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# Value agonistes

If a certain style of investing underperformed for years on end, you'd probably think the worse of it. And we would certainly think the worse of value investing if only that once honored approach to money-making didn't spring from the simple virtue of not overpaying.

Now in progress is a re-examination of the value school, which we approach from the bottom up as well as from the top down. As to the latter, interest rates, conditioned behavior and the cycles of taste and technology are on the editorial docket. Concerning the former, we shine a light on Mountain Lake Partners, L.P., a Marin County, Calif. value-investing partnership that has long excelled through buying the kind of companies that would never get a second look from the partners' Silicon Valley neighbors due south.

The tribulations of the descendants of Benjamin Graham and David L. Dodd are old hat to the readers of these pages. Indeed, many a paid-up subscriber has personally suffered them. Depending on definitions, "value" has underwhelmed, in comparison to "growth," for as few as a dozen years or as many as 30.

By convention, the definitions are statistical—a value stock is cheap by such measures as price-to-earnings or price-to-book. Inasmuch as the best companies in the digital age do not reveal their true colors in GAAP-compliant financials, some contend, it's these very definitions that consign a Graham and Dodd disciple to the investment shadows.

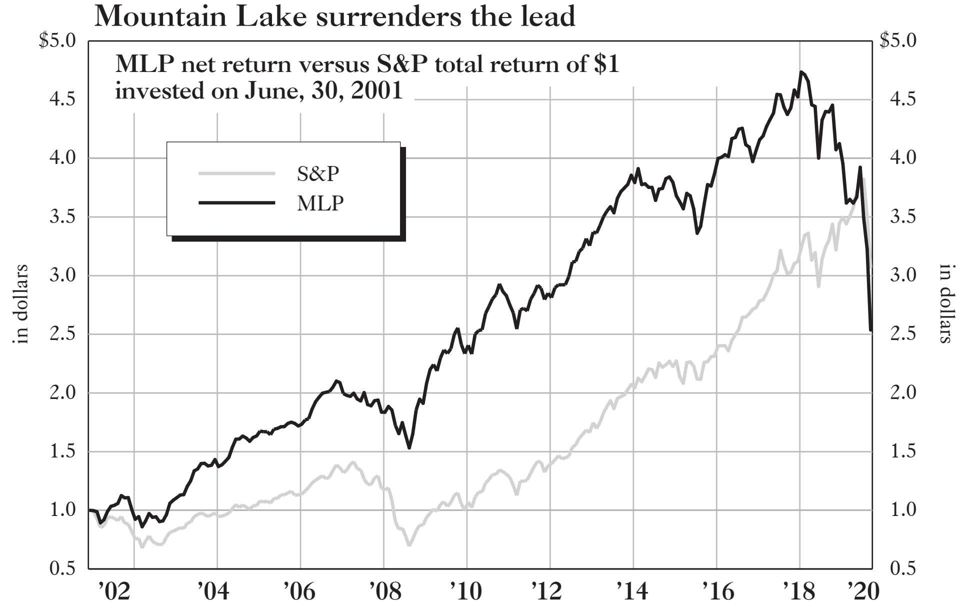
For us, we judge that the value investor can be identified as much by his brain as his portfolio. Risk-averse, she or he lives by the mantra, "Take care of the downside, and the upside will take care of itself." Resistant to consensus thinking, he or she likewise hews to the motto, "There are no bad stocks (or bonds), only bad prices."

Such a person begins the analysis of a business with a study of the balance sheet, not forgetting the footnotes; could that enterprise survive a spell of adversity? The income statement comes second. Hopeful projections of distant future earnings, discounted by today's lawn-level interest rates, come third, if at all.

By no means does every modern value investor adhere to a pure, originalist reading of *Security Analysis*. Some eschew the old standby statistical criteria like price-to-book, rather choosing to focus on such newer screening metrics as price-to-free-cash-flow. But, like Graham and Dodd, who saw the first edition of their doorstop into print in 1934 (meaning that they wrote some of that lengthy manuscript in the darkest hours of the Great Depression), the 21st-century value seeker, not content to trust in a sunlit techno-future, seeks a margin of safety in a low entry price.

If "value" is a state of mind, so, too, is "growth." One of the best investors we knew put his clients in the most exciting companies he could find. His basic approach to the valuation problem was that earnings would follow excitement. He was not averse to short-selling, but his idea of a hedge against bear markets was to make as much money as possible

**Mountain Lake surrenders the lead**




source: Mountain Lake Partners, L.P.

during bull markets. He wound up endowing museums.

As for the next 10 years, the investor and thinker Dan Rasmussen was quoted as saying here last fall (*Grant's*, Sept. 20), the question is whether the FAANGs' great run is duplicable. If it were, Amazon.com, Inc., for instance, must "do better relative to its expectations than it did over the last 10 years. Netflix must do better relative to expectations than it did over the last 10. Apple must do better. . . . I just think that is so unlikely and so improbable relative to traditional industrial companies or international companies returning something that looks like their dividend plus GDP growth, which is basically what is priced into these value stocks. I suspect that the odds are much, much better with value."

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If ever a Rorschach test were needed to sort out the many types of investment personalities, a few sentences about bond investing and risk from *Security Analysis* could fill the bill:

> Since the chief emphasis must be placed on avoidance of loss, bond selection is primarily a negative art. It is a process of exclusion and rejection, rather than of search and acceptance. In this respect the contrast with common-stock selection is fundamental in character. The prospective buyer of a given common stock is influenced more or less equally by the desire to avoid loss and the desire to make a profit. The penalty for mistakenly rejecting the issue may conceivably be as great as that for mistakenly accepting it. But an investor may reject any number of good bonds with virtually no penalty at all, provided he does not eventually accept an unsound issue. Hence, broadly speaking, there is no such thing as being unduly captious or exacting in the purchase of fixed-value investments. The observation that Walter Bagehot addressed to commercial bankers is equally applicable to the selection of investment bonds. "If there is a difficulty or a doubt the security should be declined."

Are these words to live by? you would ask the test-taker. They seem so to your editor, an admitted carrier of the value gene. Yes, bond selection must be a negative art, and even in common-stock investment, the fear of loss should counterbalance the hope of gain, because, after all, the future is a closed book.

Graham and Dodd wrote with a depression still breathing down their necks. They had no "Fed put" in their pocket, and the socialization of risk in the banking business (the system in which the owners reap the dividends, the government absorbs the existential losses) was only just beginning. The outbreak of World War II in Europe in 1939 prompted the authors to drop a line into the second, 1940 edition of their magnum opus on the inadvisability of "airy" optimism.

**Deeper value**


source: The Bloomberg

Today, reflex optimism, founded on the happy experience of the post-2008 investment era, is one obvious source of the strong relative showing of tech and growth issues over the dowdy value kind. We will hazard the guess that very few professional equity investors nowadays are "influenced more or less equally by the desire to avoid loss and the desire to make a profit."

To a professional participant in the investment-performance derby, the clear and present danger is not the risk of a loss but the risk of not keeping up. Failing to match the averages means the loss of one's assets to the commission-free SPY or its bond-market equivalents (though one's AUM has tended to drift away, whatever one has done or left undone). Nor is it lost on what remains of the discretionary-investment-management business that the Federal Reserve does not love a bear market.

If a mind inclined toward risk aversion confers no net advantage in a Fed-administered stock market, an unduly exacting personality type bestows no great benefit in today's bond market. Interest rates are lower now than they were in the Great Depression. You can be as captious as you like, but your disapproval won't change the fact that sovereign debt yields less than the rate of inflation and, in the case of $10 trillion's worth of Japanese and European securities, less than the rate of zero. Covenant-free leveraged loans are no more appealing.

Ultra-low rates advantage growth investors by giving full scope to the speculative imagination. Rock-bottom discount rates flatter projected future cash flows. A superabundance of venture capital sustains loss-making startups. Negligible bank-deposit rates draw once cautious savers into equity index funds, the top cap-weighted components of which turn out to be the big-name growth issues. So up and up goes the balloon.

But that was before everything stopped growing. America supposedly faces the sharpest, most sudden collapse in domestic demand since the dawn of the Republic. The FAANGs will not be exempt from the associated collapse in corporate earnings, as Facebook, Inc. and Alphabet, Inc., for example, come to reveal themselves as cyclicals tied to the global advertising markets. Martin Hale, founder and eponym of Hale Capital Partners, reminded the audience at the Fall 2019 *Grant's* Conference that, at one point or another, Oracle Corp., EMC Corp., Apple, Inc. and Amazon.com, Inc. had lost more than 80% of its value.

"It would be extremely odd if there was any group doomed to underperform forever or win eternally," Ben Inker, GMO's head of asset allocation, was quoted as saying in a November 2019 article in Institutional Investor. The piece ran out under the headline, "Why Value Investing Sucks." Let us see about that.

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Mountain Lake Partners is a 19-year-old equity fund managed by the husband-and-wife team of Mitch Cantor and Patricia Coronado. It's a friends-and-family equity partnership that looks after $100 million. The wife and husband (loyal *Grant's* readers and conference participants, let the record show) met on the job and married in 2003. Together, they register among the partnership's top investors. And together they signed the letter attesting to a first-quarter loss of 35.36%, net of fees and expenses, compared to a 19.60% drop, including dividends, in the S&P 500.

Nothing like that had happened before. Over the first 10 years, the partnership generated an annual compound rate of return, net of fees and expenses, of 10.96% versus the S&P's 2.72%. Their relative outperformance persisted into 2019. But with the grisly March quarter in the books, the mechanical rabbit of the S&P 500 index has overtaken them: "[T]his is the first time since inception we have lagged the market, giving up all cumulative historical advantage," the partners say.

Cantor and Coronado are what one might call the evolved kind of value investor. They like cheap stocks in out-of-favor industries, but valuation is not the first item on their investment-eligibility checklist, they say: "We think of our selection criteria as good businesses, good management and attractive valuation, closer to Buffett and Munger by design than Graham and Dodd. We have learned to never violate the good-people part of the equation."

Of course, losing money was not the focal point of the founding business plan. The original premise was "to find companies that are inexpensive compared to their future ability to earn money, generate free cash flow and grow." As the portfolio would be built without reference to any index, Cantor, the founder (Coronado was his first hire), went on, "the possibility of materially underperforming any benchmark or competitive grouping, over the short term, is quite high. To me, risk is not investment performance versus competitors. Risk is the permanent impairment of the value of the individual companies in which we have invested."

As low valuation affords a margin of safety, risk aversion was in the bones of the business. Not then contemplated was an oil price war overlaid on a pandemic superimposed on a program of limitless monetary expansion lashed to a years-long experiment in miniature interest rates.

The March 31 portfolio comprises 17 stocks, not all of which a clairvoyant would have carried into a public-health crisis. Spirit Airlines, Inc. and Allegiant Travel Co., low-cost leisure airlines, for instance, would not have made the cut (the former lost 66.5% of its value in the first three months; the latter, the fund's top position as of Dec. 30, with a 10.5% weighting, was down by 52.6%).

Nor did it help the March 31 results that energy made up nearly 30% of the portfolio. Not that *Grant's* stands in judgment against that decision. We were happy to publish, in the issue dated Jan. 11, 2019, an analysis borrowed from Cantor and Coronado. It contrasted Netflix, Inc. with a humble coal-mining master limited partnership called Alliance Resource Partners, L.P. We observed that only one of the two businesses was generating free cash flow, and it wasn't the one that now streams Joe Exotic.

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"It's no fun," politely replied Coronado the other day to a telephone call from this office asking what it's like to be down 35.36% in only three months. "But as value investors, it hasn't been fun for a long time."

At least, added Cantor, joining his wife on the line, "the problems are interesting as opposed to coming in every day like the past five years and watching everything that you don't own go up 1%, and everything that you own go down an eighth."

The partners were asked about insolvency risk to their investments during the national experiment of not going to work in the morning. They said that they liked each and every one of their investments. In the specific case of the stocks mentioned in the aforecited January 2019 issue of *Grant's*, they said, they had no such concern but were rather buying more. Thus, a 608,500-share year-end position in ARLP has become a 750,000-share position; a 650,000-share investment in Consol Energy Corp., another coal master limited partnership, has become a 795,000-share investment; and a 408,000-share holding in National Oilwell Varco, Inc. has grown to a 535,000-share holding.

In the same article, Cantor was quoted as nominating National Oilwell, a leading manufacturer of capital equipment for the oil, gas and petrochemicals industries, as the portfolio business he would want to hold if the stock were closed "for 15–20 years."

Cantor emailed an update on NOV last week: "On their Q4 conference call on Feb. 7 (ancient history now), they indicated they were thinking about share repurchases later in the year. With the loss in demand for oilfield products, we think the point of excess capital has been pushed farther out. Nonetheless, it speaks to how they were feeling about their operating results and balance-sheet issues after the worst 5½ years in the history of their business."

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Speaking with *Grant's*, the partners remarked on the fact that "more and more markets are becoming not markets."

"We are moving into this period of time," they went on, "where everything is in the purview of the world's central banks. It is not so much that there is anything wrong with value investing as there is no real price discovery going on anywhere."

Seeing that, and noting the presence of gold miners in the investment portfolio (Barrick Gold Corp. and Newmont Corp.), we asked Cantor and Coronado if they were banking on the Fed's help to reflate the energy complex.

No, Cantor replied, because energy, like any other commodity, "is still subject to the laws of supply and demand, and the demand side has evaporated and is likely to remain that way for the duration of the lockdown."

But if the oil cartel were really on the ropes, he added, gas would likely benefit from the presumably low crude price, "because 11% of the supply of domestic natural gas is associated with gas coming out of the Permian today. And if that even just stops growing, let alone shrinks, then natural gas will at a minimum have to price the cost of getting it out of the ground, which is quite a bit higher than today."

Only two of the stocks in the Mountain Lake portfolio generated a positive return in the first quarter. Ammunition-maker Vista Outdoor, Inc. was one and Newmont the other. The partners' comment on the pandemic-induced monetary response bears not only on Newmont but also on the outlook for the dollar and interest rates and therefore, ultimately, on the prospects for value investing broadly.

> Money is a symbolic representation of wealth that already exists. When a service is performed or a good produced, value is created. If that value is not immediately consumed, the pool of real savings, capital, is increased. The creation of additional currency does not increase capital. It merely decreases the value of all existing currency. So, all this spending of money created out of thin air is merely either increasing our indebtedness or debasing the existing supply of money.

By definition, fads are not for the ages, and the vogue in growth stocks and technology (each advantaged by low interest rates) will one day pass into history with today's yet undeclared recession hastening the evolutionary process. Residents of the Bay area, Cantor and Coronado say that the alignment of financial forces on Wall Street reminds them of the 2020 Super Bowl: "Through three quarters the 49ers were looking good, only to be outscored 21–0 by the Chiefs in the fourth quarter."

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