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3 Paths to Finding Value in Stocks

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John Huber,
Saber Capital Management, LLC
www.sabercapitalmgt.com
john@sabercapitalmgt.com

John Huber Brief Bio

- Founder, Portfolio Manager at Saber Capital Management, LLC
- Author of the Blog BaseHitInvesting.com, where I discuss my investing ideas
- Saber is a Registered Investment Advisor (RIA) that manages separate accounts for clients using a value investing approach
- Saber emphasizes aligned incentives (John Huber invests alongside clients)

Saber's Investment Strategy

Saber's strategy is to make investments in high-quality, well-managed businesses at attractive prices.

Qualities I Look For:

- Businesses I Understand
- Growing Intrinsic Value (High ROIC)
- Durability (Predictable Cash Flow)
- Shareholder-friendly Management
- Margin of Safety (Value)

A Common Sense Approach to Investing

"Your goal as an investor should simply be to purchase, at a rational price, a ***part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now****. Over time, you will find only a few companies that meet these standards -- so when you see one that qualifies, you should buy a meaningful amount of stock…*

"…Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

- **Warren Buffett,** 1996 Shareholder Letter

3 Paths to Finding Value

Three ways to locate value in stocks:

1. **Information Advantage**

2. **Analytical Advantage (Thinking Differently)**

3. **Time Arbitrage**

Path #1: Information Advantage

Information Advantage: Finding information that others don’t have

- This was how Buffett made a sizable amount of money in the 1950’s
- **Spinoffs/Special Situations** (Joel Greenblatt made 50% annual returns in special situations using information he located that others didn’t have)
- **Small-caps** (“hidden gems”)
- However, it is now **much easier to uncover information** in today’s world (thus minimizing this advantage)

Information Advantage

Buffett's advantage in the early years was simply looking for bargains that others weren't:

- Western Insurance - Good Business valued at less than 1 P/E (see pg 185 of Snowball)
- http://basehitinvesting.com/buffetts-early-investments/ (When Buffett found it, it had $16 of earnings and stock price that traded between $12 and $20 per share)
- Buffett was up 75% in 1951, mostly because of GEICO. He put 65% of his small portfolio and the stock roughly doubled. He sold to buy Western Insurance, which also went on to double.

Path #2: Thinking Differently

Taking the same information and interpreting it differently:

- There is no piece of information about Apple that isn't freely available
- Yet it traded at 90 in January, 110 in March, 90 in May, 110 in September
- Two various potential interpretations of its high margins:

1. **One view:** Apple is commodity hardware manufacturer that will see its margins erode
2. **Alternate view:** Apple is a consumer brand which is the reason it has achieved high margins to begin with

Thinking Differently

- Market does a poor job at judging long-term probabilities
  - Great compounders like WMT, WFC, SBUX, FAST, BRK, HD, GOOG, AMZN, PCLN all remained undervalued for a decade or more (many compounded at 20% annually for decades)
  - Even after they were widely accepted to be great companies with outstanding competitive positions, high returns on capital, attractive unit economics, and a long runway, the market still priced them "cheap" (i.e. allowed shareholders to invest at prices that subsequently yielded outstanding results, even as P/E ratios appeared high).
- Why does the market often undervalue great businesses?

Thinking Differently

Two key reasons:

- **Market is better at analyzing short-term data points than it is when it comes to analyzing long-term fundamentals** (the focus on the next few quarters deemphasizes what is important about the next 5 years; e.g. all the best engineers want to work at Google or Facebook, not Yahoo)
- **People often interpret the same set of information in very different ways**

Thinking Differently - Markel

	Book Value & Stock Price			Invested Assets		Investment Returns		Underwriting	
	Book Value per Share	Closing Stock Price	P/B Year End	Investments per Share	Investment Leverage	Equities	Overall Portfolio	Gross Written Premiums	Combined Ratio
1995	$39	$76	1.92	$171	4.4	29.7%	15.7%	$402	99%
1996	$49	$90	1.83	$209	4.3	26.9%	7.5%	$414	100%
1997	$65	$156	2.40	$258	3.9	31.4%	12.8%	$423	99%
1998	$77	$181	2.35	$268	3.5	13.3%	8.9%	$437	98%
1999	$69	$155	2.26	$291	4.2	-10.3%	-1.3%	$595	101%
2000	$103	$181	1.76	$428	4.2	26.4%	11.6%	$1,132	114%
2001	$111	$180	1.63	$366	3.3	16.9%	8.4%	$1,774	124%
2002	$118	$206	1.74	$439	3.7	-8.8%	8.3%	$2,218	103%
2003	$140	$254	1.81	$543	3.9	31.0%	10.5%	$2,572	99%
2004	$168	$364	2.16	$641	3.8	15.2%	7.9%	$2,518	96%
2005	$174	$317	1.82	$672	3.9	-0.3%	1.5%	$2,401	101%
2006	$230	$480	2.09	$753	3.3	25.9%	11.2%	$2,536	87%
2007	$265	$491	1.85	$781	2.9	-0.4%	4.8%	$2,359	88%
2008	$222	$299	1.35	$702	3.2	-34.0%	-9.6%	$2,213	99%
2009	$283	$340	1.20	$799	2.8	25.7%	13.2%	$1,906	95%
2010	$326	$378	1.16	$846	2.6	20.8%	7.9%	$1,982	97%
2011	$352	$415	1.18	$907	2.6	3.8%	6.5%	$2,291	102%
2012	$404	$433	1.07	$969	2.4	19.6%	9.0%	$2,514	97%
2013	$477	$580	1.22	$1,259	2.6	33.3%	6.8%	$3,920	97%
2014	$544	$683	1.26	$1,335	2.5	18.6%	7.4%	$4,805	95%
2015	$561	$883	1.57	$1,302	2.3	-2.5%	-0.7%	$4,633	89%

Thinking Differently - Markel

- 19% CAGR in MKL book value per share since 1986
- 17% CAGR in MKL stock price since 1986
- So the stock was undervalued for nearly 20 years (i.e. any stock that compounds at 15-20% annually for decades was undervalued)

Why were investors able to buy it at a level that allowed for such high rates of compounding going forward?

In other words, why was MKL mispriced for all those years?

Thinking Differently - Markel

Consensus View:

- Insurance isn't a great business; it's volatile, it has no product differentiation, and ROE is mediocre; thus MKL's ROE and book value growth will mean revert

Alternate View:

- Markel is a great business because of its **culture**, **prudent underwriting focus**, **common sense investment approach** and **owner-oriented management team** which combine to produce excess ROE and book value growth; and should have earned it a premium valuation

More on MKL: http://basehitinvesting.com/markel-mkl-a-compounding-machine/

Thinking Differently

Different people might come to widely different conclusions, despite being given the same set of information:

- The odds that a person gets a certain disease is 1 in 1000
- The test for that disease is 99% accurate
- Your friend just tested positive for this disease
- What is the chance your friend has the disease?

Answer?

Thinking Differently

- The odds a person gets a certain disease is 1 in 1000
- The test for that disease is 99% accurate
- Your friend just tested positive for this disease
- What is the chance your friend has the disease?

Answer? Your friend has only a 9% chance of actually having the disease.

- Many people might understandably think the answer is 99%
- Conditional Probability & False Positives: http://brownmath.com/stat/falsepos.htm

Path #3: Time Arbitrage

Time arbitrage is being willing to maintain a 3-5 year time horizon when most investors and analysts are thinking about the next quarter.

- There is no information advantage
- There is no analytical advantage
- Just a willingness to buy stocks that others are selling for short-term reasons
- Many market participants want/need short-term results and so focus is on things like:
    - Catalysts, Short-term expectations, Quarterly results

Time Arbitrage

"...the analyst interested in value is likely to place only minor emphasis upon the short-term earnings outlook; whereas the analyst who endeavors to anticipate the price movements of the near future will make such outlook his major concern."

- Ben Graham, Security Analysis

Time Arbitrage Example - Bank of America

- BAC traded from $17 to $11 and now back to near $17 again in 2016 so far, or roughly a $65 billion change in market value

- Why did the stock drop?

  - **Low oil prices** (fears that energy producers would default, causing losses for banks)

  - **Recession fears** (negative short-term impact to earnings if the economy turned down)

  - **European bank problems** (counterparty risk and further economic troubles)

- Two of the three (oil and recession fears) were legitimately possible/likely to impact the stock price and also impact short-term earnings

- None of the three were likely to impact the long-term earning power of the BAC franchise

Time Arbitrage – Wait for Opportunities

Top 10 Largest Companies in S&P 500						
Company	Ticker	Current Market Cap ($ billions)	52 Week Low	52 Week High	% Change (High/Low)	$ Change in Market Value ($ billions)
Apple	AAPL	$606	92	134	46.2%	$241
Google	GOOG	$512	515	789	53.2%	$187
Microsoft	MSFT	$437	40	57	43.1%	$134
Exxon Mobil	XOM	$362	67	90	35.4%	$97
Berkshire Hathaway	BRK.B	$341	124	149	20.3%	$63
Facebook	FB	$323	72	118	63.3%	$130
Johnson & Johnson	JNJ	$313	81	114	41.0%	$91
Amazon	AMZN	$296	386	696	80.3%	$145
General Electric	GE	$289	19	32	65.4%	$117
Wells Fargo	WFC	$257	45	59	32.1%	$73
	Average % Change High/Low				40.8%	
	Average $ Change in Market Value				$128 billion	

Time Arbitrage - Why Does This Work?

Focusing on the long-term is **difficult** because:

Takes patience. There can be periods of underperformance.

Most investors (clients) want results quarterly, or at least yearly, and so most money managers try to accommodate these short-term demands *(i.e. who cares what Apple looks like in 3 years, how many iphones are they going to sell this quarter??)*

Short-term thinking (among investors, fund managers, and corporate management teams) is pervasive now, and the speed of technology and information probably intensifies this view.

All of these decisions being made for short-term reasons creates opportunity (and the biggest market inefficiency in my opinion) for those who can look out 2-3 years.

Summary

- There are three possible advantages that stock investors can gain:
  - **Information Advantage -** Highly competitive area of focus
  - **Thinking Differently** - Can be used to think about "compounders"
  - **Time Arbitrage -** Most investment opportunities come from this category
- The first category is what most investors focus on, but yet it is the most competitive
- The last category is a structural advantage given the focus on short-term results
- I believe time arbitrage (being willing to think long-term when the majority of the market is focused on short-term) is a permanent advantage in markets

Questions/Comments?

Contact Info for **John Huber** and **Saber Capital Management, LLC**:

- Managed Account Information: sabercapitalmgt.com
- Investment Commentary: basehitinvesting.com
- john@sabercapitalmgt.com
- 919-610-6809

Thank You!

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