Fund Spy

Cigar Butts and Moats

By John Coumarianos | 06-25-09 | 06:00 AM

Financial advisors and consultants are always giving themselves intellectual hernias trying to figure out which mutual funds work well together in a portfolio. Everyone's looking for funds that all do well over time but take different routes to good long-term returns, thereby providing the entire portfolio with stability along the way. In this piece, instead of trotting out the rules of Modern Portfolio Theory, we'll review the two segments of Warren Buffett's investment career and suggest funds that should work well together based on their correspondence to those segments. Basically, choosing two funds, each one corresponding to each equally successful major part of Buffett's career, should produce a well-diversified domestic stock portfolio.

Buffett's Two Careers

Warren Buffett has effectively had two successful careers in business. First, he managed a private investment partnership (basically a long-only hedge fund) through the 1950s and 1960s, in which he bought small-cap, underfollowed businesses, some of which were undergoing restructurings or working through problems. As a general rule, Buffett's holdings were prosaic, unremarkable businesses, but he bought them at dirt-cheap prices. Windmill-maker Dempster Mill of Beatrice, Neb., was typical of some of the fare that Buffett purchased in his early years. Even Berkshire Hathaway (BRK.B) itself was a boring textile maker when Buffett bought it, though he quickly saw that its textile business was irredeemable and began redirecting its cash flow into other businesses.

Buffett knew that most inefficiencies in the market would exist among small, underfollowed stocks. He also characterized some of the small, underfollowed stocks that he bought early in his career as "cigar butts" because they were unlovely businesses, but you could pick them up off the street and smoke the last two puffs for free, as it were. Not all of Buffett's holdings were cigar butts in the sense of being distressed or turnaround situations (though some certainly were), but they were almost all small, obscure, statistically cheap companies.

Investing in businesses at rock-bottom prices is what Buffett learned from his teacher and mentor, Benjamin Graham. Graham emphasized buying securities at cheap prices, based as much as possible on an estimate of the business's book value (assets minus liabilities) rather than on future earnings, though he accepted earnings power value, too. He also stressed having a "margin of safety," which meant adjusting for undue optimism in calculating valuation, whether you were computing book value or the present value of estimated future earnings or cash flows. Low price/earnings and price/book ratios were Graham's touchstones.

Even in this early period, however, Buffett had already experienced an extraordinary success in a different kind of investing than Graham would have sanctioned. This newer kind of investing is what Buffett has practiced in his "second" career as CEO of the restructured Berkshire Hathaway. Buffett had bought American Express (AXP), a well-known business he had long admired, when its stock price was very depressed as it

faced a scandal that threatened its reputation in 1963. Buffett recognized American Express not as a cigar butt to be picked up for its last two free puffs after the scandal passed but as a business with a "moat" (similar to a castle whose moat protects it from invaders) that could be held indefinitely because its moat, or competitive advantage, would protect it from competition and allow it to produce returns on invested capital that exceeded its cost of capital as far into the future as the eye could see.

It was nice to get a hugely profitable business like American Express at a depressed price, but over the course of Buffett's second career, with the encouragement of his business partner, Charlie Munger, he's come to relax Graham's criteria for low prices. Buffett now seeks excellent businesses with moats and will settle for mediocre prices--instead of seeking the cheapest prices and settling for mediocre businesses.

So, what are some good funds that correspond to each part of Buffett's career? We'll start with small-cap funds that correspond to Buffett's early years. Then we'll move to large-cap funds that own firms with wide moats. One fund from each category could constitute the domestic-equity piece of an investor's portfolio.

We should also emphasize that the first three small-cap funds actually own very stable companies with solid balance sheets. They aren't really "cigar butts." Many of them may be more cyclical than the holdings of the large-cap funds, but they are not distressed or undergoing major, difficult restructurings. The fourth small-cap fund, by contrast, owns shakier businesses, some with high levels of debt that may be more properly called cigar butts.

Small-Cap Standouts

Royce Special Equity (RYSEX)

This Analyst Pick is managed by Morningstar's 2008 Domestic-Stock Manager of the Year, Charlie Dreifus. It's explicitly influenced by the teachings of Graham and also by those of Dreifus' teacher, accounting maven Abraham Briloff. Dreifus owns lots of prosaic industrial firms with pristine balance sheets. They tend to have some cyclicality, but they also tend to have lots of insider ownership (although Dreifus doesn't explicitly screen for that), which means that management's interests are often aligned with those of shareholders. National Presto (NPK), the fund's top holding, makes small kitchen appliances, including deep fryers, but also has a defense-products segment. National Presto has current assets of $280 million against $59 million in total liabilities and trades at a P/E ratio of around 11. It also has 30% insider ownership.

Queens Road Small Cap Value (QRSVX)

This fund is managed by Steve Scruggs, who has quietly built an impressive seven-year record. It typically holds around 50 firms that generate strong free cash flow and have solid balance sheets. It has its share of cyclical industrials such as zinc-miner Horsehead Holdings (ZINC). Zinc is used in steel galvanization, rubber tires, alkaline batteries, paint, chemicals, and pharmaceuticals. The firm's revenues declined from $546 million in 2007 to $445 million in 2008, showing its cyclicality, but the demand for zinc isn't likely to evaporate completely, and the stock has surged since Scruggs added to his position in late 2008. The firm's balance sheet sports nearly twice the amount of cash--around $96 million--than its $55 million in total liabilities, giving it the ability to withstand tough economic times. Besides solid stock-picking, the fund's fee has just been lowered to 1.24%

from 1.35%, putting it in the cheaper half of no-load small-cap funds.

Allianz NFJ Small Cap Value (PCVAX)
This Analyst Pick emphasizes dividend-paying stocks trading at low P/E and P/B ratios. It typically will be more diversified than our other two small-cap standouts, with around 100 stocks, and will avoid overweighting any sector or industry. The investment process begins with screens to identify candidates, and then moves to proprietary quantitative modeling and qualitative analysis. One of the fund's top holdings is fertilizer-maker Terra Industries (TRA). The firm has more cash than total liabilities and has a trailing P/E of less than 5. Like our other small-cap selections, this one can look bad when the markets are roaring, but its 8.5% annual return for the past decade is stellar.

Schneider Small Cap Value (SCMVX)
Although it's an Analyst Pick, this is the most dangerous fund on our list. Arnie Schneider stumbled badly with financials and homebuilders in 2008, and this fund swooned a whopping 47%. Undeterred, Schneider has mortgage REIT Anworth Mortgage Asset Corp. (ANH) at the top of the portfolio and also owns Redwood Trust (RWT). Both of these companies appear to hold high-quality mortgages, though Redwood owns "jumbo" mortgages, which are larger loans than Fannie Mae (FNM) or Freddie Mac (FRE) can guarantee. Mortgage REITs don't only face credit risk, however. Their business is based on incessantly renewing short-term loans in order to finance the longer-term mortgages. If funding dries up, they're in major trouble. On the other hand, if financing is plentiful and the yield curve is steep (meaning that there is a significant difference between short-term interest rates and long-term interest rates), the profits can be big. This fund isn't for the faint of heart.

Large-Cap Funds Holding Moats

Sequoia (SEQUX)
This Analyst Pick is a fund that Warren Buffett recommended to his partners when he unwound his original partnership. Sequoia was founded by his business-school classmate and fellow Graham student, Bill Ruane, who died in 2005 but who had already given over the reins to Bob Goldfarb. Like Buffett himself in the second half of his career, Goldfarb prefers wider-moat stocks trading at decent prices than more cyclical fare trading at ultracheap prices. In addition to maintenance-products provider Fastenal (FAST), veterinary pharmaceutical firm Idexx Laboratories (IDXX), and logistics provider Expeditors International of Washington (EXPD), all of which sport prodigious returns on invested capital, the fund owns a big slug of Buffett's Berkshire Hathaway.

Jensen (JENSX)
The Jensen fund owns companies that sport 10 straight years or more of 15% or higher returns on equity. There are few surer signs of a moat or competitive advantage than a firm's ability to achieve such high returns for an extended period of time, and Jensen doesn't mess around. If a firm fails to hit the 15% mark for one year, it is immediately eliminated from the portfolio, under the suspicion that its moat has eroded, and must prove itself for another decade before it can be considered for purchase again. As one might expect, the fund is stuffed with name-brand consumer products makers such as PepsiCo (PEP), Coca-Cola (KO), and Colgate-Palmolive (CL) along with pharmaceutical firms Johnson & Johnson (JNJ) and Abbott Laboratories (ABT).

Dreyfus Appreciation (DGAGX)
Dreyfus Appreciation, managed by Fayez Sarofim & Co. in Houston, has now beaten the S&P 500 Index for more than a quarter of a century by owning mostly consumer products and energy firms. Coca Cola, Nestle (NSRGY), and Proctor & Gamble (PG) rub shoulders with ExxonMobil (XOM) and Chevron (CVX) in this stalwart. The fund also isn't afraid of an occasional technology name, such as Apple (AAPL), that management thinks will create products that have a lock on consumer tastes for the foreseeable future. Once this tax-friendly fund snags a wide-moat stock, it almost never lets go, as its minuscule turnover--less than 10% per year over the past decade--indicates.

John Coumarianos is a fund analyst with Morningstar and editor of Morningstar's *American Fund Family Report*, a monthly newsletter that offers independent guidance on the fund family and helps investors find the best American funds. He welcomes e-mail but cannot give investment advice. Meet Morningstar's other investing specialists.