MARGIN *of* SAFETY

"In the old legend the wise men finally boiled down the history of mortal affairs into the single phrase, 'This too will pass.' Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY." [1]

- Benjamin Graham

WE THOUGHT IT WOULD BE A USEFUL EXERCISE to review the "first principles" that drive *Burgundy's* investment philosophy. Our approach can best be summarized as making concentrated investments in well-managed, high- quality companies that are purchased at significant discounts to their intrinsic values. Like any investment style, it can be out of favour and trail broad benchmarks for a period of time, but we are confident that our approach leads to strong investment returns over the long term.

Investments always carry short-term *market risk*, and that can never be completely eliminated or diversified away. We believe, however, that by thoroughly assessing and analyzing each company held in our portfolios, *business risk* can be minimized. If the investment is then made at a substantial discount to intrinsic value, then investors will truly have found a "margin of safety" that should preserve capital. As Warren Buffett states so clearly, "Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1."

WHAT ARE THE KEY CHARACTERISTICS OF A HIGH-QUALITY COMPANY?

The year 2000 demonstrated why the quality of a company and its earnings do matter when buying stocks. During the height of the technology stock mania (Q3/99-Q1/00), speculators sent the shares of many unprofitable companies soaring. It was quite a painful period for value investors like *Burgundy*. Inevitably, the reign of these stocks was relatively short lived.

The direct relationship over the long term between performance and profitability is the reason that the identification of high-quality companies with real earnings (rather than those with only the potential for distant earnings) is the starting point of our investment process. We look for companies that:

- sell a product (or products) for which demand is stable and recurring,
- enjoy limited competition, and
- are in industries that have high "barriers to entry."

1 Graham, Benjamin, The Intelligent Investor; Harper & Row; New York; Fourth Revised Edition, 1973

Companies possessing these characteristics enjoy a degree of control over their economic destiny. They have a competitive advantage and therefore strong market position. These companies usually earn high returns on equity and generate significant free cash flow. This last item, free cash flow, is critical to our evaluation. Accounting earnings alone are inadequate for complete analysis - look no further than the travails of Enron and WorldCom as examples. A company must generate cash that can be reinvested in the business or returned to shareholders in the form of a dividend or a share repurchase if we are to invest in it.

WHAT ARE THE SIGNS OF A GOOD MANAGEMENT TEAM?

Good management is an integral component of a strong company. Our evaluation of a company's management is based primarily on how well they run their business (i.e., their operating skills) and how they use the earnings (allocated capital) within that business.

How well they run their business is a relative assessment versus other management teams in the industry. We compare operating profit margins, returns on capital and any industry-specific operating measures. For example, in a retailing enterprise, same-store sales growth rates would be compared. But the approach must be more than just a quantitative one. We also try to get a sense of the intangible factors that make a great Chief Executive. Does he love his business? Is she obsessed with driving down costs? Does he enjoy beating his competition? Does she need to win? In our opinion, the most effective way to assess these intangibles is by visiting the company and spending time with its executives. The company's direction can be examined by carefully reading its Annual Report and meeting with the CEO to understand his vision. And very importantly, it can also reveal whether the company is being managed for the short-term benefit of Wall Street or the long-term interests of its own shareholders.

How well management allocates capital is key to our analysis. Companies that generate significant free cash flow in excess of their maintenance capital expenditure requirements are at the greatest risk of making poor capital allocation decisions - simply because they have the excess capital to deal with in the first place.

The capital allocation decision is of particular importance because, as minority shareholders, we have little control over these policies; control lies with top management. Our fear is that a company's Chief Executive Officer may decide to frivolously spend the company's excess cash; he may buy a couple of corporate jets, construct a 20-storey 'world' headquarters or, worst of all, acquire an unrelated, inferior business.

Inferior acquisitions have been a great destroyer of shareholder wealth. Wall Street investment bankers are only too willing to massage a CEO's ego by providing "expert" analysis of acquisition targets, which would increase the size of the CEO's domain. They produce "independent" valuations showing how much shareholder wealth will be created, even if it often means overpaying to acquire another company in an unfamiliar industry. So, after the CEO has indulged his ego, and the bankers have collected their large fee, the shareholders are usually left with an unpleasant outcome. Peter Lynch, the renowned investor, referred to this frequent event as "*diworsification*." Most acquisitions eventually destroy shareholder value (for the acquirer's stockholders), so we are very wary of acquisitive companies. We will only invest in those companies whose managements have a very disciplined value approach and have a good track record of integrating acquired companies. Capital should be allocated only to those projects that are expected to earn a rate of return in excess of the corporation's (i.e., shareholders') cost of capital.

Equally important is management's candor with shareholders when discussing the business and its prospects. Because public shareholders are minority owners, they are not privy to "boardroom discussions," so corporate insiders should be sufficiently transparent to their shareholders. It is crucial that they help owners gain a better understanding of the company and the environment in which it operates by explaining the factors that drive success and those that cause failure in their industry. A Chief Executive Officer who openly discusses the company's business risks is usually one who has also considered how to deal with those risks.

Wall Street often refers to a management having "lost credibility." We think that one of the best ways to earn credibility with investors is to rarely "surprise" them with bad news. By introducing the potential for negative outcomes and the manner in which the company is prepared to address them, a manager engenders confidence in shareholders, even when manoeuvring through difficult times.

No matter how much thought executives give to potential outcomes, they will still make many mistakes throughout their careers, some small, others large. What differentiates good managers from the others is their ability to admit a mistake has occurred, analyze it, and learn from it. In our own analysis, we believe that we learn more about an industry by studying the mistakes made, rather than the success achieved, and we highly regard a CEO's candor in these matters.

Warren Buffett perfectly encapsulates our views on the importance of straight-talk in the following statement: "The CEO who misleads others in public may eventually mislead himself in private." It is shocking how often we find this to be the case.

WHY BUY AT A DISCOUNT TO INTRINSIC VALUE?

The inevitable reversion of excessively high stock prices to reasonable levels clearly shows that valuation does matter. Ultimately, what counts are the cash flows you earn from an asset, the rate at which these cash flows grow and the interest rate at which they are discounted. When combined, these three factors provide an estimate of a company's "intrinsic value." Our investments are based on a comparison of their cost versus their intrinsic value. Before making an investment, a company is ideally trading at an approximate 30% discount to our estimate of its intrinsic value, thereby providing a significant margin of safety. We are sensitive to the price we pay, because forecasting the future with absolute certainty is impossible. This large cushion between the price paid and our estimate of the asset's true value provides a "margin of safety" against any unforeseen negative events.

The fundamental premise of capitalism is that capital moves from low return projects to ones that are expected to generate the highest risk-adjusted returns. Capital is therefore attracted to the most undervalued assets since, as their market price rises to intrinsic value, capitalists earn the highest return on their investment. That is why value investing has consistently been the most successful form of investing over the long run, and why the Forbes 400 list of America's richest people includes value investors like Warren Buffett and Charlie Munger (Berkshire Hathaway), Ned Johnson (Fidelity Investments) and David Gottesman (First Manhattan Co). It is important to note that a stock purchased for less than its true worth is not expected to immediately appreciate to its intrinsic value. The same factors that caused the undervaluation in the first place (perhaps adverse market conditions or incorrect investor perceptions) may persist for long periods of time. The value investor must have confidence that in the majority of cases, the situation will be rectified. As Ben Graham, the dean of value investing observed, "In the short run the market is a voting machine, but in the long run it is a weighing machine."

WHY MAKE CONCENTRATED INVESTMENTS?

At *Burgundy*, we prefer to make investments in relatively fewer companies than the average fund, contrary to the conventional view that diversification is the best way to minimize risk. A number of managers use this latter method to diversify away risk mainly because, in our view, they know very little about the companies in which they invest. Often, the only result overdiversification guarantees is average performance. Instead, we believe that risk can be more effectively reduced by thoroughly researching and understanding companies and their managements, and then owning a portfolio concentrated in the most appealing of these investments.

While concentrated value portfolios have the ability to produce above-average, long-term performance, their short-term results can be more volatile. A portfolio invested in fewer securities may experience greater swings against the market average, as compared to one invested in many more securities. Academics refer to this as volatility "risk" and try to diversify it away. We view this volatility as an opportunity and take advantage of dramatic swings in stock prices - especially when they decline. These declines provide opportunities to invest in terrific companies that are often unfairly battered by the markets.

CONCLUSION

Invest only when a significant discount to intrinsic value exists. Invest in high-quality businesses run by capable, honest, shareholder-minded managers.

By carefully applying these "first principles" we strive for a "margin of safety" in every investment that we make. As value investors, we believe this approach to investing preserves capital and generates strong long-term investment results.

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