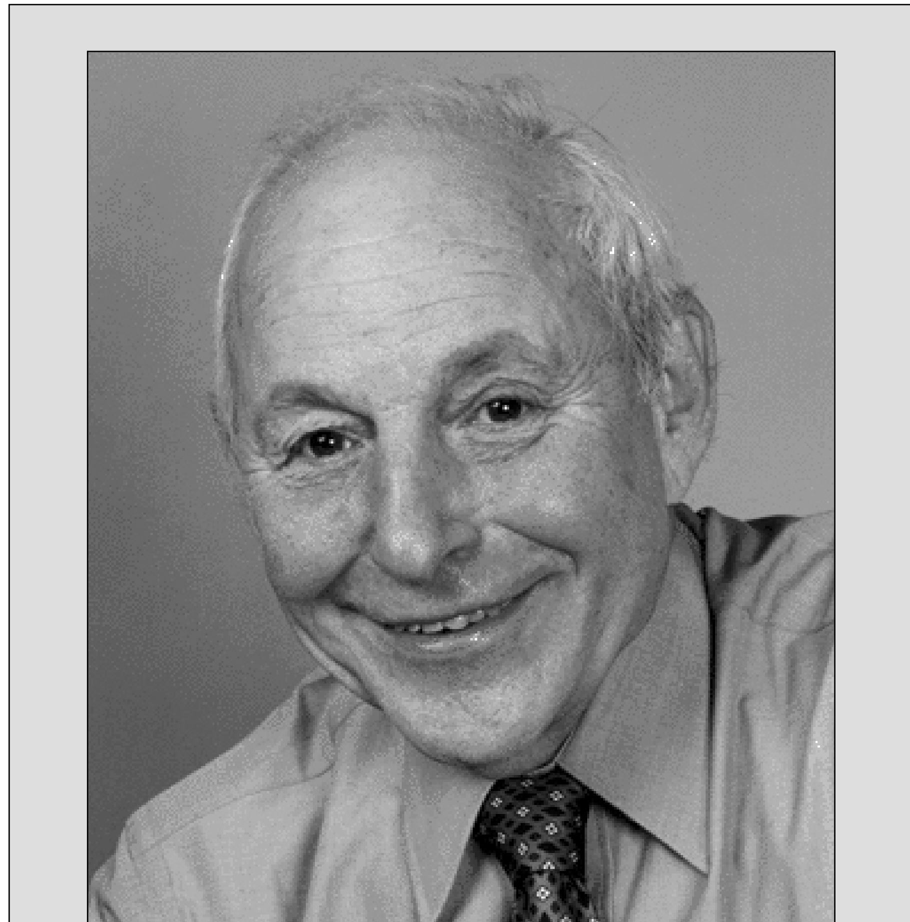
Profiles in Investing *by Eli Rabinowich*

Martin J. Whitman: Economic vs. Academic Reality

ER: How did you get started in the investment business?
MW: I was in graduate school at Princeton and I realized I wasn't cut out to be an economist - I couldn't make a living. In 1950, I was hired by Shearson Hamill to be a research trainee. I was in research for four years and their investment banking division for two years. I then spent a few years working for the Rosenwald family of Sears Roebuck fortune where we did both passive and control investing. Rosenwald was a great education. In the early seventies I wanted to go into business for myself and so I did stock holder litigation and bankruptcy, two areas which no self-respecting investment banker would then touch. We did ok in those areas and in 1984 we did a hostile takeover of a closed-end trust called Equity Strategies.
In those days it was a lot easier to do a takeover. The real value in taking over an investment company was, and is, getting the management contracts. After we got control of Equity Strategies we open-ended it and used it to buy out the bank debt of Anglo Energy which a few years later emerged from bankruptcy as Nabors Industries, the world's largest land drilling oil service company.
It was a spectacularly successful investment. At this time I discovered what a license to steal the mutual fund business was – it was like having your own toll booth on a bridge. So in 1990 I started up the Third Avenue Fund and now we have a little bit over $8 billion.



Vital Statistics
- Co-CIO of Third Avenue Management LLC
- Professor Yale School of Management
- MA, New School for Social Research
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ER: **Has it gotten harder to invest as you've gotten much bigger?**
MW: Yes and no. We still do a fair amount of distress investing as a creditor and boy is that a tough business if your not big enough to be an important player. In smaller deals, like Haynes International, we strive to own or otherwise tie-up fifty percent of the class. For example, we are in a control group at Kmart which is a several hundred million dollar position.

ER: So your size gives you an advantage over smaller funds?
MW: Absolutely. I would hate to be in this business riding the coattails of somebody else. Distress is a confrontational business.
ER: Do you typically buy the most secured debt?
MW: We will usually try to buy the most senior level of debt which will participate in the reorganization.

ER: You have some fairly specific views on risks which are perhaps not widely known to business school students can you talk about them?
MW: I've taught at Yale for more than 25 years and I even taught one year in Columbia's Executive MBA program. It's unbelievable how bad academic finance is. When academics talk about risk they mean market risk - whether the security is going to fluctuate in price. They are talking about beta, alpha and all that baloney. I would say that that is a very valuable concept if you are a day-trader or are fully margined up. We are most concerned about investment risk and properly evaluating management.

ER: So how do you manage risk?
MW: Many investor use diversification to manage risk, but diversification it is a surrogate, and usually a really poor one, for knowledge, control and price consciousness. We use some diversification because we are not control investors but above all we are very, very price conscience. Third Avenue Value Fund has about $3 billion and we own approximately 90 common stocks. The average other fund of the same size will own 300 or 400 stocks.

ER: You've been quoted as saying that it is still possible to find Ben Graham's "net-nets", is this still true?
MW: Yes. However we need to realize that GAAP is not really reality. It is not economic truth. It doesn't tell you what your income or asset value is any more than the Internal Revenue code does. GAAP defines current assets as assets that can be converted to cash in less than one year and arbitrarily classifies certain assets as current and others as fixed. If Kmart has $3 billion in inventory, it can only liquidate its inventory if it goes out of business. Inventory in retail is a fixed asset of the worst type. Not only is it permanent in the aggregate, but it's hard to value and is subject to shrinkage and style change. To call it a current asset is not realistic. Retail inventory is only a current asset in the case of liquidation not in the case of a going concern. On the other hand if a company owns income producing real estate and has triple A tenants with long-term leases in class A office buildings, then it can easily pick up the telephone and sell the properties or refinance them. The company can quickly get the cash out. It may be called PPE but it is a much more current asset than Kmart's inventory. So we define current assets as assets that are readily liquefiable. Using this definition we certainly do find companies which are trading below their economic 'net-net' value.

ER: How would you change GAAP to make it useful?
MW: In order for GAAP to be useful it should be geared towards creditors not stockholders. A creditor needs to look at what's in the business and how the business needs to perform to get its money back. One of the big issues in accounting now is whether or not companies should expense stock options. From a creditors point of view there is just a world of difference between cash payments and the issuance of common stock. They ought to go back to the old days where financials statements where basically prepared for creditors. You have an impossible task if you think you can make GAAP relevant for stockholders. And by stockholders I mean speculators who trade in and out of securities.

ER: In your writings you seem to very dismissive of WACC…
MW: Oh yeah. In order for WACC to make sense theoretically you need to assume the company has unfettered access to the capital markets. And that is just not true. Most companies finance their operations from retained earnings. The cost of retained earnings has nothing to do with the market price of common stock.

ER: What are you sell criteria?
MW: We never sell. Our whole technique works much better on the buy-side. Since we continue to attract new money there is very little pressure to sell. We sell in the open market when things become grossly overvalued. We are just not that good at selling when things are moderately over priced. We also sell when we make a mistake. Mostly we sell when our companies get taken over. Most of our sales are not to the market. I've been doing this for a long time and I've held securities for three years and sold them after they've doubled only to see them triple over the next six months. When you don't know what you are doing, doing nothing is the best course of action.

ER: In your estimation what separates good investors from great investors?
MW: Great investors all think like control people or are control investors like Buffett.

ER: What advice do you have for graduating students?
MW: I would suggest going to work for a bulge bracket investment bank, because there you combine know who with know how. There are worst things in life than being a Goldman Sachs or First Boston alumnus.

ER: Thank you very much Mr. Whitman.