

## Tom Russo on the Evolution of Quality Investing

Tom Russo, managing member of Gardner Russo & Gardner, joined the MOI Global community at Latticework New York 2018, held at the Yale Club of New York City in September.

Tom discussed the evolution of quality investing. Robert Hagstrom, senior portfolio manager of the Global Leaders Portfolio, Equity Compass Strategies, moderated the conversation.

*The following transcript has been edited for space and clarity.*

**Robert Hagstrom:** When John sent me a note and asked if I would have a chat with Tom, I immediately said, “Yes, it would be an honor.” It is because Tom is one of the exceptional, great money managers in the country.

We are the same age, but Tom clearly hit the ground running much quicker than me and had covered many more miles when we first met. When my book *The Warren Buffett Way* was published in 1994, Tom was already in his second decade of managing money at Semper Vic, which was quite extraordinary. To give you an idea, we tell the story about Sequoia Fund having the first five years of underperformance when Warren turned over money to them and how Bill said that was just a tough time and things like that. Tom started his Semper Vic Partners and decided he would outperform the market for seven consecutive years. In the first 11 years, when Warren Buffett came out, the track record showed he had beaten the market 10 out of 11 years. If you want to start a firm and get off the ground running, do what Tom did.

One reason I think what Tom has done is so impressive is that around 1984, when he started Semper Vic, he was the very first, in my judgment, to take Warren’s teachings and apply them to the international market. That was not necessarily fashionable at the time; it wasn’t the go-to decision. He was buying international stocks before Warren bought Coca-Cola, which was probably the first global multinational Warren got his hands around. Tom was light years ahead of so many of us, including Warren, in this particular area. That’s why I say it is an honor for us to be here.

A lot of people know Tom’s performance and track record but probably don’t know the person behind them. Let’s start from the beginning and get up to date.

**Tom Russo:** It’s such a pleasure to be here, and an equal pleasure for me to be here with Robert Hagstrom as we met each other back in the early 1990s, if not the late 1980s. It turns out Robert’s second book played a big role in shaping and hardening my thoughts about investing.

I grew up in a town called Janesville, Wisconsin, which has probably had an important impact on my life. My mother, oddly enough, ordered newspapers from around the world when I was a child. Every week, we’d get our newspaper from some foreign land, mainly unintelligible, but it opened my eyes to global things. In Janesville at the time, there was a family-controlled company called the Parker Pen Company. It was a luxury thing; it gave people the ability to

badge who they are by what they had. It was a powerful brand. In the arc of my career, I ended up focusing on family-controlled companies with foreign exposure, and the Parker Pen Company stands as an example of a family-controlled company that went wrong. That's part of my background. Also, I grew up in a town with a General Motors plant. Paul Ryan and Russ Feingold were from Janesville and couldn't save this plant. It was a lesson in terms of what happens to a city that becomes overly dependent on that type of business. It's an interesting background.

I went to Dartmouth College and then Stanford business and law schools. It was at business school where I met Warren Buffett in 1982. He visited our class and left several impressions that were essential for me. The first was a simple one: the government only gave one break to investors, and that's the non-taxation of unrealized gains. You should take advantage of it and structure your investment approach around that phenomenon. Then, if you're going to make money off of holding something for a long time, you should find businesses capable of growing. The old model of value investing would have been to buy a \$0.50 dollar bill, with your compound depending on how quickly that discount closes. If it closes quickly, in a year, you make 100% on your money. If it takes 10 years, you'll make 7% on your money. That type of investment doesn't really require that the asset grows in value, only a quick closure of the discount.

The complete opposite was underway with Berkshire when I met him in 1982, and in some ways, it reflected the teachings of Charlie Munger about the virtue of corporate goodwill. In the prior world, the \$0.50 dollar bill, goodwill really didn't kick in at all. It was just net-net working capital, all balance sheet-driven, and you go on to find the next one. With See's Chocolate, which I gather Warren bought on the insistence of Charlie, they had this thing called the consumer goodwill. To show you how that's played out over time, Warren said in a recent annual report that little investment of \$30 million in the early 1970s has returned \$2 billion to Berkshire, plus its independent worth is probably close to \$1.5 billion.

Now that was a terrific investment. He hasn't had to pay a penny of tax on the appreciation of the business, so he fulfilled the lesson he shared with us at Stanford Business School - the number one goal is to invest in a way that you don't have to pay taxes. However, it requires a reinvestment, and that's where things get quite difficult. It requires that you grow the intrinsic value of the business you bought shares in, and to get that done, you typically have to rely on third parties. What Warren said to the class just after the tax statement was that you can't make a good deal with a bad person, and what he was referring to had to do with agency costs. As the owner of a business, you hire managers, and managers represent your reinvestment decisions. If you get the managements wrong, you will find they intend to make investments that favor them over the owner. That was the second point Warren gave to our group, and it really drives the need to find a way to ensure that our management, as a passive public investor, builds value to us.

In my own development over the years, I have found that the alignment of our clients' money alongside of family-controlled companies has given us the ability to reduce the risk of management running their own business at the expense of owners. Because the owners retain the vote and supervision of the company, you can find drastically dull family-controlled companies. In fact, Robert lives next to one that once existed, a Pennsylvania cable company. I own shares in a Pennsylvania cable company called Comcast. Down the road from where Robert lives, was this company called Adelphia. It was as crooked as could be, and Comcast is as saintly as could be. Each of them were family-controlled, but one of them has grown to be a behemoth, and the other one went bankrupt. They had the same starting point in the same industry and the same control structure, and you just have to get one right and

pay attention to some of the issues.

You've got to find a business that allows you to reinvest. That's not easy if you have a 20- to 30-year horizon. One way I found to extend the universe of those businesses is to focus on those parts of the world where 96% of the population lived and who were undergoing population growth and growth in consumers' disposable income. Thus, in the early 1980s, we started buying foreign stocks, which was really hard to do.

Probably the first one we bought a big position in is a British cereal company, where I ended up owning 20%. My wife grew up in England, where Weetabix is based. It makes a really bad-tasting cereal, but the British love it. They associate it with something that's going to sustain them through a really hard day, but consumption has leveled off. I meet people all over the United Kingdom and ask them, "Do you still eat Weetabix?" They say, "No, I eat snack bars. My life is on the run. I can't afford the time." Then they'll say, "But if I have a busy meeting in the day, I'll always have Weetabix beforehand." It always had a great allure.

This company was family-controlled. They didn't have the ability to reinvest and were smart enough to know it. They let the business grow over time. In 1989, it had £19 million of operating income and £70 million in cash on the balance sheet. It traded at 5x EV/EBITDA, and I felt that this brand, having conquered a nation's taste as badly as it tasted, probably wasn't going anywhere, so I was prepared to invest. Over the years, the operating income went up to £60 million. The family was smart enough not to make stupid acquisitions with all that cash because it was its money. We were a 20% shareholder in the company.

Over time, the market became quite disaffected with food companies. It was during the period of the internet bubble. Shares went down a lot, and towards the end, the manager who represented the family's interest partnered with a private equity firm, and they bought the business.

The capacity to suffer as an investor was quite acute. For the first dozen years, we went straight up. The business went substantially downwards during the period of the internet bubble. In the end, it caught up with the growth of intrinsic value, as it's supposed to, and it was a long and strong compounding investment.

If you're going to invest, you probably should try not to pay taxes. In order to do that, you have to reinvest. If you're going to have to reinvest, you better do so through somebody you can trust as your agent. For us, that's come through family control over those managers so they can watch the nest egg grow for the long term alongside with us. The management setting forth to make the investments needs to have something called the capacity to suffer because if you start down a path of trying to expand a business into adjacent markets or geographies, the upfront investment spending is going to overwhelm the existing operating cash flow. Unless you have owners protecting your position as a manager knee-deep into a big campaign designed to build value for the long term, someone will come knocking on your door and say, "Your operating income's gone down for the last five years. What's going on? You don't really know what you're doing." Any protest that says, "No, we're building a plan for the future," will be greeted with disgust, and you will lose your job as a public company manager.

In our case, to the extent that the families provide management with the license to make those big investments that pay out later, we've been blessed by the better results that have come from those investments.

**Hagstrom:** Professor Jack McDonald, along with Phil Fisher and Warren, may be one of the original concentrated buy-and-hold guys. It was in McDonald's class that Warren came to speak, so he must have had some admiration for the professor. In addition to Warren, Professor McDonald, and Phil Fisher, which other great investors influenced your thinking in the 1980s as you were motoring up the hill there?

**Russo:** I'd say Bill Ruane as I went to work for the Sequoia Fund after business and law school. Bill was a completely independent thinker. In the four years I worked there, we never had a single sell-side analyst come through. It was all homemade research, which is the best kind, and none of the distractions from Wall Street filtered through that process. He had a very high tolerance for concentrated portfolio holdings, and I've adopted a portion of that. Not nearly so concentrated as he would have been willing to go, but our top three holdings are 30% of funds under management, and our top 10 holdings are 70%, so it's pretty concentrated, but Bill's even more concentrated. He had an enormous sense of humor and an enormously generous spirit and ingratiated himself well with the companies he visited and the people he associated with.

I always remember going into a meeting with him once. He knew the person in charge of a business he was considering investing in. The stocks may have been \$60 at the time, \$5 of earnings. Most analysts spend all their day visiting with management, trying to know whether it's going to be \$5, \$4.95, or \$5.05. That's usually where the rubber doesn't meet the road. But Bill said, "I'm starting to worry. What are the chances you'll lose money next year?" Of course, the CEO looks back and says, "Are you crazy? We're expecting five bucks." "No, I know that, but what are the chances you'll lose money next year?" They went on back and forth, then, exasperated, the CEO finally looked up and said, "Well, for that to happen, one of three things would have to take place." Now, those are the only three things you want to know about. Everything else that leads you to either \$5, or \$4.95, or \$5.05 is in the stock, and you don't learn anything about it. But to lead someone to say, "Well, for that to happen, these following three things would have to happen," is an extraordinary gift for getting such disclosure. That's part of the investment search, but most people cluster and he didn't.

He also had the gift of driving anything down to unit price. I remember we were looking at Duracell, and he figured out the price per battery based on the ingredients and then grossed it up by volume and all the rest. He was the complete guy.

**Hagstrom:** The folklore was that when you guys were at Sequoia, you knew the price of the paper that rolled around the cigarette. You had it down to that.

**Russo:** We owned a company called Ecusta, which was part of P.H. Glatfelter. Anyway, this concept of capacity to reinvest, capacity to suffer, shows up in so many of our holdings. Heineken may be among the most interesting ones because it shows that the capacity to suffer arises in one of two ways. It could either be that Wall Street wants you, the management, to do one thing, and you say no, or it could be Wall Street says no, and you say yes. In each case, as management of the public company, you'll be equally scorned by Wall Street because it tends to want to have a certain thing happen in its own way.

Because of Freddy Heineken's control stake, Heineken has had the courage to reach over the years. In one case, it was implored by Wall Street to acquire Brazil's second largest brewer because its main global competitor, AB InBev, gets most of its strength from Brazil. There was a belief that if Heineken grew strong there, it would have the ability to press on when other parts of the world become lit up competitively. Heineken was implored by Wall Street to make this early move and get competitive in Brazil, but Heineken said no. The price didn't

make sense, and it wasn't ready.

The business went to Kirin for \$5 billion, giving it 12% of the Brazilian beer market. Fast forward four years, and Kirin's made a mess of it. It ruined the business, made enormous losses, and came back to the market to sell it. Then the market said to Heineken, "Don't even think of touching it." Heineken looked at it and said, "That's not such a bad deal at \$590 million." The business it had the capacity to avoid (because management was protected by the family) would have cost it \$5 billion had it followed Wall Street. It ignored Wall Street when it had the chance to buy it for \$590 million. It seems to make a mockery of Wall Street. I overly generalize here, but the real issue wasn't the \$590 million. The real issue was that the business it bought was going to cost it a lot of money to get property integrated with the business Heineken already had. Those investments would be the ones that really disturb the financial markets because they're unpredictable and would burden operating income heavily.

Heineken has said that its business going forward would be burdened in a way that the investment spending that goes through the income statement as it spends another \$1 billion merging it all together would depress earnings and keep the operating margin from growing at 15 basis points a year to 10 or something. With that news in hand, the stock market took Heineken's shares down from €89 to €81. It would have kept going had this not been a family-controlled company. In the midst of all this, another competitor came along and bid for Heineken's shares because at the moment of the great collapse in the price, they tried to be opportunistic. The family said, "Go away. We control 50.1% of the shares, and there's no interest." That's the kind of protection you can get if you have a like-minded, long-term-oriented family and a business managed by people who are long-term minded.

**Hagstrom:** Will Thorndike said he wasn't going to write a second book, but he might expand it to include international managers. I told him, "You got to talk to Tom. He knows everybody." The thing is, though, that qualifying for inclusion in the book requires running allocated capital for 20 years. Everybody in *The Outsiders* ran that business for 20 years before they got the thumbs up from Will. There are not that many people out there who have a 20-year record of allocating capital. Tom said, "There is one. There are several, but one that I think does it extremely well is Heineken."

Hearing you talk about Bill Ruane, the way he can so masterfully talk with management and get to the nuts and bolts without embarrassing them, reminds me of when you took me under your wing, and we went to see Dow Jones. This must have been 1995-1996. Peter Kann, who was a Pulitzer Prize journalist and started the Asia edition of the *Wall Street Journal*, was brought in to be CEO. We entered his office, and there was an annual report laid out. Tom walked over and opened it up. It was one of those annual reports that showed you at the back 10 years trailing of earnings. Tom took his finger down to the capex line and slowly went left to right of all the money Dow Jones had spent in 10 years. Then, just as politely as anything, he said, "Peter, can you tell me how this money was put to work, what happened, and how you did it?" It was the most beautiful way of saying, "You screwed up this company with all this capital expenditure," but they went through a great dialogue. You might tell a bit of that story. I thought it was great.

**Russo:** It is the fact that it just kept consuming capital with no return. At the time, it was because Dow Jones had a series of news wires it was using to compete against Quotron and Telerate. Then Bloomberg came along with its superior product, and it was just an endless stream of expenditures that ultimately led to nothing but losses. Lest that story make me seem like I'm too clever with annual reports, this past week I met with the management of Brown-Forman. I opened up the annual report to the last page, and there are charts, Brown-

Forman's share price, the S&P, and the spirits industry in general. I commended them on that but told them the story of when I was in Greece years ago, and I had gone there with Guinness, the former Diageo.

The Greeks love Johnny Walker Black Label. There's a specific format where it was consumed in absolute barrels, and it was called the bouzoukia. The bouzoukia is an outdoor entertainment area where men and women gather at the feet of a singer in an open stage. We visited the country to see how the business was going. Just as an aside, one of the best businesses I have ever looked at was the business inside that bouzoukia. The owner had a platform there, and men would come in with their dates, peel out \$1,000, \$2,000, or \$3,000 and buy this platter of gardenias and throw them at the feet of the singer, who'd show absolute disrespect for the whole thing, but he then croons to the woman for a while to show some sort of love. In the meantime, you see this broom sweeping up the gardenias. They put them back on the plate and sell them again and again throughout the evening. The men's stature to the women who they were with for the expenditure of their money worked perfectly fine, and it was just one of those great businesses.

The next morning, I met with one of the Unilever subsidiaries in Greece, and they had in the back of the annual report a chart. Through an interpreter (because the report was in Greek), I said to the man how proud he must be, and he asked me why. I told him, "There's your chart. Here's your share price. Here's the industry's, and here's the S&P, right?" And he said, "No, no. This is labor cost. This is ingredient cost. And here's our revenue increase." This is to show you see all sorts of strange things going around the world looking for cheap stock.

**Hagstrom:** The thing is identifying compounders in the global economy. You've got two companies, well-intentioned and with good management. They're saying, "I have the capacity to suffer. I'm going to take my earnings and plow them back into the company." What metrics can you think about, discuss with management, and observe while they're going through this capacity to suffer period in their evolution to see that one is heading in the right direction and the other off the cliff? It's sometimes hard when you don't have something down there to prove whether things are going right or wrong.

**Russo:** That's a great question. I could think of a couple of examples, but it's certain that you're going to burden your income, and then it's just a question of how much they can disclose. There's a certain element of competitiveness.

Take Mastercard. The question there is whether it's technology-dependent in a way that would make it vulnerable to others coming into the market. It's very much an investment story since it's not a family-controlled company, but Ajay Banga, who runs it and treats it as if it were his child, wants this child to graduate school some day, and he's spending every penny he possibly can. The real story about Mastercard was the fact that 85% of its market exposure is in developing and emerging markets where cash is almost 100% the form of currency. He's investing enormous amounts of money with governments in mind because he has to get adopted to serve in those markets. He has to come up with ways where social benefits or aid to mothers with dependent children are disseminated directly into the payment device they have, which they can then use to buy goods for the family's needs as opposed to the world they've confronted historically, where the government will send out a check that arrives in your mailbox. The mother would have to take a day off work, go into the city to cash the check, lose a third of the money to the cashier, use another third on the father of her kids, and then get home with very little to show for the benefit. He's been all over Africa, India, and other parts of the world, trying to come up with those types of systems.

The quick and dirty way to understand the magnitude of Mastercard's spending is to see how flat its operating income has been despite the huge absorption of fixed costs due to the growth in gross dollar volumes each year for five years. The margin sticks around 55% to 60%. It could be 10 points higher if the company wasn't plying all the money back into the business.

A good contrast would be the late 1990s. E. W. Scripps and The Washington Post were companies whose shares we owned at the time. Scripps had an executive who ran several divisions. He was then out of work within the company and proposed to the family trust (which had voting control) his interest in creating a new network to wed the interest of home and garden. He created the Home and Garden TV network, which had never been done before – it was a white space, untouched. The family had television assets they could use to launch the cable operation without having to sell a share to John Malone. They had advertising skills and video production skills for the TV stations they owned. They had everything necessary in-house and just needed the approval. The trust told Ken Lowe, who created the business, he had exactly 150 million bucks to spend, at the end of which they had no more money to support the program.

The first year, he hired two people, and they may have lost a million bucks, but by the fourth year, they were burning enough money to come up with a fully programmed line-up with no revenue, so they were hemorrhaging losses on a business that may have started with \$350 million of operating income. As they entered the later years, the actual operating income was sharply weighed downward by the spending. The family trust controlled the company, so there was absolutely no distraction on the part of management. They built it well. In the end, the TV stations, the newspapers and everything else they were pledging to underwrite the cost of this thing shriveled up and went away, but this network grew in valuation to something like \$12 billion when it was bought by Discovery. It was a perfect story of burdening the income statement, secure in the notion that the family trust would not let a takeover dislodge Ken Lowe simply because the operating income failed to go up over the years when it was burdened by that specific spending.

We had the same story with The Washington Post. Don Graham went to his family and his board and secured approval to spend up to \$150 million to consolidate the for-profit education business under the umbrella of Stanley Caplan. For the same four years, he spent exactly \$150 million. At the end, he had a big donut, because it's also a question of vision, and I think Ken's vision of the broadly available market was deeper than what Don harnessed.

**Hagstrom:** Switching gears, one of the hot topics is the accounting change whereby companies that own marketable securities, Berkshire being the prime example, now are required to calculate the change in market value, and that change goes through the income statement. I know you feel strongly about this issue. Do you want to share with us?

**Russo:** It was interesting to see Warren take such a public stand on the subject because the whole point of accounting is that it's supposed to move towards a situation which conveys to you what really matters. To think that the recently engaged accounting standards force income, both the operating income from the businesses that Warren controls 100% of, and the change in share price of the portfolio holdings — they have absolutely nothing to do with anything. It's inappropriate to think this is somehow gaining more clarity in terms of what the business is delivering to you as a result of hard work and good thought. I thought he spoke well about it though.

**Hagstrom:** I know how keenly you look at executive compensation and how executives are paid over time to create shareholder value. You've said that several companies have incentive compensations for their CEOs tied to revenue growth, and it brought to your attention Conagra, Pinnacle Foods, General Mills with Blue Buffalo, Nestle (which you own), and Starbucks. Through acquisitions, there was a lot of revenue topline growth, and the CEO benefits. To what degree is that proper, and to what degree is it self-dealing for the CEO?

**Russo:** I raised the point because of the situation with Blue Buffalo, where General Mills invested \$8 billion to buy it. When you buy a business with sharply growing revenues, maybe 30% per annum at the rate Blue Buffalo was growing pre-transaction, if you cycle one year of that and then start comparing going forward the performance on which your incentive compensation will derive based on just revenue growth, you've accelerated that growth but put out \$8 billion to do it. Wise investors would suggest that \$8 billion deserves a return before your incenting just for revenue growth without a charge for capital. That was our point. Hopefully, with the portfolio companies we have, we're less exposed to that. One of the reasons I migrated to international companies over the years (70% of our holdings are non-US companies) is because their compensation system seems much more reasonable than what exists in the US, unhinged with things like capital charges.

**Hagstrom:** You said, "Today, we need to celebrate failing fast," that the notion of risk capital and how companies use capital needs to change, which requires our culture to change when it comes to taking risk. Expand on that, would you?

**Russo:** The question here is what happens to consumer goods companies that have enjoyed low volatility and strong growth over a long period of time when the digital disruptors come in. Somebody referred to Dollar Shave Club, and I don't think Gillette was even aware of it until the game was over. If you think about the prior decade, Gillette had had four assaults against its franchise - by Unilever, Target, Wilkinson/Schick, and BIC. They all went straight to the front door of castle Gillette, knocked and said, "Can we have a fight with you for market share?" It was as public as that. Of course, Gillette crushed them.

Dollar Shave Club, off in the wilderness, never had the decency to come by and say, "Let's have a fight." It had the product itself but also something that came along with it, in this case, the cool factor of getting a box every week from someone who cares enough about you to send you fresh blades. They're cheap, but it's also the notion that it's a technological platform different from what the old folks use, so there's an excitement about it. It went rampant on social networks, and at that moment, Gillette's game was over. It had kept its blades behind locked counters, behind locked screens at grocery stores and drug stores, and here's this delivery. This is something it should never have let happen. It needed to scour the social landscape with alerts that would inform it sooner. All of the businesses we owned - whether it's Unilever, Nestle, Heineken with the spirits and beer and craft brewers - need to have the capacity, the moment they see something come at them, to go into the market as soon as possible with a tactical response they can use to dislodge the early success required for the businesses that compete against them to get venture funding and then roll out the product dramatically.

We have examples in Nestlé's case. It owns Gerber, which is the dominant infant food company in the world. It uses glass bottles, and when the pouch system came along, we asked management, "What do you think?" They said, "Women like glass bottles." That was a dangerous response. It needs to have the ability to put a lookalike in the marketplace the moment it hears about something like this. It's a tactical move. To protect its main business, it needs to be tactical as well as strategic.

In general, the major food and consumer goods companies have had the luxury of strategy over tactics. That is something they'll have to change because the ability to become someone's favorite inside the social network has proved to be highly effective. At the moment, we have investigations about the limits of Facebook and what it's allowed to share and all the rest, which may provide a bit of comfort, but it's still required of the management that they become much more prepared to fail. When I met with Unilever the other day, it said it had launched 22 new personal care products in the last 12 months compared to three a year over the previous decade, and the pace of innovation had quickened.

*The following are excerpts of the Q&A session with Tom Russo:*

**Latticework Participant (Dan Roller, Maran Capital):** Your conversation touched on family-controlled businesses, patience, time horizon, and executive compensation. I'd be curious to get your take on the world of activism over the last decade or so – generally positive or negative, probably some pros and cons.

**Russo:** In its best moment, it's a question of timing and time horizon if you think about how few activists end up holding shares in the companies they've worked with 30 years later. I bought Heineken and Nestle in 1986. We have probably held the top 10 holdings for 25 years on average. I can go on at length about places where Nestle let its guard down by not responding fast. In this case, Third Point arrived with a list of thoughts and requests, and it's been a fabulous ally to the new CEO, who came in from outside the culture. We have to make these steps, partly because it's the right thing to do and also because we don't have much choice since there's someone breathing down our neck. That's been a terrific catalyst for change. Nelson Peltz was a catalyst for change when he went on the board of Heinz.

Then there's a question of duration, of how long you're going to stay. In the Nestle case, there's a huge dispute over what to do with the \$25 billion holding in L'Oréal. In theory, Nestle should get rid of it, but in practice, it's made \$27 billion, and the company is comfortable with holding it. I personally feel perfectly comfortable holding that position within the company even though the activists in this case would love to extract it, at which point they'll most likely move on. They've been an enormous factor of change, which I applaud them for.

**Latticework Participant (Dan Geary, Samson Investment Partners):** On the topic of disruption, what do you think about the competitive threat from JUUL to the core business of Philip Morris and British American Tobacco versus the opportunity JUUL has created for them by essentially validating an entirely new nicotine delivery industry?

**Russo:** It's really a provoking moment because Philip Morris, whose shares I've held for quite a long time, with a major nod to capacity to suffer, has spent the last five years developing a product heating but not burning tobacco, which would allow adult smokers to quit smoking. More than half of adult smokers in the world want to quit, and this is the product lined up. It launched in Japan. Seven million people around the world now use the IQOS product Philip Morris invented. It cost \$2.5 billion over five years to develop. The next big step is the US, and the FDA has stonewalled it. This has the potential for being extremely disruptive over time for Philip Morris because today, JUUL has in the marketplace a product that can help adult smokers quit. It doesn't have any reference to tobacco whatsoever, and it has the advantage of having become rather cool and sexy, which is a real problem.

Someone thoughtfully talked about positional goods, which are the things you use to tell people who you are by what you have. Marlboro was a 42% share cigarette for 30 years

because it said everything you wanted to hear around the world. It was called American freedom and set the world on fire.

In the US today, there's a bulk of business being done traditionally, and there's this outlier called JUUL, which has enough nicotine impact to help adult smokers quit. If it stays unchallenged as the only product in the market long enough, Philip Morris's product, which would have been perfectly suited for that market, will have tougher sledding. It's completely unknowable when the FDA will act. There seem to be no statutory requirements for it to act in any kind of haste whatsoever. Management from Altria suggested there was a chance the FDA may act on allowing the product into the market by year-end. If it did, it may come as a result of JUUL's own difficulties. If you have kids in New York City private schools, you'll know that the headmasters are absolutely paranoid about JUUL sweeping through their schools. They have a point - it's been adopted by kids today as maybe rebellion or something. But the fact is it's currently the only product addressing smoking cessation that works, and I think the FDA may think it makes sense to come in and license another one. We'll see. It's been very disruptive on the tradition of the stable tobacco market.

**Latticework Participant:** I'm curious about your thoughts on the asset management industry and whether you've ever found it interesting in any way. I don't think it's in your portfolio, so why not?

**Hagstrom:** Good question. There have been great companies and great stocks, and I've missed out on those. No particular reason. I guess I haven't spent the time thinking more deeply, simply admiring from a distance. Moving forward, you'd say, "Gosh, the fee compression looks like it's going to be inexorable and accelerating." Indexation is not only sold effectively based on low fees, but it is becoming inevitably the sponsored solution in light of regulatory change. Just think about what the Department of Labor proposes with its fiduciary role. It was an absolute one-way stop to indexation given the burden that it put on fiduciary.

I probably missed a great period of investment success. Ironically, when I was at Stanford Business School, we had to write up a company, and I looked at two. I wrote up one that's very forgettable, some business that went away, and the other one I looked at was Franklin Resources. If I had written up the second up and bought \$10,000 worth of its shares in 1982, it would have been extraordinary. That has been one of the most productive investments you could have found in the money management business.

**Latticework Participant:** Your portfolio doesn't change a lot. How hard is it for a company to make it into the Tom Russo portfolio? How frequently does it happen, and what does it take?

**Russo:** This reminds me of the conversations I had with a friend in Boston after the Red Sox won the World Series. Some months later, I asked him what was going on, and he said, "It's been terrific. I just got into the country club. I've been on the waiting list for 12 years, but there were no spots. Now that the Red Sox won, a whole bunch of people died because they had been holding out until they had the chance to see a winning team." The whole bench cleared out and in they came.

We had the death of one holding, British American Tobacco (BAT), which was part of our exposure to the tobacco industry. In light of the uncertainty in the tobacco world, we reduced that position effectively to zero. It gave us some funds, a small part of which went into Google. That would be the first new position since 2010. I think. We're getting to know that

business better. It's been a longstanding interest, but it's a small starter position.

**Hagstrom:** Tonight is the deadline for comments on the tariffs that probably would be announced tomorrow. Starting with Argentina, we've had an explosion in the currency market, and that morphed to Turkey, now to South Africa and India. What changes in your life tomorrow if they announce \$160 billion worth of tariffs on China? What changes tomorrow for Semper Vic if we had more contagion type episodes in emerging market currencies?

**Russo:** These are all major headwinds. We are going to import a lot of inflation into the US if the price adjustments required are met without a reduction in demand. Our businesses are designed to cope well with inflation. They have price-inelastic demand because their products so often help people identify who they are by what they have, and there are long-standing loyalties.

Inflation's a risk, but I think we're well-protected against that. We sell an awful lot of consumer products to Brazil, for example. It has an election coming up. The currency has been soft, and business in Brazil has been relatively soft for most of our companies. In general, the emerging markets over the past three or four years have suffered from the contagion brought about by China shrinking back and looking inwards. Now China has come back, and the emerging markets have improved a bit, but all of these headwinds will weigh upon our portfolio companies.

With regard to tariffs, we have businesses before the Chinese government that just can't get past square one. The allure of China is that if the government supports you, you can go extraordinarily far and fast, which is the story of Tencent and Alibaba. They've had such illustrious development, but recently, you see with Tencent the government's reproach on gaming and the addiction to it. Suddenly, Tencent has a problem on its hands because it was built by the government, and now it's being reined back by that same government. China's a mystery. I have no idea where we'll end up.

**Latticework Participant:** Robert, I love your book, *Investing: The Last Liberal Art*. Tom, you mentioned that something from one of his books influenced you, so I'd love for you to expand on that. Also, what meta skills make you a better investor, in your view? What things have you tried to read about and learn that you apply for investing? That's a question for both of you.

**Russo:** The first point was in Robert's second book, where he revisited the super investors of Graham and Doddsville in a most clever way – the book says that within this universe, Bill Ruane and a dozen other investors, all approach investing in a slightly different way, but they all share the value orientation and they all outperform over time. What Robert examined was extraordinary: all those who outperformed over time underperformed the S&P half the time. The conclusion is that in order to have the capacity to outperform, you must have the capacity to suffer through periods of time where you're out of sync. If you try to prevail all the time, you will clearly trade your way out of returns, and I thought that was truly profound.

**Hagstrom:** When I worked with Bill Miller, he was always big on frequency versus magnitude. In our business as asset managers, our customers want frequency of outperformance, but that leads to suboptimal returns. Bill says it's not how many times you're right but how many times you're wrong and how much money you make when you're right. That's how much money you get back when you're wrong. When the super investors of Buffettville (as I called it in the book) made money, they made a hell of a lot of money. When they underperformed, they underperformed a little, not a lot, so it wasn't a frequency

argument but a magnitude argument.

**Russo:** I've been truly fortunate to have worked with people with interesting insights, the right orientation of concentrated investments, very low turnover, and tax sensitivity. Also, the early advice by Professor McDonald was not to be provincial but to start looking internationally. Back in 1982, it was hard to do, so few were and made it very rich pickings.

**Hagstrom:** There are a lot of young people here who would like to start a successful investment career and prosper, as you have with your clients. What advice do you have for a young person today to get started, get moving, and build a successful firm, as you have?

**Russo:** Make sure you don't overpromise at the start or at any point in time. Also, be fair on fees. I invest as a 1% per year business. I think the structures that are very flattering and familiar and useful work against raising money and also keeping money if the fees are substantially higher. You have to make your own decision about that. You can do extremely well with a participating capital allocation fee structure with a relatively small amount of money because of the way the math works, and that's a perfectly reasonable way to go. In addition to expectations and fee structure, I'd say manage a portion of the funds of the families you work for because you will find that the emotions of having all of a client's money are extraordinarily hard to manage. You'll spend all your time trying to explain why you don't own something that's running along. If you have all of a person's funds, they just can't overcome the cocktail party conversation. Those would be three things: manage a portion, modest fees, and modest expectations.

**Hagstrom:** Thanks to John, all of his team, and MOI for this, and thank you for your time, Tom.