

Southeastern Asset Management: “We welcome unpredictability”

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by Robert Huebscher

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I spoke with Ross on February 15.

Bob: In your fourth quarter 2016 shareholder letter, you allowed that the number of on-deck companies, ones not currently owned but that potentially meet your investment criteria, is smaller than usual. In the past, has the number of companies in the on-deck category correlated to future returns?

Ross: There’s not been an extremely strong correlation historically except for very intense market moments when it’s obvious that there’s a big, long list of them or when markets are high and there’s barely anything. It has correlated to absolute returns in those cases.

It’s also a quality more than quantity thing. Even though today’s list, for example, is a bit smaller than average, there are a good number of potentially great ones there, and we just need the right price. We’ve pre-qualified them, and now we’re just patiently waiting. We have bought some companies since quarter end that we will talk about a little later.

Bob: Also in the fourth quarter 2016 shareholder letter, you stated that values internationally are superior to what you see in the U.S. market. Did that manifest itself in transactions in the fourth quarter and in the first quarter of this year?

Ross: It did. We have been saying this in general for a few years; Asia and Europe are more attractive than the U.S. You saw it in the fourth quarter. We had three new buys in our International Fund. We had STADA, a German drug and consumer products company that has just recently been the subject of some merger and acquisition speculation, so it’s been a good one right off the bat.

We also bought Yum China. Yum Brands was a long-term holding for us in our Partners Fund and global accounts for over 15 years. We’ve been watching it closely since we had sold it, and when it split into two companies, the China business was cheaper, and we’re very happy to own that one again.

The other company we added in our international accounts was Ferrovial. It became briefly mispriced last quarter, and we were glad to get to start adding to it again. The Partners and the Small-Cap Funds each had one new addition in the fourth quarter, but there were more opportunities internationally.

Thus far in the first quarter of 2017, we can’t show the world yet, but we’ve found some promising internationally headquartered investments. We continue to search the world, but find more things outside the U.S. than in the U.S.

Bob: Thirdly, in your fourth quarter shareholder letter, you stated, “The shift to indexing had been a headwind for the Funds for several



Ross Glotzbach

years because it drove stocks to move in lockstep and favored momentum investing, as indexing is a strategy that buys more of what has been going up. Even though indexing remains in favor, 2016, and the second half of the year in particular, saw positive signs that this force is abating. Correlations between stocks have declined, and the market began to weigh company-specific factors more, which rewards our skills as business appraisers.” How do you measure the abatement of the effect of indexing, and what might make one believe this is a sustainable trend?

Ross: I don’t have a lot to add beyond what we said in the letter. Certainly, stock correlations are one measure, and that’s a quantifiable measure of how much companies move together. Another one is the relative results of actual stock pickers—and we fall into that category—versus both the index and some that are more closet indexers that have much lower active shares

than our high 90s active share.

To your question about this being a sustainable trend, I go back to the fact that the market is a voting machine in the short run, but it's a weighing machine in the long run. Like other trends that get carried along on their own momentum in the short run, it's often very hard to say exactly when things will reverse. But value has a very, very long-term history of winning out in the end. Usually, when the market or anything else reaches the point where it seems like something will

as Alphabet calls them, which are at an even earlier stage and experiencing losses. We value all those businesses very conservatively, and we do not give credit for continued high-growth rates like they've been printing so far.

We also think that the people side of Alphabet has gotten even better since we invested. They have brought more capital and cost discipline. CFO Ruth Porat deserves some level of credit for that, and Larry Page and Sergey Brin, also, for bringing her in. They repur-

ownership over the last year or so by buying over \$100 million worth of stock personally. That's a great, big vote of confidence. We love to see that.

On the business side of Wynn versus others, it has a uniquely high level of currently non-earning or under-earning assets that will be coming online over the next several years. Its Wynn Palace property in Macau opened up last year and is ramping nicely, versus a lot of doubters who thought it would take longer. The company also has a project in Boston. Construction has begun there, and it will hopefully open in 2019. But to people just looking at the company on a current cash flow basis, there's zero credit for Boston.

A similar type asset that will come online later is the land in Las Vegas, where Wynn has a golf course that is currently underutilized, and the company is drawing up plans as we speak to turn that into a cash flow-generating asset. One other thing that we applaud: The company sold about half of its retail assets in Las Vegas at a very big multiple, versus what the stock market was giving it. That is another example of doing the right thing, and we're happy to be partnered with Wynn.

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keep going on forever, that's when it's pretty close to peaking.

Bob: Turning to some of your specific holdings, what is the margin of safety in Alphabet?

Ross: We think it's still significant. We bought the company when it was at one of its more hated points about two years ago, and we were able to pay a very good price for it. Certainly, the margin of safety is not as significant as it was then, but the value has grown strongly since, so we're still excited to hold it.

We look at it through our usual "Business, People and Price" framework. On the business, margin of safety can come from some of the non-earning and under-earning parts of this company. It has YouTube and the growing cloud business, which are probably not yet at their long-run margins. Additionally, it has driverless cars and some of the "Other Bets,"

chased their own shares, which people thought that they would never do. So they're buying in discounted shares, which we love. And they've continued to not do any big, bad deals, which can be tempting from time-to-time in the tech world.

The final thing to talk about is on the price front. Alphabet has such a great balance sheet that further gives cushion if things go wrong. Then we also apply a minority or control discount for the multi-share class structure, when in actuality, the track record of these people would deserve a premium, not a discount.

Bob: What is Wynn Resorts doing that other casino companies are not?

Ross: One big, clear differentiator would be Steve Wynn's track record and owner/operator mindset. Steve has a 40-plus-year history of building value per share. He is a large owner. He increased his

Bob: A question that's rarely asked of managers is why they sold the position they favored for a long time. I believe that Vail, in the Small-cap Fund, and Aon, in the Large-cap Fund, would be such positions for Longleaf. What occasioned the decisions to sell them?

Ross: This is usually a function of price reaching, and sometimes even exceeding, our value. The more history we have with a company and the stronger its business and people, the higher the price to value ratio (P/V) at which we are willing to sell it.

With Vail, we applaud CEO Rob Katz for growing the value per share strongly over our five-plus-year holding period. He successfully consolidated Park City, grew the season-pass business, which reduced a lot of volatility in the business, and made numerous beneficial decisions for which we're grateful. But, last year when the stock exceeded our appraisal after Vail announced that it was buying Whistler, we felt it was time to move on.

Over at Aon, which we owned for the most part of almost 15 years—we sold it once and bought it back—CEO Greg Case also had a good track record of growing the value strongly. But, again, when the price reached our appraisal, and the hard-to-quantify upside of the healthcare exchange business became a little less clear, we decided to sell.

We wish the best for both of those management teams and know that they'll continue to do well, but we did not feel that the margin of safety was there to continue holding the stocks.

Bob: Southeastern is known for engaging with the management and board members of the companies in which it invests. Have there been recent examples where this has helped formulate your investment theses?

Ross: We are constantly engaged with all of our investees and prefer to get things done behind closed doors, but I'll give you two more public examples: one that has been a clear winner for our international and global accounts, and another that has been a domestic under-performer in the market to this point, but we feel it could be a winner in the years to come.

The international winner is adidas. We knew that it had a good deal

of latent brand and margin power when we invested in 2014. Nassef Sawiris is a great businessman, who we got to know when we first invested in Texas Industries which was a Small-Cap Fund investment years ago. Sawiris went on the board of adidas at our urging. By engaging with the board and management, we saw faster margin improvement. Management also bought back shares at discounted prices. They have been monetizing non-core assets and focusing on improving the U.S. business. The company also got a great new CEO, Kasper Rorsted, in place. That one was a very happy outcome.

CONSOL Energy is the other one I'd like to talk about. We thought it likely that this company was going to split its coal and gas businesses one way or another, but after a lack of speedy execution, we filed a 13D and worked with the company in a friendly manner to improve its board. A majority of the board has turned over since we invested, and we are especially grateful that Will Thorndike is on the case as chairman. The company has sped up its monetization efforts. Last year it sold some non-core mining assets for what we thought were good prices, and the stock was rewarded for that in 2016. We think there is even more to come, and the company will finally be able to split its coal and gas businesses this year.

Bob: I know that as a value manager you don't focus on the macro issues, but there are a couple of macro questions on which I want to get some input. One is how do you handicap the risk that the new administration might engage in policies that hinder world trade? What, if anything, are you doing to adjust your portfolios for such a risk?

Ross: You've probably heard the familiar refrain from us that we're

stock pickers and not macro experts, but that doesn't mean we want to keep our heads in the sand on the macro; it means that macro factors can result in different things to different companies that we invest in or are considering investing in. Some of our companies are exporters, like United Technologies, and could benefit. Some that might be more dependent on world trade, like FedEx, might not, but there are certainly parts of FedEx, such as their domestic ground business where world trade would probably be less of a factor. Our overall net exposure is not tilted dramatically one way or another when it comes to trade. It's just too soon to know exactly how the policies will work out.

We have a large position in cash, approximately 15% to 20% across our portfolios, and are ready to deploy it intelligently should we get some volatility with one side of this debate becoming more hated than the other.

Bob: Have any other aspects of the new administration, including what some consider to be a degree of unpredictability, caused you to rethink your investment strategy or your outlook for your funds?

Ross: If we looked back over Southeastern's 40-plus-year history, there have been a lot of unpredictable events. Bond rates in the high teens in the early 1980s; Black Monday, the Berlin wall coming down, Asian crises in the late 1990s; the tech bubble, 9-11 and the global financial crisis last decade; and the Eurozone crisis in the early part of this decade. Last year, we had Brexit and the election of President Trump.

Through all of that and going forward, we remain focused on Business, People, and Price for our existing investments and potential

new ones. Like I mentioned, we have more cash today than usual. That is somewhat of a contrarian view with bulls outnumbering bears at near an all-time high, based on data from some of the services we track. The volatility index is also at a pretty low level.

But our cash holding is not a top-

down macro call. It's driven by sales of some investments that have reached their appraisal. Continuing to have that cash position of strength will allow us to invest in great, new companies if global uncertainty gives us that opportunity.

On the subject of unpredictability, when you partner with great man-

agement teams that have the ability to go on offense, unpredictability is your friend. Times like that are when you can sow the seeds for long-term value growth.

We welcome unpredictability, and we are doing our best to be prepared.

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As of December 31, 2016, the holdings discussed represented the following % of the Lingleaf Partners Funds: Yum China – Global Fund 4.9%, International Fund 4.5%; Yum Brands – None; Ferrovial – Global Fund 3.1%, International Fund 3.1%; Alphabet – Partners Fund 6.4%, Global Fund 4.0%, Wynn Resorts – Partners Fund 5.9%, Small-Cap Fund 5.4%, Global Fund 5.8%; STADA – International Fund 2.5%; Vail Resorts – None; Aon – None; Adidas – None; CONSOL Energy – Partners Fund 6.1%, Small-Cap Fund 5.7%, Global Fund 2.4%; United Technologies – Partners Fund 4.8%, Global Fund 4.5%; FedEx – Partners Fund 9.5%, Global Fund 6.6%. Current and future holdings are subject to risk.

Brexit (“British exit”) refers to the June 23, 2016 referendum by British voters to leave the European Union.

“Margin of Safety” is a reference to the difference between a stock's market price and Southeastern's calculated appraisal value. It is not a guarantee of investment performance or returns.

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