

CHAPTER 1

A TALE OF TWO MARKETS

When I finally go to stand on this spot, it just reaffirmed a lot of my beliefs about what good investing is all about. Stocks are more than just ticker symbols. They represent companies that exist in the real world of blood and sweat and tears. They have real assets that you can touch and smell and count and, in this case, walk on.

I was in Buenos Aires, Argentina, standing on some of the most valuable raw land remaining in the city—a parcel of land called Santa Maria del Plata. It was a beautiful day. The sky was a cornflower blue with big puffy white clouds and a bright yellow sun. A soft breeze blew in from the brown waters of the Rio de la Plata.

In the background, you could see the busy cranes at work in nearby Puerto Madero—a revitalized port now lined with shops and cafés, with tall office buildings making up a sparkling skyline. A five-minute cab ride and you could be in downtown Buenos Aires.

It was a great location. If you look at an aerial map of Buenos Aires down near the river, you can see two significant areas of green. One is a park and preserve. The Argentines will never develop it. The second, though, is this piece of property I stood on. The future of Buenos Aires development was right here.

In October 2006, only four months before I visited Argentina, I recommended the shares of the company that owned this land, Investments and Representations, or IRSA for short. The value implied in this land, based on what private buyers and sellers were paying, more

than covered the value of the stock in the public market. And IRSA owned lots of shopping centers, hotels, office property, and more. It was like getting the land for free.

By April 2007, the stock was up more than 40 percent. It's nice to have quick confirmation of an investment thesis.

The key insight here was simply that what was trading in the stock market—the value of IRSA's stock—did not reflect adequately the value of its assets in the private market. In other words, private buyers looking to buy the whole company would have paid a lot more than what the stock market valued IRSA's stock at.

Finding those key insights means focusing on things most investors don't focus on. Heck, most investors would never see the value of IRSA's land. It doesn't show up on an earnings statement. There's no easy way to troll for it with a computer stock screen. To discover the value of IRSA's land, investors would have to think about stocks and wealth creation in a whole different way. They would need to focus on assets and compare the value of those assets in the stock market to their value in the private market. Two markets—the public one and the private one.

I go to great lengths to uncover these kinds of deals for readers of my newsletter, *Capital & Crisis*. What I hope this book will show you is how to think about stock market values. I'll give you a framework to think about and to use and build on. You won't have to hop on a plane and go anywhere. You can start using this framework right away from your own home.

And along the way we'll cover a lot of what investment greats have done, how they did it, and the useful nuggets we can take from them. I call them “dealmakers.” *Dealmakers are people who think about stocks as whole companies, as things with real assets and cash flows that exist in the real world.*

As it turns out, this idea is part of an old playbook used throughout history. . . .

COBBLESTONES, BEER, AND BROKEN PROMISES

Jay Gould, a nineteenth-century investor, became very rich as a speculator and owner of companies. What was his secret? What was his special insight? And more importantly, is that insight something we can use today?

Gould began his career in the tannery business. He had bad timing, though, because shortly after he got started the country had another panic, and the tannery business suffered. Leather prices plummeted, and profit margins tightened.

But he didn't sell out, which is what most investors would do. Most investors have a habit of selling what's gone down and buying what's gone up. The dealmakers of the world almost never do.

In fact, Gould bought out his partner, his first big coup. It's amazing how many fortunes get started by buying stuff that no one else seems to want and hanging on until things get better. Of course, there is much more to it than that, just as there is more to a good recipe than the ingredients alone. You need to know how to use them or you wind up with a disaster in the kitchen. Investing is like that if you don't know what you are doing.

Wall Street in Gould's day was certainly no place for the unprepared. As Henry Clews observed in the first of his two memoirs:

The road to Hell is not—contrary to popular opinion—paved with good intentions. It is instead paved with cobblestones, beer and broken promises. That is Wall Street, plain and simple, the place where the faithless mingle, where dreams are shattered and fortunes lost and made.¹

That's still a pretty good description.

Gould, though, learned how to play the game. He immersed himself in studying the seasoned financiers of his day, reading financial newspapers and other material with religious dedication. It wasn't long before he reaped his first big payday, purchasing the bonds of the Rutland & Washington Railroad for 10 cents on the dollar. The R&W was a struggling line, and dirt-cheap.

In less than two years he sold it and made more than 10 times his money, netting over \$100,000—a huge amount in those days. Not even 30 years old, he was well on his way to becoming one of Wall Street's most successful players.

Now, what do we make of his story?

Charlie Munger, the witty and sometimes biting sarcastic—and funny—sidekick to Warren Buffett, likes to say, “There are answers worth billions of dollars in a thirty-dollar history book.”

I believe him. History may be an abstract teacher, but it teaches profitable lessons nonetheless. “Hindsight enhances foresight,” as James Grant, editor of the well-regarded eponymous newsletter *Grant’s*, put it.

Munger says this because the old formula still works—buy what’s cheap and hang on. But before you can understand what’s cheap, you have to understand something investors like Gould—and many others—have long understood. It’s how Gould knew the R&W was a good buy.

It is the tale of two markets.

There are two markets for stocks. I’m not talking about exchanges, like the NASDAQ or the NYSE. And I’m not talking about markets for stocks in the United States versus the market in London or some other seemingly faraway place.

I’m talking about two distinct markets whose prices for the same goods, or stocks, can vary widely at times. This variability, as you might imagine, creates opportunities for knowing investors.

The fact that two markets exist has a profound consequence for investors. It’s a fact that we’re going to vet thoroughly in this chapter. Indeed, since it forms one of the cornerstones of my entire approach to investing, we better lay it out early so that the rest of this book will make sense.

It’s so important that you may never look at a stock quote in quite the same way after you read this section.

To be more precise when I talk about two markets, I’m really referring to two markets for businesses. Stocks, remember, represent shares of a business. The newspapers print the quotes from one market every day. It’s also the one you can look up by going online and getting a stock quote. That’s one market.

But there is another market. This market consists of private transactions or transactions for whole businesses. A meaningful transaction is taking place any time one business buys another, and you should pay attention to it.

The papers don’t print these prices in their stock tables, and you can’t get them off the Internet quote systems. Yet they are every bit as real as the publicly reported stock prices.

Most people don’t appreciate this fact, so they give undue weight to the first market. That’s the one they can easily see. That’s

the one that counts when they go to buy and sell. Well, these people are making a mistake in my view. Benjamin Graham thought so, too.

Graham was one of the most important figures in investing in the twentieth century. He is widely known as the dean of security analysis. As Adam Smith (a.k.a. George Goodman) once wrote: “The reason that Graham is the undisputed dean is that before him there was no profession and after him they began to call it that.”² His books and writings were influential in teaching many how to invest. One of his disciples was Warren Buffett.

In *The Intelligent Investor*, Graham asserts that a true investor would be better off without market quotations on his stock market holdings. He writes: “[The investor] would then be spared the mental anguish caused him by other persons’ mistakes of judgment.”³ What did the great master mean by this? I think he was referring to the concept of two markets, or two prices, for the same stock.

Let me explain more about this concept.

THE REALITY OF PUBLIC QUOTATIONS

Most investors reading this book buy and sell stocks based on public quotations. If you want to buy 1,000 shares of Maltese Falcon Financial (I love those old Bogart movies!), you can do this very easily these days. You probably log on to your online broker, punch in the ticker MFF (I’m making this up by the way), and in seconds have your order filled. It’s all very easy.

You now have your 1,000 shares, which you could just as easily sell. Let me note a few things about your position at this moment:

1. You are a minority owner in Maltese Falcon Financial, an enterprise the market values at \$1 billion.
2. You are a passive owner in that you have no control or substantial influence over how the company is run or how it uses its assets—beyond the voting power of your 1,000 shares.
3. You are an outsider, meaning that you are not privy to all the information to which management is privy.

You are what is called in the trade an “outside passive minority” (OPM) investor. Although that phrase is sort of cumbersome, it’s a literal description of your position.

But your reality is not the only reality. Remember the old bit about Plato’s cave? He posited that we are all like people in a cave with a fire burning behind us as we sit looking at the shadows cast on the wall of the cave. What we see is but one reality.

Or to put it in other terms, in the investing world you are either a passenger or a driver. The OPMI is a passenger.

Now consider the other market for the same shares in the same company. This example is simplified to make a specific point. Here it is:

Let’s say Vulcan Asset Management wants to take a position in Maltese Falcon Financial (I just made up that name, though indeed there may be some new fund calling itself that).

Vulcan likes to take big bets and get involved in the companies it invests in. The guys at Vulcan think there is some hidden value in Maltese Falcon, and they feel management is not doing all it could do to realize that value. Vulcan has some ideas of its own that Maltese Falcon should pursue. Namely, Vulcan thinks that the big slug of cash in Maltese Falcon’s bank account should be used to buy back stock and that this would be the best use of Maltese’s cash because such buybacks will give the share price a kick in the pants.

So Vulcan starts to invest in the stock in pieces over several months. Unlike you, a company can’t buy all it wants at one time or the price would go through the roof. Let’s say Vulcan wants to buy \$200 million worth of stock. If it buys its whole \$200 million investment at no more than \$40 per share, it will still need to accumulate 5 million shares. On a typical day, Maltese Falcon trades, let’s say, 400,000 shares. So even if Vulcan picks up 100,000 shares a day, it will still take the company 50 days to get all it wants.

Then, too, once Vulcan buys 5 percent of Maltese Falcon, it has to file with the Securities and Exchange Commission (SEC) and publicly disclose the purchase. Now, regular folks like you and me can read about it in *Barron’s* under the section titled “13-D filings.” Not only that, but Vulcan’s competitors can see what they’re doing. All of this could affect the market price even more, especially if Vulcan has something of a reputation. When Warren Buffett buys a partial interest in just about anything, it gets written up in newspapers and magazines.

Basically, it gets thoroughly aired out in public and the price soars, making it difficult for Buffett to get any more at his price. (Most recently, Burlington Northern rose 6 percent after Buffett disclosed he had bought the stock.)

So this procedure must be a nuisance for folks like those at Vulcan, who would just love to get their full position nice and quiet.

But let's say they get their full position in, and now they own their 5 million shares or so at an average price of just under \$40. That makes Vulcan the largest shareholder in Maltese Falcon Financial. Let's say it owns 20 percent of the shares outstanding. Now management has to pay attention to Vulcan, which has some clout. It can make things happen in a proxy contest by nominating different members of the board of directors, which then can change the management team around. Vulcan can put forth different resolutions for the company to abide by. In short, it has some measure of control or influence over what happens at Maltese Falcon Financial.

INSIDE INVESTORS VERSUS OUTSIDE INVESTORS

Now let's consider Vulcan's position:

1. It is the largest single shareholder of Maltese Falcon Financial.
2. It is an active owner with some control and influence over how the company's assets are deployed.
3. It is an insider. It is privy to information and contact with management that outside owners don't have access to.

Moreover, unlike the guy with his 1,000 shares, Vulcan is not able to easily sell its shares. If it started dumping its shares, there would be a massive fall in price, and Vulcan's investment capital would be greatly impaired.

So let's summarize the differences between the two types of investors.

Instead of an outside passive minority investor, Vulcan is an inside, active, (near-) majority investor. That position is a different thing altogether, as you can readily see. There is a substantial difference between our first investor holding 1,000 shares and Vulcan.

Conversely, we might just have Vulcan buy the whole company. Let's say Vulcan makes a \$40 per share cash bid on Maltese Falcon Financial, which is a 25 percent premium over the quoted market price of \$32 per share.

The management team at Maltese takes the offer to the board of directors, and then they decide to put it up for vote among the shareholders. The shareholders accept the offer. The deal closes six months later, and Maltese becomes a wholly owned subsidiary of Vulcan. The ticker MFF is retired, and shareholders get \$40 in cash for every share of Maltese they own.

Now the question is, why would Vulcan do that? Why would it be willing to pay up to 25 percent more than the publicly quoted price?

Well, here is where things get very interesting. . . .

Let's say that Maltese has a market value on the public markets of about \$1 billion and it has no debts. In our investing approach, we call this value an enterprise value (EV), a concept familiar to many professionals and enthusiasts but not so widely used by casual investors or even media types. Basically, enterprise value is the theoretical price you would have to pay to purchase the whole business. Unlike simply looking at the market cap, EV also considers the value of debts. (I'll get into more detail about this concept and the art of valuation later.)

Let's say Maltese was trading for an EV-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio of only four times. The average investor usually talks in terms of price-earnings ratios, but the dealmaker almost never does. Again, I'll say more about this later, but just hang with me here for a minute. For now, you can think of EV-to-EBITDA as akin to a price earnings ratio, a term you are probably more familiar with. Low EV-to-EBITDA implies cheapness, and a higher ratio would imply a pricier stock—which would mean you're simply paying more per dollar of pretax earnings.

Let's also say that Vulcan knows that in the private markets companies like Maltese have been bought and sold at multiples of nine times EV-to-EBITDA. These transactions occurred with private companies. They were mostly family-owned businesses or local institutions that were bought and sold by other private companies and investors.

In any event, an EV-to-EBITDA of five for Maltese (after paying a 25 percent premium over the public market price) looks pretty darn cheap to Vulcan. So Vulcan thinks that it is getting a great deal and

that, if it wanted to, it could take Maltese and sell it into this private market and make an 80 percent gain easily on its purchase price. Because, again, the private market valuation is nine times, versus only the five times Vulcan paid. Buy for five and sell for nine. Believe it or not, you can find deals like this in the stock market—that’s what this book is about. And that’s what I do for a living—find disparities like this for my reader-investors.

In the meantime, Vulcan can run the company, pursue its strategies, and enjoy the privileges and benefits that come from owning a company.

This last point is important. The issue of control has an impact on price. Normally, you’d be willing to pay more for a business you can control versus one in which you are simply a minority investor. Control, however, is not always a plus. When you buy an entire business, owning that business entails responsibilities as well (paying taxes, following rules and regulations, and so on), some of which may be more hassle than they are worth. Contrary to popular belief, a stock may not be worth owning at any price—especially if claims against it exceed the value of the business.

But to get back to our Vulcan and Maltese example. . . .

THE PROFIT OPPORTUNITY BETWEEN THE TWO MARKETS

Now, you might say: “Well, why the heck would Maltese accept the offer?”

In reality, they might not. Management would argue strenuously that the business is worth much more than that. But the other shareholders are not so sure and think maybe management just wants to keep their plush jobs at the company. Most of the shareholders are regular people like our fellow who owns 1,000 shares. Or they are institutional investors—mutual fund managers—who need to beat their benchmarks and don’t want to wait around. A 25 percent quick gain looks good to these kinds of investors, so they accept it. Maybe management likes the deal, too, because they are getting older and want to get paid out on their stock options. There could be lots of reasons. People make bad deals all the time in business.

Of course, management could have taken matters into their own hands a bit sooner. Maybe they should have taken that wad of cash and bought back stock—a great investment given how cheap their company looked compared to private market deals. Maybe they could have banded together and bought the company themselves and taken it private. They could have sought out a more favorable deal. Lots of things could have happened.

In this example, I made the public company the cheap one. But it can happen the other way around, too. Maybe the public company's shares are valued at nine times EBITDA, and the private companies are valued at only five. Then what happens is different. Then the private companies want public stock so that they, too, can get the windfall of profits at nine times EBITDA versus only five.

In this instance, private companies similar to Maltese will go public. There will be an initial public offerings boom in these companies, and investors will snap up shares. Conversely, the public companies may use their richly valued shares to purchase private companies outright.

But the bottom line—and the most important fact I want to establish early—is that there are two markets for stocks. Stock market prices, as quoted in newspapers and online sites, prevail in one market. And that market is tethered to another market normally made up of private and well-informed buyers and sellers.

(I say “normally,” but you should not automatically assume that private market values are always the “correct” ones. Most of the time, private transactions involve knowledgeable buyers and sellers, whereas in the public markets prices can be set by millions of Joe Blow investors who suddenly think it's a cool thing to own an Internet company or an oil company or whatever is hot at the moment.)

Much of the approach in this book is playing an arbitrage between these two markets. In other words, buying public companies when they appear undervalued versus private market values.

The difficulty is that private market values are not always easily obtainable. It often takes some digging. Plus, some businesses are easier to value than others. Some businesses are unique and involve so many different parts that it's hard to value them with private market comparables. Sometimes private market comparables are just not available and you have to make some estimate of what an intelligent buyer might pay for the whole company you are looking at.

None of this should be at all surprising. If valuation were easy, investing would be easy, too. And we know that it's not so easy. But later in this book, I'm going to show you some excellent places to look for bargains and some shortcuts you can use to think like a dealmaker.

THINK LIKE A DEALMAKER

Marty Whitman is one of my favorite investors, and you'll hear more from him in the pages that follow. He runs the Third Avenue Value Fund and has been in the business for over 50 years. He's got a great track record, and his shareholder letters (and books) are loaded with investment insights and wisdom.

On the two-market concept, Whitman writes:

These two disparate markets exist for the same commodity—common stocks. That valuations ordinarily should be different between these two markets seems obvious. After all, when valuing whole businesses the standards of analysis and the decision considerations tend to be different than when trying to predict open-market stock prices.⁴

The reality of the two different markets also means that the outside passive minority investors and the inside active control investors (“the dealmakers”) have very different standards and other considerations they use to value businesses. Indeed, the dealmakers are conceptualizing those two markets in a different way.

Part of my recommendation to you is that you adopt this dealmakers' way of looking at things as much as you practically can. These ideas are the basis of the approach I follow personally and in my newsletter *Capital & Crisis*. Let's look at some of the ways in which dealmakers differ from typical outside passive minority investors.

WHAT'S MORE IMPORTANT TO YOU AS A CONTROL INVESTOR?

The control investors care more about the long term. After all, they are going to buy a business or take a large interest in a business, and as we've seen, they can't leave either of these positions very easily. This

forces them to think more about the long term. What is the long term? It is usually a period of at least several years.

When control investors look to buy a business, they care less about the immediate performance and more about the long-term performance. They are cognizant of the risk of overpaying for a star that has one good year. In my banking career, we always looked back at how a business had performed over a period of several years to get a sense of how it performed in a variety of environments and conditions.

Control investors care more about the whole picture of the business and are not fixated on earnings per share. Companies may own other assets that make them attractive to own (like IRSA with all of its raw land). Or they may have certain liabilities that make them less attractive. The dealmaker looks at the quality and quantity of resources in a business and thinks about what can be done with them. The dealmaker's focus is on building wealth.

Perhaps the most important point about thinking like a dealmaker is that it gives you a different perspective on the stock prices quoted in newspapers and available on your computer. You know a little about how those prices come about, and knowing this, you may understand why many great investors tend to view market prices not as something to predict but as something to take advantage of.

Think back to the Ben Graham quote at the beginning of this chapter. He wrote that investors would be better off without stock quotes because that way they would “be spared the mental anguish caused him by other persons’ mistakes of judgment.”⁵ What did he mean by “other persons’ mistakes in judgment”? Well, here he is articulating the profound idea that has become the basis of all intelligent investing: *quoted market prices are but one opinion of value.*

This is not a new idea. A man name John Burr Williams wrote a hefty tome called *The Theory of Investment Value* back in 1930. In this book, Williams wrote eloquently about stock quotes being merely opinions of value set at the margin. Let's hear from Williams himself:

Concerning its true worth, every man will cherish his own opinion; as to what price really is right, only time will tell. . . . [T]he market can only be an expression of opinion not a statement of fact. Today's opinion will mark today's price; tomorrow's opinion tomorrow's price; and seldom if ever will any price be exactly right as proved by the event.⁶

After laying out how stock market prices are opinions of value, Williams rolls into the dynamics of explaining the power of the *marginal opinion*:

Both wise men and foolish will trade in the market, but no one group by itself will set the price. Nor will it matter what the majority, however overwhelming, may think; for the last owner, and he alone, will set the price. Thus the *marginal* opinion will determine the market price.⁷

Think of it this way: You live in a neighborhood of 300 homes where everyone thinks the value of a house there should be \$400,000—except one guy, who sells his for \$375,000. He is the marginal opinion. So guess what price gets recorded in the real estate transactions page of the local paper? Do you panic and sell your house because the guy down the street sold his for less? Of course not. You have your own feeling for the value of your home and your neighborhood.

This is a highly simplified example, of course, but markets are like this. The marginal buyers and sellers set prices. And marginal buyers and sellers enter into transactions for all sorts of reasons, not all of them good or even rational.

Stock prices can rise even though the underlying business is getting weaker. And stock prices can fall even though the underlying business is getting stronger.

As Seth Klarman—president of Baupost Group and another great investor we’ll hear more from in these pages—notes, “It is vitally important for investors to distinguish stock price fluctuations from underlying business reality. If the general tendency is for buying to beget more buying and selling to precipitate more selling, investors must fight the tendency to capitulate to market forces.”⁸

In other words, don’t let market prices dictate your actions. It’s for this reason that I oppose the use of stop-losses—investors mechanically selling a stock because it has fallen some prescribed amount. For example, some investors automatically sell out when a stock falls 25 percent. Bad idea in my view. (We’ll be tackling the subject of when to sell in a later chapter. Having a good sell discipline is very important, and I’ve devoted an entire chapter to the topic). “Value in relation to price,” Klarman continues, “and not price alone, must determine your investment decisions.”⁹

The takeaway here is the importance of viewing market prices as the settled transactions of marginal buyers and sellers. That's all they are. They represent opinions of value at one point in time.

Put in this light, there is no reason to be worshipful of stock market quotes. They are simply prices to be taken advantage of or ignored, as the case may be. This is what the old master Benjamin Graham meant when he said the average investor would be better off without constant stock quotes—because the average investor makes too much of these prices.

This is not to say that you don't need to care about risk. The approach in this book is highly sensitized to risk. But the safety of an investment is measured in ways other than looking at the stock price.

Sound strange? Just hang in there and we'll get into a discussion of this measure of safety in the very next chapter. I assure you that after reading it, you'll think about safety and risk differently from now on.

These few points are important elements of my approach to investing. We'll talk about others in the rest of the book.

WHAT'S LESS IMPORTANT TO YOU AS A CONTROL INVESTOR?

If you're thinking like a dealmaker, notice the things that have now become less important to you.

(Warning: These next points might be shocking, offensive even. So have a seat, grab a nice drink, and try to relax. It all fits as part of the whole, but sometimes we have to clear away some of the brush before we can grow something new.)

You Don't Care about "Technical Factors"

That is, you're not really interested in "what the charts say." I can tell you from over a decade of making business deals as a corporate banker and over a decade as a financial writer that dealmakers don't consult stock charts. In my personal observation, no one thinks about charts except people who have come into the market first as traders. I can think of no business sale or transaction I've ever done or seen that involved people trying to determine when they would buy (or sell) by consulting a chart.

Put another way, you're more likely to think the charts hold some answers for you if you've never negotiated a business deal, never had to sell assets to raise money, or never managed a portfolio of businesses.

But chart readers don't see the tether that connects stock prices to the real world of flesh and blood and sweat and toil. They don't see the two markets—they only see the one. The quoted market prices are all-important to them; they take their cues from the action they see.

This is important, and unfortunately for many readers, this will be the hardest hurdle to get over because we see charts and chart readers everywhere. They are on the Internet, on the radio, and in magazines and newspapers. They sell books and speak at conferences and have great promotional copy telling you how you can turn a little money into a lot by watching Japanese candlestick patterns or other such tricks and patterns.

For these traders, charts are great. They can have a seemingly intelligent opinion on just about any stock just by running through some of their favorite charts. These people are speculators. They are short-term in-and-out traders. They are playing a whole other game than the people you will read about in this book. The approach I'm encouraging you to adopt is entirely different in its thinking and its foundations.

I'm not going to spend any time refuting chart reading. Some people use charts and fit them into an overall trading scheme, and that's fine. (Hey, some of my best friends are traders!) It's just not what this book is about.

So, in the words of the great Raymond Chandler's fictional detective Philip Marlowe, "Do I have to be polite? Or can I just be natural?" The hard-boiled, perhaps even rude, advice I have for you is this: Forget the charts.

You Don't Care as Much about the Big Picture

Most typical OPM investors love the big picture. They are very interested in what people think about where the economy is going, or what interest rates are going to do, or what the price of oil is going to be, among a myriad of other macro variables.

This is often called the top-down approach: an investor tries to think about the big picture (Are we entering a recession? Will

consumer spending rise?) and then draw conclusions from that (U.S. stocks should rise; retailers should do well). They start at the top and work their way down until they find investments that fit with their big-picture view.

Relying on this kind of analysis is fraught with risk. You have to get many parts right for it to work consistently well. The investment approach in this book has fewer moving parts and a built-in margin of safety that is simply missing from the big-picture approach.

Klarman says it best:

There is no margin of safety in top-down investing. The top-down investors are not buying based on value; they are buying based on a concept, theme or trend. There is no definable limit to the price they should pay, since value is not part of their purchase decision.¹⁰

The type of investing advocated here is a bottom-up strategy. The distinction is really one of emphasis. I write about big-picture stuff quite often, but when it comes to committing hard-earned money to an investment idea, I'm far more interested in the nitty-gritty details of the situation at hand.

The bottom-up investor understands and assesses value. He does this primarily by looking at the specifics of the investment under consideration. These specifics take precedence over his view of the economy at large. They trump his views on the market. He simply buys when he has found adequate values and refrains from buying when he can't find any.

Again, here is Klarman:

Paradoxically a bottom-up strategy is in many ways simpler to implement than a top-down one. While a top-down investor must make several accurate predictions in a row, a bottom-up investor is not in the forecasting business at all.¹¹

The whole strategy, Klarman writes, can be summed up as simply "buy a bargain and wait." As long as you have the tools and skills to assess value, you should come out ahead in the end—regardless of where the market is going at any particular time.

Control investors don't care about what they or anyone thinks about where the economy or market is headed. They make their decisions

based on real-world factors and values that they see and understand and that are sitting there right in front of them. They are more interested in understanding the business they are investing in than the big picture. They are not in the prediction business. The investment approach in *Capital & Crisis* and in this book follows their lead.

You Care Less about Factors Like Earnings per Share, Price Earnings Ratios, and Consensus Forecasts

Again, typical OPM investors seem to talk about earnings about 90 percent of the time. If the average investor knows anything about a stock beyond its price, it's probably the last earnings per share number. For this reason alone, you should want to look at other things.

The truth is that this is the most manipulated number in the whole constellation of numbers an investor could look at. But more importantly, earnings don't necessarily capture the most essential element of a business—which is whether or not it is making money.

It may sound strange, but it's true.

Let's take a simplified example to show how this happens. Say a company makes a sale of \$1 million and a profit of \$300,000 on that sale. For purposes of accounting, it books the \$300,000 as earnings (as it should), even though the company has not collected any cash.

This is common in business. You make a sale like that and you give terms. Maybe you get paid in ten days, which is great, but there is still a window during which you've booked a sale and profits and haven't collected any cash. Now, multiply this by the millions of sales the company makes in a year.

A business will always have an amount piled up in "money to be collected." This is called accounts receivable, and you can easily find it on a company's balance sheet.

In my banking career, we were acutely aware of the difference between earnings and cash flow. We had a saying: "Earnings don't repay loans—cash flow does." It was a reminder to always look beyond earnings and figure out the cash flow—the cycle of collections and disbursements. At times those cycles can vary widely; in fact, a company that otherwise appears profitable can suddenly find itself in a cash crunch.

Worse, you could end up like Lucent Technologies. Lucent made lots of sales and gave generous terms so it could keep booking those

profits for Wall Street's benefit. It kept meeting earnings targets and showing nice growth, but meanwhile its accounts receivable were ballooning. Lucent wasn't collecting the cash nearly so well as it was booking sales!

So what happens? At some point you have to write off the uncollectible receivables. Lucent's customers started to get in trouble themselves and stopped paying their bills. Some went out of business entirely. All those pretty earnings had to be reversed out. That means the company reported losses. Suddenly, those earnings per share targets went out the window. The market took down the stock. It went from over \$80 to under \$5.

All it would have taken was a small effort to pay attention to Lucent's cash flows rather than its earnings, and you would have been out of that stock well before the rest of the market even knew what was going on.

That is why you pay attention to cash flow.

But paying attention to cash flow is more than just a protective measure—it's also a way to find real gems. We'll go into more detail about this part of the equation later in the book.

The consensus earnings estimates are something else investors seem to hang on with bated breath. I would urge you not to participate in the guessing game of trying to play on quarterly earnings numbers. If you follow the approach in this book, you won't worry about the quarterly numbers. You can relax a little bit more, go out and enjoy the day, and worry a lot less in general. Trust me, you will. You'll be more confident in what you own and why you own it and about what it's worth, and you won't care who knows it.

You Care Less about Dividends

Another shocker. There are a group of investors out there who, after asking about the price and price-earnings ratio, ask what the dividend yield is. If you to want think like a dealmaker, this is how you think about dividends: Dividends are a way for a company to pay shareholders some of the cash it has earned in its business. Dividend yield is just another factor in the analysis, and one to which a dealmaker gives no special weight.

The key question is this: How well is management allocating its resources? A company that borrows money to meet its dividend

payment is probably not making a wise decision. Dividends are best paid with surplus cash flow that the business cannot put to good economic use.

So here is the assessment that needs to be made. Is management reinvesting in good projects or in a good business that is likely to create more cash for shareholders and for the business in the future? In other words, are they coming to decisions that make good use of precious resources?

One thing investors have to keep in mind is that management teams attain their position because of expertise—usually in their chosen industry. As Louis Lowenstein points out in his book *Sense and Nonsense in Corporate Finance*:

The fact that a management team has one set of skills does not mean that it also has others or that it is wise to pay a substantial premium over market, as it must usually do, to acquire a business that, if the same funds were distributed, the shareholders could purchase on their own.¹²

Said differently, great managers are not necessarily *also* great investors. Sometimes you find companies with great managers and great investors. They are rare and usually worth hanging on to. One example would be Bruce Flatt at Brookfield Asset Management (formerly Brascan). I admire what Flatt has done with Brookfield, and I feel that his company is like a Berkshire Hathaway. You can hang on to it for a long time.

BROOKFIELD, BRUCE FLATT AND THE BRAZIL-CANADA CONNECTION

The old Brascan had roots stretching back to 1899, when it was engaged in the electric power and transit business in Brazil. It was started by entrepreneurial American and Canadian engineers and investors intrigued by the potential for railway and hydroelectric profits in that country of perpetual promise—Brazil.

Its operations, in Sao Paulo and Rio de Janeiro, were combined in 1912 to form the Brazilian Traction, Light, and Power Company. Though all the

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BROOKFIELD, BRUCE FLATT AND THE BRAZIL-CANADA CONNECTION (*continued*)

action was in Brazil, the headquarters were on King Street in Toronto. Known simply as “the Light,” it grew to occupy a prominent place in Brazilian business life. The Light would earn gobs of money and cruise through six decades of Brazilian politics unscathed.

Dubbed “the Canadian Octopus” for its many interests in Brazil, the outfit employed almost 50,000 people in the 1940s and supplied electricity, water, transit, and telephone services to a sprawling network of customers.

However, a series of populist political movements in the 1960s seeking to nationalize the country’s industries soured the business environment in Brazil, turning profits into losses. After years of negotiation, the company sold parts of the business to the Brazilian government.

With the proceeds (due in installments over a period of years), the company made its first Canadian investment, buying shares of Labatt Brewery. It was the first of many. The name was changed to Brascan in 1969 (by combining the first syllables of Brazil and Canada) to better reflect the growing emphasis on Canadian investments while still retaining a link to its unique heritage. Even now, the company has hydroelectric power plants and other real estate in Brazil.

By the 1980s, Brascan had grown into an unwieldy conglomerate of widely disparate businesses that seemed to be involved in nearly everything—beer, insurance, metals, oil, financial services, forestry products, and more. Its complex financial structure mirrored its scattershot portfolio of businesses, and its balance sheet was laden with mounds of debt. At its peak, the company represented nearly one-third of the entire market capitalization of the Toronto Stock Exchange.

Brascan was a bit late to the conglomerate party, which was a hot investment idea in the 1960s. Investment writer John Train called the boom in conglomerates “one of the most elaborate and most expensive (countless billions of dollars) deceptions ever perpetrated on investors.”¹³

The idea of a conglomerate is based on several flimsy theories. Among them is the idea that you can buy lots of businesses using debt and show great gains in earnings with each new acquisition (via the magic of accounting, often called “cooking the books”). The problem with this theory, of course, is that it resembles a Ponzi scheme.

Eventually, you just have too much debt when the hard times inevitably come. Then you are sunk.

Another problem then, among many, was the idea that you could find a management team that could skillfully manage, for example, a beer business, an insurance company, a metal miner, and a restaurant chain—all at once. When the conglomerates fell apart in the late 1960s, investors lost a bundle and quickly came to distrust conglomerates as profitable investments, though there were notable exceptions (such as General Electric). Investors, though, forget, or perhaps they just don't read history.

While Brascan was following the blueprint of these dead conglomerates from the 1960s, investors seemed to think this story would end differently. Maybe Brascan's management team would be one of the exceptions and play the game better than its financial forebears. But management, however skilled, can't beat back debt without cash.

The Transformation of an Ugly Conglomerate

The enormous debts the company piled up in building its sprawling empire did the company no favors during the real estate collapse in the early 1990s, which brought Brascan under the heels of its creditors. Brascan had to sell off assets quickly to raise cash and survive—not the best way to get value for what you are selling. Though the company narrowly avoided collapse, investors were badly burned in the process, and Brascan shares fell out of favor.

So in the mid-1990s began the long rehabilitation project, which prominently featured a sort of decade-long yard sale designed to slim down and simplify the overwrought empire. These actions achieved much more than that, *as the company today is totally transformed*. Gone are the beer business, the insurance business, the oil companies, and a host of other noncore and underperforming investments.

The man behind much of this transformation has been Bruce Flatt, who took the top job at Brascan in 2002, completing a turnaround his predecessor began. Flatt's vision for Brascan, which he repeats often, is one of a simple company running office buildings and generating power. With billions of dollars in proceeds from these kinds of sales, the company has reinvested much of it in prime real estate and power plants. It still sits on a mountain of cash.

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BROOKFIELD, BRUCE FLATT AND THE BRAZIL-CANADA CONNECTION (*continued*)

The folks at Brascan like to refer to their company as an asset management company. It's not hard to see why, since the company owns a variety of assets, some of which seem not to have much to do with one another. However, there is a grand plan here, a neat logic interlocking the company and its future direction.

Flatt, before taking the top job at Brascan, was president of Brookfield Homes and led its transformation from a hodgepodge collection of industrial, retail, and office properties into a glimmering portfolio of class A office properties in leading cities, including Manhattan's World Financial Center (which was damaged in the September 11 attacks), Toronto's BCE Place, and Calgary's Bankers Hall.

Given Flatt and his team's track record so far, I wouldn't want to bet against them. In fact, Flatt and many of his senior executives are also shareholders in about 17 percent of the company. They refer to themselves as partners and work in open spaces, as opposed to individual offices. One of Flatt's heroes is Warren Buffett. Indeed, he has several Buffett-like qualities—he still drives around in a 1996 Ford Explorer and has a reputation for being something of a miser. He thinks long-term (“We’re running this place looking out a decade or more,” he says) and personally owns 4.7 million shares, worth over \$160 million. (“I’ve never sold a share,” he says.)

But the most Buffett-like thing about him may be his investment performance. Since Flatt became CEO three years ago, the average annual return to shareholders (including dividends) is nearly 30 percent.

This piece was originally published in the March 2005 issue of *Capital & Crisis*.¹⁴ As I write, Brookfield Asset Management is still a core part of the C&C portfolio and a solid long-term holding. But the point here is that Flatt appears to be a solid manager *and* a good allocator of capital. He thinks like a good investor ought to.

THE CONCEPT OF OPPORTUNITY COST

The concept of *opportunity cost* simply means that by doing one thing, you forgo the opportunity to do another thing. When you play golf one afternoon instead of staying home and watching the football game, your opportunity cost is the football game. You are going to miss it and play golf instead. You have only so much time. Corporate managers have to make these kinds of decisions all the time with the limited amount of resources they command. They have to decide which actions to pursue and which to forgo. The dividend policy process ought to be part of that thinking.

The bottom line here is that we are not looking for businesses that pay high dividends today. We may find a good investment opportunity that also pays a high dividend, but we are not actively seeking high dividend payers. There is a difference there I hope you will see.

WHAT COMPANIES DO WITH THEIR CASH

Charlie Munger likes to use a schematic that includes no-brainers, gold mines, cash cows, and cash traps. A *no-brainer* is an investment you must make if you are to have any chance at success. This kind of investment includes the usually basic investments you must make to keep your business running smoothly. The losses from not making these investments would be too much to take. The *gold mines* are investments that are expected to produce substantial returns for a long period of time. A *cash cow* requires some minimal investment to keep the cash coming, but in this investment you expect the cash eventually to peter out. And finally, *cash traps* are those investments that require lots of investment but throw off less than they required. Cash traps are the kinds of investments we don't want to see our companies making.

Many companies hesitate to pay a dividend because they see it as some sort of admission of failure. They see paying a dividend as telling the market, "Our business has no good investment opportunities with its cash, and the best we can come up with is to pay a dividend." It may be okay for a while to just let the cash pile up—but doing so is likely to make such a company the target of activists. You should avoid management teams that routinely splurge on pricey acquisitions.

Deciding what's what is not always easy or clear-cut. But these are the kinds of ideas we keep in mind in thinking about how a company uses its money.

Ultimately, we want to get money out of the investments we make. You would never invest in any shares if you did not expect that at some point you and the other shareholders were going to get a piece of the money earned.

BUY WHOLESALE, SELL RETAIL

Here are a few real-world examples to help you understand the two-market proposition in action.

It's about playing Wall Street against Main Street, as rarely do they agree about the price of anything. Sometimes Wall Street values certain assets above what private investors would pay. At other times Wall Street prices out-of-favor assets well below what private investors would pay.

Whenever I discover assets in the stock market that are selling for deep discounts on their real-world values, I have usually discovered a compelling investment opportunity . . . as I did in October 2004.

Back then the stock market was assigning an insultingly low valuation to the shares of Orient-Express Hotels (NYSE: OEH), an owner and operator of luxury hotels, restaurants, and tourist trains. By buying OEH stock, you were paying far less for comparable hotel assets than what private market buyers were paying for similar properties. Not only that, but hotel properties of all types had been commanding ever-higher prices in 2003 and 2004. The average price per room for luxury hotels in 2004 was about \$140,000 and climbing (see Figure 1.1).

Super-luxury hotels of the sort that Orient-Express owns were commanding a multiple of that price. Orient's Hotel Cipriani in Venice, for instance, is one of the world's finest hotels—fitted with precious marble and stucco. Room rates were as high as \$5,000 per night, and industry experts estimated that the 103-room hotel was worth at least \$1 million per room. That was just one asset in OEH's portfolio.

Looking at transactions for super-luxury hotels could give you a better sense of this market. The Four Seasons in Maui sold for an estimated \$740,000 per room in 2004, for example. Yet the stock market was valuing Orient-Express at only \$226,000 per room in 2004—not including the value of its interests in three fine restaurants and luxury trains.

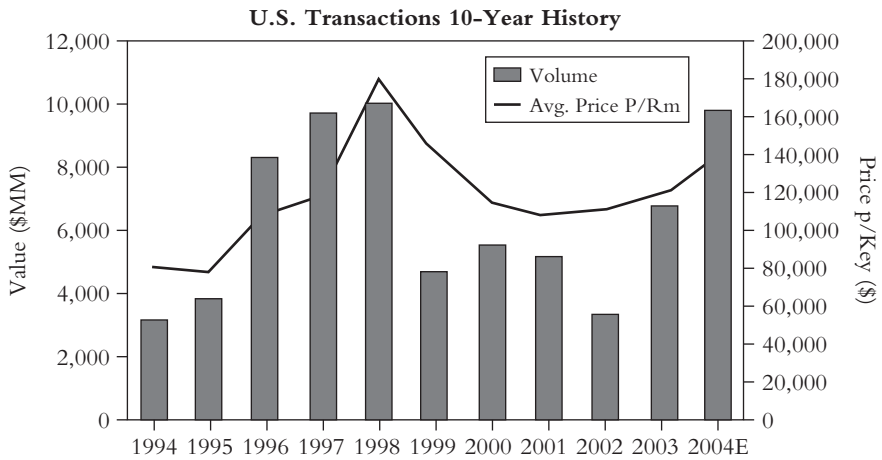


FIGURE 1.1 Ten-Year History of U.S. Transactions

Reprinted from Chris Mayer, "The World's Most Exclusive Hotels," *Capital & Crisis*, no. 8 (November 2004).

So I recommended the stock to my subscribers. After more than doubling in price over the ensuing 18 months, Orient-Express shares are no longer cheap. In fact, they look quite pricey indeed, which is why I urged my *Capital & Crisis* subscribers to book their profits and await the next opportunity.

When I sold it, Orient-Express traded at an EV-to-EBITDA ratio of nearly 25 times. The stock had gone up a lot, and now it was expensive. The value the stock market put on Orient-Express was nearly double what control investors paid for hotel assets at the time. For example, Hilton Hotels Corporation agreed to purchase the hotels of its European namesake for about 12 times the estimated 2006 EBITDA.

And many people thought that was high. I realize they are not truly comparable properties. Nonetheless, the gap is huge. This kind of analysis—taking a look at private transactions and the prices that control investors are paying—is extremely useful for figuring out what's cheap and what's not. *Most investors only compare publicly traded companies to other publicly traded companies—entirely neglecting this important "second" market for stocks where prices are determined by well-informed buyers and sellers.*

Another interesting example of the private-public market arbitrage involves Intrawest (NYSE: IDR), an owner and operator of ski resorts,

including the highly prized Whistler Mountain operation. I recommended the stock in April 2005 when it was trading at an EV-to-EBITDA multiple of only 6 times. The private market was swapping comparable properties for 11 times and greater. For example, Intrawest sold its majority interest in the Mammoth Ski Resort to Starwood Capital for 11 times its EBITDA.

One year later the stock was up 80 percent since my initial recommendation—and a private equity firm, Fortress Capital, eventually bought the whole company.

I'll leave you with one other example. I recommended NewAlliance Bancshares (NYSE: NAL), a Connecticut-based thrift, in *Capital & Crisis*. The price-to-tangible book ratio—a commonly cited ratio when dealing with financial institutions—was only about 1.8 times for NewAlliance.

If you compile a list of recent transactions for thrifts and banks, you'll see that the acquisition multiple paid was closer to three times the tangible book. Table 1.1 shows the top deals in 2005, limited to banks in the New England and mid-Atlantic regions.

Table 1.1 is limited to deals of at least \$100 million. Smaller transactions get smaller multiples. But even if you include all of them, the average price-to-tangible book ratio paid is about 2.5 times.

TABLE 1.1 2005 Deals with New England or Mid-Atlantic Target

Buyer/Target	Price/Tangible Book Announcement
Sovereign Bancorp. Inc./Independence Community Bank Corporation	3.46
TD Banknorth Inc./Hudson United Bancorp	4.46
New York Community Bancorp/ Atlantic Bank of New York	1.80
Fulton Financial Corporation/ Columbia Bancorp	3.24
Susquehanna Bancshares Inc./ Minotola National Bank	2.06
Willow Grove Bancorp Inc./ Chester Valley Bancorp Inc.	2.74
UCBH Holding Inc./ Great Eastern Bank	3.36

Data from SNL Financial.

NewAlliance is a substantial bank, the fifth-largest in Connecticut, which is a desirable and affluent market. Even if you use only the 2.5 times tangible book, you get a price of around \$20 or \$21. That's nearly 40 percent higher than the market price of \$14.51 at the time. The bank is overcapitalized, which is one reason it has been buying back its stock and boosting its dividend.

This one we sold for a small profit. You may wonder, then, why would I include this example? Well, nothing works all the time. You should know that up front. The approach to investing I use produces a high batting average, but no one bats a thousand. What I aim to do is keep my mistakes small and my profits large. Over time I know I'll come out ahead.

All the stocks I've mentioned provide an opportunity to profit from the pricing disparities between public market values and private transaction values. So whenever you're trying to buy stocks cheap, you can't afford to ignore what's happening in the private markets. Whenever Wall Street and Main Street disagree, opportunities emerge.

POSTSCRIPT

To keep it simple, I'm sticking with the two-market schematic in this book. In the real world there are actually more than two markets. For example, there is the liquidation value of a company's assets. This is the value of a company if you sold it off in pieces.

A Third Market: Liquidation Value . . . and Benjamin Graham's "Net-Nets"

Benjamin Graham liked to look at stocks that were selling in the market for less than their liquidation value—in other words, stocks so cheap that if the company were shut down and sold, investors would still make money. Not a lot of businesses meet that criterion.

Graham called these stocks "bargain issues" or "net current asset stocks." Today we often call these stocks "net-nets." Graham thought that if an investor could limit himself to buying 30 such names, he ought to do real well.

In fact, it was so obvious to the great master that he seemed almost embarrassed to say so. "It always seemed, and still seems," Graham wrote, "ridiculously simple to say that if one can acquire a diversified

group of common stocks selling for less than the applicable net current assets alone—after deducting all prior claims, and counting as *zero* the fixed and other assets . . . the results should be quite satisfactory.”¹⁵

For more than 30 years, this simple formula served Graham well. The problem, however, is that net-nets are a rare fish. Even Graham admits that running his screen did not always produce many ideas. Running the net-net filter in 1968, for example, would have brought in “only a handful, at most, of such issues.”¹⁶

Most of the net-nets were troubled companies that investors hated, and that was why they were trading where they were. That was also why Graham’s “formula” was able to work. It went against human nature. People read his ideas, they understood them, but they couldn’t follow them.

As with religion—we may understand the Ten Commandments, but there are just too many temptations—the vast majority of investors may understand a sensible approach but will not be able to stay on the righteous path.

Sometimes Graham’s beloved net-nets required stoic patience on the part of the investor to make good on the cheap shares. In writing about them, Graham warned readers not to lose patience with them if they didn’t immediately rise in price. “Sometimes the patience needed may appear quite considerable.” He related his experience in holding a net-net for three and a half years and making 165 percent—a 47 percent annual return. But almost the entire gain occurred in the fourth year. “Most of the bargain issues in our experience have not taken so long to show good profits,” Graham confided.¹⁷ But the lesson is there.

Net-nets are all but extinct on today’s major exchanges. After all, Graham hatched the idea in the 1920s and applied it during the Great Depression, when cheap stocks were rather plentiful. The world is different today.

In my banking career, this liquidation value could also be an important number. But for investors, given the kinds of businesses they look at, liquidation prices seldom come into play.

Still, while true net-nets are extremely rare in the current market environment, the idea is still sound. We’ll take a look at a variation of Graham’s approach to finding winning stocks in Chapter 4.

So, let’s leave this digression and get back to the two-market model for stocks. Once you understand and buy into the idea, other investing concepts—like margin of safety—start to make a lot more sense.