Ben Graham Centre for Value Investing

Guy Gottfried

The Founder and Managing Partner
Rational Investment Group, LP
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What is your schedule like on a daily basis? Is there anything unique in your routine that you feel is valuable for aspiring investors to consider?

I try to structure my work environment in a way that is most consistent with my strengths and tendencies. Ray Dalio said it well in his book *Principles: Life and Work*: "The happiest people discover their own nature and match their life to it." Don't get me wrong – it's essential to work on ourselves and continuously learn and evolve. But some things are ingrained in our nature and rather than try to fight them, we can work with them. For example, I've always been a night owl, and at some point in my career I concluded that no matter how much I try to change it, I'll always be most productive at night. So I start work late, come home at a normal time to be with my family and then go back to work at night. I go to bed at a time when most people are much closer to waking up than to calling it a night. That's an example of what I mean – giving yourself the conditions under which you'll thrive will make you both more content and more productive.

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Another example that is unconventional but works for me is that I do not have an investment team. I have a CFO, but I don't have investment people. For me, that means that I don't get bogged down with managing people and that I'm the one who intimately knows all of our positions. When I'm thinking about people, it's not HR-related; it's about identifying great management teams, developing relationships with them and with others involved with the business or industry, and speaking to them regularly to learn more about the company or, if it's an existing position, to make sure that my investment thesis remains intact. Additionally, it's about speaking to fellow investors and businesspeople in my network to try to find the next great underfollowed investment opportunity and to critique my ideas.

Is there anything you include in your routine for idea generation?

For idea generation, I believe that you can't do the same thing as everybody else and expect a different result. For me, I don't employ screens per sé. I find that my highest-conviction investments, like TerraVest, would be very hard to screen for because the financials don't tell the full story. So, I try to focus on certain special situations that I think can be a fertile hunting ground for great opportunities. I also speak to a select group of people who I know are like-minded and know what I tend to gravitate towards. No matter what you do, you'll end up passing on almost every investment idea that crosses your desk, but certain things improve your odds of uncovering something special.

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As I'm doing all this, I'm looking for simple businesses with talented and aligned managers, great capital allocation, a strong balance sheet and an attractive valuation. It's hard to find a business with the characteristics I described trading at a cheap price, so I focus on smaller companies that are likelier to have gone unnoticed and am willing to accept below-average liquidity to own something special.

You have stated that there is no shame in using successful methods repeatedly. How have your investment strategies evolved over time with Rational Investment Group?

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I think I've developed a talent for finding under-the-radar companies that are run by exceptional management teams who can compound capital at compelling returns, yet are trading cheaply because they are underfollowed. I think TerraVest is a great example of that. To see a company with such a superb record trading at 7.5x its after-tax free cash flow (FCF) is unusual, and this opportunity exists because TerraVest is still small and unknown. Over time, these sorts of investments have come to represent more and more of my fund's portfolio.

In your recommendation of TerraVest Industries at your talk last week, you emphasized the importance of evaluating management. However, in the case of TerraVest, management spends very little time on investor relations and there are no quarterly conference calls. With such minimal public exposure to management for TerraVest, what approach did you take in evaluating management?

The fact that management is non-promotional makes it easier to get an informational edge, so I think it's a good thing. One might say, "Well, if management doesn't do calls, it's harder to get information from them." But remember: it's not about knowing what the entire Street already knows. It's about developing an informational edge that gives you insights that are not yet priced into the stock. It may require more work – It's harder to reach out and contact people than to just hear what they have to say in a conference call or read a transcript. But if you take the time to do it, you may be handsomely rewarded for your efforts.

You might think that if a management is less focused on investor relations then they'll be less inclined to speak with you, but I've found it to be the opposite. Managements that are not inundated by inquiries from shareholders and sell-side analysts are actually more likely to take the time to speak to you. They're also less likely to have a large investor relations department, which increases your odds of connecting with senior management.

The way to approach management is to do your homework ahead of time and to demonstrate that you're long-term oriented. Focus on a company's long-run strategies and prospects rather than next quarter's earnings. Research the company and the people thoroughly and show them that you know things that they're not used to people knowing. Dig into an obscure accounting item or a transaction they did ten years ago to demonstrate the depth of your knowledge, or ask them about something you read about them or the company in the small-town newspaper where they're from that nobody else may have ever asked them about. These things will earn their respect and allow you to develop a relationship. Over time, you can often do that with multiple people from the same company and others who can provide useful scuttlebutt.

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Recognize that people like talking about themselves, their business, and their accomplishments. In general, if they respect you and see that you're in it for the long-term and you're a serious and thoughtful investor, they will be open to speaking with you and occasionally even ask for your thoughts on some things. This approach takes time, but you'll be more than amply rewarded for that time, especially with non-promotional managements.

You mentioned that you have seven holdings currently. Do you apply the

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same approach of developing personal relationships and communicating regularly to all your investments?

That's a good question and that gets to the heart of being a concentrated investor. You have to be selective and you don't have to compromise. Developing a relationship with management is a core element of my research process. If I come across an investment that seems attractive but when I try to go deeper, I find that management has no interest in speaking with me, then I take a pass. Mind you, you have to be patient and of course it's not the case that with every investment I own today that the instant I reached out, the CEO or the CFO took my call. There have been instances when I initially spoke with an investor relations person who then connected me with upper management or when I got a fellow shareholder I knew to introduce me. There are different ways to go about it and you have to be patient.

There are exceptions where it is not integral to the thesis to have a relationship with management. For instance, we hold a small position in the fund that due to a confluence of special situations trades at less than 60% of its cash with no debt and at a third of its adjusted tangible book value, and is profitable too. I do speak regularly to the company's CFO but I am not as close to the CEO or others involved with the business. Again, though, this is a small position and is an exception to the norm. Over time, I really have observed that I have been most successful as an investor when I can acquire an intimate understanding of a business and build an informational edge, and developing a relationship with management is a critical part of that process.

Concentrated investors seek to mitigate the risk of loss by being highly selective and understanding their investments as well as they possibly can, rather than by spreading their bets across a large number of holdings. Benjamin Graham has a great saying: “Investment is most intelligent when it is most business-like.” Imagine that you were a private investor or businessperson and you were approached about investing in a private business. Chances are that you would care deeply about understanding the people to whom you'd be entrusting your hard-earned capital. And if those people refused to speak with you, chances are you'd refuse to invest. I look at public market investing the same way.

You mentioned that TerraVest has been dominating in niche positions and strategically expanding into adjacent markets, while acquiring companies at a very low average price to FCF multiple of 1.9x. Is there a specific range of FCF multiples within which you look to find good investing opportunities?

To recap, I looked at the cost of all of TerraVest's recent acquisitions, including both the cost of the deal itself and the post-deal growth capex, and then estimated the current cash flows of each acquired business. On a cumulative basis, TerraVest's acquisitions have been done at less than 3.5x EV to unlevered pre-tax FCF. Then, if you factor in leverage and taxes, TerraVest's deals have been consummated at just under 2x after-tax FCF on its equity investment. That's extraordinary; I know I can't find investments trading at those sorts of multiples that are not experiencing financial distress.

In terms of what multiples I look for, it is hard to give precise figures because the attractiveness of a multiple depends on so many factors. For example, one has to consider the rate at which the business is growing and where it is in the cycle – are its earnings or cash flows at a normalized level, or are they at a cyclical peak or bottom? Sometimes, a seemingly attractive multiple isn't attractive at all because the company is simply over-earning.

Also, companies can appear to have very cheap equity multiples because they are over-leveraged and might not be cheap at all on an enterprise value basis. Excessive debt can lead to an attractive equity

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multiple on an otherwise unattractive stock. Conversely, a stock may carry a high multiple, but if the reason for that is that the business is at or near at a cyclical trough and it is therefore significantly under-earning then the stock may still be undervalued. So multiples, in and of themselves, are uninformative without understanding other factors related to the business that allow you to put those multiples into context.

How important are qualitative factors to your research process?

Qualitative factors are critical. That's why, as we discussed earlier, I spend so much time researching a company's history, forming relationships with people, etc. Factors like the competitive dynamics of a business and the strategies and attitudes of management often cannot be quantified, but without understanding them you cannot truly understand what you own. I remember once researching a stock that seemed attractive. I spoke with an executive of a privately-held competitor of that company, and he said I should stay away and outlined why, which had to do with the company's competitive position and strategy. I then spoke with two other industry insiders, both of whom also said I should avoid it and gave the exact same reason why it should be avoided! The risk that they explained to me was not evident in the company's financials and, needless to say, was not something that management had shared with me or the rest of the Street. As Albert Einstein once said, "Not everything that counts can be counted, and not everything that can be counted counts."

You mentioned that managing a portfolio requires a different set of skills compared to being an analyst. Could you expand on some of those skills?

It is not that you need an entirely different skill set – you still have to be a good analyst when managing a portfolio. But, managing a portfolio also involves decisions like position sizing. Let's say, based on your analysis, a certain security looks like it is worth buying. What weighting in your portfolio does it deserve? If you buy it, do you need to trim or exit something else because your portfolio already has a significant concentration in the same industry? Or, if you do not want to sell those other positions because you really like them too, can you still buy this new one without incurring excessive risk? These are the kinds of questions you are asking constantly, not just about new investment ideas but about your entire portfolio. The importance of objective decision-making and taming our cognitive biases is heightened when you go beyond just analyzing securities, into managing a portfolio.

How should business students that are used to learning about diversification in portfolio management classes think about position sizing in a concentrated portfolio?

I think the decision of how concentrated to make your portfolio is a very individual one. There is, of course, a point at which you can be overly concentrated or diversified. If you have 100% of your capital in two stocks or if you have over 100 different investments then chances are you're overdoing it. But setting aside the extremes, nowhere is it written in stone that you have to be concentrated in order to be a successful investor. It really depends on your particular temperament and style. That Ray Dalio quote I mentioned earlier is apt here too. Instead of trying to force yourself into a box – for example, wanting to own only a handful of stocks because Charlie Munger is your investing hero and he did it – build some experience, understand what works best for you given your natural temperament and structure your investment process accordingly. The important thing is not necessarily how many stocks you have in your portfolio but knowing yourself and being very disciplined about sticking with what works for you.

What were some of the biggest mistakes you've made in the past

and what were some of the biggest lessons you've learned from them?

I've made my share of mistakes, but before giving you a specific example, I will give you a powerful tool for dealing with mistakes regardless of what they happen to be: checklists. Years ago, I read a book on this called *The Checklist Manifesto*, which really resonated with me. The author, a surgeon by training, examined why hospitals experience so many preventable mistakes despite the often life-or-death nature of the work, while in other professions such as airline piloting, where the consequences of a mistake can also be deadly (e.g. crashing a plane), the rate of human error is extremely low. The author convincingly argues that the answer is that pilots make extensive use of checklists. And hospitals that have adopted checklists have seen dramatic reductions in preventable infections and deaths due to human error.

Now as investors, we may not be saving lives, but we are trying to avoid losing our shirts! Interestingly, one problem that hospitals have had in embracing checklists, despite their effectiveness, is that doctors' egos get in the way, and an investor might feel the same way: "Why would I, an intelligent, respected, well-trained professional need some juvenile tool like a checklist?" But cognitive biases are a fact of life. As you gain experience as an investor you will learn about your particular blind spots and biases, and a checklist is a great way to protect yourself against them.

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I will give you a personal example of a mistake I used to be prone to making. Value investors tend to like to buy things when they get cheaper. So, if you own a stock and it goes down in price, your instinct as a value investor will often be to buy more. But sometimes, you should not buy more of a stock even though it has declined in price. For example, what if the price drop is accompanied by some sort of evidence that disconfirms your investment thesis? In that case, buying more is likely a mistake and you need to combat your initial temptation to add to your investment. This is a perfect example of something to add to a checklist. A contrarian value investor who has a natural inclination to want to buy more of a position when the price falls can ask, "Am I being influenced by the stock's recent performance? Am I buying at least in part because the stock is down as opposed to valuation?" I ask myself these questions when reviewing a potential investment – and force myself to answer them in writing.

Another example is that I periodically review my entire portfolio and ask myself questions such as: if I had to build my portfolio from scratch today, would I own each of these positions and what weighting would I assign to each? And although I constantly think about my portfolio, formally asking myself this question and forcing myself to write down my answer has often led me to conclude that a certain position has become too large or is not large enough.

One warning: you may be tempted to create a huge checklist covering every mistake you could conceivably make, but that would be counterproductive. There is a quote in *The Checklist Manifesto* by a former pilot who had spent two decades developing checklists for Boeing: "A checklist cannot fly a plane." A checklist is meant to assist you, not to replace your brain. If you develop a checklist that is concise, practical, and focuses on your particular patterns of mistakes and you review it every time you are about to make an important investment decision, you will go a long way towards ensuring that your most common mistakes won't be repeated.

The past three decades have seen a significant shift in assets from active to passive investment strategies. At the end of 2017, passive funds made up 45 percent of the AUM in equity funds and 26 percent for bond funds. Do you think that is a threat or an opportunity for active investors?

Part of it is semantics: how do you define a passive investor? For example, an index ETF is definitely passive. But what about a strategy or an ETF that only buys the stocks with the lowest price-to-book value ratios in the retail segment of the Russell 2000? Is that active because it isn't blindly buying the index but is instead screening within it? Or is it passive because it's following a prescribed formula without understanding the actual investments it's making? So it partially depends on how you define passive but if you take the narrow definition of passive funds as being vehicles that mirror an index, I'd say it's an opportunity. Because when you have more and more capital being prohibited from taking fundamentals into account because of the need to mirror an index, I think that creates inefficiencies and, in turn, creates opportunities for value investors.

Could you say that the increase in passively managed funds will reduce market volatility arising from irrationality of individual investors, thereby working against value investors?

Irrationality and market inefficiencies come from market actors making investment decisions that are influenced by factors that are not related to a security's fundamentals and valuation. Of course, passive investors do not have human biases like loss aversion or confirmation bias and in that sense, they are not irrational in the way that individual investors are. But they are subject to technical factors that cause them to buy or sell irrespective of fundamentals and valuation.

> "Even if a passive fund is not subject to fear and greed, the underlying investors of that fund still are"

For example, suppose there is a hot stock in an index that has appreciated rapidly to the point that it is clearly overvalued. Not only would a passive index fund not be able to sell it, but it would actually be forced to buy more because the more this overvalued stock goes up, the higher its weighting in the index becomes. This creates a self-reinforcing cycle where the forced buying by passive funds causes the hot stock in our example to climb even higher, which then triggers even more buying by passive funds, and so on. Similarly, if a stock becomes cheaper and is clearly undervalued, or it is kicked out of the index, the passive fund would be a forced seller. I'm not saying that all passive strategies necessarily behave that way, but many do. Being compelled to buy more of whatever goes up and to sell whatever goes down is obviously irrational, maybe not in the human sense since it is driven by an algorithm rather than emotion, but it is irrational nonetheless and is a source of inefficiency.

Another point is that even if a passive fund is not subject to fear and greed, the underlying investors of that fund still are, and their decision can drive the actions of the fund. In a bull market, investors pile into index ETFs. Those ETFs then need to deploy the funds that they have raised, which they will do in proportion to each stock's weighting in its respective index. An index fund can't say, "Stock X seems overvalued so maybe I should avoid that one, and stock Y looks undervalued, so I think I'll buy more of that one" because it is deliberately designed not to take valuation into consideration – it is an indiscriminate buyer and seller.

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So ultimately, the trend toward passive investing may change the nature of market inefficiencies, but it has not done away with them, and as long as there are inefficiencies there will continue to be opportunities for value investors.