3 Paths to Finding Value in Stocks

October 25th, 2016

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**
<table>
<thead>
<tr>
<th>Year</th>
<th>Book Value per Share</th>
<th>Closing Stock Price</th>
<th>P/B Year End</th>
<th>Investments per Share</th>
<th>Investment Leverage</th>
<th>Equities</th>
<th>Overall Portfolio</th>
<th>Gross Written Premiums</th>
<th>Combined Ratio</th>
</tr>
</thead>
</table>
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

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%
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

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

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!