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An investment newsletter from the students of Columbia Business School

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Wally Weitz — Power of Good Management

Wally Weitz

Wally Weitz is the Founder and President of Weitz Investment Management, an Omaha-based fund manager with over $5 billion in AUM. Influenced by the value investing philosophy of Benjamin Graham and Warren Buffett, Mr. Weitz started his career as a securities analyst in New York after earning a BA in Economics from Carleton College in 1970. He then joined Chiles, Heider, & Co. in Omaha, working there for ten years before starting his own fund in 1983 with $11 million in assets under management at the time.

Graham & Doddsville (G&D): We would love to hear about your background. How did you originally become interested in investing?

Wally Weitz (WW): My mother was a single parent and a social worker so my grandparents gave her a small lump sum of money and introduced her to their stock broker to make sure she would not have trouble making ends meet. She and I went to lunch with him, and by the end of it, she was bored stiff while I was fascinated.

On the way back from the meeting, I started reading *How To Buy Stocks* by Louis Engel, which you can still find on Amazon. It explained the basics of what a stock is, what a bond is, and so on. I started investing two shares here and ten shares there. The ideas mainly came from the broker in New York.

That was when I was 12, and I became hooked. I went through a charting phase, and I was keeping 100 charts a day and trading on them using technical indicators. Tuition was cheap in retrospect, but losing $50 in the '60s seemed tragic.

Anyway, I stumbled on Ben Graham when I was at Carleton College, and I read *Security Analysis*. Then, I took a correspondence investment course with the New York Institute of Finance, giving me the credibility (as to initiative, not knowledge) to get a summer job with a Wall Street firm in 1970 when I graduated.

I worked at G.A. Saxton, a small OTC trading firm. It was a terrific training ground. My boss, Artie Dunn, followed the five hundred stocks we actually made a market in and you can imagine how deeply we covered them. I'm not sure if he knew who Ben Graham was, but he was intuitively a value investor.

It was supposed to be a summer job, but I just didn't leave, and nobody really noticed. I stayed for almost three years before getting married and leaving New York for Omaha. I joined a regional brokerage firm and was asked to cover local companies. Fortunately, one of those local companies was Berkshire Hathaway.

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One of my mentors in New York, Frank Monahan, told me about Warren Buffett, and my boss in Omaha was a good friend of Warren's. He took me to the Berkshire annual meeting when it was held in the National Indemnity lunchroom, and there were only three outside shareholders. As you can guess, the meeting has changed over the years.

I have paid attention to Warren over the years. A lot of what I try to do has roots in what I've learned from him. I don't claim to do it as well or to be as disciplined, but I always feel like he's looking over my shoulder as I invest or as I write our investor letters.

That brings us to 1983 when I was thirty-four years old. I left the brokerage firm to start my own investment firm. A group of clients invested $11 million into three partnerships. We kept it simple with a flat 1% management fee and no "carry." Over time, we converted the partnerships into mutual funds, and, thirty-one years later, we have 11 funds, primarily focused on equities.

The firm now has roughly $6 billion in assets with an investment team of 11. We're a little unconventional in that we're willing to hold cash, we run concentrated portfolios, and we don't manage to any particular benchmarks. Everybody at Weitz has virtually all of their investable funds and all of their retirement assets invested in our funds. Eating the home cooking is true for us. We do our own thing, and I feel fortunate to get paid to do my hobby.

G&D: What was the inspiration to strike out on your own?

WW: When I was at Saxton, the head of the firm called me in one day and said, "You're doing fine, we're not paying you much, so there's no problem, but what do you want to do with your life?"

I said, "I'd like to manage money like Harold and Frank."

He said, "Great, go get some."

"I have paid attention to Warren over the years. A lot of what I try to do has its roots in what I've learned from him."

That was the cold slap in the face that helped me realize I needed to figure out where the capital would come from if I wanted to make investment decisions and manage money.

My wife and I preferred the Midwest to New York so we moved to Omaha where a regional brokerage firm agreed to let me do research and try to find accounts to manage. For the next ten years, I managed accounts as a broker, but I thought I could do a better job for clients if I could pool the accounts and charge a fee rather than transaction-based commissions. So, I started Weitz & Co. in 1983.

G&D: Could you talk about the specific style of investing at your fund and your philosophical approach?

WW: We try to think like business owners. We believe that the value of a business is the present value of the cash the business will generate in the future. Investors use varying definitions of "cash flow" or "free cash flow," but we focus on "discretionary cash flow" – money that could be taken out of the business but which the owner might voluntarily reinvest in the business. In making estimates of future cash flows, we have to make judgments about the sustainability of the company's business model and its competitive "moat." We try to have a general sense of the economic environment, but we do not want to depend on making correct macro-economic predictions. In short, if the price of the stock is well below what an intelligent owner would pay today for the whole business, the odds are strong that something good will happen with the stock. That's the basic idea.

G&D: How much of a discount to intrinsic value or private market value is required to get you interested?

WW: We always used to say we wanted a 50% discount,

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and for years we found that kind of bargain. In recent years,

we have found ourselves paying 60% or 70%. Valuations have risen, and it's possible our valuation methods have been too conservative (We use a 12% discount rate when we do discounted cash flow models.) At any rate, we are wary of "paying up" for stocks, because history has shown that when the weighted average price-to-value of our portfolios rises, the returns over the next six to twelve months tend to be lower than when we start from lower P/V levels. If this were not the case, we would have to find a new investment method.

G&D: Could you talk about how your investing philosophy has changed over time? For example, you became more comfortable paying higher multiples for higher quality businesses. Companies like Google and TransDigm may not have been in the portfolio 25 years ago.

WW: I've been paying very close attention to Warren for 40 years. I heard him say early on that Munger taught him that a great business is worth paying up for. In one of his annual reports, he talked about economic goodwill as distinguished from accounting goodwill. Economic goodwill measures the franchise value, or the ability to charge premium prices, because of your moat.

At an intellectual level, I've been aware of that concept for 40 years. I've also been familiar with the idea of picking stocks as if you only had 20 "punches" on your investing ticket. Being able to act that way has only come gradually over time. Value investors can be drawn to the "statistically cheap," like a moth to the flame, but eventually the pain of living with mediocre companies catches up with you. Learning where to draw the line between paying up for quality and accepting a flaw because of a cheap price is part of the fun of investing.

"We try to have a general sense of the economic environment, but we do not want to depend on making correct macroeconomic predictions."

I would also say that management is a major consideration. Warren has said that it is good to buy a company that any idiot can run, because sooner or later, an idiot will be in charge. Fair enough. But if we're buying companies that generate excess cash, it's terrific if we can trust management to do something smart – accretive to per share business value – with that cash. Warren Buffett and John Malone have done wonders with discretionary cash over the years. Most others have not.

G&D: Can you take us through your investment process? Perhaps starting from idea generation through establishing a position.

WW: The ideas come from all over. We don't do much mechanical screening. We're aware of a number of companies as a result of assessing the businesses we own, their competitors, and the ecosystem. Also, everybody is reading interviews and thinking about companies all the time. We pay attention to a handful of other investors that we respect. I think the initial idea may come from any number of places.

When it's a company that's really new to our analysts and new to me, the analysts will read all the filings for the last few years as well as transcripts of conference calls and investor days. They will read about the industry and talk to others in the business. They will try to understand the company's business model and the degree to which it has control over its own destiny. Then they'll start developing a model. We try to estimate the future cash flows that we can count on.

I think the most useful part of building the model is making sure we understand the relationships among the variables. We need to know what is important to the future success of the company and how realistic our assumptions are. Precise predictions are

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Mr. Weitz discussing his investment experiences with attendees at the 2014 Omaha Dinner.

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not required (or possible). We believe in the adage: "It's better to be approximately right than precisely wrong."

Capital structure is also important. Is the balance sheet appropriately levered? How much option dilution will we face? Can we expect opportunistic buybacks? If we're dealing with a Malone company, I think it's okay to assume some stock buybacks over time. If you're dealing with many of today's tech companies, maybe you would not build in much buyback. Judgment is required. We eventually get to a model that we discuss among ourselves. We argue and develop some level of confidence that we have an approximately correct appraisal number for the business.

That might take a month on a new company that no one knows much about, or it might take an afternoon if it's an area we're pretty familiar with and we know the people involved. If a stock has fallen out of bed for some reason that we believe is temporary, we can act pretty fast on it.

G&D: Is there any part of that process you would say distinguishes Weitz from other investors?

WW: Our process is probably similar to that of other value managers. What might distinguish us is temperament. We are not just knee-jerk contrarians, but we are willing to be early and out of step with the market at times. It's often a good sign when investors and analysts agree that "the stock is extremely cheap, but we shouldn't buy it yet because there might be another bad quarter coming."

G&D: You spoke previously about how you try to poke holes in an investment thesis. Is there a way to systematically approach that?

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WW: I know that others have a process where they assign a devil's advocate to look for trouble. We don't formalize that. With a group of eight to ten of us, each one coming from a different place and background, we are pretty good at poking at the story. We have that debate and, at some point, if we decide we're comfortable with our appraisal, we buy the stock. But there often may be multiple rounds of research work that come out of the initial meeting.

G&D: Could you elaborate on how you view the cash portion of your portfolio? Is it optionality on future opportunities or just representative of a lack of current opportunities?

WW: Well, we would be quick to say it's not a market timing call. It's just a residual that comes from selling things when they get expensive and not finding cheap enough replacements. We try as hard as we can to be fully invested, and the cash represents failure to find opportunities that we really like.

G&D: What is the range of cash that you are willing to hold?

WW: We may hold as much as 30% cash. We have one fund that's allowed to borrow and sell short, and that fund is currently 63% net long. Most of the funds have around 20% to 25% held in cash at the moment.

G&D: Do you have a view on where you think we are in the economic cycle? Does that view impact your portfolio?

WW: I'm very skeptical of my own or anybody else's ability to predict the direction of the stock market. We try to have a sense of whether we face headwinds or tailwinds, but we make no pretense about being able to predict the next six or twelve months. For what it's worth, the view that seems generally correct to us is that the economy is okay, and so companies have some control over their destinies. Companies with competitive advantages will continue performing well and becoming more valuable, so I'm not bearish – I'm actually pretty optimistic.

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However, it seems as if stock prices have moved faster than underlying intrinsic values. The Fall of 2011 was the last time any of us around here were really excited about price levels in general. Since then, almost all our companies have done just fine, but their share prices have gone up faster than their business values. We have gone from 60 cent dollars to 90 cent dollars. It seems very plausible to me that either stock prices drop back down or they go sideways for a while so that business values can grow into their stock prices.

Being reasonably optimistic about the environment, if the stock market dropped 10% to 20% tomorrow, we might be willing to be 90% to 95% invested. It wouldn't take a move like the one we saw in 2008 and 2009 for us to get excited about some of the companies we follow.

G&D: How do you define and think about risk? Is it in terms of volatility, permanent loss of capital, or some other way?

WW: It's absolutely not volatility. Howard Marks has written about this extensively. He explains it so well that I like to point people towards his stuff. He has a new essay that focuses on various types of risk. It's all about the risk of permanent loss as opposed to volatility.

We love volatility. We try to appraise a company's business value and its likely growth path. The stock price should be loosely tethered to the business value over time, but volatility around that value gives us the chance to buy at a discount and sell at a premium.

In late '08 and early '09, what was then called Liberty Capital got down to around $3.50. That was fabulous. The successor to that is now about $150. Volatility is terrific. What we don't want is the permanent loss. In that recent Marks essay, he goes into all the different ways you can suffer permanent loss. He talks about having leverage risk, liquidity risk, credit risk, interest rate risk, basis risk, and all those things. Those are all variations that can cause permanent damage.

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You have people risk too. You have situations where managers push too hard on the underlings to perform. I think that's where you get the Enrons and the Worldcoms: the frauds.

There are all sorts of ways you can incur permanent loss, but that's what we're talking about, not volatility.

G&D: You've mentioned in the past that you view disproportionate overreactions to stock market selloffs as ideal opportunities. Given the reduction in quantitative easing, are you positioned to try to take advantage of a potential market reaction?

WW: We joke about that. At some point, rates have to go up. It's inevitable.

When that happens, some people will probably be surprised and unhappy. We are not positioning the portfolios for a particular market reaction to rising rates. We consider the likely effect on each company of future rate increases, but we are simply trying to hold companies that are cheap in relation to the future values of the businesses.

G&D: Do you have a view on current popular investment themes where people think the ideas are good, but they are actually just bad ideas in disguise and may be exposed at some point?

WW: Over the last several years of unusually low interest rates, one popular notion that may have been carried too far is buying "high quality dividend-paying stocks." High quality companies that are growing in value may be good investments if bought at reasonable prices, but the success of the strategy will not be based on their dividend yield. Cynical managements have raised a lot of cheap capital by using the MLP format to sell over-priced securities that look attractive

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Professionals engage with each other during the Omaha meetings.

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to unsophisticated investors because of their high current yields. The most extreme case may be those royalty trusts which will become worthless in a few years yet sell at high prices, because of their current dividend payments.

G&D: Are there common characteristics in some of your most successful investments over time?

WW: We have done really well trading financials when the Fed was raising interest rates. We have done very well over the years with cable TV companies. Investors were skeptical in the early years as cable companies borrowed huge sums to build out their systems before they had many subscribers. Interest costs and depreciation created large losses in the early years. However, cable is a subscription business with low "churn" rates, and cable companies developed new products (telephone, pay per view and broadband) that they could deliver over their existing plant. Cash flow eventually turned positive and the stocks went up several-fold. We had a similar experience with cellular telephone and benefitted when the industry consolidated.

G&D: Speaking of cable companies, we noticed that one of your larger positions is Liberty Global. Could you discuss your general thesis on that company?

WW: I like Liberty Global because they build out cable systems using a lot of leverage, generate huge amounts of free cash flow and then buy back lots of stock. Their balance sheet is highly levered, but they have a very tax efficient way to generate equity value per share.

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That's great when you have Mike Fries who is really a good operator and John Malone who is making sure that they're managing that balance sheet. I might not be interested in the same company if it were run by some other people. Management makes a huge difference in all kinds of businesses and it is critical when you're dealing with leverage.

They've been very efficient on the cost structure. They are cost conscious operators and, with Malone, you are also dealing with hypersensitivity to taxes. Their recent merger with Virgin Media provide major tax advantages. They have high debt on a per share basis, but the debt is compartmentalized in that each part is attached to a different system. They hedged currency and the interest rate risk. They have paid up in the last few years in order to lock in long term interest rates.

We value it in the mid-$50s and the stock is around $40.

G&D: Many of our readers know about Buffett and Malone, but are there any other underfollowed CEOs or management teams that you think highly of?

WW: In the banking world the Wells Fargo culture is impressive. They've had three or four CEOs since we got involved a couple of decades ago and each has been a strong leader. They have a culture that's very different from many other major U.S. banks and that's served them very well. When certain large banks got crushed in the 2008 and 2009 period, we were comfortable with Wells.

Nick Howley at TransDigm is a very disciplined buyer and strong operator with a private equity mindset, but he's collecting companies to keep instead of selling them a few years later like most private equity players. He's buying companies that are typically sole suppliers of aftermarket airplane parts. Then once he buys them, they just squeeze the costs out year after year. They get terrific margins and their business is almost like a subscription business. If you are the sole supplier of seatbelts or some type of fastener that has to be bought, it can be a great business.

We like managements that are focused and demanding, but it can be dangerous if there is too much pressure to "make the numbers." Mae West said,

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"Too much of a good thing can be wonderful." Maybe so, but we try to be alert to the possibility that a corporate overachiever may be pushing too hard.

G&D: What is your approach in dealing with management teams?

WW: We like to invest with managers we trust to treat us fairly – to treat us as partners rather than necessary evils. We want to know if they have a good, long-term business plan and have a sense as to whether they will execute it well. We want to trust them with capital allocation – investing in the business when there are good opportunities to compound value and to give capital back to shareholders when that makes sense. We generally won't have a lot of advice about how to manage the business, but we will let them know how we feel about strategic direction and capital allocation.

Management is not going to call us for advice in times of crisis or of great opportunity, so we want to know them well enough that we will trust them to make the right decisions in those critical times.

G&D: You've talked about Valeant in the past. Could you share your view of the investment case with and without the Allergan deal? Would the failure to complete the deal change your opinion in any way?

WW: Well, it would be great if Valeant is able to acquire Allergan. Given the kinds of businesses they're in, Allergan has been a natural target for Valeant. I don't know what the odds of success are at this point. They are probably not a lot better than 50/50. But if they don't buy Allergan, they will buy something else. I get a little queasy when a company announces an acquisition and both the buyer and the target go up. The implication is that there's some magic there. The "magic" with Valeant is that the earnings of the target company increase,

"We like to invest with managers we trust to treat us fairly – to treat us as partners rather than necessary evils."

because of Valeant's cutting of bloated cost structures. The bear case is that they cut too far and there's no real organic growth.

I do feel as if we're riding a tiger with Valeant. It's not the same as Berkshire Hathaway or a Liberty company.

G&D: Has your team looked at Allergan on a standalone basis? Would that be a potentially interesting investment even if the Valeant deal doesn't close?

WW: Our analyst that specializes in healthcare has liked the business, but not the price. It seems as if the promises they're making now about how they're going to be more efficient, have better margins and grow faster are a little too late. It makes you wonder why they weren't doing that before.

G&D: What would you say is the most important factor for a great business?

WW: Well, monopolies are great. We also like subscription businesses. The cable model is a very good one. They had local monopolies on pay TV in the past and, although they face more competition today, they still have great business characteristics. You want the company that has the great asset that everybody has to have and where you have pricing power. But then those things tend to trade at pretty high prices. Although we like the comfort of having the great business at a fair price, which Munger talks about, we are really looking for mispriced assets. The best of the best rarely look cheap.

We've come close on some great businesses like Visa and MasterCard a couple of times when there were fears that they would be forced to cut prices or that they would be hurt by competition from other kinds of payment systems, but we were just not willing to pay the price. Maybe someday we will. It's always a tug of war between the comfort of owning a great business and the temptation to buy the statistically cheap business. In the '70s, I bought a few things that were literally net-net Ben Graham stocks.

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Tano Santos and value investing program students at the 2014 Value Investing Program Welcome Reception where the 5x5x5 Student Value Investing Fund was announced.

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They were cigar butts. Hopefully I've gotten over that.

G&D: Can you give an overview of an investment that didn't go as anticipated, what lessons you learned from that, and how it improved your investment process?

WW: Over the years, we have had a series of successful trades – buying banks and thrifts after the Fed raised interest rates and those stocks fell. Six to nine months later, the Fed always lowered rates again and the financial stocks rallied. I now consider those trades "bad ideas we got away with." They were bad ideas because we took more risk than we realized in buying those stocks. Those banks were often over-levered and poor loan underwriters, but they (and we) got away with it because home prices always rose. Foreclosed properties could be sold at minor losses (or sometimes gains) and the risks didn't catch up with the banks. Until they did… in 2007-2009. We foresaw trouble in the mortgage business, but we owned some financials that we thought were strong enough to survive and take advantage of the problems of their weaker competitors. When losses came in 10-20x as bad as ever before, our "strong" companies were swamped by their losses and we suffered some permanent loss of capital.

From that experience, we learned to be much more imaginative about what can go wrong with a business.

G&D: Charlie Munger has this concept of lifelong learning that he has talked about. What do you do or read to make sure you keep getting better all the time? Is there some area where you think you've really improved over the years?

WW: We read all the time. We travel around and see companies, and we read. I've tilted a little more toward business history or biographies lately. A book like *The Outsiders* is a good example of what I like to read. It uses eight case studies to illustrate how unconventional managers can make a huge difference in creating per share value for shareholders.

"It's always a tug of war between the comfort of owning a great businesses and the temptation to buy the statistically cheap business."

Hopefully by reading about the successes and failures of others, and examining our own mistakes, our investment team has learned to be more discerning and realistic about the companies we research.

G&D: Is there a more recent addition to the portfolio that you'd be willing to discuss?

WW: A spin-off of the Liberty complex, Liberty Ventures, is complicated but potentially interesting. Through a series of acquisitions, Liberty had accumulated stock positions in companies they didn't really want to keep. In order to extract the value of these assets in cash without incurring capital gains taxes, they sold exchangeable securities that are convertible into those shares. The bonds had 25 to 30 year maturities and very low coupons. But, because of the optionality involved, Liberty imputed a 9% interest cost that they deducted from their earnings. So they have more tax savings than they have coupon costs. They got all the value out in cash by selling these bonds, but they have a negative cost-of-carry. In a sense, they receive additional zero interest loans each year from the government. In 20 plus years, Ventures will have to pay off the principal of the bonds and the deferred taxes, but in the meantime they can invest the cash any way they wish.

Very few people will want to bother to figure this one out, but I think it's an interesting investment that is really a blank canvas for Malone and Maffei. There has been some speculative interest in Ventures, but when we have been able to buy it at a discount to the present value of its assets, we have. We don't know what the Ventures portfolio will own in future years, but we trust management, in this case, to make good investments on our behalf.

G&D: This has been great. Thank you for taking the time with us, Mr. Weitz.