

Don Yacktman Articulates Value Investment Philosophy

We had the pleasure of sitting down with famed fund manager Don Yacktman in 2013 for a wide-ranging conversation on his investment philosophy. The conversation is packed with wisdom and insights into value investing.

Don Yacktman is a legend in the investment business. Prior to founding Yacktman Asset Management in 1992, Don served as portfolio manager of Selected Financial Services and Stein Roe & Farnham. He holds a BS *magna cum laude* in economics from The University of Utah and an MBA with distinction from Harvard University.

(The following transcript has been edited for space and clarity.)

MOI Gopal: You've spoken a lot about looking at everything as though it were a bond. Could you explain how that affects your thinking about riskier assets, about equities?

Don Yacktman: In any investment, you lay out the money today, and you have future cash flows coming in from that investment. Typically in a public company, one of those is through a dividend. When you buy the stock you know what the dividend is and, based on your historical experience, should have a reasonably accurate assessment of the reinvestment rate on that dividend.

The wildcard in investing is the money that's retained at the corporate level and reinvested for the investor by the management of the company. That usually is still the bulk of the cash flow. So to some degree, in effect you're franchising, you're entrusting that money to the management to do a decent job on the reinvestment rate.

Any time you're projecting out into the future, there's going to be a range of outcomes, because nobody can predict it with absolute certainty. The more predictable the outcomes, the higher-quality becomes your valuation process. And the lower the quality, the more risk there is, either financial risk or economic risk. The range of outcomes will become wider and wider. One has to take that into account in trying to assess the rate of return hurdle that you feel is adequate to justify an investment.

The business model is also important because a business ultimately boils down to what you buy and pay for. On the business model side – if you were to draw a grid and have one axis be fixed assets – the other be economic sensitivity, you could plot any company. The reason we look at it that way is because we're really looking for businesses that earn high returns on tangible assets.

The central tendency is for those kinds of businesses to be businesses that have low fixed-asset components and low cyclicity. Three of our top four holdings happen to be Pepsi, Procter & Gamble and Coca-Cola, all of which fit that profile — they're in effect like our AAA bonds. As long as you can buy them with an adequate rate of return, those become excellent investments. Then you start to look at lower-quality things based on the predictability of the cash flows.

MOI: When we think about it that way, where it starts with let's say the thirty-year U.S. treasury bond rate, and then all the other available assets get priced off that, could you talk

to the challenges for an investor when that benchmark is perhaps manipulated or artificial, as some have suggested?

Yacktman: That's a good question. If you look historically, we're hitting the hundred-year anniversary of the Federal Reserve System. Over the last hundred years we have averaged 3% inflation, so a dollar's gone to roughly a nickel. And over the last fifty years, it's been 4% so it's accelerated slightly. At the current time, we're below trend line — or you could maybe say that we're driving the trend line slightly lower by coming back closer to 3%.

Whichever number you use, it's dangerous to project out inflation rates that are substantially below those kinds of very long-term numbers. If you take that and look at it, long-term bonds have had a central tendency to sell at about a 3% premium to inflation. That puts you at the 6-7% level. In equities, add another 3% over that, so you're up at the 10% level. If you look at the fifty-year numbers, you'll see that with inflation at 4%, equities have been a little over 10%, so those numbers hold pretty close. The problem is, those are fifty-year numbers. One-year numbers are going to vary dramatically.

The bottom line is that it's dangerous to have a hurdle rate based on treasury bonds that are 3% or 3.6%. In the last fifteen, sixteen, or eighteen months, they've gone from 2.5% to 3.6%. Those are well below historical numbers, and that's one of the dangerous problems today, because you're looking at numbers that are way below historical numbers. It's driving equity values to much higher levels because people are basing it off current rates of long-term treasuries rather than the trend line or reasonable rates.

MOI: You've talked about looking for “escalators” as an investor. Do you feel that approach — looking for great businesses that create value over time — suits you even better in the current environment of such low interest rates? Does it help protect you against inflation in better ways than some other investments?

Yacktman: Yes. There are two elements that strike me with that question. One is that, yes, I'm a conceptual thinker, so we think of them as “beach balls” being pushed underwater, with the water level rising. We'd rather own the escalators than the moving sidewalks, in other words, businesses that are building underneath, building value at a more rapid rate.

It all starts with price. Price is the key determinant of any of these. But the more you can buy better businesses at a good price, the better off you are than buying poor businesses.

Today, because we've had a cyclical upturn in the economy and profit margins have increased for the more cyclical side of the economy, what's happened is that the spread between the really high-quality businesses and the lesser-quality businesses has narrowed — just like the premium for a lower-quality bond is too close to where it is for a high-quality bond.

Today, as we look at the market, the best values are in the very high-quality market area. You're really not being compensated adequately to take on a lot of additional risk.

MOI: It seems ironic that these types of investments — the great businesses that have great reinvestment opportunities — are available at attractive prices given that interest rates are so low and there is potential for inflation down the road. Do you agree with that, and why do you think that's the case?

Yacktman: Another thing has been that in an environment of a weak economy, these companies have tended not to increase their prices as much, because they want to maintain

market share. They've had a little bit of pressure on the cost side, so their profit margins have been squeezed a little. They've looked a duller from a rated growth standpoint and people are not excited about them. They're not high unit growth businesses. They just have enormous market shares.

They become a little dull (as dishwasher), and they have lagged the S&P on top of that for the last three years. When you have a situation like that, people tend to move away from it because they're rearview mirror investors, although driving a car and looking in the rearview mirror doesn't usually work very well. But they aren't as excited, and so they're moving away from them in a lot of cases.

MOI: Am I correctly reading into this some latent pricing power that's available with those businesses, that perhaps the managements are not looking to exploit in the near term, but you have confidence that they do have the pricing power to not only keep up with inflation but even more so down the road?

Yacktman: Yes, that's well said. At some point, things tend to come more into a normal pattern. And yes, the pricing power is there and will come back as the economy comes back.

MOI: You have stated that your investment goals are first to protect the client's money and second to grow the money. What are the key investment considerations when it comes to protecting money?

Yacktman: Protecting money in our view means avoiding dumb decisions, permanently losing the capital that you have. At the same time, we also feel somebody needs to be proactive. Because of that historical inflation rate, you get eaten alive if the money is just put under a mattress. It requires being proactive and investing to the degree that you can find opportunities that exceed your cost of capital — so that's how to protect.

On the growth side, we want to have the best risk-adjusted forward returns we can with a goal of beating the S&P from one market peak to the next peak.

MOI: Could you speak a bit about the role of portfolio management when it comes to these goals and considerations?

Yacktman: In our view, it leads to a pretty concentrated portfolio, because we're looking for the outliers, the ones that are in the tail of the so-called bell curve, although I'm not sure it's always a bell curve — the ones that stand out.

The more money one can pack into the top ten or fifteen ideas, the better off we feel you are — and ironically taking less risk as a result. Although most people see that as a risky approach, we see this as a less risky approach.

It's clear that one needs to understand the concepts of risk-adjusted forward returns and the business model and the price — because it's what you buy and what you pay. That's what the business boils down to.

MOI: Are these considerations different when one thinks about the short term versus the long term? Is there anything an investor needs to think about differently, let's say over the next couple of years versus the next twenty years?

Yacktman: The time horizon needs to be very long to use the approach we do. The one thing that comes with that is a requirement for patience. Because of our goals and our process, we will not beat the market every quarter; we will not beat the market every year.

We're looking at a peak-to-peak cycle and trying to both protect and grow the clients' money through that whole cycle. The long term is very important.

The danger is that investors can end up churning their wheels if they start to look at short-term phenomena. Unfortunately, most people can't look beyond a one-year, two-year, or maybe a three-year time frame. It's very difficult for investors to have that kind of patience, and particularly because most investors are not as sophisticated — they don't understand the process.

They look at the world and get bombarded by the news media about the danger of this or the danger of that — as opposed to taking into account the whole allocation process and what it's all about.

MOI: I want to go back to the bell curve you mentioned. You stated that in very disruptive periods, typically the tail of that bell curve gets elongated, and there are more opportunities. Am I right in concluding that when the times are not particularly disruptive, you are better off with the high-quality businesses? When there is a disruptive period, you may be rewarded by looking elsewhere?

Yacktman: There is a tendency for the more defensive things to look better in the later stages of a cycle, because they're lagging and people are getting more excited about things that are more dynamic. The key is to be totally objective.

There are three different times when opportunities tend to present themselves. Just like the yields go up on bonds when the price comes down, we see the same effect happening in stocks. It's just that stocks sometimes come down for the right reasons, too.

The disruptive periods are — the massive one where you have a market decline like in the 2008-2009 period — that creates enormous amounts of opportunity.

Then you have a situation where something hits an industry, like a dramatic change in healthcare. You'll see many more opportunities in a period of disruption because of an industry situation than a unique disruption because of some event that has occurred at a company and it's singular to that company. In each case, it's a matter of objectively looking at the headline of disappointment and saying, at what price are we willing to own this business — and trying to be objective about it while looking at the forward returns.

MOI: It really does go against this common notion that people throw around, that term of safety and they want to look for safe investments. What you've just described is really when it comes to idea generation, going to where the trouble is where the uncertainty is high as a source of opportunity, where others really try to avoid the uncertainty as investors.

Yacktman: Again, it's a time horizon issue. What people view as uncertainty may be an uncertainty in the short term but may not be as uncertain in the long term. But yes, people get scared because of short-term events and the market tends to be this manic depressant. It tends to be disruptive.

An average stock fluctuates about 50% from low to high in a twelve-month period. But occasionally, you get these outlier situations whether again for the company, an industry or the market as a whole.

MOI: Now, with the approach that you've employed so successfully over the years, what would you say is the most difficult aspect of it?

Yacktman: The most difficult aspect is to totally understand decision-making by managements. What we have found is that you like to look at their history and what decision-making process they go through. They really have about five options – to put the money back in the business, R&D, marketing, cost reduction, distribution. And if you have a big market share, marginal unit growth can provide enormous rates of return on incremental unit growth, so that's very important.

But the companies, after their infancy, start to generate excess cash and so they have to examine four other options.

One option is a dangerous one, which is acquisitions, because too often the ego overrides the economics, and this is where it gets scary. The second one is share repurchase – at least you know what you're buying. But again in both cases it's do they have discipline in price? Next one is letting the shareholders have it back through a dividend. And the last one is just sitting on it.

And how they behave, we have found, is much more important to know than what they say they're going to do because sometimes there's a gap between what they say they're going to do and what they actually do. But one needs to take that into account.

As an example, a few years ago we had a much smaller investment in Hewlett-Packard than we would have had just because we were very nervous about their capital allocation process. And they actually exceeded our worst expectations with the Autonomy acquisition where they, in our opinion, grossly overpaid for it. Those are the kind of things that become surprises in a negative sense that can also be a surprise in the positive sense.

In the case of News Corp. [NWSA] a few years ago when they wanted to buy the rest of BSkyB [London: BSY], we were a little nervous, because we were worried about them overpaying. And then of course the British parliament got unhappy with them and prevented them from doing that. And so they had to go to Plan B, which we liked better than Plan A, which was buying back their stock which we thought was a much better use of cash based on the price of stock. And so they moved that way and it ended up being a dramatic plus from what our expectations were.

MOI: Given that you allocate such importance to the role of management, have you ever been tempted about just following the jockey and perhaps compromising on business quality and price considerations believing that management is really the right one and that's the key to the investment thesis?

Yacktman: That can happen on occasion, but it's rare. I remember back when I ran Selected American buying some fireman's fund because of Jack Byrne, as an example, where I had a high degree of confidence in Jack Byrne.

But it took him years, much longer than I'd anticipated, because basically he had to move away from the business model he had, which was less than stellar to try to improve the business model and to take advantage of the values, the underpricing of the model.

What I guess I'm saying is the ideal thing is to have a good business with a good manager and a good price obviously to go along with it. It's a lot easier when you have the wind at your back than when you have the wind at your face.

Good managers generally will change the wind direction. But as investors, you can control the sails. You can't control the wind, so you become much more dependent on it. I'd rather

see the machinery humming than the machinery just littered and not doing much.

MOI: When it comes to management, would you be able to give us an example of a CEO, a capital allocator that perhaps is underappreciated by the world in how they go about business, and then it would be a good example to study, to really understand how to think about management, and what to look for as an investor?

Yacktman: Depending on timeframe, going back years ago when it was still a public company, I thought Bill Stirtz when he handled Ralston did a great job. He started with a company that before him had “*deworsified*.” He shrunk it to its most profitable core, grew the core, bought back stock, did so many things correctly. That was a sterling example.

The one that stands out in the last maybe decade or so and partly because it’s so heavily family-owned is Lancaster Colony [LANC] which is a smaller company. But they’ve shown incredible discipline in capital allocation, gradually moving into better businesses and being very careful.

We vote against every stock option plan. They had virtually no stock options. They’re very careful that they’ve done special dividends, they’ve done share repurchase, they’ve done an awful lot of things right.

MOI: If we think about investing and approach it from various angles, you’ve kindly told us about how one of your sons came to you and explained investing, roughly meaning buying above-average businesses at below-average prices, and on average that’s going to work.

And it reminds me a bit of Seth Klarman’s quote when he says that value investing is simple to understand but difficult to implement. The hard part is discipline, patience and judgment. Those three words, and you’ve mention patience earlier in the conversation today, would you tell us a bit what that means to you, discipline in investing?

Yacktman: Discipline means to continue to have a process and utilize that process over and over again so that it becomes a repetitive thing, because you have confidence, you’ve developed it. There is no substitute for knowledge and grinding it out.

My son Steve who works with me was talking to a group at a college and a question came up about a company and he said, have you read the 10-Ks and the 10-Qs? And they looked baffled like that was a surprise, and he said I do.

A lot of this is just digging it out, and really understanding the business model, and understanding all the nuances. Clearly, we’re never going to know the company as well as the management knows it, because they’re insiders. They see it every day. But really trying to understand it and so it does become a grind-it-out process.

MOI: How do you develop and nurture patience as an investor? How do you withstand this noise that tends to shrink the time horizons of most?

Yacktman: It’s interesting. When we were in downtown Chicago early on, we’d get a lot more bombardment from people because our accessibility was there. When we moved to the suburbs, it dropped off dramatically. And the less noise one gets from Wall Street, the better off you are.

Now that doesn’t mean we’re going to move to Fiji, but moving to Austin even reduced it more because there are fewer people that come through. And so it’s important to step back,

and not get caught up in the 24/7 news cycle, and just turn off a lot of that stuff. Just avoid it and concentrate.

Yes, I've commented that our office sometimes comes across more like a library than it does a trading desk at a New York brokerage firm.

MOI: What does the word "judgment" mean to you? How should an investor go about improving judgment over time?

Yacktman: To me, that means objectivity, really thinking through the process, and being as objective as one can, recognizing that in our business, we're basically wrong almost all the time because nobody buys everything at the bottom and sells everything at the top. It's a matter of recognizing that.

That doesn't mean we can't be well above average, but there is a degree of probability in this and that recognizing that we're all human, and we're going to make mistakes, and don't try to defend the indefensible.

When one makes a mistake, admit it, learn from it, move on, and try to improve on what the mistake was so that we don't repeat it over and over again.

MOI: To come back to these escalators as you refer to them, how do you judge whether a company has a moat and the sustainability of that moat?

Yacktman: Usually the moats come as a result of big market shares, which ultimately what it amounts to is a low cost position. In other words, you can get a moat, say if you're a mining company because you find a vein of some particular product or commodity and it's right at the surface let's say, you just happen to luck out, and it's just real cheap to get at - that can happen.

But the majority of the time, it becomes a result of just doing correct big business principles, continuing to make the product better, and not compete on price but on quality. You make the quality better and so as a result of that you start to get more sales, which then in turn gives you a chance to drive down the cost because of the experience curve.

A company that has a 40% share of the market doesn't make twice as much as somebody who has a 20% share. They'll make four times as much. But in the process, one needs to bring down the price to benefit the consumers and expand the market.

That's one of my concerns about Apple is that whether they've held up their pricing too much, creating enormous profit margins that are simply unsustainable. Better to give up some of the profit margin and build such a strong position that it's very difficult for other people to attack your position.

MOI: If Apple represents that one side, would you say the Coca-Colas of the world, or Procter & Gamble or Pepsi, they're on the opposite side? Or do you feel they're not optimizing the price recently and they have potential to do a better job extracting profits over time?

Yacktman: It's a combination of two things. One is in the case of the Cokes and Pepsis is that their businesses are a little bit more mature. They're little more like cash cows, so to speak. But once you've established an enormous position and the business has matured to the point where unit growth is slowing down, then you can lose it. But somebody really can't take it away from you.

Apple, you still have enough disruption because of technology change. I can't tell you what a cellphone's going to look like ten years from now any more than anybody else can. But my guess is that people will still be using Tide detergent, a very high percentage of them, just because of the solidified position of that market share and what it does for them.

There are going to be some exceptions to the rules but those are the basic rules that I see. That's why technology is very tough even when somebody has a big market share, because you can have disruptive changes. And sometimes it can just be technology entering something that previously didn't have it.

Think of what happened to the encyclopedia business with the result of the Internet. It basically disappeared. You changed the whole model of accessing information from a book to online and the ability to change it. That would be an example of disruption coming from technology.

MOI: If we go back to the role of management, you've stated that companies like Procter & Gamble or Coca-Cola can lose their market share but nobody can really take it away from them. What are the ways a company like that can lose its market share?

Yacktman: Probably the best way I can give as an example again, if you go back to the 1970s, Budweiser and Schlitz both had about the same market share in beer. I'm not a beer drinker but as I understand, Schlitz basically found a process that made it a lot faster to produce the beer and so they could do it cheaper, but they ended up creating a product that the marketplace didn't like.

And as a result of that, there was a dramatic shift and then it was all over. Budweiser took over the market basically and ended up with about half of the beer market before it went private or before InBev in effect bought them. Here's a case where they just made a tremendous error.

Coke made a huge error when they came out with new coke but you'll notice how quickly they adapted to that and came back with Classic Coke, recognizing that they could have destroyed the company. Again, some of these things become just making the correct decisions. And if you blow it, then recognizing quickly you've blown it, and go back and improve it.

Look at what's happened in the last few years with J.C. Penney and how they had this tremendous change in business model and it was a disaster. I don't know if they're redeemable but we'll find out.

MOI: In a case like that, it seems that there are examples of great capital allocators who have tried their hand in retail. What would you look for in a case like that when it comes to management? Or do you feel that management could never really persuade you even if it had a great case for turning it around it, and so on, and allocating capital in a way that an investor would want? Do you feel management could ever convince you to invest in those businesses, which are not your typical escalators?

Yacktman: Ever is a long time. The question is have they reached the point of no return? Retailing is a tough business to begin with. It's a very competitive business. It is very difficult to create loyalty.



This conversation was recorded in November 2013.