Columbia Business School

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

Issue XX Winter 2014

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Lee Ainslie—No Holds Investing

Lee Ainslie

Lee S. Ainslie III is the head of Maverick Capital, which he formed in 1993. Prior to founding Maverick, he worked at Julian Robertson's Tiger Management. He holds a bachelor's degree from the University of Virginia and an MBA from the University of North Carolina's Kenan-Flagler Business School.

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Ken Shubin Stein—A Study in Investing

Ken Shubin Stein

Dr. Kenneth Shubin Stein is the Founder and Portfolio Manager of Spencer Capital Management and the Chairman of Spencer Capital Holdings. Spencer Capital is a value -oriented investment

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Geoffrey Batt—Perception and Reality

Geoffrey Batt

Geoffrey Batt is the managing partner and founder of the Euphrates Iraq Fund. He has been investing on the Iraq Stock Exchange since January 2008. Mr.

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Jim Grant—Lifelong Observer

Jim Grant

James Grant is the founder and editor of *Grant's Interest Rate Observer*, a twice-monthly journal of the financial markets. After graduating from Indiana University with a degree in economics and Phi Beta Kappa accolades and earning a degree in international affairs from Columbia University, he began his journalistic

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Justin Muzinich—Find Good Businesses

Justin Muzinich

Justin Muzinich is a President at Muzinich and Co. Inc., a privately owned investment management firm with a focus on rigorous credit analysis. Prior to joining Muzinich, he was a Managing Director at EMS Capital and worked in the mergers and acquisitions group at Morgan Stanley. Mr. Muzinich holds a Juris Doctor degree from Yale Law School, where he was an

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Welcome to *Graham & Doddsville*

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.

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

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We are pleased to bring you the 20th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

We were lucky enough to speak with five great thinkers and investors who provide a range of different perspectives and investment approaches to this issue. **Lee Ainslie** recounts how he founded Maverick Capital and shares his thoughts on hiring analysts and structuring his team. Mr. Ainslie also describes what he looks for in a good investment, shares an idea that he likes, and candidly recounts past mistakes that he has learned from.

Justin Muzinich talks through his perspectives as a credit investor—both in looking at credit ideas and running a credit-oriented asset management business. He also talks about the opportunity he sees in the European debt markets.

Geoffrey Batt shares his unique transition from a philosophy student to a frontier markets investor focused on Iraq. He explains his interest in the Iraqi markets and describes his process for searching for equity markets that are on the verge of a significant re-rating. Mr. Batt also shares some interesting ideas he currently sees in Iraq.

Ken Shubin Stein discusses the structural and behavioral elements of investing and describes the methods his firm employs to improve its investment process. Mr. Shubin-Stein also shares some present and historical ideas.

James Grant discusses his career in investment journalism, argues for significant overhauls to the global financial system, and discusses how skepticism shapes both better journalists and investors.

This issue also contains pictures from the 23rd Annual Graham & Dodd Breakfast, which took place on October 4th at The Pierre Hotel in New York, and featured Neil Petroff of the Ontario Teachers' Pension Plan as the keynote speaker. Lastly, this issue includes the winning pitch from the 2013 Darden @ Virginia Investing Challenge, and the four finalist pitches for the 2014 Moon Lee Prize Competition.

We would like to thank our interviewees for sharing their time and insights with our readers. As always, we invite you to contact us if you have any comments or suggestions, and we thank you very much for reading.

- G&Dsville Editors

Neil Petroff speaking at the 23rd annual Graham and Dodd Breakfast

Bruce Berkowitz speaking at the 2013 CSIMA Conference

Ken Shubin Stein

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management firm with a successful long-term track record investing in undervalued securities and special situations. He is also an Adjunct Professor at Columbia Business School, where he teaches the Advanced Investment Research course. Dr. Shubin Stein is a graduate of the Albert Einstein College of Medicine where he completed a 5-year medical and research program with a focus on molecular genetics. He has a B.A. from Columbia College, Columbia University with a dual concentration in Premedical Studies and Political Science.

Graham & Doddsville (G&D): You have a fairly non-traditional background for a value investor. How did you become interested in investing and how did you make the transition from getting your M.D. to investing?

Ken Shubin Stein (KSS): From an early age, I've always had an interest in both health care and investing. My mom introduced me to investing when I was a kid and she is the first one who taught me about buying stocks. I was exposed to Warren Buffett in the early '80s, and that was pure luck. Buffett is so good at writing about it that he makes you think you can invest well too, even though it's difficult.

But he makes it accessible and that's how I became interested. I started investing early, and quickly took over handling investments for my family. I was investing concurrently with my science and medical training, and eventually made a decision that I wanted to make investing a career.

"We think about process a lot, and we've tried to create a process that maximizes our chance for great outcomes.

For us, a process needs to be explicit, repeatable, and flexible."

One of the things about investing that is different from a field such as health care is that the spectrum of approaches that people follow is wider. There are certainly lots of debates in health care but, in finance, we have different views on fundamental concepts about the way the world works and there are conflicting ideas accepted at business schools—an obvious one is the efficient market hypothesis, another is the question of whether volatility is risk. These simple, core questions are debated decades after first being asked and I find that interesting.

G&D: Are you still involved in healthcare other than investing in it?

KSS: I still have a passion for healthcare and a strong network in that world. Many members of my family are doctors and scientists, and I am on the Board of Advisors at the Hospital for Special Surgery, so I regularly speak with doctors, scientists and healthcare executives. Additionally, I am involved from a public health standpoint through Crutches 4 Kids, a charity that I co-founded to help collect crutches from people who have and don't need them any more, and distribute them to children who need and don't have them.

G&D: How has your medical and scientific background helped you as an investor?

KSS: It's been helpful in

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Ken Shubin Stein

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Ken Shubin Stein

Columbia Business School students visited Warren Buffett in Omaha in the fall of 2013.

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terms of understanding how to perform research, how to think about a question, how to think about what are the critical factors, and how to collect the data and analyze the results. We think about process a lot, and we've tried to create a process that maximizes our chance for great outcomes.

For us, a process needs to be explicit, repeatable, and flexible. If it's not explicit, then the process can't be studied and used by different people and, if it's not repeatable, then you can't iterate and improve the process. Lastly, a process needs to be flexible because there are many different situations in life. Things change. The credit markets change and attractive opportunities change. You may be evaluating a hard asset that is not producing cash flow, but has the potential to generate significant cash in the future. Or you may be evaluating a high return on capital business, like an asset management firm, that produces significant cash flow, but the important assets of the firm walk out the door every night. So the process has to be explicit, repeatable and flexible to allow it to be improved over time.

I learned to be a lifelong learner from my parents and from my medical and scientific training. Early in my career, I worked for two fantastic surgeons named Russell Warren and George Murrell, both at the Hospital for Special Surgery, and they both epitomized lifelong learning and continuous improvement. They take it seriously and they're both very good at it.

G&D: You have spoken before about learning to learn, can you elaborate on this topic?

KSS: Sure. Thinking about thinking, or metacognition, has been around for a while and the field keeps improving. Something we try to do well is to think about what we are doing, what we are trying to learn, and how we can best learn it. There are some great articles and books out there on this topic. Dan Coyle's book *The Little Book of Talent* has a great list of tools people can use to accelerate learning. *The Art of Learning* by Josh Waitzkin is another good book on this topic. We do active literature searches where we assign researchers 10-50 hours to go through basic and clinical science articles, as well as pieces on other fields, such as art, professional sports, coaching, and all sorts of things. We try to be effective in this process even though it's not always efficient.

"We borrow tools from other fields. We look at what's available in the science of cognition or decision-making. We think about how to apply to our circumstances work that's being done academically about human thinking."

We think about efficiency and effectiveness a lot too. "Efficiency" is getting a lot of units of output for a unit of input. But you could be efficiently running in the wrong direction and it would not be effective. Sometimes, we know we're engaging in a process where there's no way to be efficient and maximize effectiveness. A good example of this is looking for certain types of acquisitions. There isn't a really efficient way to do this. You can't completely screen for it and, if you're looking for something that you can't screen for or develop an efficient search process around, it means that, although you're going to try to head in the right direction and be effective, you are going to have to turn over a lot of rocks to find what you are looking for. Another example of this is literature searches. We

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will read broadly with an idea of what we're trying to accomplish, but it's not always efficient. We think about efficiency and effectiveness separately.

G&D: You've taught the Advanced Investment Research course at Columbia for the past five years. What motivates you to teach and has it affected your investing?

I love teaching and have had an especially great experience teaching at Columbia. Bruce Greenwald and Louisa Serene Schneider have been terrific in helping me grow as a teacher. They have been supportive and helpful as I learned how to organize the class and communicate effectively with students in the business school environment. One great aspect about teaching for the past five years is that most of my former students are now analysts and portfolio managers, or doing other interesting things in the world. I actively stay in touch with the class alumni and I get a tremendous amount of satisfaction seeing them progress in life.

Teaching has also been great for me as an investor. The process of taking what I do and making it explicit, of breaking it down into discrete, teachable steps, and of answering challenging questions from smart students has refined my thinking about every aspect of the investing process. Additionally, we are fortunate to have some leading investors visit the class and answer questions in a small, off-the-record environment, which is very educational for both the students and me.

G&D: Can you share your process for evaluating a prospective idea?

"We think we can have four possible edges and we try to understand whether one or more is present in a given situation. The four edges are: informational, analytical, behavioral and structural."

KSS: We use a four-step process for evaluating ideas. Step 1 is to form a hypothesis. Step 2 is the study design, or, said another way, identifying the important questions and developing a plan to answer them. Step 3 is doing the work to answer the questions; this is analogous to running the experiment. Step 4 is analyzing the data and then refining our hypothesis. We iterate this four-step process over and over again.

We borrow tools from other fields. We look at what's available in the science of cognition or decision-making. We think about how to apply to our circumstances work that's being done academically about human thinking. We put effort into applying these ideas; this requires some creativity and some guesswork. We make educated guesses about how to apply something. I'll give you a specific example. Charlie Munger famously has his list of 25 psychological tendencies of human misjudgment—25 mistakes we make in how we think. We went one by one through each cause, rephrasing it in our own words, and tried to figure out how we could apply it to our checklist process to improve our decision-making.

Whether you call it behavioral finance or neuroeconomics or innate and acquired cognitive biases, these terms are circling around the same basic issue: how do our brains make decisions under different circumstances? For decades, people have been trying to describe this idea academically. Now there's diverse vernacular in that world because it hasn't coalesced into one unified field yet, but what's really interesting to me is how to

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take that learning and specifically apply it. How do we develop de-biasing techniques? How do we develop standard operating procedures that can help us make better decisions? It's all very humbling because it's complicated and nuanced; applying it is difficult and, to a degree, personal. So it's going to work differently for different firms and different people, but we work hard on applying it and making it practical.

G&D: How do you think about getting an edge? Is it different from situation to situation and is there a common thread?

KSS: There is a common thread. We think we can have four possible edges and we try to understand whether one or more is present in a given situation. The four edges are: informational, analytical, behavioral and structural.

The first two edges, informational and analytical, are necessarily related and sometimes overlap.

We work hard to find information that is helpful and legal to use. Sometimes we are able to find great pieces of information that, combined with other information, increase our understanding of an opportunity. This is often referred to as the mosaic approach, and it is the link to the analytical edge we regularly seek.

Having an analytical edge means taking available information and arraying it so that we can glean better insights. This is where having deep industry expertise sometimes helps because certain information will mean more to us than to the market—either we are more aware of the history of the industry or we have experience with the industry players and have a better behavioral insight into those people. Analytical insights are frequently possible and it's a matter of arraying information in a creative way and deeply knowing something—having a good circle of competence.

"This is where having deep industry expertise sometimes helps because certain information will mean more to us than to the market."

Behavioral edges are central to value investing. It's being greedy when others are fearful and fearful when others are greedy. It is understanding the lessons of behavioral finance and neuroeconomics, and then applying them to the idea at hand. These opportunities come up regularly. There will always be the opportunity to gain a behavioral edge because most innate cognitive biases are Darwinian. Evolutionary forces caused these behaviors to evolve because they were useful at a prior point in history even though they are not useful in modern, complex markets. They are hardwired into all of us.

With a structural edge, you know exactly why something is cheap or expensive. For example, if a bond is downgraded from investment grade to non-investment grade, there are certain holders who have to sell it. If a stock is kicked out of, or included in, an index, this will cause buying and selling transactions that are not based on the price-to-value relationship. Spin-off and distressed situations also regularly have these forces at work.

G&D: Do you try to create structural and behavioral advantages inside of your own structure and process?

KSS: We do. There are

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plenty of managers who may have a long investment horizon, but their clients do not; therefore, they don't have strong hands for a true long-term perspective. There are few investment firms that can execute on a long-term horizon. There's an enormous amount of institutional and retail capital that has high liquidity and, as a result, the manager doesn't have that much staying power or ability to invest in things that may take three, four, or more years to work out. So firms that have patient capital definitely have a structural advantage.

We think about the application of psychology and the science of cognition to both our analysis and our portfolio management, and we have multiple checklists and processes in place to try to improve how we think and make decisions. It's not perfect. This is rough work, so while we might use specific scientific terms to describe everything, the work itself doesn't go out to the second decimal place. It's really "best efforts" and we're constantly trying to improve. We're constantly finding mistakes and fixing them.

G&D: How do you balance your time between doing investment analysis and thinking about the behavioral and process elements?

KSS: We think about these things all the time; it's an overarching theme of our firm. We don't do what Google does where we take 20% of our time to pursue pet projects—it's not that structured. We are always talking about these things and asking ourselves, How can we be better? What can we do? What are other people doing that we can learn from?

There's a quote by Picasso, which basically says good artists copy and great artists steal. There's been a great deal written about looking at what other investors do that works and copying it. We look at other investors and we also observe other fields to see how star performers do their jobs and continue to improve. Professional athletes offer an example. Even once they're at the top of their field and at peak performance, they still use coaches. They go over the basics. They use the psychology of visualization. They think about nutrition and rest in order to perform better. The system built around professional athletes is impressive and robust because the stakes are high and measurable. So we are always thinking about how to improve and it permeates our firm.

"There are plenty of managers who may have a long investment horizon, but their clients do not; therefore, they don't have strong hands for a true long-term perspective."

G&D: Is there a particular strategy or type of investment that you are comfortable with or have a particular expertise in?

We're not dogmatic about investing in a cheap, mediocre company or a non-earning, but undervalued asset, or a profitable company with sustainably high returns on capital. We've done all of them. What we are very careful about is reflecting on past mistakes and thinking about what works best in our hands. We have a pretty good idea of what works best for us, and part of the reason is because I really wanted to understand our difficult experience in 2008. Different techniques work differently in different people's hands. We all have different life experiences, different training, and different brains. So something that works for someone else, I may not be able to do well. What I

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really want to know is what I can do well, so I do more of it, and what do I not do well, so I do less of it.

After 2008, we did a one-year project looking for mistakes we could learn from. The challenging part of this process was differentiating between a true positive and a false positive and a true negative and a false negative. It's important that you separate process and outcome.

The best situation, a true positive, is when you have a good process and you have a good outcome. If you have a bad process and a bad outcome, that's a true negative. The tricky part is what happens if you're unlucky and you have a good process, but a bad outcome—a false negative. It is important not to be fooled by false negatives. If we're doing the right thing, but occasionally it doesn't work, it doesn't make sense to abandon that process, because over time it will do well.

The riskiest thing is getting lucky—a false positive. You have a positive result, but your process was poor. That's the most dangerous because, after a few false positives, you typically go bigger, and that leads to the old saying of "succeed small, fail big." So we think about this pretty carefully.

We engaged an outside analyst to help us and we invited back former employees to review every investment decision we've made. We went through

"If we're doing the right thing, but occasionally it doesn't work, it doesn't make sense to abandon that process, because over time it will do well."

this obsessively for a year and we came up with a list of about two dozen red flags of places where we've lost money in the past and where, after much analysis and debate, we decided it was because of a bad process and not just bad luck.

This review has been tremendously helpful to our investment process, it has helped make us better analysts, and it has helped make me a better portfolio manager. While these red flags don't mean we'll never repeat mistakes, they are cautionary flags. The red flags slow me down and make me think about a time when I was confident that something similar to the idea in front of me was a great idea, and then I made a mistake and lost money. I would say this is one of the most helpful things we've implemented as a firm. To a degree, it comes out of Daniel Kahneman's work detailed in his book, *Thinking Fast and Slow*. The framework that he describes says that the brain has these two mechanisms of thinking—fast and slow.

Basically, the idea is that, for the work we do, fast decisions don't help. So we try to slow down. For example, we explicitly put circuit breakers into our checklists now so that we sleep on decisions. We have taken some of the learning from the literature on decision-making and creativity research, and lessons from great creative thinkers and investors, such as John Griffin, who taught the Advanced Investment Research course for a long time. One take-away from this is the idea that putting yourself in different situations, sleeping on ideas and letting yourself be creative lets you engage your subconscious to process information.

In medicine, there is an acronym, HALT—hungry,

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angry, lonely, and tired—and, under these conditions, decision-making worsens. For example, under these conditions, people who are addicted to drugs will have a higher rate of recidivism, meaning they'll fall back on their old patterns of behavior even though they know it is ruining their lives. I've added a P for pain, which also has a direct impact on emotion and decision-making. So with HALT P, we try to think about both the psychological and physiological framework for making decisions. We ask ourselves, as we're making decisions and as we're thinking about things, are any of these conditions present? Are we hungry, angry, lonely, tired or in pain for one reason or another? And, if so, realize that it's suboptimal for decision-making and, if possible, don't make the decision.

Something else that's really important is nutrition. Blood sugar levels and general nutritional states have an impact on cognition and, I think, this is one of the areas that is underappreciated. Our nutritional levels directly impact our decision-making. Buffett talks a lot about fear and greed as frameworks or contexts within which decisions are made, I would add to that HALT P and nutrition.

G&D: So what you're saying is that Cherry Coke actually is good for investment decision-making?

KSS: It seems to work for Buffett, but not many others.

G&D: Can you share a couple of past investment ideas, including an activist idea? And any current ideas you would be willing to talk about?

"We tackle things not by trying to prove them, but by trying to disprove them. Falsifying a thesis is the fundamental approach of the scientific method and it's an approach we use and like."

KSS: Sure. We have a concentrated portfolio and we often hold investments for several years. I'll talk about a couple of past and present ones.

SeraCare Life Sciences was an idea that hit a couple of the edges we talked about. It was a post-bankruptcy, small company that provided reagents and other important things to laboratories. It was a straightforward investment if you understood it, because, coming out of bankruptcy, there were structural issues of why people couldn't buy it. It was inaccessible to some firms due to its small size or to firms without stable capital. It required an understanding of how laboratories and the FDA approval process works because some of the reagents that they provide were actually written into the FDA approval process for the test kits using their reagents.

When you run a laboratory, you want to minimize variation in processes so that your results are reliable. So what can you control in a laboratory? What are the variables? Well, the things that change in a laboratory are your inputs such as your reagents, so you usually have complete control over that, and you don't want to change them if you don't have to.

So, understanding that, you appreciate the durable, competitive advantage of selling things that are small and relatively inexpensive, but critical to a large process. We invested in the company at around $3 per

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Bill Ackman at the 2013 Pershing Square Competition.

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share. We expected it to be worth $6 in two to three years and it was bought out in less than a year at $4. It was good to be paid $4, but I would have preferred to wait another year or two and been paid $6.These things happen.

"What was interesting about AIG when we invested several years ago was that it was one of the most hated companies in America."

Osteotech was one of our activist ideas. Osteotech was a situation where a large institutional investor asked us to partner with them. Activism is about strategy and tactics. You need to have a strategy to create value, but even with that, you can lose an activist campaign if you dot your "i's" and cross your "t's" incorrectly.

The company makes the gold-standard demineralized bone matrix product called Grafton, which is frequently used in orthopedic and other types of surgery. Osteotech spent a significant amount of capital on research that was partially productive. They had a dysfunctional sales effort; they had a misaligned management team, and they put much of the money they generated into various things that weren't productive. The latter is common in healthcare—often a company has something, a drug or device, that generates significant cash and management invests it all in risky ideas rather than returning the profits to shareholders.

So we got involved. We analyzed the situation and we went through our pre-investment checklist for activism. Osteotech passed. We ran a campaign to replace the entire board. We met with ISS and a number of large shareholders, and we made the case that our plan would create shareholder value.

It was a good investment. Shareholders made a 100% return in less than a year from the time we became involved.
An example from the insurance industry is AIG. What was interesting about AIG when we invested several years ago was that, I think, it was one of the most hated companies in America. When we were making our investment, there were bus tours in Connecticut taking people to the homes of executives who worked at AIG so they could see where the "evil" AIG people lived.

Think about that for a minute. These executives likely had nothing to do with what happened; AIG is a large global company. Think about the implication of people paying to get on a bus to come see the home where an executive who works for this hated company lives. This is a great example of behavioral bias. People were embarrassed to say they worked at AIG, and many portfolio managers were reluctant to own the poster child for the financial crisis.

Half a dozen government agencies had been living inside of AIG, going through their books, and the government owned the majority of the company. We had the following thesis: over five years the stock would be at least a triple because we were investing at half of stated tangible book value, investment income was below normal due to artificially depressed bond yields, and the company was buying back significant amounts of stock.

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We thought book value was conservatively stated because the government agencies had a bureaucratic incentive to come up with a conservative number. There was new management in place and their incentives—like the incentives of most new management in a turn-around situation—were to state all the problems up front because none of it was their fault. Additionally, bond yields were kept low by the Fed and we didn't believe that would last forever. And lastly, management was buying back large amounts of its stock, which was a powerful signal that they believed the stock was significantly undervalued.

G&D: Could you share your analytical process or the research that you did on the idea? What kind of work did you do to prove some of the key points you mentioned?

KSS: We tackle things not by trying to prove them, but by trying to disprove them. Falsifying a thesis is the fundamental approach of the scientific method and it's an approach we use and like.

I'll compare and contrast SeraCare with AIG. One was small, the other was large. One was post-bankruptcy and a special situation, the other was a large, out-of-favor company. Thus, the processes were different. With SeraCare, all the research techniques that I teach are what we did. We made phone calls, we spoke to people who work at the laboratory—the end-users—we spoke to the buyers, and we investigated the regulatory framework. Some of the information we knew already because it's a health care idea.

One of the benefits of our business is that, once you develop expertise in an area, you don't have to start from scratch every single time. So, in this respect, SeraCare was both interesting and relatively straightforward in terms of the work, and we tackled it using all the tools from Advanced Investment Research and really tried to understand the specifics of the buyers and sellers, the industry, the trends, and the supply/demand issues. Understanding the switching costs became important in this case, and then trying to understand a low case earnings power analysis was possible, especially if you understood health care as an industry and where the trends were going.

"Another red flag is investing in an average or less-than-average business without multiple ways to win."

With health care, often, the problem is that, since we have a fundamentally challenged industry, there will be a lot of changes to reimbursements and the way margins are going to work in the future. That is a problem for many health care-related ideas. In the case of SeraCare, we understood how the issue applied to the company and why it was protected from a lot of it. And it was undervalued enough that it was okay.

With AIG, there were some similarities and some differences. We have invested in insurance for a long time and this helps in understanding the industry and the basic transaction. We always try to understand deeply why someone buys or sells. Why does someone buy this product or service from this company and why would they not buy it from that company? These are basic, but important, questions. And, in the case of AIG, we felt comfortable in our understanding of the components of the business and industry. Even though we were not experts in some of the non-core assets, we had a sufficient margin of safety and we

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David Winters at the 2013 Omaha Dinner.

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were comfortable with the liability analysis and the liquidation value, which were significantly higher than where we purchased our stock and where it still is today.

When we think about intrinsic value, it is always a rough guess, a range. In my mind, if I throw out a number to you, such as, "I think intrinsic value for this stock is 100," what I'm really saying, and the way we internally use that statement, is, "It's 100, give or take 10 to 15%. It might be 85, it might be 115." It's 100, with implied error bars around the statement.

We are cautious about our ability to really know what something's worth, and we only invest in situations where the price is well below that range. With AIG, it was with the benefit of a political analysis, which we do sometimes. And I don't mean "political" in the sense of "who's going to win the election," I mean "political" in understanding how Washington works, because that's something you can sometimes understand. Washington works in a specific way, with different parts of the system having different incentives and, if you understand these dynamics, you can analyze situations as to how they're likely to work out.

G&D: How do you balance just reading the public materials versus really going in and kicking the tires? How do you think about the trade-off between the time spent and the knowledge gained?

KSS: The general reading and research we do is the same for all ideas but, beyond that, we use our process to guide us in which research tools to use. Once we begin formulating the questions we think are important, then we figure out what needs to be done to best answer those questions.

Often, making research calls to industry participants, employees, customers, and others, is helpful, but there are certain ideas where the information those calls can give may already be known, or not additive to the key investment factors that are driving the investment decision. We also learn a lot from publicly available materials that are not so obvious. For example, government databases can offer very useful data, but it usually needs be carefully analyzed to gain insights from it.

"We think about risk as 'How much money can we lose and what's the probability of losing it?' It's a private business way of thinking about risk and it's simple, but not easy."

G&D: Have you experienced any anchoring effects in processing new information where, because of the previous knowledge, you don't necessarily fully incorporate updated data?

KSS: Yes, and AIG is an example of that. AIG is a company that I had followed for well over a decade, and there were a lot of things about the old way AIG was run that I didn't like. After the credit crisis, I really had to force myself to drop my prior thoughts, good and bad, about the company and look at it fresh because it was a different situation—different management, different balance sheet, and different asset collection. So much was new that I, in a forceful way, had to take a clean approach to it.

G&D: While we're on the topic of mistakes and biases, are there any big red flags from the self-analysis you conducted that you would be willing to share with our readers?

KSS: I'll throw out a couple that we are now more

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sensitive to than before the credit crisis. We are extra cautious if the company is in a dynamic industry. If things are changing rapidly in an industry, it calls into question the durability of a competitive advantage; for example, maybe the buying transaction is changing. In retail, Amazon is fundamentally changing the way buying occurs and, if you're a retailer, you have to think about the impact of this trend. Some industries are more difficult to understand than others and, if they're changing, they're often too tough to analyze.

Another red flag is investing in an average or less-than-average business without multiple ways to win. For good businesses, sometimes, we have a clear thesis. We understand what our edge is, and we have a clear idea of the way it will work out. We think there's one highly probable future path. In contrast, for average or below average quality companies, more can go wrong, so we prefer to have the potential for more than one thing to go right to unlock the value we see. This "more than one way to win" approach works better for us than investing in such companies solely when they are available for purchase at a low valuation.

An additional red flag is the presence of unions. Union leaders don't always act in ways you would think are best for their constituencies. Sometimes, they act in a way that's best for them personally and their ability to keep their elected position in the union. One of the things I've developed a greater appreciation for is that, sometimes, I'll look at a situation and think, "Oh, that person's not acting rationally." However, what's actually happening is they're acting rationally for their circumstance, but we may not know enough to appreciate the various forces at work. In Washington, you see this a great deal and you see it with unions as well. You also see it with leaders of organizations.

"Building a firm is a combination of timing, skill and luck, and what I have learned is that it's a different thing from just being a good investor."

This is why aligning incentives is so important, because, if you don't align incentives, the rational thing for a leader to do based on his or her own self-interest might not be in your best interest. It's important to align incentives to ensure you're operating toward a common goal. That's a lesson that we've learned the hard way.

One last one that can be more subtle is the red flag that goes up when a company is either acquiring other companies or investing in capex projects that are different from what they have done in the past. The new acquisitions or projects may be different in size and scope, or may be in new areas but, either way, they pose a risk that needs to be considered carefully. This is especially true if the new large project is causing the company to incur more debt.

G&D: Are value traps on your list of red flags?

KSS: I don't use the term "value trap." I find it more helpful to say, "Okay, I made a mistake. I didn't understand a component of this, so it's not working out." Generally, if you're right in your analysis, including understanding the incentives of the company's leadership, then most of the time the market will agree with you in two to three years.

G&D: Could you talk a little bit about your process for sourcing ideas and figuring out what's worth your time to analyze?

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KSS: Sure, Charlie Munger has spoken about there being three good ways to identify ideas. The first is to look for companies that are cannibalizing themselves by doing significant share repurchases. We look at those and we think about share repurchases, not in dollars or share count, but in percentage of shares outstanding. The second is in spinoffs, and we broaden that to corporate situations or special situations because they have similar dynamics. And the third is cloning or looking at other investors. We read what people do and try to reverse engineer why someone bought something.

In addition to those three areas where we actively look for ideas, we also receive inbound ideas from investors we know or who are part of the Columbia community. Generally, we have more ideas than time and we are usually trying to triage them and decide which ones to work on.

G&D: Are there any ideas that you're particularly excited about right now?

KSS: Howard Hughes is going to continue to develop its assets and add value over a long period of time. We have owned it since it was spun-off from General Growth Properties when GGP was in bankruptcy. In addition to its tremendous assets, Howard Hughes has a fantastic CEO, David Weinreb, and an excellent, shareholder-friendly board, led by Bill Ackman. I think that, even though the price has meaningfully appreciated, its assets are going to continue to improve for the next five to ten years and intrinsic value per share will increase.

G&D: How do you think about the selling decision?

KSS: Selling is specific to

"If things are changing rapidly in an industry, it calls into question the durability of a competitive advantage."

the security and what we want in the portfolio, so, again, it's rough work and we are constantly trying to get better at it. The way I broadly think about it is, if it's not a great asset or a great company, then we are going to sell at the low end of our range of what we think it's worth, and if it is a great asset or company, then we are going to hold on longer. That's our rough guideline, but we don't have a mathematical rule. The selling decision is also in the context of what else is going on in the portfolio.

I am also specific about the way I phrased my earlier statement—if it's not great, then we sell. That "if/then" statement helps because, if you put it the other way, it's just too easy to take something that's a little better than average and put it in that bucket of, "Oh, we should hold it longer." I have certainly made that mistake, so now I just think about it as, "Is it great? Yes or no?" If it's great, fine, we'll probably hold it longer, but if not, if it's anything less than great, then we're going to sell it early.

G&D: What are your thoughts on shorting and its relationship to portfolio management?

KSS: We generally don't short. We have in the past and we have a good track record of doing it, but the reason for that record might be because we've only done it occasionally. We've done it in two situations—both where it's been incredibly obvious and where there was a security that lent itself to doing it, like a very long dated put or it was part of a cap structure arbitrage where we bought the parent and

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shorted out the subsidiary. But the latter case is not really shorting; it's just setting up a trade to isolate the asset that we wanted to own.

After the credit crisis, we raised our standards and it's helped us, I think, be better investors. Our current framework for managing the portfolio is: for the first 80% of our capital, we'll only invest in something if we think it's a double in two to three years; for the next 10%, we raise the bar and will only invest if we think it's a three to four multiple return in two to three years; and then, for the last 10%, which rarely gets invested except during extremes, we'll only invest if we think it's a four to five multiple return in two to three years. By following this simple portfolio management structure, we're safer because if 2008 happens again (and surely another crisis will happen) we'll know how much capital we can invest at those lower prices.

On that topic, I'd like to talk about cash for a second because I think it's an underappreciated, aggressive asset. Most people say it's defensive, for the obvious reason that, in most normal environments, if you're holding cash, it's earning close to nothing. I think it's actually an aggressive strategic asset because it's one of the few things that rises in value as the market plunges. Its value is inversely proportional to how challenging the environment is.

G&D: Given your framework and portfolio concentration, how do you think about position sizing?

"I think it's actually an aggressive strategic asset because it's one of the few things that rises in value as the market plunges."

KSS: For us, position sizing has to do with absolute risk. We take the perspective that, if you are not levered, and your companies are not too levered, then volatility is not risk. This isn't always true because of reflexivity and some other things but, for our purposes, volatility of a security price is not intrinsically risk, although the two can occur together. We think about risk as "How much money can we lose and what's the probability of losing it?" It's a private business way of thinking about risk and it's simple, but not easy. A lot of things we do are that way.

We will make something a large position if we think there is an extremely low chance of losing money on a permanent basis. Even if we think it might be a 4x return, if the idea could be a zero, it'll be a small position. For something to be a significant position, such as a 10-15% position, it has to be very safe, for example, a low-levered real estate opportunity such as Howard Hughes.

One of the reasons we invest in real estate, along with healthcare and insurance, is because it has distinct points of value creation. If you take raw land and put in sewer and power, you have improved it and it's a more valuable asset. It's a step function. If you then get easements and get permits to build big buildings and you land an anchor tenant for a 20-year lease, you've improved the real estate again. So, if you understand how real estate development works, you can track these things. Howard Hughes has made a lot of improvements in recent years, and they're going to do a lot more, and that's why we think it's a five or ten-year idea.

G&D: Let's talk about the experience of running your business. You've co-founded a couple of partnerships along the way. How have these experiences built on

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each other and compared to each other and what have you taken away from each of them?

KSS: Building a firm is a combination of timing, skill and luck, and what I have learned is that it's a different thing from just being a good investor. Something I appreciate more now than I did 10-15 years ago is how important communication is with your partners, your investors, and all of your stakeholders.

The second thing I would say is that it is a much different environment today than it was 15 years ago. The industry has changed quite a bit in terms of the investor base. It used to be a business of mostly individual investors, and now it is a business of mostly institutional investors. So if you want to build a business today, it's more challenging unless you come from a brand-name firm or you start at a certain size. Being small is great for investing but a challenge for building the business.

In our case, we have $80 million in assets under management. We had $400 million before the credit crisis and we made the decision during the crisis to give cash back to our clients who were under extreme distress, even though we had some capital locked up. I made the decision that I didn't want people to experience extreme financial stress while I was holding onto their capital. I made what I thought was the right ethical decision, although it did hurt our business, to open up the fund and, basically, release the capital. We became a funding source at a time when many hedge funds were gating their capital. The benefit of making that decision is we had a lot of grateful clients, although we didn't have their assets.

"Be explicit about learning and progressing. Constantly trying to improve and designing systems for yourself to accomplish goals yields significant rewards over time."

We had to rebuild the firm after that happened. One of the ways I did it was by putting a lot of thought into trying to get more stable, long-term capital, perhaps, in a different structure than a hedge fund, or in addition to one. This led me to get interested in buying a business. So I, along with some of our former investors, bought a reinsurance company, and that reinsurance company, Spencer Capital Holdings, is a client of our investment management firm.

G&D: The reinsurance business seems like a great source of long-term capital, but if you underwrite poorly you can certainly lose money. How do you think about running and managing that business and acquiring the right talent for it?

KSS: It is important to understand that our reinsurance company is a frequency business, not a severity one. A frequency business underwrites generally predictable losses and a severity business underwrites risks that don't happen often or predictably, but when they do occur, they are usually severe and expensive. We can still lose money, but it's less often and less extreme than with a severity business.

Given the nature of our losses, we have the latitude to invest much of the float in equities, which helps our returns most of the time. It also makes us an attractive employer for someone interested in investing because we have a lot of flexibility in how we deploy capital.

G&D: Did you decide to go into reinsurance because of

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your past experience?

KSS: Yes, I specifically wanted to be in reinsurance, so I spent time looking at ideas and deals before finding one that worked. That's an example of something I would say was effective but not efficient.

G&D: Do you have any words of advice to investors who are thinking about starting a fund today?

KSS: My advice to anyone who wants to start a business is to have at least a five-year timeline. If you're predicating your decision on being profitable in the first two to three years, I think that's more challenging of a choice.

G&D: How do you allocate time and how has that fluctuated as the business evolved and developed?

We use four lists to organize our ideas and prioritize our time. List #1 is the ideas we currently have capital at risk in—our current investments—and this takes priority over everything else. List #2 is a small list of one to three ideas that we're actively doing deep research on. List #3 is a list of ideas we might do research on. We collect interesting ideas and put them on List #3 and, when space opens up on List #2, we'll discuss all the ideas on List #3 and decide which one to promote to List #2. List #4 is our watch list. It is composed of ideas we might want to own if the price changed, or a risk issue was resolved.

When doing a deep dive into an idea, we sometimes use external consultants to help us deepen our research by focusing on one key area we want more information on quickly or to help broaden our research by aggregating large amounts of information from diffuse sources. We've spent ten years getting better at working with outsourced research providers and now we can take virtually any topic and find people with the appropriate technical or science or general investigative journalism backgrounds and outsource a research project to them. Our experience also enables us to use research assistants to do robust literature searches. It is time consuming and it lends itself to outsourcing once you learn how to manage the process.

I try to receive information the same way every time because it makes it more efficient for me to go through large amounts of data, articles, and videos. It takes a lot of work on someone else's part to collect and organize the information, but then I can get through it efficiently. This has all been worked out over ten years, but we still work to improve the process.

G&D: What advice would you give to students who are interested in a career in investing?

KSS: I would say only do it if you really enjoy it. If you have a passion for the work—for solving problems, for constantly learning, and for the psychological aspects of investing—then try to get a job at a firm where you can learn from someone else's experience. This isn't a requirement, and I didn't have that experience but, generally, I think working at a place where you can learn from a more experienced investor can accelerate your development early in your career.

The other suggestion I have is to get serious early in your career about mastery. Be explicit about learning and progressing. Constantly trying to improve and designing systems for yourself to accomplish goals yields significant rewards over time.

G&D: Ken, thank you very much for your time.

Lee Ainslie

Lee Ainslie

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Graham & Doddsville (G&D): How did you get interested in investing?

Lee Ainslie (LA): When I was in eighth grade, my father was the headmaster of a boarding school, and the school decided to start an investing club. I thought that sounded fun and interesting, so I asked if I could join that club, which they let me do. I started keeping a paper portfolio, and my interest developed from there.

G&D: It's well known that you got your start under Julian Robertson at Tiger Management. Was there anything that was markedly different than the public perception about the way things were run at Tiger?

LA: I'm not sure I have a strong understanding of what the public perception is, so it's hard to say if anything was markedly different. When I was there, it was a smaller firm. When I accepted the offer, they were managing around $500 million. I was only there for three and a half years, but by the time I left, the firm had grown pretty dramatically, both in terms of assets and in terms of people. I certainly learned a great deal from Julian but also from my peers there. What truly made Tiger a special place was that you were surrounded by so many individuals who were not only very talented and dedicated investors, but also just really nice people. I developed many friendships, which have lasted the twenty years since I left. We all had different pockets of knowledge about investing, not only in terms of sectors and industries, but also different ways of looking at and thinking about stocks. We spent a lot of time comparing notes and playing devil's advocate to each other, and so the collective talent of the team ended up being a great benefit to my investing education.

"If a week goes by that I haven't learned something new, then that is really a wasted week. Sometimes, I'll discover another way of evaluating a particular stock or hear about a decision by a management team that could be interesting."

G&D: Since that time, have there been other investors or books that you've read that have really influenced you?

LA: At one point in time, I read every single investing book I could get my hands on. Then Amazon came along, and the number of investment books has grown exponentially! In terms of who influences me now, I would really point to my peers at Maverick. We have worked hard to recreate that part of the culture of Tiger in that I am surrounded by extremely talented investors. If a week goes by that I haven't learned something new, then that is really a wasted week. Sometimes, I'll discover another way of evaluating a particular stock or hear about a decision by a management team that could be interesting. Other days, I'll learn about a development in an industry that changes my perception of the competitive dynamics in that industry or recognize a certain macro development may have a meaningful impact on the environment. Whatever it is, I'm hopefully learning every day. We have tried to develop a culture where we have a group of people who view themselves as peers, who are not afraid to challenge one another, who enjoy working together and who are driven by common goals and values. I believe I'm a much better investor today than I was twenty years ago, and I really have my colleagues to thank for

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that more than anything else.

G&D: What led you to your decision to leave Tiger and start Maverick Capital?

LA: That was an extremely difficult decision because I had been treated extremely well at Tiger and had so much respect for Julian. I was approached by a family in Texas who were sort of serial entrepreneurs and had decided that they wanted to help launch a hedge fund. I declined their offer to work with them more than once, but they were persistent. I finally recognized that even though I was not sure I was ready to take on such responsibility, that when I would finally be ready, the odds of finding this kind of opportunity would be slim to none given their track record of success in a number of different fields and their willingness to be so supportive of this new venture. I am very thankful to them. While they have not been actively involved in the business for many years, they remain good friends and significant investors.

G&D: What was Julian's reaction to it? Did he give you any words of advice?

LA: His reaction was understandably mixed. I don't recall his giving me any particular advice when I told him about my decision. However, by that point I had already had three plus years of hearing from him how critical integrity and reputation are in the investment business, and those are lessons I certainly took to heart.

"There's a trade-off with having very narrow expertise. If one focuses on just a very small number of names they can develop a deep understanding of certain companies but may lose perspective of how that opportunity set compares to a broader universe."

G&D: What was the toughest part of the transition going from working for Julian as an analyst to running your own fund?

LA: At Tiger you were essentially expected to be the foremost authority on a small number of stocks. For the investments you oversaw, no other public investor should know more about those companies than you did. This objective was possible because most folks were responsible for anywhere from a handful to a couple dozen positions in the portfolio. However, an appropriately diversified portfolio requires more than a handful of stocks, so I needed a different approach when starting Maverick. Likewise, a properly diversified portfolio is not just focused on one sector or on one region, and so there was a period of time when I was more dependent upon sell-side analysts and friends than I was comfortable with. For someone who was very accustomed to being extremely close to each investment I was responsible for that was a bit of a scary feeling. That drove a very early effort to expand the internal resources at Maverick, but initially during the first couple of years, that was the biggest transition.

G&D: That was a concerted effort when you started to have analysts covering a smaller number of names. A lot of analysts we talk to have pretty broad coverage universes, so your goal was to have the depth of knowledge that comes with having a smaller number of names.

LA: There's a trade-off with having very narrow expertise. If one focuses on just a very small number of

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names they can develop a deep understanding of certain companies but may lose perspective of how that opportunity set compares to a broader universe. So how do you have your cake and eat it too? We addressed this issue by hiring what we refer to as sector heads who oversee our efforts in each of the six broad industry groups in which we invest. By 1998, we had heads for each sector so there was finally no stock in the portfolio where I was the only individual tracking the investment. The next five years were spent building out the depth and talent of those teams. Now we typically have three to six people on each sector team. Over the last decade, the incremental growth of the investment team has been driven by developing expertise that is beneficial to all the sector teams. Today, we generally hold about four investment positions per investment professional. At most hedge funds, this ratio seems to average somewhere between 10 and 20. This gives us a significant advantage in terms of the quantity and depth of our due diligence behind each investment decision and how familiar we are with the companies in which we invest.

To ensure that our sector heads have a strong understanding of the relative attractiveness of their investments to a broader universe and are attuned to developments that may impact different industries we established a stock committee that usually meets several hours each week. This group includes every sector head, our Chief Risk Officer, and myself, and is chaired by Andrew Warford. These meetings are focused on evaluating and reviewing potential and current investments, and under Andrew's leadership we have done a wonderful job of maintaining a very consistent and very high hurdle for including a stock in the portfolio.

There's also a weekly portfolio management meeting that I lead in which we consider our portfolio exposures and risks in light of different developments around the world. We have tried to find a balance that allows our sector teams to be quite focused on the industries they cover and yet to be fully informed about factors outside of their universe that could play a role in their decisions.

G&D: As you were building your analyst team, what did you look for in the people that you hired?

LA: The initial group consisted of people whom I had known for a long time and had great confidence in their abilities. However, each of these individuals were being asked to take a risk in that they would almost certainly make less money in the short term in the hope that together, as a team, we would be successful over time. They had to have confidence in our effort.

Today, the majority of our investment team joined Maverick as an analyst. Typically, our analysts have worked for two years at a Wall Street firm or a consulting firm before joining us. We make a two-year commitment to them and expect the same in return, and some are asked to stay longer. We usually hire one to three analysts each year, and it's a highly selective process. We review hundreds of resumes from extraordinarily well-qualified individuals. Our selection process has improved meaningfully over the last few years. First, we changed our interviewing process to make it very targeted on evaluating different skills and attributes that we believe are essential to success at our firm. Secondly, we introduced a third-party testing component which measures characteristics that the interviewing process may not reveal. Thirdly, we spent time analyzing the success of past recommendations of the folks on our team who conducted our interviews to understand who in the past was adept at predicting good candidates—evaluating people and evaluating securities are two different skills.

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The most important components we gauge include competitiveness, mental flexibility and emotional consistency—that last trait is surprisingly important. This is a very stressful business. We are all human, and we all make mistakes. How one responds to those mistakes and whether someone can keep a level head and make thoughtful decisions is critical. Conversely, how does one respond to a few big wins? With some folks, early success leads to inflated confidence that may slow the recognition of a mistake.

At the end of the day, investing is not rocket science. Most of the folks we're interviewing are certainly bright enough to discount a cash flow stream or calculate a P/E multiple. Productivity and dedication can be much more important differentiators than just raw brain power. Intelligence helps, but whether you're driving a Porsche or a Ferrari doesn't matter too much if the speed limit is 65 MPH.

G&D: One thing we read about was that your team is trained in lie detection and interview techniques. Is that an important process when you are interviewing a management team or conducting channel checks?

LA: I'd say it's helpful but not extremely important. There is some training you can do to improve your ability to recognize signals that can help you determine whether someone is not being forthright or honest. This can come in handy when you're talking to a management team and asking difficult questions. We haven't found that these techniques provide some magical ability, but they can help you understand whether someone is addressing a topic that gives them discomfort.

"This is a very stressful business. We are all human, and we all make mistakes. How one responds to those mistakes and whether someone can keep a level head and make thoughtful decisions is critical."

G&D: Was this training a result of you having been lied to by a management team in the past?

LA: Not really, I think every business in the world continually becomes more competitive. I'm sure that's true for the dry cleaner down the block—I bet their business is more challenging than it was a decade ago. That's certainly true in our field, and so you constantly have to find ways to improve. If you're not improving you eventually get left behind. So this training really was a result of trying to find ways to improve our abilities. I heard about this group of ex-CIA officers who conduct this coaching from one of our investors actually, and I think it's been helpful.

G&D: How have your responsibilities as a portfolio manager evolved over the years? Are you still close to every investment decision you make?

LA: Over the years it's been a bit cyclical. If you go to the very beginning, we had one investment professional, so I was very close to every decision we made, for better or worse. There have been periods where the business itself has required a larger investment of time as we were going through changes in our process or rough patches in performance so investors want to speak with me more. Other times, I end up investing more time in evaluating and managing our investment team—these responsibilities tend to ebb

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Lee Ainslie

Professor Tano Santos at the 2013 Moon Lee Prize Competition.

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and flow. Over the past couple of years, the amount of time I have had to invest in running the business has been relatively light.

We typically have about 150 stocks in the portfolio, and I am familiar with all of them, but I am closer to our larger positions and investments that have not worked the way that we had expected. So when I'm doing a deep dive or going to visit a management team, often the P&L of that position has a minus sign in front of it. With Andrew's role as chair of the stock committee, both he and the relevant sector head are very close to each investment, and to me it's reassuring to know that we have at least two senior, proven investment professionals very attuned to the potential return and risks of each stock in the portfolio.

G&D: Can you talk a little bit about the difference in how you think about the timeframe and the sizing between long and short ideas? How you think about the similarities and differences in regards to portfolio construction?

LA: I think compared to many other hedge funds, we may have a longer term timeframe and tend to think very strategically when evaluating different industries and companies. We are typically looking to understand where a business will be in two to three years. However, this is different from our average holding periods, as often others begin to recognize some of the elements of the investment that we have been focusing on and the position becomes incrementally less attractive, and of course other times we recognize that we're wrong. Nevertheless on the long side, our typical holding period is still over a year, and on the short side it is closer to nine months. Although our investment horizon is similar for longs and shorts, our holding period ends up being longer on the long side because we have often been fortunate to identify great businesses run by talented managers. When a business is generating a strong return on capital and the cash flow stream can be reinvested effectively, then we may able to own that stock for several years. The short side typically doesn't work that way because when a company has significant issues, these flaws usually come to light sooner rather than later. So on the short side, you often end up having more of an event orientation.

In terms of sizing, our average long is roughly twice the size of an average short at Maverick, and our long portfolio is more concentrated than our short portfolio. This construction allows us to maintain net long exposure typically between 30% and 60%. The greater level of diversification of our short portfolio reflects the riskier nature of these investments and that these positions turn over more frequently, so having a deeper bench of such investments is helpful.

"We believe that having responsibility for both longs and shorts sharpens analytical judgment and helps a team build a more complete understanding of a particular industry."

G&D: We've interviewed investors who have said that it's rare to find people who are adept at both long and short investing. Have you found that to be the case?

LA: I disagree with that thesis. We believe that having responsibility for both longs and shorts sharpens analytical judgment and helps a team build a more complete

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understanding of a particular industry. In my experience, people that are solely focused on shorts tend to become extreme pessimists. They look at any situation and immediately start to find all of the things that may go wrong, while quickly overlooking important potential positives. Furthermore, shorting is more challenging for several reasons, one of which is that the market tends to appreciate over time. So even talented short-sellers who are generating alpha tend to get rather frustrated over time. These issues may be even more acute at Maverick than many firms because all of our short exposure is achieved by shorting individual stocks, as opposed to using ETFs, S&P puts, or other market-related instruments.

We have always held our sector teams responsible for both long and short investments, and our investment process is pretty similar for each. To dramatically oversimplify, we are trying to identify the winners and losers in each industry in which we invest and then evaluate the discrepancies between our conclusions and consensus views, and I believe that is an effective approach for both longs and shorts. While many firms seem to be markedly better on either long or short investments, at Maverick we have added 6% of alpha per year on both longs and shorts, so I believe this balance supports our approach.

G&D: You said in an interview a few years ago that classic value investors often invest purely on valuation and that was something that you just weren't comfortable with. How much weight do you place on valuation?

LA: To be clear, I think that valuation is a critical component of understanding where investment opportunities may lie. But I think many "value investors" purely focus on that metric and may ignore other important considerations. It's one thing if you have a very cheap stock and reasons to believe that the cheap valuation will not persist: there's a new management team, there's an activist shareholder, they're restructuring, they just made a decision to buy back stock, and so forth. I believe it is important to identify a catalyst that should benefit the valuation. The approach of simply identifying a very cheap stock that often has been cheap for a while and then just crossing your fingers and hoping the world will wake up and be willing to assign a higher valuation one day soon is not a very effective approach in my judgment. So while we place great emphasis on valuation in our investment decisions, valuation alone should never be the driver of either a long or a short investment.

G&D: Can you talk about your idea generation process? Are you finding yourself looking more at new ideas or at ideas that you've been tracking for many years?

LA: We have always considered our universe to be every stock in the world that trades more than $10 million a day and has a $1 billion market cap. As we speak, there are almost 3,000 such stocks—this excludes A shares in China as US investors only have a limited capacity to invest in these stocks today. If we did, it would add several hundred stocks to our universe. At Maverick, our investment process is driven by our six industry sector teams, which have global responsibility. Each sector team has between three and five people.

Idea generation almost always takes place in these sector teams. There are times I have an idea that merits further evaluation, but most of our sector heads have spent their entire careers focusing on one industry, and they have each proven that they are very talented investors—so we would never move forward on an idea without their input. Our sector heads are probably responsible for the majority of new ideas, but even our junior analysts are expected to develop actionable

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investment theses. From that spark of an idea, if it's a company we know well, one little data point can be enough for us to move quickly. However, if it's a company we have not analyzed before, it typically takes months before a stock can make its way into the portfolio because we will do a deep dive not only on the company in which we're considering investing, but also on the competitors, customers and suppliers of that company. For better or worse, this process can take a very long time.

G&D: What do you look for in these deep dives? What qualities make for a good investment?

LA: By deep dive, I mean we typically have extensive meetings with as many different members of management as possible as well as managers of different regions or product lines if possible. The most critical factor that we're trying to evaluate is the quality of management—their intelligence, competiveness and, most importantly, their desire to create shareholder value. At the end of the day, businesses are run by people, and different management teams have different motivations and different abilities. As investors, it is critical that we have a strong understanding of the quality and the objectives of every management team in which we invest.

Of course, we also want to have a very deep understanding of the businesses in which we invest: the sustainability of the business, of the growth and of the cash flow. The primary point of our extensive conversations with customers, suppliers and competitors is the evaluation a company's strategic position and the strength of a company's moat or competitive advantages. As we discussed a few minutes ago, valuation is also an important consideration for us. I believe that a successful investor must be very comfortable with a number of different valuation methodologies and have the wisdom to recognize which valuation approach is going to be the most relevant in different situations. The most commonly used valuation metric at Maverick is sustainable free cash flow in comparison to enterprise value. But we may also consider metrics such as enterprise value to revenues, book value, free cash flow yield, P/E ratio, dividend yield, and so forth. Different metrics will be more or less important in different situations.

"The most critical factor that we're trying to evaluate is the quality of management—their intelligence, competiveness and, most importantly, their desire to create shareholder value."

Finally, as I mentioned earlier, we consider how differentiated our view is; not to say that we will only invest in things where we have a contrarian perspective. For example, Microsoft in the early 1990s and Wal-Mart in the early 1980s were consensus buys among virtually all Wall Street firms, and yet they were among the most successful stocks of their day. So it's not impossible, but the odds are against you if your view is the same as everyone else's because that view is probably already reflected in a stock's valuation. Our most successful investments tend to be those where our research process has led us to a conclusion that is different than the perspective commonly held

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by most investors, and these deep dives allow us to develop significant confidence in these differentiated views.

G&D: You've met a lot of management teams over your career. Have you found more often than not that they are thinking the right things in regards to creating shareholder value, or is it kind of the alternative where you're generally disappointed?

LA: One of the things we really try to make sure our team understands is that if someone is able to become the CEO of a Fortune 500 company, the odds are that individual is going to be pretty impressive across the conference table for 45 minutes. These executives are not dumb; they know exactly what you're trying to get at, what you want to hear, what Wall Street thinks the right answers are, and like all good politicians they will do their best to highlight the strengths of their business. When you delve into the potentially weaker aspects of their company, they will typically try to gloss over your concerns or even obfuscate the issues. So when we evaluate a management team, we're much more focused on analyzing past decisions and actions than simply reviewing their responses to our questions. We also invest a lot of time in trying to interview people they've worked with before or people they've competed against and have found insights gleaned through those conversations very helpful over the years.

G&D: You have been quoted as saying there are no "holds." You either "buy" or "sell". How do you implement that practically in your portfolio?

LA: I think I have read almost everything that Warren Buffett has written, and I agree with more than 95% of his thinking, but this is one area where I disagree. I understand the tax impact of turnover, but nevertheless, I would argue that an investor should be able to overcome the negative tax consequences of shorter-term holdings through more efficient use of capital. For example, if I am starting a new fund, and my portfolio is a blank sheet of paper then I will evaluate the potential return of every potential investment from the prices the market is offering that day. I can decide how much risk I am willing to take to achieve expected returns, and I can evaluate how each opportunity compares to every other opportunity to develop a portfolio which I believe represents the optimal use of capital. In my view, tomorrow, I should go through the exact same process taking into account any new information including changes in the price of securities. If I conclude that a different portfolio would be preferable then I should buy or sell securities to get to the portfolio that I believe represents the optimal use of capital once again.

This is exactly why we primarily invest in liquid, public equities—so we have the ability to improve our portfolio every day. If we conclude that a 3% position in stock X would be the ideal position size, then we should try to get to that position size that day. Whether stock X is new to the portfolio or it's a position we've held for years is not horribly relevant. Likewise, whether we entered that day with a 2% position or a 4% position in stock X should not play a role in our determination of the most appropriate position size. I think too often investors get wed to certain investments that have worked well or perhaps because they've developed a nice relationship with management that they don't want to disrupt, and so investors often get complacent and comfortable with their current portfolio. In my judgment, it is critical to attempt to identify the best possible use of capital continuously.

The "no holds" concept simply reflects the approach that every investment should represent a very compelling risk/reward opportunity from current prices, and if that's not the case then that capital should be redeployed into positions

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that are viewed as very compelling at current prices. In the perfect world, every member of our investment team is pounding the table to increase the size their positions every day until they are at a maximum size in terms liquidity or risk contribution. When somebody tells me that they don't think we should sell a stock, but that they wouldn't buy more at the current price either, then that investment probably does not represent one of our very best uses of capital—unless the size of the position is already at a maximum from a risk perspective. We want our portfolio invested in the most attractive use of capital today at current price points, and if a certain position no longer represents that then we should sell. Sometimes, people have a hard time with this because this philosophy often means we are reducing or exiting a position before it's reached our expected price. For example, if a stock is 10% away from our original target price, we are likely to sell because we think there are many other opportunities with greater upside. Conceptually, our team has to accept this concept of "no holds."

G&D: Are there industries or countries that you have a different view on versus the market?

LA: In our core hedge fund, we try to maintain a balance of longs and shorts in every industry and in every region in which we invest. We try to avoid market timing or sector rotation calls. Our returns are driven by our ability to generate alpha within industries and regions.

G&D: Can you talk about a mistake that you've made on an investment that has changed the way you think about things?

LA: Unfortunately, I can go through many examples of mistakes that we've learned from. In terms of risk/return management, we develop a risk case that we think has a 10% chance of taking place—so a case that is not highly likely, yet certainly in the realm of possibility—and we vigorously debate the assumptions behind these risk cases. In measuring potential downside, we have often used historical dynamics, such as trough book value or revenue multiples. One of the lessons of 2008, and even more so in 2011, was that, in certain environments those historical patterns can collapse. We took too much comfort in the thought that many stocks were sitting at levels where the downside risks appeared very limited given they were so close to the historical lows on such metrics, and we were proven wrong.

In terms of a specific company, we invested in a company called NeoStar, which was a result of a merger between Software Etc. and Babbage's in late 1994. The companies were the two largest sellers of computer software and operated in malls around the US. On paper, NeoStar was very attractively positioned. By merging, these two competitors would enjoy economies of scale and could improve pricing. As this merger was taking place both Sega and Nintendo had roll-outs of their new game platforms, both of which ended up being bigger than people expected. At the same time, Windows 95 was coming out, so you had huge drivers to both PC and gaming software sales as well as very significant synergy opportunities. These businesses should enjoy meaningful operating leverage, so just improving comp store sales a few percent should have had a nice impact on operating margins. Putting all these factors together, we concluded that the company would earn significantly more than investors were expecting. And we were wrong. We were wrong because management just blew it. When you asked me about characteristics I look for in stocks, I mentioned quality of management is the most important. While our investment case for NeoStar was extremely compelling, we were doomed by horrific execution. In doing a postmortem, it became

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clear the merger was a disaster. The companies continued to be run as separate entities and continued to compete viciously. There was huge in-fighting about who was going to get what responsibility. Instead of taking advantage of the obvious synergies, they had duplicate efforts on many different fronts. One large vendor told us that two different people each thought they were ordering for all the stores and as a result, important orders were placed twice, and they literally ended up with twice the expected inventory. It was just an unmitigated disaster. We bought the stock right after the merger in early 1995, and by 1996 it was all falling apart. Our strategic analysis proved correct—both the gaming platforms were huge and Windows 95 became the best-selling operating system of all time. Realizing the potential synergies seemed straightforward as well. But the important lesson was that such considerations are not relevant if the management team is subpar.

G&D: What advice would you give to the students who are interested in a career in investing?

LA: Two things: first, read a lot. Read as many investment books as you can get your hands on. I've been able to learn something from almost every book I have ever read. Secondly, the path to an investment career is not necessarily to work at a hedge fund or at a large mutual fund complex. You can start your career by simply improving your understanding of how different industries or companies work or how Wall Street works. Any brokerage firm or Wall Street firm can be a path to an investment career. A lot of people move from the sell-side to the buy-side over time. We probably have as many former McKinsey consultants as we do former Morgan Stanley investment bankers.

G&D: A lot of our students are also interested in starting their own funds. Assuming they can raise capital, would you recommend that they spend the first few years trying to get training somewhere first, or do you think it is okay to start right after business school without any formal training?

LA: The capital is important, but the know-how is even more important. The fear with starting right away without a great deal of experience is you don't get many mulligans in this field. If you launch a fund that has disappointing performance, then go to work for another firm for a few years and eventually try to launch another fund—potential investors are still going to want to delve into the returns of your initial effort. Not that a poor record can't be overcome, but it's certainly going to make raising capital harder. You can't just tell people not to count your past record because you didn't know what you were doing. So the first couple of years become a make or break period. If it were me, I would want to stack the deck in my favor as much as possible. When I decided to launch Maverick, I had been with Tiger for three years, and I was still scared to death. I was young, naive and probably a touch arrogant in hindsight. If I had a better understanding of the challenges of successfully starting a fund, I'm not sure I would have departed Tiger. Also, today's world is far more competitive. The odds of a small group of people launching a small fund and growing that fund into a large entity are just much smaller today. When I started, there were probably about 100 hedge funds in the world. Today, there are over 7,000.

G&D: Lee, thank you for your time.

Professor Bruce Greenwald and Heilbrunn Center Director Louisa Serene Schneider at the 2013 Graham and Dodd Breakfast.

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Geoffrey Batt

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Batt launched the Euphrates Iraq Fund in October 2010. Prior to his Iraq investments, Mr. Batt was an analyst at Quantrarian Capital Management. He studied philosophy at Columbia University.

Graham & Doddsville (G&D): Let's start with your background—what drew you to investing, and in particular, to investing in Iraq?

Geoffrey Batt (GB): I studied philosophy at Columbia as an undergrad and had absolutely no intention whatsoever of getting involved in finance. I didn't know anything about the stock market. I honestly didn't know the difference between a stock and a bond. I was strictly interested in academics and very much wanted to pursue a Ph.D. in philosophy. I took a graduate seminar in my junior year and there was a third year Ph.D. student in the class who was much older, maybe in his forties. But he was, in my opinion, clearly the smartest guy in the room, probably smarter than the professor. He was also a bit eccentric to put it politely. He seemed very interesting, though, and one day we bumped into each other on campus, started talking, and a friendship developed from that. After knowing him for a while, I mentioned that I was going to have to leave school for a year to save up money because I couldn't renew my student loans.

I revealed this to him having really no idea who he was. But then he started telling me this story of how, before school, he was running a fund that was one of the first to invest in post-Soviet era Russian equities during the 1990s. Russia turned out to be one of the best places in the world to invest in at that time so it was quite successful, but he also had a lifelong dream of pursuing a philosophy doctorate. It turned out that he was in the process of starting a new family office to focus on investing in East Asian emerging markets and asked if I'd be interested in working for him during the time off. If it went well, he told me I'd get a bonus that would more than cover my tuition and in the meantime I'd get to learn about the world. He said something along the lines of, "the last thing the world needs is another philosopher with no real experience." He was of the opinion that philosophy provides a good training for financial markets.

"Philosophy teaches you to take whatever the prevailing wisdom is and challenge it."

I actually thought he was nuts. He didn't fit my conception of what an ultra-high net worth individual looked like. But I went to the library and looked him up and it was all true. His name was Dan Cloud. You couldn't bring up good pictures on the internet at the time but I saw there was a Barron's article on him that I had to look up on microfilm. Everything he said was there. So I decided to give it a shot. I went to work for him, with his family office, and learned about East Asia and the markets that they were investing in—Thailand, Hong Kong, South Korea, Singapore, Indonesia, Vietnam, et cetera. Dan was very much a macro driven investor, looking at things from a top down point of view. What he had me looking for were countries that seemed to have the best potential to grow very rapidly and had the most interesting demographic profiles.

I more or less just tried to learn on the job, and I would say after six months or so I started getting very

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interested in companies themselves. I didn't have the slightest clue about how to analyze or value them so I spent the next six months trying to learn. The first thing I read was *The Intelligent Investor*. I felt pretty confident that I understood it, so I went on to *Security Analysis* and read that. I still read it—to this day, I think I've finished it seven or eight times. *Security Analysis* gave me a basic framework, however imperfectly I understood it, that I could use to approach valuing companies on an individual level. And that's when it became very interesting to me. The macro stuff, it has its place, I suppose. I'm not a value purist in the sense that I altogether shun macro considerations. But to me, the real interesting work is in finding the next big company, the kind of deeply undervalued company that has the potential to appreciate ten, twenty, thirty times over a ten year period.

G&D: How did that year working for Dan turn out?

GB: The year went really well. We were mostly invested in Thailand and I think the market was up 110% or so in 2003-04. I got a bonus, which at the time seemed quite large. In retrospect, it wasn't, but when you're approaching things from the perspective of what you're going to earn in philosophy, it seemed like quite a lot of money.

And so I went back to school and had enough money left over to invest on my own. And you know, before I started working for him, my focus was 100% philosophy. When I came back, it was 50/50—50% philosophy and 50% markets. And as that year progressed, it gradually shifted to 0% philosophy and 100% markets. Toward the end, I was sitting in class with my laptop open reading 10-Qs and 10-Ks rather than paying attention to the professor. I was two classes short of graduating and decided that I had enough.

In retrospect, it was an unwise decision because I didn't have as much money as I thought I did. Maybe I was a bit delusional in thinking it, but I was determined to just go out on my own and become an independent investor. I still had library access at Columbia and there was a Bloomberg there so I thought it would be perfect. I told Dan my plans and he said, "Look, you can't just go out on your own and not have structure. You really need to have a mentor for this process, somebody who can help guide you if you're going in the wrong direction or to provide you with advice and support and criticism." So I decided to strike up that relationship with him informally where I would start on my own but he would serve as my mentor.

G&D: And what was the focus going to be initially?

GB: Several different stock markets over time have gone through these historic equity re-ratings and what I was really taught to do when I was working for Dan, and what he was taught to do when he first got involved in the business, was to find opportunities for historic re-ratings.

Let me try to define what that is. It's a type of secular bull market that tends to last for seven to fifteen years, In the case of Japan, their bull market started in 1950 and lasted until 1989. That is one of the longest ones that I am aware of. Russia was fourteen to fifteen years. You can get a secular bull market that lasts for seven to fifteen years and during that period companies on the exchange can see their profits go up 20x. Initially they might be trading at 2-4x earnings and by the end of the bull market, they are trading at 15-20x earnings. There's an improvement that gradually gets recognized. Initially, the market goes up but the moves are commensurate with profit growth. If profits grow 40% and the company is trading at 8x earnings, then the stock goes up 40% but still trades at 8x earnings. But towards the end, people get really exuberant and assume that the good times are going to last forever and that's when you see multiple expansion. So it's when you get

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"I'm not a value purist in the sense that I altogether shun macro considerations. But to me, the real interesting work is in finding the next big company, the kind of deeply undervalued company that has the potential to appreciate ten, twenty, thirty times over a ten year period."

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significant profit growth over a long period of time coupled with multiple expansion that you can get these spectacular stock market moves.

When Dan first got involved in the business, it was in China in the 1980s. He finished school and went off to China to work for a British brokerage firm. The guys who taught him made their fortunes investing in Hong Kong and South Korea in the 1960s and 1970s. South Korea was socially and politically an utter basket case at that time. It was ruled by a dictator, Park, for around 19 years. He was a guy who had suspended the constitution two or three times, murdered the opposition. Park was brutal but this was also the period that is referred to as the South Korean economic miracle. So despite the fact there was quite a lot of political and social instability in that country, it happened contemporaneously with an economic miracle. These guys recognized that and they believed that many of the things that typically keep people away from markets—bombings, violence, general instability—really don't matter that much. As long as it's not related to the economic development of the country, it doesn't matter. That was what Dan was taught.

"Several different stock markets over time have gone through these historic equity re-ratings and what I was really taught to do when I was working for Dan, and what he was taught to do when he first got involved in the business, was to find opportunities for historic re-ratings."

So he later went off and was searching for the next big thing. He found it in Russia and launched his fund in 1994. Russia from 1992-1994 was also a basket case. Yeltsin lost an election in 1993 but decided it wasn't valid just by decree and suspended the constitution. Parliament was obviously very upset about that so he sent tanks in to fire on Parliament in 1993. Literally, the President of Russia was using the military to fire on the Parliament building and kill MPs. But it turned out that was the ideal time to get involved in Russia. These sorts of alarming states of affairs, they really, it turns out in retrospect, don't matter much. They're terrifying and for that reason most investors don't get involved in their markets. When it's most opportune to invest in a market, most people are doing anything but investing there. They stay very far away.

But he was there and started a fund, Firebird. And I think that fund was up 50x, net after two and twenty, so it was an extraordinary run. I think it was one of the best performing emerging market funds in the world during that period. So that's really what I was taught to look for—these types of really alarming and chaotic transitional situations in a country that, for whatever reason, was living in the stone ages or had some kind of very flawed economic system in place for decades. Something transformative occurs that is followed by a move away from whatever was plaguing it before to something more positive, more market and capitalist oriented. If you can find that kind of situation, that's a potential candidate for a historic equity re-rating.

G&D: What else goes into it?

GB: There's a lot more but that's the first thing you want to look for. It seems to me at least, the greatest opportunities in any market, any asset class, any investment generally that you're going to make, are those in which there's a very wide gap between perception and reality. So the perception of a country that has these characteristics is obviously going to be very negative because there's political instability, social instability, and so on. But if the economic situation is positive, if the country has a couple years of very high GDP growth, inflation is relatively stable and they have price stability, then this is where I think the macro very much comes into play.

You want to look at things like, are deposits in the banking sector growing? Is the currency relatively stable? Generally what you're looking for are signs of macro stability and economic growth. If you can find these things, then that implies there are institutions in place that are capable of

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achieving this stability. If you have price and currency stability, that presupposes a central bank exists that is capable of imposing stability on the system. And that also presupposes that you have some sort of technocrat running the institution. So if you have credible institutions at the financial and economic level that are able to achieve macro stability, then whatever has been holding back that country from realizing its potential, if they can transition away from it, macro conditions aren't going to interfere with development.

If you look at countries that had the potential to do this but failed, like any South American country in the 1960s, what destroyed them is that they had chronically high inflation, they had persistently weak currencies, and they lacked the institutional framework that was vital to achieve the stability that you needed to get that kind of economic take-off. If you're a business person, how do you plan for the future if the currency is devalued by 80% and there's prospect for further devaluation? How do you plan for the future if you cannot estimate what your real returns are going to be because the currency and prices are so unstable? It leads to a very short term outlook. That is what prevents an economy from realizing its potential.

G&D: In some of these countries where there is perceived political risk, how do you separate out the noise from true risk? Take Yeltsin for example, if you have a leader or autocrat who is willing to go and fire on Parliament, how do you get comfortable that he also isn't also willing to devalue the currency?

"The South Korean example under Park demonstrates that economic miracles and historic equity re-ratings can happen even in iron-fisted dictatorships."

GB: Right. So this is obviously a key consideration and a great question. In South Korea, I'm not so sure I could ever have gotten comfortable with the fact that Park ruled the way he did. Dictatorships can be very stable, but, by their very nature, they're stable until they're not. If there's an issue, if suddenly the dictator can no longer rule, what follows? Also if the dictator goes crazy, there's no mechanism to easily remove him and then you can get a dangerous scenario where he just starts printing money or devaluing the currency—you could have a revolution or other undesirable developments follow. Still, the South Korean example under Park demonstrates that economic miracles and historic equity re-ratings can happen even in iron-fisted dictatorships.

That said, I have a preference for transitional countries where there is a democratic political system in place. Taking Russia and Yeltsin, you could make an argument that what Yeltsin was actually doing was establishing legitimacy of the state itself—that the state itself was being undermined by a group that was trying to take control, the former Communist party, and Yeltsin was trying to prevent that. So you could argue his aims were noble and he was actually trying to install a capitalist, democratic framework, and that action, though autocratic, was directed toward something that was ultimately in the country's best interest.

When you look at a country

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that has a great deal of violence and where the political leaders have a reputation for ruling with an iron fist, even if democratic,

"I had thought of Iraq as a failed state in the middle of a civil war. I knew nothing about it beyond what I read in the New York Times or saw on TV. And so I thought the article was odd because how on earth is a failed state in a civil war increasing oil production?"

the key is this: why are they doing it? Are they doing it to enrich themselves? Or is it mixed motives—maybe partially to enrich themselves but also to help the country? No one is entirely acting out of altruistic motives but in dictatorships that lead to disaster, it is often purely just corruption and self-enrichment. In the case of Russia and also in the case of Iraq, what you find is that what these guys are really doing is attempting to establish the state's monopoly on the just use of force. That is a critical part of establishing the legitimacy or sovereignty of a country. In these transitional situations, what seems to matter most is that the state demonstrates to the people that only it has the authority to use force justly. Really what the state is doing is demonstrating it has the capability and willingness to establish law and order. Sometimes that can be brutal. But if it's done to ultimately achieve democratic ends, then it seems like it's justifiable and something that at least I can get comfortable with. So I think that probably applies to what Yeltsin did. And when I look at Iraq, I think it very much applies to what has happened in Iraq since 2008. To the extent there has been political violence, it's been done for reasons that are almost always justifiable in those terms. We observe the behavior of the Iraqi political elite very closely. What we ask is this—are they behaving in a pragmatic way? Is there a rational self-interest to what they're doing? Are they able to make pragmatic compromise? Rather than drive the car off a cliff, do they actually stop short before they go over the edge? I mean, if you want to prove a point, you can prove a point and ultimately die for it. Or you could stop short and compromise and admit that some parts of your arguments are wrong or you're not going to push for certain parts of whatever you were striving for. In Iraq, this is what we tend to find. The various political actors that are constantly feuding with each other use heated and often alarming rhetoric, but at the end of the day, when they're on the brink, they always pull back and make some kind of pragmatic compromise. And it tends to be compromise that is rationally self-interested. That, to me, is very encouraging because you see the same, or similar, sorts of behaviors in democracies throughout the world, including the West.

G&D: For instance, in raising the debt ceiling?

GB: Right. And that to me is even more insane in a way because, and I guess this is contentious, at least in the Iraqi political system they tend to be arguing about things of great significance. I mean this is a country in the very early stages of its development, ten years removed from Saddam, and they have quite a lot they need to work out. In our country, this seems completely unnecessary—to put a gun to our head when we don't really need to. So I would say, in a way, politicians in Iraq operate more rationally than politicians in the US. This is

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a sad state of affairs I suppose.

But getting back to how I found Iraq, I was searching for that next thing. In 2007, every market in the world was in a bull market. It's hard to think of any asset class that didn't produce a fairly spectacular gain over the prior five-year period. Equity markets around the world were strong, commodities were strong, even certain currency markets had produced very strong returns. It was hard to find anything that fit into this category of deeply distressed, transitional situation. And it was right around that time that I read an article about how Iraq was increasing its oil production, which I thought was very strange.
I had thought of Iraq as a failed state in the middle of a civil war. I knew nothing about it beyond what I read in the *New York Times* or saw on TV. And so I thought the article was odd because how on earth is a failed state in a civil war increasing oil production? You can't reconcile those two data points. Increasing oil production implies there is a functional state that is capable of achieving this. One of those two points of view had to be incorrect. So I looked into the matter more closely and saw it wasn't just oil production, but that they had a hyperinflation that started in 1990 and ended in 2006. They did have a civil war but it had ended by early 2007 and so by that summer, violence was about 75% below its peak. Deposits in the banking sector were increasing, electricity generation was increasing, and the economy was starting to grow pretty rapidly. When I looked at these macro variables, what I found was that the consensus view was very much at odds with reality, that what you were seeing on television was about as far removed from what was actually happening in Iraq as it could be. Yes, things were awful but the media was not making the distinction. They weren't showing you any improvements that took place over that year. But it looked to me like there was pretty compelling objective evidence that Iraq had reached a turning point.

This is exactly the sort of situation that you want to look for when you're searching for these potential historic equity re-ratings. There is objective data that portrays a positive picture yet there is a perception that none of that is happening, there is a perception that quite the opposite is happening, that there is capital flight, hyperinflation, chronically weak currency, falling oil production, economic depression, and so on. That was the image that I had in my head; I think that was a fairly representative view in the West at that time and still is.

G&D: And was that enough to convince you?

GB: I went back to Dan with the idea and he said something like, "You've come to me with 100 ideas and 99 of them were bad or okay, but I know this one is good because the very first thought that I had when you mentioned it to me was how can I steal it from you?" But he said he would help me pursue it. I should study it for the next six months and see if I could confirm that the data is accurate. So I studied the country, its markets, its political situation, and its history for the next six months. And by the end of 2007, I was convinced that there was a legitimate change taking place and that the country had turned a very important corner in its development. Then the question became, how do you take advantage of that? It just so happened that there was a stock market. It was very small and I was shocked to find it. I think at the time the whole market had a capitalization of about $2 billion, which was smaller than the Palestinian stock exchange which had only launched in the summer of 2007.

I e-mailed every broker that was on the stock exchange website, maybe 50 brokers, and I got 5 or 10 replies. Only a few of them were in English and only one of them was in coherent English, so I chose him. I wired $2,000 there, bought

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"I went back to Dan with the idea and he said something like, 'You've come to me with 100 ideas and 99 of them were bad or okay, but I know this one is good because the very first thought that I had when you mentioned it to me was how can I steal it from you?"

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Louisa Serene Schneider and Marty Whitman at the 2013 Graham and Dodd Breakfast.

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a stock, sold it the next day and wired the money back out of the country to see if I could complete the whole cycle. It turned out that it was very easy to do. So with that, I put most of my investable assets into Iraq, and then around January 2008, Dan gave me a managed account and put me in touch with his two partners at Firebird. I presented the idea to them and they each gave me a managed account as well. I had my own money there and three managed accounts for two years.

Back then, I was probably one of the few, if not the only person, in the West who was investing in this market. I thought there could be demand for this kind of frontier investment and I was credibly in a position to create a fund to capture what I thought was untapped demand. The one problem was that I didn't have a track record and I had a very unorthodox background so I needed someone with a pedigree. And that was Dan. I started the company and sold him 20% of it, with the agreement that he would be a partner but not be involved in day-to-day operations. Having him made it pretty easy to market. People thought, "The guy who found Russia is now looking at Iraq, so there must be something interesting there."

So that is how I got involved. I was looking for what I thought was the next historic equity re-rating, and only found it after I thought I had pretty much exhausted all of the options. It was a complete shock that it turned out to be Iraq because it was the very last place that I would have anticipated. But that's the key, take some country with a stigma like North Korea or Myanmar—people are really excited about Myanmar now, so maybe that's not such a good example—and see where it leads.

G&D: Zimbabwe?

"Having him made it pretty easy to market. People thought, 'The guy who found Russia is now looking at Iraq, so there must be something interesting there.'"

GB: Actually, people are excited about Zimbabwe, too. They're enthusiastic about a lot of Africa right now, which is interesting. Take Nigeria for example. Nigeria has a serious and growing problem with Al-Qaeda. They don't control the northeast part of their country and it's in a state of emergency. But if you look at the valuations in Nigeria, consumer products companies are trading for 30x earnings. They might be growing fairly rapidly but the multiples being assigned to their earnings are absurdly high and certainly don't price in the risks.

Iraq, on the other hand, is actually quite similar if you just look at the data. Iraq produces more oil and its oil production is increasing while Nigeria's is flat. Iraq has substantially greater foreign exchange reserves. They produce more electricity with a smaller population and their electricity generation increases each year. GDP per capita is higher and GDP itself is higher. Relative to every development that you can think of, Iraq has the edge. Both have a problem with Al-Qaeda and the levels of violence are somewhat comparable—Iraq is worse but it's not that much worse. But you can buy a branded consumer products company for 7x earnings in Iraq whereas in Nigeria it's trading at 30x earnings.

So it's fascinating when you look at the interest that people have in Africa that

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they completely disregard the risks that are attendant in those countries and take those very same risks and exclusively focus on them in Iraq. The same is true in Mexico. Sixty thousand people died in Mexico from 2007 to 2011 in what was very much a civil war. The government still does not control parts of western Mexico. The police and military have given up. Look at their consumer product goods companies—they trade at 40x earnings. This actually illustrates quite nicely the irrational extremes that markets go to. Do they teach efficient markets theory at Columbia these days?

G&D: It depends. In some classes, they do, with limits.

GB: But efficient markets theory is completely incompatible with value investing and I would imagine that for business schools generally, it is a part of the curriculum. Just look at the behavior of market participants and how they appraise value where the conditions are almost identical, but the only difference is geography or the name of the country. In one situation the perceived risks are very low and the valuations are quite high and in the other country the perceived risks are very high and the valuations are quite low. It shows how far the investing community departs from a rational assessment of value and how difficult it is for a market to accurately price risk. The places that you would last think you'd want to put money can turn out to be the most interesting. That's how I found Iraq and it was quite a surprise. But after I studied it closely, it fit the narrative beautifully. That's why I am there.

"So it's fascinating when you look at the interest that people have in Africa that they completely disregard the risks that are attendant in those countries and take those very same risks and exclusively focus on them in Iraq."

G&D: You mentioned a couple key indicators about Iraq, like power generation and natural resource production. Is there a standard set of data that you look for when you are evaluating countries?

GB: Does the country have the ability to become much larger in the future than it is in the present? So in the case of Russia after the collapse of the Soviet Union, Germany and Italy after World War II, and South Korea after the war there, you were looking at countries where the economies were quite small for various reasons, but they had the potential to become orders of magnitude larger. When you look at a country like Sri Lanka, what do they really have? How much tea can they actually export? How much is that going to drive their economy in the next twenty or thirty years? There are markets that can be interesting for a year or two, maybe up to five years, but you want more than that.

Does it have economic scalability to it? You want to look for the presence of credible institutions that are capable of achieving the macro stability that is necessary for the country to grow over time.

And you want to look for cheap assets. You must have a mispricing. If Iraq was already pricing all this in during 2007-08, if everyone was optimistic about the future and stocks there were trading at 30-40x earnings, then you weren't being compensated for the risk. After the other

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conditions are satisfied, that last factor is vital because it's your margin of safety.

G&D: Do you need foreign institutional investors to get involved for a country to re-rate?

"I think they have an ability not only to matter economically, not only to be orders of magnitude larger in the future than they are today, but to be one of the most important economies in the world in 20-25 years."

GB: It depends. You would think that you absolutely need foreign money to fuel it but South Korea, to the best of my knowledge, didn't have that much foreign money and neither did Germany or Italy in the 1950s. Most foreign money stayed away from Japan until the 1970s. During the 1950s and 1960s they had capital controls in Japan so if you invested you couldn't take your money out for two years and that kept a lot of people away. Emerging markets were something very few people went near prior to the 1980s. So the historic re-ratings that have taken place since then, I think, have had a foreign component to them. But I don't think it is essential. History shows that they've happened without foreign money, particularly in a petro-state. Take Saudi Arabia—you can't invest there directly and they've had spectacular bull markets that were driven entirely by petro dollars and the oil cycle.

G&D: How did Iraq fit into that framework?

GB: Iraq is a neat case. It was a country that, in the 1960s and 1970s, was on the verge of becoming one of the most powerful petro-states in the world. Oil production was around 500,000 barrels a day in the 1950s. By 1979, the year Saddam comes into power, it was 3.5 million barrels/day. GDP per capita went from $500 in the mid-1960s to $3,500 by 1979. They had this extraordinary economic transformation taking place and Saddam destroyed it all. For the next two and a half decades, it was really one of the single greatest episodes of wealth destruction the world has ever seen outside of Myanmar and North Korea. It was dreadful. By the time Saddam was overthrown, GDP per capita was back to $500 again. Oil production is right around the same level it was at in the mid-1960s. The country was on a trajectory that was going to have it rival Saudi Arabia in terms of oil production and exports, and have an economy that was almost as large, but it was derailed. It was taken off course by the mismanagement of a dictator. That actually made Iraq stand out much more than South Korea or, say, Hong Kong. South Korea never really had a history of growth before the 1960s and 1970s. It was mainly subsistence level agriculture with no real history of modern economic development. Iraq had that and they lost it. It was just a matter of whether they could get it back. When you look at their oil industry, they have the ability over the next fifteen to twenty years to rival Saudi. They could conceivably become the second swing oil producer in the world. Saudi would no longer be the only country that has enough spare capacity to meet unexpected demand for the world. So I think they have an ability not only to matter economically, not only to be orders of magnitude larger in the future than they are today, but to be one of the most important economies in the

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world in 20-25 years. And that's not an overstatement; if they are producing 9-10 million barrels of oil a day, that puts them right up there with anyone else. And when you look at the tiny size of their banking sector, the tiny size of their consumer product sector, the valuations that we found in their real estate markets in 2008-09 and even present, it was a country which was stunted. It was like a giant stuffed in this tiny little cage. It is very difficult to tell when it is stuffed inside but once you take it out, it stands fifty feet tall.

Take their banking sector as an example. In 2003, there were $300 million of assets in the private banks. Now the private banks have about $16 billion. They've gone from $300 million to $16 billion in ten years. GDP in 2004 was $25 billion. By the end of 2012, it was $210 billion. So even though they have experienced extraordinarily rapid growth, banking assets are still less than 10% of GDP. The top five banks in Saudi Arabia have assets that are about 50% of GDP. So let's say Iraq has a $600 billion economy by 2030. If the top five banks were to equally split half of that, it would be $60 billion in assets for each bank. The biggest bank right now has $1.5 billion in assets and a market cap of $300 million. So when I talk about scalable economic growth and scope for growth, this gives you an idea. And it's very rare to find a market in a country that has that much scope for growth. That's what I think makes Iraq unique—it has more scope for growth than any country I am aware of in the world today.

G&D: Once you found an interesting situation like Iraq, how did you think about efficiently screening the opportunity set there?

GB: Well, thankfully there are only about 90 companies on the exchange and I would say about 20-30 of them are what I would call investable. It is a very narrow set of companies. So a lot of this is simplified by the small size of the exchange and its limited number of offerings.

We are really making two types of investments. We're investing in emerging franchises, which are companies that are outside the oil space and tend to be managed by entrepreneurial people. They're very much profit-driven. They're owner-managers, so they have significant stakes in the business themselves. They're transparent and they appreciate the importance of reputation, brand, and establishing dominance in their particular industry. Because they're able to achieve that, it gives them pricing power, it gives them scale, and it gives them all these other benefits. Another, second category of company would be the classic Ben Graham, deep-value kind of investment. It's far from a franchise. It's just simply that net current assets are "x" and the stock market appraisal of that is 0.1x, so you're buying a dollar for ten cents. Most of the investments we make are the first category.

When I first started to invest in Iraq, I went more towards the latter category, which I think was a mistake. What I've learned from making investments in companies that seem very cheap based on net asset value or net current asset value is that it's very easy to underestimate management's ability to destroy value. Even slightly sub-par management can make a series of decisions that will wipe away your initial margin of safety.

Then there's still the question of how you realize the value. Graham was of the opinion that the market would eventually correct itself, that the market in the short run was a voting machine and in the long run was a weighing machine so that eventually, it will be valued correctly. That's probably true in the West, but less so in a frontier market, where you're going to have to be very careful about assuming an activist role and you can't rely on the market to be even slightly efficient over a long period of time. It could stay inefficient and undervalue an

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"What I've learned from making investments in companies that seem very cheap based on net asset value is that it's very easy to underestimate management's ability to destroy value. Even slightly sub-par management can make a series of decisions that will wipe away your initial margin of safety."

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investment for a decade and you could end up in a value trap for ten years. So it's difficult to realize the value if it's not destroyed, and there's a high probability that sub-par management will destroy it anyway.

G&D: How do you approach portfolio management given that there are only 20 to 30 companies you would call investable?

GB: We have twelve companies in our portfolio and the top ten make up 95% of it, so it's very concentrated. The largest position is 30% of the portfolio, so we obviously don't define risk as price volatility. We're thinking about it in terms of probability of permanent loss of capital.

"The largest position is 30% of the portfolio, so we obviously don't define risk as price volatility. We're thinking about it in terms of probability of permanent loss of capital."

The most important thing we look for is a business where we can trust the people who are running it. By definition, trust is something that's built over time. For the first few years that I was involved in Iraq, that's more or less what I was learning—who I could trust, what companies were putting out financial statements that faithfully represented the condition of the business, which companies seemed like they were doing well but may not have been accurately reporting performance, which companies had unsavory people running the business, and so on. You start to figure that out over a few years. And after you travel there and meet the people, you're in a much better position to say with confidence if you should trust them.

I think this is, again, the market benefiting us. Because there's such a small group of companies that we think are investable, it gives us the ability to concentrate rather than look all over the place. There are some frontier market funds that have investments across twenty countries. How on earth could you possibly know the management in each country? And they have fifty or more investments! How can you possibly know if you can trust these guys or not? Even a team of ten or fifteen people can't pay enough attention to each company to establish that.

I think trust in the people managing the business is paramount, because it's pretty easy to spot a good company. So, if you see a bank in a country like Iraq that is experiencing its first private credit cycle and has an economy that is growing pretty rapidly, you'd expect to see the balance sheet grow very rapidly. You look at the balance sheets over time and it's pretty obvious which companies look interesting and which ones don't. This one is growing but puts all its money into T-bills. It's completely risk-averse. OK, that's not very interesting. However, this one over here has seen its loan to deposit ratio go from 5% to 40%. They have a very low NPL ratio, ROE has been trending up. All the metrics that you would use to analyze a bank are not only looking positive, but they're really strong, and yet it's trading for just 5x earnings. If you see a bank that is growing earnings at 40% or 50% a year, trades at 5x earnings and a discount to tangible book, and has a ROE of 30%, that looks really interesting, right? Then you meet the management, get to know them over a period of years, and that's what lets you build the confidence there is something real behind those numbers.

G&D: How long did it take you to get comfortable enough to make your first investment in Iraq?

GB: Initially, I wasn't comfortable with any particular company. In January 2008, when I started, I bought everything that traded, so it was the exact opposite strategy. Back then, it was very difficult to find information about these companies from a distance. Quite a lot has changed since that time. Now, quarterly reports are published in a timely manner, sometimes even ahead of when US companies file. It's not unusual in a very early stage frontier market to have extremely limited data that you can use to conduct due diligence. The rational

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strategy if you're going to invest in that setting is to have smaller positions. How can you have conviction about something like that? It's more of a macro investment.

What I've found is that having my own money invested in these companies is really what makes the difference. When you have money invested in a bunch of companies that you don't know much about, you suddenly have a very strong motivation to know as much about them as you possibly can. And so once the money was invested, I had to find out everything I could. And that really was what the next two years were about. It took about two years after I made my first investment before I felt confident that I really did understand which businesses were legitimate, which ones should be avoided, which ones could go either way. And that's also why there wasn't a fund initially. I didn't feel as if I had the requisite understanding of the companies and the market until I was involved for more than two years. So initially it was just a very broad bet on the market and that later became a very concentrated set of value investments.

G&D: What do you think makes philosophy a good training ground for investors?

GB: When you study the history of philosophy, what you find is that many of the great philosophers were deeply skeptical people. They were like Steve Jobs in a way, iconoclasts who looked at convention as if it was something to be broken. Socrates is a perfect example of this. He walked around Greece and challenged any kind of convention or power structure he saw. And I think the general idea that you learn from studying these historical philosophers is that there's a lot to be gained from a skeptical world view. If you simply accept what you're told, if you are simply a receptacle that takes in whatever information is provided to you without critically accessing it, it's going to be very hard for you to do anything other than live a conventional life. If you look at the people who have had the most success in markets, or in business generally, you find they tend to be people who are skeptical of whatever the prevailing convention is and will challenge it and try to change it. To get involved in Iraq, you had to be very open-minded and had to have a very skeptical view about the ability of the media to provide you with an accurate portrayal of reality. If I were not skeptical, I would have seen the data, and I would have said even if Iraq were increasing oil production, the country's still just a basket case because that's what I read in the *New York Times*. Philosophy is useful in a general sense because it can give you a skeptical world view.

"What I've found is that having my own money invested in these companies is really what makes the difference."

Then you can take that skepticism and apply it at the company level. Thousands of years ago, philosophers were asking questions like how would you define a table? And if you went around the room, each one of us would come up with a definition of a table and everyone else would poke holes in it. The smartest philosophers in the world have struggled with these very basic ideas and they can't find a satisfactory way to treat the problem. You realize that about 99.9% of everything you hear is complete and utter bullshit. Take the convention that markets are efficient. Approaching it from a philosophy background, it was very easy

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for me to take that idea and reject it.

I remember Caterpillar in 2010 or 2011 printing a five-year earnings forecast. We're talking about construction and mining equipment, which are as cyclical as anything can be. How on earth can the CEO know what their earnings situation is going to look like five years from now? And to the extent the market actually believes what he is putting out and pricing it into the shares, that is an extraordinary mistake. When I looked at the sell-side, they were pointing out just how bullish they were on CAT. Since then the stock has just gone sideways and now of course we're approaching 2015 and they're guiding down because it's just not the market or economy they thought it was going to be.

So when you apply philosophy to your analysis of individual companies, it makes you much more skeptical of management's ability to forecast into the future. To the extent a manager or a company is going to get your trust, they're going to have to earn it and that's going to take quite a long time. Philosophy teaches you to take whatever the prevailing wisdom is and challenge it. Sometimes it turns out the prevailing wisdom is right, so you should accept it; other times it turns out the prevailing wisdom is way off the mark. If you find a situation like that, then there's typically an opportunity to profit from it.

G&D: Would you mind talking about a specific investment idea within Iraq?

"The stock was trading at about 3x earnings and had a 10% dividend yield. To give you an idea, in 2012, the company's earnings actually grew over 400%. We were just scooping up as much as we possibly could."

GB: Sure, I can discuss Baghdad Soft Drinks, the Pepsi bottling and distribution company there. Pepsi has 80% market share in Iraq. It's one of the few countries where it's dominant. Normally it's the reverse—Coke is closer to 80% and Pepsi is 20%—but Coke has struggled in Iraq for a number of identifiable reasons.

Baghdad Soft Drinks received its Pepsi license in 1984 and lost it in 1991 when sanctions were imposed on Iraq after the first Gulf War. By the time Saddam was overthrown in 2003, Pepsi was eager to return to Iraq so they reached out to Baghdad Soft Drinks in order to reestablish the relationship. Some of their factories had been severely damaged by the war. What hadn't been damaged was obsolete because, while the sanctions were in place, they couldn't import equipment. So the equipment from the 1980s was still there in 2003. The company was just a mess. Pepsi floated a $30 million loan to help rehabilitate operations.

The management at that point in time were ex-Baathists. Saddam was from the Baath Party, and the party's economic ideology was basically Arab socialism. You had 3,000 employees when you needed just 1,000. Pepsi, in one of the hottest places on earth and where people don't want to drink Coke, pretty much sells itself. You could put a dog or a five year old kid in charge and sales would grow. The question is what part of that is going to fall to the bottom line. What I found was that most of the revenue growth in the company from 2003-2007

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was being soaked up by these inefficiencies. By the time you got to the bottom line, there was nothing left. By 2007, the company was unable to service the loan from Pepsi. It contacted two local businessmen for help. The two guys looked at the situation and eventually approached Pepsi about selling them the loan. Pepsi agreed and the businessmen immediately converted the loan into a controlling stake in the company, firing the managers who had initially asked for their help. They also fired 2,000 of the 3,000 employees and instituted a performance-based compensation scheme for the remainder. A year later, revenues had tripled and they turned their first profit. They became fully certified by Pepsi for quality control and quality assurance for the first time and the thousand remaining employees were paid double what they made under their previous salary.

Starting in 2007 and continuing to the present, the new management really focused on streamlining the operations and making them much more efficient. If you looked at their EBITDA margins under the old management, they were typically either negative or 1%-2%. If you look at Coke and Pepsi bottling and distribution companies in comparable emerging markets, the EBITDA margin range is normally 15%-20%. We've seen a normalization of Baghdad Soft Drink's margins so they're now about 15.5%.

The new owners spent a lot of money up front to put in a direct distribution system and it's now paying off. The public electricity grid at the time was unreliable, so they built their own generator to make sure they could run 24/7. They made the company much more efficient and with a company like this, it's about volume growth and efficiency.

Iraq consumes about 21 liters of soft drinks per capita. If you look at other emerging market countries, it's anywhere from 60-100 liters. You have a growing population, growing GDP per capita, and each year they're consuming more Pepsi. It's the dominant soft drink company there so there are compelling reasons to believe that sales will continue to grow. Management has demonstrated its ability to improve operating efficiency. If sales can grow at the 20%-35% rate we expect and margins expand by 200-300 basis points, then suddenly earnings could be up 100%. It's that kind of story.

We own 11% of the company. According to the CEO, we're the only Westerner to ever visit the bottling facility. In 2012, there was a bear market in Iraq, with the market low occurring sometime in the summer of that year. At that time, the stock was trading at about 3x earnings and had a 10% dividend yield. To give you an idea, in 2012, the company's earnings actually grew over 400%. We were just scooping up as much as we possibly could. That's why it's 30% of the fund. It was 15% but with the total return, it's since doubled. We haven't sold a share. It still trades for around 6-7x earnings and remains deeply undervalued.

G&D: Before we finish, do you have any thoughts on where the next Iraq-type market opportunity may be?

GB: It's hard for me to think of a place now. Maybe Afghanistan? Five or ten years from now, maybe it will be Iran. Iraq was the very last place I thought I would find an opportunity like this and I don't know if there is a similar place today. Maybe it's still Iraq.

G&D: Thank you so much for sitting down with us, Mr. Batt.

"Iraq was the very last place I thought I would find an opportunity like this and I don't know if there is a similar place today. Maybe it's still Iraq."

Heilbrunn Center for Graham & Dodd Investing

csima

COLUMBIA STUDENT INVESTMENT MANAGEMENT ASSOCIATION

Rocket Fuel Inc. (Nasdaq: FUEL) - Short
Winner - 2013 Darden @ Virginia Investing Challenge

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Matt is a first-year MBA student at CBS. Prior to CBS, he worked in private equity at Navigation Capital and in healthcare investment banking at SunTrust Robinson Humphrey.

Patrick is a first-year MBA student at CBS. Prior to CBS, he worked in investment banking at Morgan Stanley covering Latin America.

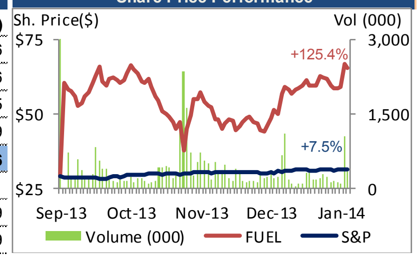
Brian is a first-year MBA student at CBS. Prior to CBS, he worked at Millennium Technology Value Partners.

Matt, Patrick, and Brian defeated 14 other top business schools at the Darden @ Virginia Investing Challenge.

Capitalization Summary	
Share Price	65.37
Diluted Shares (MM)	39.5
Market Cap ($MM)	**2,579.4**
Net Cash ($MM)	98.4
Enterprise Value ($MM)	**2,481.0**
EV/ Sales 2014E	5.92x
Target Price	**29.00**
% Return	*55.6%*
Short Interest % of Float	28.6%

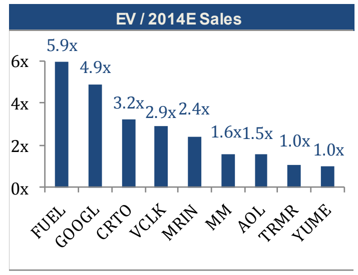
Ownership Structure		
Holder	**%TSO**	**($MM)**
Mohr Davidow Ventures	33.4	716
Nokia Growth Partners	8.2	176
Northgate Capital	6.3	135
Labrador Ventures	4.6	99
Total VC Holdings	**52.5**	**1,126**
Insiders	17.7	379
Float	29.8	639

Share Price Performance



Recommendation:
Short FUEL with a price target of $29.00. As a demand side platform ("DSP") operating in the ad tech space, FUEL is a recent IPO issue enjoying substantial top-line growth and as a result, currently trades at a high-flying valuation. At 5.9x 2014E revenue, FUEL trades at a premium to the broader ad-tech space, where the average comp trades for 2.2x 2014E revenue. However, after speaking with an array of industry participants, we believe FUEL is nothing special in an increasingly commoditized and competitive marketplace. We expect continued revenue growth, but the street's expectations of long-term growth without margin compression are reflective of exuberant irrationality. Because FUEL's venture firm-concentrated investor base is well in the money, we expect selling pressure in conjunction with these firms' lock-up expiration in March 2014. Our target is 56% below a recent closing price of $65.37.

EV / 2014E Sales



Company Description
FUEL is a DSP that leverages big data through artificial intelligence ("AI") technology to optimize ad buying in a real-time buying ("RTB") environment. FUEL's predictive modeling solution is built on its optimization engine, which utilizes significant computational infrastructure to deliver automated, measurable digital ad campaigns. Its solution is designed to optimize direct-response campaigns, as well as brand campaigns geared towards lifting brand metrics. FUEL primarily sells its solution to advertising agencies and advertisers. FUEL was founded in 2008 and IPO'd in September of 2013.

Investment Thesis
FUEL is not a broken business, but our channel checks revealed that it is a much worse business than valuations imply, and participants in the industry know this is true. The ad-tech space is an extremely crowded and competitive category, with participants ranging from massive, fully-integrated solution providers such as Google, Yahoo, and AOL, to digital ad agencies such as IPG and Publicis / Omnicom, to scaled single-solution providers such as FUEL and Criteo (public) as well as Turn and DataXu (private). Our original thesis is that FUEL could be instantly disintermediated by large providers such as Google that operate on all sides of the ad tech ecosystem, or could be marginalized over time by similar, scaled single-solution providers competing on the basis of price. To back up the thesis, we conducted detailed interviews with 15 industry participants, including major FUEL customers, former FUEL leadership and investors, ad-tech investors, and industry experts. The interviews confirmed our margin compression thesis, but we were shocked at how cynical industry participants are towards FUEL and DSPs in general. While we believe the entire DSP category is highly overvalued, FUEL stands out, trading for 5.9x 2014E revenue versus 2.2x for the category, even though FUEL will not generate any earnings or positive cash flow until 2016 at the earliest.

Undifferentiated provider in a crowded and competitive marketplace. We estimate that FUEL is one of over 90 DSP solution providers, and we expect the continued commoditization of the market to impact margins over time. One interviewee, who is an advertised FUEL "success story" and CEO of a top-50 marketing firm, equated DSPs to the ad networks, whose gross margins have been compressed from 40%+ in the 1990's to less than 10% today. Channel checks reveal that there is little differentiation across the industry, although everyone claims to have the same technological advantages. For example, FUEL advertises itself as "AI, Big Data Driven Real-Time Programmatic Buying," virtually identical to competitors Turn and DataXu's claims of "Data Driven Advertising Using Programmatic Solutions," and "Programmatic Optimized Real Time Buying Leveraging Big Data."

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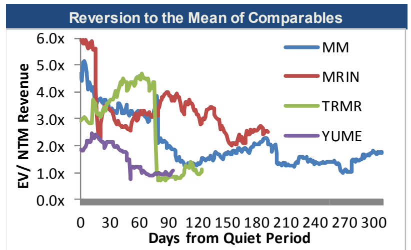
Rocket Fuel Inc. (continued from previous page)

Poor competitive position. In addition to scaled single-solution providers, FUEL faces competition from a who's who list of media companies with fully-integrated platforms. FUEL generates the bulk of its revenue by selling to marketing firms that own the client relationship; however, many of these firms either have their own similar solutions, or have chosen to outsource the solution based on the view that this portion of the value-chain will be commoditized. In addition, FUEL competes for ad dollars against large media businesses such as Google that have their own DSP solution in addition to high value-added offerings such ad networks and exchanges. These competitors have exhibited an increasing propensity to internalize ad spending via large upfront ad buys on owned, high-value properties such as YouTube.

Unsustainable business model. We believe that FUEL's current 40-50% gross margins are a result of the industry's nascence, but will be pressured over time. Industry experts agreed, by suggesting that because gross margins result from taking advantage of an evaporating arbitrage on media costs, they will get squeezed from both ends of the value chain. One customer noted, "DSPs are an arbitrage game and this game is coming to an end. The technology is being commoditized...These companies try to capture market share by losing money… their business model is not viable in the long-term." The industry is also plagued by low customer switching costs, and most advertisers utilize multiple DSPs to generate price competition. We believe that the best positioned DSPs will be those that provide platform SAAS solutions, such as DataXu. FUEL recognizes this and is currently working on a SAAS offering. Finally, interviews with customers reveal their displeasure with certain FUEL business practices. These practices, which included FUEL communicating a lower media margin than they were actually getting, did not become known by a certain customer until he obtained detailed access to data on the campaign that FUEL was running. We believe that increasing transparency from SAAS solutions will pressure margins.

Ad-tech mean reversion and a clear catalyst. Ad-tech companies have IPO'd with high valuations due to substantial growth prospects; however, multiples tend to compress towards 1.0-3.0x NTM revenue over time. We analyzed multiples post-quiet period expiry on pure-play ad-tech businesses, and found that each firm traded down, with an average reduction of 2.2x NTM revenue. This is due to the street's tendency to reduce expectations from the lofty levels. To illustrate, most FUEL initiation pieces assumed 42%+ 2012-2018 sales CAGRs with no margin compression, and one DCF valuation assumed a 30x terminal multiple on 2023 FCF. CRTO and MM, the closest comps, trade for 3.2x and 1.6x 2014E sales with their 33% and 32% 2012-2018 CAGRs, exhibiting the downswing in multiples even with still high expected growth. We also believe that the lock-up expiry on 3/19/14 will serve as a catalyst. ~33% of shares O/S are held by venture firm Mohr Davidow (~40 days of trading), and ~19% are held by other venture backers. We expect significant selling pressure in conjunction with the lock-up expiry as MD stands to generate a much needed 30x+ return on its investment at our $29.00 target. Channel checks reveal that the MD fund that holds the FUEL stake has not yet had a big exit, and due to its 2007 vintage and fund-raising cycle, we expect the firm to liquidate its FUEL holdings ASAP.

Reversion to the Mean of Comparables



Valuation

Our valuation used 2014E and 2015E revenue multiples, and a DCF assuming a 10-12% cost of equity. We believe that FUEL will have impressive top-line growth in the coming years with a CAGR of 66% between 2012-16, comparing favorably to the industry's 40%. However, analysts are expecting a CAGR of 75% mainly from much too aggressive assumptions on customer and ARPU growth (ARPU has remained flat in recent qtrs, supporting our thesis). In addition, we expect competition to keep EBITDA margins to ~15% at best (CRTO disclosed in its in roadshow that ~15% margins are its long-term target) vs. margins of 20%+ from research analysts.

Base Case vs. Analyst Estimates

Metric	Base	Street
2014E Sales	388.9	419.8
2015E Sales	555.9	679.0
2016E Sales	810.7	1,000.3
2014E EBITDA Margin	(0.8%)	0.8%
2015E EBITDA Margin	2.9%	5.7%
2016E EBITDA Margin	7.8%	10.2%
LT EBITDA Margin	15.0%	>20%
Target Price	29.0	63.0
Implied EV / 2014E Sales	2.5x	5.7x

Summary of Key Financials

	2012A	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Active Users	536	1,018	1,579	2,131	2,813	3,572	4,394	5,273	6,064	6,670	7,004
Growth (%)		*90.0%*	*55.0%*	*35.0%*	*32.0%*	*27.0%*	*23.0%*	*20.0%*	*15.0%*	*10.0%*	*5.0%*
Sales	106,589	231,981	388,882	555,860	810,680	1,039,859	1,291,816	1,565,681	1,818,539	2,020,397	2,142,631
Growth (%)	*138.7%*	*117.6%*	*67.6%*	*42.9%*	*45.8%*	*28.3%*	*24.2%*	*21.2%*	*16.2%*	*11.1%*	*6.1%*
EBITDA	(2,981)	(5,244)	(3,025)	16,220	63,423	103,190	144,986	192,946	235,018	271,207	319,754
Margin (%)	*(2.8%)*	*(2.3%)*	*(0.8%)*	*2.9%*	*7.8%*	*9.9%*	*11.2%*	*12.3%*	*12.9%*	*13.4%*	*14.9%*
Unlevered Free Cash Flow	(27,566)	(28,559)	(40,919)	(29,126)	7,524	24,192	47,957	71,933	97,087	115,074	142,952

XPO Logistics (NYSE: XPO) – Long

Stephen Lieu
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Stephen is a second-year MBA student, participant in the Heilbrunn Center's Value Investing Program, and Co-President of the Columbia Student Investment Management Association (CSIMA). Prior to Columbia Business School, he worked for four years in investment banking and private equity. Stephen holds a BS from the Wharton School, University of Pennsylvania.

Stephen was a member of the team that placed 1st in the 2013 Pershing Square Challenge and a member of the team that placed 2nd in the 2012 UNC Alpha Challenge.

Stephen is a finalist in the 5th annual Moon Lee Prize Competition.

Investment Recommendation

Buy the common shares of XPO Logistics with a three-year target share price of $49, which represents 87% total upside (23% IRR over three years). There are three main points to my thesis:

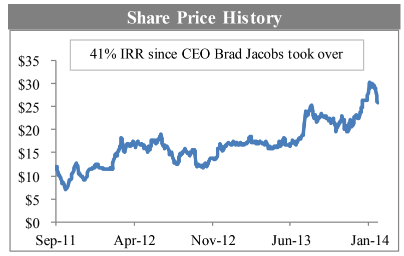
1) Industry characteristics, which include a large and growing market size, high fragmentation, long runway of acquisition opportunities, and significant competitive advantages to scale, provide for an attractive consolidation opportunity.
2) Acquisition benefits, which include private/public multiple arbitrage, revenue synergies, cost synergies, and strengthening of moat, are highly compelling.
3) XPO has everything in place – a CEO with a phenomenal track record of consolidating industries, management team with substantial industry experience, significant insider ownership, and easy access to capital – to successfully execute its consolidation strategy.

As of 1/29/14; in USD m except per share data

Current Capitalization	
Stock Price	$25.96
Dil. Shares Outs (M)	57.9
Market Cap	**$1,503**
Plus: Debt	1
Less: Cash	(67)
Enterprise Value	**$1,437**

Trading Statistics	
52-Week Range	$15.48-$30.90
Dividend Yield	0.0%
Avg. Daily Volume (M)	435.0
Short Interest as % of Float	20.7%

Share Price History



Business Description

XPO is one of the largest third-party logistics providers (3PL) in North America, offering freight brokerage, intermodal, expedited transportation, and freight forwarding services to companies in a wide variety of industries. The company essentially serves as a middle man, connecting shippers (customers) with carriers (transportation providers), and collects a fee for brokering the transactions. XPO has a network of ~12,000 active customers and ~24,000 transportation companies, and operates 124 offices in North America.

XPO is pursuing an aggressive roll-up of the industry. Since CEO Brad Jacobs joined the company in September 2011, XPO has made 11 acquisitions, increasing revenues from $175 million to a run-rate of ~$2 billion. Management has stated that its goal is to reach $5 billion in revenues and $300 million in EBITDA by 2017.

Investment Thesis

1) Industry characteristics, which include a large and growing market size, high fragmentation, long runway of acquisition opportunities, and significant competitive advantages to scale, provide for an attractive consolidation opportunity.

Large and growing market: U.S. trucking is a $350 billion market, of which only 15% (~$50 billion) is intermediated through 3PLs. The 15% penetration rate is expected to increase significantly over the next decade as more companies realize the economic benefits of outsourcing to 3PLs. Over the past five years, trucking brokerage has grown at 2-3x GDP and is expected to continue at this pace.

High fragmentation and long runway of acquisition opportunities: The U.S. truck brokerage industry is highly fragmented, with over 10,000 licensed truck brokers in the U.S. The majority of truck brokers are small: more than 99% generate less than $10 million in EBITDA. With smaller brokers facing intense competition from increasingly larger competitors (as XPO and others look to consolidate the industry) and operational headwinds (increased IT sophistication and working capital requirements), they are becoming more willing to sell their businesses.

Significant competitive advantages to scale: Potential customers are attracted to providers with a large network of existing carriers, while potential carriers are attracted to providers with a large base of existing customers. This benefits the large 3PLs as it creates a virtuous cycle of increasing customers and carriers, and creates an impediment to growth for smaller 3PLs.

2) Acquisition benefits, which include private/public multiple arbitrage, revenue synergies, cost synergies, and strengthening of moat, are highly compelling.

Public/private market arbitrage: Large 3PLs (of XPO's size) currently trade at an average 13x LTM EBITDA, in-line with their 10-year historical average. XPO acquires mid-sized 3PLs at 8-11x LTM EBITDA, and smaller 3PLs at 5-7x LTM EBITDA, resulting in acquisitions being immediately accretive.

Revenue synergies: There are substantial cross-selling opportunities between XPO and acquired companies' customer bases. Further, the aggregation of the acquired companies' route history data allows XPO to improve its pricing algorithms and price more effectively, helping to increase both margins and customer satisfaction.

Cost synergies: XPO eliminates duplicative back-office functions, such as legal, IT, and accounting.

Strengthening of moat: XPO's competitive positioning increases with each acquisition. As XPO gains scale, the company's ability to attract new customers and carriers strengthens, and there is a virtuous cycle of growth. Scale begets further scale.

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XPO Logistics (continued from previous page)

3) *XPO has everything in place – a CEO with a phenomenal track record of consolidating industries, management team with substantial industry experience, significant insider ownership, and easy access to capital – to successfully execute its consolidation strategy*.

CEO with a phenomenal track record: Over his 35-year career, Brad Jacobs has built four separate billion-dollar businesses from scratch. At his two most recent companies, United Waste Systems and United Rentals, he successfully executed roll-ups in the waste and equipment rental industries, respectively. During his tenure at United Waste Systems, the company outperformed the S&P 500 by 5.6x. During his tenure at United Rentals, the company grew to become the largest equipment rental company in the world, and outperformed the S&P by 2.2x.

Management team with substantial industry experience: Brad Jacobs has assembled a team of experienced transportation industry veterans from large competitors like C.H. Robinson and Echo Global Logistics, as well as from investment banks. For example, the Chief Strategy Officer was formerly the lead transportation analyst at Goldman Sachs, while the CFO was formerly the lead transportation analyst at Stifel Nicolaus. The entire management team has a wealth of experience, knowledge, insight, and contacts in the transportation industry.

Significant insider ownership: Management and the board own 41% of the company and Brad Jacobs has personally invested $75 million into XPO. Incentives are aligned with shareholders.

Access to capital: Given Jacobs' strong reputation on the street, XPO has easily been able to raise capital for acquisitions.

Financial Projections and Valuation

I believe management's goal to reach $5 billion in revenues and $300 million in EBITDA by 2017 is achievable, given that XPO has already reached $2 billion in run-rate revenues in just over two years. I apply an 11.5x forward EBITDA multiple (in-line with current average 3PL multiple) to 2017 EBITDA to arrive at a 2016 target share price of $49 for 87% total return, or 23% IRR over three years.

	2013A	2014E	2015E	2016E	2017E	Total ('14-'17)
Revenue (run-rate)	1,000	2,500	3,500	4,525	5,478	
Organic		*250*	*500*	*525*	*453*	1,728
Acquisitions	*450*	*1,250*	*500*	*500*	*500*	2,750
EBITDA		50	117	211	329	
Margin%		*2.0%*	*3.3%*	*4.7%*	*6.0%*	
Acquisition Price		396	200	200	200	996
EV/EBITDA		*10.3x*	*8.0x*	*8.0x*	*8.0x*	
FCF		20	52	106	181	359
% of Revenue		*0.8%*	*1.5%*	*2.3%*	*3.3%*	
Debt Issuance		0	148	94	19	261
Total Debt		*0*	*148*	*242*	*261*	
Leverage		*0.0x*	*1.3x*	*1.1x*	*0.8x*	
Equity Issuance		376	0	0	0	376
Shares Issued		*15.0*	*0.0*	*0.0*	*0.0*	

	Bear	Base	Bull
Revenue (2017)	4,382	5,478	6,573
EBITDA (2017)	219	329	460
Margin%	*5.0%*	*6.0%*	*7.0%*
Fwd. EBITDA Multiple	*10.0x*	*11.5x*	*13.0x*
Enterprise Value	2,191	3,779	5,981
Less: Debt (2016)	(242)	(242)	(242)
Equity Value	1,949	3,538	5,739
Shares Outstanding (2016)	72.9	72.9	72.9
Curr. Shares Outstanding	*57.9*	*57.9*	*57.9*
New Shares Issued	*15.0*	*15.0*	*15.0*
Share Price	$27	$49	$79
Current Share Price	$26	$26	$26
Upside	*3%*	*87%*	*203%*
IRR	*1%*	*23%*	*45%*

Investment Risks and Mitigants

1) *Acquisition integration*: XPO has been executing acquisitions at reasonably attractive valuations. Integrating them is the single biggest risk, and the key to the company's success.

Mitigant: Before closing any acquisition, XPO mandates all of its acquired companies' employees to sign non-compete agreements, helping to ensure that salespeople and their customer relationships remain with XPO. Additionally, Jacobs stated that he deliberately delayed acquisition activity initially while he established the infrastructure to support significant scale, showing that he understands the process of building large companies. Furthermore, Jacobs has done this before, having acquired and integrated over 450 companies during his time at United Waste Systems and United Rentals. Finally, Jacobs and his management team have significant skin in the game (41% ownership stake) and are highly incentivized to do well.

2) *Competition for acquisitions*: Other truck brokerage firms have recently been making acquisitions. XPO could be bidding directly against its competitors for the same targets.

Mitigant: The U.S. truck brokerage market is very large and highly fragmented, with over 10,000 truck brokers. Furthermore, XPO has easier access to capital (given Jacobs' prior track record) and an M&A team with significant experience in executing acquisitions.

3) *Shift from trucking to intermodal (rail)*: Improving reliability and timeliness of intermodal, rising diesel prices, increased highway congestion, and a shortage of truck drivers are causing a secular shift away from trucking towards rail.

Mitigant: Increasing penetration of trucking logistics outsourcing will help drive organic growth. Additionally, XPO's recent entrance into intermodal through the acquisition of Pacer (third largest provider of intermodal services in North America) helps hedge this risk and provides an additional avenue for growth.

World Acceptance Corp. (Nasdaq: WRLD) - Short

Patrick Stadelhofer, CFA
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CAPITALIZATION ($M)	
Share Price - *as of 1/22/14*	$88.97
Total Diluted Shares (m)	12.478
Market Cap	**$1,110.1**
Less: Cash and Cash Equiv.	(14.5)
Plus: Senior Notes Payable	486.9
Enterprise Value	**$1,582.5**

CURRENT VALUATION	LTM
TEV / Sales	2.3x
TEV / EBITDA	7.3x
TEV / EBIT	7.6x
Price / EPS	10.3x
Price / Book	2.7x

Patrick is a second-year MBA student and the recipient of the Heilbrunn Fellowship. While at Columbia Business School, he has worked at VGI Partners, a high conviction global equity manager, which he will join after graduation as an Investment Analyst. Prior to school, he was an investment banking Associate at Lazard. Patrick holds a BBA from the George Washington University and is a CFA charterholder.

Patrick is a finalist in the 5th annual Moon Lee Prize Competition.

Recommendation

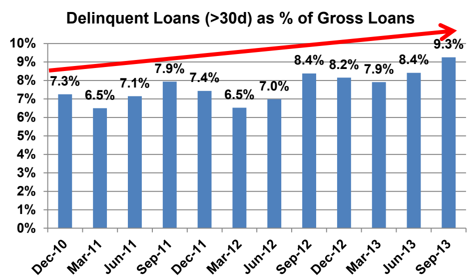
Short World Acceptance Corp. (NASDAQ: WRLD) with a target price of $46, a 48% short upside from its current level. WRLD provides a highly attractive risk/reward profile, as a lot of the short downside is already priced into the stock, with limited potential for large value creation by the company but a significant potential for dramatic value destruction.

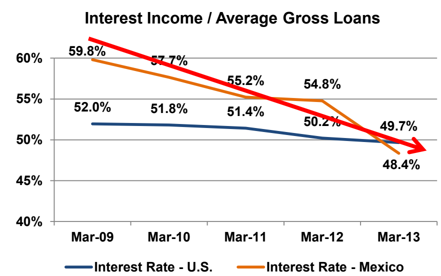
Background

World Acceptance issues and refinances installment loans to primarily subprime borrowers in the U.S. and Mexico. WRLD has benefited from the weak economic climate since the recession, with the stock up over 430% over the past five years as the company's portfolio and footprint have grown.

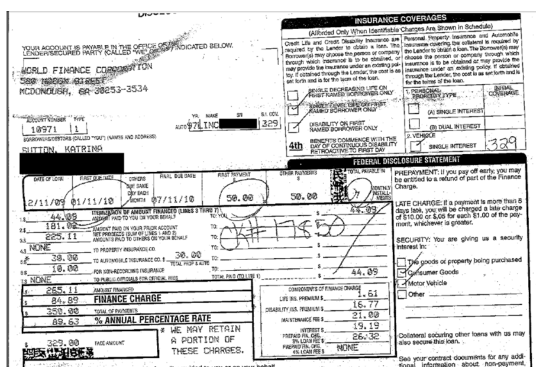
Investment Thesis

Core business continues deteriorating, with lower credit quality and interest rates: WRLD's loans have increased nearly 95% since FY08, concurring with higher delinquency as it reaches more (and perhaps lower-quality) borrowers. 9.3% of the loan portfolio is currently delinquent (>30d overdue). At the same time, WRLD has seen interest rate erosion due to regulatory pressure, competitive factors, and an increase in average balances. Many jurisdictions have usury laws regulating maximum rates that can be charged; if states and courts impose or tighten rules, interest rates will come down further (e.g., there are ongoing efforts to impose a federal 36% interest rate cap).





CFPB cracks down on "add-on" sales of high-margin insurance: WRLD distributes insurance for a third party (see its confusing form at right). It earns high-margin commissions for distributing this insurance ($51.3m in FY13, nearly a third of pre-tax income). While there are clear legal requirements for proper disclosure, former employees are saying that "they were instructed not to tell customers the insurance is voluntary" (WLRD denies this). If it makes it appear to consumers that they are required to sign up for insurance, this "deceptive" marketing might be illegal. The Consumer Financial Protection Bureau has begun cracking down on deceptive practices, including against so-called "add-on" products. It considers the following factors in evaluating the effectiveness of disclosures at preventing consumers from being misled, including those related to add-ons: "Is the statement prominent enough for the consumer to notice? Is the information presented in an easy-to-understand format and at a time when the consumer's attention is not distracted elsewhere?" A recent CFPB White Paper on payday loans and deposit advances concluded "that further attention is warranted to protect consumers" and that "the CFPB expects to use its authorities to provide such protections." There is even legislative pressure, with Sen. Ron Wyden (D-OR) asking the CFPB at a July 25, 2013 committee hearing: "So what can be done about World Acceptance?"



World Acceptance Corp. (continued from previous page)

Investment Thesis (continued)

Loan rollover model and capital structure present risks of a liquidity crunch:

Loan rollovers issues. Nearly 80% of WRLD's loans outstanding are refinancings of existing loans (including delinquent ones) or represent relationships with "former" borrowers; only 12% are completely new customers. A loan that is constantly refinanced does not need to be paid back, becoming a permanent part of the borrower's "capital structure." There is significant discretion in which loan gets refinanced or charged off, which could mask deteriorating quality and lead to understated provisions. Currently the new customers create inflows that continue the refinancing circle, but if WRLD were to run out of new borrowers or if repayment patterns were to deteriorate, it could find itself in a liquidity crunch. Some states (e.g. WA) have begun limiting the number of allowed refinancings per year. If WRLD left a state, it could also create liquidity issues (*e.g.*, TX, TN, and GA each contain more loans than all new borrowers).

Capital structure issues. Despite its large regulatory and economic risks, WRLD utilizes meaningful debt in its capital structure and intends to continue to increase leverage through share repurchases. In fact, its net debt balance has risen from 17% of net loans in March 2011 to 61% currently. WRLD is drawing on a revolving facility that has been extended several times, most recently in September 2013, and expires in November 2015. While the lenders were recently willing to extend this facility, such a willingness is not guaranteed for the future, especially if WRLD encounters regulatory or operating headwinds.

Recent management disruptions might be a harbinger of bad developments:

Departures. November's unexplained departure ("personal reasons") of Mark Roland, COO, raises significant questions about management. Additionally, CFO Kelly Malson announced her "retirement" (at age 43) in September 2013; she had been CFO since 2006 and is "pursuing other life objectives."

Internal Controls Warning. Auditor KPGM identified a "material weakness" in internal controls, concluding that WRLD "has not maintained effective internal control over financial reporting." WRLD did not have a documented policy for establishing loan loss allowances. It also did not have a control to assess whether the accounting treatment of renewals was in accordance with GAAP and what impact renewals would have on the estimate of the allowance for loan losses

Insider selling. Significant insider sales (chart above, sales are red) are also a negative signal for WRLD.

Valuation

For the base case, modeling most of the business conservatively, with key drivers being: continued office openings, continued growth in loans per office, interest rates continuing to decline, charge-offs and provisions increasing, and the insurance commission business shrinking to a fraction of its size under a regulatory crackdown.

The target price of $46 is an equal blend of three valuation methods (see right). A more aggressive bull case (disappearance of insurance commissions by FY15) yields a target of $22 (75% short upside).

TARGET PRICE - BASE CASE	
DCF (10% WACC, 3% g)	$36.70
EBIT Multiple (8x FY18)	$43.61
EPS Multiple (10x FY18)	$58.78
Target Today (Rounded)	**$46.00**
Current Share Price	$88.97
Short Upside/(Downside) %	48.3%

SUMMARY FINANCIALS ($M)

	Actual Mar-11	Actual Mar-12	Actual Mar-13	Model Mar-14	Model Mar-15	Model Mar-16	Model Mar-17	Model Mar-18
U.S. Offices	972	1,032	1,084	1,134	1,179	1,221	1,257	1,295
Mexican Offices	95	105	119	134	150	167	183	202
Total Offices	**1,067**	**1,137**	**1,203**	**1,268**	**1,329**	**1,387**	**1,441**	**1,497**
Average Gross Loans	$822.7	$923.9	$1,019.9	$1,115.1	$1,212.3	$1,311.0	$1,409.2	$1,508.6
Per Office ($k)	*$771*	*$813*	*$848*	*$879*	*$912*	*$945*	*$978*	*$1,008*
Average Interest Rate	51.6%	50.5%	49.6%	49.1%	48.6%	48.1%	47.6%	47.1%
Interest and Fee Income	**$424.6**	**$466.5**	**$505.5**	**$547.1**	**$588.9**	**$630.5**	**$671.0**	**$711.3**
Insurance Commissions	41.7	47.2	51.3	57.5	29.3	22.3	23.9	25.5
Other Revenue	25.2	26.5	26.9	27.9	28.9	30.0	31.1	32.2
Total Revenue	**$491.4**	**$540.2**	**$583.7**	**$632.5**	**$647.0**	**$682.8**	**$726.0**	**$769.0**
Change	*11.5%*	*9.9%*	*8.1%*	*8.4%*	*2.3%*	*5.5%*	*6.3%*	*5.9%*
Operating Income	**$158.0**	**$173.8**	**$183.7**	**$201.7**	**$183.4**	**$183.4**	**$189.9**	**$195.1**
Margin	*32.2%*	*32.2%*	*31.5%*	*31.9%*	*28.3%*	*26.9%*	*26.2%*	*25.4%*
Diluted EPS	**$5.63**	**$6.59**	**$7.88**	**$8.61**	**$7.80**	**$7.93**	**$8.46**	**$9.03**

Risks and Bear Case

Ongoing growth in lending and office openings could increase WRLD earnings.

Mexico (7% of revenues in FY13) could become large and drive future growth and profitability.

Short squeeze as 35% of CSO is currently sold short (mitigated by large passive institutional ownership).

CFPB could decline to investigate or investigate but not act, permanently validating the business model.

Without CFPB action, the base case still yields a 25% upside, implying CFPB is remaining 24% of upside.

The bear case of continued growth and improving rates and credit quality yields a $106 price target (19% downside), indicating an attractive risk-reward versus the 48% base case upside and 75% bull case upside.

Pandora (NYSE: P) - Long

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Akhil is a second-year MBA student in the Heilbrunn Center's Value Investing Program. Over the summer, he worked at Owl Creek.

He and his team (Eric Lai and Jeremy Colvin) were finalists at the 2013 Pershing Square Challenge, where they pitched LONG Dollar Tree (DLTR). Akhil graduated in 2008 from the University of Chicago; he majored in mathematics and economics.

Akhil is a finalist in the 5th annual Moon Lee Prize Competition.

Recommendation:
Buy Pandora ($26.82 as of 12/12/2013) with a probability-weighted price target of **$38 (40% upside)**

Background:
- Internet radio company with 72MM active users
- Pandora makes money via a) Subscription ($36/year, no ads) or b) Ad-supported listening
- Available on many platforms (PC, mobile, tablet, cars, TVs, etc.). ~80% listening is non-PC, primarily mobile
- Steadily capturing US terrestrial radio share; 8% today (vs 5% in 2011). Importantly Pandora is only 3% of the $17BN radio advertising market; they will close this gap

Capital Structure	
Price (12/12/2013)	$26.82
Shares outstanding	192.15
Market cap	5,153
Cash	(437)
Debt	0
EV	4,716

Consensus estimates	2013E	2014E	2015E
Revenue	$628	$821	$976
% growth		31%	19%
EBITDA	($2)	$41	$85
EPS	$0.02	$0.21	$0.32
EBITDA %	-0.4%	5.0%	8.7%

Multiples	2013E	2014E	2015E
EV/Sales	7.5x	5.7x	4.8x
EV/EBITDA	NA	113.9x	55.2x
P/E	1,158.6x	130.1x	84.3x

Thesis:
1. Revenue inflection point. Pandora has found a way to monetize mobile listeners and they still have many levers to pull. Furthermore, barriers to advertising are coming down
2. More and more ubiquitous. Advertiser ROI is favorable
3. Relatively unfazed by competitor launches
4. Blue sky: Pandora could expand overseas or get acquired

1. Revenue inflection point; barriers to radio advertising are coming down
- Pandora has guided to 3MM paying subs and 69MM nonpaying subs (i.e. ad supported)
- Mobile and PC RPMs were $34 and $58 respectively (RPM = revenue per 1,000 hours listened). **Mobile RPMs have been increasing rapidly** and this has been primarily due to a) Appointing a new CEO in 2013 (Brian McAndrews) who is an advertising expert, b) **mix-shifting from national to local ads; local RPM = 3-4x national RPM,** c) experimenting with ads (e.g. back to back spots) and surgically inserting more ads without increasing churn
- In September 2013 Pandora removed a monthly listening cap (40 hours) on mobile devices, a cap that they put in place in May 2013 because they couldn't monetize mobile listening. **In my opinion, this was a revenue inflection point**
- Levers that Pandora can pull to increase Mobile listening: **a) Ad minutes per hour** (currently 2 mins/hr versus 13-16 mins/hr on terrestrial radio, mgmt. stated that they want to go higher), and **b) Revenue per minute of ads** (breaking down unit economics => ~$11 per ad minute, this can go up to ~$14)

Exhibit: How high can mobile RPMs go? Comparison of current ($35) versus Theoretical ($62)

Mobile RPM breakdown:			
Mobile - Ad minutes per hour	2.0	3.0	*Upper limit from Q2 call*
Mobile hours listened (BN)	2.8	2.8	
# Mobile ad minutes	5.58	8.37	
Mobile Ad RPM per minute	$17.66	$20.81	*Mix-shift toward local ads*
% Audio	60%	66%	
Mobile Ad RPM per minute (Audio)	$10.59	$13.75	*Q3 call: "$9-$12 range"*
Local RPM	$19.00	$19.00	*High teens*
National RPM	$4.00	$4.00	*Low-to-mid s.d.*
% local	44%	65%	*74% of radio is local ads*
Mobile Ad RPM per minute (Audio)	$10.59	$13.75	
Mobile Ad RPM per minute (Display)	$7.06	$7.06	*No increase*
Mobile RPM	**$35.31**	**$62.44**	

		Ad minutes per hour								
	$62	1	1.5	2	2.5	3	3.5	4	4.5	5
% Local	35%	$16	$24	$33	$41	$49	$57	$65	$73	$82
	40%	$17	$26	$34	$43	$51	$60	$68	$77	$85
	45%	$18	$27	$36	$45	$53	$62	$71	$80	$89
	50%	$19	$28	$37	$46	$56	$65	$74	$84	$93
	55%	$19	$29	$39	$48	$58	$68	$77	$87	$97
	60%	$20	$30	$40	$50	$60	$70	$80	$90	$100
	65%	$21	$31	$42	$52	**$62**	$73	$83	$94	$104
	70%	$22	$32	$43	$54	$65	$75	$86	$97	$108
	75%	$22	$33	$45	$56	$67	$78	$89	$100	$112

- Pandora needs a local salesforce if its going to sell local ads. These salesforces are being rolled out; Pandora is currently in 29 markets (50% of listeners) and my model assumes 50% increase in SG&A over next couple of years
- Barriers to radio advertising are coming down. Pandora is now integrated into media-buying platforms (i.e. media buyers can look up Pandora audience size and compare to radio in various markets)
- Furthermore, Nielsen recently bought Arbitron (the Nielsen of radio) and stated that it will now start ranking Pandora. Previously Arbitron did not rank Pandora and this meant that buyers couldn't compare Pandora versus terrestrial radio ratings easily

Pandora (continued from previous page)

2. More and more ubiquitous. Advertiser ROI is favorable

- At launch, Pandora was PC only. Today listeners can consume Pandora on mobile, tablet, TV, car, etc. At some point it is likely that Pandora will offer separate advertising solutions for each platform
- Advertiser ROI is superior to that of terrestrial radio because: a) Terrestrial radio tends to have 4-5 min ad blocks every 30 mins and users change channels during these blocks, b) an ad on terrestrial radio is played to all listeners at the same time whereas an ad on Pandora is played to a user listening to a custom-built station => advertisers can segment and tailor ads on Pandora, c) Pandora has untapped geo-location potential, i.e. they could play you an ad for a store that you walk by (they don't do this as of today but they can) and these ads should have higher RPMs
- To sum it up: **8% of listening share but only 3% of advertising revenues + good ad product whose ROI is higher than terrestrial radio ROI + many RPM levers to pull**

3. Relatively unfazed by competitor launches

- Apple launched iTunes radio in September 2013 and claimed that they had 20MM users and 1BN songs played in 1 month. 1BN songs = 4BN minutes = 67MM hours. 67MM hours / 20MM users = 3.3 hrs/mo
- **Pandora users average 18 hrs/mo, i.e. 6x as much as iTunes radio**
- The launch appears to have been quite underwhelming. Pandora's active user count dropped from 72MM to 70MM but they made it back up 1-2 months later
- Spotify launched an ad supported radio service in December 2013. They only have 24MM users (6MM paying) so the impact on Pandora should be minimal. Pandora was down 7% on the day of the launch and I think that this could be a buying opportunity

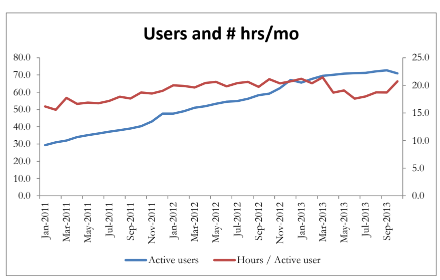
4. Blue sky: Pandora could expand overseas or get acquired

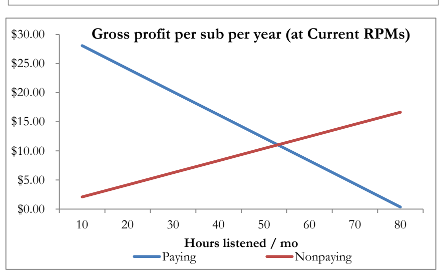
- Pandora has 200MM users of which 72MM are active (streamed in the last month)
- Competitors have chosen to build versus buy, but Pandora ($5BN market cap) would be a tuck-in deal
- Gross margins are 44% so Pandora is worth a lot to a buyer who has a large salesforce (they could buy the company and wipe out SG&A)
- **Potential Catalyst: Outcome of royalty negotiations**. Pandora will negotiate post-2015 royalty rates in 2014, its possible that a buyer could emerge after those rates are set. Furthermore, Pandora could strike a deal with music labels directly for royalties (currently it pays royalties under a federal statutory license... but it could pay them directly to labels) and this could be another catalyst if the rates are favorable
- Pandora could also move overseas if it strikes a direct royalty deal with labels. Currently Pandora is only available in Australia, New Zealand and the U.S. (as those countries have federal statutory licenses)
- **September 2013 equity raise could be catalyst** for a direct deal with labels followed by overseas expansion. Direct deals require upfront advances to labels and management stated that the equity raise would allow them to address such opportunities "from a position of strength"

<u>Valuation:</u>

(MM)

Valuation (2016E)	Bull	Base	Bear
Probability	30%	50%	20%
Hours listened (BN)	25.3	23.8	19.8
Mobile RPM	$73	$63	$54
PC RPM	$96	$89	$78
Content acquisition costs % Revenue	38%	42%	47%
Revenue	1,870	1,566	1,144
Operating profit	574	372	122
Operating margin	31%	24%	11%
EBITDA	619	410	150
EBITDA margin	33%	26%	13%
EPS	$1.98	$1.55	$0.66
Multiple	25.0x	25.0x	25.0x
Target price	**$50**	**$39**	**$16**
% upside	85%	45%	-39%
IRR	36%	20%	-22%
Probability-weighted Price	**$38**		
% upside	40%		
IRR	18%		





Post Holdings (NYSE: POST) – Long

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Jackson is a second-year MBA student, participant in the Heilbrunn Center's Value Investing Program, and Co-Editor of *Graham & Doddsville,* the Columbia Student Investment Management Association (CSIMA) newsletter. Over the summer, he interned at PIMCO in the credit research group.

Prior to Columbia Business School, he worked for the Federal Reserve Bank of Dallas. Jackson holds a BS in economics and engineering from Southern Methodist University.

Jackson is a finalist in the 5th annual Moon Lee Prize Competition.

Recommendation

Purchase shares of POST. My target price of $105 implies 90% upside over three years, or a ~25% IRR.

Capital Structure	
Share Pr. 1/27/14	$54.80
Shares Out. (mm)	33.0
Mkt. Cap. ($ mm)	1,808.4
+ Debt + Pfd. (PF)	2,452.0
- Cash & Equiv. (PF)	359.1
Enterprise Value	3,901.3
Key Stats	
52 Wk. hi/lo	55.9 / 36.7
Dividend Yield	0.0%
Short Interest	8.2%
Avg. Dly. Volume (mm)	0.4
Est. Intrinsic Val.	**$105**
Upside (downside)	**92%**

Business Description / History

POST is a consumer packaged goods company which manufactures and distributes ready-to-eat cereals in the U.S. with 10.4% market share (3rd largest). Additionally, POST has created two new platforms—active nutrition and private label—to capitalize on secular growth in the health and wellness category and in organic and gluten free foods. Notable brands include: Grape Nuts, Honey Bunches of Oats, Honeycomb, Pebbles, Raisin Bran, Premier Protein, Dymatize Nutrition, and Dakota Growers among others.

POST became a publicly traded company in early February, 2012 when it was spun-off from Ralcorp. POST was initially spun-out of Kraft Foods and merged into Ralcorp in 2007 for a total consideration of $2.6bn (including $950mm in debt), the TEV post spin-off from Ralcorp was roughly 2bn based on a share price of ~$30. Shortly after the spin-off, in November 2012, ConAgra agreed to purchase Ralcorp (made the offer in 2011 before the spin and closed in 2013).

Investment Thesis

I) The POST management team lead by Bill Stiritz is best in class

A critical aspect of investing in POST is that William Stiritz became chairman and CEO of the spin-off. This is the same William Stiritz profiled in *The Outsiders* for his stellar performance running Ralston Purina. Over his 19-year tenure at Ralston Purina, he delivered a 20% compound return through intelligent acquisitions, divestitures, and share repurchases (ultimately repurchasing 60% of the shares outstanding). Also relevant is that Stiritz pulled a cadre of business managers from Ralston Purina to POST (CFO Vitale, COO Block, and EVP of Marketing Holbrook), deepening the management bench and giving comfort that the right team is in place and focused on creating shareholder value.

In *The Outsiders*, Thorndike states: "Under Ralston's management, distribution was expanded, redundant costs were eliminated, new products were introduced and cash flow grew significantly...pretax profit margins grew from 9 percent to 15 percent." Stiritz is repeating the process. For example, he re-launched the Great Grains brand and grew volume 7.4% in 2012 and 9% in 2013.

Stiritz's incentives are well aligned with shareholders – he currently receives an annual salary of $1 and all other compensation in the form of stock options / share ownership. He currently has 1.55 million options with a strike price of $31.25 and 600,000 options with a strike price of $40.30. In addition, he directly owns ~370,000 shares.

II) Acquisition strategy through platform expansion and increased attention to the historic Post cereal business

Stiritz made his intentions known in POST's pre-spin S-1, "As an independent company, we will be able to allocate capital more efficiently and have direct access to debt and equity capital markets. We anticipate that these characteristics will improve our ability to continue to develop innovative new products, pursue acquisitions and other growth opportunities, extend our brands into adjacent categories and increase our ability to motivate employees by providing compensation that is tied directly to our business results."

And in the 2012 annual report, "Post received less and less attention as it became part of an ever larger conglomerate…historical "best in class" margins reflected an insufficient amount of support for the portfolio…We believe Post requires a top notch in-house sales force…Our business generates attractive cash flow and we intend to use that cash to reduce debt, repurchase shares, and/or make acquisitions…We intend to expand our platform of iconic brands by identifying organic opportunities to extend those brands into new product lines or markets. In addition, we intend to pursue acquisition opportunities that can strengthen our current portfolio of branded products or enable us to expand into complementary categories, geographic regions or distribution channels."

With Stiritz at the helm POST has been very acquisitive over the past two years – acquired roughly 50% of POST's pro-forma revenue – using FCF and leverage to purchase companies that now form the base of their active nutrition and private label platforms. These platforms will enable management to rapidly drive efficiencies in future acquisitions and fold new products into their existing distribution network. After accounting for synergies and the NPV of tax benefits the average acquisition price has been 8.2x EBITDA. Not counting the NPV of tax benefits I estimate POST is achieving an 8-9% levered free cash flow yield on its acquisitions. The historic POST ready-to-eat cereal business has also benefitted from additional focus since the spin-off and has stabilized with growth of 2.5% in 2013 compared to a category decline of 2.2%.

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Post Holdings (continued from previous page)

III) POST closely resembles a publicly traded LBO providing significant upside for the equity

Indeed this is Stiritz's intention, in the 2013 annual report he states, "Post Holdings competes for your capital allocation. To earn it we must deliver risk adjusted returns commensurate with your assessment of risk and your alternatives. Perhaps uniquely, we view Post as a hybrid of a traditional public company and a private equity fund. We use many of the same tools as a private equity company – relatively higher leverage, investment analysis and adaptive management. We also view our portfolio as dynamic, reacting to opportunities as they develop. However, unlike most private equity firms, we also provide Centers of Excellence to create competitive advantages for our operating companies. And we do this in the public forum allowing our investors greater transparency and, most importantly, the ability to act on their own accord."

POST has undertaken six acquisitions since being spun off and financed a significant portion of the cash consideration with debt. The leverage employed, while increasing risk to a degree, results in significant upside to equity holders and is accomplished in a prudent manner as the consumer staples product is less cyclical. Added comfort is gained from the significant cash flow generated by the historic POST cereal business as well as the newly acquired businesses.

Valuation

POST is currently trading at 11.4x forward EBITDA after adjusting for recently completed and announced acquisitions. While valuation is contingent on management actions and the opportunity for attractive acquisitions, recent activity and comments on the latest earnings call regarding deal flow are encouraging. I assume POST will continue to make acquisitions at a pace that keeps net leverage near current levels (roughly 5x) and that acquisitions are done at 8.5x. Holding net leverage roughly constant I derive revenue and EBITDA acquired based on the assumption that the EBITDA margin of future acquisitions will be similar to the recent average (~18%). I estimate organic growth at 3% and modest EBITDA margin expansion of 25bps annually. The result is $750mm in 2017 EBITDA to which I apply a 10x forward multiple resulting in a $105 share price in 2016, yielding a ~25% IRR over three years.

Financials	2010	2011	2012	2013	2014PF	2015E	2016E	2017E
Revenue	996.7	968.2	958.9	1,034.1	1,866.8	2,478.4	3,163.9	3,925.4
Growth	*-7.0%*	*-2.9%*	*-1.0%*	*7.8%*	*80.5%*	*32.8%*	*27.7%*	*24.1%*
EBITDA	265.6	256.6	202.3	191.3	341.3	459.3	594.2	747.1
Margin	*26.6%*	*26.5%*	*21.1%*	*18.5%*	*18.3%*	*18.5%*	*18.8%*	*19.0%*
FCF	111.3	128.9	113.1	86.4	152.1	215.3	288.4	372.0
as a % of Sales	*11.2%*	*13.3%*	*11.8%*	*8.4%*	*8.1%*	*8.7%*	*9.1%*	*9.5%*
Acq. Revenue	nm	nm	nm	nm	nm	555.6	611.1	666.7
Acq. EBITDA	nm	nm	nm	nm	nm	100.0	110.0	120.0
Total Debt	716.5	784.5	945.6	1,408.6	1,900.0	2,400.0	2,950.0	3,550.0
Gross Leverage	2.7x	3.1x	4.7x	7.4x	5.6x	5.2x	5.0x	4.8x

Recent Acquisitions	Hearthside	Premier	Dakota	Golden Boy	Dymatize	Total
Purchase Price	158.0	180.0	370.0	300.0	380.0	1,388.0
Multiple	8.8x	9.7x	8.4x	8.6x	9.0x	8.8x
Multiple adj. for tax benefits	7.4x	8.4x	8.4x	8.6x	8.0x	8.2x
Revenue	70.0	135.0	300.0	220.0	195.0	920.0
EBITDA	18.0	18.5	44.0	35.0	42.0	157.5

Investment Risks

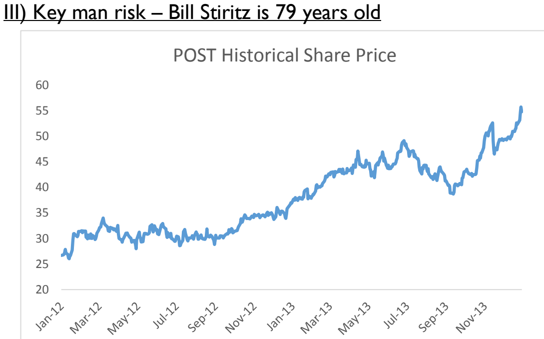
I) Capital markets become less accommodative

Mitigant: While accommodative markets aid POST's current strategy, and help the incremental upside, it isn't the whole story. Stiritz and his team operated Ralston for 19 years in varying market climates with great success. Ultimately Stiritz repurchased 60% of Ralston's shares and spun-off or divested multiple businesses in his quest to create shareholder value.

II) Management becomes overly focused on the story and stretches on price for acquisitions

Mitigant: While at Ralston Stiritz was very calculated in his capital allocation decisions and would look at the prospective return on repurchasing stock as a benchmark against which other investments were compared. They also avoided competitive auctions and only pursued acquisitions that were attractive using conservative assumptions.

III) Key man risk – Bill Stiritz is 79 years old



Mitigant: This is a concern but as noted previously, multiple members of the top management team worked with Stiritz at Ralston with great success. Additionally, you're paying 11.4x forward EBITDA for POST when General Mills is at 10.7x and Kellogg is at 10.6x, so the risk of loss looks fairly minimal. You still have a very good management team in place but you may lose some incremental upside. That said, Stiritz looks like he is in good shape and purportedly drinks protein shakes (which POST now sells) on a regular basis.

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Jim Grant

Jim Grant

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career as a reporter for *The Baltimore Sun* and *Barron's*. In 1983, he set out on his own, founding *Grant's*. He has written several financial histories, biographies, and collections of *Grant's* articles, as well as the introduction to the Sixth Edition of *Security Analysis*. In 2013, Grant was inducted into the Fixed Income Analysts Society Hall of Fame. He is also a member of the Council on Foreign Relations and a trustee of the New York Historical Society.

Graham & Doddsville (G&D): What first drew you to the world of economics and what led you to pursue a career in journalism?

Jim Grant (JG): Circuitously, is how I arrived here. I was a serious teenage French horn player—serious and almost good enough to play professionally. Using a baseball analogy, I was just good enough to play in the Cape Cod League.

So I went to Ithaca College to become a music teacher. I quit after one semester, served in the Navy, returned to civilian life as a clerk on a Wall Street bond desk, and went back to college, this time to study economics at Indiana University.

When the time came to get a job, I joined the staff of *The Baltimore Sun*—this was in 1972—where I met my wife, Patricia, and discovered my vocation. Financial news at *The Baltimore Sun* was the least prestigious job on the paper, a sure dead end. I didn't know the phrase "contrary opinion" but I seemed to have had a bent for it. I took that job and a couple of years later went to *Barron's*. That was in 1975. I was there about eight years. I wrote some editorials and originated the credit markets column, "Current Yield." I quit in 1983 to found *Grant's*.

G&D: What prompted you to start *Grant's*?

JG: I picked the wrong side in an intramural argument at *Barron's*. I had to leave. The question was, Where could I go? I decided to start my own paper rather than working for someone else's. I had no idea what a brave plan that was. I started *Grant's* with the $75,000 I'd accumulated in my Dow Jones profit-sharing plan. That lasted just about 8 months. Subscribers were scarce, very scarce. It seems the world had enough to read even without *Grant's*. I'd just published my first book, a biography of the investor Bernard Baruch, which did not set the world of literature on fire. Nor did *Grant's* set the world of journalism on fire. Nothing was going well. We had two kids and not much money. My wife, a banker at Lehman Brothers, had all the courage I needed. She said, "Well, let's persist," and we did. We were lucky enough to find an angel investor named John Holman, now known on these premises as St. John. He invested $35,000 and that was all we needed. I must say, he made a pretty good investment. That was in 1984.

My friend Lew Lehrman, a successful entrepreneur and a good investor, says that you're not a true entrepreneur unless you nearly go broke twice. I'm still waiting for number two, but the first time was enough for me.

G&D: Who do you consider to be some of the main influences in your economic philosophy?

JG: In college, I loved the writing of John Kenneth Galbraith. My junior year at Indiana, I went to the American Economics Association annual meeting in Manhattan. I walked into a room and at the end of the room was an elevator. And in that elevator stood John Kenneth Galbraith himself, about seven feet tall. I was awestruck. Before very long, I am pleased to say, my tastes matured. I got interested in free market literature, laissez-faire literature, the Austrian approach—Hayek, Mises, Röpke, and the rest.

Good financial writing, to me, is good writing. I have

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Jim Grant

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tried to emulate the masters. Walter Bagehot, the great Victorian editor of *The Economist*, is one. I used to read old bound copies of *The Economist* in the New York Public Library, just glorying in Bagehot's writing. Another is Frederic Bastiat, who urged his readers to look beyond that "which is seen" to that "which is not seen"—in other words, to imagine the unintended consequences of human action. I have learned from Henry Hazlitt, who wrote free-market editorials for *The New York Times*, if you can imagine that; John Brooks, author of *Once in Golconda*; and Bray Hammond, author of a wonderful history entitled *Banks and Politics in America*.

Then there's the great Fred Schwed, Jr., author of *Where Are The Customers' Yachts?* It's delightful, word for word among the wisest books ever written about Wall Street.

G&D: You mentioned Hayek and Mises. Why do you think the Austrians seem to be a source of controversy these days? Mainstream academia seems to write them off while others take them very seriously. What's your take on Austrian economics and where do you think it is better or worse than traditional economics?

JG: First, let me say that no single canon of economic thought has all the answers. The Austrians preach freedom and the price mechanism, each of which is a fine cause. Then, too,

"My friend Lew Lehrman, a successful entrepreneur and a good investor, says that you're not a true entrepreneur unless you nearly go broke twice. I'm still waiting for number two, but the first time was enough for me."

Austrian doctrine puts interest rates at the center of the theory of the business cycle. Certainly, that rings a bell for someone whose publication has "interest rate" in its name.

G&D: In your "increasingly famous" cartoons, you frequently reference Ben Graham's concept of Mr. Market. How important to you are Graham's lessons and how do they apply in the modern world?

JG: Graham reminds us that markets are just as efficient as the people who operate in them. They—the people—overreact. They underreact. They try to follow their heads but they often follow their hearts. They ought to buy low and sell high, but they tend to wind up doing the opposite.

Graham knew all about the emotional side of investing. Between the top of the stock market in 1929 and the bottom in 1932, his hedge fund was down by 70%. He picked himself up, dusted himself off, and wrote his magnum opus, *Security Analysis*. He might have given up, but he didn't. By the way, Graham was a wonderful writer as well as an analyst. *Security Analysis* is a model of expository prose.

G&D: A lot of value investors have begun to fancy themselves macroeconomists of late. What do you think about value investors who are trying to be macroeconomists?

JG: Let me tell you first about the ones who refused to fancy themselves macroeconomists. Investors who turned a blind eye to credit—to monetary policy, to the Federal Reserve—didn't notice the stupendous buildup of bad debt through

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Jim Grant

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2007. They tended to own a lot of optically cheap financial stocks that got cheaper and cheaper until they weren't there anymore.

Seth Klarman, a renowned value investor, says that run-of-the-mill talk about the macroeconomic future reminds him of sports radio. Everyone has an opinion, and every opinion is equally valid, or invalid, or vapid.

We can't know the future. But we can observe the present. Sometimes interest rates and credit and the cycles of credit are more important than stock selection. That was true in 2007 and 2008, and it will no doubt be true again at some point.

Allow me to suggest a book on a related subject. It's Oscar Morgenstern's *On the Accuracy of Economic Observations*. The second edition came out fifty years ago. In it, Morgenstern exposes the errors and fallacies that riddle macroeconomic data. Don't settle for what the data say, urges Morgenstern in so many words; ask what they mean. Marty Whitman, founder of the Third Avenue funds, has the same message for users of corporate financial information.

To take an example, the CPI says that prices are rising by a little less than 2% a year. Which prices? The ones in the index, of course. More specifically, the seasonally-adjusted and hedonically-adjusted ones in the index. It's no easy thing to build a price index—the compilers must make all kinds of choices that may or may not comport with your own ideas of relevance and fairness. It's no easy thing to interpret a price index, either. We shouldn't be so quick to accept these figures at face value.

G&D: Howard Marks emphasizes not forecasting but simply knowing where you are in the economy.

JG: Exactly! We should be more like Henry Singleton, the CEO of Teledyne in the 1950s and 1960s. Singleton baffled his critics by doing what hadn't been done before. For instance, he would purchase his own stock in the market when he judged it was unreasonably cheap. His critics demanded that he present a long-range corporate plan. Singleton replied that he had no plan and wanted none—the future was too full of surprises. His only plan, said the visionary, was to come to work in the morning with an open mind.

G&D: You have a whole team of analysts at *Grant's*. How is the work organized and how does an issue of *Grant's* come together?

JG: I sometimes wonder myself. Ideas come into the office; finished copy goes out. I write all the copy but by no means generate all of the ideas.

Our readers contribute some of our best ideas. In 2006, Alan Fournier, managing member of Pennant Capital Management, suggested that we look into mortgage derivatives. We did, under the somewhat uninviting page one headline, "Inside ACE Securities' HEL Trust, Series 2005-HES." It was the first of what proved to be many bearish stories on structured finance, mortgage derivatives and the like. By 2008, our readers were awfully glad we'd published them.

I'll be forever grateful to Alan for the idea and to Dan Gertner, a *Grant's* analyst at the time, for doing the hard work. Dan was a chemical engineer by training. He had no experience with mortgage-backed securities. But he knew a bad idea when he saw one.

It actually helped, I think, that he was not an expert in derivatives or structured finance. It was the mortgage experts who tried to tout us off the story. Nobody at *Grant's* is an expert. We're all generalists.

G&D: Do you prefer team members who come from economics or finance backgrounds?

JG: Yes. Smart people fit in well, too, as do those who are curious and tireless and

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"No single canon of economic thought has all the answers."

Jim Grant

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can write good, sound sentences. We publish every other week and have for 30 years. I'm no longer surprised that we actually manage to produce a 12-page issue of *Grant's*, though I am always grateful.

I've got to say that ours is not the most electrifying newsroom you've ever walked into. It's more like the reference room of a public library.

There are seven of us, not including the copy editor or the cartoonist, who work only on the days we go to press. There are three analysts: Evan Lorenz, David Peligal and Charley Grant (the last-named being my son). Del Coleman handles circulation, John McCarthy is the production chief and Eric Whitehead is the general administrator. If a subscriber needs a little encouragement to renew his subscription, he will hear from our discreetly persuasive marketing man, John D'Alberto.

A proper issue of *Grant's* is a little like a bride on her wedding day: something old (a little history), something new (never hurts in journalism), something borrowed (credit is our main subject) and something blue (we've been known to be bearish). The analysts submit memos, from which I write articles.

G&D: Given the extensive research in your memos and the very large bookshelf in your office, how much time do you devote to reading?

JG: I read when I'm not writing. As far as that goes, I read to write. I'm usually working on a book—a hobby, not a profit center, I can assure you. My new book is a history of the depression of 1920-21. It was the last laissez-faire depression in America. In

"Investors who turned a blind eye to credit—to monetary policy, to the Federal Reserve—didn't notice the stupendous buildup of bad debt through 2007. They tended to own a lot of optically cheap financial stocks that got cheaper and cheaper until they weren't there anymore."

response to a collapse in prices and a surge in unemployment, the administrations of Woodrow Wilson and Warren Harding balanced the budget and, through the Federal Reserve, raised interest rates. No "stimulus," no TARP, no QE, no ZIRP. Yet the depression did come to an end (from top to bottom, it lasted for 18 months), after which the 1920s proverbially roared. There, I've given away the plot. Simon & Schuster will publish it in the fall.

G&D: Do you have any favorite books that you would recommend?

JG: Besides the titles listed on the *Grant's* website, I'll mention two. One is James Boswell's 1791 *Life of Samuel Johnson,* a book about life and therefore about investing, although it contains no actionable stock ideas. A true category killer, Boswell managed to write the best biography in the English language that was also the first biography in the English language. I read it over and over.

The other—a little different—*is Banking and the Business Cycle*, by C.A. Phillips, et al. To my mind, it's the best contemporary analysis of the Great Depression.

G&D: Given your thoughts on the Fed and the gold standard, what did you think when Ron Paul suggested that if he were elected, he would name you Chairman of the Fed?

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Jim Grant

Alex Porter at the 2013 Moon Lee Prize Competition.

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JG: Wise choice. And I can tell what I'd do. Day One, I would open the Fed's very first Office of Unintended Consequences.

G&D: If you were president and could not nominate yourself as Fed Chairman, who would you nominate?

JG: My friend Lew Lehrman, whom I mentioned a moment ago. He made a lot of money by building up Rite Aid, which others subsequently unbuilt. He has devoted much of his life to studying monetary questions. He is the most knowledgeable and world-wise exponent of the gold standard in America.

G&D: What do you think it would take to move back to the gold standard?

JG: A clear demonstration that the non-gold standard isn't working. For me, I'm already persuaded, though many seem not to be. The system in place is a system of price control and market manipulation. The Fed sets interest rates. It manipulates the stock market. It materializes trillions of new dollars.

Unsound, I would call it, but the system does have its beneficiaries. Washington, D.C., is one. Greenwich, Connecticut, is another. Ultra-low interest rates and fast-paced money printing facilitate federal borrowing and lubricate leveraged finance. Ergo, both the government and Wall Street have a vested interest in not changing things. These are potent constituencies.

Laura Ingalls Wilder illustrates the moral side of the monetary question in one of her *Little House* books. This one, entitled *Farmer Boy*, is set in upstate New York. One day, the protagonist is at the fair, and his father gives him a 50-cent piece. The father asks him, "You know what this is?" Silence. "Well it's money. Do you know what money is?" Again, silence. "Money, son, is work." Here's the question: Is money work? Or is it an instrument of public policy? The voters will ultimately have to decide.

G&D: What would happen in the economy if the US and presumably at that point, the world, moved back to a gold standard? There are a lot of arguments that it would throw a wrench in the financial system, but in your opinion, what would that scenario look like?

JG: If I were king, or chairman, I would present the gold standard to the nation as a monetary system grounded in free markets and individual responsibility. The system we have is one of command and control. Sitting at the control panel are former tenured faculty members—the cream of the economics departments of the top universities. They do what they think is best. Here at *Grant's*, we call it the Ph.D. standard. The FOMC has become a kind of seat-of-the-pants economic planning bureau. The gold standard, by contrast, operates through the price mechanism. Money is defined in law as a weight of gold. Paper dollars are convertible into gold, and vice versa, at the fixed and statutory rate.

Is that a good idea? It was a good and serviceable idea for most of American history and, as far as that goes, for most of the modern commercial history of the West. You asked about the "financial system." Under the gold standard, banks were the property of the stockholders, not of the taxpayers. If a bank became impaired or insolvent, the stockholders got a capital call (that arrangement, called "double liability," was phased out in the 1930s). I believe that that is the direction in which our financial reforms should be headed, not toward more regulatory micromanagement and not more monetary improvisation, or "learning by doing," as Chairman Bernanke candidly styled QE, zero percent interest rates and the rest of it.

G&D: If you were to grade Ben Bernanke's performance as Fed Chair, how would you evaluate him?

JG: I would say A for

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Columbia Student Investment Management Association

Jim Grant

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intentions, F for theory, C for short- and intermediate-term results. By results, I mean that the world turns on its axis; America is more prosperous than, say, France; and most people who want work seem to be able to find work. It's a far cry, though, from dynamic American prosperity. As for the long-term costs of this extraordinary monetary experiment, I expect them to be sky high.

I say that because price control doesn't work. As far as I know, it has never worked. By controlling some prices, e.g., interest rates, you invariably distort others. The Fed is trying to fool Mother Nature.

G&D: Being a proponent of the gold standard, what do you think of Bitcoin?

Bitcoin is a monetary cry for help by the technological elites. They don't like the idea of government money in general, and they disapprove of QE and zero percent interest rates in particular. Their solution is a crypto-currency that governments can't print. As an alternative, allow me to suggest a tangible monetary asset that governments can't print. One which has been accepted as money for millennia, which is scarce, fungible, ductile, beautiful, and universally accepted as money. Hey, Silicon Valley: You'll never lose gold on your hard drive.

G&D: You focus a lot on risks in the economy at large. How do you think investors should look at risk and reward and how does that compare to how central bankers should think about it?

JG: The manager of one of the world's biggest hedge funds looked into the CNBC cameras the other day and said that risk is the volatility of returns. I would say—many value investors would agree—that risk is the likelihood of the permanent impairment of capital.

"We can't know the future. But we can observe the present."

In the case of a central banker, risk is a little different. As Ron Paul's prospective Fed chairman, I would define risk as the chance that market intervention in whatever form winds up doing more harm than good.

G&D: Given the current state of the economy and the low interest rate environment, it sounds like you perceive risks that others do not. What facts, measures, or indications bother you most?

JG: Here's a fact: China's banking assets represent one-third of world GDP, whereas China's economic output represents only 12% of world GDP. Never before has the world seen the likes of China's credit bubble. It's a clear and present danger for us all.

And here's a sign of the times: Amazon, with a trailing P/E multiple of more than 1,000, is preparing to build a new corporate headquarters in Seattle that may absorb more than 100% of cumulative net income since the company's founding in 1994.

Now, there are always things to worry about. Different today is the monetary policy backdrop. Which values are true? Which are inflated? In a time of zero percent interest rates, it's not always easy to tell.

G&D: Where can the average investor find income?

The average, risk-averse investor can't. There's none to be had, at least none in natural form. To generate yield, you must apply leverage. This is the stuff of businessman's risk. A pair of examples: Annaly Capital Management (NYSE:NLY), a

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mortgage real estate investment trust, which changes hands at 83% of book value to yield 11.4%; and Blackstone Mortgage Trust (NYSE:BXMT), a new real estate finance company, which trades at 113% of book value to yield 6.43%. We judge both to be reasonable risks. More speculative, but—we think, also priced appropriately for the risk—are long-dated Puerto Rico general obligation bonds. The 5s of 2041 trade at 65.40 to yield a triple tax-exempt 8.18%. Widows and orphans stand clear.

G&D: What about the great debate over tapering?

JG: *Grant's* is on record as saying that the Fed won't taper. Or, that if it does taper, it will likely de-taper—i.e., reverse course to intervene once more—because the economic patient is hooked on stimulus.

The source of the Fed's problem (which, of course, is everyone's problem) is that there ought to be deflation. In a time of technological wonder, prices ought to fall, as they fell in the final quarter of the 19th century. As it costs less to produce things (and services), so it should cost less to buy them. In an attempt to force the price level higher by an arbitrary 2% a year, the central bank inevitably creates too much money. Those redundant dollars don't disappear. They inflate something—and that something, these days, is investment assets. The Fed doesn't seem to mind; higher stock prices are part and parcel of the central bankers' recovery program. But when markets crash, the Fed returns to do more of what levitated those markets in the first place.

"A proper issue of Grant's is a little like a bride on her wedding day: something old (a little history), something new (never hurts in journalism), something borrowed (credit is our main subject), and something blue (we've been known to be bearish)."

The central bank did it in the early 2000s to bind up the wounds of the dot-com crash; and, of course, it's repeated the treatment, only with much heavier does, from 2009 to date. Observe that ultra-low interest rates encourage debt formation. The trouble with debt is that it tends to be deflationary. Leveraged firms tend to overproduce in order to generate the revenue with which to remain solvent. Overproduction presses down on prices. Easy access to speculative credit prolongs the life of marginal firms. They don't go broke but continue to produce, thereby adding to the physical volume of production and so to the overhead weight on prices. Debt is deflationary the more it drives production or the more it inhibits consumption.

You see the problem. The Fed is egging on inflation with one hand but suppressing it with the other. It materializes the dollars that drive some prices higher. It fosters the debt that drives other prices lower. What it refuses to do is let markets clear.

G&D: Do you think there's a multi-year playbook that they're following or is it more day-to-day?

JG: Well, if they're "data-dependent," as they insist they are, they're just as good as the quality of their data. And they're just as good as the soundness of their theories. In short—by my lights—they're not very good.

G&D: Where in the world

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do you see there being attractive investment opportunities right now?

JG: We are finding it harder to find good long ideas, easier to find good short ideas. Years ago, when I believed I could predict the future, I would have answered your question by declaring that the top is in: Sell everything! Older and—maybe—wiser, I know that I don't know that the top is in. What I think I know is that risk increasingly overshadows reward in stocks and bonds alike.

G&D: Have you tracked the returns of the investment ideas that you include in *Grant's*?

JG: No. I'm not sure which is harder, investing or writing about investing. What I do know is that they are different. For a decade and more, Alex Porter and I were the general partners of Nippon Partners, a long-only partnership that invested in Japan. We worked hard at securities analysis and portfolio management, but we didn't have to publish our findings, in scintillating prose (complete with a funny cartoon) every two weeks.

At *Grant's*, we analyze securities and we comment on credit and on China and on the prices of modern art and on anything else that strikes our fancy. But we manage no portfolios. We size no positions. We hedge no currencies. I don't track our returns because they wouldn't be returns. They would a journalist's idea of returns.

G&D: There are some who compare journalism and investing. In fact there's the notion that being an investor is like being an editorialist because you have to find the facts and then connect them to form an argument or opinion.

JG: Plenty of people leave journalism to go to Wall Street and find that investing is not as easy as it seemed while they were writing about it. And there are plenty of people who invest for a living whose annual letters are fun to read only because the first paragraph says, "Dear investor, we were up 46% this year." Beautiful prose.

G&D: How do you manage to maintain a healthy skepticism without becoming overly cynical?

JG: It can be hard. To anyone who was bearish on the dot-com mania, as I was, the year 1998 lasted for about 6 years; 1999 dragged on, seemingly, for another 15 years. But then, blessedly, came the year 2000. You start rooting for bad things.

A friend of mine and a fine investor, Frederick E. "Shad" Rowe, calls himself a recovering short seller. Shad was bearish with the rest of us skeptics and cynics in the late 1980s and very early 1990s. Then he turned bullish, did very well, and became much happier. His mother was the inspiration for one of my favorite *Grant's* cartoons. A married couple is seen in the family kitchen. They happen to be bears. She is laying a paw consolingly over his shoulder. Obviously, the market has been soaring. "Don't worry cupcake," she is saying. "I just know something terrible is going to happen."

I am cyclically bearish and permanently—temperamentally—skeptical. But one has to navigate this terrain between cynicism and skepticism. One cannot be bearish on life, and I'm happy to say that I'm not.

G&D: What advice do you have for students or investors in the early stages of their career?

JG: See the older gent walking down the street, the one not checking a mobile device? He has money, security, position. In short, he possesses everything you don't have and desperately want. But do you know something? The elderly gent would give his money, security and position for your bounding energy, full head of hair and limitless prospects. You should enjoy them!

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

"Here's the question: Is money work? Or is it an instrument of public policy? The voters will ultimately have to decide."

Justin Muzinich

Justin Muzinich

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Olin Fellow in Law, Economics and Public Policy, and an MBA from Harvard Business School, from which he graduated with highest honors as a Baker Scholar.

Graham & Doddsville (G&D): Can you tell us a little bit about your background and how you got interested in investing?

Justin Muzinich (JM): Sure, I've always been interested in investing. When I was in college I ran a student investment fund and enjoyed it. I didn't know anything really about finance, which in some ways was an advantage because we thought more about the companies—their business model, products—than about numbers in a spreadsheet.

As your career progresses, you understand how important thinking about companies is as opposed to just thinking about numbers. In college you take that approach out of naiveté. We thought we had a comparative advantage understanding technology stocks because we were the generation using their products and we were more in the flow of what was popular than someone sitting behind a desk in New York all day.

G&D: You have both an MBA and a JD. What was the rationale for pursuing both and has it helped you being on the fixed income side of investing?

JM: Post-college, I worked at Morgan Stanley in their mergers and acquisitions group and there I learned a lot about finance. That can be a good or a bad thing, as an investor, because as a banker you can end up solving for an outcome as opposed to taking an unbiased view as to what a company is worth.

I went to business school to round out my banking experience. I enjoyed finance, but I also wanted to think about businesses more holistically, learn how businesses think about sales, product development and management.

I went to law school because I thought law was a very stimulating field. In law school you get to think about big questions and you don't get that opportunity often in your career. Once you are working full-time, it can often be more difficult than you'd like to step back. I was lucky enough to go to Yale, which is a place that gives you lots of flexibility to follow your interests. It also ended up being very helpful in fixed income, since you deal with contracts and other legal and regulatory issues all the time.

G&D: Did you ever think of practicing law?

JM: Never very seriously. I spent a summer practicing law to get a sense for what it was like. I wanted more insight into how the law actually worked.

G&D: You started out doing equity investing and moved to fixed income. Why did you make the move and what do you see as the primary differences?

JM: I was very lucky out of graduate school to work for a fund that had been spun out of a family office with a lot of capital. It was a very small group of us and we could think with a very long horizon and look for good businesses. We did mostly equities, and I really enjoyed it.

But there was something especially stimulating to me about fixed income. On the credit side, whether you are looking at senior loans, or high yield or emerging market debt, you have to do all the analysis you do for equities. You have to understand the companies to ensure you are going to get your coupons and principal. But there is also a much broader analysis you have to do in terms of reading the debt contracts and understanding covenants; it's more complicated and in some ways that's very appealing.

Another difference is that in credit, you can be more certain of the outcome. You buy a bond and you have three or four years left of its life, either it's going to pay you $100 or it's going to default. So the market

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can move against you for six months or a year, but if that bond is money good it's going to move back pretty quickly because you have a pull to par.

In that way you are rewarded quickly if your analysis is right. In equities something can trade from 15 times to 10 times and can stay there for years and years. Eventually if you buy at a low enough valuation and you are actually collecting dividends you'll be fine, and that's what value investing is, but it can take a really long time to be proven right. Whereas in credit if you are right, generally you see that in a shorter period of time. That's, I think, an important difference.

G&D: When looking for investments your criteria sound very similar to Buffett-style equity criteria, really looking for a strong business with competitive moats. How do you find that working from the credit side? It gives you better principal protection but it seems like an equity way of thinking.

JM: That is something we think about a lot in fixed income. Unless you are doing distressed investing you are paid just for sitting around—whatever the coupon is, 7%, 8%, etc. What you need to ensure is that you are going to be paid back and avoid losses through default.

So thinking about the business model and making sure you are going to be paid in almost any circumstance is really important. In some ways it is similar to the margin of safety concept on the equity side.

There are two ways of looking at the bond market. One is to look at it as a securities market. Securities prices go up and down, and you try to buy a bond today because you think in a month or a quarter it will be worth more. The equivalent on the equity side is technical investing or momentum investing or something like that.

Alternatively you can approach bonds as a market in which you are lending money to companies. What you care about is that the company and the business model are strong enough to pay you interest and principal over the life of the bond. If that is your approach you have to be sure that regardless of all the things happening to a company that they can't control, that they can still pay you interest and pay you principal because you understand the drivers of their business well enough. That approach is the equivalent, on the equity side, to a margin of safety or value investing concept. That is the approach we take because we take uncertainty very seriously.

G&D: That's interesting. Howard Marks spoke to our class last week and talked about how Graham and Dodd emphasized fixed income investing being a negative art in that you don't always have to pick the right ones but you really need to avoid picking the bad ones.

JM: It's absolutely the case in fixed income because the historical recovery rates in the high yield market, for instance, are typically forty cents on the dollar. So if you make a mistake you are getting 40 cents back. That's a lot of coupon you are giving away if you have a default. It is a negative art in that sense. You've got to try to make sure the business can withstand everything that's happening around it in order to minimize your default rate.

G&D: Corporate credit markets are very broad; how do you narrow the opportunity set?

JM: We segment the world by industry at an analyst level and do a first cut to eliminate issues or companies that we aren't going to spend time on, either because they're too small or they're just too illiquid. You can cut the universe down by one third—to one half—depending on exactly what you are looking for. From what's remaining, we try to do work on most companies.

What's really important in narrowing the opportunity set is that you have a sense of what happens with com-

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"As your career progresses, you understand how important thinking about companies is as opposed to just thinking about numbers."

Justin Muzinich

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panies during difficult periods. We think one of the best ways to have that sense is to have experienced people on the team who have seen a number of cycles. It's fine to think in the abstract about what happens when the economy deteriorates. But when you actually know how companies behave and what management teams have done, what companies try to do with covenants, what happens to cash flows in cyclical industries—having a team that has lived these issues gives you a lot of comfort as you go into a downturn.

G&D: It would be interesting to talk about the business model of an asset manager and how you view it versus how some other large asset managers approach it.

JM: There are many sides to that question. How you set up your organization is really important for long-term success and there are lots of decisions you can make that might enhance short term profitability but are the wrong long-term decisions for generating good returns, and ultimately that is what matters.

One decision we made on the business side is to have senior investment professionals, with the goal of minimizing defaults. While you may not make this decision if you are focused on short term profitability, we try to keep sight of what's really important to success in the business. Here it's attention to protecting on the downside and having the experience to know what happens to companies in difficult times.

The other decision we've made is to stay focused on corporate credit. Lots of asset managers, for a variety of reasons, start with a focus but then want to get into a lot of different verticals from a diversity of business perspective. So they'll start in growth equity and then move to value equities, and maybe from value equities move into converts and credit.

I can see why people do that, but we feel we have a competitive edge by doing nothing but credit. We are very aligned with our investors because we can't do credit badly and then rely on an equity team to perform well. This focus also generates robust debate, because credit is what people discuss all the time, and real debate is important to the investment process. Talking about credit all the time might sound boring, I'm sure it does, but that is what makes you good. So a big business model decision has been to stay focused on corporate credit.

A third business model decision has been to be global. This requires investment teams in several countries, and again is not something you would do if you were focused on short term profitability. But we think it makes us better investors with a broader opportunity set to be able to invest in European and emerging market credit, not just US credit.

G&D: Muzinich & Co. flies under the radar more than we would expect from a firm with your AUM. Is that a strategic decision or is that just the fact that we come from a non-credit background?

JM: It is a strategic decision. We think what is going to matter over the long term is doing a great job for our investors. It doesn't help us to do a great job for our investors by appearing on TV. Our view is that we just want to stay focused on what's ultimately going to matter over the long run, which is picking good companies at the right valuations.

G&D: Do you find it affects your investment process at all? There are some people who deliberately try to stay off the radar so that it's easier for them to do deeper due diligence.

JM: Some might keep a low profile because their profile is not one which companies they invest in would like. But we're generally investors that companies like to have, because of our longer term outlook, so we don't have a problem with access to management etcetera. For us it's more just a matter of where we put our

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focus and what consumes our time every day. Spending time on TV does not help us earn good returns. Time management is one of the most important things in investing and we just want to be focused on what will matter over the long run.

G&D: In terms of focusing on corporate credit, you primarily do high yield, but will you branch into investment grade if you think there is some type of dislocation?

JM: The firm is not just high yield; we define it as global corporate credit generally. So we do a fair amount of crossover investing between, for instance, investment grade and high yield because of structural reasons. When you make the transition from investment grade to high yield there are often a lot of forced sellers and inefficiencies. Over time that's been an interesting area for us to focus on.

We also invest in senior loans and we have a hedged vehicle which has a lot of flexibility to put on arbitrage trades. We look at the whole credit universe, except upper tier investment grade, because that is driven by interest rates. We don't think we can consistently predict what's going to happen to interest rates, which is a very liquid and efficient market. So we try to be very honest about that with our investors.

We also don't do a lot of distressed investing. We have people who have done distressed, and we certainly can. But if you are going to do distressed full time, it's as much legal analysis as it is credit analysis and that is a different skill set. Again, we want to be focused on what we're really good at.

G&D: So if one of the names you hold does move into a distressed situation will you work with them on a credit committee?

JM: Yes, if that is the right thing to do for investors, absolutely.

G&D: In terms of portfolio management, how do you think about the number of positions you have and industry concentration? Are you managing to a benchmark in some instances and not others?

JM: We don't manage to a benchmark. Certainly some of our investors might be more benchmark oriented than we are; it's just a reality of the investment world. The way the industry is set up you have investment committees and consultants who use benchmarks so you can't avoid it to some degree.

But we don't make investment decisions based on a benchmark. For instance, we hardly held any financials going into 2008, even though they were part of the benchmark. We hardly held any telecom going into 2000, and at times we've been totally out of industries when we think it's the right thing. There are people in the investment world who look at benchmarks, but benchmarks don't drive our investment decisions.

G&D: What kept you out of financials in 2008?

JM: On financials, it wasn't a great insight that financials were going to go through all the turmoil they ultimately did. We weren't totally comfortable with what was happening, but we didn't make some great call that there was going to be a financial collapse either.

We were out of financials because we couldn't evaluate them from a credit perspective. The first rule of credit investing is you don't invest if you don't understand, and that requires a lot of intellectual honesty.

They were such black boxes. I remember talking to a very senior research analyst, one of the most senior banking analysts on Wall Street, at the end of 2007. I asked him, "Can you really look me in the eye and tell me that you understand the risks broker-dealers are exposed to or is this a black box?" This guy who had made a career of financials, who has been covering financials for 20 years and writes very long reports on these institutions, said that at the end of the day, it's a black box.

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"We were out of financials because we couldn't evaluate them from a credit perspective. The first rule of credit investing is you don't invest if you don't understand, and that requires a lot of intellectual honesty."

Justin Muzinich

Professor Bruce Greenwald speaking at the 2013 CSIMA Conference.

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We just didn't know what exposures they had on their own book and what they had done to hedge out exposures. There wasn't transparency, which you need for credit investing.

G&D: Has that changed since then? Have you guys moved into more financials?

JM: In the case of broker-dealers for instance, we still feel like we really can't evaluate the risks to the point where we are comfortable. There are times when you might get paid for that uncertainty. But you really need to be paid a lot. That said, there is a price where taking on this uncertainty can make sense. We will invest in leasing companies where there is actually collateral you can understand and it's much more transparent. But that's just not the case with the broker-dealers.

G&D: Coming back to diversification, how do you think about it in the context of fixed income portfolios?

JM: From the equity side there are pro and con arguments for diversification. And there is certainly an argument to be made for just investing in a handful of companies you know really well, where you really understand what's going on in the business.

On the credit side, because it's a negative art, and because so much of it is risk control, I think there is a good argument for diversification. If you only have ten names in an equity book and one triples, that's great. That makes a lot of sense. In credit you usually buy something at $100 or relatively close to par, unless it is a distressed market, but you are not going to get $300 back; maybe you'll get slightly above par.

So you don't get the payoff from being concentrated. On the flip side you can get hurt if you hold ten names and something unexpected happens, and one position ends up being worth 40 cents on the dollar. One way to control that risk is diversification and that's why banks and lending institutions also have diversified books.

When I was spending a lot of time on equities I came to dislike the word diversification as an equity analyst. In fixed income I've come to appreciate it.

G&D: Do you mind talking a bit about what you do in terms of credit long-short ideas and where you see most opportunities?

JM: Sure, we see lots of opportunities. Generally what we try to do is look for companies that are yielding a similar amount but have very different risk profiles. Over time yields generally reflect risk profiles so the securities eventually should converge to fair value.

There are two areas where we generally find opportunities. One is intra-capital structure arbitrage. One company might have senior loans and high yield bonds, and let's say the market has really rallied and they're trading at about the same levels. But senior loans are floating rate instruments and high yield bonds are fixed rate, and the loans are senior in the capital structure.

With interest rates so low now it's difficult for them to go much lower. So you should get paid more to own high yield, because it doesn't have a floating rate feature and it's lower in capital structure. When credit markets rally it's often because of technicals in the market, and the same when they sell off. Everything will move up together and often the price between these two securities in the capital structure will converge substantially. When that happens we can arbitrage the two against each other. We short the bonds, for instance, and go long the loan. You largely offset your cost of carry from shorting the bonds.

Another area where we often find ideas are what we call intra-industry trades. There will be two companies in the same industry, one with a great business model and one we think is a very bad business model, more cyclical maybe or just a different cost structure.

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Again, in a strong market, bonds often move within the industry in the same way and then when there is pressure on the market, bonds are differentiated. But when everything is moving up the yields get pretty close.

G&D: On the opposite side, when spreads haven't necessarily converged, when they've diverged, how do you go about identifying attractive trades?

JM: Often what we've seen happening, and this is partly because the books of broker-dealers are smaller because they are not making markets in the way they used to, is big liquid bond complexes, in periods of stress, will trade off more than less liquid ones, because retail money is moving in and out of the market, and retail focused funds have to sell more liquid bonds to satisfy redemptions.

So we often see artificial pressure being put on big liquid complexes and often these are companies where there is no question that they are not going to default. They have huge equity market capitalizations and we know the business models very well. It's just that the flows are causing movements in security prices within the markets.

So we'll often see opportunities around flow-based names when the market sells off and we can arbitrage those against names that aren't selling off as much, or aren't as flow-based.

G&D: Do you think the rise of high yield ETFs exacerbates that sort of behavior?

JM: It exacerbates some of that behavior. ETFs—we could talk for an hour just about this—create their own sets of inefficiencies around the market because they're rule-based. They operate based on arbitrary rules. Not rules that are based on the value of the underlying company, but rules that say you can only own certain types of issues or certain types of securities. So if there are outflows then that type of issue or that type of security gets sold, it has nothing to do with the underlying value of the company, it's just because of some rule being executed. So we spend a lot of time trying to understand those rules and the pressure that those rules put on different securities.

G&D: Based on that liquidity aspect, will you typically hold cash bonds or do you consider using credit default swaps (CDS) to gain exposure?

JM: We'll typically hold cash bonds. In our hedge strategy we'll use CDS, but we typically transact in the cash markets.

G&D: Given the current interest rate environment and the fact that interest rates are going to have to go up from here at some point, how are you thinking about duration?

JM: For the more credit-focused part of the market, duration doesn't matter too much. The long term correlation of the high yield market to the ten year treasury is zero. It's actually very slightly negative even.

That's because in a rising rate environment companies are generally doing well, and likely have some pricing power from inflation, so even if rates are moving up, spreads will often compress at the same time. That's historically been true, but sometimes it doesn't happen. But generally it's not illogical that you would be in a spread compressing environment at the same time that rates are going up. However you may get to a point where spreads can't compress anymore and rates still rise.

Especially when rates are low and the curve is fairly flat, we'll be on the shorter duration side. However, we don't have an in-house view of where rates are going. But we can have a view that there is a lot of uncertainty about rates and we're not being paid for that uncertainty. Also, in our hedged strategy, we have the flexibility to arbitrage out duration. If you put on a trade going long loans and short the bonds you achieve this.

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G&D: What about the duration needs of your investors?

JM: Different investors have different duration needs. For instance, insurance companies often match asset and liability duration, whereas endowments sometimes do not. The duration needs of our investors can drive whether they invest with us in duration-hedged strategies or not.

G&D: You are also involved in opportunities outside of the U.S., particularly in Europe. Could you explain the opportunity you see there?

JM: The European debt markets are really interesting right now. The European high yield market developed after the U.S. high yield market. The private equity market there developed after the U.S. private equity market. On the debt side of things they often take their cue from the U.S. markets.

Several decades ago, small and medium size businesses in the U.S. got a majority of their financing from banks. That's come down over the last few decades to about 30 percent. In Europe, small and medium size businesses get about 90 percent of their financing from banks. Banks in Europe are under tremendous pressure, they are de-levering, and their banks did not restructure in the way our banks did in 2009.

For a variety of reasons this is putting more pressure on small and medium size businesses than on large businesses. One of the ways banks make money is cross-selling. They don't make that much money on the actual loans they make to companies, but on selling foreign exchange services and a variety of other services to companies they make loans to.

Banks can do more cross-selling to large companies because their businesses are more international, therefore they need these additional services. So as banks are capital constrained, they're focusing more and more on large companies. While all companies in Europe are feeling the pinch of the credit crunch, the small to medium size companies are most impacted.

A lot of these businesses are great businesses. We've been spending a lot of time for instance in Northern Italy, where there are a lot of well protected niche businesses that have made it through multiple cycles including 2008 and 2009. So the businesses which remain are often very good. They often have long-term international contracts. But if they want to expand or they have an opportunity to win a new contract, they just can't get financing anymore.

So through our investment funds we can provide financing to them, which we think is a good risk-reward for the investors in our funds. We do have to match assets and liabilities because these are private loans. You are not going to get your money back until the maturity of the loan so you have to make sure your capital is long term. But we see some pretty good opportunities and have been spending a lot of time in Europe.

G&D: What was it that drew you to Italy? Was it the fact that their financial institutions have taken a particular beating or was it some other reason?

JM: We're looking at all of Europe. In Italy and Spain the banks are in more trouble than other countries. There are a lot of northern Italian business we know from experience are very well run. There are lots of great manufacturing businesses and a great manufacturing culture.

We thought that in Italy, because it was one of the powder kegs of Europe, there was a good chance the baby was being thrown out with the bath water. People didn't want to deal with a company because it had an Italian flag, even if most of its revenue came from outside Italy. Many businesses in Italy were just as solid as businesses in Germany.

You still have to be sensitive to the regulatory regime and the bankruptcy regime. But the different bankruptcy

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regimes always existed, while the price that you paid in 2007 versus 2008 or 2009 really gapped out when you looked at Germany compared Italy. That's because companies were being dismissed simply because of their Italian flag.

G&D: How do you build that business out, do you set up an origination team on the ground and how time intensive is it?

JM: It took us a year and a tremendous amount of work to set up before we were really comfortable with it. If you are going do it right, you've got to put the infrastructure in place and hire a number of people in Italy. Now we're seeing strong deal flow and a decent number seem to be very good risk-reward opportunities. They are good business models with low debt to EBITDA that need financing and we can be good long term partners because we have a long term view of the world and want to help them grow.

G&D: We noticed that you co-authored an article with Dean Hubbard recently and were curious what motivated you to work on that and how it relates to your investing? And is there a particular area that you think the Fed should be focusing on currently to address excesses?

JM: We co-authored one piece together and Glenn Hubbard is just a terrific guy. It was a privilege to work together. On the first part of the question, how does that overlap with investing? I think investing is about being curious and I think that leads very naturally to writing.

Investing is a never-ending stream of interesting questions. You can think about business models, about the world, about what other people are thinking and where there are opportunities. Often, thinking about companies leads to thinking about some broader question, because companies inhabit a world around them.

I also believe it is important to try to contribute to the public debate if you have an idea, even if in just a small way.

In terms of the Fed, we have some views in our article about what the Fed can and can't credibly do. We think it's difficult given the way the Fed is structured right now to credibly say they're going to be very good at what's called "macro prudential regulation," which is just a fancy word for trying to stop bubbles.

We should think about institutional reform rather than lots of these small rules-based reforms around the edges, which don't fundamentally change the mandate or structure of the Fed.

G&D: Could you briefly talk about a mistake you've made, either in investing or in your career, and what you learned from it?

JM: Early in your career it's easy to be overly focused on numbers, especially if you are coming out of an investment bank or out of business school, and I made this mistake. Numbers are really important and you certainly have to understand valuation, but the most important thing is finding good businesses. I think it's easy early in your career not to appreciate what really makes a good business. I love reading Buffett's letters and his discussions about moats around good businesses, but until you interact with enough businesses and understand what a moat actually is, you don't really appreciate it.

G&D: Any parting words of advice to our readers, and especially to any students interested in careers in investing?

JM: I'll come back to something I said earlier in the interview, which is to try to be really stimulated by investing and to keep a sense of curiosity. I think that's what makes the best investors. It allows you to have insights into where there might be opportunities and that's a very important starting point for investing.

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

"Numbers are really important and you certainly have to understand valuation, but the most important thing is finding good businesses."

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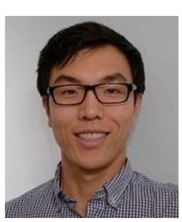

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