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Issue XVII

Winter 2013

## JANA Partners — Collaboratively Unlocking Value



Barry Rosenstein

Scott Ostfeld

Founded in 2001, JANA Partners is a value-oriented investment advisor specializing in event-driven investing. G&D sat down with two of the firm's partners, Barry Rosenstein and Scott Ostfeld '02. Barry Rosenstein is the founder and Managing Partner of JANA Partners. Prior

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## Daniel Krueger — “Uncertainty is our friend”



Daniel Krueger

Daniel Krueger '02 is a Managing Director and Partner at Owl Creek Asset Management, a hedge fund in New

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## Frank Martin — Winning by Not Losing



Frank Martin

Frank Martin is the founder and owner of Martin Capital Management, an investment partnership based out of Elkhart, Indiana. He is the author of two books on investing, *Speculative Contagion* (2005) and *A Decade of Delusions* (2011).

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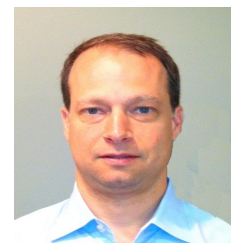
Russell Glass

## Russell Glass — Arbitrageur of Value

Russell Glass is founder and managing partner of RDG Capital Management, a New York-based investment management firm that specializes in activist investing. Prior to RDG Capital, Mr. Glass served as President of Icahn Associates, the investment firm of Carl Icahn. A passionate sports fan, Mr.

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## Jon Friedland — Searching for International Battleships



Jon Friedland

Jon Friedland '97 is the Director of International Research at Amici Capital (formerly named Porter Orlin). He is responsible for sourcing and analyzing the firm's international long and short ideas. Prior to joining Amici in 2001, he worked at Zweig-Dimenna Associates, a New York-based

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## Welcome to Graham & Doddsville



Pictured: Professor Bruce Greenwald. The Heilbrunn Center sponsors the Applied Value Investing program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.



Pictured: Heilbrunn Center Director Louisa Serene Schneider. Louisa skillfully leads the Heilbrunn 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.

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We are proud to bring you the latest installment of *Graham & Doddsville*. This is the 17<sup>th</sup> edition of Columbia Business School's student-led investment newsletter, co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association.

We were very fortunate to sit down with six well-respected and successful investors that span the value investing spectrum – they prove the old adage, 'there is more than one way to skin a cat.'

**Barry Rosenstein** and **Scott Ostfeld '02** from **JANA Partners** explained their process for constructively engaging management in activist situations. They also talked about how their entrepreneurial backgrounds have helped shape their careers and the way they look at companies.

Distressed expert **Dan Krueger '02** from **Owl Creek Asset Management** shared the intricacies of distressed debt investing that make it his favorite hunting ground for ideas. He also explained how the economics of averaging down create

very attractive risk-return scenarios, as well as how he encourages his team, in their early work on a company, to zero in on the key questions that need to be answered.

**Frank Martin** from **Martin Capital Management** described how he picks companies on a bottom-up basis, yet spends much of his time thoroughly studying the macroeconomic environment. He also explained his reasoning for having a conservatively positioned portfolio today. Mr. Martin goes into detail about the behavioral aspects of investing and what he does to avoid traps to which many investors fall prey.

Activist **Russell Glass** from **RDG Capital** made us very envious when he shared his unique business school and early career experiences. Mr. Glass thoroughly shared how his firm has been able to profit handsomely by actively advocating for the sale of undervalued companies. He also illuminated for us how the large amounts of cash in private equity and corporate hands could lead to a robust mergers and acquisitions environment in

the coming years.

**Jon Friedland '97** from **Amici Capital** shared with us the factors that make a company a 'battleship' company. He then conveyed the attractiveness of searching for these companies in emerging markets.

This issue also contains pictures from the 22nd Annual Graham & Dodd Breakfast, which took place on October 5 at the Pierre Hotel in New York. Investing luminaries Tom Russo, Bill Ackman, Mario Gabelli, William von Mueffling, and others were on hand to mingle and listen to keynote speaker Meryl Witmer from Eagle Capital Partners.

We thank our featured investors for sharing their time and insights with our readers. Please feel free to contact us if you have comments or ideas about the newsletter as we continue to refine this publication for future editions. We hope you enjoy reading this issue of *Graham & Doddsville* and find the interviews as informative and thought-provoking in written form as we found them to be in person.

## CSIMA Scholarship

The Columbia Student Investment Management Association (CSIMA) will be awarding its inaugural scholarship this spring with the proceeds from today's conference. Through this program, we will award a \$10,000 scholarship to an incoming Columbia Business School student that exhibits an outstanding aptitude and commitment to investment management. All incoming MBA students in the Class of 2015 are eligible to apply and the recipient will be chosen by a panel of CSIMA students.

We are excited to initiate this scholarship and look forward to making this an annual tradition.



## 22nd Annual Graham & Dodd Breakfast, Oct 5, 2012 at Pierre Hotel



**Keynote Speaker – Meryl Witmer**



**Bill Ackman**



**Mario Gabelli with William von Mueffling**



**Tom Russo in deep conversation with Sid and Helaine Lerner**



**Dean Hubbard thanks Ms. Witmer**



**Prof. Greenwald makes a point**



**Engaged audience**

***“Bring a sharp pencil and leave your emotions at home!” – Meryl Witmer***

## JANA Partners



**Barry Rosenstein**

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to founding **JANA Partners**, Mr. Rosenstein was the founder and Managing Partner of Sagaponack Partners, a private equity fund. Mr. Rosenstein received his MBA from Wharton and his B.S. from Lehigh University. Scott Ostfeld is a partner of JANA Partners and is responsible for special situations investments, including active shareholder engagement. Prior to joining JANA Partners, Mr. Ostfeld was with GSC Partners in its distressed debt private equity group. Mr. Ostfeld received his MBA from Columbia Business School, his J.D. from Columbia Law School, and a B.A. from Columbia University.

**G&D:** Can you tell us about your background and how you became interested in investing?



**Scott Ostfeld**

**Barry Rosenstein (BR):** I wasn't one of these people who invested when I was nine years old. I was good at math and I was interested in business. Frankly, I didn't really know much about Wall Street at all but as I read more about the business world when I was in college, it became clear to me that I should go back to business school. I did so at Wharton. There seems to be a hot industry anytime that you are in graduate school. When I graduated from Wharton in 1984, investment banking was the hot field, so that's where I focused my efforts.

I actually didn't have a lot of luck getting a job coming

out of business school. The interviews didn't go that well for me, and there weren't big banking programs like there are today. What did lead to a job was cold-calling. The trick I used to get jobs coming out of business school was to call people after 5:00 p.m., when their secretaries had left, so that the person I really wanted to speak to would likely pick up the phone themselves. In the case of my first job opportunity, I cold-called a Wharton alumnus at a boutique firm called Warburg, Becker, Paribas. Unfortunately, the first week on the job, the firm was sold to Merrill Lynch and I was again without a job. That was the start of my career. Fortunately, Merrill called me about a week later and told me I could interview for a job with them and, apparently, they needed bodies so they hired me. I worked in banking for about two and a half years but I frankly didn't like it that much.

Back in the mid-80s, corporate raiders were beginning to make themselves known, and I would excitedly read about their exploits at the time. That was an interesting world to me, so the question was how to get into that field? I once again tried the cold-call technique (I don't remember how I found his number) to speak to one of the main raiders of the time – a guy named Asher Edelman – and wouldn't you know it, he

answered the phone. I started talking as fast as I could and he finally said, "Well, come on in." This led to me becoming Edelman's co-head of takeovers, a job for which I really wasn't qualified.

**G&D:** Can you tell us the story of how you actually got the job offer from Asher Edelman?

**BR:** Asher was the corporate raider back then, and I was a nobody associate at Merrill Lynch; no one there even knew who I was. He started by telling me that he'd been talking to the heads of the M&A departments at various investment banks about coming to work for him to co-head his takeover business. I didn't understand why he was telling me this as it had nothing to do with me. After about 15 minutes, he turned to me and said, "I think you and I are going to do a deal here." I had no idea what he meant. Then he asked, "What's it going to take to get you to take this job?" At the time, I was making a salary of \$40,000 and hoping for a \$30,000 bonus, but my reviews were not strong so I didn't have high hopes. I had heard that the top merchant acquisition bankers made \$1 million, which was more money than I had ever heard of in my life. So I said to him, "one million dollars." He stared at me for 30 or 45 seconds, which is a long time when you're completely full of crap. Then he

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said, "Alright, done. You just have to start tomorrow," to which I responded, "I'll start right now. I'll sleep here tonight if you want." That's how I became co-head of takeovers for Asher Edelman. I wasn't prepared for the position when I started, so I had to figure out the responsibilities of the role as I went along. This made for a uniquely amazing experience.

**G&D:** How old were you then?

**BR:** I was 27.

**G&D:** That was quite a career advancement at that age!

**BR:** I'll add a funny post-script to it, as well. The very first deal I was working on, we were trying to take over a supermarket chain called Lucky Stores and sure enough, Edelman had approached Merrill Lynch for the takeover financing. About a week into my job as co-head of takeovers, Merrill's senior M&A team came in to our office to talk to us about the financing. I noticed the Merrill people looking at me as they were probably thinking, "What's he doing here? I didn't know he was assigned to the deal." I was so insignificant at Merrill Lynch that nobody even knew I had left. So Asher gave his 30-second introduction and then said, "My co-head of takeovers, Barry here, is going to take you through the financing we're looking for." Every

jaw hit the floor.

**G&D:** Clearly you had a lot to learn essentially starting from scratch. What are some of the things that stand out in your mind that you learned during that period working for Asher that shaped the way you run the

***"But from Asher [Edelman], I probably learned more important skills. These had more to do with taking risks while not blinking and remaining fearless. I give him a lot of credit... he had great instincts and he never showed fear, even if he felt it at times. That was an important lesson."***

firm today?

**BR:** I didn't really learn anything technical from

Asher. I learned technical balance sheet analysis and business analysis more through working on situations, talking to bankers, and talking to some of the other people who were working at the firm. But from Asher, I probably learned more important skills. These had more to do with taking risks while not blinking and remaining fearless. I give him a lot of credit. He wasn't the most technically savvy guy, but he had great instincts and he never showed fear, even if he felt it at times. That was an important lesson.

**G&D:** Mr. Ostfeld, can you walk our readers through your unique background? How has this background impacted your investment style?

**Scott Ostfeld (SO):** I was an Art History major when I was in undergraduate school at Columbia, so that didn't necessarily portend a career in finance. I started two businesses in college. I started a menu business where the restaurants around Columbia paid me to put their menus into a menu book that I distributed to students for free. This was just before the Internet had taken off, which certainly would have put me out of business. I also started an event planning business. One of the problems back then as a Columbia undergraduate student was that there was no central place to congre-

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gate at night – you may have seen somebody on campus, but you never saw them at night. So I started initiating events at different venues for Columbia students, where I was paid to bring students. It grew to the point where I was organizing events for Tahari and Lacoste in New York and even Miami. Toward the end of my time as an undergraduate, I applied to the law school thinking I wanted to be a lawyer, though not necessarily understanding what that meant. I also had an entrepreneurial orientation, so on a whim I said, “Maybe I should go to business school as well.” I was lucky because the business school typically doesn’t admit candidates with no real work experience.

The foundation of entrepreneurial experience, law school, and business school has helped me as an activist investor. Entrepreneurial experience gave me an ‘owner orientation’ that is very helpful in thinking about how to create value at companies. Business school and law school gave me many of the foundational tools to be a competent analyst. Believe it or not, I had never even used Excel before I attended business school. Courses like Advanced Corporate Finance, Corporate Restructuring and Corporate Tax gave me a great foundation for analyzing companies and thinking about ways to unlock value.

During my time in business school and law school, I spent a summer at Wachtell Lipton, which today happens to be on the other side of our firm in activist situations. That was an interesting experience that helped frame the debate on shareholder versus board and management power. After graduation, I went into investment banking, where I focused on helping companies unlock value. From there, I moved into distressed private equity. That was basically investing in the context of a legal process to gain control of a company and improve value as an equity owner, which was again leveraging many of my skills and experiences. I then moved to activism when I joined JANA Partners about seven years ago, which puts all of my experiences to work evaluating companies with an owner orientation to figure out how to unlock value.

**G&D:** Mr. Rosenstein, you were involved in many entrepreneurial situations before you founded JANA – will you talk about a few of them?

**BR:** My career is not very conventional. I didn’t grow up in the hedge fund business and work for a bunch of people and then decide to start my own firm. I was kind of a serial entrepreneur. Some things worked and some things didn’t work. When I left Asher, I did two things. First, I went off on my own and I made a

tender offer to try and buy a public company called Justin Industries, which was the largest manufacturer of cowboy boots and bricks in the country. I never acquired control of the company, however. [Editor’s Note: This Company was later acquired by Berkshire Hathaway in 2000.] It was an interesting experience being the person on the firing line, as opposed to somebody’s right-hand man. It was also interesting trying to go after the oldest company in the state of Texas.

I also became involved in the cellular industry. I was invited by a group of gentlemen to form a partnership that submitted applications for all of the remaining rural cellular licenses in the U.S. that had not yet been awarded. The FCC didn’t hold auctions at that time – they just held a lottery – so all one had to do was apply. We invested a relatively small amount of capital to meet the legal fees associated with applying and we then applied to every location in the country. We figured we had a one in three chance of winning one of them. It was like playing the lottery but with much better odds. In fact, we won Mississippi and the Poconos and, after building the necessary systems, sold them for a terrific return.

I then moved to San Francisco at the end of 1991. Remember that this was back when New York was

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going through extremely difficult times – the homeless problem was out of control, Wall Street was completely dead, and there was nothing to do. In the meantime, I met some people in San Francisco who asked me if I wanted to join them to start a new investment and merchant banking business. Not having anything else to do, I decided to give it a try for a year or two and then return to New York. I ultimately stayed in San Francisco for 16 years! After about five years of helping build that successful little boutique business, I left to start my own firm.

**G&D:** Towards the end of your time in San Francisco, you made an investment in Copart, the salvage vehicle auction company. Could you tell us about this business and your thesis at the time?

**BR:** That's right. Near the end of my time on the west coast, I did a deal which was something of a life changer for me in certain ways. Yet again, I cold-called someone – this time it was a participant in the auto salvage industry. Auto salvage is a fragmented industry that runs an auction on behalf of insurance companies for permanently damaged vehicles. This is the company that the insurance company calls and says, "Go pick up the car for us, turn it into a salvage vehicle, run an auction, and sell it." Some people buy the cars to fix them

and use them again and other people buy them for the parts.

I became curious about auto salvage after someone had mentioned that it could be attractive. So I started calling one participant in the industry after another, each more unsavory than the last. I finally met a guy named Willis Johnson who had a little company called Copart. At the time, Copart had one location in California, generated \$8 million in revenue, and offered neither audited financials nor GAAP accounting. Copart was basically a dirt lot with a barbed wire fence and dogs running around. The headquarters building was a temporary corrugated metal building, and Johnson fractured the English language regularly. The only thing that I could think of, as I was trudging around in the mud with the CEO, was that I can't believe my career has fallen this far, this rapidly. Nevertheless, I probably spent four hours with Johnson. I remember calling my wife on the phone on the way back to San Francisco and saying, "You know, I think I just met the smartest guy I have ever met in business."

Willis Johnson was a self-taught, self-made businessman. He had a vision for creating a national company and signing national contracts. He also believed he had a way of sharing the proceeds with the insurance companies so that there

was an incentive to get better pricing. He had all kinds of ideas that no one in his industry had done to date. I returned to my office in the city and tried to scrape together the \$7 million to back him. I remember everybody telling me that I was crazy being in this industry and backing this person. But I just saw something in him. I was able to back him and he turned out to be one in a million. He bought a number of companies, integrated them very well, and started to build a real company. Copart went public a little over a year after my investment. Today, it's a \$4 billion market cap company and it has hundreds of locations all around the world. Their business has shifted to the internet now, of course, and today it's the biggest online seller of automobiles in the world.

**G&D:** What inspired you to found JANA Partners and to include a distinct activist investing approach within part of your business?

**BR:** So I made some money on my various ventures and that provided a springboard for me to start my own private equity firm in 1997. I ran that for about three years and produced very average results for my investors. It was a very difficult time for the private equity market and I was just happy that the investors were returned their principal plus a small return. But I really didn't like the busi-

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Pictured: Mario Gabelli at Omaha Dinner in May 2012.

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Pictured: Louisa Schneider and Glenn Hubbard at Graham & Dodd Breakfast in October 2012.

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ness. I felt like I couldn't be entrepreneurial – if we won a deal, it was because we had offered to pay more than everybody else. It was right around 2000 when I decided to not raise another fund.

I instead saw an opportunity in the public markets to close what I saw as a gap between the price at which public companies were trading and what I felt their ultimate private market values were worth. So not knowing anything about how a hedge fund works, I set up a hedge fund.

I remember when I was trying to raise money, traveling to various institutions and talking about being an activist. People would say, "That's not a strategy; you'll never raise money; nobody does that; forget it." Things have really changed. My very first investor was Lee Cooperman [Editor's Note: Cooperman was featured in Issue 13 of *Graham & Doddsville*], who had been a close friend for many, many years and someone I viewed as a mentor. He largely understood the idea and believed in what I was trying to do. He backed me when nobody else really would.

I started with \$17 million and no expectations beyond that. Before I knew it, the business grew and by 2007, we had over \$8 billion under management. We generated a pretty strong track record over this period of time, as well. Then I lived

through 2008 and a big downturn, with assets under management falling a lot. I restructured the whole firm over the last couple of years

**"I think we're 'right-term' because we try to consider all available information and construct the optimal plan for the company under the circumstances that are known or knowable and predictable over a reasonable period of time to best position the company for success. I think that's the right time frame, frankly, for a board to be evaluating the opportunity set for the company."**

and we are back flying again. Other than probably 2008 and a year or two after that, it's actually been a lot of fun.

**G&D:** Does your activist approach stem from the fact that you have a sense of what good businesses are and how a business should be managed to get to the private market value? Is that how you convince the management to unlock the value?

**BR:** Right. Nobody was really doing that when we started. There were a lot of companies that were value traps. They either needed to restructure, sell off money-losing businesses, spin off an unrelated business, or they just didn't belong independent and needed to be sold. My initial impetus was to try and force that kind of change.

**G&D:** Many value investors talk about having a long-term approach, but at JANA you have a medium-term time frame. Why is this the right time frame?

**SO:** I wouldn't even call it medium-term; I'd call it 'right-term'. I think we're 'right-term' because we try to consider all available information and construct the optimal plan for the company under the circumstances that are known or knowable and predictable over a reasonable period of time to best position the company for success. I think that's the right time frame, frankly, for a board to be evaluating the opportunity set for the company. So I think our horizon maps

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appropriately with the board's horizon.

**G&D:** How much overlap is there between JANA's passive efforts (that is, non-activist ideas in this context) versus its activist efforts?

**SO:** We are one team, one portfolio, all on one floor, all interacting on a regular basis. So there is a constant flow of ideas from passive to active, and frankly, many of us can't separate our brain and say, "This one's clearly active, this one's passive." Frequently positions fall in the middle. But my primary focus is on the activist side, and that's what I'm paying attention to 90% of the time.

**G&D:** Does your activist style impact your portfolio construction – meaning, does the fact that you are often the catalyst enable you to be more concentrated than you would otherwise feel comfortable being?

**SO:** Yes. Our highest conviction ideas are the ideas where we have the most impact on the outcome. Those are our activist ideas which tend to be our largest and highest returning positions in the portfolio. You're also, frankly, doing a lot of work on these positions, so you want to benefit from that work by making it a large position. So our portfolio can be a bit more concentrated.

**G&D:** You've been an activist in many companies in

the last 10 years, but it's never come down to a proxy vote and you've never been very vocal about your position. How do you

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engage management? What makes the strategy possible?

**BR:** Well for the first part of that, I would say you have to be prepared to go all the way because if you're not,

you'll be pushed as far as you're willing to go and then you have nothing. Nobody ever questions whether we're prepared to go all the way. We are very careful about how we prosecute activism. We've never had one actually go to a final vote because management comes to the realization that there's no point going to a final vote because they're going to lose.

The reasons are twofold: one is our approach and the other is our structure. In our approach, we're extremely disciplined. I don't want to be only an activist because then you force things and the quality of your ideas is diluted. We don't ever have to be an activist here. We can just invest in event-driven situations. For something to be an activist play, all of the criteria have to be present for us. We came up with this rubric we call V-cubed, which is Value, Votes, and Variety of ways to win. Basically, we have to be comfortable buying in at a valuation that provides us with a margin of safety, irrespective of any activism we will attempt to initiate and that may be unsuccessful. We have to be comfortable that if it really came down to a vote that we would have shareholder support. And variety of ways to win – you want to make sure that there's more than one lever you can pull in case circumstances change. In my experience, if you have

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all three of those checked off, you're guaranteed victory. If you're missing one of them, there's a good chance you're going to lose. We're extremely judicious.

In terms of our approach, I have no ego with respect to these activist pursuits. I don't need to claim victory or get credit. I try to work behind the scenes. I tell every one of these CEOs that they can be the hero, and we'll be their biggest advocate, if they do what we want them to do. Instead of going on TV and forcing people or embarrassing people, I find it much more effective when I give them a chance and I treat them with respect. We can go hard at somebody if we have to, but in my experience you convince people to go along with you a lot more successfully if you treat them the right way.

**G&D:** How is JANA Partners structured to conduct activist investing?

**BR:** We run our activism activities like a machine. It's what these guys do every day, all day long. We also bring in industry partners in all of these situations; so we're not just financial guys. We bring in industry operators who have greater expertise and track records than existing management teams, so it's very hard for the management teams to argue against us when they're arguing against people who are better thought of in the industry than they

are.

**SO:** When we become involved in situations, we typically are working with industry operators who are helping us carefully analyze the situation and are on

***“In terms of our approach, I have no ego with respect to these activist pursuits. I don't need to claim victory or get credit. I try to work behind the scenes. I tell every one of these CEOs that they can be the hero, and we'll be their biggest advocate, if they do what we want them to do.”***

standby to become board members if necessary. Given our successful track record and collaborative

reputation we are able to attract very accomplished, experienced, and successful value creators who get a very good reception when we do bring them to companies or run them for slates. For example, when we were involved in CNET in 2008, we ran a slate of directors to help turn the company around. We had very qualified people like John Miller, who had run AOL, and Julius Genachowski, who only months after being on our slate was nominated by President Obama to be chairman of the FCC. As with CNET, when we do run a slate, it's designed and tailored to address the very specific need at the company.

**G&D:** How do you go about finding your activist targets? Do you screen for companies through valuation screens or do you generally find your ideas through other means?

**SO:** A friend who works at another activist firm aptly described it: it's a bit like panning for gold. You need a lot of throughput to find that gold nugget. I can't say we ever know where our next idea is going to come from, but looking for activist ideas is very similar to how you would look for traditional investment opportunities in public equities. There's screening, reading research reports, talking to industry operators, talking to companies about their competitors, and bench-

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marking peers. Ideas can come from other shareholders calling and from following events that create opportunities such as an announced acquisition that doesn't make sense for shareholders.

**G&D:** Mr. Rosenstein, you said that last year was the strongest environment for activist investors that you had seen in your career. Do you think that's still the case, and why is this?

**BR:** I do. I think there are a couple of reasons for this. In terms of opportunity set, there are a lot of companies that are undervalued. I find stocks at very reasonable prices. I think that you still have a dynamic today that exists where a lot of companies are worth a lot more than where they're trading and where they would trade as private companies. I also think balance sheets are very healthy with lots of cash. You have financing rates that are very low. You also have the dynamic where companies and managements are having difficulty generating internal growth and so they're as open to value creating ideas as they have ever been. That's from an opportunity set standpoint.

Then, if you think about the environment for activism and the market's perception of activism, we don't face the kind of fights that we used to face. Ten years ago, I'd show up in front of a company and they would

sue us or put a poison pill in place. We don't get any of that anymore, because the companies have come to realize that all they're doing is alienating their own shareholder base and it's counterproductive. We hire the same bankers and lawyers all the time and we know what they tell management teams, at least in our case. They tell them, "You can't ignore JANA. They do their homework, they come up with good ideas, they're really tough, they're not going to go away, and you're better off just trying to work things out with them." I think those two broad dynamics continue to create a great environment for what we do.

**G&D:** Has the recent increase in funds with activist strategies made it any tougher for you to find your ideas?

**SO:** There really aren't that many activists, and there certainly aren't that many activists with a 12-year track record of collaboratively unlocking value the way that we have. There are also not that many activists that focus on the market cap size that we have participated in (\$10-\$20 billion), particularly in the past two years. It is actually much less competitive today than it was prior to the financial crisis when everybody was an activist investor. Yet the opportunity set today is very attractive for activism.

**G&D:** What, in your opinion, is a driving motivation behind the subset of corporate America management teams that have a penchant for limiting or destroying value for shareholders? Is it related to self-preservation? Empire building? Disengaged boards?

**SO:** It's very difficult to answer because it runs the spectrum. You sometimes have companies with good operators who think they're doing things that make sense for shareholders, but they may not be as experienced navigating the capital markets or as thoughtful about ways to increase the value of a stock. You also have situations where CEOs or boards are not prioritizing the right things. Some may be interested in growing at the expense of unlocking value. Other times you get people in situations that are not competent enough to execute the appropriate strategy to maximize value.

**BR:** A big part of the problem is that the incentives are all wrong. If these were family businesses and they owned all the stock, they probably wouldn't be making a lot of the decisions that they're making. But they own very little stock and most of the stock they own has been given to them or is in the form of options. Their current compensation is probably more valuable and important to them. As

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*"...we don't face the kind of fights that we used to face. Ten years ago, I'd show up in front of a company and they would sue us or put a poison pill in place. We don't get any of that anymore, because the companies have come to realize that all they're doing is alienating their own shareholder base and it's counterproductive."*

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## JANA Partners

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***“If you went back and looked at the activist situations we’ve been involved in, and you were to categorize them, they are actually fairly balanced among capital allocation, capital return, blocking M&A deals, separations or divestitures, buybacks, sales of companies, and operational turnarounds. The common thread is that we advocated steps that best positioned the companies to create value.”***

a result, the incentive is to run a bigger and bigger company. The bigger the company you run, the more you can justify higher compensation levels and it makes you feel like a big shot in town. The incentives are all perverse. I think ultimately when you start to point out irrefutable facts and you get shareholder support they see your point. I would say in most cases, management is trying to do the right thing, but they’re either blinded or they are not necessarily always looking to maximize value. They’re just going about their business every day and they’re lost in the forest a little bit. But you also have some people who are just not thinking about things the right way and are thinking about themselves and not the shareholders. They may protest and say that’s not the case but it is. It’s not until someone like us shows up and they feel threatened that they actually move. The proof is in the returns we generate. In virtually every situation, the stocks have reacted extremely positively and not just short-term bumps, but companies have been rerated. All of a sudden companies go from being value destroyers to value creators.

**G&D:** Recently, JANA has pushed for spin-offs in several companies. Is that simply a coincidence, or do you prefer to deal in spin-offs?

**SO:** We like to find situa-

tions where assets are held in inefficient structures, either because there is a more appropriate structure to own it in like an MLP, or you’re combining assets that don’t make sense together. I think it’s actually a coincidence that we’ve had a few in a row that have been more spin-off focused. If you went back and looked at the activist situations we’ve been involved in, and you were to categorize them, they are actually fairly balanced among capital allocation, capital return, blocking M&A deals, separations or divestitures, buybacks, sales of companies, and operational turnarounds. The common thread is that we advocated steps that best positioned the companies to create value.

**G&D:** One oft-heard criticism of activist investors is that you are simply ‘pulling value forward’ and harming a company’s future prospects. How would you respond to this characterization?

**SO:** As long as you’re doing something that doesn’t harm the value of the company, accelerating the benefits to shareholders is exactly what creating value is all about. The best example, of course, is buying back stock. If you have a great long-term story and a value-creating plan ahead of you, why would you wait and buy back stock after the market fully reflects the value? From a capital allocation standpoint, you want to buy

back stock ahead of all that. If an activist is pillaging a business for some kind of short-term gain, then that’s problematic, but if they are advocating steps that make the stock more valuable, then they are doing exactly what the board and management are supposed to do. If an activist were harming a company’s future prospects every time they showed up at a company, they would not be successful winning over shareholders who may end up owning the stock after the activist has sold and moved on.

**G&D:** Is there any mistake from your career that might stand out or something that you really learned from them that sticks with you today?

**BR:** I’ve made so many mistakes I can’t even think about it. I’ll give you one thing that’s not an investing concept, but something that I’ve come to realize that might be helpful. Being polite to people and treating people with respect is good business. It’s not just a good thing to do, it actually inures to your benefit as well. If you’re a jerk to somebody, they remember. They may never get the opportunity to pay you back, but if they do, they surely will. I’ve had more instances where I’ve interacted with somebody I don’t even remember, perhaps 10 years prior and this person shows up working for a potential investor or is in-

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volved with the company and they say, "You were really good to me. You were really nice to me. I didn't forget that." And they've invested with us or they've helped us get a company to do something. To me there's no upside to treating people badly.

**SO:** When I was working in investment banking, I had this naïve and mistaken view that if you have a good idea that a company should pursue, it will automatically be adopted and pursued. Changing the status quo at a company isn't easy and sometimes requires more than just logic.

**G&D:** Do you have any advice for the readers who are keen to get into investing or activist investing?

**BR:** Go to places where you can learn. You can learn from every experience, but just provide yourself with the best opportunities to work with people who you think are smart and who you respect. Maybe the world's changed and you can go right into the hedge fund space today, but I still think there's something to be said for having more of a fundamental background, getting training at an investment bank or private equity firm, and then moving into the principal side and the public markets. I think that's a good way to access it. But again, maybe hedge funds are hiring directly out of business school. We don't

hire people unless they have significant work experience. I don't necessarily care that they went to business school, but they've got to have significant work experience at an investment bank and another hedge

***"Being polite to people and treating people with respect is good business. It's not just a good thing to do, it actually inures to your benefit as well. If you're a jerk to somebody, they remember. ... To me there's no upside to treating people badly."***

fund or private equity fund, and probably five plus years of experience before we'll bring them in as an analyst here. Don't be afraid to make changes and jump. If I thought about the downside, I wouldn't have done half the things that I did. And after the fact, as I sit here, I think I must have been out of my mind to do

some of these things. Just take chances, go for it, and don't look down.

**SO:** Investing is a lot harder than Columbia Business School. A hypothetical 'A' in the investing world, the point at which you are performing at the highest level, only requires being right more than half the time. The truth is investing can be very frustrating, difficult, unpredictable, and grueling. So you should only pursue the career if you have the passion, if you're intellectually curious, and if you're committed to it, because at every turn, you can be very quickly humbled. That's the nature of the business.

**G&D:** Mr. Ostfeld, you started with an entrepreneurial background and ended up in a career in investing. What advice would you give students who are interested in both investing and being involved in an operating business?

**SO:** If you learn how to invest and manage money that's portable to anything you want to do.

**G&D:** Mr. Rosenstein and Mr. Ostfeld, it's been a pleasure speaking with you.



Pictured: Bill Miller at CSIMA Conference in February 2012.

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## Daniel Krueger



Daniel Krueger

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**York that manages over \$3 billion. He is Co-Portfolio Manager of Owl Creek's Flagship Funds and is the firm's Global Head of Credit. Prior to Owl Creek, Mr. Krueger worked in distressed debt at Chase Securities and Angelo Gordon. Mr. Krueger earned his A.B. from Harvard College and his MBA from Columbia Business School.**

**G&D:** What was your introduction to investing?

**DK:** When I was graduating from college, I had no idea what investment banking was, but I knew that all of the smart kids were going to New York to do it, so I figured I would join them. I came to New York and worked for five years at Chase in investment banking and private equity, as well as on the distressed loan desk. As a junior analyst in the healthcare group, I vividly remember my boss and me working on a proposed M&A deal between two companies that had stock prices that were trading pretty close to zero. What I had learned in analyst training, and what had been reinforced through that point in my career, was that the total enterprise value of a company is the sum of its debt, plus the number of shares times the market price of the shares, minus cash. But that math didn't really work in this situation. It was very clear that the math had broken down, and it was because these were distressed companies where

the debt was worth less than face value and the equity was trading at option value. I noticed that some representatives of a distressed hedge fund that owned the bank debt of one of the companies were sitting silently in the back of the room at every meeting

**"It was very clear that the math had broken down, and it was because these were distressed companies where the debt was worth less than face value and the equity was trading at option value...it was very clear that [the creditors] were in charge, not the stockholders."**

and, even though they were creditors, it was very clear that they were in charge, not the stockholders. As a junior analyst, a year out of college, I found that dynamic very interesting and very intellectually stimulating. That gave me a taste for

distressed. I really enjoyed the complexity, the way that different people had different motivations, and that the power shifted from equity holders to creditors in such situations.

I eventually progressed to a distressed analyst position on the loan desk and then, against the advice of my colleagues, decided to go to business school. I went to Columbia Business School in 2000. Right around that time, the default rate had started to ramp up. Everybody told me, "Krueger you're being an idiot. Why are you going back to business school? You're picking the exact wrong time to go. You're going to miss the entire cycle." I figured they may be right about that, but I planned to be doing distressed for a really long time, not just for the next few years. I thought the tools I could gain in business school outweighed not being able to work on a few distressed credits over the next couple of years. Luckily for me, they turned out to be only partially right – although the default rate had moved materially higher while I was in business school, there was still a lot to work on when I got out, including Enron, Adelphia, WorldCom, and others. I started working at Owl Creek part-time during the second semester of my second year at Columbia Business School and stayed on full-time after graduating. So I've been here for almost

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11 years.

**G&D:** How did you make the decision to join Owl Creek, a start-up fund at the time?

**DK:** During the summer between my first and second years of business school, I worked at Angelo Gordon, which was a leader in distressed debt investing. I really liked my experience at Angelo Gordon. Those guys have mostly moved to different places now, but Jeff Aronson and the other members of the team are some of the smartest guys I've ever been around. They weren't hiring full-time analysts at the time, so they did me a big service by introducing me to other people like Jeff Altman, who is the Managing Partner of Owl Creek. When Jeff gave me an offer, it was really a no-brainer because I was joining somebody who already had a tremendous pedigree and background (from his time at Franklin Mutual working with Michael Price), who was a known money-maker, and somebody from whom I would learn a lot. I was getting in at the ground floor, so I looked at it and thought, "This is great, if it works it's going to really, really work and I would have been the first analyst that he hires. If it doesn't work – I'm twenty something years old and single. I'll go find another job." Luckily for me, it did work and it's been a great ride over the past 11 years, during which we've seen a cou-

ple of major distressed cycles. I've certainly learned a lot from Jeff since I joined him and I've learned a lot from being in this position. I'm now a Co-PM of Owl Creek's Flagship and Credit strategies and Global Head of Credit.

**G&D:** Could you share some of the unique aspects of distressed credit investing that you particularly appreciate?

**DK:** I feel very fortunate to work in distressed debt, especially in schizophrenic markets like these where there is massive volatility all around the world. This is an event-driven investor's dream, and no style of value investing is more event-driven than distressed, in my opinion. I always approach things with the same mindset asking myself: "What is it that I don't know, and do I really know any better than the next guy?" What I love about credit, and distressed in particular, is that you have built-in events that you can analyze. For example, here at Owl Creek, most of our best investments are ones that we never need to sell. We'll buy loans or bonds and then get taken out for cash at maturity, or there will be a liquidation. There's an element of separation from macro events. We may buy a bond at 80 (meaning that the market price equals 80% of the face amount) that matures in a year, knowing that while the market may move over the

next 12 months – Greece may do this, the Japanese Yen will do that, China may have a hard landing or a soft landing – the liquidity of the issuer, which we spent extensive time analyzing, is almost entirely independent of those things. I know that I don't need other investors in the market to pat me on the back and say, "Good job. That's a smart investment and now I want to make it too." The treasurer of that company will either wire us the money at maturity or not. If they do, then we know exactly what our return profile will be – the 20 points from 80 to 100 plus the coupons. That's a huge asset to have in investing – these defined, built-in events.

We take risk for a living, all investors do, and we are comfortable with that. What I like about the distressed asset class, though, is that the risks we are taking are concentrated around the things we are analyzing, leaving fewer unanalyzable risks to worry about. Your results should, over time, more accurately reflect the quality of the work that you do and the soundness of the investment thesis, as opposed to other big-picture things that can make valuations move up and down every day.

**G&D:** Are you involved at all in the equity side of things?

**DK:** I will occasionally

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***"We take risk for a living, all investors do, and we are comfortable with that. What I like about the distressed asset class, though, is that the risks we are taking are concentrated around the things we are analyzing, leaving fewer unanalyzable risks to worry about."***

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work on equities. I head up the credit side of the portfolio and my colleague, Jeff Lee, heads up the equity side and we both report to Jeff Altman. But there have been periods of time over the past 11 years where there has been less to do in credit. Distressed is a cyclical business and you need to know when to really press your bets and you need to know when to walk away. The trick is that in those times when you are supposed to be loading the boat, it usually makes you sick to your stomach to add risk, so it's easier said than done. But in those periods of time when we are doing less in credit, I might work on equities.

The analyst team here is pretty fluid between credit and equities. You don't really notice a difference in terms of the conversations around here, whether you're talking about a credit or a stock. It's all about: "What is causing the mispricing in the market price? What advantage do we think we have in terms of our view? How high is our conviction level? What is our margin of safety for being wrong?" The answers to those questions help us decide whether an idea will go into the portfolio or not, and, if it does, what size it should be. The framework for analyzing risk/reward is, to us, identical no matter what type of security you're looking at. Namely, you need to understand the range of possible outcomes

for a security, which scenarios are more or less likely to occur, and how much money you can make or lose in the different scenarios. Once you've established a proper framework, the answer jumps off the page, and it's a matter of deciding if the opportunity is attractive enough to go into the portfolio or not.

**G&D:** Do your analysts focus on specific sectors or are they generalists?

**DK:** Most people here start off as a generalist but over time develop expertise in certain industries. In terms of division of labor, it makes sense to have somebody who's already looked at five media companies look at the next one, if they can. On the other hand, some of the most interesting conversations we'll have around here are the ones where we get a fresh set of eyes looking at an industry or company, which I think is what really separates good investors from average ones. We don't think that we're the smartest people that work at hedge funds. If we've added a secret sauce to our portfolio construction, it has come through our group dynamic, constantly reminding ourselves that we can be shocked by things that were previously unknown, and reminding each other to remain intellectually honest. If you use intellectual honesty to ascribe probabilities to different sets of events, over time smart investors should do

well if they stick to their discipline and don't get carried away with the sea of noise that exists in the financial media.

**G&D:** Could you talk a bit about idea generation at Owl Creek?

**DK:** Ideas are generated by everyone, from Jeff Altman at the top to the summer analyst. We don't take a whole lot of pride in idea ownership here. We're trying to make money with the capital that we invest. If an analyst comes up with an idea, they'll bounce it around with the PMs and other analysts, getting different people's perspectives. As an example, one of our analysts was a bankruptcy lawyer for a number of years before going to the buy-side and his niche at Owl Creek is to evaluate the legal component of our ideas – mostly on the credit side but occasionally on the equity side as well. So you'll usually have multiple people chiming in on an idea. Our belief is that the more people you have taking a look at something, the higher the probability that you either eliminate what is only a mediocre idea or recognize when you've got something pretty special. To us, that's just simple math. I hear some people at other places argue that if you open up the discussion to too large of a group, then you make it too hard to get ideas into the portfolio, because it's easy for one or two people

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**"If you use intellectual honesty to ascribe probabilities to different sets of events, over time smart investors should do well if they stick to their discipline and don't get carried away with the sea of noise that exists in the financial media."**

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to torpedo the sentiment. But I think that's exactly the point. There are thousands of securities out there that we can invest in today that are "pretty good," but if that's the burden required to get into your portfolio, then what are you really doing to differentiate yourself? You know when you have something special when four, five, or ten smart people can sit in a room and agree that the risk/reward is uniquely good, and I'm fortunate at Owl Creek to be surrounded by such people.

**G&D:** When you've fully analyzed something and you're comfortable that it's still attractive, do you gradually build a position in the name or do you establish the full position immediately?

**DK:** As you can imagine, we pass on more than 90% of the things that we look at. If it does pass the initial smell test, analysts will come into my office if it's on the credit side or Jeff's office if it's on the equity side, and we'll bounce the idea around a little bit. If it continues to look interesting, we'll usually get the whole investment team together to talk about it. The last component is to decide that we're ready to dip our toe in. We very rarely will make something a full position right off the bat. Usually what we prefer to do is make it a small- to medium-sized position but leave plenty of room to add to it

if the price moves against us. If you think about it mathematically, in a perfect world, if you're looking at a bond that's trading at 50 cents on the dollar and you pass on it, if it moves to 49, it should be slightly more attractive now, assuming all else is equal. And then at 48 it's even slightly more attractive, etc., etc. Eventually it could get to a point where you think it's attractive enough to go into your portfolio, and let's say that's at 43. Now, you couldn't possibly want to make it a giant position at 43, otherwise you should have bought some at 44 because the risk/reward isn't that dramatically different. So we'll usually dip our toe in to start and let the risk/reward come to us.

Our best investments are ones where we dip our toe in at, to take the prior example, 43 cents on the dollar and a few days or weeks or months later it's trading at 31. In distressed, that happens all the time. Bonds can move up and down by 10 points on headlines like litigation outcomes, a busted financial covenant, the sale of a business, or something else significant, but sometimes the price can swing around on no news at all. If the latter happens, then you can load up the boat at the lower prices. Lehman Brothers is a great example of irrational price moves – that bond started trading in the 30s the week that it filed, and then it was in the 20s and people

thought "Why did I buy in the 30s?" Then it was in the low teens and they thought, "Wait a minute, what am I missing? I must not be getting something." Then the CDS [credit default swap] auction (which occurs a month after a default) priced the bonds around nine. Granted, Lehman's a very bizarre animal because that was of course the biggest bankruptcy of all time. A huge amount of debt all of a sudden went from investment grade hands to looking for a home in the distressed market, which was not nearly large enough to absorb that amount of paper. But that's the point: a good investor needs to understand that the value of a security is built from the bottom up, using good analysis, and that markets follow valuation. Not vice versa.

**G&D:** Since it's more likely that a judge or some other third party will get involved in the distressed space relative to non-distressed credit or equity investing, how do you get comfortable with the risk/reward of your investment ideas given this additional layer of uncertainty?

**DK:** That's a great question. You're teeing up an answer that is very important to get across in order to properly describe the opportunities in distressed investing. First of all, uncertainty, to us as distressed investors, is our friend, be-

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Pictured: Michael Karsch of Karsch Capital Management at CSIMA Conference in February 2012.

**"...a good investor needs to understand that the value of a security is built from the bottom up, using good analysis, and that markets follow valuation. Not vice versa."**

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cause uncertainty is something investors will pay to avoid – sometimes pay a large amount. We love situations like Lehman which we call “high uncertainty, low risk.” In those few weeks after Lehman filed, any person's analysis of what the ultimate recovery would be on those bonds had enormous holes in it. Every good analyst who was looking at that situation had dozens or possibly hundreds of unanswered questions. But we knew these would eventually get answered over the coming months, quarters, or years.

What's interesting about the process, and about the distressed asset class, is that occasionally you'll be given an opportunity to buy something at a price where even though you have a hundred unanswered questions, you realize that regardless of what the answers are, you probably can't lose a lot of money, and most of the time you will make a little or a lot. This obviously assumes that you correctly understand the capital structure, which is key in distressed investing. Some people looked at a Lehman Brothers holding company bond trading at nine cents on the dollar and thought about the fact that if you deconsolidated the balance sheet and calculated what the assets of the holding company were, which included individual assets, as well as tens of billions of dollars of intercompany receivables from other Leh-

man entities, you knew that the numerator in a recovery calculation was going to be a giant number.

At that point the analysis turns to the denominator – the other unsecured claims. In that regard, some people were talking about these really scary things, swap contracts, guarantee claims, customer losses, etc., and it sounded really bad. But what you were supposed to be doing is building your waterfall model, understanding all of the different variables, and coming up with a realistic range of outcomes from bad to good. If you had done this, you would have realized that even in the worst possible scenario, you still got an answer where you're not going to lose a lot of money from nine cents on the dollar because you were essentially the most senior part of the waterfall, and where across most of the range of outcomes you would be making very good risk-adjusted returns. To put numbers around this, if your base case showed a recovery of 30 cents on the dollar, your estimated claims, the denominator, could be twice as bad as in your base case and you'd still get a recovery of 15 cents on the dollar and earn a double-digit IRR over five years. That's a pretty massive margin of safety. So high uncertainty, low risk is a subcategory within distressed that we love.

Secondly, we don't think

that a judge's decision on litigation is an unanalyzable blue cell. We talk about such things every day here at Owl Creek. We also hire outside counsel to chime in on these issues, which is money very well spent when considering we manage a few billion dollars of credit investments on the long and short side. We run a pretty concentrated book. We're not the sort of investors that want to sprinkle our assets across 100 different ideas. Our 10 biggest positions represent the vast majority of the credit portfolio, so we know those 10 positions extremely well and we have very high conviction in them. I can assure you that as they're trading lower, with very few exceptions, we're not selling them and running for the exits, we're buying more. And when they trade higher we try and remind ourselves of the need to have the discipline to start to sell things as the risk/reward becomes less favorable because of price moves. This buy and sell discipline sounds pretty simple, yet all of us know that it's a lot easier said than done. We try to use the group dynamic to remind ourselves of that ongoing challenge and to make sure that we don't get caught in a trap where we fall in love with our own positions.

**G&D:** You mentioned at the CSIMA Conference last year that it's very important

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**“...uncertainty, to us as distressed investors, is our friend, because uncertainty is something investors will pay to avoid – sometimes pay a large amount. We love situations like Lehman which we call ‘high uncertainty, low risk.’”**

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to stick to your investment process. Could you describe Owl Creek's investment process and how you built it over the years?

**DK:** Generally speaking, we're big believers in the notion that you need to focus early on in the analysis on the major drivers of what's going to make or lose you money in the investment, and avoid the temptation to simply go out and gather a lot of data. The reason I say that is not only because it's a waste of time to do the latter, but in the worst examples, extraneous data are a red herring that can cause a person to draw an incorrect conclusion. There's an interesting book written by the CIA for their internal use that talks about this concept. The book can actually be read online for free on the CIA's website — just Google "CIA intelligence analysis book" and you should be able to find it. In it, it describes how the human mind can keep very few concepts in mind at any one time. As an example, the book asks the reader to try to multiply any pair of two-digit numbers in one's head, say  $47 \times 63$ . This is a task that is easy to do with a pen and paper but is tricky to do in one's head because it's hard to keep all the pieces of the puzzle at the forefront of one's mind together at the same time.

In that regard, what I say to the students in my class as a tip, and something that we do around here, is to try

and build the model very early in the process. If I ask you to analyze a bond that's trading at 52 cents on the dollar, and let's say it's a company that makes TVs, your first inclination is to read a hundred things about the company and go talk to them and do a bunch of calls and other stuff. That's all important work to do, of course, but I might suggest to you that you should do a little bit of work first, and then you should start to think about what's going to make that price look cheap or expensive. Think about the variables that go into the analysis: sales growth, margins, capex, whether they win or lose a contract, things like that, and then build your valuation model in Excel, and think about what the blue assumption cells are. Without doing a lot of hard work, you won't yet have good views about what the right numbers are to plug into your blue assumption cells, but you'll then go out and talk to the company and be able to ask targeted questions that specifically address the blue cells. Over time the model will evolve and become more refined, and you'll be building on earlier work and making *improvements*, not just gathering more facts. What I found in my time doing this and going to conferences or sitting in small group meetings, is that a lot of people will have an hour with the CEO and ask about a lot of industry jargon that could only possibly matter if you knew absolutely all

there is to know about everything else in the universe, and these were the last few things you didn't know. But most of the time there's two or three big things that really matter and it makes sense to focus the research effort there.

In distressed, specifically, sometimes you can have a situation where the outcome is dependent on a single variable. For example, does the intercompany loan exist between Subsidiary A and Subsidiary B? It's either there or it's not, and if it's there your bonds are worth par, and if it's not your bonds are worth zero. In that scenario, does it really make sense to ask why ARPU at the holding company was down 2% in the third quarter? That's an exaggeration, of course, but the point remains the same.

We also do a lot of primary research. It's a cliché obviously, but then again there are a lot of things in investing that people can agree are important but which they don't actually do. It's not enough to just hear from the sell-side that a certain contract has very loose language surrounding the termination rights of a large customer. You need to go find that contract, if it's in the public domain, and you need to read it. Maybe you need to ask a lawyer who's an expert in contract law to read it as well and give you his or her opinion, especially if that's a big part

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***"This buy and sell discipline sounds pretty simple, yet all of us know that it's a lot easier said than done. We try to use the group dynamic to remind ourselves of that ongoing challenge and to make sure that we don't get caught in a trap where we fall in love with our own positions."***

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of the risk/reward.

The process for analysis in distressed is very tedious, very labor intensive, and very boring. Sure, parts of it can be action-packed, like when you're sitting in court and the judge walks out to give you the answer to the key question on your investment, and you know the bonds will move 20 points in a few minutes, you're just not sure if it will be up or down. But to get to that place you need to have read two credit agreements, 16 indentures, understood the financial covenants backwards and forwards, modeled out the company's operations quarter-by-quarter for the next eight quarters to understand exactly when they'll run out of cash, looked through 8-Ks, prospectuses, regulatory filings to look for intercompany loans or special dividends that could have been paid up or down in the structure, etc. We're generally looking at big organizational structures that have a lot of different pieces, which increases the complexity and workload, but also maximizes the chances of finding mispriced securities.

Take a company like TXU. This was the largest LBO of all time, has a huge amount of debt, multiple layers of the capital structure (subordinated, senior, and secured) at multiple different subsidiaries with cross-guaranties, funds flows in many different directions, tax issues that arise from the corporate structure,

etc. — these are things for which you need a special toolkit to analyze. You need to be willing to invest the time to look through all of the documents and, let's not forget, this is all on top of the valuation work that every analyst would need to do to analyze an equity. So you need to be skilled at valuation, but you also need to be strong in your understanding of all of the structural aspects of distressed investing. Then, if that weren't complicated enough, you need to understand the motivations of different people: What does the LBO sponsor want to do? Do they want to extend their option on their out-of-the-money equity or file the company tomorrow? What currency might they have with which to get a deal done with creditors? What does management want? What do employees want? What do competitors want? How are competitors going to react if this company goes into bankruptcy? For example, one of our current investments is in an industrial company. A few years ago when the company was distressed and their EBITDA was negative, their competitors went out of their way to lower prices to make it that much worse and try and force the company to liquidate. The whole industry got screwed up because of these pricing actions. That didn't work and the company is still in business today. Pricing is now going through the roof in that industry, even in a

mediocre to bad economy, because it has a lot of catching up to do.

Another thing we do as part of our investment process is remind each other to tune out the market noise that a lot of us have been tacitly trained to tune in. I think a lot of people mistakenly think the task in investing is to try to predict in which direction market prices will go next. It's a subtle difference, but I think it's a mistake from the start to think about it that way, as opposed to thinking about potential outcomes and the payoff structure across that range of outcomes. What the great investors that I respect most recognize is that the market is not some wild beast in need of being tamed, but that mispricings in the market are what create the opportunities. And if your analysis causes you to have a certain view, long or short, you cannot expect that every day, or every week, or even every year you will be rewarded for your view. We try to use our team environment to remind ourselves of that, and it's easier to stick with one's conviction when you have a lot of smart people around you also buy into the investment thesis, as opposed to being alone in your view.

**G&D:** Can you talk about a current investment idea that you like?

**DK:** There's a company

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**"I think a lot of people mistakenly think the task in investing is to try to predict in which direction market prices will go next. It's a subtle difference, but I think it's a mistake from the start to think about it that way, as opposed to thinking about potential outcomes and the payoff structure across that range of outcomes."**

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called Aiful where we own a lot of debt. It's a Japanese company that does consumer finance. They provide consumers with small micro-loans, generally equivalent to a few thousand dollars. This business doesn't exist in the U.S., where credit cards serve this purpose. The background here is important, so let me spend a couple minutes on that. The reason this company was interesting to us initially was because they got into trouble a number of years ago when the Supreme Court in Japan ruled that Aiful and certain competitors had been charging an interest rate above the legal limit. You might ask yourself why they would do something that's illegal. In Japan, there are different interest rate caps based on different types of businesses and these companies always pushed the envelope in terms of what category they fell into. The Supreme Court came back and said, "You're wrong and you've been acting too aggressively all these years." Overnight, giant contingent liabilities popped up for these companies because their former customers would now be able to sue them to recover damages for this excess interest. The size of this new liability caused Aiful's bonds to eventually trade down as low as the 30s around the summer of 2009, for bonds that were maturing in a year or two.

We didn't necessarily love

the company, and we certainly didn't believe that that liability was fictitious or that it should be ignored. But what we did recognize was

***"You need to be willing to invest the time to look through all of the documents and, let's not forget, this is all on top of the valuation work that every analyst would need to do to analyze an equity. You need to be skilled at valuation but you also need to be strong in your understanding of all of the structural aspects of the distressed asset class. Then, if that weren't complicated enough, you need to understand the motivations of different people..."***

that the liability was not going to "mature" and become payable anytime soon. In that respect, we viewed our near-dated bonds as quasi-senior to these liabilities. Over time, people

would sue these companies and drain out cash, and, indeed, you could see in their historical financial statements the cash coming out of these companies. What we liked about this dynamic and the risk/reward of the position at the time is that their assets were largely unencumbered, meaning they had not been pledged as collateral to other lenders, and, thus, the company was free to use these assets however it wanted. We reasoned that one option for the company was to sell those assets and use the proceeds to pay our bonds as they came due. Another option was to get us to voluntarily extend our bond maturities into the future if they granted us the assets as collateral. The latter was a deal we would have done because we would have gone from owning unsecured bonds with a lot of downside in the event of a default to being secured and very well protected. Ultimately, the path chosen by the company was one where the assets were pledged to the banks to get them to extend their maturities a number of years. As soon as that was done it cleared a pathway for our bonds to get repaid at par upon maturity.

Fast forward to today – what we own now is that bank debt which got extended, which is a different bet. The original idea was a liquidity bet where if we got it wrong we were going to

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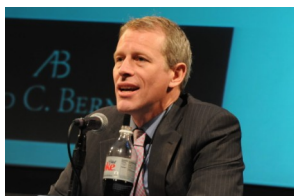


Pictured: Bruce Greenwald at Graham & Dodd Breakfast in October 2012.

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Pictured: Whitney Tilson of T2 Partners LLC at CSIMA Conference in February 2012.

**“...it's only with the benefit of understanding your downside that you can start to dream about the upside.”**

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get creamed in terms of our recovery, but where we thought our probability of getting paid off at par was good enough to warrant the downside risk. Today it's the opposite – it's a valuation bet, not a liquidity bet, where we think our downside is limited even in the worst case outcome. We think that the assets of this company, in our base case, should create enough value for this bank debt to get back par. In addition to that, the fundamentals of the company have been improving because the cash outflows from the excess interest liabilities have been coming down recently. We think that the market has been overly cynical about the ability of this company to dig itself out of its hole operationally. There's a maturity date in the summer of 2014, so you'll eventually get an answer to the question. In our view, it has very good downside protection because it is secured debt, and you've already built in a large margin of safety just in the discounted price from par down to 60, where it trades today. The upside/downside is very compelling, meaning you can make enough money on the upside owning it at 60 – i.e. +67% on your money – to justify the downside risk. That's very distinct from buying a bond at 100 cents on the dollar, where your valuation work may indicate that you're “covered” on valuation by 67%, but you don't keep that upside because a bond is always

capped at par plus interest; i.e. the shareholders are getting that 67% upside.

Lately, in this environment, we love buying 1<sup>st</sup> lien bank debt. It's very comforting to know that when you're a secured creditor, you are first in line and that, almost always, you will get some recovery on your paper because it's highly unlikely that the residual recovery value on the assets after bankruptcy fees and liquidation fees would be zero. So if you're comfortable that you'll have some recovery in a worst-case scenario, then the upside/downside analysis becomes really important. What we say to each other around here is that it's only with the benefit of understanding your downside that you can start to dream about the upside. For example, if you have 1<sup>st</sup> lien bank debt at 50 cents on the dollar, and you think the ultimate recovery can be somewhere from 30 to 90, you would probably buy it because your upside is 40 points and your downside is 20 points, so you have a 2-to-1 upside/downside ratio. Your expected return, assuming a normal distribution, is +20% (from 50 to 60). Now imagine that, on no fundamental news, the bank debt trades down 20% to 40 – your upside/downside is now dramatically different, even though the price is down “only” 20%. Think about it, from 40, you've got upside of 50 and downside of 10, so your upside/downside has im-

proved from 2-to-1 to 5-to-1. However much you liked it at 50, you should really love it at 40. I think a lot of people miss this relationship because they are overly focused on their base case outcome and the return that one scenario would generate rather than thinking about the *range* of possible outcomes. If you're not thinking about how much capital you have at risk, i.e. the downside, then I think you're leaving out a very important part of the equation.

**G&D:** What is another investment that you like currently?

**DK:** Sometimes distressed opportunities come in the form of equities, and we've played a lot of distressed equities over the years. We like buying out of the money options at a cheap price, and that's what you get today owning Leap Wireless equity. In fact we would argue it's not even “out” of the money. Leap is a wireless company that trades at a little over \$6 a share. The market value of equity is around \$500 million, but that represents only a sliver of the total enterprise value. What we love about this idea, and the reason we bucket this as a credit idea, is that you need to understand the capital structure and the liquidity of this company in order to understand the risk/reward. We think the liquidity profile is decent enough that it doesn't need

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to file for bankruptcy any-time soon, and you've got a very large shareholder as Chairman of the Board, so you shouldn't see management proactively filing the company to the detriment of shareholders. So our starting point is that we've got an option that will survive for at least a few years.

Then we think about what our asset is and what it could be worth in different scenarios. A lot of people like to look at EBITDA multiples for this company, but I think that's really missing the point, because Leap's most important asset cannot be discerned on the income statement, but rather on the balance sheet. It's not how much EBITDA they generated over the past 12 months, it's the spectrum that they own, as well as the subscriber base that they have and all the plant and equipment that they've accumulated over time. If you think about it that way and then you reason that other people are buying and selling the stock based on EBITDA multiples, it strikes you that you may have something interesting to look at here. We're not the world's leading experts on spectrum and we're not going to pretend to be, but we know enough about it to know that most people are in the same camp as we are in, even if they don't admit it to themselves. The traded values of spectrum over time have been all over the map.

So we've got a highly volatile asset where we've made a bet in a small part of the capital structure and we have a long period of time to find out how things end up. So, figuratively speaking, if we roll the "spectrum valuation" die and it hits on one of the upside cases, we should make multiples of our money owning this equity. You can do this math for yourself and you'll see pretty clearly that you can make two, three, four, five, six times your money in scenarios that are not pie in the sky. Plus, we get to roll that die multiple times, given the company's liquidity. If we're wrong, the stock may go to zero, but we believe even that is questionable given management's expectations of turning the corner and getting to positive free cash flow. The debt trades around par, at least for now, so raising some money in a debt financing is another option for the company if they choose it. We would never make this a giant position in our funds given the downside risk. Rather, we would size it so we can live to fight another day if we roll snake eyes. The point of portfolio construction is to have enough of a mix of these in your portfolio where over time you should do pretty well if you've properly analyzed the probabilities of various outcomes and how much you make or lose in each scenario.

**G&D:** What do you think about the management team there? The company has a

ton of spectrum that it is not using and it seems surprising that the management team has not tried to monetize it sooner given its leverage profile.

**DK:** Actually, my understanding is that over the past couple of years the company has sold a significant chunk of out-of-footprint spectrum to raise liquidity, so I don't immediately agree with the premise of the question. And as I said, we think the company has a decent liquidity runway. Let's say we're wrong, though. The other possible path for this company is that they go into bankruptcy. As I say to my students on the first day of class every year, bankruptcy has a negative connotation in society, but bankruptcy and Chapter 11 exist for a reason. It exists to allow a company to transition out of its old, bad capital structure into a new, more manageable capital structure as smoothly as possible, as well as restructure operations via renegotiation of leases, supply contracts, union agreements, etc. So if Leap went into bankruptcy, theory tells you that creditors will get into a room and negotiate a plan of reorganization, vote it through, and then come out of bankruptcy and continue along its path of operations. But another thing that frequently happens in bankruptcy is that the assets get sold to the highest bidder. If that happens, and if you go back to that bottom-up

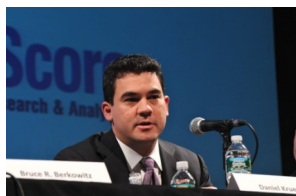
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**"[With Leap Wireless equity], you can do this math for yourself and you'll see pretty clearly that you can make two, three, four, five, six times your money in scenarios that are not pie in the sky."**

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Pictured: Daniel Krueger at CSIMA Conference in February 2012.

**“We don’t play very much at all in the new issuance market. We view that as our future supply of distressed credits.”**

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valuation work around the spectrum and other assets, you can certainly build a case for why this stock might be worth a lot of money in a bankruptcy. GGP is an example of a stock that came out of bankruptcy with substantial value. So it wouldn’t be the worst thing if this company was on the cusp of bankruptcy and the market incorrectly traded the stock at pennies on the dollar because it equated bankruptcy with a worthless stock. Clearly, you should be adding a lot more stock in that scenario if the analysis hasn’t changed much and if you thought the risk/reward was good at \$6 per share.

**G&D:** As a guest lecturer in Columbia Business School’s *Special Situations* class recently, Howard Marks showed several charts of how surprisingly consistent the high-yield market cycles are. We’ve been in a period of a lot of high-yield issuance and rich valuations for a while now. How are you positioned or thinking about taking advantage of the eventual opportunities in that market?

**DK:** We don’t play very much at all in the new issuance market. We view that as our future supply of distressed credits. We’ve seen this movie before and Howard Marks is telling you a story of how it ends – it usually doesn’t end pretty. We don’t disagree with that, but it’s important to recog-

nize that no amount of work can make an opportunity appear in front of you. The best one can hope for as the reward for a lot of hard work is to uncover opportunities that already exist, but that is not a given upfront. The reason I mention this is that we try not to get too wrapped up in trying to predict what the future opportunity set will look like. We find that doing so can sometimes cause additional, unnecessary pressure to trade.

The measure of how attractive the opportunity set is at any given point in time is how much stuff is getting into the portfolio. Right now we’ve got over 60% of our assets invested on the long side in credit, and we’ve also got a lot of exposure on the short side, so clearly we are finding plenty to do. Remember that even when the default rate is low, as it has been recently, you can still have situations where companies are getting into trouble but not defaulting, which creates opportunities for very high returns within a defined period of time – i.e. owning stressed bonds to maturity.

Like I said before, we run a very concentrated credit book. You don’t make more money by owning *more* names, you make more money by owning *better* names. So I don’t worry that we’re not going to be able to find 10 to 20 high-conviction ideas to own at any one time, not

including a lot of other good short ideas, especially when you think about the fact that we’re a global investor that can invest in any part of the world. Today, we’ve got roughly 40% of our credit portfolio invested in situations outside the U.S. on the long side.

**G&D:** Do you utilize credit default swaps (CDS) and, if so, how?

**DK:** We tend to use CDS a lot on the short side. Occasionally we use it on the long side as well. And sometimes we do both, on the same company, by using what’s called the “CDS curve” to make very precise credit bets at some precise point in the future. The on-the-run CDS contract that most people quote is the five-year contract. This represents how much you have to pay per year to buy protection against the default of a company for five years. You pay the same amount each year for five years, and if a default occurs within the five-year period, then the owner of protection gets the benefit of getting 100 cents on the dollar for the notional amount, and the protection holder returns the post-default value of the bond to the party who sold the protection. But think about it: why five years? It’s a totally arbitrary number. If you were properly analyzing the credit risk of a company, you should be able to form a view of the credit profile

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within discrete buckets of time.

Nowadays, a lot of traders will trade CDS contracts that are four, three, two, and one years out, and sometimes even shorter, in addition to the more customary five-year contract. That's very interesting to us because in very complex situations you could form the view, for example, that a company's credit risk is largely in the twelve months between three and four years from now, but not before or after that. This sort of unnatural credit curve could exist for a lot of reasons, such as how much cash the company has on its books versus the cash burn, whether it has an unfunded revolver, when it might violate the financial covenants in the credit agreement, whether it has a big subordinated bond maturity in a few years, whether it has a big customer contract that might roll off, etc.

I won't mention the name, but right now we have a position in our books where we own protection through June 20th of 2013 that we bought for 18 points upfront, but we simultaneously sold protection through September 20th of 2013 at 31 points upfront. We're long the credit risk of this company for only three months, but we got paid 13 points (the delta between 31 and 18) to take that risk. So we've essentially constructed a three-month bond that is issued on June 21<sup>st</sup> of 2013 and matures on

September 20<sup>th</sup> of 2013 for which we paid 87 cents on the dollar.

So why did we do that? We did that because this is a distressed company with bank debt trading at distressed levels, and we think that there's a reasonable probability that in the next few months, the auditors will go in to do their review and they will look at the company's liquidity profile and projections and say "no clean opinion." If that happens and they don't get a clean opinion in their 10-K, that would be an event of default under the bank agreement. We find it very unlikely that lenders would not use that as an opportunity to push the company into bankruptcy – and for good reason – because this company pays out an enormous amount of money in coupons to junior creditors every year. And every time a dollar goes to a junior creditor, that's a dollar less that the first-lien secured creditors get to keep upon a bankruptcy filing. So we think they would love to use that as a lever to push the company in.

The timeframe for that default exists before the expiration of our June protection, and if there is a default, our short and long positions cancel each other out and we keep our 13 points. On the other hand, if the company gets a clean opinion, then it will keep chugging along – we don't think there's any material risk that

they bust covenants due to financial performance before the end of the third quarter. In that case, the company would survive past the expiration of the CDS that we sold in September, so we would again keep the 13 points, as both the contract we bought and the contract we sold would have expired worthless. So we're fine with the company defaulting before June, defaulting after September, or never defaulting. If the company defaults in July, of course, we have a problem. But that's a calculated risk we are taking, and we've sized the position accordingly. I wouldn't advise you to put your entire 401K into this one trade, but within a portfolio of a bunch of different event-driven ideas, it's a good one to have because we think the ability to earn the equivalent of 15% for three months of risk, or the equivalent of 75% on an annualized basis, is a mis-priced opportunity given the facts here. As we say around the office when trying to illustrate the risk/reward of a binary-outcome idea, if we put this same trade on a hundred times over our careers, we will have done very well, even though not every time will we have made money.

**G&D:** Could you describe your strategy on the short side and how it's different from your strategy on the long side, if at all?

**DK:** In terms of doing the

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**"So we've essentially constructed [using CDS contracts] a three-month bond that is issued on June 21<sup>st</sup> of 2013 and matures on September 20<sup>th</sup> of 2013 for which we paid 87 cents on the dollar."**

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**“Let's remember that in credit – to oversimplify it – you are analyzing only two questions: First, what is the probability of a default, and second, if there is a default, what will the recovery on the debt be? Clearly the answers to those two questions depend on a thousand other questions being answered, but if you're not thinking about it that way then you're not really doing credit analysis in my view.”**

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analysis on the short side, it's the same as it is on the long side. As you might guess, we tend to short companies that aren't yet perceived as stressed or distressed. Occasionally we'll press a short when the company has already broken, but most of the time we will simply buy CDS on companies where we foresee some higher probability that things will get really messy than what is reflected in current credit spreads. Let's remember that in credit – to oversimplify it – you are analyzing only two questions: First, what is the probability of a default, and second, if there is a default, what will the recovery on the debt be? Clearly the answers to those two questions depend on a thousand other questions being answered, but if you're not thinking about it that way then you're not really doing credit analysis in my view. So as credit investors, and especially as distressed investors, we're built to analyze and opine on tail outcomes.

Japanese steel companies, on which we own a lot of CDS, are extremely leveraged, and bankruptcies in Japan tend to produce horrible outcomes. I think the average historical recovery over a long period of time has been roughly 13 cents on the dollar, much worse than in the U.S. where it's in the 40s. The steel industry as we all know is a very cyclical industry. By owning CDS we own an option that

if something bad happens – maybe supply and demand in the steel market gets out of whack because of all the new supply in China, or maybe there is a bad global slowdown – we would be paid handsomely. We don't pretend like we can predict with certainty what's going to happen, but we own an option on something happening in a realm where there's a lot of inherent volatility due to operating leverage, financial leverage, and cyclicity.

The one pushback we always get on this idea is that in Japan, whenever companies get into trouble, the banks just come in and bail them out. They say that the banks don't really do any credit analysis, it doesn't matter what a company's leverage is, what its cash flow is – if it's a big industrial company, it asks for the money and gets it. First, we disagree that this is always true, as we've seen some Japanese companies go into insolvency proceedings. Japan Airlines and Elpida are examples. I also feel like in an environment where there's already a tough economic landscape, to think that the system needs to continue to exist to subsidize the highest-cost producer of steel in the world doesn't ring true when viewed through an economic lens.

We may get this wrong, and if we do we will have lost a couple of hundred basis points on the notional posi-

tion per year for a couple of years, and we'll take the position off and move on with life. But if any of these positions end up working, we'll make many multiples of what we're investing in this trade per year to keep it on. On the short side the analysis is the same but usually the attraction is that we're looking for problems that the market doesn't give much weight to today that we think should have a higher weight.

**G&D:** You've been teaching at Columbia Business School since 2006. Could you describe the genesis of your class and whether you've seen any change in the students since you began teaching it?

DK: When they first asked me to teach the class, I said, "No thanks. I think that's a poor idea for a class because distressed investing is really the intersection of value investing (I'm not going to compete with Bruce Greenwald and all these other fabulous professors on value investing), bankruptcy law (no one can compare to Harvey Miller, who teaches that at the Law School), and turnaround management (again, something that is already taught very well)." They asked me again a year later, and I reasoned that rather than try and teach those things, I would just be the professor who gathers it together and puts it in a package that involves making money –

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making good risk/reward decisions.

I tell my students that, first of all, I truly believe the class and the skill set of distressed investing is something that doesn't only apply to distressed investors. I think it's a very useful class to have taken if you're going to work in private equity or if you're going to work in equities. How many times have we seen equity investors and equity sell-side analysts get caught in a trap because they didn't look at a company's capital structure or think about its liquidity? If you're just looking at a P/E multiple, you're not capturing a lot of other things that are important to your stock. Areas such as advisory and consulting at some time or another also touch the distressed landscape. Even if you're the CEO of a company and your company never goes into bankruptcy, your competitor might. If this happens, what is the competitor going to do? Who's going to buy them? Are they going to shut all of their plants? Are they going to slash their labor costs and use that to under-price you? There are a lot of different things that could happen. So these are all things that pop up in distressed and pop up in my class.

I've always been very impressed by the students in my class. I'm always very excited to see the progression from the first day of class to the last day. At the start of every semester, I

think it will be almost impossible to teach these 40 to 45 students about distressed investing because it's a very daunting topic and something that, in a lot of ways, you really can't teach. You learn it on the job over a number of years. I still learn something new every day, which is why I like my job so much.

**G&D:** Do you have any advice that you would give to students interested in distressed investing?

**DK:** My advice for business school students generally is that the most important asset you have at this stage in your career is your human capital, not your financial capital. Occasionally I see people worrying about who's going to pay them the most or which firm has the most glamour attached to it, which I think is a mistake. In a Warren Buffett-style of value investing, if your most important asset is your human capital, then you need to try to set it on a growth trajectory with a double-digit CAGR for a number of years. After a while, that will grow into something powerful, and then you'll have many more options. The way you do that is to, first of all, find a job working with people who you like and in an environment where you can do meaningful work and learn a lot. Certainly that's what I got when I joined Jeff here at Owl Creek. It was Jeff, me, and one of my classmates from Columbia, Shai Tam-

bor. It was just the three of us on the investing side and we were trying to make a go of it. In that sort of scenario, the world is your oyster.

In distressed specifically, like I said before, you learn on the job. A lot of people in distressed have a broad array of different backgrounds: turnaround advisors, lawyers, bankers, sell-side analysts, private equity investors, etc. So if you're a second-year student at Columbia Business School today and you think you definitely want to go into distressed, don't think that if it's not your first job out of business school that you can't find your way in eventually. When we hire people to come in at the analyst level here at Owl Creek, we expect them to have a passion for investing and a lot of raw horsepower, but they don't need to be Seth Klarman their first day on the job. They need to be people who are smart, who have the right skill set, and who we think can develop into good investors over time.

**G&D:** Thank you very much for your time, Mr. Krueger.

***“In a Warren Buffett-style of value investing, if your most important asset is your human capital you need to set it on a growth trajectory with double digit CAGR for a number of years. In a number of years that will have grown into something that's powerful and useful and something that will be even more important to you.”***

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## Frank Martin



**Frank Martin**

**“We call Elkhart ‘Omaha East’ [laughs]. I can’t think of a better place to be than in Elkhart, or a better place not to be than in New York. I don’t get the typical distractions in Elkhart. ... I think it’s a lot easier to be independent without the herd pushing you toward the mediocre middle. I know for sure it’s much easier to think independently.”**

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**After graduating from Northwestern University in 1964, Mr. Martin served as an officer in the Navy for two years. He is an avid reader, writer, and philanthropist. He is founder and chairman of DreamsWork, a mentoring and scholarship program for inner-city children. He received his MBA with honors from Indiana University South Bend in 1978.**

**G&D:** Can you tell us about your background and how you became interested in investing?

**FM:** As an investment management major, I took a course during my senior year at Northwestern on security analysis. The teacher was an adjunct faculty member, Corliss Anderson, who was one of the founders of Duff, Anderson & Clark, which was a Chicago-based municipal bond firm that has since been broken into pieces. Anderson was the perfect mix between the theoretical and the practical. He had been in the field, and he used Graham’s *Security Analysis* as his textbook. It was a watershed event for me.

But I have to tell you, unlike a lot of the investors you’ve featured in *Graham & Doddsville*, if I had any epiphany, it really occurred in slow motion. I went to Northwestern primarily to become a Navy pilot, so I was a naval ROTC student. My dream as a kid was to fly

a fighter or attack aircraft off carriers. I defaulted into my investment management career because I flunked the flight physical three times due to an astigmatism, which is a minor eye disorder. So I didn’t lend Coke machines or conduct other for-profit endeavors as the child prodigy, Warren Buffett, did.

Finally, perhaps as a means of compensation, a latent and almost insatiable desire for knowledge and wisdom emerged and I became an avid reader. I suspect I read at least 30 hours each week, between books, periodicals, and the current news. I avoid all the social media sites but am fastidious about emails.

**G&D:** Your firm is located in Elkhart, Indiana, far away from New York City, the hub of the investing world. In what ways has this been a positive for you?

We call Elkhart ‘Omaha East’ [laughs]. I can’t think of a better place to be than in Elkhart, or a better place not to be than in New York. I don’t get the typical distractions in Elkhart. We have no watering holes, at least so far as I am aware. I haven’t been to a bar in my life for after-work drinks. I think it’s a lot easier to be independent without the herd pushing you toward the mediocre middle. I know for sure it’s much easier to think independently. I control most of my input because it

primarily comes in print form. I also watch Bruce Greenwald, your professor at Columbia Business School, from time to time on video, along with other investors I respect such as Kyle Bass and David Einhorn.

Another positive is that my commute is 10 minutes. Compare that to how long the average New Yorker spends getting to and from work, and you get an idea of the competitive advantage I have. But I also have another edge. I get up seven days a week at 4:30 in the morning. The first four hours are the most productive in my day. There’s an old adage that says, “An hour in the morning is worth two any other time of the day.” In terms of staying current, at 4:30 I begin with the internet versions of the *Financial Times* and *The New York Times*. I then read *The Wall Street Journal* and sign onto Bloomberg early to read the news and check the global markets. I usually get this done before 5:30 in the morning. *The Economist* is on my list, but not as a daily read. Given the abundance of information, the biggest challenge for all of us is to separate the wheat from the chaff. By limiting myself to an hour for current news at the beginning of each day, I effectively impose a time filter that forces me to seek out the meaningful over the trivial.

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**G&D:** What led you to the founding of Martin Capital Management?

**FM:** It took me 20 years to get there! I started in 1966 on the sell side with Walston and Company. My mandate was to go out and sell. The product *de jure* was, believe it or not, Hedge Fund of America. I was told as a rookie that Hedge Fund of America was designed to make money on the long and the short side. But I learned in 1969 that you could actually lose people money, even with hedge funds, which left a really bad taste in my mouth.

I didn't like this idea of being in a position where you could actually lose people money as a fiduciary. So I spent the next 10 years on the municipal finance side of the business. As interest rates rose through the 1970s, it was a very fun business for me. At one point in the early 1980s, the lowest-yielding tax-exempt bond I had in my own portfolio was 14%. That was back with 50% tax rates. So gross that up, and that's a 28% equivalent, which is three times the Ibbotson return since 1926. That's a no-brainer type of investment.

Since I originated these financings and had some access to investors in the area, I asked them if they wanted to participate. Of course, most of them said in the early 1980s, "Jeez, with

CDs yielding 14%, why would I lock myself into a 20% tax-exempt bond?" As we know, one of the great challenges in our profession is to see beyond the moment, even though most people live in that space.

***"At one point in the early 1980s, the lowest-yielding tax-exempt bond I had in my own portfolio was 14%. That was back with 50% tax rates. So gross that up, and that's a 28% equivalent, which is three times the Ibbotson return since 1926. That's a no-brainer type of investment."***

Through sheer persistence and force of will, I managed to convince some people. The nice thing about selling people 20-year tax-exempts, which were all callable in 10 years, is that they think you're a genius for the next 10 years because as rates

came down those high coupons kept looking better and better. So I was kind of a local hero there for a while. Then, when the municipal yields fell, the spreads narrowed. The M&A world came alive. So since I was used to doing these kinds of long-tailed transactions, it was an easy transition to M&A. When Walston failed, I sold our office to McDonald and Company in 1974, which had a strong presence in the municipal market, and were guys who I greatly admired who were very skilled in the M&A arena. They were great teachers. One of those teachers, Mark Filippell, eventually co-founded Western Reserve Partners and I sit on the M&A firm's board.

I cut my investment teeth in the early 1980s; I had to make one correct decision at that time – I had to believe that interest rates would come down. That was an easy call, I felt, because the U.S. Dollar was clearly the world's reserve currency, and in that role, we simply couldn't be running a double-digit inflation number indefinitely or we'd lose our credibility completely. If interest rates came down, then P/E's would come up, and stocks would be an excellent play. If interest rates came down, bonds would be an even better play. I put my entire retirement plan in 13.5% 20-year zero-coupon bonds. That was an automatic 12-

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bagger without any credit or duration risk – all in U.S. treasuries, which then allowed me to do a lot of other things. In the 1980s I had more ideas than I had money. Three clients and I bought a 25% stake in a bank at 50% of book value that was well capitalized and returning 15% on equity. Once again, the math is pretty simple – 15% on stated equity is 30% on my cost. I bought a lot of it, and it was ultimately a 10-bagger. We had a few other ideas like that and I thought it was prudent to make big bets because investors were generally over consumed with avoiding risk. In other words, the antithesis of today. The 1980s were just an incredible time to be an investor. And I hope – and expect – that someday we may find ourselves in an environment where risk is overvalued and return is underpriced! And this time, double-digit interest rates may not be the cause.

When I was 36 (1978), I was diagnosed with multiple sclerosis (MS). I knew that the life of a mergers and acquisitions banker, which is all travel and pure madness, would not be the career for me in the later stages of my life. So I went back to school at night and had a wonderful time earning my MBA and the CFA charter. Just before the market crash in 1987, I hung out my shingle. 1987 was beautiful because I was fully invested in tax-exempt bonds and

U.S. treasuries when October 19<sup>th</sup> hit. I had been writing for a long time about the dangers that I had seen. So even though I was a startup and didn't have that many clients, I was able to call all of them that night and say, "Your portfolios are actually up for the day because of the flight to safety." I got off on a good foot with my new clients in 1987.

***"When it comes to compounding, I'm not sure everyone understands that percentage losses and gains are not equal. I've always managed to avoid the large losses. Imagine something as simple as that being one of your secret sauces!"***

**G&D:** Given that the macro environment plays an important role in your investment style, can you talk about how you've thought through some of the significant events of the past 25 years?

The 1990s were a

fascinating and equally perilous time because the public, which had long been absent from the market as measured by the ICI fund flows, came back in spades. I think there were 5 million families that were in funds at the beginning of the decade and nearly 50 million at the end. So it became an increasingly retail-oriented market. The 1990s were capped off with the dot com bubble and the insane valuations, so during that time I was mostly playing defense. Of course, I was still collecting good coupons from the tax-exempt bonds. The year 2000 was a watershed year for me. I thought anything technology-related or dot com-related was insanely expensive. But the bifurcation of the market was clear. I could buy mundane manufacturing companies – the 'main street' companies, if you will – on the cheap. So if you look at our investment results from early 2000 to 2001, we were up sharply while the market was down. As you can imagine, we fell behind the markets in the late 1990s. There was no way you could keep up with the near doubling of some of the technology-related indices during the height of the bubble. But we made it up by going up when the market went down in the early part of the next decade. When it comes to compounding, I'm not sure everyone understands that percentage losses and gains are not equal. I've always

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managed to avoid the large losses. Imagine something as simple as that being one of your secret sauces!

The same thing really happened later on as we approached the financial crisis. It was pretty easy to see that what I called “the easy money fool’s rally” of 2003-2007 was going to end badly. You couldn’t describe it exactly. Ben Graham said, “You don’t have to know a man’s exact weight to know if he’s obese.” Like in the early 1980s when buying long-term bonds, I only had to be generally right. Anecdotally you could look at things, such as house prices, the impending end-game of Hyman Minsky’s financial innovation hypothesis, a shamefully lax financial regulatory environment, and the perverse incentives up and down the food chain, which included the rating agencies that became complicit by abdicating their role as watchdogs. And the list goes on. I looked at structured finance deals, and the whole idea of overcollateralization or redundancies, to the extent they had any, and the idea of layering risk in tranches to get higher ratings struck me as insanity. I didn’t know it would end as badly as it did, however.

I came back from the Berkshire meeting in May 2007 thinking that Charlie Munger was right – you must avoid catastrophic losses in your portfolio if

you hope to achieve competitive long term compounding. Although most of the time I am a long-only investor, the financial system had become so untethered from reality that I wound up doing what Michael Burry later described as “going long the short side.” I tried to sell everybody in the firm on the idea of buying puts on the investment banks. As was thoroughly documented in Chapter 10 of *Decade of Delusions*\*, it was understandably a tough sell. So I went through the investment banking section in Value Line and picked four or five companies that I thought were candidates. Bear Stearns had won the Investment Bank of the Year award for three years running, so I figured that they had lots of hubris. Like a superficial Michael Burry, I read a couple of their high-yield money market fund prospectuses from cover to cover, which was quite a job. I thought, “Oh my goodness, these guys are smoking dope!” So Bear Stearns was an easy candidate. Of course, Lehman was always playing it a bit fast and loose and too close to the edge in terms of leverage, so it was another easy candidate. Merrill Lynch was our custodian before we moved to Fidelity, so I had some personal experience in dealing with the chaos at Merrill. Call it envy, but I, like Michael Lewis, always felt that Goldman Sachs was pushing the envelope as

well. It was a simple call. Deep out-of-the-money puts were exceptionally cheap, unlike today. You almost couldn’t afford not to do it. Kyle Bass calls such situations “asymmetric bets,” where the payoff is many times the risk incurred. They are as rare as they are profitable.

*[\*Editor’s note: all of the opinions/events/decisions and so on referred to in the interview were chronicled real-time in Martin Capital Management’s annual reports – several reaching 100 pages – that became the grist of two books, Speculative Contagion (2006) and A Decade of Delusions (2011).]*

Let’s go back to the year 2000. I looked at valuations using a crude approximation of what Bob Shiller turned into something incredibly helpful. The Shiller P/E ratio uses inflation-adjusted data and 10-year moving averages of earnings. Valuations were in the insane area – they were much higher than where they were in the late 1920s. I looked at the broad-based inclination to take unrewarded risks – the speculative contagion, which had permeated Wall Street and particularly the retail investor. We hadn’t gotten into the huge leverage problem yet. I believed then as I believe now that we were at a secular market top. If you look at the Shiller data, these markets typically don’t clear until the

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Shiller P/E gets below 10 times, and sometimes materially below.

Buffett at the same time was writing about 17-year cycles, which I had thought a lot about, and I agreed with. Around 2000, I wrote that I wouldn't be surprised if a 6% coupon U.S. treasury would outperform the equity markets through the next cycle. Once again, the beauty is in its simplicity. Let's say in 2000 you bought a 6% 20-year zero-coupon treasury. Today, it's got seven years to run. It would have cost you 33 cents on the dollar. I think because of the low five-year rates, it would be selling at 96 cents on the dollar. That's an internal rate of return of just under 9%, versus a sub-2% return, including dividends, for the S&P 500. The S&P 500 would have to be at 3,500 to match the zero.

The problem with that is the institutional imperative. People don't pay us to think, they pay us to act. They don't pay you for playing good defense; they pay you for playing good offense. One would think that everybody understands Einstein's great insight – that compound interest is the most powerful force in the universe. We all are aware of the simple example that a 50% loss requires a 100% gain to equal things out. Be that as it may, people would rather play offense and then lick their wounds after they have a bad experience on

the downside. If our competitors behave that way and we understand the difference between time-weighted and dollar-weighted returns, the "edge" of our sword cuts two ways!

***"The problem with  
[investing in  
government bonds]  
is the institutional  
imperative. People  
don't pay us to  
think, they pay us  
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pay you for playing  
good defense; they  
pay you for playing  
good offense."***

**G&D:** Much like in the late 1990s, your defensive nature served you well during the market run-up and collapse following the financial crisis. Could you describe your defensive nature and this latter period a bit?

**FM:** I would like to think that being defensive is an educated conclusion. The first book, *Speculative Contagion*, came out in 2006. At the time people said to me, "Gee, I like your book, but I have no idea how to pronounce the title." I would say to them, "You wait, in a few years, the word 'contagion' will be part of the common vernacular of the trade." This is, of course, what has happened. So the title was ahead of its time, but I'm not sure the book was. A *Decade of Delusions* was sort of a capstone in 2011 for the preceding decade, which was a decade that I have felt had been way too risky for two reasons. First, valuations had been stretched, certainly if you used the aforementioned Shiller P/E. Second, because of increased financial leverage throughout the world, tail risks had increased greatly. With that overhang throughout the decade, I was thinking to myself, "Wow, what I don't need to do is get blindsided because we are paid on performance. I don't want to get underwater." You can't afford to get deep underwater if you really expect to achieve good long-term compounding. I'm invariably defensive too early as I was then. And I justified that because of the optionality of cash, the aforementioned overvaluation, and the tail risks that I think people had not priced in. I hope that

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sometime in the not too distant future, the markets will complete what I consider the ultimate end phase of a secular bear market that really began with the peak in 2000. This is clearly a minority view.

**G&D:** In your opinion, are the market and the American economy on their way to being mended and attractive or does it remain as “deluded” as it was during the last decade?

I would ask the question, can the excesses built up from the success generated by a long period of conservative economics and deregulation be cleansed in a matter of six months from September 2008 to March of 2009? I don't think human behavior works that way. Most of us need to have a trip to a woodshed before we begin to mend our ways. There's a good analogy with the labor market. Labor has been bludgeoned in part because of the excesses in the financial sector. And many homeowners, who are part of the labor pool, have also been suffering greatly. I think this will be resolved through a significant behavioral change. People will not use their home as an ATM. They will not use homes as a way of making a quick profit. Throughout my investment life, people used their home as a way to build up equity by paying down their mortgage, not as a speculative vehicle.

I also think people's expectations related to jobs have been greatly downsized. People are thinking much more rationally. A job is no longer an entitlement, it is a

***“I would ask the question, can the excesses built up from the success generated by a long period of conservative economics and deregulation be cleansed in a matter of six months from September 2008 to March of 2009? I don't think human behavior works that way. Most of us need to have a trip to a woodshed before we begin to mend our ways.”***

privilege. What's going to happen, I think, is that the longer this goes on, the better our workforce's attitude toward laboring is going to be, and the more competitive we're going to

be on the global stage. I could see a renaissance in manufacturing in America because of the traumatizing events through which labor has gone. Workers have reordered their expectations – we're not going to have folks at GM making, with benefits, anything comparable to what they made in the heydays. I think we're going to spend a lot of time focusing on those areas where manufacturing can enjoy a renaissance and where labor inputs will be reasonable on the world stage. I think that's really exciting. Matt Ridley's, *The Rational Optimist*, helps one understand where the opportunities just might arise.

On the other hand, profit margins are peaking. Top-line growth hasn't been there. You can't cut costs to prosperity. You eventually have to have top-line growth. The economy continues to struggle. I'm worried about the fact that tax revenues have averaged 18% of GDP – true over the long-term, with a low standard deviation, and seemingly impervious to how high the top marginal tax rate is – and we're spending at a rate of more than 24%. It's that issue that I think we have to address at the legislative level, which I don't think has much of a chance of occurring for some time to come.

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Pictured: Mario Gabelli and David Winters at Omaha Dinner in May 2012.

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Additionally, I do think that the capital markets have not gone through any kind of catharsis of the sort that labor has. Labor no longer has a powerful lobby but capital does. I recently read that \$3.6 trillion of corporate bonds were sold by mid-December 2012 – who's buying those? Well, it's in part the small investor who's disaffected with equities and bound and determined to get some yield out of something, so he's stretching out the risk curve and scrambling for some sort of return.

The shadow banking system in the United States is \$25 trillion, I believe, and \$65 trillion globally. Neither domestically nor globally have the numbers changed much since 2007. In the United States, total assets in our banking system are \$13 trillion. So the shadow banking system, which is mostly asset-backed lending, is double the size of the regulated lending market. Ben Bernanke really doesn't have as much control over the financial mechanism as most of us would like to think. You would have thought that the whole shadow system – the arms-length securitization system – would have collapsed, but the numbers suggest otherwise. This all tells me that 2008-2009 wasn't cathartic, and that we're kind of back to the old games.

The banking lobby is just incredibly strong, even

today. That's why I think Dodd-Frank is the toothless tiger. All this leads me to believe that we're just playing games with ourselves. The bell curve is a joke, and value at risk is a concept that is a really lousy measure of true risk. I think you've got to gross up risk at the big banks, derivatives risk in particular. If you do that today you've got yourself a crisis. So the world's financial system remains in a critical state. Basel II allowed the European banks to go to a 2% capital ratio. Is that not a prescription for disaster? I just don't think we've written the final chapter in this. We are at a critical state, but I have no idea what the catalyst is.

**G&D:** Can you talk about the investment strategy at Martin Capital Management?

**FM:** I would like to say that we're a situationally-sensitive value investor. Everything is situation-specific. The situation I've just described is one that suggests that tomorrow's opportunity set may be better than today's. So sometimes you have to play defense. You're always trying to find fish that swim against the stream, but shopping in a crowded big-box store shortly before Christmas is really problematic. What's your edge if you're piling in there with everybody else? This is often a significant failing on my part – I think I've been so preoccupied with top-

down, especially over the last decade, that I've missed a lot of layups that I could have had if I had been just a little more open-minded and shorter-term oriented. I'm like Bob Rodriguez in that I've been very defensive since the summer of 2010, and that has not paid me very well because the default asset class, for a guy who's looking for some place other than the market to put his money, doesn't yield anything. So for the first time in my investment life, there is not an alternative that actually pays me something.

But believe it or not, when it comes to individual security selection, we are a bottom-up firm. We're not interested in cigar butts; we're a classic Buffett-type investor. We want companies that we don't have to sell unless the market bids them up to uneconomic prices. For example, Gentex is one of our current holdings. We've actually bought Gentex twice. I love buying the same company twice because you've already done your work. It's very efficient. I bought it the first time in late 2008 and again recently. The business performed beautifully during the recession, but the stock became too expensive. Then they had some news regarding their rear camera display option, which was negatively received. The cameras were going to be placed on the dash instead

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of in the mirrors on a couple of their big customers' cars. But I didn't think that this development was that material, and I love the demonstrated productivity of their research process. The stock tanked a number of months ago, so we took a big position in it again. I also really admire the CEO.

The first document I read on any company is the proxy statement because I want to know where the incentives and rewards are. Obviously I like owner-operators, but you don't find those in the big-cap companies. Then you've got to read the 10-K to find out what the real story is, because the 10-K is the annual report without the adjectives. If you strip out the adjectives in an annual report, it looks pretty bland. Of course the 10-K requires disclosures like risk factors that you would never put in an annual report. If you're comfortable with a company after you get through those two documents, then it's time to see if management squares up with what the 10-K says. I also always read five years' worth of glossy annual reports, and I always read them in one sitting. It's a great exercise. You would not believe how many companies' reports are so different year-to-year that you don't even recognize them as the same company. I want to make sure that one year is not inconsistent with the year preceding.

**G&D:** Many value investors tend to avoid macroeconomic thinking in their individual stock selection. Why is it so important to understand the top-down perspective along with bottom-up analysis?

**FM:** Because I think this is really a fascinating subject, and I notice that most value investors are primarily bottom-up. I took you through the decade of delusions, but let's go back to 2006. The 2006 Berkshire Hathaway annual report came out in March of 2007, and the meeting was May 5<sup>th</sup> of 2007. So I'm reading the annual report about what Buffett was looking for in a successor. Let me read you these two short paragraphs:

"Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions."

Now I would say that there's nothing micro about that, nothing bottom-up. And then he goes on to say:

"Temperament is also important. Independent thinking, emotional stability, and a keen understanding of

both human and institutional behavior are vital to long-term investment success. I've seen a lot of very smart people who have lacked these virtues."

I was reading this and thinking, "Where's the bottom-up stuff in this?" Was this kind of a quiet warning to the world that things were crazy? Based on his subsequent behavior, I don't think it was. But I think he hit the nail absolutely on the head. There are times where you've got to think top-down when the risks I mentioned earlier are present, perhaps in spades. That's why I think as I do, and that's why I hope that my job will become immediately redundant when we experience the downside of the cycle. This is really critical to how this might differentiate me. As I say, it's situational. When stocks are cheap, and tail risks are priced in, or we've gotten rid of some of the tail risks by addressing some of the still excessive leverage throughout the entire system, then you really won't have to worry. The biggest tail risk, obviously, is still financial, unless you listen to Leon Panetta saying that we might have a cyber Pearl Harbor. But that's so abstract that I can't price it in. But the "gray" swan risk of another leg in the financial crisis is real. While we can't assign a probability to it, it's nonetheless real.

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**"But I think  
[Warren Buffett]  
hit the nail  
absolutely on the  
head. There are  
times where you've  
got to think top-  
down when the  
[macroeconomic]  
risks I mentioned  
earlier are present,  
perhaps in  
spades."**

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## Frank Martin



Pictured: Bruce Greenwald and David Einhorn at CSIMA Conference in February 2012.

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**G&D:** Could you describe the interaction between you and your team?

**FM:** The dynamic tension that exists between my team and me is a good thing because the guys force me to keep my bottom-up eyes open, and I force them to keep their top-down eyes open. So I like that tension. We all get along. This is a group that appreciates my perspective, and I appreciate theirs. We have an open forum – everybody can say what's on his mind. Ultimately, I make the final decision, but I respect these guys, so I listen to them.

**G&D:** You said in your book, *A Decade of Delusions*, that you attempt to continually understand the psychology of the marketplace to gain a competitive edge. What is the genesis of your interest in, and commitment to, understanding the psychology of groups?

I think this is something that I hope you will put in your mental hard drive, because it's been a great asset to me over the years. Again, I live in Elkhart, IN. It can be very intimidating reading the guys interviewed in *Graham & Doddsville*, or, if I'm inclined – which I'm typically not – to watch CNBC and the talking heads. There are some guys in this industry who are really smart. So I may ask myself, what edge do I possibly have with this crowd?

*The Crowd*, written in 1895 by Gustave Le Bon, is probably the most instrumental book in framing my ability to go against the grain of conventional thought and not feel insecure. Le Bon basically said that when one joins a crowd – when one becomes part of the herd – he tends to function at a much lower level. In the capital markets – because of the Bloomberg terminal, because of instantaneous communications, because everything is live and online – we can create instantaneous synthetic crowds. This whole business with 'the Fed has our back, that as long as the Fed is going to keep the spigots open, you're not going to get a bear market,' is a simple suggestion – according to Le Bon, the crowd loves simple suggestions. Understandably, it is incapable of complex reasoning. Imagine the edge one has if one simply disassociates himself from the crowd.

For example, I think many investors are misreading what the Fed is doing today. Once they submit to the will of the crowd they are almost Pavlovian in responding to the simplicity of the "Bernanke put" and are thus oblivious to the long-term consequences. Somehow this has to be unwound. Everybody thinks, "Well we'll just grow our way out of it." Well, perhaps we will, but given

that we've barely begun a deleveraging cycle that will impact growth for a long time, that's not a bet I'm willing to make.

At Northwestern I took a survey course in religion in which I read the great theologian Reinhold Niebuhr's *Moral Man and Immoral Society* and was enamored with it. It was my first introduction to crowd behavior. When *Extraordinary Popular Delusions and The Madness of Crowds* came along, I devoured that. The title is so descriptive and so timeless; think of how well it describes the mood of today. Bob Shiller is a leading light among a growing group of behavioral economists, and his *Irrational Exuberance*, published in early 2000, revealed his multidisciplinary capacity. I almost didn't read the second edition that came out in 2005, because it was essentially a reprint... except for a rather fascinating discussion on the emerging real estate bubble! What he said in a practical sense resonated so well with all the social science theory I had read. I'm deeply in his debt. I just read Daniel Kahneman's *Thinking, Fast and Slow*, and I think that he and the late Amos Tversky are some of the great behavioral scientists. Since nobody in our industry thinks about this very much, I think about it a lot.

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**G&D:** Even Kahneman admits that knowing about the failings of human psychology and decision-making doesn't mean you won't still fall prey to them. Are there specific steps in your investment process that ensure you won't fall prey to these biases and heuristics?

**FM:** That's a problem everybody has to acknowledge that they have. It's painful to read a book like his because you wonder just how much of your subconscious biases are ruling your decision-making. I try to benchmark my thinking, and thus try to override my biases, by frequently looking at a host of charts I'd made using Bob Shiller's 10-year moving average data. I'm aware that biases exist. What I don't know is to what extent they invade my otherwise rational mind. Clearly they do but I am utterly uncertain as to how much. I find some solace in the Bertrand Russell quote: "The trouble with the world is that the stupid are cocksure and the intelligent are full of doubt."

I agree with Nassim Taleb – whose work I find incredibly stimulating although he can be an offensive writer – that everything has to go through the Pascal's Wager filter (he couldn't even resist taking issue with the great French mathematician's and probability theorist's use of the spiritual metaphor!). If

there's a chance the future will prove that I'm wrong about a decision that I'm considering, whether I'm wrong because of biases or I'm wrong because I incorrectly assessed the situation, if the downside is permanent loss of capital, I

***"If there's a chance the future will prove that I'm wrong about a decision that I'm considering, whether I'm wrong because of biases or I'm wrong because I incorrectly assessed the situation, if the downside is permanent loss of capital, I can't go forward with that decision."***

can't go forward with that decision. If the downside is the loss of an opportunity, then I'm okay. By playing defense like I'm playing right now, the worst that will happen to those for whom I'm a fiduciary, if you believe

that cash is a good hedge against deflation and a respectable hedge against inflation, and offers huge optionality, is that I'm going to let an opportunity slip by. The beauty in this business is that there are just hordes of future opportunities waiting and some of them may be huge if you're patient. And I think Ben Franklin summed it up well: "He who has patience can have what he will."

For those who are long with the throng, they're going to have to explain, if I'm right, why they're down, say, 50%. I've never been in that position; our clients have never suffered a bear market. In bull markets, you underperform. Being down under 7% in 2008 and being up so nicely in 2009 probably put us in the top 5% of our class. But we trailed pretty significantly from 2003 to 2007. And I'm trailing now again. So I'm a classic 'win by not losing' guy, at least for the time being – at least in this high-tail risk, overvalued market. But I will welcome when "this too will pass" because this is no way to live. I'd rather be totally focused on individual companies, fully invested, and sticking the ones I really like in a lockbox – like Gentex – not even thinking about it for five or ten years.

**G&D:** Your firm's annual report shows that since 2000, you've never been

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more than 70% invested. Were there times in the late 1980s or during the 1990s where you were fully invested?

**FM:** I started managing money for others in 1987 and for myself for many years before. I was always 100% invested. That could be long tax-exempt bonds at 14%. It might have been owning a bank in the early 1980s. In fact, the 1980s were a most atypical period for me. I actually borrowed money for a while. I'm a guy who doesn't like to use leverage. I haven't borrowed money for the last 30 years of my life for anything – I pay cash for everything, because I think if an investment doesn't work without leverage, it's not an investment you should do. But the 1980s were a time where I had many more ideas than I had money. I can envision a period in the future where this could happen again. It's easy to imagine a number of scenarios that could cause prices to sell as dramatically below what they're worth as they have been selling dramatically above what they're worth.

**G&D:** Your separately managed accounts don't have a traditional fee structure. Can you talk about your fee structure and why you feel it's a better alternative to the traditional 2 and 20?

**FM:** Obviously a 10% gross return with a 2 and 20 fee

nets around 5.6%. That's just awful. So I thought, let's come out with a pricing structure that I would want when my estate comes to be managed by my firm after my death. So I came up with a 90 basis points maintenance fee for most accounts, or – 'or' is the critical word – 10% of the gains above a high water mark. Granted, this is Elkhart, but this money management business, if you actually make money for clients, is nicely profitable, even at 90 basis points or 10% of gains above a high water mark.

If you look at this in the context of the grand sweep of history, we are living in a most unusual time that is surely getting long in the tooth. In finance everything is cyclical whereas in, say, technology, today's ideas are built on the shoulders of yesterday's. Think iPod, iPhone, and iPad. You can make incredible fortunes in this business, and you don't have to overcharge to do it. You get to build equity, which means you never have to worry about your finances, unless you're a bad investor. If anything, our industry has become an embarrassment of riches. In the aggregate, after fees we are a negative value-added proposition.

People say to me at parties, "How come you're not charging regular hedge fund fees?" (People mistake us for a hedge fund because of our investment style.) "Isn't

your hedge fund valuable enough?" And I reply, "I don't know. Look at our track record for yourself." And they say, "Well, your track record is pretty good." And I say, "Why should I charge 2 and 20?" And they say, "Well, if you don't, you give the impression that your service isn't as valuable." The "you pay for what you get" belief is so well entrenched – with substantial justification in most cases – that the weaker players among the hedge funds have been able to thrive unexposed under that perceptual umbrella. I suspect that 2 and 20 will have changed dramatically by 2020 because it simply cannot survive forever in a low-return environment. Maybe we'll be seen as leading the charge. Admittedly, I think it's hard for a value investor to understand the appeal of Veblen goods – like the high-end German cars or Rolex watches – or even most hedge funds.

**G&D:** What was the impetus for launching your first mutual fund in May of 2012?

**FM:** We never had a marketing person until two years ago. We brought on a fellow who I believe is a great marketing thinker and strategist. He asked me when he came aboard, "Why don't you have a product for the retail investor?"

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Sometimes you need a catalyst to overcome inertia. First of all, it takes you about a year, if you are methodical, to get the concept from inception to market. Then we went out and talked to some people that we like as long-term investors. We said to them, "Are there buyers for a fund that is basically a call option on financial assets becoming more rationally priced, maybe even cheap?" Bob Rodriguez, who's been as risk-averse as I have, says that in expensive markets, he'd try to get people to buy his fund. He'd say, "We've got a lot of dry powder take advantage of opportunities as they appear" (Of course they think 30% cash is extravagant. I think 30% cash is straddling the fence!). What Rodriguez found is that they'll say, "I don't want to put my money with you now, and pay fees, because you're not earning anything. Call me when things get cheap."

But, most investors are afraid to buy when everything's cheap. Even if they know things are cheap, they worry that they will become cheaper and they find it difficult to pull the trigger. So the trick for us is to see if we can get people into the fund without any assurance other than that we have the courage of their convictions – when prices were higher! We've been good at stepping up when times are tough and stocks are cheap.

If you can reach those kinds of people, you'll have the kind of investors you want and deserve. We take the relatively unusual tact of posting commentaries to the fund's website [Martin Focused Value Fund] to keep investors regularly apprised of our thinking. The most recent was "Why Would an Enterprising Investor Hold Cash Today?" With our fund, like our separately managed accounts, we depart from the mainstream: we control the critical asset allocation decision like the FPA funds do. Done right, it has a very salutary effect on dollar-weighted returns. Most investors chase performance while we are looking for value. I doubt that we will ever have a problem of too much money coming in over the transom. But still, biggest is not always best.

If I can read the tea leaves and we do go through this cathartic process, it's probably going to be like post-1974. Buffett knocked the ball out of the park from 1974 to the early 1980s in a bumpy, flattish market. The public was exiting the markets, particularly through funds. But what he found was lots of individual values. If I could paint a picture of the future, I'd say it'd be something like that, or maybe something like Japan. There have been great opportunities in Japan. But ever since the Nikkei 225 began its long meltdown from 39,000 in

1989, ultimately getting as low as 7500 and currently trading around 10,800, it's been a trader's or contrarian investor's market. I hope that we don't go into a Japan-style, lethargic period, but unlike the post-2009 episode, I don't think we're going to go back to the races following the next down leg. If it's more like the post-'74 experience in the U.S., sentiment will be negative and prices will remain cheap and investors will stay risk-averse for a much longer time. Stocks will be unpopular and the whole process will be anything but glamorous. In that environment, I think the fund could do well because then we could strictly focus on stock-picking and grow slowly, while attracting the kind of clients who just might stay the course. I openly admit that trying to find permanent capital in the mutual fund space admittedly may be insanity by another name. I think Chuck Royce talked about that in his *Graham & Doddsville* interview (Fall 2012 issue).

**G&D:** Can you walk us through your process for finding new ideas?

**FM:** Obviously one thing we don't have, which Warren Buffett and Seth Klarman do have, is incredible sourcing opportunities for investment ideas. We have about 40 names that we've

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Pictured: Bill Ackman of Pershing Square Capital Management at Pershing Square Challenge in April 2012.

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identified as businesses we'd like to own at a price. The cost structure of building and maintaining an inventory of "ideas" is quite different from manufacturing. In our fixed-cost business, we analysts think of ourselves as Santa's elves, working day in and day out to build inventory for Christmas. Our job is to build an inventory of investable ideas, so that when prices come to us, we'll get to pick maybe 15 or 20 names. We'd like to get it up to about 50, and then we'd like to do what Gerald Loeb, from E.F. Hutton, recommended years ago – every time you add one, you take one away.

We obviously won't know in advance which companies, out of these 50, we'll buy, but we'll follow them closely and add them individually to the portfolio when they get down to a price that is likely to produce an expected return of, say, at least 15%, properly risk-adjusted. So it won't be top-down at all. It'll just be when individual names like Gentex fall to a price range where I can say, this thing's going to double in five years or less. We'll default into being fully invested. Obviously, exogenous forces like bear markets produce a plethora of buying opportunities. One must be more circumspect when the precipitating forces that lead to lower prices are endogenous.

**G&D:** What advice do you have for students interested in the investment management industry?

**FM:** As soon as you can disabuse yourself of the importance of money, it will help you immensely. All the stuff that's important in life, you get for free. All the stuff that's unimportant, you buy with money. When I first started, I said to myself, 'Boy, as soon as I make a million dollars, I will be secure.' Now that shows you how misguided I was. But as a starving student, you're really low on Maslow's hierarchy. It's not unnatural to think, 'money will fix my problems.' But if you can disabuse the notion that money is a measure of success, it will really help you.

Money is very corruptive. Obviously it's not been the case with Buffett. You'll notice the way he lives. People don't talk about this very often, but it's clear in John Templeton and certainly in Buffett, that the great value investors have a lifestyle that's earmarked by frugality. There is no doubt in my mind that Buffett discovered early on that redundant personal assets are really liabilities in disguise – that you can easily lose your personal freedom by becoming slave to your possessions. In fact, I've never really understood how a guy can claim to be a fully committed value investor and live big. You talk about going to see

managements and looking for little clues about whether their behaviors reconcile with their talk. When I see a value investor who lives really big, it strikes me as a contradiction in terms. I know there are many exceptions and there are dangers in stereotyping – but when you see such lifestyles, it makes you want to dig a little deeper.

**G&D:** It's obvious from this interview that you are a voracious reader. Keeping the list pretty short, what books would you recommend that students read?

Toward disabusing money as a measure of success, I recommend two books. One is Viktor Frankl's *Man's Search for Meaning*. In that book, he says that success, money, and all the accouterments of the so-called "good life" should never be sought for their own sake, but should be the unintended side effect of devoting yourself to a cause greater than yourself, or loving a person more than you love yourself. If you can identify what you're doing as a cause, and it happens to be remunerative, it can be a good thing. One of the things I decided when I made my career choice is that if I'm going to be good at what I did, I'd like to be paid for it. This profession does that. It's what you do with your largess that defines you. "The measure

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**"People don't talk about this very often, but it's clear in John Templeton and certainly in Buffett, that the great value investors have a lifestyle that's earmarked by frugality. ... In fact, I've never really understood how a guy can claim to be a fully committed value investor and live big."**

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of a man is not what he gets, but what he gives.”

I'd also have people pick up Kahlil Gibran's *The Prophet*. He writes about work, and he writes about giving. Those are two chapters that I would highly recommend to young people. I think that will help shape who you become.

I'm 70 years old and I'm in a wheelchair. Even though I no longer play golf, I'm like the golfer who shoots (works) his age [laughs]. It isn't work at all. I love it. I don't want to acquire knowledge for knowledge sake, rather for wisdom's sake. When I read that Todd Combs researches an idea for 500 hours before he buys it, that's kind of impressive. That's what all of our analysts and I should aspire to. If you've read *Outliers*, you'll understand that you've got to do the 10,000 hours. There are no shortcuts. Too much IQ can actually be an impediment. When I read the stories of the great achievers in our industry, most of them appeared to have ample intelligence. What seems to differentiate them is that they appear to have overcome the limitation embedded in the idea that “because I'm so smart I don't have to work very hard.”

Don't limit yourself to just reading business and economics. Read philosophy and read the great economic thinkers.

Adam Smith is famous for *Wealth of Nations*. But my favorite book of Adam Smith's is *The Theory of Moral Sentiments*. Smith basically says, if you take care of your customers' interest, you'll take care of your own. So if you sell the best good and if you meet the customers' needs better than your competitors, you'll always do well. The

**“If you want to,  
you can make all  
the mistakes by try-  
ing to learn every-  
thing yourself, or  
you can sit at the  
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to do, and shortcut  
that.”**

theme of Smith's second book explains why the system broke down in the last 15 years. *The Theory of Moral Sentiments* spoke about the importance of ethical behavior throughout the system. So when people – and this is Charlie Munger's big criticism which he calls “moral drift” – started cutting corners and

exploiting the asymmetry of information between agent and principal in increasingly complex systems, capitalism broke down. It's because everybody forgot the second of Adam Smith's two great books. It's a great system, but only if the players live by the Golden Rule.

Lastly, some of the most important of life's lessons are not taught in books. By all means, find mentors who you think are really worthy of respect, people who have lived their lives in ways that you admire. You can't imitate Buffett, but you can emulate him. I have a mentor wall that is the first thing you see in my small office. By identifying men who you really admire, you can shortcut your learning curve tremendously. You learn ethics by example. Jack Bogle and Warren Buffett, in terms of shaping my values, have really had a huge impact. And I probably have another 10 or 15 people on the list of people to whom I am in debt in perpetuity. If you want to, you can make all the mistakes by trying to learn everything yourself, or you can sit at the feet of the masters, which I have chosen to do, and shortcut that.

**G&D:** Mr. Martin, it's been a pleasure speaking with you.

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## Russell Glass



**Russell Glass**

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**Glass is co-owner of the New York Mets and is a director of the San Diego Chargers. He also advised Jerry Jones on the \$140 million acquisition of the Dallas Cowboys when he was 26 years old. Mr. Glass earned his B.A. in economics from Princeton University and his MBA from Stanford Business School.**

**G&D:** What was your introduction to investing?

**RG:** Growing up, my main interests were investing and sports, though I found I was more successful with investing. I have been fortunate to pursue both these interests throughout my career. On the investment side I have served as the President of Icahn Associates, the investment firm of Carl Icahn, and later as the founder of RDG Capital Management. On the sports side I recently became a co-owner of the New York Mets and, for a number of years, I have also been a director of the Spanos-family-owned San Diego Chargers. My interest in investing started at an early age. I made my first investment at age 13 when I bought some California real estate in northern Los Angeles County prior to the construction of a new highway that would reduce commute time from the property to downtown by half. I purposely selected land close to a new McDonald's that was under

construction figuring they do a great deal of future traffic pattern analysis and demographic research to determine attractive locations. A few years later, in high school, I used to read Value Line investment research reports and was fortunate to get a summer internship at LF Rothschild Unterberg Towbin where I worked in the risk arbitrage department. It was a great learning experience to analyze companies involved in M&A activity. I then went to Princeton and majored in economics. After graduation, I started my career at Kidder Peabody & Co., where I worked in corporate finance advising companies on their defense of hostile takeovers, which put me at the forefront of the 1980s hostile takeover wave. Afterwards, I decided to go to Stanford Business School where I had a roommate who happened to be the nephew of Alex Spanos, the owner of the NFL's San Diego Chargers and founder of the A.G. Spanos Companies, one of the top real estate developers in the country. Eventually, I started working as a financial advisor for the privately held Spanos organization on a part-time basis while in graduate school. My schedule at Stanford was unique in that I would go to class in the mornings, then frequently take the Spanos corporate jet to attend business meetings during the day, and later fly back in time to attend class in the

afternoon.

After graduation from Stanford Business School, I set up Premier Partners, a merchant bank in Dallas with a close friend and classmate of mine from Princeton. Our first transaction was advising Jerry Jones on the \$140 million acquisition of the NFL Dallas Cowboys when I was 26 years old. Although many who did not know him at the time thought Jerry may have overpaid because the highest price for an NFL franchise until then was only \$100 million, the investment has yielded greater than an estimated 20x return, or \$3.5 billion in value, as the team is currently appraised for approximately \$2 billion and has probably generated cumulative operating profits in excess of \$1.5 billion. The Cowboys went 1-15 during Jerry's first year of owning the team but ended up winning the Super Bowl a few years later. The fact that Jerry was able to sell luxury suites in a very weak economy at the time and turn around an uncompetitive team early in his ownership tenure demonstrates what a consummate marketing expert and extraordinary entrepreneur he is.

**G&D:** How did your career progress from advisory into investing?

**RG:** My focus has always been on investing in

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***"My schedule at Stanford was unique in that I would go to class in the mornings, then frequently take the Spanos corporate jet to attend business meetings during the day, and later fly back in time to attend class in the afternoon."***

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companies that are undervalued – I’m a value investor. After advising Jerry Jones on the Dallas Cowboys purchase, I set up an independent investment research firm called Premier Investment Research and served as an investment advisor to a select group of investors including the Hunt family, owner of the NFL Kansas City Chiefs, led by Lamar Hunt, who was both a sports visionary and successful businessman. Our investment research firm provided investors with in-depth, fundamental, 100-page research reports. We were hired on an annual retainer basis – so it was truly an independent research service with no conflicts of interests. We were not paid on our ability to trade or set up management meetings, but rather on our ability to help our clients find profitable ideas. Back then, 99% of Wall Street research had a ‘Buy’ recommendation, but our research was 1/3 ‘Buy’, 1/3 ‘Sell’, and 1/3 ‘Fair Value’.

We took the approach of looking at public companies from the perspective of a private equity owner. Our research consisted of thorough due diligence as opposed to just predicting next quarter’s earnings. This thoroughness caught the attention of a number of mutual funds, hedge funds, and investment managers such as Fidelity Investments, Wellington Management, and Neuberger & Berman,

as well as investor Carl Icahn. After some time though, I realized that being a principal had a number of advantages over being a research analyst.

I decided to partner with a group of former executives and associates of T. Boone Pickens forming Relational Investors, an activist fund based in California. The idea of the fund was to use corporate governance as a means to hold management accountable to shareholders. I saw the efficacy of being a proactive investor in companies years earlier, after seeing Boone Pickens’ success with Gulf Oil, which when he invested in it, was trading at a steep discount to the intrinsic value of its reserves because it was so poorly managed. After a couple of years at Relational, Carl Icahn recruited me to become President of Icahn Associates. Carl was a great mentor. He is a self-made professional with great intelligence and strategic acumen – he went to Princeton from a public high school that had probably never sent a student to Princeton before. Carl was one of the first and most prominent investors who believed in taking a proactive approach to investing in public companies. When I joined his firm he had already established himself as a legendary investor.

**G&D:** How does Carl compare to other investors

whom you’ve worked with or have come in contact with throughout your career?

**RG:** In my opinion, Carl has been the pioneer of catalyst-driven, activist investing. He is both a pure value investor and tactician who has produced investment success with a multitude of companies, both on the long and short sides. Carl’s returns have been excellent and he is an impressive short seller, which most people don’t know or pay attention to. His investments have compelling risk-adjusted return profiles. When you look at other investors or hedge funds, you cannot just look at the headline return. You need to know how much leverage was used and what other types of risks were taken to generate those returns. Carl’s portfolios are prudently hedged, so I would say that his risk-adjusted returns are even more impressive than most realize.

**G&D:** Can you talk about your current firm, RDG Capital?

**RG:** At RDG, I have essentially replicated the staffing and structure at Icahn Associates. We have four investment professionals, all of whom have M&A backgrounds. Our investment style is private equity oriented – we employ a hybrid private equity / public investment

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*“The idea of the fund was to use corporate governance as a means to hold management accountable to shareholders. I saw the efficacy of being a proactive investor in companies years earlier, after seeing Boone Pickens’ success with Gulf Oil, which when he invested in it, was trading at a steep discount to the intrinsic value of its reserves because it was so poorly managed.”*

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strategy. We look for undervalued public companies that can benefit from a catalyst to both enhance and unlock value. We focus on U.S. equities, consider ourselves to be industry agnostic, and invest across the market capitalization spectrum, although most of our historical investments have generally been in small and midsize companies. Among the catalyst events we generally focus on are private equity and strategic buyouts, corporate spinoffs and divestitures, monetization transactions of non-core assets, share buybacks, special dividend distributions and other

if we believe an opportunity is compelling, not just because we have to put money to work. As a result our investment process yields a high rate of profitable investments because we have such a high threshold for value – we typically require at least a 50% “margin of safety” as Seth Klarman from Baupost would say.

**G&D:** Can you give us a little detail on your research

opening expenses, growth-oriented R&D and capital expenditures, or other costs associated with investing for the future. If you find cheap companies that are unfairly penalized for making long-term investments in the business, those investments can become very productive and yield significant returns for the business and its investors. We also favor companies which trade at low valuations relative to their sustainable free cash flow that have operating margin improvement potential and which often have a sum of the parts value in excess of their trading price.



**RDG Capital team**

**“I have always believed some of the best investment decisions are those you choose not to make. Our special situations investment approach allows us to invest if we believe an opportunity is compelling, not just because we have to put money to work.”**

recapitalization events, and improvements in operating management and corporate governance.

Historically we have structured special purpose investment partnerships with co-investors who we believe bring strategic value or industry experience to each investment opportunity. I have always believed some of the best investment decisions are those you choose not to make. Our special situations investment approach allows us to invest

process?

**RG:** We first conduct a statistical valuation screen to generate ideas, and if they pass our screen, we perform a more detailed quantitative assessment and analyze companies on a qualitative basis. While our systematic screen finds public companies that trade at a significant discount to peers, we also look at things others often do not focus on or issues for which the market unjustly penalizes companies, such as pre-

Once having identified interesting undervalued companies, we then conduct extensive due diligence with management, industry analysts, customers, competitors, bankers, and often private equity firms who have relevant sector expertise. I have also been on the board of several companies in an array of industries, including real estate, energy, biotech, manufacturing, and business services. These directorships give our team insights into many types of

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## Russell Glass

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businesses and provide valuable operating executive relationships. We have a great pool of industry contacts that we can call on when we need to do a deep dive to learn about an investment opportunity. If we still find the opportunity attractive after such an evaluation process, we then consider what catalyst events may enhance and unlock shareholder value. Finally, we consider the corporate governance structure and shareholder composition of a company to determine the feasibility of implementing the desired catalyst initiatives. Ultimately, we seek to invest in those companies which meet all our investment criteria. It is a very time- and labor-intensive process, as we want to understand the business and not just the security. That process usually takes about three to six months before we make each investment. By maintaining these investment disciplines and acting like private equity investors in publicly traded companies, we have historically generated unlevered IRR in excess of 30%.

**G&D:** Can you provide an example of this strategy as it applied to a past investment?

**RG:** A couple of years ago, we invested in Benihana, the Japanese steak house chain. At the time, the enterprise value was less than \$75

million, despite the fact that the company had only recently invested \$150 million in cumulative capital expenditures over the prior few years. The market was discounting the recent capital improvements by 50% and assigning zero value to the existing restaurant chain generating \$25 million in recession-level EBITDA which you were essentially getting for free.

At the time, the company was trading at less than 3x EBITDA and, moreover, owned about \$50 million worth of real estate underlying several of its restaurant locations which could be monetized via a sale/leaseback transaction. If you took the near \$75 million enterprise value and subtracted the approximate \$50 million in real estate value, the company was really trading at just 1x EBITDA adjusted for the modest incremental rent expense. Furthermore, at the time of our initial investment, the economy was just starting to come out of the recession, and we believed that the company could increase EBITDA from \$25 million to \$40+ million just based on a recovery in same store sales growth and without any operational improvements. Yet, we were also able to identify a number of operational improvements that could be made, including centralization of purchasing (many of the restaurants at the time had been buying supplies

independently), improving staff scheduling, increasing higher-margin beverage revenue mix, and licensing the Benihana brand to selected grocery products. Finally, we were also attracted to the fact that in addition to owning its flagship restaurant chain, Benihana also owned two other restaurant concepts, New York-based Haru and Mid-Atlantic-based RA Sushi. These restaurant chain subsidiaries separately were worth nearly the entire market value of the parent company.

We decided to team up with a restaurant-focused private equity firm and made a buyout offer to the company. Though our offer was rejected, the company subsequently hired Jefferies to explore strategic alternatives and eventually sold itself to Angelo Gordon. The stock went from \$4 to \$16 per share in less than two and a half years.

As industry-agnostic investors, we look for public companies that would be better off being private entities. If you look at a typical industry-focused fund, the sector that it focuses on would likely be compelling as an undervalued opportunity only 5% of the time, and it would be reasonably valued or overvalued the other 95% of the time. This is the nature of a reasonably efficient capital market –

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***“As industry-agnostic investors, we look for public companies that would be better off being private entities. If you look at a typical industry-focused fund, the sector that it focuses on would likely be compelling as an undervalued opportunity only 5% of the time, and it would be reasonably valued or overvalued the other 95% of the time.”***

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Pictured: Tom Russo speaks at the Omaha Dinner in May 2012.

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much of what is out there is fairly priced at any given point in time. We try to focus on the 5% of companies that are valuation outliers, regardless of the industries that they're in, and because of this, we will typically only invest in half a dozen to a dozen companies on an annual basis.

**G&D:** What is your targeted time horizon for a typical investment?

**RG:** We'd ideally like to see value created within a year's time, if not sooner, but we are not short-term opportunists. As arbitrageurs of value we are content to invest in longer-term opportunities. Our investments have generally ranged from six months to two years. The longer you're in an investment, the longer you're subject to exogenous risks. If you can influence change sooner, it increases your IRR and reduces macroeconomic risk. We aim to generate the highest return with the least amount of risk, so the faster we can help push along the value-unlocking moves that need to be made, the better.

We also view a company's annual meeting as a way to enact change and gain support from other shareholders. Every public company is required to hold an annual meeting, and some companies allow for the calling of a special meeting. As I mentioned earlier, all of our investment

professionals have M&A backgrounds, which we find helpful to navigate these corporate governance matters.

**G&D:** Can you talk about a recent investment?

retail and manufacturing industries. For large retailers and manufacturers, this is mission critical software – approximately 75% of the top retailers and manufacturers use JDA's software. The supply chain management software industry has been undergoing significant consolidation.

When we started looking at the company, we were able to identify a high quality company trading at a low valuation relative to its sustainable free cash flow with significant costs that could be cut out by a strategic acquirer. Trading around \$27 per share, the company had an approximate \$1 billion enterprise value and, generating nearly \$200 million in EBITDA, was trading at only 5x EBITDA, or an approximate 20% free cash flow yield given the low capital-intensive nature of the business, with substantial recurring revenue from long-term software maintenance contracts. Based on our analysis, we believed a strategic buyer could extract as much as \$125 million in synergies so, in reality, the company could generate more than \$300 million in adjusted EBITDA, implying an approximate 3x pro forma EBITDA multiple, an especially attractive discount to the 10-12x average EBITDA multiple of its enterprise software industry peers.

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**“We’d ideally like to see value created within a year’s time, if not sooner, but we are not short-term opportunists. As arbitrageurs of value we are content to invest in longer-term opportunities.”**

**RG:** Several months ago, we became involved with an enterprise software company called JDA Software. JDA is primarily known as a best-in-class supply chain management software vendor for the

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At the time, the company was under investigation for accounting irregularities by the Securities and Exchange Commission. We looked into the accounting issue and determined that it was not fraudulent in nature, but rather a minor issue regarding the historical timing of revenue recognition. JDA was also in the process of completing the integration of an acquisition and preparing to introduce a promising new multi-channel software product, so we expected better results going forward.

Based on the steady nature of its business – high-margin long-term contracts, sticky customer relationships, and low churn – we thought the company could easily do a highly accretive leveraged recapitalization share buyback which would result in stock appreciation from \$27 to \$40 per share. One of the two largest shareholders had already achieved board representation and was advocating for a sale of the company. The company's valuation metrics and fundamentals were compelling. It had a low EV/EBITDA multiple on both an absolute and relative basis compared to its peers, was trading at a 20% free cash flow yield, was growing revenue and earnings at high single digits on an organic basis, and had operating margin improvement in process from the cost savings implemented in a

recently completed acquisition and the pending introduction of new products. JDA also had an M&A value according to our analysis that indicated a private equity or strategic acquirer could justify paying \$45+ per share or a 50%+ premium and still expect to generate an attractive 25%+ equity IRR and an active shareholder base with customary corporate governance policies. In fact, we believed the private market value was double the public market value.

We liked the investment because there were multiple ways to win, either through an accretive share buyback or a sale of the company at a substantial premium. In the end, the company recently received a \$45 per share buyout offer from Red Prairie, an enterprise software company owned by private equity firm New Mountain Capital. It was a good outcome for management, private equity investors, and shareholders.

**G&D:** In a recent guest lecture at Columbia Business School you mentioned that you believe there will be a tsunami of buyouts in the next couple of years. Could you expand on that?

**RG:** We estimate there is approximately \$150 billion in private equity capital that was raised a few years ago in vintage 2007-2008 buyout funds that has yet to be deployed and needs to be

spent in the next 24 months before LP capital commitments expire. Private equity firms are eager to put this capital to work. We figure altogether there is \$300+ billion in private equity “dry powder” plus \$750 billion in readily available low-interest debt financing in a robust credit market (in which leveraged buyout debt/EBITDA multiples have increased to near historic levels); this translates into \$1+ trillion in private equity-sponsored acquisitions in the next 24-36 months. Additionally, there is \$1.7+ trillion in cash on the balance sheets of non-financial corporations, nearly one third of which is higher than amounts typically held under normal economic conditions. We believe a reasonable portion of this capital (together with new public equity issuance and additional debt financing) will be directed toward public company M&A activity.

Our thesis is that in the last few years, most companies have grown earnings by cutting costs. By now, most companies cannot cut costs much more because there is no room. Economic growth is going to be slow for the foreseeable future, which means that for most companies, top-line revenue growth will be sluggish. Therefore, in order for companies to grow bottom-line earnings there is strong motivation to acquire

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**“We figure altogether there is \$300+ billion in private equity “dry powder” plus \$750 billion in readily available low-interest debt financing in a robust credit market (in which leveraged buyout debt/EBITDA multiples have increased to near historic levels); this translates into \$1+ trillion in private equity-sponsored acquisitions in the next 24-36 months.”**

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industry competitors and eliminate duplicative costs. This scenario should result in an increase in both friendly and hostile M&A activity in the next few years. In fact, this expectation is supported by a relatively recent Ernst & Young survey which indicated that 36% of U.S. corporations intend to engage in M&A activity within the next year or so.

**G&D:** It sounds like some of those supportive dynamics have been in place for a while. Why do you think the buyout activity hasn't ramped up this year?

**RG:** The election certainly played a part – corporate executives don't like to make important M&A decisions in an uncertain environment. They want to know what the tax, healthcare, and regulatory environment is going to look like. With the election over, there is more clarity. Companies have reached the end of their cost-cutting ability, as well. To put this in a sports analogy, we believe that we're in the 7<sup>th</sup> or 8<sup>th</sup> inning of companies reducing internal costs and will now begin to see a shift to acquiring businesses.

**G&D:** Do you think activist investors are still viewed with a stigma? It seems like it is now more socially acceptable, if you will, to engage management and advocate for change than it was 10 or 15 years ago.

**RG:** Working with Carl (Icahn) helped me see the merits of being a proactive investor in companies. Just as Steve Schwarzman and Henry Kravis find attractive

***“It's important to look at companies through the lens of a private equity investor. We like a hybrid approach – being a public shareholder but thinking and acting like a private equity fractional business owner. Although we lack the absolute control of a private equity owner, in cases where we garner the support of a majority of shareholders, we become the informal voice of the majority and thereby have influence on management.”***

businesses and enhance those businesses, we believe professional public market shareholders can do the same. It's important to look

at companies through the lens of a private equity investor. We like a hybrid approach – being a public shareholder but thinking and acting like a private equity fractional business owner. Although we lack the absolute control of a private equity owner, in cases where we garner the support of a majority of shareholders, we become the informal voice of the majority and thereby have influence on management. In the past we have hosted informal shareholder forums to discuss the management and future direction of companies in which we are a stakeholder. The benefit of being a public investor is that you can typically acquire equity at a significant discount to its intrinsic private market value (rather than a buyout premium), employ no leverage (rather than 4x or often greater debt/EBITDA in an LBO), and still have an element of constructive influence on the company.

There's been a positive change towards shareholder activism in the past 10 years. The rise of proxy advisory firms has provided a level playing field. After recognizing years of corporate mismanagement and malfeasance, institutional investors have become justifiably more active and now have a greater willingness to support dissident shareholder initiatives. Unlike in the past when

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institutional investors almost always sided with incumbent management against activist shareholders, in recent years dissident shareholders have actually more often than not won the majority of proxy contests or reached favorable settlements, such as board representation, to avert a proxy contest. Although there is still the classic management / agency dilemma in corporate America, the board and management of more companies, recognizing their fiduciary duties to shareholders, have become appropriately more responsive to activist investors. We think activist investing is still in its early stages here, and international markets are 10 to 20 years behind the U.S. with regard to corporate governance and activism.

**G&D:** In terms of the range of activists, from friendly activists such as Relational at one end to the more antagonist activists on the other end of the spectrum, where do you stand? Why is this approach best for you?

**RG:** We are in the middle of the activism spectrum with flexibility to work on a constructive, collegial basis with incumbent management to the extent they are legitimately willing to explore ways to enhance shareholder value, but also to work as a staunch defender of shareholder rights in cases where

management does not have their personal interests properly aligned to maximize shareholder value. In these cases, we organize shareholder forums, engage in proxy contests, and exercise other corporate governance measures to hold management accountable to serve the best interest of shareholders.

**G&D:** You've done academic research around activist investing and how once an activist becomes involved, a company's stock price outperforms the market. Can you talk a little about your research?

**RG:** As an undergraduate majoring in economics at Princeton I wrote an academic research report on the efficiency of capital markets and the economic benefits of shareholder activism and hostile takeovers. Since then, there have been numerous academic studies highlighting the efficacy of shareholder activism on investor returns. In a study conducted by researchers at Wharton and Columbia Business School, companies which had been the subject of 13D filings indicating the presence of an activist shareholder generally outperformed the S&P 500 by approximately 5%-7% per annum.

**G&D:** Do you feel that the activist investor field is getting crowded? Are there still the same opportunities for you that were available

10-15 years ago?

**RG:** While the number of activists has grown modestly in recent years I believe the opportunity set has grown more and that we are still at the early stage of public shareholders taking more initiative in the governance of the companies they own.

**G&D:** Can you talk about a few mistakes you've made in your career?

I should have bought more land in southern California when I was 13 years old.

**G&D:** What's the best advice you've ever received?

**RG:** Working with Alex Spanos taught me to have a "can-do" attitude. From a man who overcame adversity early in his life to become one of America's true Horatio Alger success stories, Alex advised me to set achievable goals in life and, when confronted by challenge, to act with integrity and dedication to "just make it happen."

**G&D:** Thank you very much for your time, Mr. Glass.

**"In a study conducted by researchers at Wharton and Columbia Business School, companies which had been the subject of 13D filings indicating the presence of an activist shareholder generally outperformed the S&P 500 by approximately 5%-7% per annum."**

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## Jon Friedland



**Jon Friedland**

**“The great thing about the investment business is that there are investment opportunities to suit anyone’s background, interest, and creativity.”**

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hedge fund, where he was responsible for media, entertainment, and leisure ideas for the firm. Mr. Friedland received his B.A. in Political Science from Vassar College in 1991 and his MBA from Columbia Business School in 1997.

**G&D:** How did you first become interested in investing and what brought you to Amici?

**JF:** At Columbia Business School, I took a number of classes that had a profound impact on the course of my career. Bruce Greenwald’s Value Investing class was one. The creativity and clarity with which he analyzed businesses was fascinating. Second was Security Analysis with Jim Rogers. He put students in the role of a real time company analyst. New York-based investment managers with expertise on our companies would come to Jim’s class to grill us. It was great. It gave me a sense of how much you should know before making an investment. And I fell in love with the explosive learning process that accompanies primary research on an industry or company.

I was hired out of CBS by a large hedge fund because I had done some original primary research on an ultrasound system manufacturer for that Security Analysis class. My research suggested the company’s stock was highly overvalued, at a time when

the stock was widely owned by many hedge funds. After a few years at that fund, Pat Duff, a fellow CBS Alum who had been one of my visiting Security Analysis professors, introduced me to Paul Orlin and Alex Porter of Amici Capital. We hit it off very well in terms of investment philosophy and approach. That was over 10 years ago and I still come to work happy every day.

**G&D:** What is the meaning behind the name of your firm, Amici Capital?

**JF:** As of January we changed the name of the management company from Porter Orlin to Amici Capital to align it with the name of our funds. ‘Amici’ in Latin means ‘friends’. The capital that was initially raised was from friends, so from the beginning Amici was used in our funds’ names. Since the firm’s establishment in 1976, we have maintained the philosophy that our investors and partners should be treated as friends. Amici is also reflective of the cooperative culture within the firm.

**G&D:** What drew your initial interest to investing primarily outside of the U.S.? What are some of the advantages and disadvantages with an international focus?

**JF:** Halfway through my college career at Vassar, I took a semester off and

backpacked around Asia. This was perhaps my first explosive learning experience. I traveled by boat, bus, train, and plane all over China, Tibet, Thailand, Vietnam, and Nepal. For someone that grew up in Ohio, this was really an eye-opening trip. I fell in love with learning about different cultures, which led me to a five-year career in foreign aid prior to attending CBS.

The great thing about the investment business is that there are investment opportunities to suit anyone’s background, interest, and creativity. When I came to Amici in 2001, there was little international investment. Then in 2002 we saw a number of restructurings of international companies in industries that I had studied carefully in the U.S. – specifically the telecommunications and cable television industries. Companies like NTL Incorporated in the UK and pan-emerging market cell phone operator Millicom International were trading at distressed levels because of forced sales and complexity. The comfort that I had from my foreign aid work in Africa, Asia, and Latin America was important. It helped us to become more comfortable applying the Amici investment process of deep fundamental business, industry, and valuation analysis to recognize that these companies were trading at a significant

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## Jon Friedland

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discount to intrinsic value.

Around this time we were also short automotive manufacturers in the U.S. in large part because competitors in Japan and elsewhere were gaining market share and operated with structural advantages. Additionally, we were short some IT consulting companies in the U.S. as their most profitable business lines were facing stiff and increasing competition from Indian IT outsourcing companies.

I think at that time, and increasingly since then, the ability to apply our investment process to an expanded universe of investment candidates improves the likelihood of our success. I think this is a big advantage for us.

**G&D:** Are international / domestic pair trades, such as the aforementioned ones from a decade ago, a big part of what you look for?

**JF:** We do not seek out pair trades. We are quite active in our industry analysis in trying to identify both winners and losers. Sometimes this will result in a short or hedge from the same industry, but each investment, long or short in our portfolio, goes through the same investment scrutiny and must stand on its own.

**G&D:** There is an extensive universe of international companies.

How do you narrow down your hunting ground to a manageable level from which to sort through to find new ideas?

**JF:** We try to invest in the same way and in the same types of companies no matter where we invest. We are looking for great franchises trading at substantial discounts to intrinsic value.

We invest in emerging markets because our view is that consumers, corporates, and sovereigns in emerging markets have far better balance sheets than they do in the developed world. As a result, we believe that economic growth in emerging markets is going to be far greater than it will be in the developed world. The World Bank just published a study projecting that GDP growth in developed countries in 2013 will be 1.2% and in developing markets it will be 5.5%, which is a huge differential.

Within that context we take a multi-pronged approach. First, we invest in companies doing business in specific emerging market countries, India and Brazil being primary examples, where we have a high degree of confidence in the long-term macro outlook. Both countries have large populations and diversified economies that are capable of supporting world-class companies. Second, both of those countries are fairly

inwardly driven. Imports to GDP plus exports to GDP sum to a mid-30% of GDP in both, which is quite low by comparative standards. We like internally-driven economies because they are less subject to global economic winds. Increasingly we have also developed contacts and experience in these countries, which has increased our comfort level further.

Secondly, we invest in global companies that do business in a portfolio of emerging markets countries, many of which we would not invest in directly. We are able, through a portfolio approach, to take advantage of positive trends in countries in which we would not take a concentrated position. Brazil and India have predictable government policies and a rule of law that we understand. We cannot say this about many other countries.

**G&D:** How do you go about looking for new ideas?

**JF:** As our team travels, reads, and speaks to people, we are always looking for great companies that we would love to own at the right price.

We enter these companies into a database and refer to these companies as our 'Battleships'. These are large, highly profitable, and well-capitalized companies

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Pictured: Jon Friedland speaking at the Moon Lee Prize Competition in January 2012.

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that have demonstrated pricing power in consolidated industries with low competitive intensity. They are run by management teams that have established a record of intelligent capital allocation and have made strategic decisions we understand. We believe that investing in 'Battleship' companies, as distinct from very small upstart companies with illiquid stock, gives us an added margin of safety because these companies are less likely to be blown around by economic volatility. We believe this is an important risk management component when investing in emerging markets, where both operating performance and stock price performance can be more volatile.

**G&D:** It sounds like you are looking for 'Warren Buffett-like' companies and have a longer-term time horizon than the typical hedge fund.

**JF:** In a way that is right. Our Battleships list contains roughly 100 international companies that we would like to own at the right price. We may own only a certain number of these companies at any given time, but pick our entry and exit points based on current valuations. They may not all be attractive investments in any particular year, but the common thread is our high degree of confidence in their long-term ability to capitalize on the

opportunities presented to them. We have met and studied management at most of these companies, and have done extensive

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work on them over the years.

**G&D:** How do you find the next name to add to this

list, the 101<sup>st</sup> company?

**JF:** It comes slowly. We may add two to five companies a year, while at the same time a few companies will come off of the list if some missteps have happened or the story has changed. We do a lot of traveling to Latin America, Asia, and Europe looking for new ideas and we like to meet with new companies. We are always looking for new candidates.

**G&D:** How important is meeting with a management team face to face?

**JF:** It is very important. We believe that strong management teams play a critical role in the ultimate success of an investment. We need to know that management teams are thinking like owners and we have to understand their long-term outlook for their company and their industry. We need to understand what is important to them, how they incentivize their employees, and what their company culture is like. For us, this interaction is important and can be telling. I can recall one otherwise promising investment that we passed on after meeting the CEO who was very crude, which we feared was an indication of poor judgment in other areas.

**G&D:** How do you manage your long and short exposure? Is there any mathematical component to

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it, or is it more based on the quality of long and short ideas at a point in time?

**JF:** The Amici Global Fund that I manage is somewhat different than our core funds. It offers concentrated exposure to the international positions within our core Amici funds managed by Paul Orlin. The Amici Global Fund was established to take advantage of the attractive emerging market dynamics we discussed before. It generally has a larger net long exposure and accepts more volatility on the assumption of a highly attractive long-term opportunity. At any given time, our exposure is a function of the risk/reward opportunities we are seeing with individual stocks. We are not macro investors.

We also pay close attention to valuations across the emerging market asset class on an absolute basis and on a relative basis compared to developed markets. This analysis goes back 20 years to give us a sense of whether the odds are stacked in our favor. Emerging market stocks are volatile and correlated, so we think it is important to be conscious of this data.

**G&D:** Where are we today in terms of emerging market attractiveness versus developed markets?

**JF:** Sometimes you have to go outside the U.S. to find a 'grand bargain'. We believe

that the much faster growth rates of the developing world economies described in the World Bank report we discussed, coupled with a valuation discount to developed market stocks, creates a rich opportunity set in emerging countries.

Now is an interesting time to invest in emerging markets because emerging market governments are increasingly making positive long-term policy decisions, having exhausted most other options. This is in part because many countries are bumping up against more governors on their growth rates than they have in the past decade. Inflation recently has been stubbornly high and a lot of labor has already come into the labor pool. More fundamental changes and action from governments is required than has been necessary over the past decade. What gives us comfort is that we are starting to see that happen.

For example, in India since September we have seen liberalization relating to foreign direct investment in retail and aerospace, a reduction in subsidies for diesel and natural gas prices, and the first hike in government-run railroad fares in a decade. Real interest rates in Brazil have plummeted from over 10% to less than 2% in the past eight years, much of this reduction in the last year and a half. The government in Brazil has recently issued

RFPs for \$65 billion worth of infrastructure products.

A lot of emerging markets are turning the global liquidity surge from developed market central banks into their advantage, trying to steer capital toward foreign direct investments as opposed to portfolio flows. We look at this as a third, and smarter, stimulus tool in addition to the more conventional fiscal and monetary tools.

**G&D:** Can you talk about an idea that you like right now?

**JF:** Our compliance department will not allow me to mention specific names, but I can speak more broadly. Real estate in India is currently an area that is ripe for investment. There are a few 'Battleship' companies that have managed to come through the latest down-cycle intact and are in a good position. We have a position in a company that owns a land parcel outside of a major Indian city, in an area akin to Greenwich, Connecticut outside of New York, which it is developing into residential and commercial space. We believe it has an asset value substantially greater than its current market value. The question is whether this asset value will ever be realized for the benefit of minority investors.

We are seeing signs of

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**"Sometimes you have to go outside the U.S. to find a 'grand bargain'. We believe that the much faster growth rates of the developing world economies described in the World Bank report we discussed [1.2% growth in developed countries vs. 5.5% growth in emerging markets], coupled with a valuation discount to developed market stocks, creates a rich opportunity set in emerging countries."**

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Pictured: Paul Orlin of Amici Capital speaking at the Moon Lee Prize Competition in January 2012.

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positive strategic changes in operating practices that suggest the asset value may become visible and we are hopeful that it will appreciate in the next year. We have seen developers sell down crown-jewel assets and non-core assets to shore up their balance sheets. We see a willingness to re-focus business models on core competencies. The roots of these management teams are as buyers, developers, and marketers of land. They have now outsourced construction and project management to best-in-class companies and substantially reduced the volume of product they seek to bring to market annually. This will improve quality, pricing integrity, and ultimately cash flows.

Furthermore, in India we think there is a good chance that interest rates come down in the next year, which will increase valuations and will increase the availability of mortgages from extremely low levels. Mortgages are below 5% of GDP in India, well below the global average.

We see a similar situation with Brazilian homebuilders. Over the last residential real estate cycle, all of the developers raised money at the same time and began to grow launches at multiples of prior 5- and 10-year rates. Unlike in India, project oversight and management was a core competence historically in

Brazil. But to support growth, Brazilian homebuilders began to outsource oversight of construction to such an extent that they lost complete control of the process. The cost and time overruns were enormous and destroyed profitability. Because of the way things are accounted for, the entire hit to profitability comes at the end of a project – you can't go back and restate prior periods. Financial results look terrible now but new construction launches have declined substantially from a few years ago. We think that profitability of these companies may very well return to high levels. These companies are currently trading at or below liquidation value, with no value ascribed to the ongoing value of the business.

**G&D:** We remember the impact that the Beijing Olympics in 2008 had on the level of investment spending in China. How much do the impending 2014 World Cup and 2016 Olympics impact the way you look at construction in Brazil?

**JF:** I look at these events as helping force good decisions. Airports, rail lines, and roads around the country are going to have to see some investment. Brazil has among the worst infrastructure in the world. I am hopeful that these events are serving as

catalysts to help get the Brazilian government to take some positive actions as discussed earlier.

**G&D:** It seems that you are primarily focused on hard asset plays in emerging markets. Do you spend much time looking at other types of businesses in these markets?

**JF:** Absolutely. There are such powerful tailwinds behind consumers, such as rapidly rising wages and standards of living. Consumer-focused companies are among our favorite investment themes in developing markets, as long as we can purchase them at reasonable valuations. We have invested in drugstore and mall companies in Brazil. There is a big secular shift from informal to formalized retail in the country. Some of these companies that have scale, buying power, and systems are benefitting tremendously. In India we have invested in beverage companies. Last year we invested in a company that had substantial share in the beverage industry. It ran into some distribution issues that had impaired profitability in the short term. We studied how similar disruptions had impacted profitability at the company over medium-term periods, and realized that the company was likely to recover and pass through incremental costs that it faced. In fact, it was one of

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## Jon Friedland

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the largest contributors to last year's profitability.

**G&D:** What is Amici's "secret sauce?" What has led to your outperformance over the long term?

**JF:** We have an investment process that has been refined since 1976 and we seek constant improvement in that process. We know how to identify great businesses and broken businesses. We have the ability to judge management teams by meeting with them and by analyzing quantitative changes that occur in a business while a specific team is in charge. We also constantly assess risk/reward in our individual positions and pockets of risk in the portfolio.

Over the past eight years, we have developed a wide array of contacts across the globe. There are not many funds that are U.S.-based value investors that have the ability or the inclination to look intensively for single names in many foreign countries. We've found ourselves increasingly capable of monitoring many different situations via our list of 'Battleship' companies. When a disruption takes place with a company on this list, due to our team-oriented nature, we are capable of collapsing a lot of resources on an idea and quickly coming to a conclusion.

**G&D:** Amici had great firm-wide performance in 2008.

Your Core funds were down less than 6% versus a 37% decline for the S&P 500. How were you able to achieve such a great year when many other hedge funds and the broader market struggled?

**JF:** We have a culture of risk management at Amici Capital. It is always primary in our minds. We are never going to chase performance if we don't think the opportunity set looks attractive. We are heavily short single names – this is a core part of what we do. In the process of turning up great businesses you are always going to turn up some losers. It is important to hedge the portfolio with a set of companies that are misunderstood from a perspective that is too optimistic. Our performance in 2008 was a function of sensing the risks in the global macroeconomic environment and reducing exposure slightly, and, most importantly, having a set of shorts that were oriented toward the leverage that had built up in the system.

**G&D:** Do you have any parting words of wisdom for our readers?

**JF:** As you come out of business school it is important to take the best opportunity you can find where you can get the best exposure to a variety of situations so you can see what you like and what you are good at. Ideally that job

ultimately becomes a long-term proposition, but once you are seasoned and have some maturity allowing you to understand yourself better, you might discover that you should be elsewhere instead. Find a place that you are comfortable with. I was at a growth-oriented hedge fund prior to coming to Amici and found myself as the 'low-beta' guy there, whereas at Amici Capital I tend to be more comfortable as the 'high-beta' guy. Find a place where you can bring your interests, your passions, and your experience and try to differentiate yourself.

**G&D:** Thank you for sharing your thoughts with us, Mr. Friedland.

*"We have an investment process that has been refined since 1976 and we seek constant improvement in that process. We know how to identify great businesses and broken businesses. We have the ability to judge management teams by meeting with them and by analyzing quantitative changes that occur in a business while a specific team is in charge. We also constantly assess risk/reward in our individual positions and pockets of risk in the portfolio."*

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Please also share with us any suggestions for future issues of *Graham and Doddsville*:

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