

5x5x5 Interview with Founder, Thomas Russo  
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LOUISA SCHNEIDER: I am honored to do this interview on behalf of the Heilbrunn Center for Graham and Dodd Investing and Value Investing at Columbia Business School. You are a legend in the value investing community. Tom, you teach each year in Bruce Greenwald's well-known Legends in Value Investing course, alongside greats like Warren Buffett and Seth Klarman, and you sit on the board of the Heilbrunn Center for Graham and Dodd Investing.

You have recently conceived and formally pledged to give a gift to create and fund the first-ever Student Value Investment Fund at Columbia Business School. First off, thank you for your vision and your dedication to value investing and, in particular, value investing at Columbia and to education and philanthropy.

To start, many universities and business schools have student investment funds. However, this one, titled 5x5x5, is unique in many ways. Would you describe what the title stands for, what, if anything, was the inspiration behind the fund, and how did you generally come up with this unique idea?

TOM RUSSO: Great introduction. Thank you very much. 5x5x5 arose from an idea that students ought to have an opportunity to learn more from student investment funds and from the grim review of the shortfalls of most funds that are in practice today. 5x5x5 simply means to have five investments (a concentrated portfolio), with no more than five articulated reasons for each investment (keep the points clear and simple), and then hold those investments for five years. So the concentration is certainly something that has been in practice in my life and it reflects something that Warren Buffett suggested when I was a student in business school in the 1980s, that you do not have that many good ideas across a career. With 5x5x5, after five years you will have twenty-five investments in the portfolio, so there will be plenty of occasions to learn important lessons from those investments over time.

If you cannot explain the purpose for an investment off a couple of very, very powerful forces, you are probably not getting a strong enough statement in the first place. It is the old story of trying to get the horizon of the investors stretched out beyond five minutes, or five days, or even five quarters.

A five-year horizon allows you to get to the outcome where you have business forces working for you and you will make your way through the choppy and disruptive markets. But, if you do not stretch your horizon out, you will probably fail to identify strong enough characteristics to carry the capital forward profitably.

The kind of prototypical student-run portfolio today, whether it is undergraduate or graduate, or whether it is PhDs, I suspect, is basically a process whereby a group of people is formed around interest and, upon election, they immediately set to work selling

everything that was in the portfolio prior to their appointment. They have exactly seven weeks to fill up the portfolio with investments and then it is quite clear that within the next three months, their work will be done.

LOUISA SCHNEIDER: Right.

TOM RUSSO: Now, the biggest lessons that occur in such a setting would be those lessons that occur over time and that is why this discipline of holding for five years becomes so important, because the greatest lesson is to watch something that seems so inexorable crash and burn, especially if it is a very slow-moving car wreck.

TOM RUSSO: And you will watch the author of the idea, the person who is going to be driving the car wreck, and they will have an opportunity to account for themselves and the lessons of humility that surface from such an experience is far more instructive than the person for whom a rented share in AAPL happens to go up twelve percent during the seven weeks in which they were actually committed in capital.

LOUISA SCHNEIDER: Why Columbia? And why the Value Investing Program under Bruce Greenwald?

TOM RUSSO: It is because of Bruce Greenwald, and the many adjunct professors and applied learning at the core of the Heilbrunn Center, where the theory of value investing and the practice of value investing are directly linked, that this became the natural place to make such a unique commitment.

There are no better places that have the legacy of Benjamin Graham and Warren Buffett, literally the birthplace of value investing. As you correctly noted, I went to Stanford Business and Law school. The Stanford Business School is full of great lessons, but on a more limited basis. There is a lucky handful of students at Stanford Business School who have been fortunate over the years to have studied under value investing professor, Jack McDonald. However, Stanford Business School did not happen to have either Warren Buffett or Ben Graham as alums. Additionally, Stanford Business School has chosen not to focus as measurably on value investing as has Columbia University. As part of the curriculum taught through the Heilbrunn Center at Columbia Business School, value investing legacy is deeply observed in broad coursework and is at the very core of the Value Investing Program at Columbia.

So, there are very few places where I think the proper tools are given to investors to handle this responsibility. In the case of this Student Investment Fund, 5x5x5, serious money will be committed from the beginning and there is a serious beneficiary at the end of all of this, which is, student scholarships. And, so, you want to make sure if you are going to embark on an experiment that there are adults in the playground, and I think with the Heilbrunn Center, with Bruce Greenwald, Tano Santos, and Louisa Schneider, there are plenty of excellent chaperones.

LOUISA SCHNEIDER: Thank you.

TOM RUSSO: And that is terribly important, because I want the 5x5x5 portfolio to have every chance to succeed and help underscore the message that long-term investing is actually a worthy and profitable pursuit.

LOUISA SCHNEIDER: You are an extremely successful manager, with your own fund, for almost 25 years now. How does the idea behind 5x5x5 speak to your own process and philosophy?

TOM RUSSO: Well, I think as early as 1982 when I first met Warren Buffett, his comment was the ideal holding period is forever, implying that you should take advantage of the one break that the US government gives investors and that is the non-taxation of unrealized gains.

Buffett described how, without triggering the gain, over time your compound is taking place on money borrowed from the US Treasury, enhancing the return on your personal commitment of capital. If a position remains unsold and is leveraged up by the taxes otherwise owed, the investment compounds them both and you leverage up your returns. But this approach requires the hardest thing, which is finding a business that has the ability to reinvest so that it can continue to justify your capital over long periods of time.

TOM RUSSO: The competitive forces today, whether it is technology, whether it is developing and emerging markets, whether it is regulation, whether it is taxation, litigation, there are so many corrosive elements to firms being able to reinvest competitively years into the future.

LOUISA SCHNEIDER: You are known for focusing on three problems when it comes to opportunities. Fifty-cent dollars, great brands, and “capacity to suffer”. You have alluded to that. How do you think about these three ideas and the context of 5x5x5?

TOM RUSSO: Fifty-cent dollars is a practice that, unfortunately, does not scale and is terribly time-dependent, and so the first pillar would be quite small.

TOM RUSSO: It is really the business’s “capacity to reinvest” that drives the client’s capital forward, and I think that has to do with a whole host of co-forces. For me, that arena has been brands, and so the consumer brand is a form of a monopoly in its ability to satisfy the consumer. Emotional attachment to brands creates customer captivity and loyalty.

TOM RUSSO: The “capacity to reinvest”, in my universe, starts with companies that enjoy the privilege of strong brands globally distributed. Globally is key because if you are bound by the four corners of the United States of America, you only have three hundred and fifty million eyes, ears, and mouths to serve, and if you could somehow step beyond our shores, you increase your served market substantially.

TOM RUSSO: Brands are a big component. “Capacity to reinvest” also has a requirement of management. Management has to have an orientation that is long-term because it burdens heavily upfront reported profits. When a business embarks upon the proper amount of spending, large enough amount of spending upfront to deliver long-

term wealth down the path, their managements typically find that spending the proper amount of money burdens current reported earning. However, if management has the “capacity to reinvest” for such future gains, even at the cost of current reported earnings, the company has the “capacity to suffer” which is as equally important as is the “capacity to reinvest”.

TOM RUSSO: In most instances, the best-positioned companies to have that duration, that long-term view, are companies with the founding families still acting as direct management and still shielding management from what is, today, the increasingly fierce world of activist investors.

These investors are willing to shake any tree at any moment for small fruit today, but in so doing, break branches and starve the future growth. The ability for a family to say “Go away” is really beneficial.

LOUISA SCHNEIDER: Understood. Now, switching gears to your investing history since your time at Sequoia and then managing Semper Vic, how has your process and philosophy evolved and changed? And how will the structure of 5x5x5 have flexibility to change and evolve accordingly?

TOM RUSSO: I think what has been certain for me has been a growing concentration in portfolio position sizes and in the willingness to invest the most critical asset one has to invest, which is time in pursuit of investments. When you find a business that has the characteristics of a GEICO properly managed, or of a Nestlé properly managed for the long-term, you can comfortably make a sizable investment. Also, I have evolved to be now probably eighty percent non-US when, at the start, I was probably only forty percent non-US. I have evolved to one hundred percent large caps, whereas in the start I was probably 50-50 large cap, small cap.

TOM RUSSO: I have become more concentrated because I recognize how rare it is to find the business with embedded latent appeal, the “capacity to reinvest”, and then the culture that can drive the process. But it is just a handful of companies that meet that test and, in this case, we will end up with twenty-five companies.

LOUISA SCHNEIDER: Yes. On that note, what are your hopes and expectations for the performance of 5x5x5?

TOM RUSSO: First of all, the performance of the actual funds under management is really the great unknown because to actually make businesses produce in this fashion of long-term buy-and-hold, deeply ownership-minded investing in public equities, you have to have the capacity to do absolutely nothing blissfully for a very long period of time and that is a skill that I think comes with age. When you are starting out, all things look possible and then, over time, you start to slow down.

The goal of the 5x5x5 Fund would be, at the end of five years, to have invested a substantial amount of money to have achieved solid returns which enable reinvestment and then the excess amount will be able to drop into scholarship.

If, at the end of the day, this program drives the ability for people to come to school and learn the tools that they can then apply themselves later on, it will have succeeded.

TOM RUSSO: And the biggest payback, I think, as is so often the case though, is probably on the human side. Those who are participating will inevitably be a less rarefied expression of what it means to be a great investor, and they will be social and they will have at least one or two occasions a year where the prior years' participants present themselves for a common review of the portfolio performance, and specifically of their own accounting for themselves as it relates to those who attend whose businesses have performed particularly poorly, or particularly well.

TOM RUSSO: And, that humility or that kind of modesty around the successes which would mark a true investor, would, I think, inform those students looking at this as a potential career.

TOM RUSSO: Lastly, the networking effect that will come with time of having enough of these students come through and having a host of people return to campus once or twice a year, ought to give the students a chance to at least begin to think of themselves as potential participants in this interesting business.

TOM RUSSO: The alumni participation is absolutely critical because if you are going to hold someone accountable for an idea for five years, what better way to do it than having them participate with the subsequent classes to describe their frustrations or their success?

LOUISA SCHNEIDER: Do you expect the ideas elected for 5x5x5 to fit squarely in your investing process and style?

TOM RUSSO: I would love to be surprised. I mean, one of the joys of this will be to have the different interpretations of where value lies surface.

LOUISA SCHNEIDER: Many graduates of the Value Investing Program work at hedge funds. What are the constraints that are placed on the students who are investing in the 5x5x5 Fund? Will they be able to present short ideas?

TOM RUSSO: One of the great successes of this program will be that it becomes very unsponsored and dull within the school, because, you know, ideally it would do just what we described. It would find five great names. They would grow like paint, and then the next year five names would grow like paint. You know, in the end you have compounded your money at an attractive long-term rate even while hopefully avoiding the rocket ships, though promising drama and investment flare so often end up "flaming out".

LOUISA SCHNEIDER: So in closing, what is the best advice you have received from a mentor with regards to your investing style that perhaps has led to your success.

TOM RUSSO: Well, I would just go back to this concept of the ability to do nothing. I mean, that just seems to be so underrated, and then the power of compounding. So much

of this is really spun out of Berkshire-land. With the quality of those insights, how could you not want to absorb them? But, the hardest thing is to do nothing for very long periods of time and that is probably the strongest strengths. I grew up in Wisconsin surrounded by farmers, and the concept of laying something down and watching it grow for a very, very, very long period of time had inherent appeal. My mother's family came from Titusville, Pennsylvania, where oil was discovered, and the oil business came and created immense wealth, and then it went away. So the notion of the impermanence of aspects of investing has stayed with me.

LOUISA SCHNEIDER: Since inception in 1984, your firm has outperformed the market by at least 500bps but during certain years has underperformed the market. Do you see this playing out in 5x5x5? And how might this add to the learning?

TOM RUSSO: Well, I think it is extraordinarily helpful. Semper Vic enjoyed the "capacity to suffer". For instance, Semper Vic's return in 1999 was negative two percent which compared very unfavorably against both the Dow Jones and the S&P which were up 27 percent and 21 percent respectively. However, staying invested in traditional business permitted Semper Vic to advance sharply following the collapse of the high tech bubble that had so badly inflated the returns of both the Dow Jones and the S&P. Accordingly, Semper Vic ended up adding most of its value added as an investment vehicle in the years that followed. As I said, I think if this becomes known as the most dull portfolio on Morningside Heights, that would be the heart of the great lessons and I suspect that people will see, much like I have witnessed over the past four years, this ascendancy of certain investments where they seem to require of an investor that they have either an opinion or a position, and how they actually end up stalling out.

LOUISA SCHNEIDER: Why is 5x5x5 different?

TOM RUSSO: The evidence of how investment funds run by students typically fail is enough reason why not to embark upon anything in the first place, because it is just about popularity and it is just about finding the fastest way to get outstanding near-term results, and that way of investing reinforces all the worst of the conduct on Wall Street. It is an entry into the world of fiduciary stewardship and responsibility, with all the wrong motivations, because trying to achieve returns in seven weeks is not investing. What is unique about 5x5x5 is that this structure is designed to try to stretch all of those forces out and impress upon the process by its very structure, longevity, as a core value.

LOUISA SCHNEIDER: Presenting an idea for the 5x5x5 today, what might that idea be?

TOM RUSSO: It would have to be Nestlé. Nestlé has the benefits of brands that have existed globally in over a hundred markets for over a hundred years. They have multi-lingual and multi-cultural talent that allows them to activate those brands. Nestlé has the balance sheet and cash flow from its existing mature Western markets that are both available to fund investment at scale that will have their returns realized over decades to come. Finally, Nestlé has evidenced frequently the management's "dual capacity to reinvest" and "capacity to suffer", with the most dramatic and celebrated example being Nespresso. Nespresso is Nestlé's single-serve premium coffee division which forced its

zealous management to “suffer” deeply, taking over fifteen years before the project broke even. Today, however, having investing the proper amount and delivered to the consumer satisfying product, Nespresso’s revenues exceed \$5 billion and generate incredible returns off invested capital for owners. Accordingly, Nestlé would be the one position, if forced to choose, other than Berkshire Hathaway which I regard as sacred as “mother’s milk” .... That is the one.

LOUISA SCHNEIDER: Terrific, great. Thank you.

TOM RUSSO: I also want to add that I have a son who went here.

TOM RUSSO: And the Value Investing Program transformed his life. Columbia has been a big part of my family’s life and we wanted to make sure that we respect it for the great transformation that is offered to so many people who we revere. Finally, I hope that through our commitment to this hopefully exciting new program within Columbia Business School that I will in part repay my families’ long-term debt to Columbia University which has had over decades a roll to play in both undergraduate and graduate lives of so many of my family members.

LOUISA SCHNEIDER: Wonderful.