FEATURES

Value Investing Meets Momentum Investing

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, Rich Pzena.

Professional History

- Managing Principal and CEO Pzena Investment Management
- Director of U.S. Equity Investments and Chief Research Officer, Sanford C. Bernstein & Company.
- Institutional Investor All America Research Team from 1988-1990
- B.S. *summa cum laude*, M.B.A., Wharton School, University of Pennsylvania

ER: How did you first get started in the investment business?

RP: Well, I guess I've always been interested in the stock market. When I went to school I wrote my master's thesis with Joel [Greenblatt] and another guy. It was basically a review of Graham and Dodd, on how the small investor can beat the market. We wound up having it published in the Journal of Portfolio Management. I took security analysis at Wharton and it was the worst course I ever took. You were taught to extrapolate into the future and to do regression analysis. I thought why would anybody ever do this for a living. Professionally, I started in the investment business in 1986 when I joined Sanford Bernstein as an oil industry analyst. Prior to that, I had worked for Amoco for five years after business school. The oil industry at the time was the "hot" industry. It was like technology in 1998, 1999, and 2000. It's hard to imagine, but 32% of the S&P 500 was energy in 1981. Technology got up to about that and even a little higher in 2000. After five years of working in a big company, I had enough and I went to Bernstein as their oil analyst and published reports on the big oil companies. I knew pretty quickly that a sell-side analyst's job wasn't for me. It was a good exposure to the investment business but the sell-side was too much sell and not enough research and investing. At the time Bernstein was undergoing a major expansion. They really got "hot" in the mid-80's and by the late 80's the firm was expanding into a lot of different products -- one of which was small cap value. So, I got the opportunity to basically start their small cap value product. I took it from the business plan stage to hiring the research department and developing the whole investment process, marketing it, and actually wound up raising about a billion dollars. This was in 1991. Shortly thereafter, Bernstein retired and Lew Sanders became the chairman and I became Director of U.S. Equity Investments. My responsibility was really to oversee the whole domestic investment process working very, very closely with Lew on Strategic Value, Bernstein's Deep Value product.

ER: When did you start your own firm?

RP: After Bernstein got really big, around $80 Billion, I started getting "antsy" about wanting to do something on my own--really a personal dream more than anything else. As firms get bigger and bigger, it becomes less fun for someone doing real research because your ability to have a significant impact through research is diminished. When I left, my real dream was to be able to do the kind of quality research and investment process that happened at Bernstein but do it without the constraints of having so much money. So I left at the end of 1995 to start my own firm.

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Rich Pzena

ER: Tell me about starting your own firm.

RP: We actually started in Joel's conference room--he let me use his conference room for several months before we got some space. The stress of the first year was building the infrastructure and research team. Then, starting in the fourth quarter of 1997, we entered probably the worst value environment in history with the Internet bubble. We went through two and a half years of really being tested. That was the hardest period of my life -- because we weren't really established as a firm at that point in time. We had a good record the first seven quarters, and then we went through ten quarters of really lousy performance. Not that we lost a lot of money for people but we just didn't participate in the big rally. Those were the years when the S&P was up 30% each year and the NASDQ was up 100%. That was the hardest.

ER: Were you invested at that time or were you in cash?

RP: No, no, we were fully invested. We were so excited about the prospects of what was available in the value world that we were going around making speeches about how crazy the world is and "look at these companies that you can buy--they're four times cash flow and they're #1 and #2 in their markets. There's nothing wrong with them." And then you would look at what somebody would pay for Cisco with a $500 billion market cap and $1 billion in earnings, and you think, how could that be? To get a 15% return on your $500 billion you have to make $75 billion -- I'm just doing simple arithmetic -- How could you believe this, right? We stuck to our discipline during that two and a half year period and then got rewarded afterwards. While we were going through it, it was awful. But when you look back on it, for us it was really a blessing in disguise because so many of our competitors drifted away from their discipline of being value investors because they couldn't take the pressure--couldn't take the client pressure, couldn't taking losing every day. And, so when the rebound came, we were very well positioned. We had a spectacular 2000 and a lot of people didn't, because if you were in the growth area, you got killed. So, a lot of the value guys really didn't participate in the big run-up in 2000 and 2001, and that's what made our business, really.

ER: Can you briefly describe your investment philosophy?

RP: Yes, it's very straightforward. The simple way of describing it is we are trying to buy good businesses when the price falls dramatically relative to their normal earnings power. You have to be realistic as a value investor because value is created by deterioration. You don't get to buy the best businesses, with the best characteristics at a low price - that's not what sells for a low price. So, we first use our computer system to identify potential value candidates. The hard part is making the judgment as to whether the businesses are really any good, whether the problems are in fact temporary or permanent, and whether the earnings really should be higher than they currently are. And, that's where all the time and research energy is expended. The trade-off is that deterioration creates the opportunity, but deterioration is bad from a momentum investing standpoint (and momentum works), so we try and wait until a company stabilizes before buying.

ER: So, you first identify a stock that is progressing down, but you won't purchase it until the earnings have stabilized?

RP: Right. We'll do all the work. And then we'll just sit on our hands**...** And wait. For example, we bought Cracker Barrel Old Country Store, a national restaurant chain. Basically, they screwed up. They were a low priced restaurant with lines waiting to get in. Then a new manager took over and decided to raise prices. The plan backfired, sales declined and the stock collapsed. It went from like $42 to $8 at the bottom. It popped up on our screens at $15 but there were still negative sales growth. And, so we monitored the company and did the work. We liked the company. There was a lot of real estate involved in it, so we analyzed the real estate. The company brought back the old manager and his business plan

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Zell and the Art of Real Estate Entrepreneurship

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heavily with the Real Estate Center at Columbia. To a rapt audience, Mr. Zell kicked off his speech with an anecdote about one of his many trips back to the University of Michigan, when he encountered their new head of Clinical Psychology. "What's new?" he asked, breaking the silence. "Well," replied the head psychologist, "In our newest development, we've replaced the mice in the mazes with MBAs." "Oh really?" Mr. Zell responded. The psychologist added, "Yes. For three reasons: 1) there are more of them, 2) the researchers tend to get less attracted to them, and 3) there are some things even the mice weren't willing to do." As it turns out, the stories to follow would be more truthful, yet just as entertaining, insightful, and applicable.

Sam Zell got his start by entering the world of real estate while he was still in college, by managing property for student housing. As a student himself, he understood the student mentality. Who would be better equipped, he argued, to effectively manage the property? From there, he began to acquire and invest in property in Chicago, particularly distressed real estate beginning with the property crash in the 1970s. He went on to form REITs, became the first to publicly finance them, and proceeded to take advantage of opportunities in other segments, adding a varied set of businesses to his holdings.

Sam Zell's view on entrepreneurship is simple; at the most basic level it is all about attitude and mindset. Entrepreneurs, Mr. Zell argued, think from the perspective of an individual rather than that of an organization, or worse yet – conventional wisdom. "Entrepreneurship's greatest enemy is conventional wisdom," Zell said. From this foundation he continued to build the rest of the key attributes of successful entrepreneurs.

Being incredibly observant and constantly curious are necessary to those seeking to succeed as an entrepreneur. These characteristics drive entrepreneurs to be on the constant look out for problems and subsequently devise their potential solutions, to always increase their knowledge base, and to see opportunities that may be invisible to everyone else. "How can I do it better? How can I make it more effective? How can I seek what other people don't seek?" For example, upon recognizing that recent outsourcing trends would undoubtedly affect his business, Mr. Zell flew to Bangalore and invested his time in talking with experts in the outsourcing business. To Mr. Zell, "The real entrepreneur is never satisfied and is constantly asking 'What's out there?' 'What's the vision?'"

Mr. Zell also stressed the importance of simplicity, logic, and common sense. He reminded us about the most basic concept of supply and demand as he related a tale about an endeavor concerning railcars. During the early 80s, the demand for railcar loadings in the United States was flat, and as it experienced no growth, the industry was deemed unfavorable. Because of this, railcar owners began to scrap their railcars, thus decreasing the industry supply by 65%. Keep in mind though that the demand was not decreasing – it was just flat. The profit opportunity Mr. Zell saw was as clear as the two supply and demand lines he drew on the board, and he was not shy about stating the obvious. Already an owner in the railcar industry, he bought up all the used railcars in the United States, adding to his fleet of 17,000 railcars until it totaled 92,000. He later sold them to GE for $2.2 billion in 1992, at a profit of $500 million.

Hand in hand with looking for opportunities is recognizing good ones, Mr. Zell added, and having the sense of urgency to take advantage of them. To illustrate an example of quick decision making and implementation, he discussed one of his holdings – Jacor Communications, a small company that held 17 radio stations. During that time, the government only allowed companies to hold 17 or fewer stations. This changed in 1996, when the FCC passed telecom deregulation and removed the restriction. Companies were subsequently free to own an unlimited number of stations provided the holdings consisted of no more than 40% of the market. Seeing this as yet another extraordinary opportunity, Mr. Zell quickly bought all the radio stations he could, ending up with a total of 234 stations. Jacor repackaged the radio stations, made their operations more cost effective, and created marketing presences to gain dominance in local markets. Jacor then sold the bundle to Clear Channel for $6.4 billion in 1998, two short years later. All this profit was generated from an initial investment of $50 million in 1995.

Moving in one direction when everyone steadfastly moves in another often translates into feeling very alone. Throughout the talk, Mr. Zell reminded us how he would often wonder where the other opportunists were when he was setting about amazing deals. Where was everyone else when Mr. Zell foresaw a fortune in buying up distressed property? Was this actually the correct tactic to take? This is where self confidence kicks in, and strength of convictions. An entrepreneur, Mr. Zell repeated, needs an enormous amount of self confidence, to go hand in hand with optimism and perseverance. For all the times that "things don't work out," these qualities would carry the lone entrepreneur to the next opportunity looming ahead, making the next day worth getting up for. But "Most of the time," he would often say, "if you're really making the right decisions, you're more than likely going to be alone."

Mr. Zell went on to discuss the importance of selling, and being able to clearly communicate business ideas. He talked about always keeping one's eye on the objective, and about always testing one's convictions. And as much as one learned through what Mr. Zell was saying, one also learned by what was unspoken. Sam Zell showed incredible energy; a passion for opportunities that was as strong as his zest for life. He spoke openly to the audience – free with his words and free with his motions, his demeanor showed his enthusiasm in talking to us. Mr. Zell also proved to be sincere, remaining accessible to people for 20 minutes for one-on-one questions after the Q&A.

Mr. Zell closed his speech with a quote by Daniel Birnham, a famous architect of Chicago, which summed up his views on life, a mantra that everyone at this school can probably take to heart: "Make no little plans. They have no magic to stir men's blood. And probably themselves will not be realized. Make big plans. Aim high, in hope and work."

Profiles in Investing: Rich Pzena

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was just to roll everything back to the way it was before. And, we thought, well okay, that sounds like a good idea. Sometimes it's not a rocket science, I gotta tell you. It sounded pretty logical to us. There was a lot of real estate supporting the downside here but same store sales were still negative. So, we waited. After the company cancelled an analyst call the stock went to $8 -- where it stayed for six months. While it was sitting at $8, the sales went from –5%, to –3%, to –1%, to flat and then stayed flat for a few months and that's when we bought. Sales certainly could have turned negative again. We didn't know. But, it wasn't deteriorating at the time and we thought that this was a really good time to buy.

ER: You also mentioned that momentum works. What do you mean by that?

RP: Yeah, momentum investing works. It does. There is statistical evidence for it. There is statistical evidence for value investing, too. Momentum investing is based on the clear evidence of serial correlation of earnings. If you have an environment where sales are declining, you have a high probability that the next quarter they are going to continue to decline until they don't anymore. So momentum investing would tell you that investing in a company during a period of continuing deterioration is a bad idea, and that you should wait until stability is reached before making your investment.

ER: What exactly are normalized earnings? Is it an extrapolation of historical trends?

RP: Yes, our system just looks at history. Our system then ranks the companies cheapest to most expensive on the basis of price to normalized earnings. We then overlay our own judgment on it. What we mean by normal really is what should the business be capable of earning given it's history--the history is important--but also given the industry structure, given the competitive situation--can you identify specific competitive pluses or minuses that might affect the business plan. So, we use history as the base and then we make a judgment whether history is relevant or not.

ER: What went into creating your screening system?

RP: I built something similar to this at Bernstein. On my first day as research director after being the oil analyst for five years, a drug analyst came over to me and said, "look, here's this new billion dollar drug and another new billion dollar drug, and this one's half a billion dollars, and you add all this stuff up and they're going to grow their top line 15% a year and they're not going to have to add any more sales people, so the margins are going to expand. They're going to have so much excess cash flow, they're going to buy back tons of stock. You do the arithmetic and EPS is going to grow 40% a year for the next five years, and it's really cheap." Now, I'm sitting there as an oil analyst, not even able to pronounce the drugs he's talking about, thinking how am I ever going to evaluate this? So, I decided that I needed to know some historical precedent to have an intelligent discussion with an analyst. Really, analysts tend to take the current and add incremental improvements to it. So, that's what the analyst did. They take the current state of affairs and then the company describes all these new drugs, so they added it on and it looked great. So, I said, "five years ago didn't they have all these wonderful plans for new drugs? How come they didn't grow 40% a year in the last five years?" The reality is that there's bad stuff that happens as well as good to these companies. Some of the drugs become competitive and some of them are duds. So I built this system as a tool while I was at Sanford Bernstein just to help me in the quality control process of research, and then decided to really make it more sophisticated and use it as a screen here.

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

RP: I don't know how this is going to sound, but this was the most meaningful piece of business advice I ever got: Find something to do that you really like doing - don't accept a job where you're not going to have fun because you think it might lead to something better in the future. Do what you really enjoy.

ER: Thank you very much Mr. Pzena.