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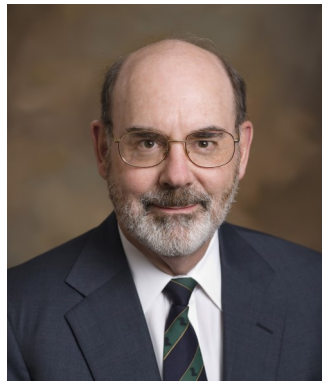


COLUMBIA STUDENT INVESTMENT
MANAGEMENT ASSOCIATION

Issue XVIII

Spring 2013

Preston Athey — Holding Winners Longer



Preston Athey

Preston Athey is a vice president of T. Rowe Price Group and has led the \$8 billion T. Rowe Price Small-Cap Value Fund since 1991. During that time, the fund has returned nearly 11.9% per year after fees, making it a superior performer among its peers. Prior to joining the firm in 1978, he was a contract administrator on Admiral H. G. Rickover's staff at the U.S. Atomic Energy Commission. Preston earned a B.A. in economics from Yale University and an M.B.A. from Stanford University. He has also earned the Chartered Financial Analyst designation and is a Chartered Investment Counselor.

(Continued on page 10)

Li Lu — Know What You Don't Know



Li Lu

Li Lu '96 is the founder of Himalaya Capital, an investment partnership focused on both public and private opportunities in Asia and North America. Mr. Li grew up in China and was a student leader in the 1989 Tiananmen Square protests. Prior to founding Himalaya Capital in 1997, Mr. Li worked in investment banking. He earned his B.A. in economics from Columbia College, a J.D. from Columbia Law School, and an M.B.A. from Columbia Business School.

(Continued on page 24)

Paul Isaac — Know Your Style and Enjoy the Ride



Paul Isaac

Paul Isaac is the founder of Arbiter Partners, a New-York based hedge fund and nephew of noted value investor Walter Schloss. Prior to Arbiter, he was the Chief Investment Officer at Cadogan Management, a fund of funds. Mr. Isaac began his career at the Allied International-American Eagle Trading Corporation. He graduated from Williams College with Highest Honors in Political Economy and was a

Thomas J. Watson Foundation Fellow.

(Continued on page 46)

Welcome to *Graham & Doddsville*



Pictured: Professor Bruce Greenwald. The Heilbrunn Center sponsors the Applied Value Investing program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners.



Pictured: Heilbrunn Center Director Louisa Serene Schneider. Louisa skillfully leads the Heilbrunn Center, cultivating strong relationships with some of the world's most experienced value investors and creating numerous learning opportunities for students interested in value investing. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.

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It is our pleasure to bring you the 18th edition of *Graham & Doddsville*. This student-led investment publication of Columbia Business School is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA).

Our first interview is with **Preston Athey**, the long-tenured portfolio manager of the T. Rowe Price Small Cap Value fund. Mr. Athey discussed how he thinks about selling stocks, something which so many value investors find to be one of the toughest parts of the profession. He also walked through the theses on a couple of stocks he currently likes and imparted other bits of wisdom gained from more than 20 successful years as a money manager.

Li Lu, founder of Himalaya Capital and annual guest lecturer in Professor Greenwald's value investing course, was gracious enough to spend time with us and detail his thoughts on investing. Mr. Li highlighted how he initially received the value investing "inoculation" from Warren Buffett himself as well as his thesis for an investment in

Chinese car manufacturer BYD. In reading this interview, we expect you will also have a sense of Mr. Li's commitment to intellectual honesty, something he believes is critical to being a successful investor.

We also had the opportunity to sit down with **Paul Isaac** of Arbitr Partners, who described the experiences and influences of growing up in a family closely tied to the value investing community. He also fielded questions regarding investing internationally - which included the discussion of a promising (if illiquid) investment opportunity among regional banks affiliated with Crédit Agricole - and the risks that potentially face markets when the Fed eventually ceases its extraordinary monetary operations.

Due to popular demand, after a two issue hiatus, student pitches are back! We are glad to be able to share with you seven great ideas from the 2013 Moon Lee Prize Competition and the 2013 Pershing Square Challenge.

With this being our last issue as editors of *Graham &*

Doddsville, we want to spend a brief moment looking back at our time leading this publication. The many interviews we conducted with successful, respected and contemplative value investors are some of our fondest memories of our time at Columbia Business School. It has been an experience we have truly appreciated from our first day on the "job". We leave *Graham & Doddsville* in the eminently capable hands of Chris Brigham, Jackson Thies and Jason Yang, and we look forward to reading the thought provoking interviews they will assemble in next year's three editions. We also want to share our great appreciation for the diligent efforts of Richard Hunt and Stephen Lieu. They did an excellent job this year and we were lucky to have them as part of the team. CSIMA will be in good hands next year with those two at the helm as co-presidents. Lastly, as always, we thank our great lineup of investor interviewees for sharing their time and insights and we thank you for reading.

G&Dsville Editors



Bill Miller of Legg Mason chats with a guest at the 2013 CSIMA Conference



Jane Siebels of Green Cay Asset Management answers questions at the 2013 CSIMA Conference

2013 CSIMA Conference—February 1, 2013 at Columbia Business School



Bruce Greenwald and Seth Klarman



Jeremy Grantham speaking with Tom Russo



Louisa Schneider presents a tribute to Ben Graham



Bruce Berkowitz during Q&A

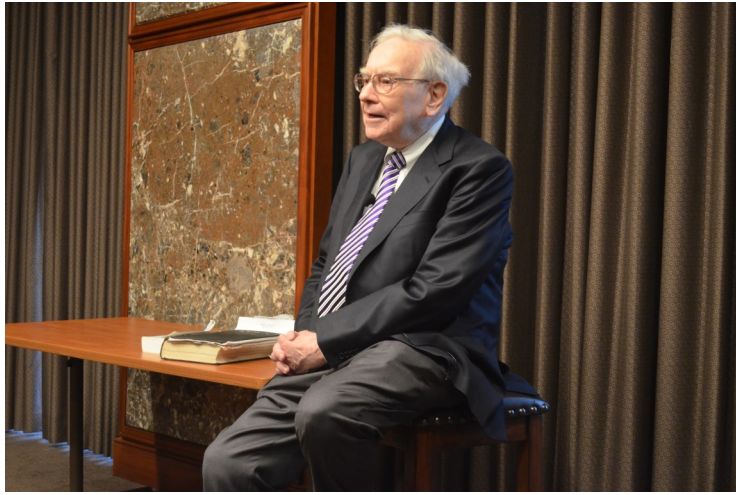


Student conference coordinators Matt Christ, Geoff Abbott, and Ashley Miller deliver opening remarks



Jean-Marie Eveillard talks with audience members in between panels

Columbia Business School Trek to Omaha — Fall 2012



Warren Buffett speaks to students visiting Omaha

An annual tradition at Columbia Business School, a group of 19 students traveled to Omaha in November 2012. The first event on the agenda was a dinner with Todd Combs '02, an investment manager at Berkshire Hathaway. Combs spent time discussing his investment approach and his in-depth research process, and took questions from students. The following day, along with other schools, CBS students enjoyed an hour-long Q&A session with Warren Buffett '51, followed by a customary lunch at Piccolo's. The trip also included a tour of local Berkshire retailers Borsheims and Nebraska Furniture Mart.



Meeting the Oracle of Omaha



Shopping at Berkshire-owned Borsheims



Dining at Piccolo's, Warren Buffett's favorite restaurant



Participants pose with "Lulu," their trusty Omaha bus

2013 Moon Lee Prize Competition

On March 1, 2013, Amici Capital hosted the 4th annual Moon Lee Prize Competition. The prize is given in memoriam of Moon Lee, a dedicated value investor with Amici Capital from 2003 to 2008, who demonstrated a tireless ability to identify and analyze deep-value opportunities that few could see. In his honor, his friends at Amici Capital initiated this competition. Finalists (selected based on pitches submitted by students taking a course in Applied Value Investing) included Andrew Gordon (Crocs), Arjun Bhattacharjee (Precision Castparts), David Magid (Motors Liquidation Company GUC Trust), and Patrick Staub (Groupon). Magid walked away with the \$15,000 first-place prize while Bhattacharjee was awarded \$5,000 for his second-place finish.



Alexander Porter



The four finalists



Professor Tano Santos



The judges listen intently



Paul Orlin



David Magid

David is a second-year MBA student, participant in Columbia's Applied Value Investing Program and the co-president of CSIMA. Prior to school, he was an investment banker at Credit Suisse and next year will be a research analyst at York Capital, focused on credit and distressed debt. He holds a BA from Brandeis University.

David was the winner of the 2013 Moon Lee Prize for his pitch on the Motors Liquidation Company GUC Trust Units.

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Motors Liquidation Company GUC Trust Units (MTLQU) - Long

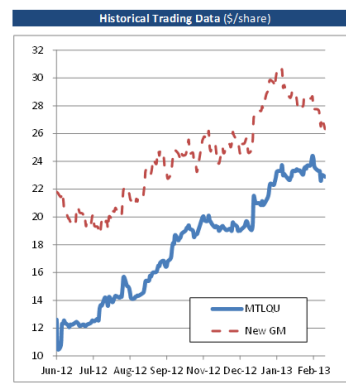
David Magid
dmagid13@gsb.columbia.edu

Investment Thesis: Motors Liquidation Company General Unsecured Creditors (GUC) Trust Units (MTLQU or Trust Units), publicly traded units of the liquidating trust set up to resolve remaining disputed general unsecured claims of the General Motors bankruptcy, currently provide a compelling risk-reward opportunity. The Trust Units, which receive a higher pay-off the more disputed claims are disallowed, are currently pricing in an unrealistically high level of allowed claims. Further, the Trust Units pay out in New GM Securities, which themselves are trading at a compelling valuation. At \$22.90/unit, the Units provide 15% - 85% upside, plus a free option on the underlying GM stock price.

MTLQU Summary Information					
(\$ millions, unless noted)					
Market Value of Trust		Total claims resolved:	\$MM	% Resolved	
Price / Unit	\$22.90	Allowed	\$428	9.7%	
Total Units	30.2	Disallowed	\$3,967	90.3%	
MV of Units	\$691.54	Total Resolved	\$4,395	100.0%	
Value / unit:	\$22.90	Current	High Case	Med Case	Low Case
Implied % Allowed	50.1%	1.3%	21.1%	21.1%	40.9%
Change in price vs current	0.0%	84.6%	48.6%	15.0%	

General Motors (GM) Summary Information				
(\$ millions, unless noted)				
Summary capitalization (As of 12/31/12)		Summary op. data (LTM 12/31/12)		
Price / Share (as of 2/25/13)	26.33	Total Revenue	152,256	
Shares Outstanding (mm)	1,366	Adj. EBITDA ⁽¹⁾ - M-Capex	7,549	
Market Capitalization	35,977	margin	5.0%	
Cash	26,121	EV multiple	4.9x	
Debt	16,050	ROIC	14.7%	
(+) Net Debt	(10,071)	P/BV	1.4x	
Preferred Equity	10,391	P/E	9.3x	
(+) Minority Interest	756			
Enterprise Value	37,053			

(1) Adjusted to add back \$5.5bn of non-cash impairment charges.



All the Pieces in Place for a Mispricing (I) Complex structure and underlying assets: The mechanics of the Trust Units payout is complicated and does not easily lend itself to traditional equity or credit analysis. (II) **Forced selling:** All initial holders of Trust Units receive their stake as a result of the resolution of their previously disputed claims, and the vast majority of these holders are natural sellers. (III) **Obscure:** The Trust Units are outside most traditional funds' investment mandates, have a relatively small market value (~\$700mm), and have very limited sell-side coverage.

Descriptions of the Trust: The Motors Liquidation Company GUC Trust is a successor to the Motors Liquidation Company (the old General Motors Corp.). The Trust was formed on March 30, 2011, for the purpose of resolving disputed general unsecured claims against the former GM (i.e. allowing GM to exit bankruptcy without resolving all outstanding claims). The Trust's assets comprise of GM common stock and warrants to purchase GM common stock. For each \$1,000 of GUC that is allowed, the Trust pays out "New GM Securities" in the following proportion:

Security	Amount	Notes
GM common shares	3.98	(NYSE:GM)
"A" GM Warrants	3.62	\$10.0 strike price; July 2016 excise date
"B" GM Warrants	3.62	\$18.33 strike price; July 2019 excise date
GUC Trust Units	1.00	Dilutive to existing Unit Trust holders

Since inception, the Trust has been very effective in resolving outstanding claims to the benefit of Trust Unit holders. Only 9.7% of the \$4.4bn in resolved claims to date have been allowed. There are ~\$5.3bn disputed claims remain outstanding, and current trading prices of the Units imply ~50% of remaining claims will be allowed.

Analysis of the Remaining Disputed General Unsecured Claims:

As of 12/31/12, there were \$5,259mm of remaining disputed GUC's. If these claims are allowed at under 50%, there will be a positive return to the units. There are three major buckets of remaining disputed claims, and for each bucket, allowed claims are highly likely to be well below 50%.

1) Term Loan Avoidance Claim (\$1,500 million)

In November 2006, the old GM entered into a \$1.5bn term loan agreement with a group of lenders, secured by a first-priority lien in certain assets of GM. Post Chapter 11 filing, GM secured a \$33 billion DIP loan from the U.S. Treasury Department and Export Development Canada. GM received court permission to use a portion of the proceeds to repay in full the Term Loan obligation, given its first-priority claim status. Subsequently, it was discovered that a lien securing the term loan was not properly perfected. As a result, the Unsecured Creditors Committee is seeking to have the proceeds of that repayment clawed back (proceeds would not benefit Trust Unit holders), and the \$1.5bn claim would become a general unsecured claim (thus the potential for \$1.5bn incremental allowed GUC). The matter has been awaiting a ruling from the judge from approximately two years. While there is uncertainty in how Judge Gerber will rule, it is highly unlikely that most of the \$1.5bn potential for incremental allowed unsecured claims will be realized:

MTLQU (Continued from previous page)

- I. The court will likely reject the request. The 2008 UCC-3 Termination Statement, which canceled the lien perfection, was filed erroneously, for a totally unrelated transaction, and by a law firm not representing JP Morgan (the admin agent) in term loan. Further, JPM did not authorize the filing.
- II. It is undisputed that the term loan was also properly secured by additional collateral, consisting of 26 fixture filings filed by JPM in counties where term loan collateral was located and a UCC-1 financing statement against Saturn as debtor. The value of this uncontested collateral alone was more than sufficient to cover the term loan (book value of \$5.6bn 3 days prior to filing).

Therefore, a reasonable range of outcomes (i.e. new allowed claims) for the Term Loan Avoidance is between \$0 (0% allowed) and \$600mm (40%).

2) Nova Scotia Litigation Claim (\$2,680 million)

In 2003, GM's wholly-owned, unlimited liability subsidiary, GM Nova Scotia Finance, issued ~\$1bn of notes, which were guaranteed by GM. In March 2009, a group of holders of these notes sued GM entities for "oppressive conduct," as a result of transfers of funds from Nova Scotia Finance to GM. In an effort to settle before filing and keep the Canadian unit out of bankruptcy, holders dropped the suit and released GM from liability in exchange for (i) a \$367mm consent fee; (ii) the right to assert \$2.7bn in claims against the GM estate (double dip claim plus swap claim). While this is the area with the greatest variability in potential outcomes, there is a strong case that much of the \$2.7bn claim will be disallowed:

- I. The deal was completed post-petition (and backdated) and without court approval. Judge Gerber was "shocked" to learn of the transaction and berated the "lack of disclosure to the court."
- II. The "consent fee" of \$367mm was egregious and uneconomic. It represented over 35% of the notional amount of notes at issue, as should therefore be reclassified as a principal pay down.
- III. Strong fraudulent conveyance argument: In the deal, GM did not receive the reasonably equivalent value necessary in any pre-petition transaction.

Therefore, a reasonable range of outcomes for the Nova Scotia Litigation Claim is between \$0 (0% allowed) and \$1,340mm (50%). This issue is currently in trail before Judge Gerber.

3) Miscellaneous Claims (\$1,079 million)

The composition of the remaining \$1,079mm of claims closely mirrors all the claims resolved to date. It is reasonable to assume these claims will follow the historical resolution pattern (~10%), albeit incrementally more will be allowed as it is later in the process. However, this is offset by fact that the \$377mm of these claims are likely all duplicitous debt claims, and will be disallowed. Therefore, it is conservative to assume, for the remaining "other" claims, \$70mm (10%) – \$210mm (30%) of claims will be allowed.

Combining that analysis, the Trust Units are worth between \$26 and \$43, or up 15 to 85% (see right).

Trust Unit Valuation build-up			
	Current	High	Low
	Implied		
Ad'l allowed claims (\$BN):	2,635	70	2,151
Total Allowed Claims	\$32,834	\$30,269	\$32,349
Total Units	32.8	30.3	32.3
GUC Trust Assets (in millions):			
GM Common Stock:	17.24	27.45	19.17
"A" Warrants	15.67	24.95	17.42
"B" Warrants	15.67	24.95	17.42
Asset Distributions / Unit:			
GM Common Stock:	0.53	0.91	0.59
"A" Warrants	0.48	0.82	0.54
"B" Warrants	0.48	0.82	0.54
Value of Distributable Assets / Unit:			
GM Common Stock:	\$13.83	\$23.88	\$15.60
"A" Warrants	\$8.16	\$14.10	\$9.21
"B" Warrants	\$5.13	\$8.87	\$5.80
Total (pretax)	\$27.12	\$46.85	\$30.61
Less: Trust Tax on Capital Gains / share:			
Total tax / unit	(\$4.22)	(\$4.58)	(\$4.28)
Total Value/unit (post tax)	\$22.90	\$42.27	\$26.32
Implied % Allowed	50.1%	1.3%	40.9%
Change vs current	0.0%	84.6%	15.0%

Underlying GM Securities are Cheap as Well: While not central to my analysis, the GM securities underlying the Trust are currently cheap, only making the Trust Units more compelling:

- Cheap absolute valuation: 4.9x EV/EBITDA – Maint-Capex (20% yield); 1.4x P/B; 9.3x P/E (LTM)
- Good business: ~15% ROIC; strong brand power, global presence (#1 in China).
- Post-bankruptcy GM has a much stronger balance sheet and improved cost structure.
- Levered to continued global economic recovery.
- Impacted by temporary bankruptcy overhang, concerns about pensions and weakness in Europe

Investors can also hedge out the price risk of these securities, and just invest in the "discount to NAV" type situation that currently exists in the Trust Units.

Key Investment Risks

- Adverse tax implications of rising GM stock price (*mitigant: gains from rising stock price more than offsets losses from increased tax liability*).
- Timing uncertainty of ultimate claim resolution (*likely resolved within year due to trust expiry*).
- Underlying value of GM securities (*margin of safety in both valuation and claim allowance*).
- Unexpected, adverse ruling from Judge Gerber.

Precision Castparts Corp (PCP) - Long

Arjun Bhattacharjee
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Arjun Bhattacharjee

Arjun is a second-year MBA student participating in the Applied Value Investing Program. While at school, he has worked at three long/short equity hedge funds. Prior to enrolling at Columbia Business School, he was in private equity and investment banking. Arjun holds a BA from Macalester College.

Arjun was the second place winner of the 2013 Moon Lee Prize for his pitch on Precision Castparts and was part of the second place winning team of the 2012 Pershing Square Challenge for an activist pitch on Ingersoll-Rand.

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	Historical Financials, FYE March 31st											Projected Financials, FYE March 31st				
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013P ⁽¹⁾	2014	2015	2016	
Share Price (4/16/2013)	\$ 184.55															
Shares Outstanding	148															
Revenue	\$ 2,448	\$ 1,809	\$ 1,913	\$ 2,900	\$ 3,480	\$ 5,221	\$ 6,719	\$ 6,801	\$ 5,487	\$ 6,220	\$ 7,215	\$ 9,902	\$ 10,971	\$ 12,732	\$ 14,948	
Growth		(26.1%)	5.8%	51.6%	20.0%	50.0%	28.7%	1.2%	(19.3%)	13.4%	16.0%	37.3%	10.8%	16.0%	17.4%	
EBIT	\$ 351	\$ 290	\$ 274	\$ 423	\$ 554	\$ 957	\$ 1,490	\$ 1,590	\$ 1,422	\$ 1,503	\$ 1,817	\$ 2,405	\$ 2,898	\$ 3,373	\$ 3,895	
Margins	14.3%	16.0%	14.3%	14.6%	15.9%	18.3%	22.3%	23.5%	25.9%	24.2%	25.2%	24.3%	26.4%	26.5%	26.1%	
EPS	\$ 1.56	\$ 2.84	\$ 1.10	\$ 1.83	\$ 2.58	\$ 4.59	\$ 7.04	\$ 7.43	\$ 6.49	\$ 7.04	\$ 8.41	\$ 10.56	\$ 12.72	\$ 14.77	\$ 17.01	
Growth		81.9%	(61.2%)	66.0%	41.3%	77.6%	53.5%	5.5%	(12.7%)	8.6%	19.4%	25.6%	20.5%	16.1%	15.1%	
Consensus												\$ 9.74	\$ 12.02	\$ 14.04	\$ 15.08	
FY 2014 P/E	14.5x															
FY 2014 EV / EBIT	10.5x															
FCF	\$ 172	\$ 206	\$ 138	\$ 328	\$ 266	\$ 634	\$ 729	\$ 890	\$ 925	\$ 1,026	\$ 898	\$ 1,274	\$ 1,665	\$ 2,038	\$ 2,423	
FY 2016 P/E	10.9x															
FY 2016 EV / EBIT	7.8x															
ROIC	10.0%	8.7%	6.5%	9.1%	12.7%	18.8%	24.0%	22.2%	16.7%	14.8%	15.2%	14.4%	13.5%	13.8%	13.9%	

(1) Pro forma for acquisitions

Business Description

Precision Castparts (NYSE:PCP) ("PCP", "the Company") manufactures highly engineered and critical, alloy based components for the commercial aerospace, power generation and oil & gas industries. **PCP is a leading supplier to all jet engine manufacturers** and as such, almost all aircraft in the sky fly with parts (**turbine parts, fasteners, subassemblies, nickel alloys**) made by PCP. The Company's unique ability (stems from ownership of unique assets and decades of knowledge/experience) to make complex parts out of nickel and titanium has resulted in **very high market share**. This combined with the fact that **PCP's parts are not especially expensive** in the context of overall costs (e.g. PCP represents ~ 5% of a 787) allow PCP to earn high returns.

Recommendation

I recommend a **long position in PCP with a price target of \$275.00, which represents 50% upside** from current levels. I believe PCP will beat near term numbers and that, consequently, **long term expectations will be revised significantly higher**.

Investment Thesis

Given its sustainable competitive advantages (unique production capabilities and vertical integration), strong management and pristine balance sheet, PCP is well positioned to take advantage of the near term accelerated growth in aerospace to continue its successful strategy of vertical integration, consolidation of lucrative niches of the aerospace supply chain and entry into fast growing adjacent markets.

- With **787 production still on track to double by the end of 2013** and with increasing exposure to this platform, PCP is poised to reap over a \$1.0 billion in sales and \$300 million of EBIT from the 787 alone over the next three years
- This increased production will drive higher utilization across PCP's platforms thereby **improving incremental margins**
- This accelerated near term growth in aerospace and the related improvement in margins will result in **record free cash flows—a \$6.5B hoard in three years**
- PCP has been a successful consolidator in the past and this **cash hoard represents a huge and undervalued opportunity**
 - PCP acquired five companies in the fragmented aerostructures segment in 2012 and intends to build out this segment
 - Both Airbus and Boeing want the supply chain, especially aerostructures, to consolidate to ensure reliability
 - **PCP's scale and vertical integration allow it to extract synergies that none of its competitors are able to**
 - Vertical integration in nickel and titanium allows PCP to lower costs through maximizing utilization of assets and maximizing scrap use across the chain
 - PCP's competitors are highly levered and unable to participate in this consolidation
- Increased titanium and nickel usage in aircraft (e.g. 787, A350Neo) represents an **expansion of PCP's TAM**
- **Specialty oil & gas pipe represents an attractive new market** given the need for corrosion resistant alloys for deepwater and shale plays
- PCP's industrial gas turbine business is at a cyclical low point—recent GE numbers suggest a **nascent recovery in IGT**

Precision Castparts (Continued from previous page)

The Street has historically underestimated the Company's ability to successfully deploy free cash flow and extract synergies from acquisitions. Having completed seven acquisitions, including its largest ever, in the last twelve months alone and poised to generate the most cash in its history, long term consensus expectations now are significantly below true earnings power thereby creating an attractive entry opportunity.

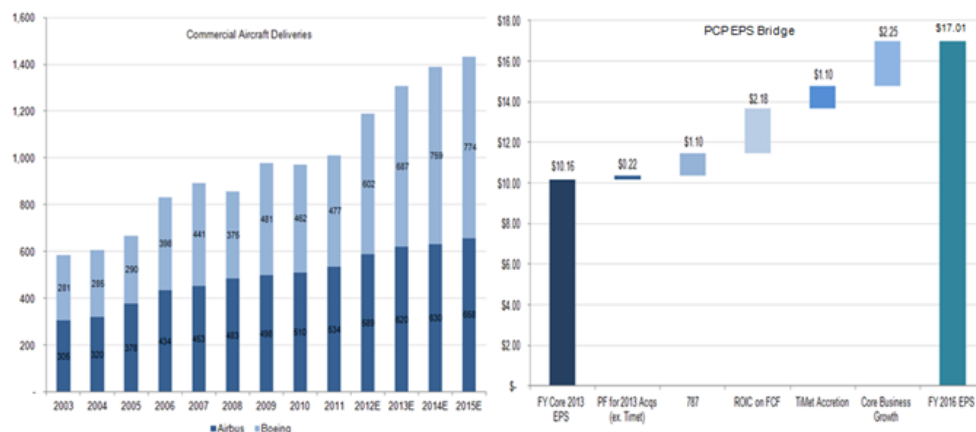


Situation Overview

During 2005 – 2008, PCP vertically integrated nickel alloys and used rising cash flows to consolidate aerospace fasteners. **During the last twelve months, PCP has effectively been setting itself up to repeat the success of the 2005 – 2008 period.** PCP acquired five companies in the aerostructures niche to create a platform to begin consolidating that segment and acquired its largest supplier of titanium. But in the context of the aerospace cycle, post 2012, there will be 50% more aircraft being delivered annually (than the 2005 – 2008 period) resulting in significantly higher cash flows.

Valuation

Based on a conservative set of assumptions, PCP will likely earn > \$17.00 / share by FY 2016 vs. \$15.08 consensus. A 16.0x P/E multiple is at historical averages and mid-cycle levels and leads to a \$275.00 price target—and represents a 20% IRR. **In summary, the record backlog in commercial aerospace supports a near term acceleration in growth, but the natural replacement cycle, emerging market demand and the introduction of new, more fuel efficient platforms will support growth thereafter.**



Risks / Mitigants

- Prolonged 787 Issues / Issue appears to center around batteries and appears to have been resolved
- Cycle Peaks in 2015 / New engine platforms (737 and A320) and continued demand from EMs

Catalysts: Q4 2013 (March) and Q1 2014 earnings re: Timet synergies; 787 production updates

Preston Athey



Preston Athey

“As a boy, my dad would often talk about the investing business, about his clients, and about managing portfolios ... one day I told him that I'd like to own a stock. That is not particularly unusual except for the fact that I was seven years old.”

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(Continued from page 1)

G&D: Could you tell us about your background and how you became interested in investing?

Preston Athey (PA): I was very fortunate because my father was an investment counselor in Chicago. As a boy, my dad would often talk about the investing business, about his clients, and about managing portfolios. Because we had a very good relationship, one day I told him that I'd like to own a stock. That is not particularly unusual except for the fact that I was seven years old. I bought one share, which was all I could afford at the time. Then I bought another stock the following year and another stock the year after that, which meant that as a little kid, I was reading annual reports. I'd look at the pictures and I didn't understand the financials, but I could kind of understand what the companies did. By the time I was in college, I'd pretty much figured out what I wanted to do in life. I took Economics as a major because that seemed to be a good foundation. Then in business school, I took all the finance and investment courses offered. That's basically how I got into it.

G&D: After graduating from Yale, you decided to postpone your career in investing and you spent five years in the Navy. What led you to that decision?

PA: Well, it was pretty

simple. At the time, we had a draft and the Vietnam War was going on, so I made the decision that for me, being a Naval Officer was probably a smarter thing than getting drafted and being an enlisted soldier in Vietnam. I wasn't moving to Canada to try to avoid the draft, but I wanted to have a little more say on how I served.

G&D: Before managing the Small-Cap Value Fund, you managed the small-cap growth portfolios. How did you make the transition from growth investing to value investing? What were some of the challenges in doing so?

PA: I came to T. Rowe Price in 1978 and spent four years as a technology analyst covering mostly telecom companies and some electrical equipment companies. In 1982, I began managing small-cap growth portfolios, which are separate accounts run in the same style as the New Horizons Fund, our small-cap growth product. Then in 1991, a spot opened up on the Small-Cap Value Fund, and the firm asked me to take that on. Within two or three weeks, it was pretty clear to me that managing the value fund was a completely different job than managing the growth fund.

First of all, it was a different set of stocks. There was almost no overlap between the two, and it was going to

take a lot of time to really get to know the companies in the fund and learn about potential new additions. I realized you couldn't do both jobs effectively, so I asked to be switched off the growth portfolios to work full-time on Small-Cap Value, which T. Rowe Price allowed me to do.

The second point is that there are significant differences in running growth and value portfolios. Interestingly, my natural proclivities in my personal account are to buy and hold growth stocks that are great companies. They may not be super high growth, but they're really solid companies. You buy them and hold them forever, and I have a number of those in the portfolio today. I was not somebody who naturally liked to go find the classic Ben Graham half-smoked cigar butt on the ground and try to get a few more puffs out of it. I had to teach myself that. It was not my natural inclination to do it; I was not a natural value investor.

On the other hand, I believe that you should develop the skills that enable you to do almost anything in your business. That's really the definition of a professional. For example, if an investment professional is asked to run a portfolio for an order of nuns and it needs to be 75% blue chip, high dividend-paying stocks and 25% good quality bonds,

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 even if you're a small-cap investor, you still ought to be able to put a different set of eyeglasses on and say, "I can do this. I know what the client needs. I know basically what has to happen. We'll take a conservative approach and do it." That's really the way I approached it. I trained myself to do what's necessary to do a good job in small-cap value and put aside my natural beliefs about growth stocks. It took about a year to change my mindset, but I did it.

G&D: How did you train yourself to be a value investor? Did any particular books or investors inspire you?

PA: I got to know the key competitors in the industry. I studied Chuck Royce of Royce & Associates, who has done a marvelous job over many years. I think of Chuck as the preeminent and certainly the earliest small-cap value practitioners. The organization that he's built is still focused on small-cap value investing. I also looked at John Neff, who had run the Windsor Fund at Vanguard for years, and is certainly a very well-known value investor. Also, I had personally been a shareholder in Berkshire Hathaway and I understood what Warren Buffett was trying to do. I had read a couple of Ben Graham's books. I understood intellectually what it meant to be a value investor and

what value investors look for, so it was a question of just putting it into practice.

“The one thing that makes me somewhat different than most of my value peers is perhaps the good fortune of having spent that first nine years as a growth investor. The result is that when I get a winner, I'm less likely to sell it too quickly. I'm more likely to let it run.”

G&D: You've been running the Small-Cap Value Fund since 1991, and your fund has outperformed the Russell 2000 over that time period. What would you say is your edge over other

small-cap investors?

PA: First of all, over that 21 ½ year history, value has done a little bit better than growth, so I've had a tailwind versus the Russell 2000 which is a blend of value and growth. That is part of our outperformance. The second thing is that when you're running a fair amount of money and you have a lot of names, you cannot do it by yourself. T. Rowe Price is just a wonderful organization. We have a lot of analysts, and part of our job is to train them. We're asking them to find interesting companies, not necessarily great companies because sometimes cheap companies that have a catalyst to change can be a great investment. We train them to look for things that make sense. So the second reason I'd give is that we have great research analysts, as I wouldn't be able to do it by myself.

The one thing that makes me somewhat different than most of my value peers is perhaps the good fortune of having spent that first nine years as a growth investor. The result is that when I get a winner, I'm less likely to sell it too quickly. I'm more likely to let it run. I follow a pretty good value discipline in adding new names to the portfolio. But some people might argue, probably legitimately so, that several of my top 25 holdings don't look like value stocks; they

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look like growth stocks. They were value stocks when I first bought them, then the catalysts came about and they began to be appreciated in the market. Then their PEs went up and growth rates accelerated. I'm not that quick to sell those. So even though I follow a value discipline, the portfolio looks like a blend portfolio in its characteristics because some of the top holdings are big winners.

G&D: Do you set price targets for the companies in your portfolio? How do you know when to sell?

PA: When I buy a stock, I personally don't have a price target in mind, and here's the reason why. If you set a price target without any reference behind it, it becomes an excuse to sell too quickly, and you may leave a lot of money on the table. For example, let's assume that you buy a stock and you've set a price target 30% above your buy price. Six months go by and it comes close to hitting your price target; is it now really a sell? What happens if the company has actually reported two wonderful quarters where earnings were up 25% each and where the market itself is up 15% in that period? You now have a company that might be just as undervalued – relative to the market, its peer group and any other metrics you might want to look at – as it was when you first bought it six months

before. That tells me you need to rethink what a fair or overvalued price would be. A lot of people don't do that.

The danger is, of course, that some people constantly raise their price targets as the stock goes up. They're always going to be 30% higher than where the current price is, even if nothing fundamentally good has happened at the company and if the market hasn't done a whole lot. I look at the valuation of the company relative to the market and its peer group. I look at where the company is in its cycle. If it's early in an economic cycle, then it may have gone up awhile but it still might have another two or three years left to go.

An example today would be homebuilder stocks. They've had a great run off the bottom. On the surface, they look ahead of themselves, and if one were to say you should take some profits in homebuilder stocks today, I'd have a hard time arguing against that. However, the housing cycle, even six to twelve months from now, could still be in the early to middle innings. We've got a long way to go as some of these companies have earnings potential of two to three times what they generated in 2012. If they earn three times what they did in 2012, today's price will look pretty cheap. That's how I think about it. Where are we in the cycle,

and where is the company relative to everything else? You need to constantly put all of that together to know whether or not you're selling a stock too early.

G&D: How has the landscape changed for the investing opportunities out there? Has it become tougher to beat the market?

PA: Interestingly, I think that in some respects it's become easier in the small-cap world. First of all, there's relatively less Wall Street research. Wall Street firms don't make as much money trading the stocks and there have not been as many IPOs and secondary opportunities to make money on the banking side. If you look at all of the various firms, there's somewhat less research being done on small-cap companies, particularly companies below \$1 billion in market cap. That means there is some opportunity for mispricing in the market with less analysis being done. Second, a greater percentage of the trading volume is now being done one of two ways: either with high frequency traders, who are really just arbitraging pennies, or with trading that's done in passive portfolios such as ETFs and index funds. One would think that trading done in passive portfolios shouldn't have much impact on the price level of individual companies, but surprisingly it does have an

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“You can imagine that when money's sloshing in and out of these passive portfolios, some of these small-cap stocks become collateral damage. When that happens, if you're nimble and know the company well, you can pick up a bargain, or trim some at a high price that's well outside of its normal range. That happens more today than it did 20 years ago.”

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 impact when fairly large amounts of money get moved in and out of passive portfolios. From time to time, some of these stocks will move fairly significantly with almost no fundamental news to account for it. You can imagine that when money's sloshing in and out of these passive portfolios, some of these small-cap stocks become collateral damage. When that happens, if you're nimble and know the company well, you can pick up a bargain, or trim some at a high price that's well outside of its normal range. That happens more today than it did 20 years ago. All of that means active managers who know what they're doing can actually gain an edge.

G&D: ETFs have been growing rapidly, and like you alluded to, they seem to have some potential for volatility since many buy and sell large baskets of securities. How do your shareholders absorb the potential for additional volatility from those passive portfolios? Does it contribute to additional volatility?

PA: When I think about some of the moves that small-caps stocks have had before ETFs existed, my gut tells me no. The difference is, in the past, you'd see volatility based on sector moves such as the whole technology sector being down 10% in the month, or based on fundamental news that would have spillover

effects in related companies. You still get that today. I'm hard pressed to say that the ETFs per se have created more volatility because we've had plenty of high-volatility periods. You could look at the VIX for the past 35 years and tell me whether there is more volatile today or not – I'm not an expert on that. However, more of the volatility today is unrelated to fundamental news from the companies, which may lead to investing opportunities.

Volatility affects all equity investors who worry about volatility. I don't think it makes a difference whether they're in a passive product or an active product. If they don't like volatility, it will make them less willing to invest in equities. If they can shrug it off and look long term, then I don't think it has an impact.

G&D: Over the past two years, you've had turnover of 4.8% and 5.5%, which is unusually low in the industry. Can you talk a little bit about the rationale behind that?

PA: The last two years have been extraordinarily low. The prior 10 years, I averaged around 10%. Historically, part of my turnover is not investment driven but rather forced on me by takeovers. If someone takes over one of your companies, you have to sell it. That is turnover, but it's not one that you

initiated. Historically on that 10% turnover rate, about 3% or 4% was related to takeovers. The other 6% to 7% would be considered manager initiated. The last two years have had lower-than-average takeover opportunities, so the low turnover rates have been partly due to that.

Additionally, if a scenario that I had painted for a particular company is still playing out, then unless it's demonstrably overpriced, I'm reluctant to sell it. First of all, a sizeable fraction of my shareholders are taxable, so if I sell something at a gain and make them pay the tax, I have to find something that's better than what I sold. It has to be substantially cheaper and have a better future to make up for the capital gains lost to tax. Studies show that it's very difficult to create enough alpha from trading to still come out ahead after taxes. The studies are very clear, and yet 98% of the trading in the stock market either ignores them or doesn't even believe them. I believe the studies. To get me to sell something, particularly something that's up, means I've either completely lost faith in the company or I think it is highly overvalued and I can do substantially better in some other stock. If you follow that philosophy religiously, it leads to quite low turnover. In a very volatile market where stocks are up a lot one

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“Unless [a position is] demonstrably overpriced, I'm reluctant to sell it. First of all, a sizeable fraction of my shareholders are taxable, so if I sell something at a gain and make them pay the tax, I have to find something that's better than what I sold. It has to be substantially cheaper and have a better future to make up for the capital gains lost to tax.”

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Pictured: Tom Russo speaks at the Omaha Dinner in May 2012.

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month and down a lot the next month, I'll probably do some trimming here and put that money back to work the following month. If takeovers pick up, turnover will go up.

G&D: How do you generate your investment ideas, and what do you look for in a good investment?

PA: About 90% of new ideas are generated by our analysts. We'll discuss the idea and if I agree that it makes sense for the portfolio, I'll generally buy a starter position and ask them to formally follow the company. Over time, as we get to know the company better, we may increase the holding. We may buy it cheaper if we happen to have a dip in the market, or we could buy it at a higher price, assuming the company is meeting its goals. That's how we generate most of our ideas.

In terms of what I look for in an investment, here's an example of the type of company that gets me excited. An analyst walks into my office and says, "Preston, I've been following this particular company for two years. I've been listening to conference calls, looking at the earnings, and I think there's definitely something here. They have a product or service that makes sense, but they've had some rough times and the stock is down from its all-time high of five years ago. When you look at the

chart, you can see it's bounced off the bottom and it seems like it's gone sideways for six months. They just reported a quarter that was better than anyone was expecting. However, the stock went up only about half a point. It's clear that nobody on Wall Street cares – all of the momentum investors are long gone. Here's the scenario – over the next

“I generally tend to avoid companies with stressed balance sheets. ... I've been through too many cycles where debt kills you.”

three years, if results improve as I think they will, the stock could be a very, very big stock.”

So first of all, I have a company with a decent product or service and a decent balance sheet. Second of all, I have a management that's either turned around the company

or has a catalyst for realizing change. Third, I have a stock that is clearly washed out. It could go down more or it could be flat for a long time, but it's unlikely that there's much euphoria surrounding the company. I don't have a lot of downside risk because everybody who owns it wants to own it. When it's an experienced analyst who has followed the company for a while and we can look at it together, it just gets me excited.

G&D: It sounds like you're not necessarily looking for a company with a moat.

PA: You would always like to see a company with a moat. Several companies that I own that have small- to mid-sized moat in their niche area. But I generally tend to avoid companies with stressed balance sheets. The types of companies that I probably would not be interested are those with high leverage, where debt significantly exceeds book equity, or companies that have made a string of acquisitions in the past and had to write half of them off. There is no capital discipline in a company like that. I've been through too many cycles where debt kills you.

G&D: Given that you focus on small-cap value stocks, you have the elevated risk of companies going under. How do you factor in that risk when looking at investment opportunities?

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PA: There's absolutely some bankruptcy risk in investing in small-cap value companies. By definition, they are considered value stocks because there's something wrong. Perhaps their record isn't very good or they're overburdened with debt or they've had some bad news that's really knocked the stock. In the 22 years that I've run the Small-Cap Value Fund, I've averaged less than one company per year go bankrupt while I own the stock. It happens occasionally, but it doesn't happen very often. I consider it an overblown concern and it's not something I spend a whole lot of time worrying about.

In March 2009, which was the bottom of the bear market, I gave an interview to Barron's on the topic 'Stocks selling for below \$1.00'. After giving the interview, I decided to check how many stocks I actually had below \$1.00. Remember, this was at the bottom of the market. At the time, 20 stocks out of 300 in the fund were selling for below \$1.00. I guarantee you, not one of them had I bought below \$1.00. In fact, most were bought at prices significantly above that, often above \$5.00, so that shows you how much they had come down. So what was going on? First of all, we were in a horrible bear market, so a lot of stocks were down. Secondly, these were probably the lower-quality

stocks of the group that I held, so in a scary market where people are worried about balance sheets or businesses that maybe aren't as solid as others, the stocks are going down a lot more. The bottom line is they're all below \$1.00. The question was asked by the reporter, "Doesn't that mean they're all going bankrupt?" In a normal market, I would say if the stock goes below a \$1.00, the market is telling you it think the company is going bankrupt. In a market like today, that's probably a reasonable guess – 20% to 30% of those companies probably will go bankrupt. But, at the bottom of a bear market when people are worried about everything, my experience was that they're not all going to go bankrupt.

There were 20 of my positions trading at below \$1.00. I believed that from that point on, when the market came back, most of these stocks would recover. A small fraction would probably go bankrupt, some would track the market, some would do substantially better, and one or two would be home runs. The question was asked "Well if that's the case, why don't you sell the ones that are going to go bankrupt and buy the ones that are going to be home runs?" If we knew that, obviously we wouldn't hold the ones that were going bankrupt. Two of those 20 companies were literally selling for less than

the value of the cash on their balance sheet, and another half dozen met Ben Graham's favorite net-net standard where they were selling for below their net working capital. I felt pretty comfortable holding those stocks. Fast forward a year, four of those 20 actually did go bankrupt. Let's say that I sold them at some point either right before or right after they filed and realized something less than \$1.00. Of the remaining 16 companies, all of them eventually recovered well above \$1.00. Some tracked the market, while some went up two times to four times. One of them, Dollar Thrifty, went from \$0.60 to \$45.00 in a year and half, at which point I sold it.

If you took that portfolio of 20 companies and evenly weighted them at 5% each, I guarantee you the two-year returns on that portfolio were better than the number one small-cap value fund in the country. But who has the guts to invest a lot of money at the bottom of the market into what the market perceives as horrible companies? I didn't sell them, but I held on and when the junk rallied, I realized my fair share of profits.

G&D: Did you add to your positions at the time?

PA: Not substantially. In a few cases, I added a little bit, but not in most cases. I had to think about risk. The

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Pictured: Jason Zweig, Mark Cooper, Jean-Marie Eveillard, John Spears and Jennifer Wallace speaking in the Graham and Dodd Investing Panel at the 2013 CSIMA Conference.

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bottom line is there is bankruptcy risk in small-cap value stocks and sometimes that's reflected in the stock price. Though even when it's reflected in the stock price, only a small fraction of companies actually go out of business.

G&D: You're known to have a knack for interviewing management – in fact, you lead the “interviewing management” training session for T. Rowe's new hires. Could you talk about how you developed this ability over time?

PA: I don't think I have an unusual knack at all. There are other people who are much better at the business of interpreting management body language – I'm not very good at that. I think what I do well though is to, over time, learn to read management teams on whether or not they're telling the truth. If you see a management enough times over the years, you can really begin to see whether they are trustworthy or not, or if they're always optimistic or always pessimistic. That's the big advantage. When you've got a lot of experience, you don't really have to sit there and ask questions and take notes all the time. You can ask a general question, hear the answer, and think through what the next follow-on question is that extends that line of reasoning. By doing that, you get a good indication of

how management really thinks. Many analysts new to the industry have their questions and don't really think about follow-ups. They're not actually thinking about what it is that they're trying to determine. They're just asking a lot of

questions. Ask about strategy and long-term goals. Ask about how they deal with problems and how they think about capital allocation. Those are CEO questions. When you interview other members of the management team, ask questions that are specific to their area.

G&D: How much weight do you put on the quality of the management versus other quantitative or qualitative factors?

PA: The longer I've been in the business, the more I think management really makes a difference. In small companies, I think management makes a huge difference. The main question is, how do you determine if it's a good management? The interview is not sufficient; it's only a first step. Interestingly though, studying the past record of that management more often than not is a pretty good indicator of what the future will be. Is the manager someone who grew up in that company and was made CEO last year? The previous 10-year record at the company is not that person's record, as he or she has only been CEO for a year. However, if he or she was the COO or had run one of the divisions, you could study that division's record, or you could study the time period that the individual was COO. You can also

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questions. I try to teach our analysts to have a line of questioning. Figure out what it is that you want to know and have a line of questioning that will help you to get to that point. Also, when you're with a CEO, don't spend time asking about CFO-related

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ask other people in the industry about the person's background and experience. What is it that the person has done that would give you confidence that he or she will be a good CEO and take the company forward? If the person has been at the job for a few years, then you can more easily judge the record.

G&D: Do you have a preferred valuation framework to assess the attractiveness of an investment?

PA: Yes. My preferred valuation framework is to use those measures of value that are most relevant for the company and the industry you're looking at. If you think of all the various metrics you might use, some are very readily available through databases and some you may have to calculate yourself because there's a measure of uncertainty. Net asset value is an uncertain number and it may rely on your forecast of cash flows and what discount rate you want to use. What is really relevant is how a knowledgeable investor in that industry would look at the company and what metrics that person would use. For example, if we were talking about a mining company where the majority of the value in the company is its proven reserves, price-to-earnings is an irrelevant measure because there are probably no earnings. Price to cash flow is probably not

relevant either, as there probably isn't a lot of cash flow, particularly in small-cap mining companies. On the other hand, if you can value the proven reserves based on takeout prices of other companies in the industry, that's the way a CEO of a competitive firm might look at valuation. You can begin to build a framework around what NAV would be and assess the current market valuation's discount or premium. If it's a premium, it's likely not interesting at all, but if it's a discount, how large is the discount? If it's more than is usual, that makes it attractive.

As an alternative example, take a service company that I own called G&K Services, which does uniform rentals. Price-to-earnings is a pretty good measure, price-to-cash flow is a pretty good measure, and price-to-book value is a reasonably good measure. You would want to look at these ratios relative to the market, relative to other companies in its industry, and relative to its own history over the past 10 years. When I find companies that are cheap on those relevant measures, that's when I start to get interested.

G&D: On that point, how do you avoid value traps at companies that seem statistically cheap but are so for a reason?

PA: The best way to avoid a value trap is to ask the

obvious question: "If this stock is so cheap, why is it cheap?" The cheaper it is, the more the market is telling you that there is something wrong. If that's the case and you're still intrigued, you better dig really deep. Maybe what you'll find is that it's a cheap stock because management uses all of the cash flow that the company generates to make poor acquisitions. By studying the past several years of their acquisitions, that may become clear. If there's no chance that management is changing because they either own too much stock, the board is in their hip pocket, or whatever the reason is, it almost doesn't matter how cheap it is. You're going to be throwing your money away. That's really how you avoid value traps.

I'll give you another example – Cliffs Natural Resources is an iron ore company that I first bought in 2000. The stock was down because its sales and earnings were down and they were expected to decrease further that year. The U.S. steel industry was hurting, and some were betting that the domestic steel industry would fade away and we would import all of our steel from Asia. Cliffs had essentially all of its reserves in Northern Minnesota, and if that played out the Chinese would not need Minnesota iron as they could get it from Australia. The market was essentially

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“The best way to avoid a value trap is to ask the obvious question: ‘If this stock is so cheap, why is it cheap?’ The cheaper it is, the more the market is telling you that there is something wrong.”

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making the bet that the steel industry wasn't coming back. On the other hand, we took the opposite view that the U.S. steel industry would come back, and that's exactly what happened.

G&D: You mentioned earlier that you do not assign price targets. How do you compare two opportunities? Also, given that you have very low turnover and hold things for a long time, at what point do you actually get around to selling?

PA: First of all, with as many companies as I have, there's almost never a situation where I have to sell something in order to buy something else. I've always got some cash and I always have many things on the sell desk and many things on the buy desk. There's some point at which a stock truly gets overpriced and you have to figure out what that is. As for selling, I have a number of sell triggers. The obvious one would be if the stock just gets too big. I'm running a small-cap fund, so if the company gets to be over \$5 billion, I move it out. Another trigger is if the stock chart goes parabolic. The stock has tripled in 12 months and although earnings are good, it's now trading at 35 times earnings.

Another trigger could be that the character of the shareholders has changed. Companies that have done

well go through the various stages of ownership. The first owners are the deep value investors, followed by the relative value investors. Then you have the GARP-y (growth at a reasonable price) investors, followed by the fundamental growth investors. Pretty soon, you have the momentum growth investors and after that, the last stage of investors focuses on pure momentum. They don't really care what the company does or what the earnings are. All they know is that the stock is going up and they want to ride it.

That type of shareholder is the most risky for me. At the first hint that there's a little perturbation in what people are expecting, momentum investors will sell a stock that could be down 25%, 30%, or 40% in a day. When I see the shareholder base shifting towards that end of the spectrum, that is my sign to get out because I don't need that kind of risk.

G&D: What are your buy triggers?

PA: If there's nothing spectacular about the stock or if I don't think I can theoretically get a double in 12-18 months, in most cases I probably won't buy it. An exception of that rule would be something like a utility. For example, if you have to own some utilities, you're just trying to find good relative value among all the various utilities. Last year, I bought shares in Texas

Industries, which is a cement producer. It was considered very risky and it wasn't earning money. You had to bet on a recovery in the housing cycle and the road-building cycle, and anything that's a big user of cement. If I thought I only had 10% or 20% upside, then I wouldn't have bothered. But I could see based on where it'd been in the past and what earnings could be in the future, that there was some likelihood that I could get a double in three years. That for me was a good buy trigger.

G&D: Given your 20+ years of experience running a value fund, are there any common mistakes that you see value investors make? You mentioned earlier about how you hold most positions longer than others do – would you consider that a mistake that other investors make?

PA: It's hard to say that's a mistake if investors take a 50% profit over a reasonable period of time and re-deploy it into the next great underpriced stock, and they have a good track record of doing that. Who am I to say that they're making an error? That's just a different style of investing. All I'm suggesting is that for me, holding winners longer has worked very, very well. I haven't had that many experiences where I've ridden a stock all the way up and then ridden it all the

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way back down. It's just a function of constantly re-evaluating what you have and where that stock is in relation to what you think a full market cycle might mean.

G&D: Do you mind talking about an idea that you currently like?

PA: I own shares in a company called Modine. It's a Wisconsin-based manufacturer of automotive radiators and heat exchange equipment. The company is particularly strong in trucks and off-road vehicles, but they also have some business in regular passenger cars. They also make industrial HVAC products. It's certainly one of the world's leaders in its market, with well over a 20% market share. The company has a checkered history over the past 25 years because it operates in a very cyclical industry; it's difficult for them to predict exactly what their sales and earnings will be from year to year. It's totally dependent on what the customers are doing and their customers are in a very cyclical industry. Additionally, before the current CEO took over five years ago, the company's capital allocation was not great. While they had a good product, they did not manufacture it in the most cost effective manner, so even in good times, their return on capital wasn't very high.

So why do I own it? Well, the stock in the last five years has been as high as \$18, and in the depths of 2009, it was actually below \$1. The stock fell from the high teens in 2011 because the truck cycle turned downwards and their auto business deteriorated. This was despite the fact that management had done a good job of improving operations. There's nothing they can do when the demand falls off. The market saw that, the stock came down, and at around \$8, we got interested. At that point, it was selling for slightly more than book value. What we saw was a company with a good product set, good market position, decent balance sheet, and a management that was doing what they could to pay down debt and improve operational efficiency. Management also seemed to understand capital allocation.

So this was really a cyclical company with nothing fundamentally wrong, where if you could wait out the cycle, the stock could be worth substantially more. We started buying at around \$8, and we continued buying it down into the \$6s, and also during its way back to about \$9 today. If we have a normal truck cycle in the next three years, if some new business they picked up in Europe is as profitable as we think it will be, and if they continue to do well on the industrial HVAC side, there's no

reason to think this company couldn't earn \$1.50 in 2015. If they earn a \$1.50 and you put a 10x multiple on earnings at the beginning of 2015, that's close to a double in the next two years. That would be a pretty attractive return. There is no guarantee that this will happen, but the stock doesn't seem to want to go below \$6 because there's book value support. The balance sheet is not too stressed. The risk-reward seems pretty good to me.

We talked a little bit about what makes me different from other investors: one thing we've discussed is that I hold winners longer. The other thing is, I'm willing to time arbitrage my investments. You can show a lot of investors an idea and they'd say, "Well that is a good price and I can see how sometime in the future the stock could be a lot higher given a normal recovery in their earnings and sales. But the problem is, it isn't going to happen in the next six months. Come to me when it looks like it's starting to happen and I'll buy the stock." So they just refuse to buy the stock. With Modine, I asked a particular Wall Street analyst who was following the company when the stock was at \$6.50, "Why aren't you recommending this stock?" He had a weak hold on it at the time. He responded, "I know what it could be three years from

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Pictured: Mario Gabelli at the 2012 Graham & Dodd Breakfast.

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now, but the next 12 months look bad to me. There's no reason their earnings are going to turn, they're barely breaking even, and I just can't afford to get out there in front of this. I have to wait until I have a lot more confidence in the next quarter or two." When he finally has confidence in the next quarter, that stock will be \$11. A move from \$6.50 to \$15 is a whole lot better than a move from \$11 to \$15. Also, if you're only running a small amount of money, you might be able to get a decent position at \$11, but if you want to make this a 50 basis point position on \$11 billion, you have to start buying it today. You can't wait until it's at \$11 because you will move it up to \$13 all by yourself. That's time arbitrage.

I'm willing to build a position and wait, not knowing when the turn will happen, because there will be other stocks in my portfolio that are working just fine that I bought two or three years before. People ask me how I can run a lot of money. It's harder than a small amount of money and you have to do things differently. One thing you can do as a value investor is to arbitrage time and to recognize that you're going to be early, but if you get the right price, it all works out in the end. By the way, the truck cycle is just starting to turn now.

sharing another idea that you currently like?

PA: I'll talk about another stock that I've been buying over the past year. It's starting to work now, but if things go as well as I think they will over the next three years, it still has a long way to go – it's a company

“One thing you can do as a value investor is to arbitrage time and to recognize that you're going to be early, but if you get the right price, it all works out in the end. “

called Redwood Trust. Redwood Trust is a mortgage REIT based in California. Its business is twofold – first, it owns mortgage securities, typically the lower-rated tranches of mortgage securities such as BBB, BB, B and the equity of a mortgage RMBS or CMBS. It's a highly risky thing to

own, but typically you get paid for that risk. The second thing they do is securitize. They buy loans, package and securitize them, and market them through an investment bank. Investors buy the AAA tranche and the AA tranche and Redwood makes a fee on it. Often, in addition to the fee, Redwood will make a spread on the sale. Therefore, a typical securitization for Redwood would be a pool of jumbo home loans that would be generated by dozens of banks around the country. These banks typically will want to hold onto the five-year ARM for their own balance sheet, but if it's a 15-year fixed or a 30-year fixed, they don't want to take that kind of duration risk, so they'll sell those to Redwood and Redwood will package them together. That market completely went away in mid-2008, and the first securitization wasn't until Redwood did it in the fourth quarter of 2010. They did two in 2011 and five in 2012. They'll probably do well north of half a dozen, maybe as many as 10 or 12 this year. They've been working on their pipeline. So the result is accelerating activity, which means they're going to generate more fees, they're going to get more spread, and they're going to get more products at the bottom end for them to hold. That's the simple story. It's very conservatively managed.

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G&D: Would you mind

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They got through the problems of 2008 and 2009 when the rest of the industry was dying. They had seen it coming and sold a lot of assets in 2007. They were very conservative and had no recourse debt on their balance sheet. The only debt they had was tied specifically to securitizations and was non-recourse to the parent, so that was not an issue. Now they're starting to lever up.

I like the company because I see an increasing set of fees and assets on which they can generate returns. The stock has done very well over the past six months, but there's no reason to think that if we have a really good housing market and Redwood continues to sell RMBS securitizations, the stock could still double over the next two or three years. It's at \$23 today. That's one where when the stock was at \$12 and somebody might say the target price is \$20, people would laugh. Well, it went through \$20 last month. So should you sell it because it hit its target price? If Redwood was selling two securitizations a year and had no opportunity to do more than that, then the stock would be kind of expensive. But it's absolutely staggering to think of how they've increased their pipeline of loans – even the big investment banks are now hard pressed to do this – while so many of their competitors went out of

business. Redwood's sitting there looking very, very smart.

G&D: Any particular industries that you are finding very attractive right now?

PA: Not so much industries. I would say that one of the questions I'm always asking broker salespeople is, "I don't want to know what your analysts like. Tell me what your clients hate. What are the sectors that are most hated? What are the industries that your clients don't want to hear about?" It doesn't even necessarily mean that's the best value, but I just want to know what the world hates. When it's out of favor and really hated, that to me is a good sign, and it means it's time to do the work and move forward.

I'll tell you some areas that seem to be relatively hated today, but I can't necessarily tell you that they're good values. Education stocks today are relatively hated, and that's tied to increasing regulatory constraints from Washington and the fact that in an improving economy, fewer people feel that they have to go back to school, particularly a school where they have to borrow a lot of money. Shipping stocks in general and oil tanker stocks in particular are really hated. Again for good reason, almost nobody is making any money in that industry and there will be

more bankruptcies before we're done. Energy stocks are not quite hated but they're certainly way down from where they were a couple of years ago. Also, mining stocks are increasingly hated these days. Those are the areas where I would say there are opportunities. On the other hand, can I say that it's a great time to be buying software as a service companies? Most of those are trading at high valuations and there aren't too many bargains in that area.

G&D: Are there any companies that you would have traditionally invested in which now you stay away because of destructive technologies like Amazon or e-commerce?

PA: Years ago, a lot of people would have told you that newspapers are a great business. Newspapers are not a great business anymore. Some individual newspapers may still have a good return on capital and a good margin, but let's face it, newspapers are a dying industry. Most of them have not found a way to monetize the content if people don't actually buy a physical paper. I don't know one that's really making enough money from their website to pay for all the journalists on the staff.

In a related field, TV and radio are still decent businesses, but an awful lot

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Pictured: 2013 CSIMA Conference

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of TV and radio stations were bought at very high prices over the last 10 years, so people who made those investments are not getting a good return on their investment. I probably would not invest in any newspaper company today, and I would only invest in a radio or TV company if I found that it was really cheap, and if management understood the need to generate cash to pay a dividend or buy back stock, and not spend cash buying other stations because the return on capital would be pretty low.

G&D: How would you rate the attractiveness of the equity markets generally today?

PA: They're certainly less attractive than they were four years ago. In March 2009, in hindsight one could say that was a once in every 10 years kind of a valuation that you had available. We all know that if you had had the guts to buy at that time, you'd have made very, very handsome returns on a diversified portfolio of U.S. equities. Having said that, I think the stock market is fairly valued today on its own right, but I think the bond market is overpriced. If the choice is to put money in cash, bonds, or stocks, I think stocks are clearly the best investment in that group. If you expand it to other things that particularly large institutions can invest in such as direct real estate, private equity,

or foreign bonds, then U.S. equities are still reasonably attractive but may or may not be the first choice.

G&D: How much cash do you hold currently?

PA: Typically I will not go below 3% cash. That's really an amount that I feel I need in case we have a very bad market and I get redemptions. I would prefer not to have to sell some of my key holdings down 25% just to meet the needs of shareholders who decide to get out. Fortunately though, the Small-Cap Value Fund has a very loyal group of shareholders that do not whip us around. We don't attract hot money, so it's also less likely to mean that they're going to get out quickly.

Typically I won't have more than 10% cash at the top. That's a function of finding fewer stocks to buy when the market is high. It's also more likely to happen if we have a surge in takeovers. So my cash percentage generally ranges between 3% and 10%. Today, I'm somewhere a little below the midpoint of that range.

G&D: Are you concerned about the Fed eventually turning off the spigot and, if so, how are you preparing for that eventuality?

PA: I'm not worried about the Fed turning off the spigot any time soon because Mr. Bernanke has

been absolutely clear and deliberate about what he intends to do. Until we get to a 6.5% or lower unemployment rate and until we get to inflation well north of 3%, I think he's going to keep very loose money. Someday, it will be a problem, but that's not a problem today, and I'm not necessarily preparing for it. I just want to be alert to it. One of the interesting things people say is that when interest rates go up, it is bad for stocks. If you look at all of the economic cycles since World War II in the U.S., you'll find that on average, four to six tightening rounds on Fed funds occur before it really begins to affect the stock market. In fact, early on it's a good sign because it means the economy is doing well and profits are good. While price-to-earnings multiples might stall out or even begin to come down, corporate earnings are doing very well. Stocks still continue to go up even as the Fed starts to tighten. It's only when we are well into the second or third year of the tightening cycle that it begins to have an impact on the economy. We haven't even started to tighten yet, so I think we're still many months away before I even get the least bit concerned on that score.

G&D: Next year, you will be transitioning your portfolio management duties to David Wagner. What advice will you give

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him?

PA: David is going to be a worthy successor. He's a very good investor today and very experienced. He's been with us for 13 years. My advice to him will be to follow his instincts, know what he's good at, and be his own person. If he figures out what he's good at, then I'm not worried about it at all.

G&D: Are you going to miss managing the portfolio?

PA: Yes, but there's a time and a season for everything in our lives, and it'll be time for me to step down from managing institutional portfolios. I'm perfectly at peace with that decision. It's time to turn it over to the next generation. I've had a wonderful run, I love the business, I love what I do, but it's not right for me to block the next generation.

G&D: What advice would you give to students interested in a career in investing?

PA: I love that question and we could go on for hours talking about it. This is something I would say to all business students, not just those interested in investing. As you think about a career, think in a mature, long-term fashion about what you really want to do in life, and especially for the next 15 or 20 years. Do not accept the first job that comes along that seems

to have the highest paycheck. Do not automatically assume that some glamorous job that requires 80 hours a week will be all worth it three

“As you think about a career, think in a mature, long-term fashion about what you really want to do in life, and especially for the next 15 or 20 years. Do not accept the first job that comes along that seems to have the highest paycheck.”

years later. I've seen too many examples of people who get into those jobs and frankly regret it. They have no life, they can't keep up with their friends, and after a while, they're wondering why are they slaving away at

a job that they hate. They ask themselves, is this something I want to do the rest of my life? The answer's going to be no. Two or three years later, they move onto something else and maybe they've gotten some good experience, but it's really made them cynical. I encourage students to think more broadly about what it is that you really want to do in life and begin to point toward that and recognize that a balance between work and personal life is really important.

As far as going into the investments business, the one thing I would say is whether you want to be on the sell side or the buy side, whether you want to work for a long-only shop or prefer greater flexibility with a hedge fund, that's really a personal choice and some people have personalities that are more fitted for one over the other. Before you sign up, understand the stresses and risks involved in each job. Really check out the firm you're going with. How have they treated the employees that they've hired? What's the average tenure? If it's 18 months, what makes you think you're going to be any different?

G&D: Thank you very much for your time, Mr. Athey.

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Li Lu



Li Lu

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G&D: How did your unique experience as a Tiananmen Square protest leader lead you to where you are today, running Himalaya Capital?

Li Lu (LL): When I first came to Columbia University, I was dirt poor. I did not choose to come here – I just ended up here because I had nowhere else to go, having just escaped from China after Tiananmen. I was in a new country where I didn't understand the language, didn't know anybody, and didn't have a penny to my name. So I was desperate and afraid. In retrospect, that is good inspiration for trying to figure out how to make money! I just wanted to know how to survive.

For the first couple of years, I really struggled with the language, but I eventually became much more comfortable. I always had this fear in the back of my mind of how I was going to make a living here. I didn't even think about success at the time – I just wanted to pay my bills. I grew up in Communist China and never had much money to my name, and then all of a sudden I had giant student loans. So naturally I tried to make a buck or two.

One day, about two years after I arrived, a friend of mine who knew my issues said, "If you really want to make money you have to listen to this fellow. He truly knows how to make

money." I wasn't sure what it was all about. I just remember thinking that there was a "buffet" involved. So I assumed that it was some kind of talk with a free lunch! I said it was a good combination – a free lunch plus a talk about how to make money. So I went. To my dismay there was no

through right out of the gate. And I thought this fellow was just so intelligent – he could put very complex ideas into such simple terms. I was immediately drawn to value investing. By the time the lecture was over, I thought that this was what I was looking for; I could do this.

At the time, I couldn't really start companies, and I didn't want to work in a big company because of the differences in language and culture. Investing, on the other hand, sounded like it required a lot of reading and mathematics, hard work, and good judgment – I was confident that I could do those things well. And the fundamental principles of value investing appealed to me – buy good securities at a bargain price. If you're wrong, you won't lose a lot, but if you're right you're going to make a lot. It fit my personality and temperament very well. Warren used to say, "Value investing is like an inoculation – either it takes or it doesn't." I totally agree with him. There are few people that switch in between or get it gradually. They either get it right away or they don't get it at all. I never really tried anything else. The first time I heard it, it just made sense; and I heard it from the best. I guess it turned out better than a free lunch.

"There are few people that switch in between or get it [value investing] gradually. They either get it right away or they don't get it at all. I never really tried anything else. The first time I heard it, it just made sense; and I heard it from the best."

lunch. [laughs] There was just a guy with the name "Buffett."

Mr. Buffett really made a lot of sense during that talk. It was like a punch in my eyes. It was like I had just woken up and a light had switched on. His honesty came

G&D: How did your investing process develop differently from Buffett's?

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LL: Part of the game of investing is to come into your own. You must find some way that perfectly fits your personality because there is some element of a zero sum game in investing. If you buy, somebody else has to sell. And when you sell, somebody has to buy. You can't both be right. You really want to be sure that you are better informed and better reasoned than the person on the other side of the trade. It is a competitive game, so you're going to run into a lot of very intelligent, hardworking fellows.

The only way to gain an edge is through long and hard work. Do what you love to do, so you just naturally do it or think about it all the time, even if you are relaxing, and even if you're just walking in the park. Over time, you can accumulate a huge advantage if it comes naturally to you like this. The ones who really figure out their own style and stick to it and let their natural temperament take over will have a big advantage.

The game of investing is a process of discovering: who you are, what you're interested in, what you're good at, what you love to do, then magnifying that until you gain a sizable edge over all the other people. When do you know you are really better? Charlie Munger always said, "I would not feel entitled to a view unless I could successfully argue

against the best counterargument of the smartest opponent." He is right about that.

Investing is about predicting the future, and the future is inherently unpredictable. Therefore the only way you can do it better is to assess all the facts and truly know what you know and know what you don't know. That's your probability edge. Nothing is 100%, but if you always swing when you have an overwhelmingly better edge, then over time, you will do very well.

G&D: How did you become friends with Charlie Munger? Do you have a friendship with Warren Buffett as well?

LL: Charlie and I have some very close mutual friends. Over time, we started talking about businesses, and then it evolved into a strong bond. I view him as a mentor, teacher, partner, and friend, all in one. I am also friendly with Warren, but not nearly as close as with Charlie because Warren is in Omaha. I admire him, and I learn more about him from his writings and deeds than through interpersonal interactions. I have a lot of interaction with Charlie, so I know him both as person and through his writing and personal deeds.

G&D: Do you have a favorite Charlie Munger quote?

LL: Oh, there are so many. We share a fundamental ethos about life and about approaching investing. So I learn more about how to conduct myself personally as much, if not more, than investing.

G&D: How would you define your circle of competence?

LL: I let my own personal interests define my circle of competence. Obviously I know something about China, Asia, and America – those are things that I am really familiar with. I have also over the years expanded my horizon [in terms of analyzing businesses].

I started out looking for cheap securities. When you start out, you really have no choice. You don't have enough experience, and you don't want to lose money, so what do you do? You end up buying dirt-cheap securities. But over time, if you are interested in businesses in addition to securities, you begin to become a student of businesses.

Eventually, one thing leads to another and you begin to learn different businesses. You learn the DNAs of businesses, how they progress, and why they are so strong. Over time, I really fell in love with strong businesses. I morphed into finding strong businesses at bargain prices. I still have a streak in me that favors finding really cheap securi-

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“There is some element of a zero sum game in investing. If you buy, somebody else has to sell. And when you sell, somebody has to buy. You can't both be right. You really want to be sure that you are better informed and better reasoned than the person on the other side of the trade.”

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ties – I just can't help it! But over time, I've become more attracted to looking for great businesses that are inherently superior, more competitive, easier to predict, and with strong management teams. I'm just not quite satisfied with the secondary market. As I said, there is an aspect of the securities business that is zero-sum. And that's the area in which I don't feel entirely comfortable. I'm more interested, by my nature, in win-win situations.

I want to create wealth together with the business operators and employees when I invest. So that led me to venture businesses. I try to apply the principles of intelligent investing there, but I actually can contribute quite a bit, so it becomes a win-win situation.

Over my career, I've had the satisfaction of building a number of different venture businesses. Some of them became enormously successful, even after we sold them. You could say we sold them too early! I was the first investor in Capital IQ, and then look at what happened. If we would have kept it, we would have been far richer! It's not like we didn't make a lot of money in that investment. We did. [laughs] But I like it that way. I like to create something that everybody finds useful. We created employment, and we created a beautiful product that's sustainable, and everybody made a lot of money, even

the people who bought the business from us.

I like win-win situations. I do not complain about selling Capital IQ too early. We made a lot of money on that investment, and we contributed a great deal. I remain friends with the founders. That aspect gave me enormous pleasure. But the venture side is hard to scale; you must put in a lot of effort. So, over time, I gradually moved into helping in a different way. Even in public securities, you can still be very helpful and constructive. So, that's who I am. I'm still learning, and I'm still interested. I'm still young, and still incredibly curious. So, who knows? Hopefully, I will continue to gradually expand my circle of competence.

G&D: How were you able to figure out that Capital IQ would become so successful?

LL: In the beginning it was Bloomberg. We wanted to create something just like Bloomberg, and in the process, we grew to appreciate Bloomberg much more because it was so hard to compete with them. Then we realized the investment banking side was not fully penetrated.

So we basically applied what we learned about Bloomberg and created a similar product for the investment banking side. Over time, we also penetrated different businesses like private equi-

ty. We learned quickly that we couldn't really compete with Bloomberg.

G&D: You don't short stocks at Himalaya, correct?

LL: That's right; not any more. That change occurred nine years ago. Shorting was one of the worst mistakes I've made.

G&D: Is your lack of a short book due to your desire to be a constructive third-party for companies and their management teams?

LL: Yes. But also, you can be 100% right, and you could still bankrupt yourself. That aspect of shorting just frustrated me too much! [laughs]

Three things about shorting make it a miserable business. On the long side, you have 100% downside but unlimited upside. On the short side, you have 100% upside and unlimited downside. I do not like that math. Second, the best short has some element of fraud. However, a fraud can be perpetrated for a long time. Of course you borrow to short, so they could really just wear you down. That's why I could be 100% right and bankrupt at the same time. But, you know what, you go bankrupt first! Lastly, it screws up your mind. Shorts just grab your mind and take away from the concentrated effort that is required to do proper

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“The only way to gain an edge is through long and hard work. Do what you love to do, so you just naturally do it or think about it all the time, even if you are relaxing...Over time, you can accumulate a huge advantage if it comes naturally to you like this.”

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long investing. So, those are the three reasons why I just stay away from shorting.

It was a mistake on my part. I shorted for a couple of years. I don't discard people who are really doing well at shorting – it's just not me. If I want to add a fourth reason, it is that the economy overall has been really growing at a compounding rate for 200-300 years, ever since the modern science technology era. So, naturally, the economic trend favors long positions rather than short.

But you cannot live life without making a mistake. Every time I make a mistake I learn something.

G&D: How were you able to get Charlie Munger interested in a company like BYD [a Chinese company which manufactures electric cars, batteries, electronics and solar equipment] given that Berkshire Hathaway typically shies away from technology-oriented companies?

LL: I don't think that Warren and Charlie are ideological. Neither am I. It's really how much you know. The story of BYD is relatively simple. This guy, who is a really terrific engineer, started the business from just a \$300,000 loan with no additional money until the IPO. He created a company with \$8 billion in revenue and 170,000 employees and tens of thousands of engineers. He solved a whole

bunch of different problems. So you have to admit the record is impressive. They also happen to be in the right industry and the right environment, and they get the right support from the government. Their engineering culture consistently demonstrates its ability to tackle big, difficult problems. It works. So it's hard not to be impressed by the record the guy has. At the time we invested, we had quite a bit of a margin of safety.

“...you cannot live life without making a mistake. Every time I make a mistake I learn something.”

They play in a big field with open-ended possibilities and have a reasonable chance of being successful. As I said, nothing is a sure thing, but this strikes me as having as good of a chance as any. Charlie was equally impressed by the company, which then led to the investment. Berkshire is not ideologically against technology stocks. They're just against anything they don't

feel comfortable with. They have that \$11 billion investment in IBM, which, I can argue, is a technology company. But I can guarantee that's not how they think about things. It has nothing to do with whether it's a technology stock or not.

G&D: Buffett admitted in a 2009 Fortune article that he doesn't really understand BYD.

LL: That is true. Warren and Charlie have a great partnership and Charlie knows more about BYD than Warren. But I would not bet against the collective track record of those two. It's not that they don't make errors from time to time. Everybody is capable of doing that. They have a few, but very, very few over a long investment career.

G&D: Do you see the quality of BYD cars improving?

LL: This company is a learning machine. Think about it – they really didn't get into industry until 10 years ago. They didn't produce their first car until eight years ago. They are in a market where every single international major brand is competing, with an all-out effort, because it's such a big market. So they never had any home advantage whatsoever because China's auto market started out completely open with everybody competing. Yet there's a little car company

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Pictured: Christopher Davis of Davis Advisors at the 2013 CSIMA Conference.

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with very little money, and, in less than 10 years, it's selling more than half a million cars a year and has carved out a position for itself. You have to say, the record is not too bad, and so there's something to it. They also have an engineering culture and a can-do spirit. They consistently demonstrate that they're able to tackle really complex engineering problems and come up with very practical solutions faster, cheaper, and better than most other people. That is an advantage in the manufacturing economy.

G&D: Can you talk about your investment process?

LL: Ideas come to me from all sources, principally from reading and talking. I don't discriminate how they come, as long as they are good ideas. You can recognize good ideas by reading a great deal and also by studying a lot of companies and constantly learning from intelligent people – hopefully more intelligent than you are, especially in their field. I try to read as much as I can. I study all of the interesting and great companies, and I talk to a lot of intelligent people. You know what? In some of those readings or conversations, ideas just click. Then you do more research and then you get comfortable or you don't get comfortable.

G&D: Are the people that you talk to fellow investors or are they people like cus-

tomers, suppliers, and management?

LL: All of them. I don't talk to as many investors – very few. I am more interested in talking to people who are actually running businesses and entrepreneurs or CEOs or just good businessmen. I read all of the major newspaper publi-

“You can recognize good ideas by reading a great deal and also by studying a lot of companies and constantly learning from intelligent people – hopefully more intelligent than you are, especially in their field.”

cations and annual reports of the leading companies. I get a lot of ideas out of those too.

G&D: How do you assess if the management is being forthright with you? How useful is it to speak with the management?

LL: Well, management always has a big influence on your success, no matter how good or how bad the business is itself. Management is always part of the equation of making the company successful, so the quality of management always matters. But to assess that quality is not that easy. If you can't assess the quality of management, you may have to make a decision in spite of that. That's just part of the process. So you have to figure out other ways such as looking at the quality of the business, the valuation, or something else until you can justify an investment.

If you do have a way to assess the quality of the management team, either because you're an astute student of human psychology, or you have a special relationship with the people, then you'll take that into consideration. Why wouldn't you? The management team is part of what really makes a company.

But, it's not that easy. It's not that easy to have an in-depth, solid understanding of the management team. Very few people are able to do that. I admire people that say, "Hey, look. Whatever the information, whatever the kind of presentation they make, I will never be able to learn about management beyond that. I know it's a show for me, so I might as well just discard it." I respect that.

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Investing is about intellectual honesty. You want to know what you know. You want to know, mostly, what you don't know. If understanding the management team is not in the cards, it's not in the cards.

G&D: What is your domestic versus international allocation?

LL: I don't have a preconceived notion about allocation. I let the opportunity dictate where I end up. I just happen to have more interest in Asia and the U.S., so that's where I end up. I do not feel that interest in Europe. I do not feel that in Africa. But I approach it with an open mind. I want to really find the best company at the best price, run by the best people and available to me at the time I am looking. Those don't necessarily always meet, and it's OK.

You start out by holding cash, and that is a pretty good opportunity cost, because it doesn't go down. So any time you find an investment, it has to be an improvement on an overall risk-adjusted basis. You may find some very interesting things, and now you've got a basket of a few interesting securities plus cash. That is a pretty good opportunity cost, and the next time you add another security, it better make the portfolio better than the existing one. You just constantly improve your oppor-

tunity cost.

G&D: Is your fund open to new investors?

LL: The fund has been closed to new investors for nine years. However, we will open it up a bit this year. We have more opportunities than we have money around, but that's

“That way we're all in the same game together. ... That ethos is what makes Charlie and Warren so special. They believe in fundamentally earned success. That's why, despite their enormous success, nobody criticizes them very much.”

rare. I usually don't want to increase our size. My ambition has never been to run the largest fund. I never wanted to earn the most money out of a fund. I just wanted to have, by the time I finished my career, one of the best track records on a risk-adjusted basis. If I achieve that, I will feel very good about myself.

That's my goal, and therefore the compensation structure of the fund reflects that. Over time, I switched into the best compensation structure I knew in the industry, the original “Buffett partnership formula”. We don't take any management fee. We provide a 6% return for free to our investors and then take 25% after that. I don't invest anything outside of the fund. I put all of my investment capital into my funds. So it's a true partnership. There are very few conflicts between the general partners and the limited partners.

That way we're all in the same game together. I have zero incentive to take new money for the sake of taking new money because I don't take things off the top. The minute that new money arrives, it begins to compound 6% on an annual basis against me, so I better be able to find something that is worthwhile and doing better. When I make money, I feel like I earn it, and when my investors make money, they earn it. It is just a better way to structure a business – you feel that everybody's success is deserved. That ethos is what makes Charlie and Warren so special. They believe in fundamentally earned success. That's why, despite their enormous success, nobody criticizes them very much. When you create the hundreds of billions in wealth for everybody

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while taking a salary of \$100,000 per year for more than 40 years, it's hard to criticize them.

G&D: Are there industries that you completely stay away from?

LL: I'm not ideologically opposed to anything. I am against any ideology. [laughs]

There are lots of things I don't know. I'll be the first one to admit. But it doesn't mean that I'm not curious from time to time. Maybe I know some aspect of the story. That little aspect might even constitute the investment. I don't know. I don't want to rule it out, but I can say that when you present me an idea, I can quickly tell you whether it's a "no" within a few minutes.

There are basically three buckets that Charlie has. "Yes", "no", or "too hard". Most of the things fall in "too hard." Some get a quick "yes" or "no", but if it's too hard, it's too hard. So you end up not doing a lot. You end up really concentrating on the ideas where you truly have the time and energy to fully understand the situation better than anybody.

G&D: How do you get comfortable with the risk/reward of a high tech company like BYD that is undergoing pretty rapid technological change? Do you think you have a good sense of what BYD will look like

10 years from now?

LL: Most businesses are subject to change if you stay with them long enough. There's not a single business that I know of that will never change. That's the fascinating thing about business. Successful businesses have some combination of things

"I think you want to avoid wrong decisions as much or more than you want to get it approximately right. If you avoid the wrong decisions, you'll probably come out okay over time."

that enable them to adapt to changes better than anyone else. In each situation, it's slightly different.

Every company in today's age is a technology company somehow, but the technology may not be on the cutting edge, and may not play an important role in the success or failure of the overall business.

Successful technology com-

panies are the ones that are capable of reinventing themselves and dealing with change. Take the example of Intel. The whole business changes every 18 months. Failure to change leads to quite a substantial disadvantage and yet they're able to build their culture based on that change.

Take Samsung – their early memory chip business decreased in price by 1% every week, and yet they really developed a culture that precisely deals with that change. So when they apply the same culture to something like a cell phone, they get ahead very quickly. Now they're outselling Apple. So culture really plays an important role in those faster-changing environments, enabling certain companies to always surge ahead of everybody else.

G&D: Do you need to understand the technology on an engineering level to have a good sense of the risk/reward?

LL: It certainly is a plus, but not a must. If you were really a great engineer in the product the business is selling, obviously it's a plus. But it's certainly not a must because no matter how good you are at a certain area, you're not so good in other areas. The pace of change is such that whatever you are now specialized in will become obsolete. But that doesn't disqualify you from making a judgment

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 on how a company can develop a culture to deal with that. Successful companies are able to deal with change consistently by hiring the right people, building the right culture, and staying ahead of their competitors. That's the aspect that really makes them successful. And that's kind of a predictable aspect of businesses.

There is always a certain element that is unpredictable. And there is a certain element that is predictable. You want to have a little of both. But overall, I think you're right. In a business that is subject to rapid change, it is a lot more difficult to make a reliable forecast. There is no question about that. But it doesn't mean an investor cannot make a few predictions that could indicate that the odds are in your favor. You want to play when you feel very comfortable that the odds are in your favor. Many times, that's searching among typically stable businesses where something has changed all of a sudden.

Take Eastman Kodak for example. It used to be one of the best companies; it invented photography. But look at where they are now. Take Bell Labs and AT&T. They used to really have all the power. They had monopoly businesses. Where are they now? Just a name. That is the nature of brutal capitalism. It's the nature of the business. Things that appear to be predictable and stable are not. Things

that don't appear to be very stable actually turn out to be.

I think you want to avoid wrong decisions as much or more than you want to get it approximately right. If you avoid the wrong decisions, you'll probably come

“The most important thing in our business is intellectual honesty. What I mean is four different things: know what you know, know what you don't know, know what you don't have to know, and realize that there is always a possibility that ‘you don't know that you don't know.’”

out okay over time. But, I agree with you, it's not easy and it's not precise or a science at all. Hopefully one improves overtime.

G&D: How do you make

your sell decisions?

LL: One should make sell decisions on one of three occasions. Number one, if you make a mistake, sell as fast as you can, even if it's a correct mistake. What do I mean by a correct mistake? Investing is a probability game. Let's say you go into a situation with 90% confidence that things will work out one way and a 10% chance they work out another way, and that 10% event happens. You sell it. Then there's a mistake that your analysis is completely wrong. You thought it was 99% one way but it was actually 99% the other way. When you realize that, sell as fast as you can. Hopefully at not too much of a loss, but even if it is a loss it doesn't matter – you have to sell it.

The second time you want to sell is when the valuation swings way too much to the other end of the extreme. I don't sell a security because it's a little overvalued, but if it is way overboard on the other side into euphoria, then I will sell it. If you are right and hold a company for a long time, you have accumulated a large amount of unrealized gains. A big portion of those unrealized gains act like borrowings from the government interest free and legally. So when you sell that position, you take all the leverage and you take a bunch of the capital out, so your return on equity has just become a

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Pictured: Mason Hawkins of Southeastern Asset Management at the 2013 CSIMA Conference.

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Pictured: Tom Russo of Gardner Russo & Gardner and Timothy Hartch of Brown Brothers Harriman at the CSIMA Conference in February 2013.

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little less.

The third occasion when to sell is when you find something that is better. Essentially, a portfolio as I said is opportunity cost. Your job as a portfolio manager is to constantly improve on your basket. You start with a high bar. You want to increase the bar higher and higher. You do that by constantly improving the opportunity costs; you find something better. Those are the three reasons that I would sell.

G&D: In your 16 years running Himalaya, you've experienced three major financial crises: the Asian financial crisis of 1997, the dot com bubble burst in 2000, and the financial crisis of 2008. How have you navigated these crises as a fund manager, and what have you learned from them?

LL: That's an excellent question. You know every time that that happens, they always bill it as "once in a century," except these major events happen every five years in my case. [laughs] What is interesting about crisis is that it puts your intellectual honesty to the test.

The most important thing in our business is intellectual honesty. What I mean is four different things: know what you know, know what you don't know, know what you don't have to know, and realize that there is always

possibility that "you don't know that you don't know." Those four things are distinctly different. In a crisis, things emerge that test you on all four categories.

For example, during the

"The most important thing in our business is intellectual honesty. What I mean is four different things: know what you know, know what you don't know, know what you don't have to know, and realize that there is always a possibility that "you don't know that you don't know."

Asian financial crisis, all of the sudden the world was saying, "how much debt do these companies have?!" Oh my goodness, they really have that much of a dependence on debt! Oh my God,

the whole country could go down!" Everyone was constantly in crisis mode. All of the things come out that you don't normally care about and normally don't pay attention to. Normally you think, "Well, that has nothing to do with my investment in this company." Then all of the sudden, you say, "Oh Jesus, it has everything to do with my company." Well, you are right or you are wrong. That crisis will put those questions to the test.

That's why people freeze in the midst of a crisis. People freeze because they were not intellectually honest before. They never quite distinguished certain issues or questions and put them into the appropriate basket. If you make an overall judgment, for example, of how the U.S. is going to perform over time through ups and downs, and you go into it knowing that there is a possibility something much worse could happen. Maybe it's small, but when it happens, it happens. At that time, the question becomes "Is it an unknown unknown," or do you know that you don't have to know? You absolutely will be asked that question.

So the financial system might be in trouble. Yes, a business needs financing, but I suppose if life goes on, my business will be there, however it will end up. So the question then becomes, "Do I have to know how

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the financial system will sort out its problems for me to predict my business?"

That's the question and that's the question that you want to answer before a financial crisis hits.

If you can answer that question honestly and correctly, you will do more after the financial crisis. Christopher Davis's grandfather used to say that you make the most money out of a bear market financial panic – you just don't know it at the time. It's always the case. Less intelligent investors will be sorted out. Intelligent investors are the ones who are always intellectually honest. They can distinctly know whether they know or they don't know, and know what they don't have to know, and that there exist unknown unknowns. If you can really put things into those categories correctly, you will pass the test. Otherwise, you will have gotten yourself in trouble.

G&D: In 2010 panel at Columbia Business School, you mentioned that Asia's role in the global financial system is becoming increasingly important. Can you talk about this view for our readers?

LL: Asia will become an important economic force, not necessarily just in a financial sense. The financial part is a derivative of Asia's overall economic performance. Asia, and particularly China, is shaping up to become a bigger economic

force in our global marketplaces because of the sheer size of it and the path that they're on.

China is on a historic path of continuing to grow into a modern economy. They

“China is so big. It has all sorts of extreme phenomena. Yes, there are ghost towns, but there are also towns that are utterly, utterly crowded ... China is a case of contradiction, as it has always been, and will always be; you'll always find evidence of every theory you want to prove.”

still have a long way to go, but they have come a long way from the starting point. Because of the enormity of the size of China, it will have a huge impact in Asia and the rest of the world. So

China and the U.S. together would make the Pacific Basin somewhat of an economic center the same way that the Atlantic Ocean was around Europe and the U.S. A lot of opportunity will emerge. That doesn't mean that it's a one-way street or a smooth pass. All sorts of things could happen. It doesn't mean you're going to make money guaranteed. But it does offer a tremendous amount of opportunity to those who can navigate this development. The importance of China cannot be ignored.

G&D: Do you have any concerns on a real estate bubble in China? We saw a 60 Minutes piece about the ghost cities in China, and it was very striking.

China is so big. It has all sorts of extreme phenomena. Yes, there are ghost towns, but there are also towns that are utterly, utterly crowded. I mean, every space is occupied, and there are towns seemingly out of nowhere that have an enormous number of high rises that are all occupied. I remember, twenty years ago that Pudong was viewed as a semi-ghost town. Today, you cannot help but be impressed by the economic vibrancy there.

We live in Manhattan, but think about it: there are 10,000 high rises in Shanghai that are taller than thirty floors, multiple times that of Manhattan – that is enor-

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mous. Manhattan probably has the highest concentration of high rises in the whole world other than Shanghai. The scary part is that China's not done. So, I say China is a case of contradiction, as it has always been, and will always be; you'll always find evidence of every theory you want to prove.

But overall, the economy still has a long way to go. They still have a sense that this is their time. It doesn't mean that they don't have problems; they have an enormous amount of problems, but so does America, and so did America over the last 200 years.

If you go through the American Civil War, the country killed two percent of its population. And yet, not only was it rebuilt, but it was rebuilt at a furious pace. And it went through two great world wars. After World War II, if you thought Japan and Germany were doomed, boy were you wrong.

G&D: Do you think real estate has gotten a little ahead of itself where there would be a need for a correction, or do you think that demand will just catch up?

LL: I put that in the "too hard" basket. I also put in the basket of "I know I don't have to know." It certainly is "I don't know", but I also know that I don't have to know! I don't want those

things to worry me.

G&D: How do you view the overall attractiveness of equities today?

LL: I also put that into "too hard" and "I know I don't have to know." I only think

"I pay attention to those macro trends only in the hope that I can have comfort that they're a tailwind as opposed to a headwind. Now, how much they can help if they're a tailwind, or how much they can hurt if they're in my face, I don't know."

about it when things go to an extreme. I don't foresee that as going to the extreme, either way. In that case, I know I don't have to know.

G&D: A lot of smart people believe that renewable

energy is the next big revolution. You've done a lot of work on battery technology and BYD, so is that something that you think about beyond batteries? What do you think the energy revolution will look like?

LL: I pay attention to those macro trends only in the hope that I can have comfort that they're a tailwind as opposed to a headwind. Now, how much they can help if they're a tailwind, or how much they can hurt if they're in my face, I don't know. But I want such macro trends to be behind me rather than in front of me. So that's the extent that I want to know mega trends.

But as a concerned citizen, I'm intellectually curious about it. But it doesn't mean that I'll be able to know for sure how a given development is going to come about. In fact, we don't know, and that's why the free market with millions of participants acting in their own self interests will figure out a way. To predict ahead of time is not easy, and the good thing is that you don't have to be able to do that.

If such trends are at your back, that's fabulous, especially if you don't need them to be at your back. If they're really a headwind, you do want to examine them a little more. So that is how I view this renewable energy issue. I know that at some point, human civiliza-

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tion will have to find something other than fossil fuels. We don't have enough fossil fuels, and we need to preserve them for agricultural and food security reasons. We also can't afford to have the weather deteriorating the way it has been over the last few decades. Eventually it will catch up to us.

So for multiple reasons I understand why we need to figure out alternatives to fossil fuels. But am I qualified to make an informed investment decision based on that now? Probably not. But if that one happened to be at my back, hey I'm all for it.

G&D: Do you have any advice for students who are interested in getting into investment management, especially for those readers who can't go and listen to Warren Buffett speak during their lunch break?

LL: If you do get a chance to meet Mr. Buffett, I'd run to it if I were you. I wouldn't even take an airplane; I would just run to Omaha! [laughs]

Start by learning from the best – listening, studying, and reading. But the most important thing in understanding the investment business is by doing it. There is no substitute to actually doing it. The best way to do it is to study one business inside and out for the purpose of making the investment – you may not actually invest. But having

gone through the discipline of understanding one business as if you own 100% of that business is very valuable.

To start, take an easy-to-understand business. It could be a tiny business – a

“Start learning from the best — listening, studying and reading. But the most important thing in understanding the investment business is by doing it.

There is no substitute for actually doing it.

The best way to do it is to study one business inside and out for the purpose of making the investment.”

little concession store, a restaurant, or a small publicly traded company. It doesn't matter. Understand one business and what really makes it tick: how it makes money, how it organizes its

finances, how management makes its decisions, how it compares to the competition, how it adjusts to the environment, how it invests extra cash, and how it finances the business.

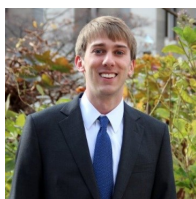
You should understand every aspect of one business as if you own 100% but you don't actually run it. This causes you to be desperate to understand every aspect to protect your investment. That will give you a sense of a disciplined approach. That's how you truly understand business and investing. Warren always says that to be a good investor, you need to be a good businessman, and to be a good businessman, you need to be a good investor in terms of capital allocation.

Start by understanding one thing within your control that you can understand inside and out. That is a terrific starting point. If you start from that basis, you are fundamentally in the right direction of becoming a great security analyst.

G&D: It was a pleasure speaking with you, Mr. Li.

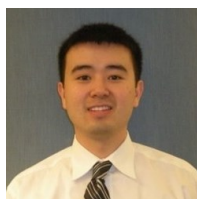
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Richard Hunt

Richard is a first-year MBA student at Columbia Business School. Richard is Co-President of the Columbia Student Investment Management Association. Prior to CBS, Richard was a Senior Financial Analyst at New Constructs.



Stephen Lieu

Stephen is a first-year MBA student at Columbia Business School. Stephen is Co-President of the Columbia Student Investment Management Association. Prior to CBS, Stephen worked for four years in investment banking and private equity.



Rahul Raymoulik

Rahul is a first-year MBA student at Columbia Business School. Prior to CBS, Rahul was a Sector Specialist at Fidelity Investments, focusing on the technology, media, and telecom industries.

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Hertz Global Holdings, Inc. (NYSE: HTZ) - Long Winner — 2013 Pershing Square Challenge

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Recommendation

We recommend investors buy Hertz stock with a 12-month target share price of \$36, which represents ~52% upside to the current share price. There are four main points to our investment thesis:

- 1) The market significantly underestimates the impact of Hertz's recent merger with Dollar Thrifty, which marks the completion of a ten-year industry consolidation that dramatically improves the competitive dynamics of the industry
- 2) The market underestimates the levers Hertz can pull to counter the negative impact of falling used car prices
- 3) Hertz has strong growth opportunities in the U.S. and will realize significant revenue and cost synergies through its acquisition of Dollar Thrifty
- 4) A divestiture of the non-core Equipment Rental segment would unlock substantial value by deleveraging the balance sheet

Business Description

Hertz operates two main segments: car rental and equipment rental. Car rental is the company's core business – it operates over 10,000 locations worldwide and generated \$7.6 billion in revenue last year. The equipment rental segment rents out industrial, construction, and material handling equipment. It generated \$1.4 billion in revenue last year.

Investment Thesis

1) The market underestimates the industry consolidation's impact on car rental pricing

Ten years ago, there were six major rental car companies. Since then, there have been a number of acquisitions: Avis acquired Budget in 2002, Enterprise acquired National Alamo in 2007, Hertz acquired Advantage in 2009, and in the past six months, Avis acquired Zipcar and Hertz acquired Dollar Thrifty. This marks the completion of an industry consolidation with the three remaining players controlling 95% of the market. We believe this oligopoly structure dramatically improves the competitive dynamics and profitability of the industry, as the three players can now focus on profitability instead of market share.

We're seeing signs of this already playing out – prior to the closing of the Dollar Thrifty acquisition in November 2012, Hertz had experienced nine consecutive quarters of pricing declines and Avis had experienced 11 consecutive quarters of pricing declines. Since the acquisition closed, pricing has increased every month.

We believe the market is significantly underestimating the improved pricing environment that has resulted from the industry's consolidation. Management's EPS guidance assumes 0% pricing growth. Sell-side consensus estimates assume only a 1% increase in pricing. Pricing is the single biggest driver of our model, as a 1% price increase results in a 6% increase in our target share price.

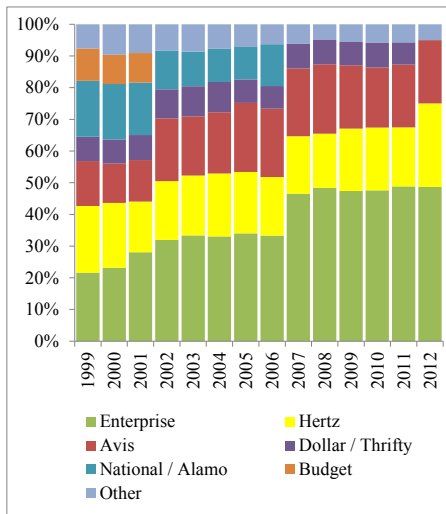
Post the Dollar Thrifty acquisition, the pricing environment has been very strong, with consistent price increases and cooperative matching among the three players. There has also been blatant price signaling by Hertz and Avis. We believe this is the beginning of long-term rational behavior in the U.S. car rental industry and management and the market's assumptions on pricing are too conservative.

As of 4/19/13; in USD m except per share data

Current Capitalization	
Stock Price	\$23.72
Diluted Shares Outstanding (M)	462.0
Market Cap	\$10,959
Corporate Debt	6,545
Cash	(1,105)
Unfunded Pension Liability	227
Enterprise Value	\$16,626

Trading Statistics	
52-Week Range	\$10.22-\$24.28
Dividend Yield	0.0%
Avg. Daily Volume (M)	7.7
Short Interest as % of Float	11.0%

Summary Valuation		
	2013e	2014e
EV / Revenue	1.5x	1.4x
EV / EBITDA	7.4x	6.4x
P / E	12.5x	9.9x



"One of the headlines I'd like to make is we don't want to gain share by reducing price. We want to gain share by increasing value, and that's how we're doing it."

– Hertz CEO in April 2013

"We're seeing our competitors move for profitability, rather than share, and that has a positive impact on all of us."

– Avis CFO in February 2013

"We've been very aggressive in initiating price increases over the last 4 months or so and I think that's had a positive impact. And we've seen a fairly good matching of increases by both Hertz and the Enterprise."

– Avis CFO in March 2013

Hertz Global Holdings (Continued from previous page)

2) The market underestimates the levers Hertz can pull to counter negative impact of falling used car prices

The market believes that Hertz's used car residual values closely follow the Manheim Market Index, the most widely followed index of used car prices. This is simply not true. Since January 2011, the Manheim Market Index is down 3%, but Hertz's residual values have actually increased by 10%. So how is this possible? It's possible because of the dramatic shift in how Hertz purchases and sells its fleet. In 2012 alone, the company reduced its purchase of program cars, whose residual values are guaranteed by auto manufacturers, from 45% in 2011 to just 19%. Not only does the company save about 1% on the purchase of these non-program cars, it can also realize substantially higher residual value selling its cars via much more profitable channels, and can keep cars on rent for longer.

For example, in 2009, the company sold 88% of its non-program cars at auction, the least profitable remarketing channel. In 2012, only 33% of the company's cars were sold at auction. So where are these cars going? Hertz sold 47% of its cars directly to dealers, which netted them \$500 more per vehicle than a comparable sale at auction. Hertz also sold 13% of its vehicles via retail, a channel that didn't exist four years ago, but today nets them an additional \$1300 per vehicle. We expect retail to triple by 2014.

These changes are possible because consumers and dealers are now willing to purchase cars online. Thanks to the internet, local markets have been transformed to national markets, which makes it easier and more profitable for Hertz to dispose of its fleet. We believe that the market does not appreciate the impact that these new channels have on Hertz's fleet cost. The market also misses the fact that declines in residual values affect all rental car companies equally, so pricing can simply increase to offset the impact of falling used car prices.

3) Hertz has strong growth opportunities in the U.S. and will realize significant revenue and cost synergies through Dollar Thrifty

There are substantial growth opportunities in the U.S. rental car market, as well as significant synergies from the Dollar Thrifty acquisition. First, we expect Hertz to increase its profitable off-airport locations. In just six years, Hertz has increased its off-airport locations by 60%, and we expect continued double-digit growth. Second, we expect double-digit growth in the value segment, a segment that grew by 25% in 2012. Third, Hertz is significantly expanding its business by using 24/7 Kiosks that allow the company to increase fleet utilization and operate in more areas in a cost-effective manner. Lastly, we expect Hertz's entire fleet to have the 24/7 car sharing ability by 2014.

Also, as a result of the Dollar Thrifty acquisition, Hertz will realize \$600 million in revenue and cost synergies over the next three years. One of the largest areas of synergies is fleet sharing, because Hertz experiences peak demand on weekdays while Dollar Thrifty experiences peak demand on weekends, and thus sharing fleet results in lower fleet costs and higher utilization. As part of our primary research, we visited a couple of Hertz locations in Manhattan and found that Hertz has already begun sharing fleet.

4) A divestiture of the non-core Equipment Rental segment would unlock substantial value

A divestiture of the non-core Equipment Rental segment (HERC) would provide shareholders with 20% incremental upside to our base case. Divesting HERC would make sense for two main reasons. First, it allows management to focus on the core and higher-return car rental business and the integration of Dollar Thrifty. Second, it would be highly deleveraging for the company, pushing it closer to its goal of becoming investment grade, and leading to an immediate EPS accretion of \$0.14 to \$0.19.

Based on our analysis, HERTZ would maximize shareholder value by leveraging up HERC, using proceeds to pay down corporate debt, and spinning off HERC in a manner that qualifies for tax-free treatment under IRS Section 355(e) "Safe Harbor" rule. The EPS accretion plus additional value in the spun-off company would lead to a 20% incremental upside

Capital Allocation

We project a steady increase in FCF going forward with FCF yield reaching 14% by 2014. Management plans to use the free cash flow to pay down debt and has stated that once it reaches its target leverage of 1.6x, it will start returning cash to shareholders. We believe Hertz will hit this mark within the next 18 months, at which point shareholders will see significant cash returns. Deploying one third of FCF towards share repurchase would lead to incremental EPS accretion of \$0.13 or 6% EPS growth to our base case estimate.

Valuation

Using an average of three valuation methodologies (P/E multiple, EV/EBITDA multiple, and SOTP analysis), we arrive at a target share price of \$36 or ~52% upside to the current price.

(\$ millions except per share)	Base	Bear	Bull	Street
<u>FY2014 Estimates</u>				
Car Rental EBITDA	\$2,413	\$1,828	\$2,727	\$2,143
Equipment Rental EBITDA	509	432	539	453
Consolidated EBITDA	\$2,922	\$2,261	\$3,266	\$2,596
EPS	\$2.87	\$1.90	\$3.39	\$2.38
<u>Target Forward Multiples</u>				
P/E	12.5x	11.0x	13.0x	12.5x
EV/EBITDA	7.4x	6.0x	8.0x	7.4x
SOTP: Car Rental	7.4x	6.0x	8.0x	7.4x
SOTP: Equipment Rental	6.2x	5.0x	6.5x	6.2x
<u>Price per Share</u>				
P/E x EPS	\$35.93	\$20.91	\$44.06	\$29.80
EV/EBITDA x EBITDA	\$36.73	\$18.87	\$46.90	\$31.53
SOTP	\$35.41	\$17.89	\$45.16	\$30.36
Target Price	\$36.00	\$19.00	\$45.00	\$30.56
Upside (Downside)	52%	(20%)	90%	29%
<u>Key Assumptions</u>				
RPD CAGR (FY'12-'14)	2.5%	(1.0%)	3.5%	0%-1%
Manheim Index CAGR (FY'12-'14)	(3.0%)	(5.0%)	(2.0%)	(2%)-(4%)
Chg. in Residual Value due to Channel Mix Shift	\$256	\$0	\$383	\$125-\$175
Cost Synergies (FY2014)	\$250	\$150	\$300	\$300

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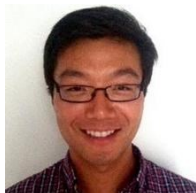
Joe Fleury

Prior to CBS, Joe worked as an analyst at Ionic Capital Management, a multi-strategy hedge fund in New York. Joe holds a BA in Economics from Yale University.



John Gallagher

Prior to CBS, John worked with the TARP funds at the U.S. Treasury Department. Before TARP, he worked for the Federal Reserve. John holds a BS in Finance from George Mason University and is a U.S. Army veteran.



Seth Kirner

Prior to CBS, Seth worked in Restructuring at Loughlin Management Partners. Prior to that he worked at Jennison Associates. Seth holds a BA in Finance from Northeastern University.

Advance Auto Parts (NYSE: AAP) - Long Finalist — 2013 Pershing Square Challenge

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Recommendation: BUY

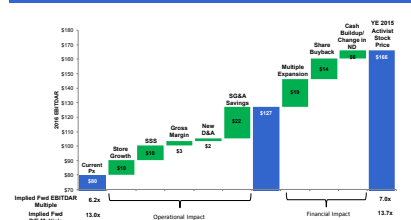
(\$ in millions except per share values)

CAPITAL STRUCTURE		TTM FINANCIAL METRICS	
Current Share Price	\$ 80.00	Enterprise Value/EBITDAR	6.7x
Avg. Daily Vol. (mm)	1.3	Enterprise Value/EBIT	12.0x
52 Week Low- High	\$61-\$93	Price/Free Cash Flow	14.1x
Short Interest	2%	Price/Earnings	15.3x
Shares - diluted	74.14	ROIC	23%
Market Cap	\$ 5,931	Free Cash Flow Yield	7.1%
(+) Debt	605		
(-) Cash	598		
(+) Capitalized Oper. Lease (6x) ¹	1,922		
Total Adj. Net Debt	\$ 1,929		
= Total Enterprise Value	\$ 7,860		

COMPS		2011	2012
SSS Growth		2.2%	-0.8%
Total Sales Growth		4.1%	0.6%

⁽¹⁾ 6x lease capitalization is industry standard used by companies, credit agencies, and analysts

CURRENT PRICE TO 2015 ACTIVIST CASE STOCK PRICE



We recommend a long position in Advance Auto Parts ("AAP") stock with a three year target price of ~\$165. AAP trades at a significant discount to its intrinsic value as well as its peers due to an inefficient cost structure as a result of historical strategic decisions. Our target price represents a ~100% upside to the current share price of \$80, and is based on a 7x forward 2016E EV/EBITDAR multiple (13.6x forward 2016 P/E). We believe that AAP is undervalued with an attractive margin of safety and that there are multiple ways to win with Advance Auto Parts. With management's current plan, a passive investor could achieve a three year IRR of 20%, resulting in 2015 stock price of about \$140. However an activist investor advocating necessary changes in operations could receive a three year IRR of 28%, resulting in a stock price of approximately \$165. In addition we believe there is a measure of downside protection because AAP could likely be a takeover candidate if the price dropped below \$70.

Key Investment Highlights

1) Strong Barriers to Entry

- Significant scale needed to compete on a national scale
- Economies of scale on sourcing allow AAP to finance majority of inventory on attractive terms

2) Significant Free Cash Flow Generation

- \$400+mm in annual free cash flow; 7% 2012 free cash flow yield
- Inventory almost fully funded by trade

3) Attractive Growth Opportunities in Commercial

- The aftermarket auto-parts industry is highly fragmented
- Significant room for consolidation
- Growth opportunities in the commercial segment for larger competitors

4) Multiple Ways to Win

- Activist proposal
- Passive investment — recent signs of a turnaround
- Merger or buyout
- Continued share buybacks

Business Description

Advance Auto Parts is a leading specialty retailer of automotive aftermarket parts, accessories, batteries and maintenance items primarily operating within the United States. As of December 2012, AAP operated 3,794 stores throughout 39 states, Puerto Rico and the Virgin Islands. AAP operates in two segments: Retail, or "Do-it-yourself" (62% of 2012 sales) and Commercial, or "Do-it-for-me" (38% of 2012 sales).

Investment Thesis

We believe AAP is a great business with meaningful competitive advantages but has been mismanaged, primarily due to underinvestment in its distribution network over the past 5 years. We believe this is the root cause of an approximately 400 basis point EBITDAR differential to O'Reilly Auto Parts, AAP's main competitor and only direct comp (AutoZone is almost entirely a retail business). This margin gap results in AAP trading at a 6.2x forward EBITDAR versus O'Reilly's 9.0x, a premium of 50% to AAP. We propose that AAP invest \$300mm over the next three years to augment their distribution network, building 6 additional distribution centers. Investing in the distribution network has two positive effects: 1) increases AAP's ability to raise prices in the commercial segment and 2) decreases AAP's distribution costs, as costly, rushed deliveries are reduced. We believe the combination of the two will help narrow the 400 basis point EBITDAR gap that currently persists between AAP and O'Reilly and also narrow the valuation gap.

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Advance Auto Parts (Continued from previous page)

Investment Thesis Continued:

Increase Prices in Commercial Segment: Commercial customers we talked to stated that delivery speed and reliability are the top factors when deciding who to use as a supplier. Currently AAP discounts its prices to compete in the commercial segment to compensate for not having daily replenishment. As such, by improving service and speed, AAP should be able to increase prices inline with peers without losing volume.

Decrease Distribution Costs in SG&A: The investment we propose in distribution centers would allow AAP to reach a critical level of 2,000 sq. ft. of distribution center per retail store, which is the level that O'Reilly, the best in class operator in the industry, cites as the necessary level to achieve daily part replenishment. Daily replenishment is critical for best-in-class service in the commercial segment, but more than 90% of AAP stores are unable to re-stock on a daily basis, and, as a result incur significant additional SG&A costs to procure and deliver parts that are stocked out. As a result, AAP spends 300bps more, as a % of sales, in SG&A than O'Reilly does. We believe that our plan to build 6 new distribution centers would allow AAP to meaningfully reduce its SG&A expenditure and close the gap versus O'Reilly.

Management: The natural question is why hasn't management implemented these changes in the past? Our analysis suggests that 1) management did not previously have the expertise to build out a distribution network for a commercial driven business and 2) management was not properly incentivized to do so. The current management team comes from a retail background and was put in place in 2008 when AAP was largely a retail business. Since 2008, AAP's percentage of sales from commercial has risen from ~25% to ~40%. Management must shift its focus towards providing the infrastructure necessary to run a commercial business.

Recent Positive Signs of Change / Near Term Catalysts:

- 1) On April 4, 2013, both the COO and SVP of Commercial Sales were fired. George Sherman, an executive who has experience at Best Buy, Home Depot and Target was hired to be President and lead the operational change and commercial focus
- 2) On March 7, 2013, AAP announced that they would implement a one-time bonus incentive to get operating margins to 12% in three years (vs. ~10% currently)
- 3) During 2012, AAP completed its first new distribution center in five years. This distribution center is the first one to offer daily replenishment
- 4) After halting share repurchases in 2012, Management stated that they will resume buying back shares at their historic levels starting in 2013

These signs are positive and are indications that the Board is willing to make the necessary changes to make AAP more cost effective and increase shareholder value

Valuation: Our activist target price represents a ~100% upside in three years to the current share price of \$80. Our price target assumes a 7x forward EBITDAR multiple (currently 6.2x) and a 13.6x forward P/E (currently 13.0x). We believe these are conservative assumptions on both a relative and absolute basis. On a relative basis, AAP's best comp, O'Reilly currently trades at 9.0x forward EBITDAR and 17.4x forward P/E. On an absolute basis, we think AAP's business justifies such multiples. Replacement auto-parts are not discretionary, AAP has significant barriers to entry, produces strong free cash flow, has attractive unit economics and has strong pricing power over suppliers (more than 85% of inventory is financed by trade).

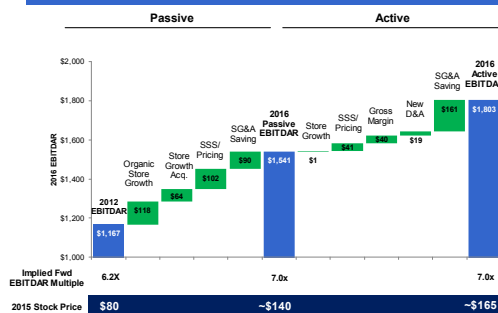
"And there are certain things I do well, but to be honest, I didn't grow up in a field organization. And one of the changes here that we're trying to affect in our senior leadership team is to add that field customer execution..."
Darren Jackson — CEO

"It's the first distribution center we've opened in many, many years, the first DC that I've opened in the five years that I've been here."
Kevin Freeland — COO

Estimated Year End 2015 Valuation

(\$ in millions)	2012		2016	
	Current	Passive	Passive	Activist
Financials				
Sales	\$ 6,205	\$ 7,686	\$ 7,908	\$ 7,908
Gross Profit	3,098	3,843	3,993	3,993
margin	49.9%	50.0%	50.5%	50.5%
SG&A	2,441	2,933	2,860	2,860
% sales	39.3%	38.2%	36.2%	36.2%
Improvement vs. 2012		117bps	317bps	
EBIT	\$ 657	\$ 910	\$ 1,134	\$ 1,134
margin	10.6%	11.8%	14.3%	14.3%
+ D&A	190	235	261	261
+ Rent	320	397	408	408
EBITDAR	\$ 1,167	\$ 1,541	\$ 1,803	\$ 1,803
margin	18.8%	20.1%	22.8%	22.8%
1-yr Fwd EV/EBITDAR Multiple	6.7x	7.0x	7.0x	7.0x
1-yr Fwd P/E Multiple	13.0x	14.4x	13.6x	13.6x
Enterprise Value	\$ 7,860	\$ 10,789	\$ 12,620	\$ 12,620
Net Debt + Leases	\$ 1,929	\$ 2,281	\$ 2,339	\$ 2,339
Stock Price	\$ 80.0	\$ 138.3	\$ 166.0	\$ 166.0
Current Stock Price	\$ 80.0	\$ 80.0	\$ 80.0	\$ 80.0
Total 3 Year Return	n/a	72.9%	107.5%	107.5%
3 year IRR	n/a	20.0%	27.6%	27.6%

EBITDAR Bridge



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Key Investment Risks: (1) failure to execute commercial business focus; (2) O'Reilly competing for same geographic areas as AAP; (3) consumers shift more towards buying new cars and the age of vehicles on the road declines significantly.



Jeremy Colvin

Prior to joining CBS, Jeremy served as an investment banking associate and analyst in the Financial Sponsors Group at Goldman Sachs. He holds a BA from Columbia College.



Eric Lai

Prior to joining CBS, Eric served as a private equity associate at American Securities. Prior to that, he was an investment banking analyst in the Industrials Group at Deutsche Bank. He holds a BA from Yale University.



Akhil Subramanian

Prior to joining CBS, Akhil was a consultant at Freakonomics Consulting. Prior to that, he was an investment banking analyst in the M&A Group at Credit Suisse. He holds a BS from University of Chicago.

Dollar Tree, Inc. (NASDAQ: DLTR) - Long Finalist — 2013 Pershing Square Challenge

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Recommendation: BUY

We recommend a BUY on Dollar Tree (DLTR) shares with a target price of \$64.75. This target price represents ~40% upside to today's price of \$45.99, and is based on 19.3x forward P/E (consistent with last three year average) as well as \$4.90 from a leveraged recap.

Current Valuation		Price Target	
Stock Price	\$45.99	Stock Price	\$64.75
Shares Out. (mm)	227.2	Shares Out. (mm)	227.2
Market Capitalization	\$10,449.2	Market Capitalization	\$14,712.2
Total Debt	271.3	Total Debt	1,500.0
Total Cash	399.9	Total Cash	399.9
TEV	\$10,320.6	TEV	\$15,812.3
FY2014E EPS	\$3.10	FY2014E EPS	\$3.10
Implied FY2014E P/E	14.8x	Implied FY2014E P/E	20.9x



Business Description

Dollar Tree is a value-oriented chain of discount variety stores that sells every item for \$1 or less. The Company currently has 4,531 stores in 48 states in the U.S. and an additional 140 stores in Canada, with a total of 40.5 million selling square feet. In 2012, Dollar Tree opened 345 new stores, expanded 87 others and closed 25, which led to an additional 2.9 million square feet. The average store has ~8,100 selling square feet, which management believes to be the optimal size operationally, giving customers a shopping environment that invites them to shop longer but also return more often (thereby increasing customer traffic). Initiatives the company has undertaken include debit and credit card penetration and a continued roll-out of frozen and refrigerated merchandise. The Company focuses on customers looking to spend the leftover change from their purchases at Wal-Mart or Target; and ideally it provides them with the best and biggest bargains in the industry.



Investment Thesis

DLTR is unlike other dollar store competitors: DLTR is the only dollar store that sells substantially all of its products at a \$1 price point. This allows DLTR to be the pre-eminent treasure hunting store where customers can maximize their bang for buck. The Company also takes advantage of not having planograms to maximize its merchandising flexibility; this leads to industry-leading price markups. Despite close proximity to Wal-Mart (75% of stores within 3 miles of WMT vs. 43% and 48% for DG and FDO respectively), DLTR enjoys the highest margins among dollar stores. Said another way, DLTR is a fill-in store to Wal-Mart as opposed to a competitor; it can exist in a symbiotic relationship as shown in the chart above.

Market has runway of at least 10,000 more stores and DLTR has superior store opportunities: DLTR (4,600 stores) sits well behind DG (>10,000) and FDO (~7,500). The U.S. currently has 64mm households making <\$50K annually (DLTR's target customer base). There are currently 30K dollar stores, which represents ~2,100 household/store nationally. Some regions such as the Southeast (1,600 households/store) are fully penetrated while other regions such as the West Coast (15,000 households/store) are under-penetrated. We estimate that at 1,600 households per store (nationally) the U.S. can support a market of ~40K stores, representing another 25% of runway. DLTR enjoys first-mover advantage in the under-penetrated west coast as it has already established a distribution center in California. This gives DLTR an advantage in the push toward market saturation.



Dollar Tree (Continued from previous page)

Convenient locations drive consumer traffic regardless of economic environment: The average DLTR customer drives 15-20 minutes per visit, and DLTR stores are conveniently located close to Wal-Marts (75% stores within 3 miles). Since customers think about total dollar spend as opposed to dollar per unit DLTR provides customers a convenient shopping experience; the average ticket is only ~\$8.

Industry leading unit economics and store returns: The average DLTR store costs less than \$400K to start up and enjoys a payback period of ~2.7 years. DLTR new store productivity has been ~87% with full-ramp by year three. First-year stores typically operate at 11% EBIT, translating to post tax ROIC of 20%. Over the past five years, DLTR has averaged an ROIC of 28% (vs. 21% and 9% for FDO and DG respectively).

The market is undervaluing DLTR: DLTR is superior in almost every single industry operating metric, notably enjoying significant advantage on EBITDA margin and ROIC. However, DLTR is trading in-line with the industry average and below DG. Over the last year, DLTR's stock price has been down 4.6% (vs. up 10.4% for DG).

Name	Retail Operating Metrics			Returns (5yr. Avg.)			Margins (5yr. Avg.)		
	Sales / Sq. Ft.	Inventory Turns	SSS (5yr. avg.)	ROA	ROE	ROIC	GM	EBITDA	Levered FCF
Dollar General	\$216	5.0x	6.8%	8.0%	13.8%	9.3%	31.2%	10.9%	3.2%
Family Dollar	\$181	4.8x	4.8%	11.7%	26.4%	21.0%	34.9%	8.9%	1.7%
Dollar Tree	\$182	4.9x	5.4%	17.6%	29.6%	28.3%	35.5%	13.4%	6.1%

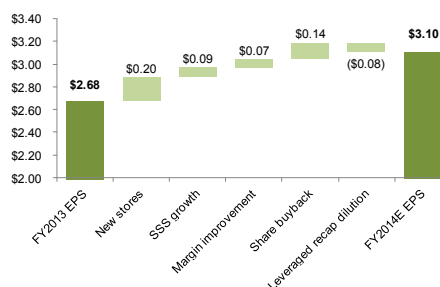
Name	Price	Shares (MM)	Mkt Cap	Net debt	TEV	Div yield	TEV / NTM EBITDA	NTM P/E	NTM EPS
Dollar General	\$49.85	327.2	\$16,312	\$2,632	\$18,944	0.0%	8.9x	15.4x	\$3.28
Family Dollar	\$59.80	115.8	\$6,925	\$604	\$7,529	1.8%	7.4x	14.8x	\$3.99
Average						0.9%	8.2x	15.1x	
Dollar Tree	\$45.99	224.6	\$10,329	(\$129)	\$10,200	0.0%	8.3x	14.8x	\$3.10

DLTR has maintained profitability despite moving to lower margin consumables: From FY2005 to FY2013, DLTR shifted its consumable mix from 41% to 51%, while lower variety and seasonal decreased from 50% to 44% and 8% to 4% respectively. Consumables consist of food, drinks and other high turnover + lower margin products. However, DLTR has maintained gross margins at 36% despite this mix-shift. Indeed, DLTR's SSS has remained robust; customers who intend on purchasing lower margin consumables end up impulse-buying seasonal and variety products.

Potential to unlock value via leveraged recapitalization: DLTR currently has \$271mm of debt on its balance sheet, representing leverage ratio of less than 0.25x. Given DLTR's strong and consistent cash flow profile (\$360-\$380mm FCF over the past 4 years), we believe that DLTR can unlock significant value by tapping the debt markets. By adding \$1.5bn senior secured bonds at 1.875% and paying the proceeds as a dividend, DLTR can unlock \$4.90 of value for shareholders or 10.9% return. The 1.875% coupon is based on what DG received less than three weeks ago. Given DLTR's superior financial metrics, we believe that DLTR could receive equal (or better) rates from investors.

Valuation

At 2014E EPS of \$3.10 and a P/E multiple of 19.3x (which is in-line with 3 year average), DLTR should be trading at ~\$64.75/ share (including the \$1.5bn leveraged recap with a share price impact of \$4.90). In order to reach \$3.10, we assume relatively conservative new store growth of (340 stores), 3% same store sales growth (below historical average 4.4%), 20bps margin uptick (below 2012 improvement) and \$500mm of share buybacks.



Near-term Catalysts

1. On pace to opening 250+ stores in FY2014
2. Q1 2014 earnings of flat to improving margins with continued roll-out of freezers
3. Q1 2014 SSS of 2-3%
4. Leveraged recap

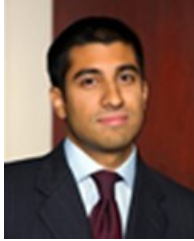
Key Investment Risks: (1) increasing competition from market saturation and Wal-Mart; (2) increasing payroll taxes could hurt discretionary spending in 2014; (3) long term inflation could be a detriment to single price point model; (4) sustained period of economic growth could see core customers trade up.

Stanley Black & Decker (NYSE: SWK) - Long Finalist — 2013 Pershing Square Challenge

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Colin Kennedy

Prior to CBS, Colin worked in Private Equity at FdG Associates. Colin holds a BA in Economics and Psychology from Duke University.

Trading Statistics (\$ in mm, except per share data)	Summary Financials	2012A	2013E	2014E	2015E	2016E	1-Year Share Price Performance	
Share Price (4/19/2013)	\$76.40	EV / Revenue	1.5x	1.4x	1.3x	1.2x		
Shares Outstanding	167	EV / Adj. EBITDA	10.1x	9.0x	7.8x	7.1x		
Market Cap.	12,736	EV / (Adj. EBITDA-Capex)	13.4x	11.3x	9.7x	8.7x		
Plus: Debt	3,538	FCF Yield	7.7%	9.0%	9.8%	10.7%		
Less: Cash	(716)	P/E	16.4x	13.5x	11.4x	10.1x		
Plus: Minority Interest	60							
Enterprise Value	15,618	Base Case Valuation						
		Revenue	10,191	11,202	12,017	12,612		13,179
Dividend Yield	2.6%	Growth - YOY	8.0%	9.9%	7.3%	4.9%		4.5%
Avg. Volume	1.5	Adj. EBITDA	1,549	1,729	1,991	2,186		2,374
Short Interest	4.1%	EPS	\$4.67	\$5.65	\$6.70	\$7.55	\$8.32	
52 wk. (High / Low)	\$82.43 / \$58.59	Adj. EBITDA Margin	15.2%	15.4%	16.6%	17.3%	18.0%	

Recommendation: BUY

We recommend a long position in Stanley Black & Decker ("SWK" or the "Company") stock with a target price of \$107.00. The stock has an asymmetrical risk/reward profile from current levels. The Company trades at a 15-20% discount to its peer group and has significantly underperformed the market in 2012-2013. Our target price represents a ~43% total upside to the current share price of \$76.40, and is based on a Sum-of-the-Parts analysis. Our downside case generates \$68.00 (down ~11%) which equates to a base case **Up/Down of 3.9x**.

SOTP Analysis

Segment	FY14E EBITDA	Current	Base Case	Avg. Comparable Company
CDIY	1,144	10.0x	10.0x	10.6x
Industrial	737	9.0x	9.0x	9.5x
Security	537	1.6x	10.5x	10.8x
Corporate Expenses	(427)	7.8x	9.8x	
Total	1,991	7.8x	9.8x	
Enterprise Value		15,618	19,605	
Current Share Price		\$76.40	\$107.00	
Dividend / Share			1.96	
Premium / (Discount) to Current			43%	

We believe that SWK is in a cycle of suboptimal capital allocation and has significant activist potential. The Company is a collection of superior market leading businesses whose intrinsic value is obscured by a conglomerate structure. SWK has strong FCF, but currently ~80% of that cash is generated overseas. This dynamic coupled with management's desire to build a 'diversified industrial company' forces the Company to undertake risky acquisitions outside of its core competency. SWK has 30% end market exposure to US construction markets, yet due to a lack of managerial focus and execution the Company has struggled to grow organically and is losing share in its core power tools and hand tools segment (CDIY). We believe an activist solution that spins out the SWK Security segment will unlock significant value for current shareholders. In addition, we believe that spinning out security will allow SWK Management to better focus on core segments and drive organic growth initiatives.

Activist Case: Spin SWK Security

Equity Value	\$107.00
Dividend / Share	\$1.96
Premium to Current	43%

**3.9x
Up/Down**

In addition, we believe there is incremental upside available to SWK shareholders by undertaking a split off and simultaneous merger (via a Reverse Morris Trust structure) with Ingersoll-Rand's Security segment. We believe this would create an Irish-domiciled security powerhouse, and the RMT transaction would add an incremental ~\$7.50 per share due to the combined company receiving a higher valuation than a straight spinoff scenario. The longer term earnings power of such an entity significantly exceeds this initial valuation increase.

Incremental Upside: RMT

RMT Value Creation	\$7.57
Total Value	\$116.53
Premium to Current	53%

**4.8x
Up/Down**

Business Description

SWK provides power and hand tools (50% of revenue), industrial and auto repair tools and engineered fasteners (28% of revenue), and mechanical access solutions and electronic monitoring systems (22% of revenue) globally.

Key Investment Highlights

Market Leading Businesses
#1 and #2 Market Share

Macro Tailwinds
30% exposure to domestic construction end markets

Significant FCF Generation
~9% 2014E FCF yield

Activist Potential: Hidden Value
1) Spin off SWK Security Asset
2) Reverse Morris Trust with Ingersoll-Rand Security Asset

Cheap Valuation
Trades below peers
11.4x 2014E P/E

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Stanley Black & Decker (Continued from previous page)

Market Leading Businesses: SWK has the #1 market position in hand and power tools within its CDIY segment and has occupied this leadership position for over 100 years. SWK’s principal brands include Stanley, Dewalt and Black & Decker and these brands are front of mind of contractors and pros in the industry. This segment will continue to benefit tremendously as housing and non-residential construction recover domestically (30% exposure) from their current depressed levels. In addition, CDIY has significant exposure to LATAM—a driver of future growth in this industry. In its Industrial Segment, SWK holds the leadership position in industrial automotive tools and engineered fasteners. This segment has high barriers to entry due to its highly engineered products, many SKU’s and mobile distribution network. In addition, the Industrial Segment has a highly fragmented and significant Total Addressable Market (~\$80 BN) that will allow for accretive acquisitions over time. In Security, SWK is the dominant player in the automated and mechanical security market and competes directly with Assa Abloy, Ingersoll-Rand and Tyco’s security division. This segment benefits from high barriers to entry as network effects are developed through longstanding relationships, code driven rules create millions of SKU’s and a high degree of customization prevent offshore competition.

Significant FCF Generation: SWK generates an approximately 9% 2014E FCF yield. The Company currently supports a strong dividend of \$1.96/share on an annual basis representing a 2.6% dividend yield at current levels.

Macro Tailwind: SWK has significant exposure to US residential and non-residential construction markets—markets that are improving but continue to operate at depressed levels. 20% of SWK revenues are tied to US residential housing, and housing starts remain ~50% below average levels. In addition, SWK has significant exposure to US commercial construction and recent improvements in the Architectural Billings Index (a leading indicator) support a nascent recovery in US commercial construction likely to occur in 12-18 months. Finally, **SWK CDIY is still 20% below peak levels** (PF for SWK and Black and Decker transaction) supporting significant upside from a continued recovery in end markets.

Significant Activist Potential: Management has been using its significant FCF to become a diversified industrial company. This strategy has not worked and has led to a vicious cycle of poor capital allocation as SWK management has been focused on non-core acquisitions in weak geographies. In addition, these acquisitions have led to management losing focus on their core business (selling power tools and hand tools) and losing domestic share. Organic growth has been roughly flat in the last decade despite management’s stated goal of 4-6% annual growth. Thus, we believe an **activist shareholder can address SWK’s problems, as a push for a tax-free spin (similar to TYCO and Ingersoll Rand) of SWK Security would unlock significant value.** Assa Abloy (a pure-play Security comparable) trades at ~12x EV/EBITDA, a significant premium to the current implied valuation for the SWK Security segment in the SWK conglomerate structure. In addition, a separation of SWK Security would enable SWK management to better focus on organic growth in the tool industry. Further, we believe the PF SWK entity (CDIY + Industrial) would be an attractive pure play acquisition target due to its significant FCF, market leading brands and strong growth prospects.

We also believe there is incremental upside available to SWK shareholders by pursuing a double RMT, which is a tax-efficient separation of the SWK Security segment and simultaneous merger with Ingersoll-Rand Security (IR announced its intention to spin-off Security in Q4 2012). This strategy would create an Irish-domiciled Security entity, which is a significant tax-benefit for future earnings and capital allocation, and form the second largest global security company with ~\$1BN EBITDA. The levered RMT structure could also allow for a dividend distribution of up to \$1.3 billion to SWK shareholders. The combined entity would create significant additional value for both SWK and IR shareholders due to its strong market position and earnings power.

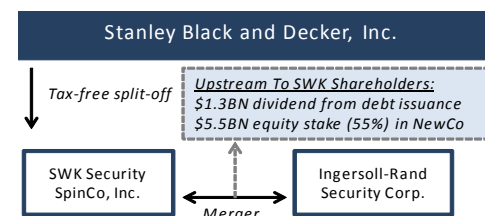
SOTP Valuation

(\$ in mm)

Segment	14E EBITDA	Current	Base Case
CDIY	1,144	10.0x	10.0x
Industrial	737	9.0x	9.0x
Security	537	1.6x	10.5x
Corporate Expenses	(427)	7.8x	9.8x
Total	1,991	7.8x	9.8x
Enterprise Value		15,618	19,605

Current Share Price	\$76.40	\$107.00
Dividend / Share		1.96
Premium / (Discount) to Current		43%

Incremental RMT Upside



RMT Value Creation	\$7.57
Total Equity Value	\$116.53
Premium / (Discount) to Current	53%

Outside Executive / Board Member

We also believe that an outside Director would be beneficial to help expedite the process to unlock hidden value for SWK shareholders. A potential candidate for this position is Edward Breen (the former chairman of Tyco, where he oversaw several spin-offs and breakups of divisions).

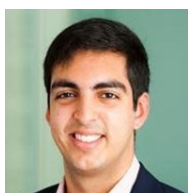
Risks

Failure of Activist Campaign: 30% exposure to US construction markets and growing emerging markets present a clear path to near term earnings growth. A 9% FCF yield is an effective floor.



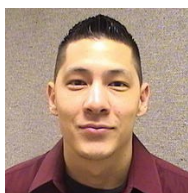
Omar Elangbawy

Omar is a second-year MBA student. Prior to Columbia, he worked in Private Equity for FLAG Capital and interned as an analyst for a small-cap, value-oriented hedge fund. Omar holds a BA in Economics and a BS in Computer Science from the University of Pennsylvania.



Ranjan Ramchandani

Ranjan is a second-year MBA student focusing on healthcare management and entrepreneurship. Before school, he worked for 3 years in the New York office of the Boston Consulting Group, where he will be returning after graduation.



Andrew Woodruff

Andrew is a second year MBA student. Before CBS, Andrew worked three years in emerging markets sales & trading for J.P. Morgan. He has worked as an analyst for two different long/short equity funds over the past year. He has also passed all three levels of the CFA exams.

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Yum! Brands, Inc. (NYSE: YUM) - Long Finalist — 2013 Pershing Square Challenge

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Capitalization	
Stock Price	\$65.04
Shares Outstanding	449.9
Market Cap	\$29,261
Cash	\$776
Debt	\$2,942
Minority Interest	\$158
Enterprise Value	\$31,585

Trading & Liquidity	
Name	Yum! Brands
Ticker	YUM
Date	4/19/12
52-Week High	\$74.75
52-Week Low	\$59.68
Free Float (m)	449.5
Insider Ownership	0.3%
Short Interest	2.3%
Daily m Volume	2.9

Implied Multiples		
	2012	2013
Revenue	\$13,633.0	\$14,053.0
EBITDA	2,758.0	2,983.0
EBIT	2,227.0	2,264.0
EV / Sales	2.3x	2.2x
EV / EBITDA	11.5x	10.6x
EV / EBIT	14.2x	14.0x

Recommendation

We recommend a long position in Yum! Brands, which we believe is undervalued due to its suboptimal operating structure. Given the predictable, steady cash flows in the U.S. and Yum's broad international footprint, we believe the inherent stability of the business lends itself to an asymmetric risk-reward profile. While the short-term focus on recent food safety and avian flu scares in China has depressed the stock price, our view on the long-term sustainability of the business makes a stake in Yum! an attractive proposition.

Our thesis revolves around two drivers of value. In order to capitalize on the value creation mechanisms we've identified, an investor would need to take an activist stance and create his/her own catalyst. The crux of our thesis is as follows:

- Yum's operating structure exposes US investors to a high degree of emerging markets risk. A spinoff of Yum's domestic operations into a separate entity from the high growth international business would allow investors to more efficiently define their risk tolerance.**
 - Yum U.S. - a stable, highly cash-generative business focused on returning capital to shareholders
 - Yum International - a growth-focused entity working to expand Yum's footprint in developed and emerging markets outside of the U.S.
 - A split would allow investors to better allocate their risk between two fundamentally different risk / growth profiles. We believe the split would reverse an estimated 25% discount on the combined entity.
- A spinoff would drive increased management discipline, improving the likelihood of capitalizing on operational improvements within each entity to drive both top-line growth and margin expansion.**
 - Yum U.S. - Continue to focus on innovative product development and franchise-level operational improvements while also improving G&A efficiency.
 - Yum International - Invest in smart growth in underpenetrated cities in China. Capitalize on largely untapped India and RoW opportunity. Consolidate suppliers and rationalize supply chain logistics where possible to improve margins.

Business Description

Yum! Brands is the world's largest quick service restaurant company with over 39,000 stores all over the world. Stores are both corporate owned and franchised under three main brands: KFC, Pizza Hut, and Taco Bell. In addition to these brands, Yum also owns a number of smaller, local brands primarily throughout China. Approximately 75% of revenues and operating income comes outside the U.S., with China making up about two-thirds of that amount. Approximately 80% of Yum's stores are franchised or licensed, leaving 20% corporate owned.

Financial Summary	Year Ended December 31,					
	2007	2008	2009	2010	2011	2012
Revenue	\$10,435	\$11,304	\$10,836	\$11,343	\$12,626	\$13,633
% Growth	-	8.3%	(4.1%)	4.7%	11.3%	8.0%
Gross Profit	2,662	2,839	2,902	3,223	3,486	3,781
% Margin	25.5%	25.1%	26.8%	28.4%	27.6%	27.7%
G&A	1,293	1,342	1,221	1,277	1,372	1,510
% Margin	12.4%	11.9%	11.3%	11.3%	10.9%	11.1%
EBIT	1,369	1,497	1,681	1,946	2,114	2,271
% Margin	13.1%	13.2%	15.5%	17.2%	16.7%	16.7%
EBITDA	1,911	2,053	2,261	2,535	2,742	2,916
% Margin	18.3%	18.2%	20.9%	22.3%	21.7%	21.4%

Yum! Brands (Continued from previous page)

Investment Thesis

1) Rationale for spinoff

- Current operating structure is an inefficient capital allocation vehicle. Yum's International operation is concentrated in China, a market that entails significant upside but also significant volatility. By contrast, the US business is largely franchise-owned and generates stable, high-margin revenues. Yum! investors are obliged to participate in risk inherent in the emerging markets portion of the business and cannot choose the level of exposure to this risk relative to the stable US business. Consequently, we believe the combined entity trades at a discount. A spinoff of the US operations would close this discount.
- The spinoff is feasible from an operational perspective. Yum! US is organized by brand vertical, whereas Yum's International divisions (China, India, and YRI) are organized by geography. Management teams and supply chains are already totally distinct. Additionally, financials are reported in line with our proposed spinoff structure, allowing investors transparency into forecasted NewCo results.
- From a governance perspective, there are few impediments to a successful spinoff. Ownership of Yum! is concentrated among institutional shareholders (>70%), insiders hold a very small percentage of the firm (less than .3%), and short interest is low. The Board is up for re-election every year and the proxy statement indicates no active poison pill mechanism.

2) US opportunities

- Yum's US brands have continued to innovate, both in terms of product development and in terms of operating model improvements. The introduction of the Doritos Locos taco in 2012 by Taco Bell was widely regarded as one of the most successful product launches in QSR history, and Taco Bell is on track to sell 500 million units in 2013. KFC will soon be making a shift to a largely boneless menu, a change it believes will align its menu closer to the tastes of younger consumers. Pizza Hut has shifted many of its locations to a "Delco Lite" model, cutting the store footprint in half and focusing on delivery/carryout operations.
- Yum US lags its peers in terms of G&A as a percentage of US sales. While this metric is highly sensitive to franchise mix and same-store sales, it is indicative of the fact that there are opportunities for increased G&A efficiency. Yum US' brand vertical operating structure has created duplicative functions (HR/IT/Finance) across business units; centralization of these functions could drive synergy value. Furthermore, menu rationalization at the brand level could allow for more efficient use of corporate ad dollars, driving increased top line. We believe the combined effects could generate an additional 200bps in margin over the next two to three years.

3) International operational improvements

- China will continue to be a growth engine. Yum! is the market leader among QSR chains but is still underpenetrated in "lower tier" smaller cities, implying significant room for growth. Additionally, Yum!'s recent acquisition of Little Sheep, the world's leading hotpot chain, suggests opportunities for growth through M&A.
- Management's focus on China growth has come at the expense of capitalizing on rest-of-world opportunities. A spinoff would allow management to focus on expanding Yum's footprint in other developing markets, particularly in India. Management guidance suggests India system sales growth will top 40% per annum over the next several years. India is also a candidate for a first major foothold for Taco Bell abroad, as pilot locations in Delhi have proved extremely successful, likely due to the relative familiarity of Indian consumers.
- The historical focus on China growth has also led to a "long tail" of international markets in which Yum! has a limited presence. A more concentrated approach to expansion in these markets will drive enhanced synergies at the franchise and corporate level as penetration in these markets approach scale.

Valuation

Our model assumes the two business units, Yum! Intl. and Yum! US, will each trade at a more appropriate multiple in line with their individual growth/risk prospects. Given the inherent stability of the US business, we have assumed the business will trade at 11x EBITDA, which is below some of the larger QSR chains in the US that have a similar mix in terms of franchised vs. company-owned stores (e.g. McDonald's). For Yum! International, we believe the growth prospects in China and RoV would allow the company to trade in-line with its competitors with a similar growth profile at 15x EBITDA. As a result, we believe an investment in Yum! Brands represents an attractive investment opportunity for an activist investor with 50-70%+ upside in two years (price target of \$100-\$110 per share by 2015).

Key Investment Risks

Given the scope of the proposed activist maneuver and the size of Yum! (\$30B), the spinoff proposal could encounter resistance from management and the Board. A proxy contest could be a protracted and difficult endeavor, though the concentrated institutional ownership and relatively lax anti-activist governance provisions mitigate this risk.

The investment is also exposed to operational risk for both the US and International businesses. Though we believe the US business is largely stable—particularly given its high proportion of franchisee ownership—a secular trend toward healthy eating could negatively affect system sales. Yum's brands are attempting to preempt this with healthier menu options (e.g. the Cantina Bell menu at Taco Bell). Internationally, the business is subject to the volatilities of emerging markets—regulatory, food safety, political, and currency risks—and to competitive threats from other multinational and international QSR chains. Nonetheless, we believe the existing infrastructure and store footprint mitigate these concerns to a certain extent.

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Paul Isaac



Paul Isaac

(Continued from page 1)

G&D: You were brought up in a family involved in early value investing circles (for example, Isaac's uncle is Walter Schloss). Barron's said that you have the "value gene." How was it growing up with relatives like that, and how did that influence your career and decision-making?

Paul Isaac (PI): I don't know that it was that unique. When I was working on a money markets trading desk, the head of the money markets department at DLJ said, "People think that all these guys in New York are so sophisticated, but they're really nothing but a bunch of tree toppers. If they'd been born in Astoria, Oregon, they'd be out topping trees for Weyerhaeuser, but they were born in New York, so the job at the end of the subway line was working in a cage or working at a trading desk. They're just tree toppers."

There's some truth to that. This was a local business. Active principal investing as a separate activity, as opposed to being a portfolio manager at a fiduciary institution (a very different thing), was really a side activity of people mainly engaged in intermediary functions, often as market makers in various types of securities. So my father, for example, graduated from the NYU School of Commerce in 1928, and wound up working at a trading desk. Some of the

trading was in the distressed securities of public utility holding companies, railroads, or a lot of the real estate companies that got into trouble in the 1930s.

In many ways, the early arbitrage business was essentially following the outcomes of those securities, which any market maker would do, especially given the relatively limited secondary turnover in the securities markets of the 1930s. You can see references to how difficult it was to maintain some of those positions in Phil Carret's memoir, *A Money Mind at 90*, and in Peter Drucker's *Adventures of a Bystander*. Drucker describes working on some Kreuger & Toll bonds for a poorly disguised Singer & Friedlander in London in the 1930s. So these were essentially a side activity of the business of being a market maker.

My father always had the idea that you basically worked in the securities business. Investing on the side meant that you could be somewhat more intrepid. You had another source of income and you did well partially because it gave you an opportunity to both see flow and to be patient. My uncle, Walter Schloss, who actually worked in the cage at Loeb Rhoades in the 1930s before he went into the service, came out and got a job at Graham-Newman. Benjamin Graham was an instructor

Walter studied under at the stock exchange institute back in the 1930s.

Graham-Newman was an investment company with a limited balance sheet in 1946. They had six or seven people on staff, and they were running about \$7 or \$8 million. Graham-Newman was doing a range of event- and cheap-securities-type investing in the 1940s. Walter got a job there as an analyst and stayed with Graham-Newman virtually until the end. He later set up a partnership because one of the Graham-Newman investors said they would stake him with \$100,000, which even at the time was a modest amount of money.

People can be active money managers in the way they are today partly as a product of a long bull market and partly as a product of developments in trading, analytics, the availability of information, as well as the separation of the execution function from the investing function as a result of regulatory changes and compliance concerns. What I remember most about growing up was that most of my father's friends were in the business. Many of them came out of the arbitrage community. A few of them, Max Heine, for example, were really in the brokerage business. When they came over, I heard a lot more about Spingarn Heine than I did about Mutual Shares,

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Paul Isaac

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which was really a sideline for customers too small to have independent brokerage accounts at Spingarn Heine.

Walter didn't talk too much about the people he knew – he talked about stocks, and that was always interesting and very memorable. But a lot of what I remember was really how prosaic it actually was. When Bob Heilbrunn came over for dinner with Harriet, they were talking more about kids and less frequently about something like the utility industry. There was no great sense of the sorts of corporate battles that people talk about today. It all seemed to move at a very slow pace.

G&D: What are the most important things you learned from your uncle or your dad about investing?

PI: They actually had very different styles. Walter was always vociferously opposed to the idea of owning bonds. My father, who was in many ways more aggressive than Walter, probably stayed about 30% in T-bills for most of the post-war period. I think Walter really had the courage of his convictions in terms of principles and ideas about valuation. With Walter, what you saw was what you got. If a stock was really cheap, Walter basically took the view that as long as managements weren't crooks, the valuation would eventually reach fair value.

My father was much more interested in the dynamics of complex situations and how things would ultimately get picked apart. For example, he closely followed the reversion of the Waddell field to Southland Royalty from Gulf Oil. This was a major case in the 1970s which hinged on whether the lease on the field could be involuntarily extended as a result of the Texas Railroad Commission's proration policies after the lease was put into effect in 1925. My father became very involved in looking at that and decided there was going to be a reversion, and he was right. But as with so many other things in investing, Southland Royalty was a spectacularly successful investment less because they were right on the reversion, but rather because the case was launched before the Arab oil embargo and was resolved after oil had tripled in value. So it was a serendipitous event that drove a large part of the return. My father was much more interested in finding a deeper edge. He was more of a company analyst in some ways than Walter was.

G&D: Are you more like Walter Schloss, in that you look for statistically cheap stocks, or more like your father, in that you look for complex situations?

PI: The process has moved on and become somewhat

more complicated. You have to be sensitive to both. When a stock is relatively expensive, it is much harder to assess whether other people have simply done a better job than me at assessing the probabilities of successful outcomes. So you have to start with something that is demonstrably cheap because, first, it is harder to get hurt if you fall out of a basement window, and second, it's so difficult to assess whether other people have a more accurate handle on favorable characteristics than you do.

G&D: How do you ensure that the statistically cheap stocks aren't value traps?

PI: They are always value traps in retrospect, right? In other words, if it works, it's not a value trap. There are certain characteristics that lead to value traps. For example, a company with an extremely conservative financial policy and entrenched management that has no desire to increase the dynamism of the company or to realize the value in the security can lead to a value trap – you can be sitting with something for a very long time with relatively little uplift in the asset value or a corporate event which captures much of the disparity between the secondary market price and asset value.

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Paul Isaac



Pictured: The four finalists of the Moon Lee Prize Competition in March 2013.

“The question in avoiding a value trap is twofold. First, are the dominant shareholders or management incentivized to have some kind of a transaction that's going to increase the market value of the company in the near future? And second, is the intrinsic value of the company increasing at a relatively attractive rate of return?”

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But those situations have a way of eventually resolving themselves. There was a company, Stern and Stern Textile, which was a textile importing business that accumulated a tremendous amount of cash and always sold at a very cheap price relative to its book value. It disappointed an awful lot of people. But then a family member died who was active in the business and had a major holding in the company. So they worked a deal where they sold off the textile business and merged the company into one of the Neuberger Berman mutual funds. Ultimately it worked out very well, but for years it was a value trap.

The question in avoiding a value trap is twofold. First, are the dominant shareholders or management incentivized to have some kind of a transaction that's going to increase the market value of the company in the near future? And second, is the intrinsic value of the company increasing at a relatively attractive rate of return? If you've got the latter, then presumably the valuation is going to rise at least at that rate of return, even preserving a big sum-of-the-parts discount under an unfavorable value trap situation. What you'd love to have is both, but what you want to avoid is where you have neither.

My father had a saying that you never make a lot of money unless you lose

money on your first purchase. If the valuation never becomes really compelling, there is always a tendency to be less involved. Pain is nature's way of telling you that you're doing something wrong, and mindlessly buying more just because something goes down is a poor practice. But it is also equally true that just because you've discovered something cheap with long-term merit does not mean that the rotation out of a previous population of investors that is currently occurring is going to stop just because you're buying some. This is a tension you have to look for, assess, and accept as a fact of life.

G&D: There were a number of years where you ran both a fund of hedge funds and a hedge fund at the same time. Can you compare and contrast these two experiences?

PI: First of all, there's the question of what's a hedge fund. It's pretty much anybody who is running tradable assets and gets an incentive fee. So it's a very inclusive definition. A fund of funds is really somebody who's running assets invested in a collection of hedge funds. The fund of funds business that I was involved with provided a zero-beta-targeted portfolio of hedge funds that aimed for a moderate rate of return at low volatility with diversification away from the return characteristics of

the broad equity markets, and the broad bond markets for institutional investors.

It's a frustrating business. It's like trying to become a professional three-legged racer – you're trying to put together a variety of funds where you want them to be great runners, but not collectively run too fast, and they have to do it in the approved form. I met some fascinating people, and it was very interesting to see the different ways in which people thought about and structured their portfolios.

Running a hedge fund is more to my taste partly because I like coming up with an idea and seeing it through on my own. I also have something of a Lewis Carroll/Red Queen approach to investing – you've got to run really fast to stay in the same place in the long run, particularly when you're dealing with taxes and inflation. So I'm relatively aggressive in terms of how I run money. As long as the underlying value of the securities I own is continually improving, I'm somewhat indifferent to what happens on an interim market basis. That is the antithesis of what you're doing in the fund of funds business. A fund of funds business can be thought of as an annuity with a knockout option – if you have too much of an investor drawdown, you're going to lose your annuity. This has adverse feedback

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Paul Isaac

(Continued from page 48)
effects when other investors flee and cause instability in your organization. So, it requires you to think very much in terms of controlling volatility.

There are similar constraints running a hedge fund, but they are less acute. In that sense, I find it an easier process, partially because I can focus on the intrinsic attractiveness of the underlying securities and not worry so much about what might happen to them over the short run.

G&D: At the fund of funds, you managed to completely avoid all investments in Bernie Madoff's funds. How you were able to do that?

PI: Any investment decision should be made on the basis of your enthusiasm for that investment. It shouldn't be made because you can't think of a reason not to be in that investment. Anybody who did any serious due diligence on the Madoff funds rapidly discovered that you couldn't figure out what they were doing. Plus, from the scuttlebutt, it seemed very unlikely that anybody could deploy the amount of money Madoff was widely reputed to be running in the strategies that people believed he was using. In addition, there were other people who were trying to do the same thing, and weren't doing it nearly as successfully as Madoff was.

There were other red flags

that would give you pause, apart from things like the accountants, which we never actually got to. One of them was that nobody ever left. It's very hard for managers to hold all of their good people forever. Yet, no one ever left the Madoff organization to set up "Madoff Light." It was very anomalous. The attraction of Madoff was that he was purportedly doing what we were supposed to be doing; but much better. In other

"Any investment decision should be made on the basis of your enthusiasm for that investment. It shouldn't be made because you can't think of a reason not to be in that investment."

words, he was running with low volatility and reportedly moderately high returns. There are lots of funds where if you're willing to accept somewhat higher volatility, you were likely to earn a Madoff-like return, and you could be perfectly comfortable with them. So, why invest with Madoff?

G&D: Can you talk about your search process?

PI: Every security that you own, with the exception of new issues, has already been owned by somebody else. So it's really the standard stuff. We screen for businesses that are inexpensive relative to straightforward criteria. We try to find businesses or industries that are becoming somewhat cyclically depressed. We also try to find good businesses that are down considerably because they've disappointed people. Sometimes it's related to a broad development within a particular field. For example, we've decided that the increase of compliance and regulatory burdens on community banks is going to make community banking relatively difficult to conduct profitably, particularly in a low-interest-rate environment. So we're interested in acquiring shares in banks with reasonable footprints that are relatively clean trading at significant discounts to their tangible book value. If the discount is great enough, the lack of profitability is not a deterrent – it's actually an incentive because chances are they're more likely to give up the ghost.

We also look at industries that are undergoing consolidation. We try to find things that would have asymmetric payoffs in terms of financial market fashions. I confess that I'm always interested in following what

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Pictured: Paul Orlin of Amici Capital at the Moon Lee Prize Competition in March 2013.

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really smart people do in this business and the stuff they're most frustrated in. There's an old Marty Whitman line that says, "You should do what I do, but just do it two years later." I'm perfectly happy to listen to Marty. I'll look at what he bought a couple of years ago that hasn't worked that he still owns, particularly if he's adding to it, and see if we agree.

We also look for commodity businesses that are cyclically depressed that may undergo a long-term reversion to the mean, especially if the replacement cost is a lot higher for capacity that is currently embedded in the producers. We try to determine how long it's likely to take and how cheap these things are, and what their earnings power is going to be at the peak. Can we see ourselves getting an attractive IRR making some moderately unfavorable assumptions?

Sometimes it's sum-of-the-parts stuff. Sometimes it's relatively complex structures that occasionally fall out of favor. There are fashions in this business, and the things that are out of fashion may well be worth looking at.

G&D: How do you assess management? Many investors spend a lot of time with management while others tend to avoid them.

PI: I started out with a relatively small personal

portfolio. It's not like I'm going to call up Jeffrey Immelt and say, "Let's chew the fat over what you're going to do at GE." So in that sense, no, we don't really talk to management in most cases. However, with smaller companies, we may talk to them, especially if the leadership or strategic view of the company is particularly important. We want to understand how they look at the business and determine if that's a reasonable strategy for them to pursue. Also, if they come in and their eyes are rolling in alternate directions in either socket, you might want to avoid the company. If they seem to be really knowledgeable and engaged in the business, and if they function well with the other senior members of the management team, then that's a plus.

There are people who say, "I want to have a great capital allocator," and within limits I understand that. Occasionally we will follow that, too. So, for example, our largest position is in the Bolloré Group in France. That is partially the result of Vincent Bolloré and his talents, although it happens to be very cheap statistically and is a complex situation as well.

Anytime John Malone comes up with yet another fanciful creation, and it seems to be trading at a thirty or forty percent discount to NAV, we're inclined to get involved. He's done a

wonderful job of building a large number of businesses, and NAV discounts in Malone vehicles don't seem to survive very long. So in that particular case, I think the management matters a lot.

We won't buy something at a premium just because it's a particular manager or promotional guy. There are certain people where, if their stock is trading relatively inexpensively and they have a track record, we're more inclined to get involved.

In certain types of businesses, the management has a much bigger effect on operating effectiveness, and when we get involved we want to talk to them about strategy. A lot of managements really try, and they try hard. Most businesses are more complex and more difficult than they ever seem to outsiders. If senior management is intelligently engaged with the business and has a plausible plan for dealing with the issues that we see and the stock is cheap, then that's a big plus for us.

But we're not looking for Sir Galahad. We're not necessarily going to find him, and we certainly don't have the ability to identify him better than others. On the short side, there is a bit of a tension because I react viscerally negatively to highly promotional

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managements, yet those people are extremely talented in getting the stock up. So you have to recognize that the promotional guy you dislike may actually be very good at causing you a lot of pain in something that you think is a natural short.

G&D: Have you considered taking activist positions where management is not extracting full value?

PI: The presence of other people who we think are competent activists is a positive, especially if we think the stock is attractive. It won't cause us to buy the stock, but a "make your own catalyst kit" is a positive to a lot of value situations. I prefer to have someone else do the work. We do a pretty good job looking for value and sometimes finding it amid complexity. But what I ideally want to do is just buy T-bills at 120% a year in a non-inflationary environment. The problem is that the market won't do that for me.

So we generally do not seek to be activists. Doing it well is a lot of work, and we have a limited number of people to spread over a moderately large number of positions. However, we have had two activist positions in the past. First, we invested in an insurance company undergoing turmoil because the nonagenarian founder, who

was also the largest shareholder, had decided that he wanted to do the best impersonation of Corporate King Lear ever seen in the Hudson Valley. We thought that could destabilize the company. So one of our analysts, not me, went on the board and contributed clarity to the strategic process, and I think this really did a lot of good for shareholders.

In another case, we invested in a real estate company that was extremely inexpensive and had some, frankly, incompetent second-generation family leadership. The family managed to get itself into trouble financially in the crisis, and we had someone go on the board to help with the strategic effort. When management did a deal that we thought was extremely unfavorable for shareholders, we went to the acquirer and said, "If you don't let us in the deal, we have to consider putting in a competing bid for the company." This was after our guy was off the board, but we came to terms and participated in the buyout vehicle. So if we can make a difference, we will push for change. We can't always make a difference though I don't want to rule anything out. I think our role is rarely activist, but when we get involved, we try to be as positive as possible and act for the benefit of all shareholders as much as possible.

G&D: You've said in the past that you don't necessarily look for catalysts and that allows you to have a longer-term holding period. Could you explain the rationale behind this strategy?

PI: Many times, what's happening is that we're buying into something that has gone down a lot recently. And it's going down for good reasons; there are people who are disenchanted, there have been cyclical problems, there may be a general economic problem, or there may be product or business transitional issues. We try to figure out what the company is worth if it's competently run under normal future conditions. Maybe it's not attractive today, but if it continues to go down, you may start to see an attractive IRR on a weighted-average basis. There are a couple of points here that I think are a bit of an advantage for us.

First, we don't have a stop-loss discipline, and second, we don't require a catalyst. Many hedge funds have a stop-loss discipline, so they really aren't buying a stock – in some ways, they're buying a knockout option, creating an inherent, inflexible whipsaw risk in the financial proposition. These stops are often pretty tight and it is easy to lose your acceptable loss, plus it becomes difficult to get involved again.

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We have the problem that we may have to revisit our assumptions, but if we do and decide that it's even cheaper, we can buy more. We have sense of certainty of what's going to happen from here. We're competing against a lot of really smart people. If there's an obvious catalyst, other people will jump on it and the price will go up. But we're more inclined to play out these multiple possible path opportunities. In practical terms, that means that we're not looking at shorter-duration transactions or positions. Many of the things that we get involved with can take one to several years to work out. We therefore generate most of our return in the form of long-term capital gains. That's attractive for most of our investors who are taxable individuals.

G&D: Is it the same on the short side?

PI: No. Short investing is not the opposite of value investing. Short investing is actually the opposite of growth investing. It is much more dependent upon continued checks of the growth story. Shorting is a challenge for us just as it is for almost every other hedge fund manager.

G&D: How do you determine your long-short allocations? Is it just based on the attractiveness of your current ideas, or do you use the macro picture

to help determine allocations?

PI: It is a bottom-up proposition. If you can't find enough bottom-up ideas, it gets harder to fill the portfolio. A target-rich environment probably means that you're running your gross lower because volatility has gone up pretty sharply. You may be in some particularly difficult macroeconomic circumstances where you may have had a draw-down and have to be sensitive to what your investors are doing.

So, ironically, a lot of guys at really low market bottoms are trying to be substantially net long, managing their gross, and biting their fingernails that their investors will give them enough time for the recognition of value. When stocks are expensive, there is more of a tendency to try to find shorts against them to control the aggregate size of the net, which pushes up your gross. That also means you're probably trying to find securities that are more liquid, so you can adjust the portfolio more quickly if circumstances change. Volatility also acts as a constraint on gross because you want to limit how much your portfolio bounces around.

You're trying to find the best bottom-up situations that you can and manage them against the constraints of liquidity, volatility, balance

sheet, and investor sensitivity.

G&D: How you think about position sizing when you initiate a position?

PI: Different funds will size positions in different ways, partially because they have a different implied volatility target that they're shooting for so as to not to rattle their investors.

We are all running portfolios that have a sort of leverage – where we have participating capital, it can be withdrawn. There's probably an absolute drawdown level where money tends to flow out, but there's also a relative performance level where money tends to flow out. That is based upon your investors' expectations, surprise, and the temperamental population that you've targeted and have accumulated.

I take chunkier positions than most other hedge fund managers. Our history has been relatively volatile, and it's worked out well for our investors. So my limited partners have been more tolerant (so far) than many others, which is very fortunate.

That said, I'm very conscious of any binary risk in a security. Some things may seem tremendously attractive, but you've got to be honest about them. If the wrong court case arises,

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if foreclosures continue to cascade down, or if there are serious business transition problems, you could have a substantial loss. There also may be too much leverage and the enterprise could become financially fragile because of covenant violations, for example. Under those circumstances, I will restrict the position size to about half of the maximum for a security that has all of the attractive elements.

There's no magic formula to it, but securities with a fair amount of binary risk are going to have higher rates of return when they work. It's important to be in a position where you're not under a lot of pressure to get out of a position just because it's not working for a while.

G&D: Can you talk about a stock that you think is attractive?

PI: We have a sizable position in the Class B shares of Greif, Inc. The company is a packaging manufacturer with two classes of stock, Class A and Class B. The Class A stock is liquid and is in several indices. The Class B stock has all the voting rights and is entitled to 150% of the per-Class-A-share dividends and earnings. Yet, it often trades at a discount to the Class A shares. The Class B shares currently trade at about 105% of the Class A share price.

I like the business. It's a perfectly reasonable business. We're not long the Class A shares. We bought the Class B shares because they were very inexpensive. We have accumulated a large position in Class B shares relative to us. Now it's a 6%-7% position.

I first encountered the company in the 1970s when Tweedy, Browne had bought Greif in a vehicle they took over, a small

"I'm very conscious of any binary risk in a security. Some things may seem tremendously attractive, but you've got to be honest about them."

closed-end fund called Cambridge Fund. My uncle, Walter Schloss, had offices with Tweedy. I knew a little bit about them and thought they were talented people. So I bought some of Cambridge Fund because it was trading at a 25% or 30% discount from NAV. I eventually got a little bit of Greif A after the liquidation of the Cambridge Fund, and so I gained some familiarity with it. I later saw that it had become quite

inexpensive again, particularly the Class B shares, in the aftermath of the 2002 bear market and started building a position.

There were a number of things about it that we liked. They had a CEO who did a wonderful job of rationalizing the business and making it more profitable. There was an octogenarian granddaughter of the founder who controlled a lot of Class B stock. She subsequently has passed away. The family is no longer involved in the business, and they seem to disagree with each other about enough things that it's not impossible that something could happen to the business. You now see a pattern where management in the company is buying back Class B shares much more aggressively than they're buying back Class A shares.

They also have some interesting diversification initiatives, notably into flexible packaging, where they're manufacturing all sorts of bags for bulk transport. Where we currently have it, it's trading at about ten times earnings on the Class B shares and pays about a five and change dividend. This is with depressed profitability in a business that we think is growing. Greif Manufacturing has 240 plants that manufacture containers for people making stuff, so it's hard to

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Pictured: Meryl Witmer at the 2012 Graham & Dodd Breakfast

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imagine that it's going to get supplanted anytime soon. It's been a nice stock for us over time. Between the dividends and the appreciation, it's been a mid-to-high teens IRR. We have traded around the position occasionally, either by doing "buy-writes" selling calls on Class A shares, or in some cases shorting the A outright when the A really significantly outran the B.

G&D: Is six or seven percent generally your largest position size?

PI: No. In fact our Bolloré-related positions are now in the high-teens of capital. The stock has done very well. We still think it's very cheap, so we have not sold any.

We also have a sizable position in Goldman Sachs. There was no particular insight there. I was in too early when it was trading at a substantial discount to tangible book value, and then it traded down to a level where we re-upped. It's by far the most productive investment banking organization in terms of revenues per head. The company still does a really good job of recruiting and developing a culture internally, so they have a deep bench. The combination of a deep bench and higher comp than all of their competitors indicated that they are going to have a leg up in adjusting to the new ways of Wall

Street.

What should a well-run investment banking firm applying moderate leverage with a lot of fee-based businesses be able to generate? A ten-to-twelve percent ROE seemed pretty reasonable. If that's the case, Goldman should trade at 1.2 to 1.4 times tangible book value in this environment. Buying in at 0.8 to 0.9 times tangible book, with an underlying rate of accretion in the mid-to-high single digits, given the earnings that they were generating, seemed reasonable.

Our second-largest position is more esoteric. It's in the regional affiliates of Crédit Agricole. Crédit Agricole is a bit like the federal farm credit system. The majority ownership is a pyramid with several thousand local mutual societies at the bottom. They own, through a special class of stock, the majority of each of 40 regional Crédit Agricole banks. Crédit Agricole Sud Rhone Alpes, Crédit Agricole d'Ile de France, and so on.

The regional banks collectively own all of a holding company called Rue La Boétie, which owns 56% of the listed Crédit Agricole vehicle, which in turn controls their foreign holdings, the insurance companies, the asset management division, and about 25% of each of the regional banks. While

people tend to think of it as a top-down organization, the real locus of power within the organization is the board of the holding company of the regional banks. The regional banks needed capital in the 1990s, so they issued a class of share which is effectively a non-voting economic share that, for dividends and earnings purposes, ranks pari passu with the 25% holding in each of the regional banks owned by the corporate and investment bank.

So there are 13 of these non-voting shares in these various regional banks, which are decent regional banks. They have non-performing assets of 1% to 4% of assets. They usually have loan loss reserves of 70% to 150% of the non-performing assets. The tangible common equity to assets runs 8% to 15% on the outside. The ROE runs in the mid-single digits to about 10%. The efficiency ratios are around 45% to 60%.

These are not bad regional banks, and as they have assets between \$8 and \$60 billion apiece, they're also not tiny, either. You can get information on them if you speak French or can use Google Toolbar. Just go to the website of each of the regional banks. They don't make it easy for you. You have to go through the site and find the required legal filings, and then they'll show

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trimestral reports.

These things are trading at 25%-40% of tangible book, with somewhat depressed earnings this year, partially because of economic conditions in France, partially because of incremental taxes, and partially because of the lack of flow through of any earnings from the holding entity where they take the dividends into their income statement when they pay them.

These entities are trading at five or six times earnings. They're paying dividends of five to seven percent. Most of them have buyback programs. There have been buybacks of whole share classes of these entities. When they've occurred they've been at significant premiums to what these are currently trading for.

We had some misgivings about the French economic situation and the value of the Euro, so we neutralized a large chunk of our Euro exposure by shorting ten- to fifteen-year French sovereign treasuries against the position when the Euro was at \$1.30. If these banks are going to get into serious trouble, it's unlikely that France will continue to have a bond market that's trading at two percent in fifteen years. We're getting a nice current income on the position, and there is some accretion to book value. My hope is that these things

are not entirely rational for an essentially mutual institution to have outstanding indefinitely, and we may get some buybacks of whole issues. These positions are not terribly easy to buy – they typically trade between twenty thousand and a couple hundred thousand dollars a day each, so accumulating them took a long time.

G&D: What is the composition of the assets at the regionals? Is it what we would expect from traditional banks?

PI: Yeah, it's small commercial, consumer, and municipal loans. The one thing that really concerns me is if interest rates were to go up moderately, it probably would help their profitability. But if interest rates were to go up a lot, there is an inherent duration mismatch because they do some term lending, particularly to municipalities. So I think that is probably the biggest risk if you're looking for an outlying structural risk.

G&D: Seth Klarman in his 2012 letter to investors commented that the end of the "free lunch" of low interest rates and high government spending could come to an end, which would push interest rates up significantly and could cause significant financial pain. Are you preparing for that moment?

PI: You have to be

concerned about it. In 1994, I was working in a brokerage house that was primarily in the fixed income business. We were clearing for some people who were small mortgage securities dealers out of town, and a couple of them vaporized in the experience. Anybody who went through the Granite Capital meltdown and its associated mortgage bond debacle or anyone who experienced the second quarter of 1994, which was the worst quarter on record for the treasury market, went through a very painful experience. At one point treasuries were down more than 20%.

Everybody has to be concerned. With the degree of debt that's out there, the authorities are likely to lean very heavily on a really sharp increase in interest rates. Otherwise, given the very short average duration of treasury debt, it's just inconceivable to me that they would let Treasury bill rates go up to 6%, 8%, or 10%, almost regardless of how stupid the policies would be that would be needed to suppress rates. At high rates, it's much more difficult to manage your government budget because of the increase in the cost of debt service.

The United States and other countries have experienced sharply negative real returns on fixed income instruments. So, yes, I am

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concerned about what will happen when interest rates go up. It could have a pronounced effect on financial markets, and it's not going to be any fun to go through. We're not even talking about rates going to 10% – it will be pretty ugly even if the 5-year goes up to 3% or 4%. That's one of the reasons why what the Fed is doing is progressively less effective. In other words, people aren't stupid. They are anticipating that at some point this is going to have to end. Therefore, I think it has a major effect on the willingness of people to lock up long-term commitments.

G&D: How do you get comfortable with the regulatory and general investing environment in more esoteric countries such as Sri Lanka, where you have invested in the past?

PI: Well, greed helps! My father, and to a lesser extent, Walter, had a saying that he almost never invested outside the United States because he'd always found plenty of opportunities to lose money in the American markets. There have been some changes that make it easier to invest in places like Sri Lanka, most notably the ability to control execution and risk, and the ability to get information. Changes in corporate governance standards in foreign markets have also helped.

If I look at Merck versus Sanofi, what's the real difference of the geographic allocation of their business base? Sanofi is doing something like 60% of its business in Europe, 30% in North America, and 10% in Asia. Merck is doing 15% in Asia, 40% in Europe, and 45% in North America. Just how much of a home country bias can you justify when you have truly international businesses?

Nevertheless, for us to go overseas, the opportunity must be very compelling. That may be because we can't express the idea through an American security, or because the valuation disparity is simply enormous. Then we have to be reasonably comfortable that the legal system works for us. I don't relish the idea of being an unsympathetic hedge fund investor in France, but I can tolerate it, particularly if we like the management.

But on the other hand, we really don't do anything in Russia or China because we don't have any real comfort in the accounting, the legal system, or the culture. And if we make a lot of money, there's a chance that someone will try to take it away. So that skews the risk-reward ratio in a way that we don't get involved. But in a lot of other countries, there are intermediate positions. You lose the color, the context, and the familiarity, but valuation, particularly if

there are international valuation parameters, can make a difference.

I know a great investor in London. He buys breweries partially based upon the cost per hectoliter of capacity, and when he finds a ten-to-one disparity between his longs and shorts, he figures he has a pretty good trade. I'm not nearly that sophisticated or intrepid, but there is a price at which things become attractive, and then you're looking for some indication that you're likely to make money.

In Sri Lanka we got involved because it was extremely inexpensive. The Civil War had also ended recently. The country has a history of British-based accounting and commercial law, which gave us some comfort. Some of the situations that we were involved in had substantial foreign shareholders from countries with good corporate governance standards, which gave us comfort with that sort of J/V partner. It wasn't necessarily favorable for outside shareholders, but it was unlikely there were going to be a tremendous number of self-interested deals on the part of principals that were going to take out value.

If we can get comfortable with the institutional risks, and there is enough of a valuation disparity, we will get involved. That does

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“My father, and to a lesser extent, Walter [Schloss], had a saying that he almost never invested outside the United States because he'd always found plenty of opportunities to lose money in the American markets.”

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 carry the risk that we get involved in a perma-cheap or in something where we don't understand the principals' motivations. But if you're falling out of a basement window with something that is very inexpensive, chances are you're not getting hurt all that badly, and you pick yourself up and hopefully you have some disproportionate winners that compensate for the incremental uncertainties.

G&D: Do you have analysts that only look at international deals?

PI: No, if an idea takes us overseas, then we'll look at it. Personally, I like smaller markets that have natural oligopolistic tendencies simply because of the limited size of the markets. So, I have personal holdings in places like Mauritius, Bermuda, and Sri Lanka.

At Arbitrator, which has a greater liquidity requirement, we follow investment themes in liquid markets in industries that we understand reasonably well. For example, we have a small long position in Pacific Rubiales, which is a sizable Colombian oil company that was started by one of the teams of Petróleos de Venezuela engineers that fled the Chávez politicization of the company. Colombia is a petroliferous area, and the politics of Colombia have been getting better. Venezuela will be less

inclined to be aggressive in the region after Chávez's death, and the FARC will probably get less support. Pacific Rubiales, which has a good record of developing reserves, is trading inexpensively relative to North American analogs. It's a company of some size and we're willing to make a bet.

G&D: You're a noted bear on Amazon. What is your short thesis on the stock?

PI: I am bearish. It's not a primary driver of the portfolio, and it's one where I've been wrong in P&L terms. We actually short Amazon by essentially doing a naked buy-write. We sell calls on Amazon and roll them and alter the exposure somewhat based upon certain valuation criteria.

The question of what Amazon's business model will be when it grows up is still not proven. Amazon had developed a terrific business, and may still have a terrific business in physical media – books and physical things like DVDs – because originally about 20% of the U.S. population was not near a media superstore. Now that you don't have many bookstores any more, that physical market may have grown, and Amazon clearly dominates it.

However, they've got the problem that an increasing amount of media is being digitized. This is changing Amazon's business model

and opening up potential competition from a multiplicity of sources. I look at the Kindle, and it strikes me that it's an intermediate step to better-quality screens on tablets with other types of services that can be linked more broadly with how people manage their media intake. So, it doesn't strike me that the Kindle is a long-term moat for Amazon within that sector.

Amazon does not have an asset-light model. Amazon now has a depreciation rate that is slightly higher last year than Aéropostale's and somewhat lower than Gap's. They've got 50 million square feet of these vast, dystopian warehouses that have been Taylorized with monitored guys walking around fulfilling orders. It's very difficult for them to automate that. They are losing the sales tax advantage that they had progressively, and it will eventually go away completely.

It's true that they can deliver a lot of goods to a lot of people, but they are competing against the implied untaxed labor costs of people going to the store and picking up their own stuff. Amazon has delivery expenses. We are long this trend via UPS, because we could buy it at a 6% or 7% free cash flow yield. UPS's network would be difficult to replicate and is already quite profitable. A lot of

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the hopes of what people want to get from of Amazon are ultimately going to be indissolubly associated with a guy in a brown suit and a brown truck.

Amazon has been spectacular at being able to find new areas to go into unprofitably. It will be difficult for them to develop their third-party business because it's really a fulfillment operation.

Where they've become a merchant, they are rapidly becoming competitors to companies that they serve, which limits Amazon's ability to be a preferred vendor of choice on that kind of platform. E-commerce is not a unique skill. Amazon does it well, but other people also do it well.

Amazon has a negative working capital model. They have actually used a portion of that negative working capital to fund their very large capital plan. They have to continue to grow, because if they ever stopped growing, they would no longer be able to keep their expenses down by paying a substantial portion of their wage bill in stock options. When you put all that together, there's a good chance Amazon is a perpetual motion machine. I am a happy Amazon customer. If somebody is willing to sell me stuff at cost or below, why not? They do a very competent job. But as an investment proposition, I don't get it.

You can also have shopping bots that can intermediate among vendors very, very quickly. In other words, people argue that Amazon can aggregate things from everywhere, and they have tremendous economies of scale. But when you're up to \$50 billion of sales, what kind of scale do you need to become profitable?

I'm a great admirer of people who can find Phil Fisher-like growth situations. I'm not good at doing that. But the essence of a Phil Fisher growth situation is that it's a rapidly growing business that does such a good job of fulfilling customers' needs that it is profitable enough to fund its own more-rapid-than-normal growth. Amazon funds its growth through a combination of anti-dilutive stock offerings through options and its negative working capital model, and I don't think that's the same thing.

I've got one guy who told me today, "Hey, look, given the rapid growth of the number of searches on Amazon for goods that get sold through Amazon, if I value that relative to the valuation of Google based on its search and advertising business, I can justify a substantial portion of the market cap for Amazon based on what it would be able to do if it turned it into a local advertising business." Instead, Amazon manages to advertise itself for goods that it sells at no profit. So

I'm not sure that's really the same thing.

Businesses have to make profits to justify their valuations. It's a critical mass issue for many businesses, which should result in a higher degree of profitability going forward. But how large does a company have to be before they start making money in some aspects of their business? And the fact that Amazon isn't profitable at their current scale makes me wonder whether it's all that profitable in any material portion.

It's interesting because we're focusing on Amazon. It's a decent-sized short for us. It's really not going to be a major driver of the portfolio. But it's also an indication of a failing that we all have in our business –this tendency to look for the big controversial name and then have an opinion. Often the big controversial name is controversial for legitimate reasons, and you don't have to get involved. You can get involved in names about which any sane person is going to basically say, yeah that's cheap, and I just want to know why it's going to get un-cheap? Or, yeah that's really expensive, but why do you think they won't be able to keep the promotion going?

It's fun to have a debate about something like Amazon because it's a "how do you like those Yankees"

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"Amazon has been spectacular at being able to find new areas to go into unprofitably. ... As an investment proposition, I don't get it."

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Paul Isaac

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topic? It indicates that a lot of us are spending time on things where it's very difficult to have more than a moderate incremental advantage. You have only a limited amount of time, attention, and analytical resources. This whole exercise that we've got is one of 'applied epistemology': what do we know and how do we know it? Try to look at things on a scale where you can have a relative information advantage compared to the rest of the world. We are in an intermediate stage where that's getting harder given our size, but I'm always a little bit surprised that individuals, particularly for their own account, don't do that more.

G&D: Do you have any advice for students looking to get into investment management?

PI: It's a very long race. You've got half your capital from the last doubling, which is one reason why you have all these elderly guys tottering up and giving you advice at Columbia. Time really matters. Compounding really matters. The investing process really matters. What are you doing for whom?

There are an awful lot of investment products out there that are targeted for specific agency needs of particular types of investors. They are not necessarily ideal ways of investing for

somebody looking to maximize their own capital. I think targeting investment products is perfectly valid work. Products are designed for institutional contexts and they conform to popular preferences. These can be enormously lucrative jobs, you can build up tremendously attractive businesses out of them, and some people make a lot of money doing it. I don't see anything wrong with that even if I think it is sub-optimal for my investing preferences.

But it's important to distinguish that type of investment approach from one that fully reflects your temperament and style. Figure out who you are, what you're trying to accomplish, and what your temperament is. Otherwise, you may find yourself as a square peg in a round hole. On the other hand, I'm a great believer that there is not one right slot. You're going to learn a lot about investing, no matter where you wind up.

Most of you are going to have careers that are twenty-five to forty years long. And by the way, the investing world will be very different. You will have been through several economic cycles and there will, undoubtedly, have been a number of important agency and regulatory changes, none of which you'll be able to forecast with precision. So don't decide you want to be Carl

Icahn when you're eighty because, by that time, the world could be a very different place. It's going to be very path dependent as to how you get there.

You should be personally and financially conservative for a few reasons. First, it is a cyclical business, as people have now rediscovered. Second, it's a lot more fun if you have some of your own money to invest. And third, it opens up a lot of flexibility to you, particularly in the intermediate stages of your career.

Enjoying the ride is really important. Too many people have a fixed star of what they want to become. Frankly, I started in some very different areas, and I had several sub-specialties shot out from under me in the course of various types of technological or regulatory changes. Be open to where this will take you or what opportunities you will have. You could be a great growth stock guy; but if you find yourself in the middle of the TMT bubble maybe you're supposed to shift your focus for a while, if you have the ability to do so.

G&D: It was a pleasure speaking with you, Mr. Isaac.

“You should be personally and financially conservative for a few reasons. First, it is a cyclical business, as people have now rediscovered. Second, it’s a lot more fun if you have some of your own money to invest. And third, it opens up a lot of flexibility to you, particularly in the intermediate stages of your career.”

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