Enduring Principles of Value Investing

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In this interview, Kim Shannon, CFA, president of Sionna Investment Managers, talks with legendary investor Charles H. Brandes, CFA, chairman of Brandes Investment Partners, L.P., about his 40 years of unwavering global value investing. In addition to key lessons on implementing a value investing philosophy, Brandes discusses the current market environment and investment opportunities.

At the Equity Research and Valuation 2014 conference in Boston, Kim Shannon, CFA, of Sionna Investment Managers discussed global value investing with Charles H. Brandes, CFA. With 40 years of experience as a global value investor, Brandes, chairman of Brandes Investment Partners, L.P., shared his personal career history, his investing philosophy, and the risks and benefits of global value investing.

Kim Shannon, CFA: I would like to begin by noting that you did not start your career on the buy side. Is there a story about your career transitions?

Charles H. Brandes, CFA: Well, it was somewhat serendipitous. The overall stock market was down 45% from top to bottom in 1970, which was understandably debilitating to investors, and there was very little activity in our office. An older gentleman walked in to open an account. When he told me his name, I knew who he was—Benjamin Graham, the father of value investing and a teacher of Warren Buffett, who had already done pretty well in investing.

He purchased a thousand shares of National Presto Industries, a company that had been an example in his most recent edition of *The Intelligent Investor*. The example had been of a net–net current asset value issue, which had been one of Graham's famous criteria from the 1930s for investing. The goal was to buy companies at a price no higher than two-thirds of their net–net current assets. Thus, the investor gets the whole company at a cost below that of its net liquid assets.

After making the purchase, I asked Graham if we could get together to talk about investing. Graham had been an instigator of the CFA designation as well as an adjunct professor at Columbia University in New York, and he taught a little at the University of California, Los Angeles, after moving to California. When I told him I would like to learn about investing, he was very enthusiastic about the opportunity to teach someone.

The things I learned from Graham were fundamental and made so much sense to me. I learned about the need to focus on long-term thinking and to think like I was the owner of the whole company—regardless of how much of the stock I owned. I also learned that it is not possible to outperform other investors if I am thinking like them. It is imperative to find a different perspective from others to obtain different results.

The end of this story is that I accepted Graham's philosophy completely at that time. I had checked the investing track records back to the 1930s of all of those following the Graham and Dodd philosophy, and they all exhibited superior long-term performance. But accepting the value investing philosophy was easier than implementing it at the time. The early 1970s was the era of the "Nifty Fifty," in which the prevalent investing philosophy was that the only stocks that should ever be purchased—and purchased regardless of their current prices—were the 50 biggest growth stocks in the world. These stocks were trading at an average of 46 times earnings, which made no sense to me after listening to Graham. Then along came 1974, and the market was down 47.5%; it was the perfect time to move to the buy side as a newly converted value investor. I started my own firm in 1974, and it has worked out very well ever since.

Shannon: I noticed in your book[1] that you have a copy of the letter you received from Graham on the opening of your firm, with his comment that this was an excellent time to start an enterprise of this nature.

This presentation comes from the Equity Research and Valuation Conference held in Boston on 20–21 November 2014 in partnership with the Boston Security Analysts Society.

[1]Charles H. Brandes, *Brandes on Value: The Independent Investor* (New York: McGraw-Hill Education, 2015).

Brandes: Yes, that was his quote in the letter. He was flattered that I was going to use the Graham and Dodd philosophy. This was in 1974, and his health was starting to deteriorate; he passed away in 1976.

Shannon: Not many firms have a 40-year track record in global investing itself. Not only were very few firms investing globally 40 years ago, but also, few have survived of those that were. How did a guy in San Diego come to do global and emerging market investing so early in the game?

Brandes: That was another circumstance that was somewhat beyond my control, similar to the visit from Graham. My very first client was a non-American who had moved to California for the weather. He said that he appreciated our fundamentalism and adherence to the Graham and Dodd philosophy, but could we not find good companies at big discounts outside of the United States? Because he was my very first client, I replied, "Of course we could do that. Value investing works anywhere in the world." We found this to be a true statement, even though we did not know it to be true at the time!

Shannon: I imagine that you must consider yourself to be a contrarian, as all good value investors seem to be. But are there not some difficult moments in being a value investor? How quickly were you tested? I know that you have been deeply invested in Japan when no one wanted to be there, as well as being out of Japan when everyone thought it was the place to be. Talk about being a contrarian investor and hanging in during the tough times.

Brandes: I do not know if I would use the term "contrarian" for deep value investors. We do not look at companies or build a portfolio just to be different from other investors. The fundamentals have to be there. As Graham taught me, it is necessary to think differently from everyone else to outperform everyone else.

Two of the important advantages of value investors over "normal" investors are patience and long-term thinking. Those traits go against our human nature. But human beings are herd animals, too. We like to be part of a group and to think that we are accepted because we are doing what everyone else thinks is right. So, value investors have to have a non-herd personality. Clients often criticize us for this characteristic because they become uncomfortable with what is happening. The clients may be worried with the concerns of the world and busy with short-term thinking in general. And the value investor may be thinking about how he can take advantage of the same geopolitical concerns that make clients uncomfortable.

You mentioned Japan as an example. In 1988 and 1989, Japan was considered to be one of the strongest economies; it was going to "take over the world," at least partially because of its superior management techniques. Japan was buying a lot of major real estate properties in the United States at this time, and Japan's market was trading in the range of 30–50 times earnings.

As value investors, we had nothing invested in Japan at the time, and people were wondering, how we could *not* be invested in Japan? Then, about three or four years ago, we began to invest heavily in Japan. At that time, everyone was concerned with Japan's aging population, its tremendous sovereign debt, its deflationary environment, and the fact that corporate management had little concern for shareholders.

Some of our institutional clients were saying, "How could you be so dumb?" And we would respond to them, "We realize all of these things, but we are also looking at the prices on very good companies trading at 35-year lows." Well, it is possible that we invested in Japan a little early, but these situations have happened in the past and will happen again in the future. Actually, we look forward to it happening because when people are really scared about what we are doing, more often than not, it is probably a very good thing to be doing.

Shannon: Moving on to valuation methodology, what are the key valuation criteria that you use to invest? What sort of companies do you avoid? How do you pick stocks at your firm, and do you ever break the rules?

Brandes: I have always expressed one basic principle to the people in our research department: Never buy an airline! But they have ignored this rule, and we have lost a great deal of money on some airlines and done pretty well on others. We try to be totally flexible while relying on basic fundamentals. We start with basic value screens, such as price to book, price to earnings, price to cash flow, and solid balance sheets. And when we identify something that may have value, it is time for our research analysts—who are industry specialists rather than country specialists—to conduct deep fundamental research from the standpoint of really understanding the company in relationship to the industry it is in and the part of the world it is in. Our analysts come to understand the markets, the technology, the balance sheets, and the long-term history of earnings. It is not that complicated, but it is intense, fundamental research.

Shannon: Do you think that valuation using value investing principles is more challenging today with the current market structure? Is it more difficult to identify opportunities?

Brandes: No, I do not think so. Whether it is high-net-worth clients or institutional clients, the human behavior of short-term thinking and acting on fear or

greed does not change. Obviously, some of the more recent developments, such as the credit crisis, put certain companies at values that, in hindsight, were ridiculously low. Now we know that if investors had purchased early in 2009, they would have made a lot of money. But markets were inefficient for all of the reasons that we know, including such things as mark-to-market accounting that forced banks and other financial firms to raise capital at very low prices. These sorts of events will continue to happen in the future, and value opportunities will continue to exist.

Shannon: Is a focus on dividend investing important to you? Are dividends or share repurchases more important?

Brandes: Dividends are not something that we look for as a basic fundamental characteristic of a business; they are a secondary characteristic. The basic fundamental characteristics include, of course, earnings, cash flows, and the necessity of reinvestment, as well as changes in technology. None of these items have anything to do with dividends, but I admit that, generally, the portfolios of value investors have a higher dividend yield than their benchmarks do. I was looking at our large-cap international portfolio today, and its dividend yield was 4.1%. So, yes, the dividends are there.

Shannon: Moving on to corporate governance, are you willing to pay more for good governance in emerging markets than in developed markets? Is it more or less critical in these markets?

Brandes: Yes, we are willing to pay more for good governance that is accompanied by good management in general and good thinking in terms of the company. We would be willing to pay more for that in either type of market but not more in emerging versus in developed markets.

Shannon: Where are you finding investment opportunities globally—Japan, Europe, emerging markets? Where are the so-called dark spaces where other investors are not looking, if there is such a thing in today's marketplace?

Brandes: Taking your last question, yes, there are such places. What is so great about value investing is that the values do not tend to disappear altogether; something is always available. We like to have the flexibility to follow value opportunities anywhere, and our clients typically provide that flexibility.

Considering simple criteria, such as price to earnings or price to book or dividend yields or decent economics, the best values today are generally in emerging markets. Although emerging markets did experience a recovery after the financial crisis, they have offered no performance at all over the past three years. We are finding some good companies that are very cheap in China and in South America. Brazil, for example, is a scary place now from a geopolitical perspective, but there are some good companies there that are very cheap.

Also, people are afraid of Europe because of the potential for recession or because of the euro, but we are finding good companies there. There are even some good values based in France. If a company has good global dispersion of sales, the euro–US dollar exchange rate will be less important.

In Japan, we were overallocated during its major rally in 2013, although we have reduced our current exposure closer to benchmark. Regarding the yen, Japanese exporters are now in pretty good shape, so we still own Japan.

Shannon: Investors are always trying to find out what allocation they should make for various categories in their portfolios. With 40 years of global investing experience, what would you suggest for the weight of emerging markets in client portfolios?

Brandes: The proportion of global GDP from emerging markets is approximately 37%. Of course, this proportion is affected significantly by such countries as China and even India. Then, look at the MSCI ACWI (MSCI All Country World Index), which currently contains only about 7% from emerging markets. Let me share an interesting statistic: Out of 100 newborn babies, how many of them are born in emerging markets, as defined by Morgan Stanley Capital International? No one is likely to guess the answer, which is 99 out of 100.

Rather than looking at emerging markets right now, I like to think of them by asking, If someone invested in emerging markets—at today's prices of approximately 1.4 times book value or 12 times earnings or 3% dividend yield—what would the value look like 10 years into the future? Emerging markets are going to continue to grow more rapidly than developed markets, so most investors should probably have a substantial allocation to them. I have more than 20% of my portfolio in emerging markets, and I am probably low.

Shannon: How would you define risk management today? How would you define it overall?

Brandes: I think what is going on today is very unfortunate and quite harmful to some investors. For many large institutions, their number one objective seems to be reducing risk, however they have defined it. Most investors seem to define risk as short-term volatility, which has little to do with true investment risk. I find it amazing that the number one objective of large institutions is *not* to provide good, long-term rates of return in building wealth for their clients. I have not seen anything quite like today's attitude toward risk in my entire career. I hear the advisers saying, "You have to be totally diversified, and you have to worry about price fluctuations, and you have to use Sharpe or Treynor ratios, and you have to be

long–short, and you have to have hedge funds, and you have to have a significant allocation to leveraged real estate as well as commodities." This attitude makes investing very complicated, and I think it is very damaging to many investors.

We have a think tank called the "Brandes Institute," and Robert M. Maynard is involved with it. Bob is the chief investment officer at the Public Employee Retirement System of Idaho, and he helps keep our think tank's focus very simple. He has conducted a study of the so-called endowment model of investing versus a simple model. He has been criticizing what Harvard University is doing with the endowment model since before its performance started to decline. Not only does he agree that it has made investing complicated, but he also states that if you look at performance over a longer period of time, the endowment model has not really provided an improvement. His research is available on the Brandes Institute website.[2]

For so many managers, it is seemingly important to be using the newest techniques. But there are really no new techniques that truly help performance; the only thing that helps performance is good, basic, fundamental, long-term thinking.

Shannon: In equity investing, there has been a huge movement toward passive investment strategies. Do you have any views on defending active management against this flow to passive, which saves on fees in a low-return environment?

Brandes: In some cases, passive management does make sense. The movement toward passive investing has been so large since 2008 that we now have had correlations between equities go to a high of approximately 85%. This situation indicates that little to no distinction is being made among assets—no distinction between companies that deserve to have more capital and companies that do not deserve to have more capital. Where do the funds come from that are managed by the big pension or endowment plans? They come from the economy and from businesses that are creating new wealth because of past capital allocations that were properly made. If these asset managers are not attempting to make proper allocations of capital in the US free enterprise economy, then they are not investing in the responsible manner they should be.

Let me pose a question: What would happen to our economy and the businesses in it if everyone invested in a passive manner?

Shannon: Yes, the big question for me in a situation like that would be, who is pricing securities accurately? Here is a question from the audience about foreign exchange: How do you, as a US dollar–based investor, incorporate foreign exchange issues into your analysis given the weak yen and euro?

Brandes: Currency risk obviously exists, especially in the short term for global investors like us. We do not believe that we can forecast currencies at all, so we do not attempt to do so. Our philosophy is somewhat controversial because some managers do and some do not, but we do not hedge against currencies. The reasons are that hedging detracts from returns over longer periods of time and it can also be quite expensive for long-term holders. We have conducted a study at the Brandes Institute concerning the difference in results in hedging versus not hedging our non-US equities over longer periods of time. Although the difference can be large in the short run, we found that it was not very significant in the long run. Recall my mentioning that we were heavily invested in Japan during its 2013 rally. Not being hedged when the yen had declined so much in value definitely hurt our returns.

But our tendency is to view currencies from a bottom-up approach. We try to understand how currency fluctuations would help or hurt a specific business. For example, we own European oil and gas investments, and many investors are worried about the relationship between the euro and the US dollar. But revenues in oil and gas are priced in US dollars, so the exchange rate should not hurt our returns. We constantly consider how our portfolio will be affected by currency movements, but we do not hedge the exposures.

Shannon: Where you are investing today, and would you be willing to invest in Russia and Brazil?

Brandes: Investing in Russia or Brazil opens an investor up to geopolitical risks. But when so many other investors are worried about those risks, the prices become so cheap that some of them become compelling values. For example, Gazprom trades at two times earnings. Lukoil—one of the world's largest integrated oil companies with great reserves—trades at four times earnings. We do not always believe everything that we read in the way of earnings, but I have found that when stocks get this cheap, the risk–return ratio is so high that it is worth it to take some of the risk.

In the early 1980s, I remember looking at the emerging market closest to our headquarters in San Diego: Mexico. I was looking at Teléfonos de México. At the time, it was public but only a small portion was publicly traded—long before Carlos Slim took it over. It was trading at 10% of its stated book value and at approximately 1.5 times its earnings. Of course, infrastructure in Mexico in the early 1980s was terrible—in some cases, it would take six months to get a phone—but at that price, it was something worth buying even if the

[2]See www.brandes.com/docs/default-source/brandes-institute/back-to-the-future-conventional-investing-in-a-complex-world.pdf.

earnings could not be fully trusted. It was clear what it was spending on its infrastructure, and investors were paying only 10% of the total cost. As it turns out, we have owned Teléfonos de México on and off ever since, and the rates of return have been incredibly large.

Shannon: What is your average holding period? Can it be less than a year?

Brandes: It can be less than a year, but only if the stock price has increased a tremendous amount in a short period of time. Our average holding period is closer to four years, so our turnover is somewhere in the range of 20%.

Shannon: How do you define risk from the perspective of concentration in individual securities? Do you take big bets or small bets?

Brandes: We tend to take medium bets. If you look at the rest of the institutional investor world, our portfolios appear to be fairly concentrated with 50–70 different positions. Over the years, there have been several studies on the issue of proper diversification. Some of the studies have stated that adequate diversification is possible with as few as 10 securities when they have no correlation. But we have found that we can handle 50–70 positions well and that it is a good way to build a portfolio.

Shannon: You mentioned that you want your portfolio managers to have the flexibility to find opportunities anywhere. Is that hard to do when your funds are assessed according to narrow or rigid style boxes or benchmarks?

Brandes: We do not let that constrain us. We explain our methods to our clients and tell them that we have used the same principles for 40 years. We know that we have to keep up with which industries are gaining and which are losing, and we have to keep up with technology. But we have been basic Graham and Dodd value investors, and we do not intend to change. If there are accounts that would restrict us in a major way, we will not take those accounts.

Shannon: Do your analysts have experience understanding local accounting rules? If not, do you address this issue when there are differences in the standards? Do the new International Financial Reporting Standards rules make it easier?

Brandes: Accounting is always a major factor for research into individual companies, regardless of what standards are being used. Many of our analysts hold CPA and CFA designations. With the advent of international accounting standards, financial statements are a little more trustworthy and may require less interpretation. But it remains vital for us to translate the accounting into what is actually transpiring on an economic basis.

Shannon: I have a final question, which is taken from an email received from you not too long ago. You stated that no matter how they evolve, country value analysts who think long term are weird, not entirely human, and unemotional about money and that they enjoy being isolated and alone. Earlier today, we heard Joel Tillinghast[3] comment that fund managers are somewhat nerdy as well. How would you respond to this?

Brandes: On 19 October 1987—the day the stock market dropped 22%—we had an SEC examiner in the office making a routine investigation. She knew us very well, was quite nice, and was closing in on retirement age. Those working in our office never pay that much attention to markets on a daily basis, so we were not aware of the market drop. The examiner came running out of the office, looking very scared and forgetting our examination to immediately phone her husband to check on their retirement assets.

At the same time, we received a phone call from Henry Emerson, the publisher of *Outstanding Investor Digest*, who wanted to know what we were doing in regard to the devastating market news. He also wanted to know how our clients were taking this. I told Henry we were not actually doing anything about the situation. He wrote this up in his *Digest*, stating that I was a really weird person. I have no direct emotions about finance. Although I may be exaggerating a little in stating this, I get happier when stock prices go down because they never stay down forever. Low prices present an excellent opportunity rather than being something to be feared.

Shannon: Thank you for sharing your insights from more than 40 years of global investing.

This article qualifies for 0.5 CE credit.

[3]Tillinghast is a renowned stock picker with a 25-year career history at Fidelity Investments.