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STALWART

In Investing "Then What?" Is A Very Good Question To Ask

The importance of focusing on what you know and stretching your investing horizon to allow companies to compound value.

OUTLOOK BUSINESS

An influential event in his life was Warren Buffett's visit to Professor Jack McDonald's class in 1984 at Stanford Business School. What struck him about Buffett was that he came across as a person who spent most of his time thinking about things that made sense to him, unlike things they taught at Stanford, which didn't make any sense to him. For someone who started off as a bond analyst and later became an analyst with the Sequoia Fund, **Thomas A Russo** *has really come a long way to make his mark as a value investor. He manages over $6 billion through separately managed accounts and the* *flagship Semper Vic Partners Fund. Russo has delivered a net annualised return of 12.61% since inception against 8.48% for the S&P 500*

. The 58-year-old attributes a large part of his success to Warren Buffett's investment philosophy that propounds the importance of focusing on what you know and stretching your investing horizon to allow companies to compound value. Not surprisingly, a large part of his portfolio comprises foods, spirits and consumer companies that he believes have global brands, extensive reinvestment opportunities and the potential to keep growing.

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How did the 50-cent dollar bill become one of your touchstones in investing?

A 50-cent dollar bill is just an expression that Benjamin Graham used and Buffett incorporated. The fact of the matter is that businesses are really dependent on timing. If you truly get a 50-cent dollar bill and the dollar bill doesn't grow, your rate of return is completely driven by when you close that discount. When Graham wrote about it, one had to just take a look at the balance sheet to get that number

> **Companies driven by technology are more at risk since it changes at an accelerating pace**

. But today there are many liabilities that don't appear on a balance sheet. For example, if you have to close a company on environmental costs, you cannot quantify pre-termination costs for labour and other claims. If you have a difficult time assessing liabilities because of legislation, you are probably better off finding a dollar bill that will grow in value. But then, that comes from the capacity to reinvest. However, a question that arises is: will managers invest enough, since the investments would come at the cost of earnings? For example, take the case of a hedge fund [Highfields Capital Management] that is averse to the Canada-based Tim Horton's Coffee expanding in the US market. The fund wrote a letter to the CEO saying, "You have to stop making those investments as you are reporting losses and we want to ensure profits." Despite upfront losses, investors should applaud a good long-term investment because if companies stop spending they can't create competitive advantage.

How many companies in recent times have met your other investing criterion: the capacity to suffer?

Cadbury, which has a great market presence around the world, was doing a good job in China where it spent a lot of money, moving from the three big cities to tier 2 or 3 cities

> **You have to be alert to whether they [food companies] are building their business around what Wall Street wants from them versus what you might want from them as an owner**

. They were losing money because they are in the process of developing a market. I was delighted because they had the first-mover advantage in 200 markets with over 1 million people. Then came along Kraft, which wanted to see better numbers. Soon enough, they closed down the 200 tier 2 or 3 markets, delivering back to investors seemingly better profits but one that ended up destroying value. They were losing money but they were developing a preference that would have played out over time. Or, take the case of Starbucks, which lost money but today has a leading position in China because of coffee. Now, coffee is habit forming and highly branded. I think they built something of lasting value. We have in our portfolio of spirits companies, those that were willing to go to China when the prospects weren't that exciting. They have really great powerful franchises and yet they have only penetrated 1% of the market. That is a lot of opportunity.

But how do you know whether a very important capital allocation decision will translate into something meaningful down the years?

Take the case of Amazon and Barnes & Noble. Barnes & Noble decided to launch an electronic reader to take on the Kindle from Amazon. Now, Kindle wants to go after the iPad with Kindle Fire, but then it's actually a touchpad. Barnes & Noble is better off keeping money in its pocket rather trying to come up with an e-reader, nor should Amazon pursue a product that will end up competing with Samsung touchpads. It is not a fair fight. In the case of Barnes & Noble, they are probably not going to get a return from their initiative. It is a judgement call and I have no way of knowing [whether it will succeed]. But in Amazon's case, I am pretty sure there are millions of businesses that fear its [Amazon's] capacity to reinvest and its ability to build a new platform to enter verticals that were once the privilege of a few. Even a company as vast and oppressive as Google is, in some ways, challenged by Amazon. If you are looking to buy a TV you will end up searching on Google, but if you are a believer in Amazon you trust yourself to get a good deal.

In India, ITC generates a RoE of over 100% in its tobacco business but is losing money for the past 10 years in its food business comprising biscuits, noodles, confectionery and dairy. We now have a situation where Nestlé, which lost money in the noodles business for 25 years before turning the corner, is facing intense competition. But the market is taking a favourable view of Nestlé versus ITC's capital allocation decision. Between the two, what determines which one has a good or a bad capital allocation?

In a new category such as confectionery, ITC doesn't have an aspirational heritage. ITC has great distribution and it can get the product into the market. But it's my belief that, when it comes to making a choice, a first-time consumer who has to buy a chocolate will probably opt for Nestlé's Kit Kat over the former because somewhere in the back of his mind Kit Kat is registered as a great aspirational brand. The same will hold true for Nestlé if it decides to enter the cigarette business and is willing to invest million of dollars to displace ITC. As long as ITC doesn't lost focus of its cigarettes business in its attempt to go after the chocolate market, leaving its brands unprotected, I wouldn't give Nestlé high marks for gaining traction in the cigarette business. So that's a culture thing. Now, for example, Nestlé can source ideas from all over the world, but ITC can't seek out its parent BAT for a best chocolate mix. It has no other sources for consumer insights and information for products. So, therein lies the answer.

How do you differentiate between a sustainable moat and an unsustainable one?

I typically rely on the past to guide me here. I once believed the newspaper business was a sustainable moat but that disappeared with the advent of technology. One of the greatest sources of wealth around the world was on account of newspapers, but that is no longer the case. I would say a sustainable moat has been the cigarette industry even as we are about to see new generation products such as electronic cigarettes. Consumer brands have been an area of great returns for a very long time and will probably remain so in markets where they did not have a presence, just like Nestlé's ability to grow its business by reinvesting in economies such as India and China. It has been proven that people know how to live without a Jaguar. They have learnt to live with an Audi instead. Maybe they will learn to live without an Audi as well. But if you are a Kit Kat consumer you will never learn to live without a Kit Kat. The structure of the industry is such that you have more margin to invest back into marketing, innovation and communication to keep consuming more.

Make that large

A strong preference for global consumer companies is very evident in Russo's flagship fund

SECURITY	% ASSETS	SECTOR
Nestlé SA-Spons ADR	10.5	Consumer
Berkshire Hathaway Inc C1 A	10.4	Financial
Philip Morris International Inc	9.4	Consumer
Compagnie Financierè Richemont SA	8.2	Consumer
Heineken Holding NV	7.3	Consumer
SabMiller PLC	6.6	Consumer
Pernod Ricard	6.3	Consumer
Mastercard Inc C1 A	6.0	Financial
Wells Fargo	5.6	Financial
Anheuser-Busch InBev ADR	4.8	Consumer
Unilever NV ADR	4.3	Consumer
British American Tobacco PLC	3.6	Consumer
Altria Group Inc	3.4	Consumer
Diageo PLC	3.0	Consumer
Brown-Forman Corp C1 A	2.8	Consumer
Comcast Corp Special C1 A	2.4	Media
Martin Marietta Materials	2.1	Materials
Scripps Networks Interactive C1 A	1.3	Media
Washington Post C1 A	0.6	Media

Is there a broad framework to value moats into different categories in terms of attractiveness and durability? What kind of valuation differential would you ascribe when you straddle the whole spectrum?

Companies driven by technology are more at risk since technology changes at an ever-accelerating pace. Let's take the case of Blackberry. I don't have the ability to know what will endure in technology. But in the case of Kit Kat they innovate. While Kit Kat is sold in pack of four in the West they innovated in India with a single pack. That is a pretty smart innovation because it increases affordability. By the way, it is priced at more than a quarter of the price of the big one. Hence, it absorbs the fractional costs that consume profits when you don't have scale. Then there is also the possibility of introducing a white chocolate instead of a brown or a dark chocolate. At the end of the day, Kit Kat itself will outlast technology. My parents ate it and my grandchildren will probably eat it. That is a powerful and enduring franchise. Instead, in technology, at some point you have to decide which new cell phone to buy. You might spend $500 and you get a discount if you switch to someone else's network. So, the consumer is really quite fickle at the point of purchase. In this case, it is not clear what is the value of one versus the other.

In other words, food companies enjoy the strongest moat…

That is just for me. Food, without cigarettes, which are more habit forming, or high-end luxury spirits whether it is a brand such as Maotai in China or whether it is Johnnie Walker Black Label, which I gather is a must-purchase at duty-free airports for everyone returning to India. If that is indeed the case, isn't it a terribly powerful franchise? Think about the aspirational quality of that product developed over decades of people coveting it. I think that is a very powerful franchise. The only reason you have to buy duty-free is that the Indian government has yet to figure out a way to open up the domestic market. People talk of vacuum cleaners as powerful franchises, with Hoover and Dyson's emerging as strong brands. But I don't think people derive the same emotional replenishment from buying a vacuum cleaner brand.

There are various points in time when Blackberry and Nokia looked like great franchises. But it didn't turn out that way in hindsight and their stocks got battered.

The answer to this lies in doing what Charlie Munger does. He likes to ask the question: 'Then what?' That is a very good question to ask. It keeps you out of trouble. Say, you are the only player selling a hot handset. After a point if it seems as if you have an unbreakable grip on the market, it is probably a case where it is already priced into the stock. When it is glorious, it's too expensive and when it's broken, it is often hard to do a comeback act in technology. If you buy [the stock] cheap and it stays cheap, that is not going to get you anywhere. When you buy it at the peak, you have the risk of losing out to a generational shift in technology. I use this question [then what?] to keep out of those kinds of problems. If you look at Apple it is a blend of everything. It has fallen from grace and its share of smartphone market is way down. They have a mountain of cash, which makes it look like a cheaper investment. But do they have the consumers' trust and goodwill and will they continue to delight through innovation? It's just not clear.

But is there a way to answer the question [then what?] because good and large lovable franchises will not be available to you at 50 cents to a dollar, unless hit by bad news?

Apple is down from $740 to $450. But at a time when Foxconn [supplier to Apple] is being questioned for work conditions for young kids, will Apple retain its lustre with customers around the world after they realise that the parts that go into the handset come from 12-year-old boys who are overstressed and jumping out of windows? That is not a happy situation. They might have to spend lot of money to come up with a safer and secure supply chain. You have to think about those perceptions. Everyone knows that Foxconn has a problem with its workforce and it may tarnish the brand equity of Apple. But the answer is, it may not matter and there may be something more. I haven't really seen that myself, so I can't comment further. But a lot of other investors believe the cash and the earnings power is enough for Apple to overcome its worries.

Can you list the dos and don'ts of investing in food companies, since you have a lot of experience in the sector?

I think you have to be alert to whether they are building their business around what Wall Street wants from them versus what you might want from them as an owner. For example, one of my food companies described the pitfall of trying to measure up to Wall Street's standard of looking at "the total percentage of business from products that are only two years old". So, in order to measure up, I will keep coming up with new products and that may not be the right strategy. Kraft Foods, for example, launched Tassimo, a coffee machine. But to underwrite it, they starved Maxwell House, their very valuable coffee business, of marketing money. They put everything behind Tassimo to jump the revenues in year one. They accomplished what Wall Street rewarded them for, but it was built on an untested platform. It was underwritten by borrowed marketing spend from an established brand and a fall in revenue in the latter would have hurt much harder. You don't want to starve a business such as Maxwell House, which has great goodwill. It was a mistake and that is something that you want to avoid.

You like to invest in MNCs but there are regional players that have a strong edge over them. For example, the world over local beer tends to outsell foreign brands…

If local tends to be the mainstream, it will continue to outsell. Heineken's business has always been to capture that mainstream through ownership of a local beer and then bringing in the premium beer on top. The premium beer alone doesn't have enough business to fund the distribution infrastructure but it's profitable if you throw in your premium beer on top of a filled truck that is going out. While local brands are valuable, the question is, will they be able to make the migration to other markets. Radico Khaitan competes with us in the spirits business with a whole portfolio of local brands. It competes with Diageo, Brown-Forman and Pernod Ricard in your market. But it is not likely that its portfolio brands can go somewhere else. Again here it's a case of: then what? Take the case of Diageo, which is competing effectively in India through the Vijay Mallya-owned United Spirits. Even as they are doing it, they have made an investment in Brazil and another one in Turkey. At the end of the day, if you go to any hotel or market around the world you will see top 14 global brands and it's unlikely to feature a local Indian brand. That is why I tend to favour global brands because they have a long reinvestment runway.

Why are you averse to owning independent subsidiaries of MNCs when their revenue and earnings potential is far greater than the parent entity?

It's not that I haven't owned subsidiaries, but I have asked the question: then what? For example, the parent Unilever doesn't want its subsidiary in Indonesia to move on to Pakistan or to some other market. At some point in time these subsidiaries will have to confront the problem of: then what? Also, I can invest in the parent at a lower multiple compared with what I would have to pay for growth, albeit faster, in emerging markets. Then, there is the aspect in a relationship where a person with power may favour themselves. For example, in Indonesia, Unilever is asking the local company to pay higher royalty because they want to get reimbursed for some of the structural costs they are absorbing at the headquarters. Also, the parent company can always come in and acquire the local company.