The VIEW *from* BURGUNDY

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THE OUTSIDE ZEBRAS

JOHN TRAIN, IN HIS OUTSTANDING BOOK, *The Money Masters*, relays the following story in his chapter on Ralph Wanger. Wanger, as manager of the well-known Acorn Fund, is a famous investor, and is obviously a very talented writer.

Zebras have the same problem as institutional portfolio managers. First, both seek profits. For portfolio managers, above average performance; for zebras, fresh grass. Secondly, both dislike risk. Portfolio managers can get fired; zebras can get eaten by lions.

Third, both move in herds. They look alike, think alike and stick close together. If you are a zebra, and live in a herd, the key decision you have to make is where to stand in relation to the herd. When you think that conditions are safe, the outside of the herd is the best, for there the grass is fresh, while those in the middle see only grass which is half-eaten or trampled down. The aggressive zebras, on the outside of the herd, eat much better.

On the other hand – or other hoof – there comes a time when lions approach. The outside zebras end up as lion lunch, and the skinny zebras in the middle of the pack may eat less well but they are still alive.

A portfolio manager for an institution such as a bank trust department cannot afford to be an Outside Zebra. For him, the optimal strategy is simple: stay in the centre of the herd at all times. As long as he continues to buy the popular stocks… he cannot be faulted. To quote one portfolio manager, 'It really doesn't matter a lot to me what happens to Johnson & Johnson as long as everyone has it all together.' But on the other hand, he cannot afford to try for large gains on unfamiliar stocks, which would leave him open to criticism if the idea fails.

Needless to say, this Inside Zebra philosophy doesn't appeal to us as long-term investors.

We have all tried to be Outside Zebras most of the time, and there are plenty of claw marks on us.[†]

The Value Investor as an Outside Zebra

We think Ralph Wanger's story has an important message for value investors. True value investors buy only when a stock is too cheap, and sell when the market price is too expensive compared to the true intrinsic value of the company.

While value investing is a style of investing that a fair number of professionals talk about, in our opinion there are very few who practice it successfully. The reason is that, like the Outside Zebra, being a value investor is often an uncomfortable position to be in. It requires the willingness to do what is unpopular and the discipline to stick with your decision while the majority of investors are going in a different direction.

At Burgundy, we are entirely committed to value investing. Doing it successfully is, we believe, our greatest strength.

Value in Canadian Equities

There is a great start to 1993 as the Burgundy Canadian Equity Fund returned 19.9% compared to 8.3% for the TSE 300 Index. While one swallow does not make a summer, it is nice to score a few runs early on in the ballgame. This extends the record of outperformance relative to the Index dating from 1981 by the Fund's manager, John Di Tomasso.

Our "bottom-up" value investing approach is so-called because our focus and analysis is directed towards the purchase and sale of specific investments. This technique is especially pertinent to stock selection. We are the other end of the spectrum from the "top-down" approach – which is an attempt to understand and determine the implications of the big picture (global macroeconomic factors such as interest rates, currencies, etc.). This overview then works its way down through the Canadian economy and various industry groups, and eventually assesses individual securities within those broader contexts.

The top-down method is comprehensive – too comprehensive, actually. There is simply more information (which changes by the minute, incidentally) than any person or group of persons can assimilate and properly integrate into a world view designed to produce successful investment decisions. Given the millions of factors that must be identified, understood and correctly placed within a dynamic context, the job requires superhuman effort and ability.

At Burgundy, we recognize that weighty matters like GNP growth, future interest rates and the monetary policy of central banks affect securities markets in a major way. And sure, it's fun to play armchair economist with the boys over a cognac or two, yet even then it is difficult to get a consensus, let alone a confident conclusion. So, in our experience, the end result of all this work is economic forecasts that have little predictive value where it counts: investment results.

We have found that it is better to focus our efforts on the valuation of individual companies, particularly on the calculation of intrinsic value, and the comparison of intrinsic value to market price.

However, after this disclaimer regarding macroeconomic analysis, it is our general view that we are in a recovering economy, if only in a slow way. Canada has had three very grim years and we feel that some factors are now improving. It should be remembered that Canada is basically a very rich country. Significant restructuring of companies, closing inefficient operations, increasing productivity and paying attention (at last!) to international competitiveness have all been going on in a major way for several years. While painful, these steps should lead to a stronger base and eventually a more prosperous corporate Canada.

Most important of all is that some good companies are available at very reasonable prices in comparison to Burgundy's estimate of the company's intrinsic value. These bargain companies appear in various areas of the economy but, in our opinion, they are at the moment particularly prevalent in the industrial (St. Lawrence Cement, Dofasco) and financial sectors (TD Bank, National Trust). The opportunities are less common now than a year ago; the stock market has gradually increased in price and is an average of 9% higher than it was then.

It goes without saying that a stock should be sold when it becomes fully priced. Sometimes, however, a particular stock (for any number of reasons) will become the darling of the street and gain momentum, or an industry will capture the imaginations (and the pens) of brokerage analysts. At such times, even though our targeted price might have been reached, we might hold onto the entire position, or sell only a part of it, in order to let the market carry the stock higher. This is not our usual practice, mind you, since it presumes that this overpriced security will become even more overpriced – the greater fool theory. True, market prices do fluctuate between extremes of over- and undervaluation, but one must recognize that holding an overpriced stock implies, from that point, a greater price risk than the potential reward.

Although we are still able to find enough Canadian opportunities to efficiently diversify our portfolios, they are becoming fewer and we may set aside cash reserves as targeted sales take place.

Value in the U.S. is Harder to Find

We are finding it difficult to identify bargains in the United States as stocks overall are being valued at much higher levels than in Canada. Nevertheless, we have established positions in a few new American companies that we judge to be of outstanding value.

An example is Loews Corp. (NYSE $98) following its recent sharp decline. We believe that Loews is an excellent example of a good company that is very significantly undervalued. The key reasons follow:

- Loews is run by a great investor and businessman, Larry Tisch. There is no doubt that Tisch is one of the great investors of our day and someone we have admired for many years. John Train's *The Money Masters* contains a full chapter on Mr. Tisch, who is ably assisted in his endeavours at Loews by several relatives including Jim Tisch, his son. Insiders own 26% of the stock.
- Over the past 10 years, book value per share has grown from $16.92 in 1982 to $84.10 in 1992, which, coupled with dividends, means shareholders have had a return of 20.7% per annum over the decade.
- Loews is in casualty insurance (control of CNA Insurance), tobacco (Lorillard), Loews Hotels, Bulova Watches and CBS Television. Through CNA, Loews has a very large securities portfolio, and also a large corporate portfolio.
- The company has an excellent financial record with 10-year return on equity averaging over 15%, and an even better record of building shareholders' value since Loews had been constantly buying back its own stock for many years. This is clearly a company exhibiting canny capital allocation skills, using excess cash flow to buy back its own undervalued stock and creating value on a very tax efficient basis for its shareholders.
- The loss in 1992 reflects the establishment of a $1.5 billion reserve at CNA for asbestos suits.
- The current share price is $98. If the book value is adjusted to market for its CNA shares (it is a public company on its own) and availing Lorillard at 10 times pretax earnings, Loews is worth $195 per share or twice the current price.
- The current price of $98 compares to recent analyst estimates of $11 per share for a PE ratio of 8.9 times.

Endnotes

†. Train, John. The Money Masters. New York: Harper & Row Publishers, 1989.

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