

Long-Term Value Investing and Current Market Opportunities

Glenn Surowiec of GDS Investments reflected on long-term investing and current opportunities at Best Ideas 2019.

During the conversation with John Mihaljevic, Glenn discussed his thesis on General Electric (US: GE), among other ideas and case studies.

The following transcript has been edited for space and clarity.

John Mihaljevic: Instead of a formal presentation, we'll have a Q&A. Perhaps we could start with an assessment of your portfolio and outlook going forward.

Glenn Surowiec: Yes, let's start talking about investment philosophy. I am a value investor. I believe price is what you pay, and value is what you get.

I favor higher quality companies, companies capable of compounding an acceptable rate of return over a long period of time. That approach leads me to industry leaders with high return on invested capital and wise stewards of leadership to manage the capital allocation process. Also, my preference is a low turnover portfolio. My approach seeks cheap companies, maybe misunderstood companies, and I might have a different perspective over the long term than the market's perspective.

A cornerstone of value investing favors emotional discipline focused on long-term potential in a world increasingly devoted to the short-term. That approach renders my focus to an inch wide and a mile deep. I prefer to own a handful of companies I understand and that meet all of my valuation criteria.

Mihaljevic: Glenn, maybe we can go to an example. GE is a company you know quite well. It's in the crosshairs, but how do you look at something like that in terms of taking a longer-term view?

Surowiec: GE is probably a deeper turnaround. I still own it, and I own it at higher prices. Sometimes, when you endure large unrealizable losses, it's not so apparent whether you're wrong or early. In a situation like GE's, it makes sense to recheck facts and make sure the logic is still in place. Volatility should not guide long-term decisions.

John Flannery did a decent job taking over from Jeff Immelt. He redirected the company down a different path. Jeff Immelt made overpriced acquisitions, whether it was around stock or whether it was Alstom within GE Energy and Power, or Baker Hughes. Jeff Immelt spread the company wide, and he did so in an undisciplined way. John Flannery simplified the organization, restructured power, and built the next generation of GE around aviation. Healthcare was the right move. In October, John Flannery was let go, and the board brought in Larry Culp.

When I say "brought in," he was already a member of the board. He came in February. Larry Culp has an exceptional track record. He ran Danaher for 14 years, from 2000 to 2014. Danaher's market cap and revenue grew fivefold over that period.

Danaher is one of those companies most investors and most laypeople have never heard about. But, in some ways, it was almost the antithesis of how to run a conglomerate; contrast that with the way the GE conglomerate had been run. Danaher employs 60,000 people, and less than 200 work in the corporate headquarters in Washington, D.C. He brought a change in culture. Culp believes leadership should be out in the field, and he has a phenomenal track record; he will continue to do what John

Flannery started.

Culp needs to accelerate changes, and he needs to bring additional liquidity quicker than John Flannery was able to. More importantly, GE needs to send a cultural signal that Culp is an outsider, and this outsider offers perspective capable of helping create value for shareholders and employees.

For a company like GE to bring in an outsider, it tells stakeholders that GE endures a serious problem. GE presents the good and the bad. GE Capital continues to unwind and is essentially in runoff mode. Legacy liabilities need to be addressed, and it is trying to address them by building reserve. A reinsurance transaction could potentially help resolve these risks.

GE is trying to do something with Baker Hughes, the publicly traded BHGE it telegraphed to the market. GE is trying to do something with GE Healthcare via an IPO or spinoff or some other corporate transaction. Power is still a work in process, and GE is addressing it, not unlike what Bank of America (BAC) tried to do by separating the bad stuff and restructuring around the good stuff.

BAC is one of my more successful investments. I originally invested at \$10 per share after 2008 or 2009. It wasn't at the height of the crisis, but issues lingered. I thought Brian Moynihan was doing great things, and the market was still concerned about legacy mortgage operations. BAC'S management failed to realize two things. A lot of progress had been made with the core long-term businesses. Also, BAC understated profitability because it supported this legacy mortgage business. Overhead was higher than it should have been.

I first bought it at \$10 and averaged down, and it ultimately bottomed at around \$5. I had large unrealizable losses there, but I felt the company was putting the business on the right track. Its recent price is near \$26.

GE, with the right execution - I'm a big fan of Larry Cup - GE can carve out a trajectory similar to Bank of America's.

Mihaljevic: It seems GE's valuation has come down so much, if it can get through this period without dilution, the upside will be intact. What's your level of confidence in terms of GE weathering this period without issuing equity?

Surowiec: That's a good question. The market already discounts some dilution. GE recently cut the dividend, and management aims to reallocate capital with different priorities. GE's success enduring this time depends on whether deterioration in power persists. If some of these contingent liabilities turn out to be greater than expected and/or if GE can't offload risk to a reinsurance company, it might not be able to avoid issuing equity. GE announced a \$92 million share offering in BHGE and a secondary offering. This addresses near-term liquidity short of issuing equity. I don't know that anything is off the table. Larry Culp will certainly do what's in the best interest of long-term shareholders.

BAC did the same thing when it issued convertible preferred stock to Warren Buffett. The market endured a near-term reaction. In the long term, it probably made sense.

Was it dilutive? Possibly. It depends on how you look at it. Was it necessary? Maybe. Hindsight's 20/20. Maybe BAC could have gotten by without the preferred issue. But it de-risked the company so it could move and focus on things outside of liquidity and capital structure. The preferred issue allowed BAC to take a different path and know it enjoyed the comfort of having Warren Buffett as a major shareholder.

In the near term, dilution creates a negative impact. In the long term, not all dilution is created equal.

If you can bring in a partner and take a risk off the table such as liquidity, then it can have a positive impact. Putting the dilution thing aside, GE has other levers to pull. I don't know if an equity issue serves its first option, but I don't know if it's off the table either. But the fact it effectively eliminated the dividend reveals how GE considers many choices. GE senses its assets have value, and it is not locked into any particular path. I can tell you that Larry Culp, at least based on what he did for Danaher, locked into long-term shareholder value. If that means pursuing one strategy or a different one or a hybrid of the two, then he'll probably do what's financially responsible.

Mihaljevic: Are his incentives aligned with the long-term shareholder gains?

Surowiec: Yes. Not only has Larry Culp been a buyer in the open market, the vast majority of how he's paid directly aligns with equity owners' interests.

Mihaljevic: That's helpful. Glenn, maybe stepping back a little, you talked about philosophy in the beginning. I know you are on the lookout not just for deep and undervalued, but also for quality. What do you look for when you say quality? Is it more the business or the management team?

Surowiec: That's a good question. First, I look introspectively. I think these questions of quality come up in a lot of your conferences. You have a lot of different value investors who operate differently. They have an investment committee, and some operate with a single person making decisions. I'm more of the latter. I network with a group of people, and that's healthy. But in terms of having final say over a decision, you have to understand what companies you need to own in order to win long term. Lots of people that can do the whole "I'll buy a dollar and pay \$0.60," a la Ben Graham. They look for those kinds of cigar butts and they can be highly successful.

My philosophy is this: I don't want to say trial and error because directionally, I started down this approach, but my winning formula is pretty simple. Price is what you pay. Value is what you get. I seek value.

I need a denominator and that equation to go up, which means I look for businesses creating more value every year. How they go up is different. Some create value with measured acquisitions. Some do it through opportunistic share repurchases. Some apply their pricing power. Some try to broaden the scope of what they do. Some enjoy economies of scale. I mean, there's a variety of ways you can increase the value of a company. I've owned companies where you have John Malone, who does his thing, and maybe he uses more leverage. His might be more maybe tax driven, and he's dealing with a certain industry. I've owned companies that Vernon Hill has been part of. He is more de novo organic expansion where, literally, he's taking a model that works and he's building another store and yet another store, a la Home Depot or McDonald's. I am indifferent; I only want to make sure value rise.

The companies I look for, the companies I feel most secure about for my clients are number one or number two in their industries. I don't like to deviate. Typically, if the industry operates in a duopoly, then all the better. A number one with 9% market share where it's highly fragmented...that is different than a number one with 35% market share and the next closest competitor might be at 20% and 15 competitors make up the remaining 45%.

I prefer the latter. Capital structure we talked about with GE, and GE falls outside of this a little. But most of my companies are extremely conservatively financed.

I'm not interested in companies trying to maximize economic theory when it comes to leverage because sometimes you're not building the capital structure around the most likely event. You're building it around the hundred-year flood. I prefer companies operating with that mindset.

To introduce a Will Thorndike reference, I look for outsider CEOs. There's a huge tailwind to being in

a good to great business and having a management team that is a tailwind and not a headwind. Management teams can come in and destroy a great business because they're essentially renting their jobs. They know they have five years to make a difference. They try to hit home run after home run when maybe singles and doubles are more suitable for what they're trying to accomplish.

I am definitely looking for outsider CEOs, and the way you identify that is, you look at how they allocated capital in the past. You want to talk to them if possible. You want to listen to what they say and what they do. You want to read 10-Ks.

Through that process, you discover a lot of CEOs came through the organization through the sales channel. Without generalizing, I found a lot of those CEOs to be dangerous. I would prefer a less charismatic CEO and someone who is more operationally savvy, someone who understands the manufacturing process. I would rather a CEO who understands the finance piece of the business as opposed to someone who constantly needs to defer to the CFO. Because, at the end of the day, if you have a CEO who takes ownership over every aspect of the organization and you have a CEO who understands the significance of capital reallocation processes, they are in a better position to make decisions in shareholders' best interests. We'll be agnostic whether it comes to paying dividends, buying back stock, pursuing M&A, or maybe investing in our own business; they will choose the most appropriate path. Those are CEOs that I want to align myself with.

Whenever I hear CEOs say, "Yes, we bought back stock because we wanted to offset dilution and equity compensation," I say, "That doesn't make any sense." If your stock is overvalued, then why are you buying back stock? Maybe dilution isn't such a bad idea. Or, if you have companies issuing debt when the stock is overvalued, it doesn't make any sense.

Mihaljevic: I'm curious about your take on the accepted wisdom that brands are not necessarily what they used to be. How do you look at the pace of innovation and the pace of destruction of some types of moats historically viewed as wide? Have these developments pushed you toward expanding the circle of competence, maybe looking at companies in the technology space?

Surowiec: I do own quite a few companies in the technology space. There's no question the lifecycle of companies has shortened. Disruption cuts both ways. It presents opportunity, and it also means companies will be on the other side of that force. For decades, certain industries enjoyed a reputation for moats and pricing power; the reputations might not be true.

Traditional thinking targets newspaper and consumer product companies, like Colgate, as suitable positions during recessions. I'm not sure that thinking is true. They are vulnerable and I have stayed away from them. Other companies present a real moat. I look at metrics like net promoter score to determine which brands consumers value. Net promoter score is just one data point, but other data points can corroborate. Investors must be mindful of an environment. Because of the pace of technology and the pace of that change, moats are not what they used to be. I don't know about expanding the circle, but maybe rerolling it is the right way to think about it. The irony is that companies with moats today might be vulnerable. For example, Apple has a moat and operates in a huge ecosystem. If you consider what's happening in the Valley, many companies open up second, third, and fourth lines of business. In the past, a clear separation seemed to distinguish Apple's business from Google's, Amazon's, and maybe Alibaba's. Those lines are getting blurrier.

Investors must be mindful of changing moats and a company's competitive situation. Certainly, some companies today enjoy wide moats. Jeff Bezos made reference to this either in his last shareholder letter or I read it somewhere, but he said, "Listen, at the end of the day, we will get disrupted. You need to build an organization with an edge preventing it from getting stuck in the mud." That's the world we live in. It's not universally good, and it's not universally bad. It's something investors need to

evaluate.

Mihaljevic: To the extent you're willing to talk about it, I'd be curious in what kinds of technology-related companies you found have value.

Surowiec: I've owned Qualcomm for a while. While it is not a traditional technology company the way a lot of people think about technology, but it has a long-term earnings growth story. I like what Qualcomm is doing after the NXPI acquisition failed because they didn't get Chinese regulatory approval, and they engaged in a massive buyback at accretive prices. Some overhang exists because of the licensing dispute with Apple. That's a company I like. It has a rich pipeline. It spends an enormous amount of money on R&D. I'm comfortable owning Qualcomm partly because it is shrinking the denominator in the earnings per share calculation and it is on the wave of many emerging technologies.

Many emerging market companies' stock prices have declined. For example, prices for some of the biggest companies in China have come down to interesting levels. These companies are entrenched, similar to the way Google is with domestic search and Amazon with domestic e-commerce and the cloud. Prices for these emerging market names, because of some of the trade angst, have come down quite a bit. Those are in my portfolio, and they are interesting to me.

I have owned the FANG names at one point or another over the life of GDS Investments. I do not own them now. They've all done quite well. I was early in getting them out of the portfolio, but I was right in my entry price. If you look at Apple, investors were uncertain about its ability to reinvent things after Steve Jobs. However, I was comfortable with what Tim Cook was doing, initiated positions then, and it performed well. My concern is not that Apple has come full circle. Certainly, it's off a lot from the last month or two. But when you're dealing with trillion-dollar companies, the next leg of growth gets difficult, and it's not a bet I want to make. If you look at the upgrade cycle we've seen with the core smartphone product, you see it gets longer and longer. With each new innovation, customers will be less inclined to upgrade. The industry is starting to see that now. The ecosystem will be there, but I'm not sure people will pay \$1,200 for the next generation phone when they see maybe a 5% improvement. When you have the price continuing to go up with the rate of improvements coming down, that's an uncomfortable intersection. That's what I've been doing lately in technology.

Mihaljevic: Great, that's helpful. I'd be curious also, Glenn, to know what you think about holding cash both in general as well as in this market environment that might be a late stage bull market. We're getting some jitters now. What do you think about cash in the portfolio?

Surowiec: I think about cash not necessarily in a top-down way but more in a bottom-up way. If I have ideas and if I have more great ideas than cash, then I would like to be close to fully invested. On the other hand, if I have more cash than great ideas, I'd like to build up cash.

If you look at my history, I've been anywhere from 0 to 30% cash, depending on the opportunity set. Today the economy is slowing, and people are nervous. If you look at individual names, the Caterpillars, the DowDuPonts, and look at traditionally economically sensitive names, the stocks are pricing in some of the slowing economy. DowDuPont has a great CEO in Ed Breen who did wonderful things at Tyco. They'll break up the company. Value will increase as they do that in 2019 and 2020. The price is at multi-year lows. Bellwethers whose prices have dropped imply some recognition the economy is slowing down. I don't own Caterpillar, but I do own DowDuPont.

Directionally, our market is more similar to the late '90s when we had the huge concentration of capital misallocation into some of the growthier names. If you look at the disparity between Russell 1000 growth and the Russell 1000 value, a slowing economy will act as a catalyst for a rotation of the

value. That's the missing ingredient. People will become more price conscious when the growth isn't there. I am less than 10% in cash. I've used volatility in September, October, and November to do two things: Increase my cash position and upgrade the portfolio. I have rerouted away from positions that have gained value and from companies carrying too much business risk. I have added to positions in cheap, bulletproof companies with structural tailwinds over the next 5 to 10 years. I'm encouraged by how a slowing economy might force investors to reprice certain growthier assets; that presents an advantage for value-oriented managers.

Mihaljevic: You've talked about Commerce Bancorp in the past. Will you update us? Has it developed the way you expected? Do you consider it one of those solid pillars?

Surowiec: I owned Commerce for a long time. It was a 15-year holding up until it was sold in 2007 to Citibank. I have since participated in Vernon Hill ventures. The first is Republic Bank, which is a small bank in Philadelphia involved in de novo expansion Commerce was so famous for. It's around \$7 or \$8, and my basis in that is about \$1.50. Its venture in the UK is also interesting. It is involved with a bank called Metro Bank. I own Metro Bank. I like Metro Bank for more than the obvious reasons. You have Vernon Hill's involvement and you have a formula that was highly successful in the States. The model in the UK will work better than it did in the States. I say that only because the UK banking system has not witnessed a single new bank charter since 1840. This industry is ripe for disruption.

You have this maverick in Vernon Hill. You have competitors incapable of dealing with this new way of bringing in deposits because the HSBCs and the Barclays and a lot of these four or five banks that control 98% of market share haven't reinvested in a retail banking business. Their culture isn't suited to bringing in deposits. These six legacy banks are out of step and bureaucratic. If you talk to customers of these legacy banks, they do not do business with the banks because of any underlying goodwill. They do business with them because of a lack of alternatives.

I bring it back to other models. Did people go to Hechinger, Builders Square, and Grossman because they absolutely loved the experience, or did they go there because there wasn't a Home Depot? It was the latter. They were there temporarily.

I've always been fascinated by models on the verge of disruption. Management thinks their customers have more loyalty than they have. You see a model that's coming around, and you see the distinction between, in this case, deposits that are there for all the right reasons.

Commerce brought in deposits for all the right reasons. It didn't have customers. It had fans, and it had people who felt they could not do without Commerce. It was because of friendly service. It was because Commerce was open seven days a week. It was because depositors could visit before and after work and know the bank would be open. Commerce's lenders were known to work with businesses throughout the economic cycle, where other lenders were known to cut off lending during recessions and business slow-downs.

Metro is in a good position because it is scratching the surface for what will be a decade- or two-decade-long runway. I own Metro. I own Republic Bank. Studying Commerce's model, working at Commerce, and having relationships with people at Commerce, give an advantage about understanding what's happening and how powerful the model is. I am bullish on both of these businesses.

Mihaljevic: Metro Bank's price has dropped, probably because of Brexit and related concerns. These concerns have nothing to do with the long-term economics of the business. It seems now might be a good time to look at Metro Bank.

Surowiec: It would be a great time.

Mihaljevic: Glenn, thank you. It's always a pleasure. When we do these Q&As, we never quite know where it's headed, but I always learn a lot. I'm sure those listening have picked up some things to follow up on, as well. Thank you for taking the time to do this.

About the instructor:

Glenn Surowiec started GDS Investments in 2012. From 2001 to 2012, he worked for Alsin Capital Management, Inc. as an equity research analyst (2001-2003), co-portfolio manager (2003-2008), and portfolio manager (2008-2012). Glenn has a BA in Management (Accounting concentration) from Gettysburg College and an MBA (Finance concentration) from Southern Methodist University. His interests include running, cycling, golfing and youth coaching.