Whitman and Eveillard on Value Investing

By Robert Huebscher
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Two legends of the value investing world, Marty Whitman and Jean-Marie Eveillard, shared their insights recently into the current crisis and forecasts for the economy and the markets. Wealth Track's Consuelo Mack hosted the discussion between the two icons, which took place on March 31 at the Investment News Retirement Income Summit.

Value investors traditionally have little heeded macroeconomic trends, preferring instead to focus on the intrinsic value of companies. Their ultimate goal is buying assets "on the cheap" — for less than they are truly worth — but tradition has been tested by the current crisis.

Whitman began the discussion by admitting that he wished he had paid more attention to macro events, even though, he added, he was "not qualified" to do so.

Whitman's flagship fund, the Third Avenue Value Fund, struggled in 2008, – losing 45.6%. Over the last 10 years, though, it has returned 4.43%, 6.67 percentage points better than its benchmark, the MSCI World Index.

Since World War II, central bankers have focused on aiding GDP growth and controlling inflation, Whitman said, but they have ignored "the third leg of the stool" -creditworthiness. "Cheap is no longer a sufficient condition" for value investors, he said. "The companies we buy had better be creditworthy."

Eveillard agreed that credit and leverage are playing a central role in the crisis, noting that leverage amplifies mistakes in down markets.

Eveillard's First Eagle U.S. Value Fund had a better year in 2008 than most, losing 23.1%. Over the last one, three, and five year periods the fund has ranked in the top percentile of its peer group.

Although studies have shown that value investing has consistently delivered superior performance, other studies have also found that value investors are strikingly few in number. Whitman and Eveillard both addressed this paradox.

Eveillard attributed the dearth of value investors to two factors. Value investing is inherently hard work, given that most public sources of information – including sell-side research – are insufficient to provide a competitive advantage, he said. More importantly, value investing requires a long-term horizon, and most investors are too impatient to wait for market values to rise to intrinsic values. “Human nature is to shrink from pain,” he said. “It’s not that value investors are masochists,” he added, it’s just that they are more patient.

Whitman believes value investors are more numerous than most people think. “Many value investors are controlling investors,” he said, expanding the traditional realm of value investors to include those who take ownership positions in a single company or a small number of companies.

Eveillard and Whitman both said current valuations are extremely attractive.

“These are the best opportunities I have seen in my lifetime as a bottom-up investor,” said Whitman, whose career spans more than 50 years. Whitman cited an example – GMAC 2010 loans – which he recently bought at a 55% yield to maturity, knowing that his expertise as an investor in distressed securities would likely be tested.

Eveillard sees tremendous opportunities across the capital structure. He noted that some bank loans, to which all other debt and equity are subordinate, trade at 60 to 65 cents on the dollar. He is also very bullish on gold, given the path central bankers are taking: increasing the money supply, which, he believes, will ultimately cause inflation.

While some bank loans offer value, many are the byproduct of private equity transactions involving companies that now lack the liquidity to refinance their debt. “Much of the private equity investments by endowments will be shown to be nonsensical,” he added. “Private equity investments are no better than a leveraged investment in a bull equity market.”

Whitman likes common stocks, but only in companies that are well-capitalized. He looks for firms that have high free cash flow, strong asset values, and prices that reflect a 50-60% discount relative to intrinsic value. His target rate-of-return is a minimum of 10% over a five- to ten-year time horizon.

Both Whitman and Eveillard like Asian companies, particularly Chinese companies trading on the Hong Kong exchange. “The only risk to growth in China is political,” Whitman said.

The US consumer, Eveillard said, is “tapped out” and will remain so for the next three to five years. Germany and Japan, however, have the potential for additional consumer spending. He likes a number of Japanese companies that are well-positioned for those markets. Japan is “the only developed economy with a great number of small, Graham and Dodd companies,” Eveillard said. He also cited the lack of leverage and strong balance sheets across Japanese industry. “We can seldom buy a business for less than nothing,” he said, but that is now possible in the Japanese markets.

"The Japanese companies didn't listen to Wall Street when they advised them to optimize their balance sheets, by buying back stock and taking on leverage," Eveillard said, and they are much stronger now as a result. "Nine times out of ten it pays not to listen to Wall Street," he said.

"When I'm in a good mood, I say Wall Street is a vast promotional machine," Eveillard said. "When I'm in a bad mood, they are a den of thieves."

The conversation at one point turned to the subject of the automakers, who had been granted a reprieve by President Obama the day before the event. GM will eventually end up in bankruptcy, Whitman said, since voluntary workouts among bondholders "never happen because there is a huge holdout problem."

Eveillard wished that Detroit was dealt with "more harshly." He called the automakers treatment symptomatic of a more general phenomenon where "failure is rewarded and good behavior is punished."