

We revisit our exclusive conversation with Tom Gayner, chief investment officer and co-chief executive officer of Markel Corporation. In this timeless interview, conducted near the stock market bottom in March 2009, Tom provides some much-needed perspective and investment wisdom.

MOI Global: You have stated that the businesses you seek should have (1) a demonstrated record of profitability and good returns on total capital, (2) high measures of talent and integrity in management, (3) favorable reinvestment dynamics over time, and (4) a purchase price that is fair or better. Perfection, however, is rarely attainable in the stock market. Have you had to compromise on these criteria, and if so, could you illuminate for us how you decide on acceptable versus unacceptable trade-offs?

Tom Gayner: While you say that perfection is rarely obtainable in the stock market, I would go so far as to say that it is never obtainable in the stock market. Perfection doesn't exist in this world. All of my choices involve various degrees of compromise and tradeoffs. As an accountant, I can tell you that my wife and children are sick of hearing me use the phrase "opportunity cost". Every decision is also another decision (at least) and every non-decision is also a series of other decisions.

The challenge is to get the balance roughly right between the choices that actually exist. All of the four points I lay out are north stars that guide me. I admit though, that I have never personally been to the North Pole.

The one area where I will not compromise is in the area of integrity. I may not make every judgment correctly when I'm trying to make sure I'm dealing with people of integrity but I will never knowingly entrust money to people when I am concerned about their integrity. Even if you get everything else right, the integrity factor can kill you. My father used to tell me that, "you can't do a good deal with a bad person." And he was right.

The other factors can be thought of as shades of gray and nuances. We look for as much of the good as we can find and weigh that against what we have to pay for it, our expectation of how durable the business will be, and what our other alternatives are. I don't have a formula or algorithm to get that precisely right, I just spend all my time thinking, reading, and adapting as best as I can.

MOI: How does your approach to international investing differ from that to investing in U.S. equities?

Gayner: I don't think international investing is as different as it used to be. I believe that the world in general is becoming a smaller place. Given the advances in technology and communication, everything is starting to correlate with everything else. I think that growth rates, economic development, and rates of return on investment are all tending to head in the same direction. Capital has a universal passport and it heads to wherever it needs to go to earn the best returns possible.

Companies, especially the larger global companies where we tend to make most of our investments are doing business all around the world. All of these things tend to make nationality and borders slightly less relevant than what was previously the case.

One question I usually ask people when they ask me about our global investment approach is to mention two companies to them. I say that both companies make engines and move things from one place to another. One of them is Caterpillar and one of them is Honda. Which one is the international company and which one is the domestic firm? Depending on my mood, I give the person either an A or F on that exam. While Caterpillar is headquartered in Peoria Illinois, it does more of its business outside the U.S. than inside. While Honda is headquartered in Japan, I believe the U.S. is still its largest market. Your brokerage statements or pie chart presentations will probably show CAT as a U.S. company and Honda as an International company. I think that is a superficial difference and not a good guide to know if you are investing internationally or not.

Both of those are global companies and doing business all around the world. In my mind it is a distinction without a difference to describe one as a U.S. company and the other as an international firm.

That same sort of look through to where the company does business applies to a lot of the companies we invest in. Even though Markel is a relatively small company in the grand scheme of things, over a third of our business comes from outside the U.S. these days. That is just business written outside the borders of the U.S. Digging deeper, I think you would find that a lot of our U.S. written business relates to companies doing meaningful foreign sales and a lot of our internationally written business relates to activities that circle back to the U.S. The world is increasingly interconnected and I just try to make sure we are investing in the best business possible at the appropriate price.

MOI: You emphasize the impact of the passage of time on your investments. With the trend toward compression of time horizons and a focus on short-term performance in the investment industry, we are seeing many investors—even those who consider themselves value investors—emphasizing near-term stock price catalysts. Do you see a growing inefficiency in the pricing of “boring” investments that will deliver returns over time versus investments that are expected to pay off at a foreseeable point in time?

Gayner: Yes. To expand on that one word answer, I think there is a real time arbitrage opening up right now. An old saying is that in a bull market, your time horizons grow longer and longer. In a bear market, they grow shorter and shorter. The bear market experience of the last few years compresses time horizons for a lot of people. Even if they want to remain focused on the long term, there are inevitable career risks in not putting results on the books today when people are so anxious about every aspect of their lives.

I think that means the playing field for longer-term investing is getting less crowded. Fewer people are able to think about the long term and I believe that creates an opportunity to buy wonderful, long duration investments, at better prices than has been the case in the last decade or so.

MOI: What is the one mistake that keeps investors from reaching their goals?

Gayner: I've made so many mistakes over the years that I struggle to isolate just one as the biggest single mistake. Among the choices though I think excessive leverage has been the most personally painful. I did not fully appreciate the degree of leverage that existed in so many aspects of so many businesses and how painful the unwinding of that leverage would prove to be.

Leverage also can be a good guide on the integrity factor that I mentioned earlier. One of the great investors I've tried to learn from is Shelby Davis. Shelby said that you almost never come across frauds at companies with little or no debt. If you think about it, that statement makes perfect sense. If a bad person is going to try and steal some money, they will logically want to steal as much as possible. Typically, that means they will have as much debt on the books as possible in addition to equity in order to increase the size of the haul. Staying away from excessive leverage cures a lot of ills.

Another huge mistake that I think people in general make is to mislabel risks. Specifically, people seem to think about risks in nominal rather than real terms. To have a lot of cash or government bonds has been a comforting thing in the past few years, but I think it is a mistake to think that means you are not taking risks. You are, it's just that you are taking real risks as opposed to nominal ones. The purchasing power of the currency continues to decline. It is a huge mistake not to take that into account.

The other types of mistakes are well known and probably not too valuable to rehash. Chasing performance, thinking you can really effectively trade in and out of the market, using volatility as a precise quantitative measurement of risks etc... are all potential mistakes that investors tend to make.

To circle back to your original question about what is the single biggest risk, I would try to summarize all of these things as examples of not thinking. You can never put things on autopilot in this world. You must be constantly and continuously engaged with what is happening in business, technology, marketplaces, governments, social trends, demographics, science and absolutely everything you can possibly process in order to be as good a thinker as possible. When you go to sleep each night, be prepared to get up in the morning and do it all again for as long as you are responsible for taking care of people's money. There are no days off.

MOI: The rationale for institutions acting as conduits of capital has been that the average investor cannot possibly know as much as a professional devoted to researching companies on a full-time basis. However, as David Swensen and Warren Buffett have observed, investment funds of all stripes have failed investors on an after-fee, after-tax basis. Has our system of investment by agents rather than by principals destroyed value for the ultimate owners of American equity capital, and if so, is there any remedy?

Gayner: One risk I worry about in this interview is oversimplifying things. I run that risk again in trying to answer this question. I think that principal/agency conflicts describe a lot of what we are struggling with these days. Agents in general became too powerful recently

and abused their stewardship responsibilities to their principals. First off, that is an incredibly broad statement and there are countless examples of agents who are doing a great and honest job. That being said though, in general, the agents have the upper hand and they've abused it.

I make that statement in a broad sense and beyond just the realms of investing and business. Buffett talks about the "institutional imperative" and the behaviors that stem from that notion. One of the central management challenges for any large institution or organization is how to keep the principal/agency conflict in balance. The familiar saying of, "The inmates are running the asylum" is really just another way of describing how agents tend to push aside the interests of the principals over time.

Over the years, I guess that problem has mostly been solved by institutions growing so big that they gradually or suddenly decline or fail. The agents lose their positions and new principals emerge to build up new institutions. It seems like we are going through one of those cycles in a big macro way right now.

MOI: You have observed a "strong connection between managing companies and investing in them." Unlike most investors, you have had an opportunity at Markel to be intimately involved in both managing and investing. How should investors go about building this critical skill set if they don't have an opportunity to manage a business?

Gayner: Well, my wife did her undergraduate degree in chemistry and her master's degree in chemical engineering. When asked about the difference between the two she talks about thinking about things theoretically, doing them on a bench scale, and then scaling them up to industrial quantities. Wherever you are and whatever you are doing you are probably at least thinking about some things theoretically, and practicing them at a bench scale level. Do that as much as possible and scale up where it makes sense to do so. If you are thinking along the way it would seem almost impossible not to learn at the same time.

In my case, the academic training of accounting and the gradual increase in responsibilities in business and investing have all constantly worked together to help me understand, manage, and act. Over the last two years I've told people, "Every day seems like a dog year." I can't help but think that a lot of us are learning tremendous lessons from this period in our lives. Fortunately, with longevity increasing, being only 47 should give me a lot of years to continue to learn and apply better wisdom to my tasks.

MOI: You define a "fair" price as one that allows you to earn long-term returns in line with the returns on equity of the business in which you invest. When paying a "fair" price, the expected return therefore comes entirely from the business rather than from multiple expansion. Based on this definition, the recent market carnage has created an opportunity to pay less than a "fair" price for many great businesses. In Wall Street parlance, does this make you a bull?

Gayner: Yes. This too is a complicated question and I run the profound risk of oversimplifying again. Investing to me is the ownership of an interest in a business. Business to me is the form and organization by which people creatively apply their skills and

talents to solving problems or serving other people. The more a business serves others, and the more problems they solve, the more profitable they will be and the more an investor in those enterprises should make.

I believe that the path of human progress will continue forward. We are not going into a new dark age and I think comparisons with the great depression are over done. Frankly, I am bullish not just because of the valuation opportunity you describe but because of my fundamental belief that as a world we continue to make secular progress amid cyclicity.

The good news to come will surprise me just as much as the bad news did in the last few years but I believe good news will happen. The most energizing activity for me is spend time with my high school and college age children and their friends. They are not scarred by looking at their lower 401k balances. They don't have 401k's. They don't talk about the market and a lot fewer of them are talking about going to Wall Street. They talk about alternative energy, biofuels, technology and other things that will propel human progress in real ways.

I would rather own a piece of their dreams and future economic prospects than a bar of gold or a government bond. Those pieces of dreams are called equities. Equities are congealed intellectual capital and that is what I want.

MOI: As equities declined precipitously in 2008, seemingly with little regard for valuation, some value-oriented investors adopted the view that it was no longer possible to invest from the "bottom up" but that survival depended on having a solid grasp of the big picture as well. Seth Klarman appeared to disagree with this view when he said that he worried from the top down but invested from the bottom up. Has your scrutiny of the macro picture changed as a result of the economic crisis of 2008 and 2009?

Gayner: Seth Klarman is smarter than me and I think he phrased it exactly right. The experiences of 2008 and 2009 exposed some things that I should have been more worried about than I was. I read a lot of financial history and studied about human nature. I've found it is a far different experience to live through this type of period as opposed to just reading about it and I think I will be a better investor as a consequence of having lived through this time.

My main worry right now is the possibility of inflation due to the actions of the government. Inflation is part of how the world is trying to get out from under the excess level of leverage that exists. Not to contradict another gentleman who is smarter than I am, Milton Friedman, but inflation is not just a monetary phenomenon in my opinion. There are psychological aspects to it as well. If inflationary psychology takes hold I don't see how you could keep long term interest rates anywhere near where they are today. If long rates go up then the price of every asset goes down. While I think intellectual capital with repricing ability is the best way to mitigate that risk it will not be fun to go through that process if inflation heats up too much. There is a "tipping point" as Malcolm Gladwell would say where a little inflation is helpful, but too much is absolutely destructive. And I mean destructive way beyond just the stock market but in terms of social fabric issues. I am constantly thinking about this dimension and trying to be a good steward of the finances at Markel in the

context of this risk.

MOI: In his 2008 letter to Berkshire Hathaway shareholders, Warren Buffett commented on the “once-unthinkable dosages” of government aid to banks and other companies. He warned that “one likely consequence is an onslaught of inflation.” How can investors protect themselves from the risk of accelerating inflation? Is buying good businesses with pricing power sufficient, or should investors try to expand their circle of competence to include companies engaged in the production of natural resources?

Gayner: I think I answered this question partially when I answered the previous question. If inflation really gets going, I don’t think anything I can do would really be enough to fully protect against that risk. I would rather own a dynamic business with pricing power than physical assets. Natural resource stocks would probably go up as that environment manifested itself but I’m not sure that those are really good businesses in the long run. Every time an oil company pumps out a barrel of oil, it needs to replace that to keep going next year. The costs of finding new supplies tend to go up just as much if not more than the sales prices. The accounting lags reality since the costs of goods sold reflect historical rather than future costs, which creates an illusory accounting profit that isn’t real in an economic sense. In fact, the misunderstanding of accounting, and agency risks often lead to uneconomic behavior on the part of many managements. As a result of all these factors, I’m not sure that investing in natural resources accomplishes as much as you might want.

The most important real protection is to own businesses which can reprice their products faster than their costs rise. That is a lot easier to say and describe than it is to actually find.

MOI: In a 2007 interview with Morningstar you described Warren Buffett as “the leading teacher of all of us.” What is the single most important thing you have learned from Warren Buffett?

Gayner: It would be impossible to answer this question and do it justice in the context of this interview.

To list a few thoughts though, I think that remembering that investing is based on underlying businesses, constantly working to learn as much as you can about as many things as you can, telling the truth, remembering that you are a steward and that people are depending on you to do your best, and working as many hours of the day as you can stay awake covers a lot of what I think we can learn from his example.

MOI: What books have you read in recent years that have stood out as valuable additions to your “latticework of mental models”?

Gayner: There are a number of books that help you to think and teach you things you didn’t know. We all know [Security Analysis](#) and [The Intelligent Investor](#) and they have stood the test of time.

I think [Mark Twain](#) is a great writer and his insights and observations about human nature and money are invaluable. He was broke and rich several times in his life and his writing

carries an undertone of his struggles with money. You get a twofer from Twain. You can laugh and learn at the same time.

I read endlessly. [John Wooden](#), the basketball coach at UCLA during their dynasty is a hero to me. [General Grant](#) is a hero. [Warren Buffett](#) is a hero. Pick some good heroes and read everything you can about them.

I also like reading about history, psychology, and human nature, technological progress and scientific thought. The world is a fascinating place and you will never run out of rich material if you want to keep understanding more and more.

I think I saw a recent interview with [Seth Klarman](#) where he said something like, “value investing is the marriage of a contrarian and a calculator.” Some books, like Twain’s, the histories and biographies help you with the human nature and contrarian side of that equation. Some books, like the ones about science and technological developments, along with the accounting homework I did a long time ago, help you with the calculator side. Both elements are essential. Each is severely limited without appropriate balance and understanding from the other side.

In addition to the above interview, the MOI Global community is grateful to have benefited from Tom Gayner’s wisdom on other occasions as well. For example, Tom discussed the [drivers of long-term compounding](#) at Latticework New York 2017 and [insurance and the Markel business model](#) at Best Ideas 2013.