Intelligent Investing Transcript

Transcript: Chuck Royce

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[00:08] Steve: Saving Detroit

Welcome, I'm Steve Forbes.

It's a pleasure and a privilege to introduce you to our featured guest: Chuck Royce, chief investment officer of The Royce Funds. Chuck's a legendary value investor who has, for years, profited from the small and mid-sized companies that represent the cutting edge of American entrepreneurship. He'll share lessons and insights from his 46 years of investing.

But first,

In the 1960s, general motors held back on sales because it feared an antitrust suit. Now it's going to the government with a tin cup.

The U.S. auto industry can regain its prestige and profitability, but a bailout alone won't do it. Ford, General Motors and Chrysler need structural changes so profitability will become a possibility.

U.S. automakers usually make good money overseas. GM and Ford make very good small, fuel-efficient cars in foreign markets. But they're not allowed to bring them into the U.S. It's madness. Let them import the cars they build overseas. Thrifty Americans will love them.

All parties must sacrifice. Shareholders are already virtually whipped out. Bond holders will take a big bath, losing at least two-thirds of their principle. Top executives will suffer big pay cuts. Labor must also make concessions now in order to preserve jobs and opportunity in the future.

Among the changes: flexible work rules, like we see in American facilities of foreign automakers. Big reforms are needed on fringe benefits--the *cash* pay difference between workers of the Big Three and those working here for foreign auto companies is not that big.

Such basic changes will turbo-charge Detroit and make it a source of tax money for Washington instead of a recipient of money from taxpayers.

And now, my conversation with Chuck Royce.

[02:04] Small Stocks, Big Money

STEVE FORBES: Chuck, thank you for being with us.

CHUCK ROYCE: My pleasure.

STEVE FORBES: First, if you could explain your approach. You like small-cap, micro-cap stocks. And so what are your basic philosophies you've brought to market?

CHUCK ROYCE: Well, the theory, which didn't necessarily work in the last year, is that these are essentially non-correlated assets with large-cap, that they have embedded in them more inefficiency, that you can sort of sort, that very large number of stocks, there's thousands of small cap stocks, 5,000, 8,000 depending.

STEVE FORBES: Well first define, as you see, the small-cap and the micro-cap stock.

CHUCK ROYCE: We've used traditionally, although we change it every few years, two and a half billion and under with micro being 500 million and under. We have ratcheted that up over the last 20 years, but that's sort of where we are now.

STEVE FORBES: And precisely because these are small; institutions tend to overlook them. You can find bargains.

CHUCK ROYCE: Well, that's the theory. The theory is that this is a historically inefficient area, that there's less broker research, there's less institutional interest, that people tend to sort of come and go and it sets up tremendous opportunities from time to time, and that over the long term, possibly, you can get a higher return, maybe in a hundred basis points or more. And I think that's sort of been the general principle behind that.

STEVE FORBES: Because these things are relatively small, you don't feel you have liquidity problems with these?

CHUCK ROYCE: Definitely. If we had to sell all the stocks in one day, we would have liquidity problems. So liquidity is a very real thing and it's an important part of it. But liquidity is a risk. And you would like to think you're going to get paid for that risk. So the illiquidity, which is embedded especially at the smaller end of small, is a positive in the long term. Because we will through our, hopefully our, clever picks and our trading expertise, we will work against the liquidity issues and create successful enterprises that will grow in capitalization. And then there's more liquidity. So that's the theory.

STEVE FORBES: So you look for managements that have been in there for awhile?

CHUCK ROYCE: Absolutely. Management is important. Balance sheets are important. Small is, well, there are lots of mythologies around small; they're not so small. These are companies with 10, 15, 20 year track records with highly specialized businesses, often a narrow marketplace business. Unlike GE or unlike Triple M [3M], they are not made up of hundreds of businesses. So at some level, they're actually easier to get your arms around.

[05:03] Greenspan's Mistakes

STEVE FORBES: You mentioned the past year, which I think has humbled just about everybody. What do you think brought about the events of the past year, which certainly we haven't seen in our lifetime.

CHUCK ROYCE: Well, we're sorting that out now. Obviously, it's a combination of things. It's not any one thing. Certainly, cheap money available, essentially for a long period of time.

STEVE FORBES: That was Mr. Greenspan.

CHUCK ROYCE: Mr. Greenspan seemed to think cheap money was the only outcome. I think that was wrong. I think that is a very important part of the issue. But then through our cleverness in financial instruments, we created, as [Warren] Buffett says, "weapons of mass destruction in derivatives."

And some of the derivatives are perfectly sensible, ordinary course of business. Interest rate swaps certainly come to mind. But then we got carried away because our financial people are very good at this stuff. So we created these products that had counterparty issues that we're still sorting out.

STEVE FORBES: So this kind of blew up all the patterns of the past?

CHUCK ROYCE: Thus far, it was blown up the patterns of the past. As we were talking a few minutes ago, there hasn't been a single asset area that was protected, not sort of tried and true asset areas, not specialized industries, certainly not natural resources, certainly not dividend paying stocks, certainly not real estate REITs. In the whole spectrum of the stock market, there hasn't been a single zone of safety other than cash.

STEVE FORBES: And given prospects for inflation, even that may not be a long-term asset.

CHUCK ROYCE: Well, cash is a funny animal today. It pays you nothing or negative. And possibly if you're a foreign investor seeking safety, you're going to assume the risk of a dollar in the same moment. So it's a very funny moment to be in where cash pays nothing.

[07:17] Don't Lose Money

STEVE FORBES: And you have said that one of the chief tasks of a money manager is not to lose money.

CHUCK ROYCE: Right. And I'm embarrassed to say we lost a lot of money. We lost around 30 to 50%, depending on which fund, for our funds from their peak in July of '07 until a few weeks ago. The low was Nov. 20. And it was in the neighborhood of 40 to 50% across the board.

STEVE FORBES: Well, how does a successful money manager like yourself, who's been able to do very well over the

years, cope with a loss like that? What do you learn from it and how do you make sure it doesn't throw you off balance and question everything you've ever done?

CHUCK ROYCE: Well, we are questioning the techniques. We have a risk adverse mentality. We are very much attempting to minimize losses on the downside. We measure that all the time. And this is going to stand out as an exception in terms of the outcomes that we would've expected.

In general, we like to think we'll be down about half in a bear market and up, maybe approximating a bull market, and therefore creating a nice return set, risk reward. That did not happen this time. And I suppose that proves the old rule that not everything is going to be a hundred percent.

[08:40] Leverage Ruled The Day

STEVE FORBES: What have you learned from this, other than the peculiar times can lead to peculiar--

CHUCK ROYCE: Well, the systematic risk was not on my radar screen. When this started, August of last year had its high volatility moments. This whole subprime and packaging of securities and the unwinding of some of that, I thought, would just unwind. It would not move on to the entire financial structure. I just didn't see that, nor do I think about that all the time. But I did not assume we would have the kind of systematic risk that developed quickly in the spring.

STEVE FORBES: What do you think brought that about? Because if you look at the actual losses on the subprimes, they're nowhere near the 20 cents or 10 cents on the dollar you see as some of these things priced at now.

CHUCK ROYCE: Well, the investment banks, when they were freed from the restrictions, took advantage of that and began leveraging their balance sheets, each kind of mimicking the other. You know, "O'Neill's comment at Merrill Lynch, then "I wish I was like Goldman," you know, he'll live to regret.

So leverage became the instrument of the day. Proprietary trading desks all were trying to mimic hedge funds. The facility for doing LBO's and holding some of the principle in the interim while the loans are sold was a function of investment banks. Pre-marketing of the syndicated mortgages abroad, everywhere around the world, was a function of investment banks. And they were left holding the bag.

And 130 times equity, the math is pretty simple. Three percent losses and you're gone.

[10:41] Margin of Safety

STEVE FORBES: Looking back over this year and the years before, what is the best financial lesson you've learned?

CHUCK ROYCE: Well, to me, it's the old [Benjamin] Graham and [David] Dodd margin of safety. Now maybe we've redefined what a true margin of safety is. But margin of safety, it's a wonderful set of words because it implies that you should be spending your time on the risk factor in a company.

And we like to think we do that; the balance sheet is critical. Balance sheets mean that you probably are minimizing debts, that the company should have sufficient returns on assets to grow on their own without leverage. What you don't want is highly leveraged; high ROE companies that where the slightest little bad wind can change everything overnight.

So this whole concept of margin of safety and there's lots of ways to talk about margin of safety. Certainly the financial margin of safety, though, is probably the most critical, and then valuation and concentration. But I probably want that up on my desk with the lights going off on that every 10 minutes now.

[11:56] Too Many Banks

STEVE FORBES: You talked about companies able to grow without a lot of leverage, which gets to the banking system, the source of capital. How do you see that shaking out?

CHUCK ROYCE: Well, we are re-equitizing the banking system. We have too many banks. Somebody told me we have 8,000 banks out there. It's kind of hard to believe. But as you know, and if you go anywhere, you see local banks, local banks, regional banks, national banks.

And I would say no matter what else goes on over the next five years, a number of banks will decline. Some of them in just perfectly normal ways and some because they no longer are viable. So that process will go on a long time. And I think it's almost separate from the subprime issue. It's just that we have too many banks. We've encouraged too many banks. We

made it too easy to be a bank. Most countries don't have anywhere near the number of banks we do.

STEVE FORBES: And in terms of availability of capital, what's going to happen in the future on that?

CHUCK ROYCE: Well, the government is providing capital. You know, at the end of the day this is probably going to have more private equity funds in the banking system. It has historically not been where private equity funds have migrated, but I could see them taking a role there. I think in the most recent legislation they've been given permission to quickly get bank charters.

[13:28] Wall Street Partnerships

STEVE FORBES: So do you see a situation where, now that Goldman and Morgan are trying to morph into commercial banks, that..

CHUCK ROYCE: Well, they didn't want to.

STEVE FORBES: .. out of an instinct of survival? Do you think we'll see the rise of, you mentioned equity funds, where the old partnerships, where ..

CHUCK ROYCE: The Brown Brothers that ..

STEVE FORBES: .. yes, the kind of things we grew up with?

CHUCK ROYCE: Well, they all were partnerships. So that's a very interesting idea. Will we return to the days of, "My word is my bond, and my partnership account is at risk, and therefore we will lend very carefully?" Well, that would be interesting. There's no sign that that's happening, though.

STEVE FORBES: You've mentioned the huge bull market we got in bonds since the early '80s. Some people thought it was going to end five years ago. And is this truly the last leg of it where 30 year treasuries are getting near 3%.

CHUCK ROYCE: Right. Well, I would say it has to be. I have begun a systematic short of that particular instrument. I just don't see how it's possible that with the dollar at risk over long periods of time, with our highly inflationary money supply creating an environment that we can hold those rates. We know we can control short-term rates. That's easy. That's the Fed's job. But the long-term rates are controlled by the world. And will the world let us get away with that? I would doubt it.

[15:03] Modest Inflation and Bonds

STEVE FORBES: You've said on occasion you look forward to inflation. Explain it, because I think I know what you mean.

CHUCK ROYCE: Well, modest inflation is always a good idea. The inflationary forces that are modest are fine. High inflation, obviously, is very disruptive. But a little bit of inflation is perfectly fine. But it's going to be awhile. We need an economic recovery for a little bit of inflation.

We've had specialized commodity inflation recently, up until July. That created havoc also. So there are all sorts of forms of inflation. And I think it's going to be awhile, though, before that's an issue. Certainly a year or so.

STEVE FORBES: But it gets to your point on bonds. This is as good as it's going to get in the bond world.

CHUCK ROYCE: Right. This is as good as it's going to get across the board. And if I was the government, I'd be selling these 30-year bonds like crazy. They should sort of slow down the T-bills and go longer.

STEVE FORBES: Well, it tells you something about the fear factor, that you can have 0% T-bills and be oversubscribed by a factor of three or four.

CHUCK ROYCE: And when you look at the last country to do that, it's not a very happy outlook either.

[16:23] Volcanic Explosion

STEVE FORBES: No. What do you think is the one misplaced assumption in business today?

CHUCK ROYCE: I think there is an overemphasis today on the short-term response to this. That if you are a mid-sized business, if you're a CEO you're probably worried about your job. But if you have the long-term outlook, you're probably not doing as strong a planning for the long-term. You're probably setting into place, "Who can we let go? What kind of plans

can we do?"

And so that transition between appropriate short-term response and appropriately taking advantage of long-term opportunities, if you're a good company with a great balance sheet, you should be using that moment to take advantage of the moment, to squash your competitors, to take market share, to eat the other guy. So I'm not seeing that yet, in the classic recession, the larger companies should buy smaller companies. But that's come to a complete standstill.

STEVE FORBES: What do you see rising up from an earthquake like this? Usually there are new players, new industries and new nameplates.

CHUCK ROYCE: What is the right metaphor, I'm not sure. But it's a volcanic explosion. And how quickly will there be new flowers on the side of the mountain? It usually happens faster than you think. No one is dare saying, "We can go up as fast as we're going down." I'm not going to say it either, but there is an extreme sort of.

STEVE FORBES: Is that lurking in your heart?

CHUCK ROYCE: Well, I hope it's not a good investment strategy. But I do think that this thing will come to some natural end, as all recessions do. I'm not sure how that takes place. And we are yet to see the role of the fiscal response that clearly everybody seems to want. So that's going to be interesting.

[18:28] This Too Shall Pass

STEVE FORBES: And in an environment like this are you able to do much investing? Or do you have to worry about redemptions and that sort of thing? Are you able to look and say, "OK, two or three years, I know this company's going to hit it out of the park"?

CHUCK ROYCE: Well, that's the right attitude. Most of our funds are open-end funds. We do have a few closed-end funds. And, of course, that's where you get more stability of capital. We've had very little, knock on wood, redemptions thus far. And we've had some positive cash days in the last couple weeks, which I'm thrilled with. We are putting the money to work.

We definitely believe that out there, three years, five years, a sort of reasonable horizon, there's tremendous, 100%, 200%, possibilities. In our micro-cap funds, I'm currently rating our stocks in the fund that, "Could they triple? Could they just double?" And I'm doing the triage between them.

STEVE FORBES: That's a nice exercise at a time like this.

CHUCK ROYCE: Well, it's an exercise. You know, we're not publishing the results because you only have a limited amount of capital.

STEVE FORBES: So your bold prediction for the future is, "This too shall pass?"

CHUCK ROYCE: Well, I do. I definitely think equity investment is a very important way of protecting against inflation, a very important way of compounding wealth, and that absolutely will continue. And I fundamentally believe our systematic risk, the proposition that society is going to fall apart because banks can't trade with each other, I think that's behind us.

STEVE FORBES: Do you see coming out of this, then, any major systematic changes that could dim future prospects? Or will it just be more stimulus and somehow the system will recover on its own?

CHUCK ROYCE: Well, I wish I knew. But we're going to have an era of reform, with all the possible trouble that that's going to get us into. Wall Street is going through an interesting financial scandal of last week. We had the week of all weeks for financial scandals. Last week, [Bernard] Madoff is extraordinary. I mean, the book obviously hasn't been written yet. But it's going to be an interesting book.

STEVE FORBES: I imagine there's several of them starting now.

CHUCK ROYCE: Right. They have to move fast.

STEVE FORBES: But in terms of real roadblocks in the future, you don't see that?

CHUCK ROYCE: I do not. I think that we are a major--we can't forget this--we're a major world power. And although the dollar has definitely had its issues over the last 10 years, I think the dollar will continue to be a major currency, even if it declines. That it's reserve currency status will not change for a long time. That we have the smartest, most clever kind of

corporate response, innovation capabilities of any country and that we will have a wonderful future as we come out of the economic recovery, as we come out of the economic sort of bottom here, trough.

STEVE FORBES: And final piece of advice to investors. Emotions. Oftentimes people jump in the market when it's going up and flee as it's going into the dumpster.

CHUCK ROYCE: Well, there's two things on that. One, turn off CNBC.

STEVE FORBES: But not Forbes.com, right?

CHUCK ROYCE: Right! Of course, not. So turn off CNBC. Use the old-fashioned thing, dollar-cost averaging. I don't know what the bottom is. When we get interested in a stock, we don't say, "We have to buy all our stock this day, this price." We dollar-cost average into all our positions. So it's a very time-tested technique. You're going to get some bad prices. And you'll get some good prices, especially if you keep your convictions intact.

STEVE FORBES: Thank you very much, Chuck.

CHUCK ROYCE: You're welcome. Thank you. I enjoyed it.

STEVE FORBES: Coming up next week. Insights and expertise from our past guests about the economic crisis, lessons learned, investment philosophies and more on a special edition of Intelligent Investing.

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