FEATURES

Value Investing Meets Momentum Investing

By Eli Rabinowich

Welcome to “Profiles in Investing”, brought to you by The Bottom Line and The Heilbrunn Center for Graham & Dodd Investing. Every week we will profile a leading investor and get an inside look into their investment philosophy.

Up next, Rich Pzena.

Professional History

• Managing Principal and CEO Pzena Investment Management
• Director of U.S. Equity Investments and Chief Research Officer, Sanford C. Bernstein & Company.
• Institutional Investor All America Research Team from 1988-1990
• B.S. summa cum laude, M.B.A. Wharton School, University of Pennsylvania

ER: How did you first get started in the investment business?

RP: Well, I guess I’ve always been interested in the stock market. When I went to school I wrote my master’s thesis with Joel [Greenblatt] and another guy. It was basically a review of Graham and Dodd, on how the small investor can beat the market. We wound up having it published in the Journal of Portfolio Management. I took security analysis. I thought why would anybody ever do this for a living. Professionally, I started in the investment business in 1986 when I joined Sanford Bernstein as an oil industry analyst. Prior to that, I had worked for Amoco for five years after business school. The oil industry at the time was the “hot” industry. It was like technology in 1998, 1999, and 2000. It’s hard to imagine, but 32% of the S&P 500 was energy in 1981. Technology got huge and 2000. It’s hard to imagine, like technology in 1998, 1999, the oil industry at the time was undergoing a major expansion. They really got “hot” in the mid-80’s and by the late 90’s the firm was expanding into a lot of different products – one of which was small cap value. So, I got the opportunity to basically start their small cap value product. I took it from the business plan stage to hiring the research department and developing the whole investment process, marketing it, and actually wound up raising about a billion dollars. This was in 1991. Shortly thereafter, Bernstein retired and Lew Sanders became the chairman and I became Director of U.S. Equity Investments. My responsibility was really to oversee the whole domestic investment process working very, very closely with Lew on Strategic Value, Bernstein’s Deep Value product.

ER: When did you start your own firm?

RP: After Bernstein got really big, around $80 Billion, I started getting “antsy” about wanting to do something on my own—really a personal dream more than anything else. As firms get bigger and bigger, it becomes less fun for someone doing real research because your ability to have a significant impact through research is diminished. When I left, my real dream was to be able to do the kind of quality research and work that happened at Bernstein but do it without the constraints of having so much money. So I left at the end of 1995 to start my own firm.

ER: Tell me about starting your own firm.

RP: We actually started in Joel’s conference room—he let us use his conference room for several months before we got some space. The stress of the first year was building the infrastructure and research team. Then, starting in the fourth quarter of 1997, we entered probably the worst value environment in history with the Internet bubble. We went through two and a half years of really being tested. That was the hardest period of my life — because we weren’t really established as a firm at that point in time. We had a good record the first seven quarters, and then we went through ten quarters of really lousy performance. Not that we lost a lot of money for people but we just didn’t participate in the big rally. Those were the years when the S&P was up 30% each year and the NASDAQ was up 100%. That was the hardest.

ER: Were you invested at that time or were you in cash?

RP: No, no, we were fully invested. We were so excited about the prospects of what was available in the value world that we were going around making speeches about how crazy the world is and “look at these companies that you can buy—they’re four times cash flow and they’re #1 and #2 in their markets. There’s nothing wrong with them.” And then you would look at what somebody would pay for Cisco with a $500 billion market cap and $1 billion in earnings, and you think, how could that be? To get a 15% return on your $500 billion you have to make $75 billion – I’m just doing simple arithmetic – How could you believe this, right? We stuck to our discipline during that two and a half year period and then we were going through it, it was awful. But when you look back on it, for us it was really a blessing in disguise because so many of our competitors drifted away from their discipline of being value investors because they couldn’t take the pressure—couldn’t take the client pressure, couldn’t taking losing every day. And, so when the rebound came, we were very well positioned. We had a spectacular 2000 and a lot of people didn’t, because if you were in the growth area, you got killed. So, a lot of the value guys really didn’t participate in the big run-up in 2000 and 2001, and that’s what made our business, really.

ER: Can you briefly describe your investment philosophy?

RP: Yes, it’s very straightforward. The simple way of describing it is we are trying to buy good businesses when the price falls dramatically relative to their normal earnings power. You have to be realistic as a value investor because value is created by deterioration. You don’t get to buy the best businesses, with the best characteristics at a low price - that’s not what sells for a low price. So, we first use our computer system to identify potential value candidates. The hard part is making the judgment as to whether the businesses are really any good, whether the problems are in fact temporary or permanent, and whether the earnings really should be higher than they currently are. And, that’s where all the time and research energy is expended. The trade-off is that deterioration creates the opportunity, but deterioration is bad from a momentum investing standpoint (and momentum works), so we try and wait until a company stabilizes before buying.

ER: So, you first identify a stock that is progressing down, but you won’t purchase it until the earnings have stabilized?

RP: Right. We’ll do all the work. And then we’ll just sit on our hands. And wait. For example, we bought Cracker Barrel Old Country Store, a national restaurant chain. Basically, they screwed up. They were a low priced restaurant with lines waiting to get in. Then a new manager took over and decided to raise prices. The plan backfired, sales declined and the stock collapsed. It went from like $42 to $8 at the bottom. It popped up on our screens at $15 but there were still negative sales growth. And, so we monitored the company and did the work. We liked the company. There was a lot of real estate involved in it, so we analyzed the real estate. The company brought back the old manager and his business plan.

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Zell and the Art of Real Estate Entrepreneurship

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heavily with the Real Estate Center at Columbia. To a rapt audience, Mr. Zell kicked off his speech with an anecdote about one of his many trips back to the University of Michigan, when he encountered their new head of Clinical Psychology. “What’s new?” he asked, breaking the silence. “Well,” replied the head psychologist, “In our newest development, we’ve replaced the mice in the mazes with MBAs.” “Oh really?” Mr. Zell responded. The psychologist added, “Yes. For three reasons: 1) there are more of them, 2) the researchers tend to get less attached to them, and 3) there are some things even the mice weren’t willing to do.” As it turns out, the stories of his rule would be more truthful, yet just as entertaining, insightful, and applicable.

Sam Zell got his start by entering the world of real estate while he was still in college, by managing property for student housing. As a student himself, he understood the student mentality. Who would be better equipped, he argued, to effectively manage the property? From there, he began to acquire and invest in property in Chicago, particularly distressed real estate beginning with the property crash in 1970. He went on to form REITs, became the first to publicly finance them, and proceeded to take advantage of opportunities in other segments, adding a varied set of businesses to his holdings. Sam Zell’s view on entrepreneurship is simple; at the most basic level it is all about attitude and mindset. Entrepreneurs, Mr. Zell argued, think from the perspective of an individual rather than that of an organization, or worse yet – conventional wisdom. “Entrepreneurship’s greatest enemy is conventional wisdom,” Zell said. From this foundation he continued to build the rest of the key attributes of successful entrepreneurs.

Being incredibly observant and constantly curious are necessary to those seeking to succeed as an entrepreneur. These characteristics drive entrepreneurs to be on the constant lookout for problems and subsequently devise their solutions. They always increase their knowledge base, and to see opportunities that may be invisible to everyone else. “How can I do it better? How can I make it more effective? How can I see what other people don’t see?” For example, upon recognizing that recent outsourcing trends would undoubtedly affect his business, Mr. Zell flew to Bangalore and invested his time in talking with experts in the outsourcing business. To Mr. Zell, “The real entrepreneur is never satisfied and is constantly asking: What’s out there? What’s the vision?”

Mr. Zell also stressed the importance of simplicity, logic, and common sense. He reminded us about the most basic concept in business, the law of demand as he related a tale about an endeavor concerning railroad cars. During the early 80s, the demand for railroad loads in the United States was flat, and as it experienced no growth, the industry was deemed unfavorable. Because of this, railroad owners began to scrap their railcars, thus decreasing the industry supply by 65%. Keep in mind though that the demand was not decreasing – it was just flat. The profit opportunity Mr. Zell saw was as clear as the flat. The profit opportunity Mr. Zell saw was as clear as the

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was just to roll everything back to the way it was before. And, we thought, well okay, that sounds like a good idea. Sometimes it’s not a rocket science, I gotta tell you. It sounded pretty logical to us. There was a lot of real estate supporting the downside here but same store sales were deteriorating at the time and we didn’t know. But, it wasn’t deteriorating at the time and we thought that this was a really good time to buy.

ER: You also mentioned that momentum works. What do you mean by that?

RP: Yeah, momentum investing works. It does. There is statistical evidence for it. There is statistical evidence for value investing, too. Momentum investing is based on the clear evidence of serial correlation of earnings. If you have an environment where sales are declining, you have a high probability that the next quarter they are going to continue to decline until they don’t anymore. So momentum investing would tell you that investing in a company during a period of continuing deterioration is a bad idea, and that you should wait until stability is reached before making your investment.

ER: What exactly are normalized earnings? Is it an extrapolation of historical trends?

RP: Yes, our system just looks at historical earnings then ranks the companies cheapest to most expensive on the basis of price to normalized earnings. We then overlay our own judgment on it. What we mean by normal reality is what should the business be capable of earning given it’s history—the history is important—but also give the industry structure, given the competitive situation—can you identify specific competitive pressures or minuses that might affect the business plan. So, we use history as the base and then we make a judgment whether history is relevant or not.

ER: What was the best piece of business advice that you ever received?

RP: I don’t know how this is going to sound, but this was the most meaningful piece of business advice I ever got: Find something to do that you really like doing - don’t accept a job where you’re not going to have fun because you think it might lead to something better in the future. Do what you really enjoy.

ER: Thank you very much Mr. Pzena.