Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: Making The Jump

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"I think the See's Candy example has an interesting teaching lesson for all of us. It's the first time we really stepped up for brand quality and it was a very hard jump for us. We were used to buying dollar bills for 50 cents." *– Charlie Munger, 1997 Berkshire Hathaway Annual Shareholder Meeting*

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In 1972, Warren Buffett and Charlie Munger did something a little out of the ordinary…they paid up for quality. Until that point in their careers, both investors had masterfully deployed the art of deep value investing, taught by Buffett's mentor Benjamin Graham. Yet it was the purchase of See's Candies that largely started the trajectory of the investors style into higher quality businesses, a style they are still known for today.

So why did they make the jump? Before answering that question we must first understand what deep value investing is, and what limitations there are to its style.

An Overview of Deep Value

The concept of deep value investing is fairly straight forward. A deep value investor acquires securities of a company for a price well discounted from the value of the assets, or in the words of Charlie Munger, "buying dollar bills for 50 cents." Acquiring the securities at a price below the assessed value of the assets gives a "margin of safety." Overtime, deep value investors see a return on their investment as the gap between the price paid and the assessed value close. Deep value investors tend to lead with an analysis of the balance sheet and have less interest in the businesses' operations. Metrics such as tangible book value, net current asset value, net-net working capital, and net cash are common approaches deep value investors lean on to sort through investment ideas.

Make no mistake, deep value investing certainly has its appeal. When done correctly, acquiring assets below their book value can be a profitable endeavor. However, there is a reason Buffett and Munger switched their focus to quality.

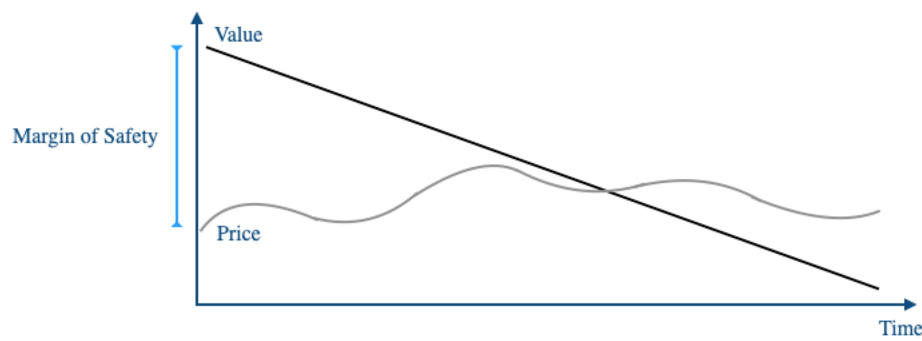
The Challenges with Deep Value

All styles of investing have challenges. Understanding these challenges allows an investor to assess if the style is good a personal fit. As it pertains to deep value investing, one must consider the following challenges it presents:

Assets Today – The first challenge with deep value investing revolves around the assessment of assets. When Benjamin Graham was deploying deep value investing, the balance sheets of companies were largely different than they are today. The left side of the balance sheet was made up of hard assets like inventory, machinery, factories, and land. Buffett too was able to operate in this environment for most of his early years. Today companies have more intangible assets such as intellectual property and goodwill. The difficulty with intangible assets is they are harder to value and can actually be of different economic value when held by different owners. Whereas a used tangible asset like a John Deere tractor would likely hold an agreed upon value regardless the owner, the value of intangible assets are less certain and more subjective. The degree of difficulty in valuing intangible assets weakens the type of margin of safety that created the advantage for deep value investors in the first place.

Catalyst Driven – Nonetheless, assuming you do find a deep value opportunity with traditional tangible assets, what happens next? Most investors make the mistake of thinking that because something is well discounted it will all of a sudden reprice once they buy it. The reality is some sort of catalyst will have to occur for that value to be realized. This can come in the form of a spin off, asset sale, or some other event that unlocks value held on the balance sheet. These catalyst events are rarely driven internally (which is why the company is priced in deep value territory altogether). In most instances the catalyst event you are waiting for will require overhaul of leadership and is better executed by activist investors or liquidators. The timing of these events can take years, which leads to the problem of…

Time Erosion of Value – While you are waiting for catalyst driven events to unlock value, the operating troubles that brought these businesses to their deep value levels will move many into worsening conditions and even levels of insolvency. Poor and even mediocre businesses come with the inherent flaw of destroying business value over time. Troubled businesses often deploy capital just to survive. Not only do these actions produce poor returns on capital, but it also eats away at the margin of safety the deep value investor was attracted to in the first place. As time goes on, the overall return potential shrinks.



Well Diversified – The likelihood of worsening operating conditions and levels of insolvency means a deep value investor must hold a large basket of securities. Doing so, prevents an investors entire bankroll from being wiped out when a few individual investments go under. The trouble with this is the advancements of technology have improved the ability to find discounted tangible asset values. Market forces more easily sniff out clear discounts to tangible value, bidding up the price and closing the overall discount. This creates less overall true deep value opportunities for investors. As a result, most investors chasing deep value are holding less actual "deep value" opportunities and more just mediocre companies selling at cheap relative valuation metrics. Mediocre companies can be more dangerous than deep value companies. In a mediocre company decisions are less easy. Management will chase opportunities in last ditch efforts to starve off the inevitable. As investors, mediocre companies attract capital in what is referred to as value traps. This can create a dire consequence for investors in the form of a slow loss of capital and huge amount of opportunity cost.

Temperament – Assuming you find deep value opportunities numbered enough to build a greatly diversified portfolio, you must conquer the next challenge of knowing your personal temperament. To understand this, let's run a hypothetical scenario…

Let us assume you find yourself owning a portfolio of deep value securities in lackluster businesses at best. Each day goes by with you excitingly waiting for others to realize what you know about the asset discount, or for some catalyst event to be announced sending the security price soaring to its true value. Month's go by, not much happens. A year goes by and despite understanding that time has eroded a portion of your return, you hold steady. All of a sudden a hiccup in the economy occurs. Nothing too bad but enough disruption that you start calculating how many of your companies can withstand a prolonged period of poor(er) operating conditions. Your calculations suggest it will be tight but they can make it. Not much later a sudden but typical market sell off occurs, and because you are holding the "not so good" businesses a large majority of your securities sell off 30% below your purchase price. Now you find yourself; 1) Holding bad companies with 2) worsening operating conditions than when you entered the investment, while 3) accepting that the intrinsic value has eroded with the passing of time and 4) sitting at 30% below your

purchase price. And to add a little satire - you can be sure this will all happen when your cousin who knows nothing about valuing businesses, tells you they made a fortune buying the stock of a futuristic truck company that's only accomplishment has been rolling a nonworking model down a hill.

To play that game requires quite the temperament. Even if you are right there is a deep level of mental agony that comes with those long stretches of time.

Inefficiencies - If you have the temperament to stick out the dark times of deep value, your wins will create equally challenging propositions. As your deep value investment approaches your calculation of intrinsic value, you will constantly have to play the game of "will it, won't it" be the closest price it gets to your exit price. Remember time erodes the value of poor and mediocre businesses. Your potential return fades as time expands. This can lead to pulling the trigger on an exit all too soon, or overestimating and missing the exit altogether.

Assuming you sale, you now have tax consequences. If your holding period was less than a year, you likely maximized your return in the form of the asset discount closing at a rapid rate to your assessed value. However, you'll be subject to short term capital gains tax which takes a much larger chunk of your overall profit. If your holding period exceeded a year, you likely took a hit on the overall realized gain with the time erosion of value, but lessened your tax consequence because of the long term capital gains rate.

Yet taxes are just part of the inefficiency. Exiting your position puts cash on the sidelines. At times this is a great position to be in. However, cash is also subject to inflation as well as "cash drag" on overall returns. This puts pressure to redeploy capital into new ideas. The trouble is more activity in investing doesn't necessarily mean more success. The greater build in cash, the greater likelihood the pressure to deploy capital will create unnecessary action, which ultimately leads to more errors.

All this to say these are just a few challenges with deep value investing.

<u>In Closing</u>

So, why did Buffett and Munger make the jump to quality?

Well, if you're not convinced by simply understanding the challenges of deep value, stay tuned for next month's memo where we discuss the benefits of quality…

Until then,

M. Carter Johnson

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