BARRON'S

INTERVIEW

Bruce Greenwald: Channeling Graham and Dodd

Everyone thinks the market is expensive. It isn't, says Greenwald.

By LESLIE P. NORTON

Updated May 13, 2017 12:23 a.m. ET

"The nightmare scenario for value investors isn't passive investing; it's everybody takes a value approach." —Bruce Greenwald *Jayne Wexler for Barron's*

When Bruce Greenwald moved to Columbia University from Bell Laboratories in 1991, Columbia alumnus and *Barron's* Roundtable member Mario Gabelli gave him tapes of lectures by Roger Murray, the retired professor who took over the legendary course in value investing that was once taught by Benjamin Graham. Value investing wasn't wildly popular at the time, and those tapes put Greenwald in mind of "an anthropologist trying to save a dying language." But when he listened to the lectures, he says, "it was just immediately clear that approach was a much better way to do things."

Greenwald has trained a generation of value investors and routinely wins plaudits for his classes, at which Warren Buffett is an occasional guest. Next year, the second edition of his popular *Value Investing: From Graham to Buffett and Beyond* will be issued. With money continuing to pour into index funds, and Columbia students set to receive their M.B.A.s, *Barron's* recently sat down with Greenwald at a coffee shop near campus. The 70-year-old opined on the flaws in discounted-cash-flow valuations, the best value investors, the stock market, globalization, and a host of other subjects. Read on for more.

What is value investing?

Greenwald: If you are going to outperform the market, somebody else has to underperform. You have to think, "Why am I the person on the right side of this transaction? Because every time I buy something I think is a good idea, someone else is selling it to me." Now, lay that beside an investment process that searches for areas where you're more likely to be on the right side of the transaction, using basic value [criteria]. One is so obvious, it's a crime that people don't do it more. Suppose I spend my life writing onshore South Texas Gulf Coast oil leases. You fly down from New York and buy one from me. Who do you think made money on that transaction?

In life, specialists do better than generalists with the same level of intelligence. Ben Graham [who with David Dodd wrote *Security Analysis*, the bible of value investing] started out specializing in railways. He was the first one to look at the ICC data, instead of the very misleading data companies put out. [Graham looked at Northern Pipe Line's filings with the Interstate Commerce Commission in 1926 and found that it owned railroad bonds and other assets worth $95 a share, even though its stock fetched $65.] Specialization is an old and honorable Graham and Dodd tradition. Look at people like [noted value investors] Tom Russo and Mario Gabelli; they all have specialties. When you start out, you want to have an industry focus.

Isn't value investing about buying cheap stocks?

There's a Graham and Dodd overlay that goes by the name of value investing, which is this idea that you will do much better with ugly diseased stocks than glamorous stocks. People have always shied away from ugly diseased opportunities. So you can take advantage of their loss aversion. What amplifies this is that people think they know much more than they do. The whole discourse about stocks is not "this is a good stock with a 65% probability" [of success]. It's "this is a good stock for sure," or "this is a piece of crap." That's just not the way reality is. It exaggerates the value of glamorous stocks and radically and consistently undervalues diseased stocks.

What’s the Bruce Greenwald spin?

Let’s start with having a better value approach. If everybody else is just doing ratio valuations, I’m not going to do better than them. Many business-school graduates try to do discounted cash flows. They estimate cash flows for five or six years, then do a terminal cash flow on a terminal growth rate and a terminal cost of capital and get a terminal value. They do a lot of variations on the assumptions and think they know what’s going on. But they never look at the balance sheet. There is a fundamental stupidity about discounted-cash-flow valuations. Depending on what you plug into the equation, you can get widely disparate multiples. You are combining very good information, your estimate of near-term cash flow, with very bad information, your estimate of distant cash flow. When you add bad information to good information, bad dominates.

We start with the balance sheet, which doesn’t project anything. If it’s a nonviable industry, I can make assumptions about liquidation value, or if it’s viable, about how the assets can be reproduced in the most efficient possible way. The second-most reliable piece of information is the profit-generating capacity of that business, normalized for accounting distortions and cyclical factors. Forget the growth and the forecasting. Let’s look at what is there today.

Is there a third element?

Yes. It has to do with the Warren Buffett instinct, the strategic assumptions. So Buffett tries to incorporate these judgments directly in his valuation. Let me give you three examples. In case one: A company has an asset value of $8 billion, and earnings power of $4 billion [normalized earnings, divided by the cost of capital]. Asset value vastly exceeds earnings-power value. The takeaway is that value is being destroyed by weak management. If they borrow to grow, they’re destroying the capital. That’s where value traps come from. Does a discounted cash-flow calculation tell you that story? Not in a million years.

Case two: Asset value and earnings power are about equal, which is exactly what would happen in a competitive market. Growth is worth zero, because competitors enter and drive the earnings down.

Case three: Asset value is $8 billion, and let’s assume earnings-power value is $40 billion. This is the Coca-Cola (ticker: KO) case. For that to be sustainable, there have to be barriers to entry. This is Buffett’s moat stock. Are there economies of scale, barriers to entry, customer captivity? I can look at reproduction value, which is a hell of a lot better than some forecast 10 years into the future.

Graham and Dodd concentrated on the competitive businesses and the badly run businesses—the cigar butts. Buffett started to analyze those first, but today he prefers franchise businesses, or those with moats.

He talks about a circle of competence. He doesn't mention the obvious extension of that, which is to say, "Look, everybody has got a limited number of specialties, and they ought to stick to that." It applies to Warren Buffett, too. So if you look at his performance in insurance, banking, in consumer nondurables, and—until it fell out of bed—media, it is much better than his performance in other areas. Now his performance in other areas is good because he is a phenomenal investor, but even for him, specialization applies.

What place does value investing have in a market that is all about passive investing and momentum? Even Buffett has endorsed passive investing.

A good active investing process consists of a value orientation, specialization, and, to be in the upper half of the return distribution, reliability. Buffett isn't telling you the full story, because he doesn't want to create competition for himself. He is saying yes, by all means do passive investing, but [he isn't saying that] to people who understand and apply these principles in a disciplined way. Is he going to do passive investing himself? Of course not. And remember, even with this trend, 70% of people are doing active investing. And passive is not so passive. These guys jigger the models all the time. The nightmare scenario for value investors isn't passive investing; it's everybody takes a value approach.

Have your course enrollments declined with the increasing popularity of passive investing?

Not much for the value program. In our classes, they learn to understand what competitive advantage is and how to invest under those circumstances, all of which are crucial to running a company. The other finance courses aren't doing so well.

What do you tell your students?

I tell them—which they don't like at all—that they have to specialize. If you go to a firm, and they have you doing autos for one month and consumer nondurables for another month, and then they start you looking at financials, you aren't going to master any of it. You are going to make stupid investment decisions, and they are going to fire you. You want to spend two to three years developing a specialty. When you get good at that, you can start to develop a second specialty. Once you appreciate what specialized knowledge of an industry looks like, then you have to be disciplined about looking in that area and at the disasters there. So if you have three specialties, two in industries hitting on all cylinders and the third is underperforming, where will you spend all your time? The underperforming one, so you can assess the probability of recovery.

What is your role at First Eagle Investment Management, where you are a special advisor?

I was director of research, half-time, for years. Ultimately, my job was to make sure analysts apply the principles I've described. I make sure everybody is a specialist and is disciplined in looking for opportunities.

Where are you finding value today?

The best way to find value consistently is to take a trend that isn't well understood and take advantage of it. Everybody today talks about disruption. [But] manufacturing is dying because productivity growth is 5% to 7% and global demand growth is maybe 2% to 3%. Employment is dying, value-added is dying.

If you look at a company like Deere [DE], making equipment is a small part of what they do. A lot goes into putting it to work and making sure it works. A lot of the company is driven by local software. Because the equipment lasts longer, the secondhand markets are a big deal. Those markets are local. For financing, you need local information so you can know the good risks. Imagine that in Illinois, 90% of the tractors and harvesters and seeders are made by Deere. Who will have the best service? Which second-hand market will be the most dense and therefore easiest to sell? Who will have the best information and financing? Deere. Kubota [6326.Japan] will have a hard time trying to break into that market. And Deere, even if it temporarily suffers in sales, has a service base that means it's not going to compete on price.

So you are suggesting that globalization…

…is finished. Trade is falling. All the production will come back to the U.S., but none of the jobs. You want companies that look like manufacturing companies where increasingly, the service component is so important. Companies with sensibly focused geographic interest. The Deeres of the world with good local strategies. I'm chairman of a fund in Europe called Paradigm Capital that is finishing its 10th year. When we find a company that fits the profile I've just described, we and our investors buy the whole thing. One company makes the controllers to open and close subway and train doors. If they break, you're in serious trouble.

Who are the best value investors?

Warren Buffett, obviously; Seth Klarman [Baupost Group]; Howard Marks [Oaktree Capital Management]; Mitch Julis [Canyon Partners]. They are very disciplined. And you want people who are good judges of business. Glenn Greenberg [Brave Warrior Advisors] is a superb judge of where the moat is, how sustainable it is. Li Lu [Himalaya Capital] is very good at picking management. So is David Swensen [Yale University endowment].

What is your market view?

Everyone thinks the market is expensive. The question is: How expensive? Jeremy Grantham says profits were about 2.5% in 1990 and about 4.5% today. He'd tell you this isn't sustainable. But if you followed what I said about what happens when you move from a competitive global manufacturing market to monopoly-like service markets, the profit share should go up. I think the 4.5% is here to stay, and the market isn't as badly overvalued as he says. The current administration will help a little. To some extent, it will benefit profits significantly. On the other hand, nobody’ll get hired.

Thanks, Bruce.