ADVISOR PERSPECTIVES

Wally Weitz on Value Investing in the Post-Crisis Era

By Robert Huebscher
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As the president and founder of Weitz Funds, Wally Weitz has spent nearly three decades putting his instinct for opportunity to work for shareholders. Influenced by the value-investing model of Benjamin Graham and Warren Buffett, Wally manages the Partners III Opportunity Fund and co-manages Value Fund, Partners Value Fund and Hickory Fund. Over the last five years, the Partners III Opportunity Fund (WPOPX) has had an annual return of 10.85%, versus 6.23% for the S&P 500 total-return index, placing it in the top 1% of its peer group, according to Morningstar.

I spoke with Wally on January 17.

Berkshire Hathaway is one of your top 10 holdings. How do you go about valuing the company, and what is its intrinsic value by your calculation?

I have been following Berkshire since the 1970's and have used a variety of valuation methods. What really matters is to understand the value of the insurance float and the business values of the wholly-owned companies. The public securities have published market values. Our analyst makes estimates of the value of the float and the future cash flows that will be generated by both the controlled and passive investments and comes up with a little over $180,000. This seems like a reasonable number to me, but as Warren says, "It's better to be approximately right, than precisely wrong."

Warren has consistently said that stated book value (currently about $112,000) significantly understates the value of the company. He has recently announced that he will repurchase shares and may pay up to 120% of stated book (a number that will rise over time). This does not put a "floor" under the stock, but it is a strong statement, coming from the master of business valuation.

Your literature indicates that you tend to stick with industries with in your circle of competence. What industries fall outside that circle, and why?

Over the years, we have added analysts to our team who have added several circles of competence that we did not have 10 and 20 years ago. Nevertheless, it is really important to know what you don't, or can't, know. Our valuation methodology is based on valuing the free cash flow that a business will generate over a long period of time, so companies whose products or competitive position evolve rapidly (like some tech or healthcare companies) or companies whose profitability depends on commodity prices or other macro factors are generally in the “too hard” pile. The same goes for companies subject to dramatic changes in the regulatory climate.

You are one among a number of value managers who have invested in Hewlett-Packard and Dell. What is the margin of safety in those businesses, and how does one determine when a value stock like those is a value trap?

We often find ourselves buying former investor favorites that have disappointed their erstwhile fans. We want to buy companies that, while not what they used to be, are still good enough to justify much higher stock prices. Understanding the difference between “permanently impaired and deteriorating” and “temporarily off-track but fixable” can be difficult. Turnarounds are not our favorite pursuit, but we invest in them occasionally.

We bought Dell several years ago and HP more recently. In both cases, the companies were generating very large amounts of free cash flow and had businesses that were at least stable and with potentially improving prospects but which had been given up for dead by most investors.

We have traded Dell successfully, and it is currently the focus of a potential LBO or leveraged recap that would give us a disappointing-but-positive result. HP is a tougher case, having been mismanaged and poorly governed for years, but we think the current risk/reward outlook is positive.

Your methodology involves estimating a company's future free cash flow and calculating a present value. How do you select the appropriate discount rate when central banks are essentially engaged in price-fixing of interest rates?

We use a 12% discount rate in all our discounted cash flow models. This gives us a “base case” business value. We want to buy shares in the company at a considerable discount to this value, and the size of the discount reflects the predictability of the business, its competitive position, balance sheet strength, etc. We might be willing to pay 70-75% of business value for a very high-quality, predictable business. Another business may be less predictable and have more flaws, and while we will consider buying it, we might be willing to pay only, say, 50 cents on the dollar of value.

Other investors who use DCF analysis may use different discount rates on different types of businesses but be willing to buy each at the same percentage of the DCF value. We are making the same adjustments but at a different point in the valuation process.

In your writings, you say that you like to see a stock price at 40% to 50% discounted to your valuation. How does the available supply of investment candidates that meet those criteria today compare with other times in your career?

Stocks today seem fairly-to-fully priced. Stock prices are a function of all sorts of unpredictable variables, and we have to be patient and take what the market gives us. Howard Marks' recent commentary, Ditto, explained why stock prices are far more volatile than companies' underlying business values. Investors tend to respond emotionally and drive stock prices way higher and way lower than is reasonable. The recent collapse in stock prices in late 2008 and early 2009 was a great example of mindless selling and was a great buying opportunity.

Extremely high prices like 1972, 1999 and 2007 and extremely low ones like 1974, 1982 and 2009 stand out in one's memory, but every year brings some opportunities for investors with conviction about business values. The European debt crisis has already provided some mini-panics—most recently October of 2011—and it will probably provide more.

In that memo he was speaking primarily about the bond markets, but he said investors' "pro-risk behavior is having its normal dangerous impact on the markets." What is your opinion? Are investors sufficiently heeding the risk that is now in the market?

Investors have plenty of things to worry about – and they are worried. Nevertheless, they are buying stocks and bonds despite their lack of confidence. Fed policy has had a positive impact on stocks, to some extent, and bonds, to an incredible extent. Sophisticated bond buyers have to know the arithmetic that dooms long-term bonds to poor results when interest rates (inevitably) rise, but apparently think they can be among the lucky that escape before bond prices collapse. We think this is like picking up quarters in front of a steamroller, and we have kept the duration of our bond portfolios extremely short.

For stock buyers, the long-term prospects of many good companies are very bright and we are comfortable holding stocks of those companies. However, many more short-term-oriented stock investors seem to be bearish and fearful yet also fully-invested, because they can't bear to be left out of a rising market. These investors will probably be sellers at the first sign of trouble and bring us some welcome volatility.

Do you agree with Howard Marks' assertion that the scramble for returns has brought elements of the pre-crisis behavior very much back to life?

Definitely. Bond investors are so desperate for yield that they are paying very high prices (receiving low yields) and buying bonds with very issuer-friendly terms and covenants. Junk – excuse me, "high-yield" – bonds are near record-low absolute yields and record-low spreads over Treasury yields. It is ironic that part of investors' current interest in bonds is driven by their recent bad experience with stocks, yet they are forgetting about the recent mistakes they made in buying bonds.

Value investors had a particularly bad year in 2008, in many cases their worst year ever. Why didn't value investing do as good a job at protecting assets in the market decline as in previous bear markets? What did you learn from the 2008 bear market experience?

Value investing, done well, is very good at protecting investors against *permanent* losses, but in a full-scale panic, all stocks tend to go down together. Gordy Crawford, one of the all-time great media investors, said in a recent interview that in a market like 2008-09, there is no place to hide. Companies with strong balance sheets and good competitive positions came through the recent recession and bear market in good shape, and their stocks have recovered. There were some companies, though, that were caught in the brief liquidity crisis after Lehman's failure and did not live to see the recovery. This was a good reminder that liquidity risk is to be avoided.

We owned some financial companies that were affected more seriously than we had anticipated, and our results suffered in 2007 and early 2008. We learned to be more imaginative about what can go wrong in the world. We also learned the benefit of acknowledging mistakes and selling before the losses got worse.

We also averaged down fairly aggressively on positions we were most confident about. This exacerbated our paper losses during the decline but was very important to our strong recovery after the market bottomed.

Would you agree that most central banks are engaged in competitive devaluations now? And if so, how does that impact your investment process?

Our focus is on bottom-up stock picking rather than macroeconomic strategy. It seems clear that central banks are being extremely accommodative. You could look at this as competitive currency devaluation to stimulate exports and economic growth. Or as an attempt to rescue sovereigns that cannot pay their debts. Or as a means to prop up badly undercapitalized banking systems in various countries. We would expect financial "accidents," where central bank activity proves ineffective and eventually has some inflationary consequences. This keeps us wary of credit and liquidity risk and focused on our companies' ability to pass along price increases.

A number of value managers have performed poorly since the market bottomed in 2009; First Eagle, Tweedy Browne, Fairholme, and even Berkshire Hathaway have all underperformed the S&P 500. I can think of a couple of possible explanations. One is the fact that interest rates are artificially low and allowing marginal companies to survive. Or it could be the fact that the Fed is incenting investors to buy riskier assets, and that that has distorted markets and blurred the distinction between growth and value. To what do you attribute the fact that quite a large number of value investors have not done well over the last few years?

Except for a few cases of troubled financial stocks, I really don't know what happened at other funds. Companies whose businesses were wounded by the recession may have been slower to recover, but it's also possible that holdings of the highest-quality companies didn't recover as fast because they didn't go down as much.

Have you deviated all from the traditional Graham and Dodd approach over the last few years?

I don't believe we deviated from our version of value investing (which I would describe more as "Buffett and Munger" than Graham and Dodd). We may have put more emphasis on quality and balance sheet strength than usual. As conditions change, we may have paid more attention to companies in different industries than we did five, 10 or 20 years ago. But the underlying basis for what we do has not changed. We want to buy understandable, predictable businesses that generate excess cash for their owners and that are managed by people we trust to redeploy that excess cash for the benefit of shareholders.

Past performance is no guarantee of future results.

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The performance data for Partners III Opportunity Fund in the article's introductory paragraph, including the ranking information, is for the Fund's Institutional Class, was obtained from Morningstar, is for the 5-year period ending January 21, 2013, and is believed to be correct.

Weitz Partners III Opportunity Fund-Institutional Class average annual total returns for the one, five, and ten-year periods ended December 31, 2012 were 12.9%, 8.1% and 10.4%, respectively. The returns assume reinvestment of dividends and redemption at the end of each period, and reflect the deduction of annual operating expenses, which as stated in the most recent Prospectus are 1.49% of the Fund's Institutional Class net assets. The returns above also include fee waivers and/or expense reimbursements previously made by the Investment Adviser; total returns would have been lower had there been no such waivers or reimbursements. Current performance may be higher or lower than the performance data quoted.

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