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.

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. 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 marginated 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. 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 concept 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.