of \$35 per share.

Key Risks

Risks to our valuation & thesis are PAMA cuts being less significant than outlined driven by hospital inclusion into sample pricing. Quest follows LabCorp by diversifying away from its declining core diagnostics business. Hospitals sell their lab business to Quest or LabCorp in order to focus on their core business of patient care. Quest is purchased by private equity, or less likely, a strategic purchaser. In fact it was rumored this summer that Quest had received an offer, however nothing materialized.



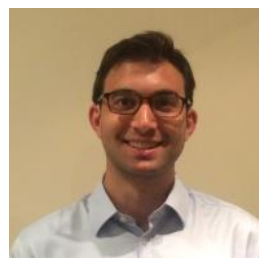
Present Value of Cash Flows	2016E	2017E	2018E	2019E	2020E
Unlevered Free Cash Flow	\$682	\$722	\$779	\$681	\$588
Discount Rate	8.25%	8.25%	8.25%	8.25%	8.25%
Discount Factor	1.08	1.17	1.27	1.37	1.48
PV of Future Unlevered Free Cash Flow	\$631	\$617	\$615	\$497	\$5,920

Enterprise Value	\$8,281				
Less: Net Debt	(\$3,170)				
Market Value	\$5,110				
Shares Outstanding	144				
Intrinsic Value	\$36				
Terminal Growth Rate				1.00%	
Enterprise WACC				8.25%	
Effective Terminal Multiple				13.79x	

		Terminal Growth Rate				
		0.00%	0.50%	1.00%	1.50%	2.00%
WACC	9.50%	\$24	\$26	\$28	\$30	\$32
	8.88%	\$27	\$29	\$31	\$34	\$37
	8.25%	\$31	\$33	\$36	\$39	\$42
	7.63%	\$35	\$38	\$41	\$45	\$49
	7.00%	\$40	\$43	\$47	\$52	\$57

**Justin Hong '17**

Justin is a first-year MBA student at Columbia Business School. Prior to CBS, Justin worked in the High Yield Bonds group at Oaktree Capital Management. This summer he will be interning at Carlson Capital.

**Zachary Rieger '17**

Zach is a first-year MBA student at Columbia Business School. Prior to CBS, Zach worked in private equity at PineBridge Investments after spending two years in BAML's technology investment banking group. He holds a BA from the University of Pennsylvania.

**Cristóbal Silva '17**

Cristóbal is a first-year MBA student at Columbia Business School. Prior to CBS, Cristóbal worked in Bancard (family office of Mr. Sebastián Piñera) co-managing a \$1B portfolio of equities, fixed income securities (High Yield and Distress) and derivatives invested in Latin America.

XPO Logistics (NYSE: XPO) - Long 2015 Alpha Challenge @ UNC Kenan-Flagler - Second Place

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Recommendation

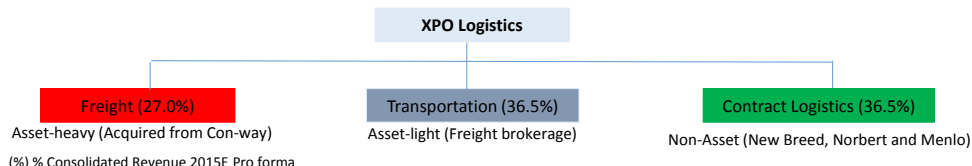
XPO is strong BUY with a target price of \$48 per share (~115% upside). XPO has a phenomenal CEO (Bradly Jacobs), a performance-driven culture, sticky relationship with customers, growth opportunities (organic and inorganically), a cash generative core business overlooked by the market and attractive valuations (10.9% and 15.7% FCFE yield 2017 and 2018 respectively).

Business Description

XPO Logistics ("XPO" or "the Company") is a top ten global provider of supply chain solutions. XPO enables customers to operate their supply chain more efficiently and at lower cost.

Bradley Jacobs consolidation the fragmented logistics market started in 2011, with the purchase of Express-1, a express carrier that operated an asset-light model with almost \$200 million in revenue. Today, XPO has more than \$15 billion of revenue and \$1.1 billion of pro forma 2015E EBITDA. Its integrated network includes approximately 84,000 employees at 1,469 locations in 32 countries serving over 50,000 customers.

Key Trading Statistics	
Share Price (01/11/2016)	\$22.58
52W High	\$50.96
52W Low	\$21.33
Avg. 3-Mo Daily Volume (\$MM)	\$29.92
Short Interest (% of DSO)	24.2%
Shares Out (MM)	132.91
Market Cap (\$MM)	\$3,001
Net debt 2015E (\$MM)	\$5,800
Adj. Min. Interest (\$MM)	\$836
EV (\$MM)	\$9,637
Revenue 2016E (\$MM)	\$15,758
Adj. EBITDA 2016E (\$MM)	\$1,198
EV/EBITDA 2016	8.04x



Investment Thesis

1) CEO with a phenomenal track record of consolidating industries, management team with substantial industry experience, incredible alignment of incentives with shareholders, and significant insider ownership
Jacobs founded and led four highly successful companies, including two public corporations that he grew through successfully consolidating historically fragmented industries:

- i.) **United Rentals (1997 – 2007):** Built world's largest equipment rental company. United Rental stock outperformed S&P 500 by 2.2x during his tenure.
- ii.) **United Waste Systems (1992 – 1997):** Created 5th largest solid waste business in North America. United Waste stock outperformed S&P 500 by 5.6x from 1992 to 1997.
- iii.) **Hamilton Resources (1984 – 1988):** Grew global oil trading company to \$1 billion.
- iv.) **Amerex Oil Associates (1979 – 1983):** Built one of the world's largest oil brokerage firms.

Management compensation includes elements that are heavily weighted to variable compensation. The performance-based equity grants to XPO NEOs are subject to the achievement of two performance goals:

- i.) Stock price must trade at or above \$60 for 20 consecutive trading days prior to April 2, 2018.
- ii.) The company's fiscal year 2017 adjusted cash earnings per share being at least \$2.50.

Jacobs and the rest of the management team own 14.5% and 1.5% of XPO, respectively.

2) XPO is uniquely leveraged to powerful secular trends in the 3PL industry. XPO's scalable technology platform and management's history of successful integration make it an ideal consolidator of an industry that is highly fragmented

There are more than 12,000 3PL providers. Many are smaller local providers that mostly offer one unsophisticated service, truckload brokerage. Through 17 acquisitions, XPO is now a true one-stop 3PL shop. The company multimodal capabilities help solve shippers' increasingly complicated supply chain problems interacting with just one counterparty. This generates sticky relationships with customers as they share strategic data with XPO and XPO co-locates workers and assets at customer sites (retention over 90%).

The infrastructure that XPO put in place in 2011, 2012, 2013, building the company like a tank in the back-office, is what separates XPO from roll-ups that have failed. XPO overinvested in its technology platform upfront with the vision and capability of taking on future acquisitions and quickly integrating them without disruptions. In fact, customer satisfaction has improved after acquisitions.

3) Two transformative deals in the past six month have raised concerns in the investment community around Mr. Jacobs' strategic view and XPO's leverage. This triggered the sell-off, which we believe is a buy opportunity.

On April, 2015 XPO announced the acquisition of European Logistics Provider Norbert Dentressangle. The price paid (including debt) was \$3,530 million (EV/EBITDA pre-synergies of 9.1x). The market reaction was "Jacobs went too far too

XPO Logistics (XPO) - Long (Continued from previous page)

quickly. It would be difficult to increase profitability". In our opinion, the deal made economic and strategic sense. XPO became the leading transatlantic logistic provider. Cross-selling opportunities raised immediately (XPO signed a contract with Zara to execute their e-fulfillment in North America within 22 days after closing). Within the first 6 month, XPO applied its proprietary technology platform, changed the compensation plan and shut-down unprofitable business. Results speak for themselves, European transportation and logistics EBITDA increased by 26% and 17% respectively in the 3Q 2015.

Then, on September, XPO announced the acquisition of Con-way for \$3 billion. When the acquisition was announced, the reaction of the street was: "This acquisition does not make sense. This is a departure from asset-light strategy". We believe the acquisition is a response to what is changing in the industry:

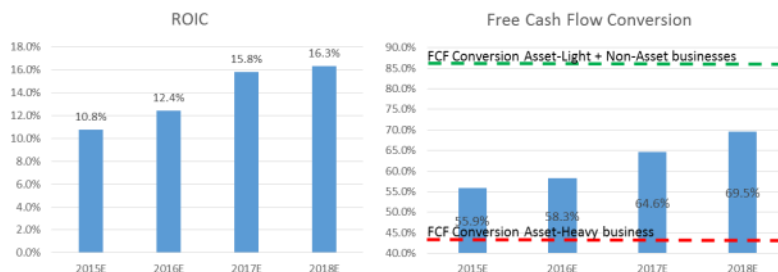
- i.) Shippers are increasingly looking to 3PL not only to help them design supply chain solutions but also to **execute**.
- ii.) Increased complexity in execution with the need for same-day and next-day delivery.
- iii.) Tight LTL capacity due to regulatory constraints and to spill over demand from tight Parcel capacity.

Regarding cost savings, our primary research confirms **Con-way** was not run efficiently. As a matter of fact, **Con-way** consistently obtained EBITDA margin below its competitors (by 200-400bps) in the last three years. We estimate XPO will achieve \$200 million on cost saving within the next 24 month (management range is \$170 - \$210 million). Incorporating this, the effective multiple paid was 4.2x EBITDA which is below the 6x peers market multiple.

4) One-time costs associated with acquisitions mask a profitable and attractive core business

In fact, organic revenue growth has stabilized at 10%. Post integration, free cash flow conversion approaches to 70% and return on invested capital (ROIC) to 16%.

XPO is now entering an "integration phase" in which organic revenue growth will translate into free cash flow generation and ROIC expansion. This will trigger a multiple re-rating and serve as a catalyst for the stock price.



Valuation

Our \$48 target price is based on the average of a DCF (WACC 10% and Exit multiple of 8.0x in 2022) and sum-of-the parts exercise (XPO's EBITDA 2017 for each business line @ listed peers' EV to fwd EBITDA multiple).

Our projections assume negative 5% and 0% revenue growth for Con-way in 2016 and 2017 respectively (economy is cooling down and new management would shut down unprofitable business). We also assume an one-time expense of \$150 million in cash on 2016 related to Con-way integration.

The company's low-base scenario is 200 bps EBITDA margin expansion over the next three years. Although XPO has delivered on every financial target it has set for itself, the market is not giving credit for this new target.

Based on XPO's core business quality and meaningful growth opportunities, We believe XPO should trade at least in line with its peers (9.8x EV to fwd EBITDA). At market price, XPO trades at 10.9x and 15.7% FCFE yield 2017 and 2018 respectively, which in our opinion is a compelling valuation for a company with double digit EBITDA growth (19% CAGR 2016-2018).

Valuation Method	Base Case	No Margin Expansion	Bear Case
DCF	\$52.44	\$29.48	\$23.70
Sum-of-the-parts	\$45.32	\$32.72	\$23.92
Price Target	\$48.88	\$31.10	\$23.81
Upside	116.5%	37.7%	5.4%
Multiples (@ Market Price \$22.58)			
EV to EBITDA 2016	8.04x	8.51x	8.51x
EV to EBITDA 2017	6.82x	7.95x	7.95x
EV to EBITDA 2018	5.67x	6.93x	6.93x
Multiples (@ Price Target)			
EV to EBITDA 2016	10.96x	9.51x	8.66x
EV to EBITDA 2017	9.29x	8.89x	8.09x
EV to EBITDA 2018	7.73x	7.74x	7.04x
Peers EV to fwd EBITDA multiple			
	10.72x	5.85x	5.77x
Weighted Average Multiple*	9.78x		

Note: EBITDA 2016 does not include one-time expense of \$150 million related to the integration of Con-Way. However, this expense is considered in the valuation.

*Weighted by segment EBITDA contribution to XPO's total EBITDA

Our bear case valuation (it assumes no margin expansion and 10% discount on peers multiple for the sum-of-the-parts valuation method and 10% discount on exit multiple for DCF valuation method) is \$23.85/share (~5.4% upside). This represents an attractive margin of safety in case the turnaround of Con-way turns out more challenging than expected.

Key risk to thesis and mitigants

(-) XPO is running at 5.0x net debt to EBITDA 2015E and the Company just added cyclicity to its results with Con-way's acquisition when the economic outlook is deteriorating. **Mitigant:** Asset-light business accounts for 77% of free cash flow. Highly cash-generative business allows deleverage to 3.8x in two years. Debt has no hard-covenants. In the case of a recession, margin in freight brokerage and contract logistics increases (evidenced in 2009) and capex at the LTL business can be cut to almost zero (2009).

(-) A shortage in available drivers could limit XPO Freight's to fully utilize the company's fleet and pressure margins through wage increases. **Mitigant:** Real driver's problem is in the truckload business, not in LTL. TL driver turnover is 95% versus 12% in LTL. Annual driver compensation in the LTL industry is \$64,000 versus \$50,000 in TL. In addition, Con-way's LTL drivers turnover is 7.5%, way below industry average (12%).

(-) Startups aim to leverage drivers' smartphones to quickly connect them with nearby companies looking to ship goods. If successful, it would disintermediate third-party brokers (CH Robinson, XPO, ECHO Logistics, etc). **Mitigant:** XPO spent \$115 million and \$400 million in technology in 2014 and 2015E, respectively. Our primary research confirms XPO's superior IT capabilities. "Mario Harik, the CIO, is a terribly talented guy. He is literally a genius IQ" – Former XPO employee. "We are likely to be the disrupter rather than the disrupted" – Bradley Jacobs

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