

Q&A with William Lock

Buffetting Global Equity: taking Quality to the next level

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Warren Buffett, widely recognised as both a pioneer and formidable exponent of long-term investing, is much admired and followed, but interestingly little replicated by institutional long-only equity managers. William Lock explores why this is the case, and discusses how a strategy that his team manages has incorporated the Buffett philosophy into a long-standing, successful global investment strategy suitable for institutional and professional equity investors.

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What is the origin of Buffett's philosophy?

WILLIAM LOCK (WL): First and foremost, there is only one Buffett. He's been extremely generous over a long period of time broadcasting the way he invests to a wide and captivated audience. We're simply discussing how we think he does it, and what we think is the relevant stuff. Interestingly, it's Benjamin Graham who is credited with developing the main philosophies behind value investing. Buffett is his most celebrated student. It was Buffett who adopted Graham's underlying approach—that stocks should be regarded as businesses and investors should calculate a business's intrinsic value based on financial fundamentals and then apply a margin of safety.

How does Buffett implement his philosophy?

WL: Initially, the approach was largely quantitative and relied heavily on stocks that were mispriced, regardless of quality. When these companies reached intrinsic value, they were sold. In practice, in the early Graham/Buffett years, the approach was largely book-value driven as a proxy for intrinsic

value which, way back in the 1960s, led him into the swamp of putting all his partnership assets into Berkshire Hathaway,¹ a textile company, which eventually had to be sold for scrap after endless restructuring.

What happened next?

WL: Buffett met Charlie Munger and evolved his investment approach, becoming far more free-cash flow driven, which led to a re-determination of what intrinsic value actually meant. Buffett lays this out in his “Owner’s Manual”—intrinsic value is the discounted value of the cash that can be taken out of a business during its remaining life. This is also our definition of intrinsic value.

The central tenet to Munger’s style was to buy easily understood, wonderful businesses, ideally at a discount to intrinsic value, and if not, then at fair value. Munger and Buffett have both contributed many, many good quotes to the investment community. One of Munger’s most famous ones—“It’s far better to buy a wonderful company at a fair price, than a fair company at a wonderful price”—rather neatly sums up his approach.

What did he mean by a “wonderful business?”

WL: Simply one which could make a high sustainable return on capital into the future, with growth potential.

How did the Buffett/Munger philosophy manifest itself in the type of holdings they went on to own?

WL: From the late 60s up until the 90s, they were prepared to buy great businesses in the public markets, as well as in the private markets, just so long as these businesses had top management teams in place. What they were looking to achieve, and again Buffett sums this up in his Owner’s Manual, was to maximise the average annual “rate of gain” in intrinsic

business value on a per share basis. Bear in mind that compared to most long-term equity investors, Buffett has many more means to realise his goal, for example through the leverage embedded in insurance companies, or using the freedom to seek opportunities in the private sector.

Can you describe any challenges the Buffett approach has faced?

WL: Since the 1990s, his style has been affected by what he terms the enemy of superior returns—the large pocket book. In other words, the larger you get, the more cash you have to put to work owing to your size, so the harder it becomes to generate superior returns. The result of this for Buffett is that provided he can still put a lot of capital to work at decent, secure returns, he seems to have lowered his threshold for what constitutes a high return business. This would help explain why he bought into utilities and even a railroad, which we struggle to see as great businesses.

What can Buffett do that institutional equity managers can’t?

WL: Well, I believe he’s less constrained. For one, Buffett and Munger’s investment preference has been to own businesses directly through acquisition. Buffett favours private deals because he can generally get a better price from sellers in return for offering a long-term congenial ecosystem for the managers or owners of the business. This doesn’t mean certain companies get an easier ride in the public markets. He’s also well aware of the power of his own brand and is not beyond “Buffetting”—using his considerable clout to get sweetheart pricing on deals available only to his investment vehicle, Berkshire Hathaway—he retained the name, if not the underlying company. Buffett and Munger’s second choice is to own parts of companies through common stock, usually obtaining a controlling or minority interest. Typically, long-only equity managers don’t own companies directly or have majority stakes.

How does he finance his buy ideas?

WL: Berkshire Hathaway has two large sources of funds in addition to free cash flows generated by its businesses and its cash holdings: deferred taxes and float—which the premia insurance subsidiaries receive before needing to pay out losses. Thanks largely to the success of Berkshire Hathaway’s Super Catastrophe underwriting business, its Reinsurance business and GEICO’s motor insurance business, both sources of funds have grown rapidly, totaling a substantial \$151bn last year.²

What advantage does this bring over long-only equity managers?

WL: As Buffett points out in the Owner’s Manual; “...deferred taxes and float... gives us the benefit of debt—an ability to have more assets working for us—with none of the drawbacks”. It also means that he can use his insurance leverage and wait around for good investments, without having to worry about a “cash drag” on performance. Generally, long-only equity managers are not permitted to hold large cash balances, or use leverage, or even get access to the specific insurance leverage Buffett enjoys.

Does Buffett have any other advantages over long only equity managers?

WL: Yes, two come to mind. One is being the ultimate long-term investor. He’s patient to buy and reluctant to sell, if at all. One of Berkshire Hathaway’s 13 owner-related principles is “Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns. We are also very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers or labor relations”. As such, for Berkshire Hathaway investors, the liquidity of holdings is less of a consideration. Most equity managers managing money on behalf of pension plans require ample

¹ This material is not intended to be taken as a recommendation for any companies Buffett has invested in, or for Berkshire Hathaway.

² Source: Berkshire Hathaway Shareholder Letter, February 27, 2016.

liquidity to satisfy short notice payments for plan flows. We regularly receive questions from clients on our liquidity profile in scenarios of market stress. Buffett generally buys in times of market stress and doesn't look to sell.

And the other one?

WL: Being able to invest in the way you want to, without restriction. Buffett and Munger control Berkshire Hathaway and have written its playbook—to own great companies, to hold them forever, and to have the luxury of time to put cash to work. They are not hostage to the typical pressures of investor short-termism. Their success is not measured by outperforming a peer group or an index, quarter over quarter, year over year. They are not penalised for tracking error or cash drag. They aren't expected to outmaneuver the markets or provide large amounts of liquidity to Berkshire Hathaway investors.

What about risk?

WL: Buffett cares about absolute risk, not relative risk. We agree. Caring about absolute risk means caring about the risk of losing money. Caring about relative risk means trying to avoid underperforming your peers or an index, irrespective of the direction of performance. To do this, you ultimately need to look like your peers or the index, not differ from them. John Maynard Keynes put it rather well. “A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no-one can really blame him.” Being brutal, the focus on relative risk and tracking error is generally code for “managing career risk.” The perverse effect of relative risk is that by losing 50% of your money in absolute terms, but having perfect tracking error in line with your peers means your career is probably safe. Basing risk on difference rather than loss is hardly what we'd consider real risk.

Is Buffett a global investor, or is there a bias to home soil?

WL: To my mind, he has the great advantage, as I've mentioned, of buying both private and public businesses in the U.S. If he was confined to just the U.S. public market, his universe for quality companies would be considerably smaller, potentially forcing a compromise on price or quality, so he has greater scope than most given the private “pipe”. He does look and participate overseas, but the record is a little more mixed. Many investment plans see the merit of investing globally since it maximises potential opportunities, but in practice they have found it difficult to execute, not least due to the historic “bucketing” of regions into U.S., EAFE and Emerging Markets and the paucity of differentiated high-quality global equity strategies.

Given the historic regional allocations, and the apparent barriers long-only equity managers face investing the Buffett way, are there any Buffett-like global strategies out there?

WL: We believe the closest one out there is the strategy we manage called Global Franchise. An ex-colleague started it 20 years ago in an attempt to effectively be a global version of what Buffett and Munger were doing in U.S. high-quality equities. Deliberately set up as a concentrated strategy, he recognised there aren't that many wonderful companies, even globally. And finding them at a fair price makes them even rarer.

How do you think you differ from Buffett and Munger?

WL: Again, there is only one Buffett and there is only one Munger. We are, if anything, stricter on defining what a wonderful business is. Buffett generally talks about a great business having long-term growth potential and requiring a sustainably high return on equity—which is AFTER leverage. We require businesses to have a very high and sustainable return

on operating capital (not equity) which is BEFORE the magnifying effects of leverage. We don't take balance sheet risk. We also require a low volatility of unlevered profit margins.

What does this mean in practice?

WL: It means Buffett can own public equities we would never touch. For example, a bank's return on capital is minuscule. We'll never likely own banks in Global Franchise. It also means we'd never own utilities or railroad companies. They have low, often leveraged returns, and high capital intensity—a lot of the cash they generate has to be ploughed back into the persistently capital hungry fixed assets, leaving fewer options for capital allocation, either back to shareholders, or to grow the business, which ultimately means their options for long-term compounding are significantly more limited.

You spoke about risk earlier—how do you think you differ?

WL: Arguably, we require a greater margin of safety. To assess intrinsic value, Buffett appears to use long-term government bond rates to determine his discount rate for the cash flows. He doesn't seem to add an equity risk premium because he views great businesses as safer in the long run than Treasuries. Why? Because they have growth potential and pricing power. Bonds have neither. We agree in principle, but in practice we use an equity risk premium which builds in more of a margin of safety than Buffett may need.

You set a very high threshold for quality. How do you measure this?

WL: We look for high and sustainable unlevered returns on operating capital employed, or ROOCE. Global Franchise's ROOCE is 60.8%, which is around 3.5x greater³ than that of the MSCI World Index. As yet, we haven't found a global equity strategy that can match this, implying Global Franchise is possibly one of the highest quality global equity

³ Source: Morgan Stanley Investment Management, FactSet. Data as at 31 December 2017.

product in the world. ROOCE isn't the only measure that sets us apart. High gross margins are a marker of pricing power. At 47%, Global Franchise has nearly double the gross margins of the broader MSCI World Index. I mentioned earlier we don't take financial risk, which is borne out by our strategy's net debt to EBITDA ratio of 1.5.

Don't government bonds offer greater safety, albeit at a lower compound return? Is this a better risk reward?

WL: Actually, we think it's a compelling option to replace at least some of the very expensive government bonds used to de-risk pension plans with a very high-quality equity strategy, such as Global Franchise. We believe this strategy has the potential to beat bonds over the long term because it has two crucial things bonds don't—pricing power and the ability to grow. The problem with Treasuries is the starting point of currently low yields. Nine countries in the developed world have 10-year bond yields below 1%, including Japan, Germany and France.⁴ Interest rates are likely to remain historically low for the foreseeable future. The average U.S. 10-year yield over the last 50 years is just over 6%. Even if the current yield rises by 75bps this year, as the potential for three 25bps increments suggests it could, it will remain more than a full standard deviation below its 50 year mean. Finally, it's worth noting that the more volatile the underlying company sponsoring the pension plan, the more logical the rationale for having a Buffett-like approach, such as Global Franchise.

And relative to broader equities, why quality now?

WL: That sounds like a timing question. We don't time markets because we don't need to. Our philosophy is very clear; in our view, compounding and capital preservation is the best route to

attractive long-term returns. The way to do this is to buy companies that do the compounding for you with their robust and organically growing economics. They can only be robust if their fortunes are not principally governed by the economic cycle, and they can only organically grow by virtue of their pricing power, driven by their market-leading positions in the right categories, and their ability to innovate, advertise and promote.

Isn't most of the market governed by the economic cycle?

WL: Yes, but we don't have to worry about most of the market. We're looking for the highest quality companies in the world. There are over 2,000 companies in our investible universe. We have less than 30, or just about 1.5% of the universe. So there's a lot we don't own, simply because they don't fit what we do. Just as an example, why wouldn't a commodity company fit us? First, it doesn't typically have the pricing power, in part because this is driven by market supply and demand but also because it rarely has the chance to innovate; new gold, new oil, new water, new iron ore? Typically, these aren't ongoing events. Second, commodities don't typically generate high returns on operating capital because of their capital intensity owing to having to have significant physical asset bases, which means they are more a consumer of cash than a generator. You simply can't compound effectively without generating sustainable and growing cash to organically develop your business, or return capital to shareholders.

Because of quantitative easing and aggressive monetary policy, aren't equities, and especially the best ones, expensive?

WL: One of the key impacts of interventionary monetary policy has been a distortion of asset prices across all asset classes. Forcing down bond yields created a hunt for yield everywhere else, elevating

valuations and giving rise to some of the unwelcome side effects of cheap money including rising leverage, the dangerous illusion that credit markets are liquid, and much greater correlation across asset classes, such that, for example, gold and financials often now move in the same direction rather than in opposite ones. The upshot is that valuations are high, with prices rising in spite of earnings generally treading water. Entrenched in the belief, or myth, that central bankers control the destinies of economies and markets, investors now follow their increased mutterings more than they concentrate on the fundamentals, creating heightened volatility and an even greater narrowing of short-term investment behaviour. We don't spend time wondering what rates might or might not do, what central bank policy might or might not do, or what any other in-vogue macro wheeze might be out there. We don't base an investment case around it. What we care about is that we don't generally pay more than long-term intrinsic value for our investments. It's a pretty staggering statistic that given the very high level of quality our companies have, with ROOCE more than 3x greater than the broader market, that the valuation premium is so narrow. The free cash flow yield is less than 10% more expensive,⁵ a level that historically is far from extended. And it's worth remembering that the free cash flows we look to own are those that are sustainable and growing, not those amplified by a certain point in the cycle. To cut a long story short, we think current valuations for the companies we own are acceptable—not cheap, but acceptable.

What would you say to those pension plans interested in investing in a very high quality global equity strategy, such as Global Franchise?

WL: Take a very long-term and patient view. Without this, you won't get the benefits of compounding. It's all about

⁴ Bloomberg, Morgan Stanley Investment Management. Data as at 13 January 2017.

⁵ Source: Morgan Stanley Investment Management. Data as at 31 December 2017.

the long term and patience, underpinned by a strategy with the freedom to invest this way.

Select a strategy that has a clear and robust philosophy and process that articulates and demonstrates repeatedly through what it owns exactly what, in its view, a wonderful company is.

Select a strategy that is able to assess and own these wonderful companies, generally at or below intrinsic value.

Select a strategy managed by a team that has complete investment independence, where the goal is to compound clients' wealth over the long term rather than focus on the short-term goal posts of peer/index performance and holdings.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose

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Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. **Free Cash Flow (FCF)** is a measure of financial performance calculated as operating cash flow minus capital spending, working capital growth, interest and taxes. **Net debt to EBITDA** is the net debt to earnings before interest depreciation and amortization (EBITDA) ratio. It is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. **Return on Operating Capital Employed (ROOCE)** is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill).

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