Profiles in Investing: A Legacy of Value

By Eli Rabinowich

Welcome to "Profiles in Investing", brought to you by The Bottom Line and The Heilbrunn Center for Graham & Dodd Investing. Every week we will profile a leading investor and get an inside look into their investment philosophy.

Up next, ***Chris Browne****.*

ER: Tweedy, Browne has a very long and distinguished history. Can you talk a little bit about the firm and some of the great names that have been associated with Tweedy, Browne?

CB: It all started when Bill Tweedy went into the security business in 1920. He was trying to figure out if there was some niche in the business where he would not have any competition. He saw that there were a number of companies out there that had limited marketability in their stock, but that they had anywhere from 50 to 150 shareholders, usually with one dominant shareholder. If a shareholder wanted to sell stock his only recourse was to sell it directly to the company. So Bill decided to become a specialist in closely held, inactively traded stocks. He did this by going to annual meetings, copying down shareholder lists and sending postcards to shareholders asking them if they wanted to buy or sell shares.

Now these closely held, inactively traded stocks were not listed on a stock exchange and so they traded at a big discount to book value. In the early 30's Bill ran across Ben Graham, the original value investor who also liked to buy stocks at a big discount to book value. And so a brokerage relationship developed between the two of them. In about 1945, my father, Howard Browne and Joe Reilly went into partnership with Tweedy and the firm became Tweedy, Browne & Reilly.

In about 1957, Tweedy retired and the firm brought on another partner, Tom Knapp. Walter Schloss, who had set up his fund in our office in 1955, introduced Tom to my father. Now Tom recognized that Tweedy had developed a franchise in lightly traded securities, in that if brokers ever needed a quote on a stock which wasn't listed they could call Tweedy for a bid. Tweedy became a buyer of last resort. Tom realized he could take advantage of these people by making low-ball bids. And then instead of selling them to another investor and trying to make a commission he wanted to keep them. So Tweedy transitioned from being a broker to an investment manager when Tom arrived. It was still a tiny operation – the partners monthly draws was about $500. In 1958, Walter introduced Warren Buffett to my father.

A few weeks later my father called up Warren and offered him six shares in some company and Warren bought them. The story goes that Warren called up Walter and said, "This guy Howard Browne has got to be the stupidest guy I ever met. He just sold me ridiculously cheap stocks." Well Walter said "they can't hold all of them, so they spread them around." So a relationship then started between my father and Warren. My father was one of Warren's principal brokers throughout the 1960's. When Warren was in New York he used to work out of our office. They would stock the office with Pepsi – he drank Pepsi in those days, not Coke. My father also bought all of Berkshire Hathaway for Warren.

ER: When did you join the firm?

CB: I arrived in 1969. I started working for the firm as a bank analyst in the summer after undergrad, with the assumption I would go back to business school after a year. Now my brother had just graduated from Harvard Business School and said "Look, there's no reason for you to go to business school. You only go to business school to get your first job, and you've already got it. You don't need it."

ER: When did Tweedy Browne start managing outside money?

CB: In the bear market of '73-'74 the firm wasn't really making any money. The firm was losing money on its trading operations. I suggested we get $10 Million under management at 1.5% flat-fee. This would cover all our expenses and allow us to make some profits.

Vital Statistics: Chris Browne

- Managing Director Tweedy, Browne Company LLC.
- Trustee of the University of Pennsylvania
- Member of the Executive Committee of the University of Pennsylvania Investment Board
- Faculty Advisory Committee of The Kennedy School at Harvard University's program in behavioral finance
- BA, University of Pennsylvania

We wrote our first investment advisory brochure and highlighted our three stock selection methods – Two thirds of net current assets; Half of book value and the arbitrage method.

ER: What about Low P/E?

CB: No. We didn't focus on earnings we focused on book value and net current assets. In those days there were a lot of stocks like that. However, we began to notice that Warren was changing his investment style. Moving away from buying what he calls "one-puffers" – lousy businesses selling at discounts and starting to buy companies like American Express and television and publishing companies. We could never quite hang our hat on that because it didn't have the anchor of book value.

Then in 1976, Jim Clark joined our firm. Now Jim had previously worked at Whitney Communications and he explained to us the valuation of television stations. He explained that book value didn't mean anything; it was the license to broadcast that was valuable. And if you looked at it there was a fairly consistent pattern of people buying television stations for 10 times cash flow. It is actually easier to value than book value, in that sometimes you will and sometimes you won't get the actual book value. But with a TV station its cash flow was its cash flow. This started us on our trend to buying better businesses. Today, we have a bias for better businesses which are selling for less than their private market value.

ER: What is private market value?

CB: Well for a TV station it is ten times cash flow. We started tracking acquisitions of companies and were able to figure out how much different businesses were worth. In the 80's a lot of leverage buyout firms would come through our offices to try and get investment ideas.

ER: How do you value a company when M&A activity becomes hyperactive and valuations seem to defy logic?

CB: Yeah you need to be careful and not take the last highest bid as the valuation standard. In an art auction, people will sometime pay way over what anybody previously paid for a piece if they really want it for their collection. So if the valuation doesn't make any sense to you then you have to give yourself a margin of safety. There has to be a fundamental grounding to the valuation or you have to ask yourself is the bidder seeing something you are not.

ER: What are your fishing grounds? Where do you invest?

BL: We tend not to be in highly cyclical businesses. The reason we shy away is because there is not a lot of visibility going forward. These are companies that have no control over the pricing of their product, such as commodity industrial companies, automobile suppliers, and utilities when they were regulated. We also don't like technology, again because you have no visibility. A company can be going along great and then a competitor invents a router that goes twice as fast, has it made in China and totally decimates the entire price structure. If you made a list of the top ten computer companies from twenty years ago, only one is still around – IBM.

However, we do like pharmaceuticals. Pharma companies have had a long-term growth rate of about 9% which is very respectable. Now everyone seems to focus on what's in the pipeline right now, but the fact is they are all paying tens of million of dollars to people in white coats running around a laboratory and eventually they'll discover something. It can be difficult to identify where the discovery is going to be so you buy a group of them and participate in the industries long-term growth. We did this when Hillary Care was on the horizon and all the pharmaceutical companies got knocked way down. JNJ was selling at 12.5x earnings.

The company was selling for the value of its consumer products and you were getting the pharmaceuticals for free. It's been a fantastic investment. We still own it. We never sold it. Sometimes it's gotten a little overvalued, but it keeps grinding out growth of about 9% to 10% a year. Unlike the technology business where all you need is an idea and a couple of VC's to fund you, in the pharmaceutical business it takes about $1 billion to bring a drug to market and then you have the patent protection. So the barriers to entry are pretty high. Additionally, you have favorable demographic trends with the population getting older and people living longer.

ER: In addition to barriers to entry and favorable demographic trends what else makes for a good investment?

CB: Free cash flow. You want businesses that

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don't require a high degree of capital reinvestment. Corporate America's return on invested capital has been just terrible. It's not terrible, it's disgraceful. We also look for companies which have some sort of pricing ability. It usually arrives from having a brand. We own a lot of Nestle. They learned how to be a global company before that word was in anybody's investment vocabulary. So we look for businesses that have pricing flexibility. We also want to know how much capital is required for an extra unit of sales. Does the variable profit flow to the bottom line? We also monitor for insider buying. This used to be an important marker, but there hasn't been that much of it lately. Then there is the quality of who is buying it. CEO and CFO purchases are much more important than an outside director.

ER: You've been in the news lately for taking an activist role in some of your investments. Is this something you see yourself getting more involved with in the future?

CB: We haven't done much of it. In the case of Hollinger, the money management was taking out personally was outrageous. The problem with these corporate governance issues is that it is very expensive to go after management. And then there is always "The Business Judgment Rule" – if the board thinks it's ok to pay management fifty million bucks, then it's ok to pay them fifty million bucks. It was a board judgment call. Until the Disney case. The Disney case changed the landscape of corporate governance maybe more than Enron, because it has empowered shareholders. What they discovered in the Disney case was that the board did not exercise much of its duties in scrutinizing the exit pay package for Michael Ovitz. The board deliberated for about 10 minutes on his $120 million dollar package – and then just rubber stamped it. A suit was filed to recover the money. The courts ruled that the board could not rely on the business judgment rule because they were very perfunctory in reviewing the package. Now D&O (Director and Officer) insurance doesn't cover board members if they are negligent in their duties, so all of a sudden board members started paying more attention. Hollinger is the exact same situation. We don't think the board exercised it duties as Directors and examined all the payments. Now this is not something we look for, but we do think investors should act like owners. It seemed to us that there was enough value in Hollinger that to just sell it and walk away was stupid.

ER: So you purchased Hollinger before you identified the corporate governance issues?

CB: We didn't buy into this thing thinking we were getting into a 'situation'. In fact, we thought the trend was improved corporate governance.

ER: How do you determine when to sell a stock?

CB: Two things. One, when you think it is selling at its private market value. The exception to that might be a company like JNJ, where you don't think you'll be able to find such a reliable grower going forward. The other reason you sell something is when you find something that is really tantalizingly cheap and you have no cash left, then you need to sell something from the portfolio. That's called "the hogs feeding at the trough."

> *"If you think your opponent is acting irrationally, go take a walk and come back. Because he isn't."*

ER: What's the best piece of business advice you've ever received?

CB: There are a couple. One, don't confuse brains with luck. It is better to maintain a certain humility about your abilities. Probably the three toughest words for anybody to mutter in the investment business are "I don't know." Which should always be followed by, "but I'll find out." The other piece of business of advice came from a mentor and it involves situation of negotiations. He said, "If you think your opponent is acting irrationally go take a walk and come back. Because he isn't." He is acting in his own best interests as he perceives them. You have to figure out how he perceives his interest. People don't tend to do things that are not in their interest. They may be wrong, but they are seldom irrational.

ER: If someone wanted to be a great investor what advice would you give them?

CB: Being a great investor isn't hard. It really gets down to the behavioral psychology aspects of the business. This is an industry that for the most part rewards activity. They think activity is great. If you are the chairman of XYZ mutual fund holding company and your portfolio manager of your mid-cap value fund hasn't had any trades in a couple of weeks you call him up and ask him if he's been on vacation. And he says, "No." So you go "Well what are you doing?" And he goes, "what I always do. I'm sitting and reading. I haven't found anything I want to own better then what I already own." Well that's not acceptable. They think people should be jockeying around. Selling Pfizer today and buying JNJ, and then switching back in a few weeks. That implies the person is alive, thinking and doing stuff. People reward action – as if we were all some sort of Hasbro toy figure. Being a great investor is nothing more than having the patience to wait for the investment principles to pay off and the ability to stick to it at times when people will look at you and say you are dopey.

ER: **What advice do you have for young people or students?**

CB: John Spear's had this great advice for anybody interested in the investment business. When you are in your mid-twenties go work for someone in their mid-fifties. Because by the time they are ready to retire in ten years, you'll be ready to take over. Unless you are so impatient that within two years you want to start your own hedge fund, because you think you can succeed in that game. A lot more people succeed in the garden variety investment management business. The other thing is if something doesn't make sense to you don't do it. And accept there are certain things you can't know. You can't know earnings five years out.

ER: Thank you very much Mr. Browne.

The REA welcomes Professor Chris Mayer back to CBS and wishes him best of luck as the new Director of the MBA Real Estate Program and the Paul Milstein Center for Real Estate

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