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INTERVIEW

Enduring Values, Enduring Value

By Lawrence C. Strauss Updated Oct. 30, 2010 12:01 a.m. ET

MARTY WHITMAN has had a long and storied career as a value investor. The 86-year-old is the founder and chairman of Third Avenue Management, where he also serves as a portfolio manager. He has written several books on value investing and has taught for many years at Yale and Syracuse. The latter is his alma mater, and its business school is named after him. In his view, a company's balance sheet is as an invaluable analytical tool, and he and his staff at Third Avenue Management spend many hours poring over them. The firm's flagship mutual fund, Third Avenue Value (ticker: TAVFX), which Whitman co-manages with Ian Lapey, is 20 years old this week. Although it had a tough 2008, losing about 45% of its value, it has rebounded. What's more, its long-term record is very solid: Its 15-year annual return of 9.82% beats 89% of its Morningstar peers. Barron'sspoke with Whitman recently at his midtown New York office.

Barron's: *What investing lessons did you learn from the financial meltdown?*
Whitman: A couple of things. One is the great importance of the quality of the balance sheet and having a strong balance sheet, which gives you safety and it gives the company the ability to be opportunistic. The other lesson I learned is the importance of management. We try to avoid permanent impairments. The only permanent impairments we suffered was with the bond insurers, and that was basically my fault because I put more faith in the management at MBIA [ticker: MBI] than I should have. The toughest thing we do is the appraisal of management. But when I look back on the last couple of years, I'm surprised about what a good job we did. So many of the managements we invested in are terrific.

As I said, we mostly avoided permanent impairments. During that period, a lot of other value guys just looked and they thought cheap was a sufficient condition, whether it was Fannie Mae or Countrywide or Lehman or Bear Stearns. None of that happened to us.

The Third Avenue Value Fund has hit its 20th anniversary. What's the biggest change since you launched it?

Marty Whitman *BRAD TRENT FOR BARRON*

Twenty years ago, our investments were strictly in North America, and now we are over 60% in Asia. Our emphasis is on safety; we need and want full disclosure and tremendous regulatory protections. Considering what we do, I wouldn't have dreamed 20 years ago that the largest area where we would be invested is Hong Kong, not the United States and Canada. It's a big change.

Is it harder to find opportunities in the East than in North America?

No. In looking for full disclosure and well-regulated markets, there is not a lot of difference.

There have been a lot of investment ideas, such as modern portfolio theory, that started in the academic world. How important are they to what you do?

They may be of some use to day traders and high-frequency traders. But as far as value investing, control investing, distress investing and credit analysis is concerned, that stuff is absolute garbage.

What about the notion that a portfolio should have some diversification to provide downside protection?

Again, in terms of value investing, control investing – though we are not control investors; we are a mutual fund—distress investing, credit analysis, this stuff is worse than useless.

So what do you emphasize as a value investor?

You have to be *gestaltist*. Every accounting number is important, and is derived from other accounting numbers. So you have to understand the whole accounting cycle. If I want to estimate earnings, and I only have one tool, I would pick the current balance sheet. As a value investor, what you are interested in is whether the company is creating wealth. There are four ways to create wealth; it is not just cash flow.

They are, one, having cash flow from operations available to security holders. A company can use that cash to expand its asset base, reduce liabilities or distribute the money to shareholders, either by paying dividends or buying back stock. Two, and probably much more important, is having earnings, which we define as creating wealth while consuming cash. Remember, though, that earnings for most companies do not have a long-term value unless the company also has access to capital markets because if it doesn't, sooner or later, it will to run out of cash. The third—and very, very important—value-creation method is resource conversion.

Such as?

Mergers and acquisitions, changes in control, massive recapitalizations, spinoffs, etc. The fourth wealth-creation method, which I touched on previously, is having extremely attractive access to capital markets.

Why do you prefer to run funds that are concentrated, rather than diversified? And how do you protect against risk when you do this?

We get protection by being price-conscious and by being extremely knowledgeable about our holdings. And diversification is a surrogate—and a damn poor surrogate—for knowledge, elements of control [of a company] and price-consciousness. If you are really a value investor and do deep research, how many investments can you be involved in at the same time? If you are a high-frequency trader, you could trade 100 securities today. The real value investors are lucky if they can do 10 investments at a time.

You mentioned the importance of knowledge. As an investor, is it harder to get an edge today?

Oh, no. There are many bargains around, based on our criteria and what we look for.

What is the state of value investing today?

A lot of the value managers are very good and very skilled. The thing that troubles me, though, is that some of the best value investors are on the short side. In the history of man, the markets have never been better than they are now for shorts. But some of these fellows are out to destroy businesses, such as when a business needs continuous access to capital markets—whether it is Bear Stearns or Lehman or, believe it or not, Goldman Sachs [GS] in 2009, and General Electric [GE]. Shorts, with present methods of communication that include blogs and cable television, might be able to bring any of them down. Because some of these value people are so good and so powerful, we at Third Avenue don't invest in companies that need relatively continuous access to the capital markets.

What about the argument that short sellers make valuable contributions to price discovery and make markets more efficient?

They don't make markets more efficient. I think they could serve a real function. I am very concerned about their influence, particularly when they try to take a company down.

Turning to another subject, what are your thoughts on the mutual-fund industry and how it has evolved?

I've been in the business a long time. I'm an old man, and all the time I've been in business, individual investors were always getting ripped off, no matter what the market system—whether through the sale of phony tax shelters or growth theories or trading strategies. And then, finally, along came the mutual-fund industry, thanks to the Investment Company Act of 1940.

For the first time, the investor got a reasonably fair shake, a very fair shake. The investor loses money in mutual funds, of course; managements can be stupid. But the investor doesn't lose money because he was cheated or because the fund fails to diversify or because the fund doesn't pay dividends or because the expense ratio is off the charts. I think the industry has a lot to offer—and probably as much as it ever had to offer.

You've done a lot of investing in financial companies over the years. What is your view of the financials today?

We are looking to make capital infusions into regional and community banks trading at discounts to their book values, but we really haven't done so yet. A big change is taking place; there are an awful lot of American companies now whose common stocks are attractively priced and meet our criteria, very much like what Hong Kong was for us five years ago. Much of that has been transferred to the U.S., particularly in high-tech companies such as Applied Materials [AMAT], which we hold in the Third Avenue Value Fund, Microsoft [MSFT], AVX [AVX] and Intel [INTC].

We have a three-pronged approach to our investments in common stocks. One, we want the company to have a super strong financial position. Two, we buy at big discounts to readily ascertainable net asset value. And, three, we like to restrict investments to companies that we think, over the next three to seven years, will grow their net asset value at least 10%, compounded annually. An awful lot of American companies now meet that standard.

What do you find attractive about community and regional banks?

Let's say I can buy a well-capitalized regional or community bank at 80% of book, and it can earn, say, a 10%-15% ROE [return on equity] annually. If it's sold out to a major [financial institution] in five years at two times book, I've probably got a 30% IRR [internal rate of return]. This has worked in the past, and it would work pretty well in the future. And we can make the banks well-capitalized by making capital infusions into them, but we haven't done any deals yet, though a lot of other people have.

Moving on, U.S. real estate has been a disaster. What are the prospects for that sector?

Commercial real estate, particularly secondary commercial—a lot of shopping centers and hotels, for example—will have a lot of trouble for a long time to come. But on a long-term basis, real estate is inherently attractive, though we are not doing anything there now in the Third Avenue Value Fund.

Most times, the securities of real-estate operating companies are a heck of a lot cheaper than real estate is. Plus, you are talking about an industry that has tremendous tax shelter and tremendous access to attractive financing, through non-recourse, fixed-rate, long-term mortgages. So while we are not doing much now in the value fund, U.S. real estate has a basic long-term appeal. Our only material domestic real-estate investment in the fund is Forest City Enterprises (FCE/B), which is an operating company.

Your portfolio has a lot of exposure to Hong Kong. What do you like about that part of the world?

We bought in three to five years ago at huge discounts, and these companies absolutely meet our criteria. All of them have a huge presence in mainland China. Hong Kong itself has been very prosperous because of its huge ties to mainland China. And given our criteria, we want that double-digit growth in net asset value over the long term.

Three to five years ago, East Asia seemed much, much more promising than North America did. I like to say that if we are wrong about these investments, it is not going to be for economic reasons. It is going to be related to political stability, which I don't have a good handle on. But I'll bet you if we are wrong, that is where it is going to come from. I'm still holding all of these mainland Chinese investments because the economy is basically a command economy and doing great things.

Are you worried about recent reports that China's economic growth is slowing?

Our holdings there are terrific, and they are still selling at pretty good discounts to net asset value. Despite the recession conditions, the average growth rate in our Hong Kong holdings has been about 15% compounded, but I don't know if the next five years are going to be better.

Could you name a few of those holdings?

Cheung Kong Holdings (00001.Hong Kong), Henderson Land Development (00012.Hong Kong), Hang Lung Group (00010.Hong Kong), Wheelock (00020.Hong Kong) and Wharf Holdings (00004.Hong Kong). Hang Lung is the shopping center king of mainland China. All of the other companies we invest in have huge private equity interests. Cheung Kong controls Hutchison Whampoa (00013.Hong Kong), the world's largest ports operator. Henderson owns 40% of Hong Kong and China Gas, a leading gas distributor in China.

What concerns you about Asia?

Look at the great advantages the United States has for an investor. We're a continental economy, and we have the world's best distribution system. We have a great labor force, really, when our workers are employed. We have the world's best university system. We have a culture people like. So, I'm excited about our East Asia investments, but the drawback is that they are not in the United States or Canada.

For years, bankruptcies have been a fertile ground for you when it comes to finding undervalued assets. Is that still the case?

Yes, very much so. We bought out of bankruptcy a 50% stake in Fleetwood Homes, which makes manufactured housing, and we are certainly looking to expand in that sector. The near-term outlook for the sector is poor, but we feel that Fleetwood, which we bought at a big discount to its replacement value, has staying power.

You've been at this game for a long time. How long do you want to keep doing this?

As long as I'm *compos mentis*. I can't be a tennis pro.

Do you still play tennis?

Oh, sure. Once or twice a week.

How is your game?

Stinks. I'm not much of an athlete, but it is good aerobic exercise.

How involved are you in running the value fund?

Very. Ian Lapey and I co-manage it. One of the things about buy-and-hold value investing is that it is not labor-intensive. It is not stressful, unlike most things on Wall Street. Just look of the number of value guys who have survived to over 100. I give you Roy Neuberger and Irving Kahn. It is a nice business.

Thanks, Marty.

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