

Tom Russo on Investing in Crisis: The Day the Dow Dropped 3,000 Points

Tom Russo of Gardner Russo & Gardner joined MOI Global members for a LIVE Q&A session at our special event, [Intelligent Investing in Crisis Mode 2020](#).

Tom reflected on the current moment in history and shared his perspective on surviving this period. Tom is famous for preferring businesses with a “capacity to suffer”. In this context, he discussed Berkshire Hathaway (NYSE: BRK), Heineken (Netherlands: HEIA), and selected other companies.

The following transcript has been edited for space and clarity.

John Mihaljevic: We witnessed the Dow Jones off 13%, or 3,000 points, today. I am very grateful to you, Tom, for taking the time on a day like this to be with us and provide his perspective.

Tom Russo: It’s a pleasure to have the chance to speak with you and your audience although this is a very rough day after a fairly rough couple of weeks for investors. They have to process so many areas of uncertainty that I think the investment community is looking for an opportunity to have a moment of relief. Unfortunately, they don’t get it. I mean, even today, news of the added measures to try to combat the virus leads one to over-exaggerate what the challenges might be. Yesterday’s efforts by the Federal Reserve to overcome the virus on the financial markets were doomed at even the thought of exercising them because doing so makes the moves feel politically driven. This, in turn, immediately undermines the surprise element and also the apolitical element supposed to accompany the independent agency called the Federal Reserve. Thus, the otherwise fairly substantial measure didn’t have anything close to its desired effect because it was also a political signal.

Certain pockets of this market are especially challenging. I’d say among the most profound ones is the commercial banking industry. Every time the yield curve flatlines like it has, it seems to drop 14% or 16%. Look at the major banks - it’s been catastrophic for them in terms of share prices. Moving from the yield challenge part of the market, you have travel, like airlines and various things keying off of endeavors that are threatened. At the final point, to the extent that threatened endeavors exist on top of a substantial amount of debt, the debt services do not know that the COVID virus has paid us a visit. They will still look for interest and payment on their debt. That will chew up businesses that have no traffic because of the concern that traffic associates with contact and the possibility of sustaining a virus we’re trying to choke out of our system. It’s happening on so many layers, and ironically, it’s happening after what was a fairly good 2019. It seems to be catching people off guard.

Mihaljevic: Tom, you have talked about companies’ capacity to suffer numerous times in the past. Now, all of our capacities to suffer are being tested. How do you think about the human element in all of this? How does one stay rational here?

Russo: It depends on whether, for instance, your compensation package is somehow tied up with the share price having a certain value on a certain day. You have time pressure in that model. Charlene and Michel de Carvalho, controlling shareholders in Heineken, don’t have the time pressure that would accompany their decisions and address their uncertainty because ultimately, they’re building for a very long-term consumer and a very long-term owner - in theory, the family generations to come. They’re not under pressure to be right at a given moment. That’s why we have long-favored businesses whose time horizon aligns with ours. Yet, I’d say it is not given much credit in a market like the one we

suffer through today. An interesting aspect is that the market seems to be in a fairly uniform sell-off phase right now, without much credit being given to the companies that possess long-dated reinvestment opportunities.

Mihaljevic: What do you focus on the most in a time like this in terms of judging how your companies will fare going forward?

Russo: Good question. What I look for is their propensity to stay the course. I mean, we do tell our investors we are “stay the course” investors. We will not act differently so long as the conversations we have with managements of portfolio companies suggest that they have not seen yet forces causing them to think there’s been a permanent shift beyond merely a delay in their products’ march to market. If there’s a sense that all we’re going through today may reorder what people esteem, care about, and don’t care about in a way that leads to brand or product choices, it might force us to rethink a company.

On the other hand, if at the end of the current period of suffering people revert to long-standing and understandable preferences and practices, I think we will hear from our managements that they continue to make the investments. In fact, if they do determine with certainty that the future looks unbroken, you may very well see them heavy up their investment. That’s because in times of strife and chaos, you can make enormous gains by virtue of sellers or competitors with inadequate funding to compete during time of uncertainty. A business positioned to know when that occurs can pounce profitably and ensure deeper competitive advantage at the end of a period like this.

After just a couple of weeks of this drumbeat, there was a \$30 billion merger announced in the insurance brokerage sector. I think it was in part because one of the companies, most likely the target, felt vulnerable as a result of the mounting pressures, possibly by being under reserve. We’re bound to see more of that. It’s conceivable you will see something like this in the cruise industry, which tends to have a lot of operating and financial leverage, and vessels tend to be uniformly dry-docked at the moment. It wouldn’t take all that long for pressures to mount in that industry to the point where you may see some consolidation. It’s an opportune time for those who have the largest amount of capital to deploy – they may find it to be a profitable period at the end of the day.

Mihaljevic: Can you talk a bit about some of the companies you have owned and continue to own that you feel are strong enough to weather this and come out stronger?

Russo: I think Berkshire is in a very interesting position, below book value with an active capacity now to buy back stock at a discount to intrinsic value. It certainly has ready and available capital to make transformative investments. I expect it has been doing so day in and day out for the last weeks. That’s an old favorite, but it certainly has characteristics that suggest this is a time when it may be able to move the ball down the field quite successfully, quite deeply.

I happen to own –and have, for quite a long time – Philip Morris, whose shares trade up and down 12% a day these days. At the operational level, it has embarked upon a fairly steady march towards rolling out its heat-not-burn reduced-risk product, which is gaining traction around the developed world and launches in the US. The shares might be below \$70 today. I think the company has a 6%-plus yield, earning well over \$5.5 a share even as it maintains very high reinvestment in research and development. I’ve stayed with a position in those shares, and the company seems to have ample yield, a competitive advantage, and a product that can help people quit smoking forever. It’s interesting.

Based on this fear over a flat yield curve, the effect on lending has driven shares in the major commercial banking industry down to mid to high single-digit P/E, which is quite unprecedented. That’s an interesting area, especially for well-capitalized banks.

Mihaljevic: To flip the coin for a moment, when you look at your portfolio, are there any companies or types of companies you regard as vulnerable or not in a position to deploy capital into new investments as a result of the current situation relative to companies like Berkshire, which clearly have a big war chest?

Russo: The question is who's competitively restrained. I'd say the businesses that have harnessed the disruptive digital technologies to drive their consumer-facing businesses have a considerable advantage over those few who continue to operate in an unmodified fashion and without regard to the new tools that leaders like Procter & Gamble, Pernod Ricard, or even Philip Morris can use to better process data to understand who are the most targeted clients and operate there.

A not unrelated part of that conversation has to do with the broad retail universe and the migration of retail spending towards e-commerce, a process which continues unabatedly. This period could very easily give an enormous push to e-commerce as we're all mandated for weeks to stay home and venture forth less. It sounds like a pitch designed by Jeff Bezos to create captive consumers who would welcome Amazon's visits. I think traditional retailers, already not faring well before the requirement that non-essential retail shut doors for the next two weeks, will find other providers to have a chance to romance their clients and delight them with the kinds of services they will get and may not have been aware they can get, in which case you have switching, and that can be quite painful for those retailers who have been able to survive the march of Amazon until now. We'll see how this affects their competitive ability to continue to deliver.

Mihaljevic: Given your experience in the market, could put the current moment in perspective for us and tell us if it is truly an unprecedented period? Can we draw parallels to episodes in the past? How concerned are you today versus, say, 2008 and other periods?

Russo: There's a global and systemic element that is frightening in this particular version of crisis. However, I don't think it's generally the case of it being built around excessive financial leverage. It doesn't have the feeling of a banking crisis reflective of sharp overbuilding with non-credit-worthy contractors all coming unglued at the same time. It's not that, but the external factors in this early inning present challenges to investors in terms of the ability to estimate the size of the problem pie. The reason is that you don't know the nature of the illness that may compound at a sufficiently fast rate once it takes hold, which turns completely upside down assumptions about the future growth rates of a variety of companies.

There's no real way of knowing because the last incidence of the SARS ended pretty early on in the stage. This one certainly seems to be more extensive in its reach. On top of that, we've never seen in our lifetimes as much disruption placed upon global trade as over the past three years. It's completely transformed alliances and long-standing trade patterns in a way that we don't know how Brexit will open up or whether the Trans-Pacific Partnership will absorb. There's an entirely new force of unrest and disruption. It's different. The institutions we've long trusted and relied on in many instances have been closed or underfunded, lack mandates, and lack clear messages. Without mandates and clear messages, they can't convey convincingly to investors that they have their own path to follow. There are forces that are more broadly disruptive simultaneously. There are more of them, and they're happening with prospects for deeper consequences than we've had to address, at least in my lifetime.

Mihaljevic: How do you think about the various scenarios or the durability of this crisis? If we were to get some medical solution to this, a treatment or a vaccine, what impact would that have, in your view?

Russo: I wish I could say in earnest that we will likely know in two weeks because that would be the manifestation of a comment I read. One of the scientific institutes in Israel yesterday suggested that

they would likely have a vaccine available within the next two to three weeks. That would be an interesting case study of how markets would react if there is a sense that the uncertainty would lift. I suspect there'd be a substantial sharp recovery. Now, understand that it won't mean anything about Brexit or the Trans-Pacific pipeline. It would mean very little about the flat yield curve. There's still stuff, but it would take away the really colossal one that keeps people indoors, avoiding others and being frightened of their shadows. I would think that if you had one of Israel's great institutions of science and medicine announce a product with the capacity to avert this crisis, you would see celebratory investment moves, possibly more substantial than would have been the outcome from efforts to engage the Fed's tools to remedy something beyond its mandate and, in so far, may have undermined its own effectiveness.

Mihaljevic: Speaking of those tools, I've read that perhaps the Fed is out of bullets at this point. What's your take on what can still be done to provide the necessary tie-over or stimulus here so that we don't get a complete breakdown of activity?

Russo: I don't really think it's going to be Fed policy. As you said, Fed policy with the empty cylinders means it can't shoot very far anyhow. There may be some developments that restore confidence and trust. Those will, as always, come suddenly and without notice. That's been part of why staying the course is our chosen approach. Most investors buying into the S&P 500 or any other index end up underperforming the index returns deeply because they tend to overleverage the house to throw money into a gapping up bull market. Then, as the sentiment turns, prices collapse, and new lows are reached, they sell out of fear because they can't stomach the daily declines. Even though they may have been inside the entire period, it's not clear they'll make the return of the index fund.

The first big upside off the bottom usually happens without much participation. When people calculate the overall return for the index, they don't adjust it for who has money invested during the ups and downs. If they did that analysis, they would find that more people were more deeply invested at the top on the way down and underinvested meaningfully at the bottom and so wouldn't participate in the snapback. I think that is how you characterize most recoveries off of periods - when the uncertainty is so broad and deep that the market is surprised by a sign of something that they take favorably and then run with it.

Mihaljevic: Speaking of index funds, passive has gained massive share over the years. Do you think that high share of passive is now exacerbating the situation? How do you think that makes it different from what we've had in the past?

Russo: As asset allocators directed ever-increasing amounts of funds to the low-fee and seemingly riskless indices, we are building to a colossal problem of index investors trying to exit at the same time and finding themselves in the midst of the world's largest-ever crowded trade. It hasn't seemed to be the story. At this moment, these appear to be more purposeful, specific investments - sell the cruise ship lines, sell airlines, or sell banks because of flat yield curves. They're specific pockets responding to specific threats. As they wind down, though, it appears that collateral selling is taking place, but the main agents do seem to be investments specific to given companies and industries that represent a person's view of the risks. It hasn't been what I'd have thought we have encountered, which is sell the index and have an equal weight of everything rushing out the door at the same time. That's not what we've experienced, at least from what I see. It's been more specific.

Mihaljevic: Are there businesses on your watch list that have now come down enough for you to get interested?

Russo: There always are interesting businesses. One of the challenging things is that there are a host of interesting ones, but they also end up having the legacy of a very big lawsuit, which has become

common in today's market. Think J&J with its big lawsuit on baby powder. You have very interesting businesses saddled with big class action lawsuits, like Monsanto's Roundup, which is now inside Bayer. Bayer may or may not be an interesting company. I think the combined market value is lower than what it paid for Monsanto, but like many attractive but maybe low-value businesses at this time in the market, there is a claimant attached that reflects some of this growing risk of global litigation.

There are plenty of other examples. They take some good businesses out of the running because you can't discount the costs to the equity owners that such challenges bear over time. There's a fatigue that sets in for working for a business deemed to be dangerous or somehow not public-minded. Other things happen, and then there's just the sheer reality of large judgments. At the same time, there are interesting businesses run by good managers who don't happen to face liabilities. There are companies we look at and are quite interested in, and this is the time to try to trade up and find businesses that you've long hoped to get at prices like this. Think of this as a one-term opportunity.

Mihaljevic: How should one think about rebalancing the portfolio in a time like this? Are you actively looking at redeploying from some holdings into others that you think will weather this period better or that have become more attractive from a valuation standpoint?

Russo: I think that's incumbent upon managers. We're long term-minded investors and extremely patient. At the same time, there are moments when patience has or has not been rewarded, and there are other available investments now at prices unrealizable before. Whereas you may have felt like you had little room to move historically with a position that if you had exited, you wouldn't really improve your lot much, today, fine businesses may have fallen sufficiently so that such a transfer will add value in terms of the quality of the investment, the promise of its future cash flows, and returns versus the investment you gave up. We actively look for that. Even though we claim at the start to be long term-minded and tax-efficient in approach, we're perfectly comfortable looking to reallocate when we can trade up, so to speak, in business quality.

Mihaljevic: Value investors often say that having cash is like having an option to deploy in bad times. In your mind, if somebody does hold cash in their portfolio, is this the time to deploy it, or do you think we're still not quite there yet?

Russo: Buffett held back on buying Walmart because he had a \$21.25 price target in mind. The stock got to \$21.5, and he never bought it, failing to make a \$10 billion fortune as a result. When you have the price of once highly esteemed businesses down 70% or 80%, you have cash and understand the business, and you think there's a chance that it'll reach only half of its original promise - if it's 30% of where it was, and you get half of its original promise, that's a 60% return - and from there, there's no reason to assume it'll stop growing its value if it's a good business. I happen to think you're paid to at least have a participation with investments on a regular basis. The challenge is that if you were to pull directly the cash and go to the sidelines, it's hard to know when you come back in - they certainly never ring a bell to tell you when it's safe to proceed. It also depends on what your role is with the family whose funds you oversee. If it's their only money, you have to behave differently from how you'd handle an allocation of a portion of money to the equity markets in a broadly diversified family office. You have different constraints depending on the charge you take on.

Mihaljevic: I believe you've owned Martin Marietta Materials long term. In your view, does the likelihood of government stimulus in the construction industry impact a business like that positively?

Russo: This business will be deeply called upon to help make America's infrastructure great. We have crumbling bridges, roads, and tunnels, and commerce increasingly requires that we take the pain to repair them so that it flows more freely. Obviously, this will require funding, and it'll probably be lower down the hierarchy now that we have operating expenses rather than capital expenses in front

of us. The operating ones are to make sure people whose jobs are lost have some income supplement, hospitalization, and healthcare. These are all public goods fully funded at this stage because the consequences of ignoring a public good is that it can become a public bad. The sickness can roll, and the costs are far greater later. At some level, it's a bit discretionary, but at the end of the day, when bridges start to crumble with cars on top of them, it's not as discretionary as people think.

The company's business will do well over time. It is also in commercial and other areas that may dry up for a while, in which case, there's possibly a bit of a balancing effect. The fundamental story with the product is that it doesn't ship far, doesn't have a substitute, and there aren't a lot of competitors, so there's a recognition that you have pricing power and high fixed cost. It's a business that can deliver substantial returns to the leaseholder or the landowner over time.

Mihaljevic: Tom, we are truly grateful for you taking the time on a day like this. I wish you and your family the very best in this turbulent time.

Russo: Thank you. I don't know if I've ever had a day like this before. I mean, I've had a series of days like this that have never been like this before, which is quite an amazing thing for someone who's been in this business for almost 40 years. Take care.

Benefit from the wisdom Tom has shared with members in the past:

- [2019](#): On wide-moat investing
- [2018](#): On the evolution of quality investing
- [2017](#): On the durability of consumer brands
- [2017](#): On mental models in a changing world
- [2017](#): On shareholder value and global brands
- [2013](#): On Berkshire Hathaway and beyond
- [2012](#): On investing in global franchise businesses

About the instructor:

Tom Russo joined Gardner Russo & Gardner LLC as a partner in 1989. In 2014 he became the Managing Member of the firm. Tom and Eugene Gardner, Jr. each manage individual separate accounts and share investment approaches and strategies. In addition, Tom serves as the Managing Member of the General Partner to Semper Vic partnerships. Tom oversees more than \$10 billion through separately managed accounts and Semper Vic partnerships. Gardner Russo & Gardner LLC is a registered investment adviser under the Investment Advisers Act of 1940, and is not associated with any bank, security dealer or other third party.

Tom's investment philosophy emphasizes return on invested capital, principally through equity investments. His approach to stock selection stresses two main points: value and price. While these would seem to be obvious key considerations in any manager's approach, it is equally obvious that all too often they are either misjudged or, perhaps more frequently, simply not viewed together. Tom looks for companies with strong cash-flow characteristics, where large amounts of "free" cash flow are generated. Portfolio companies tend to have strong balance sheets and a history of producing high rates of return on their assets. The challenge comes in finding these obviously desirable situations at reasonable or bargain prices.

Tom's investment approach is focused on a small number of industries in which companies have historically proven to be able to generate sustainable amounts of net free cash flow. (These industries typically have included food, beverage, tobacco, and advertising-supported media.) This fairly narrow approach reflects his training and discipline at the Sequoia Fund in New York, where he worked from 1984 to 1988. Tom tries to limit risk by not paying too large a multiple of a company's net free cash flow in light of prevailing interest rates. He attempts to broaden this otherwise narrow universe by including companies with smaller market capitalizations and companies in similar industries based abroad. Tom's goal is one of an absolute return rather than a relative return, and he continues his long-term investment objective of compounding assets between 10 and 20 percent per year without great turnover, thereby realizing a minimum amount of realized gains and net investment income.

Tom is the Managing Member of the General Partner of Semper Vic Partners, L.P., and Semper Vic Partners (Q.P.), L.P., limited partnerships whose combined investments are roughly \$3 billion, along with overseeing substantially more funds through separate accounts for individuals, trusts, and endowments. He is a graduate of Dartmouth College (B.A., 1977), and Stanford Business and Law Schools (JD/MBA, 1984). Memberships include Dean's Advisory Council for Stanford Law School, Dartmouth College's President's Leadership Council, and California Bar Association. Tom is a charter member of the Advisory Board for the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School. He serves on the boards of the Winston Churchill Foundation of the U.S., Facing History and Ourselves, and Storm King Art Center.