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Q3 2013 Quarterly Letter

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With all of the "noise" surrounding the macro environment lately it's sometimes easy to forget that superior investment performance over a long period of time is predicated on a very simple concept: the sustained ability to purchase mispriced investments that are trading significantly below their intrinsic value. One of the key ingredients in determining a company's intrinsic value is the assessment of management and its ability to bridge the gap between price and value.

Over the past 18 months, the companies in our portfolio have experienced an unusually high turnover rate at the CEO position. In fact, of the 19 companies we currently own, four recently replaced their CEO, and one (Microsoft) is on the cusp of a major leadership transition. This level of turnover is unprecedented in our history and creates the potential for both opportunities and challenges.

In the case of both Chesapeake and Level 3, each company recently announced a new CEO to replace the original founder. Most often, a founding CEO is uniquely gifted in growing a business and possesses a skill-set finely tuned to the early phases of a company's lifecycle. However, every company inevitably reaches an inflection point where growth begins to slow and the emphasis shifts to operational performance, return-on-investment, and maximizing profitability. It's unlikely most founders can make this transition, as was the case with both Chesapeake and Level 3. We are pleased that the two new CEOs, Jeff Storey and Doug Lawler, are focused on cultivating each company's current (and very valuable) asset base rather than expansion. To highlight this point, we have included a quote from Chesapeake's most recent earnings conference call:

"In this comprehensive review, we're looking at all of the assets, we're looking at all of the affiliates that the company has ownership in and determining which – what is the return that we're generating from those assets and affiliates…But that's something we're really focused on, because if it's not adding value and not return-centric that adds to our competitive position, we will look to divest of it…<u>it's all going to be centered on how we can drive the greatest capital discipline and the greatest returns for our shareholders</u>." Doug Lawler, CEO Chesapeake, October 1, 2013

Like Chesapeake and Level 3, we have also experienced recent turnover at the CEO position in two other long-term core holdings: Best Buy and Legg Mason. Both of these companies appointed new CEO's in the past twelve months with clear mandates to effectuate corporate turnarounds, reinvigorate the brands, and enhance operational efficiencies. After only a short period at the helm the new CEOs appear to be executing skillfully and we are encouraged by the direction of both companies.

The recent management changes at the four companies mentioned above underscore the most challenging component of our research process – accurately evaluating a management team. Unlike the analysis of financial statements, the criteria used to judge the competency of a manager is mostly qualitative. And – as was the case with Level 3, Chesapeake, Best Buy, and Legg Mason – we don't always get it right.

This is why it's important to remember that a competent management team should never be the sole (or even primary) reason for making an investment. The underlying fundamentals of a company are always more important. Buying a bad business – or paying too much for a good business – will often times prove insurmountable for even the best managers.

In the words of Warren Buffett, "when a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." In other words, it's the combination of capable managers, a fundamentally attractive business, and a truly mispriced asset that creates the opportunity for outsized investment returns.

So what constitutes a "capable" manager? In our evaluation of management we look for the following qualities and characteristics (some are measurable and others are not):

- **A financial alignment of interests with shareholders.** We want CEOs to have "skin in the game" through large share ownership plus a compensation package that is truly "pay for performance". This is important not necessarily to align potential rewards but rather to align risks.
- **A focus on profitability and shareholder returns rather than growth-at-all-costs.** We want a CEO to emphasize the bottom-line rather than the top-line. We are not looking for "empire builders".
- **A requirement that managers act with honesty, transparency, and humility.** Too much hubris often times leads to excessive risk taking and the potential for large losses.
- **And, most importantly, managers that are good capital allocators.** Operational excellence is not enough; management must have a deep understanding and appreciation for the vital role intelligent capital allocation plays in determining total returns.

This last point is critically important, yet often times overlooked by most investors. There is almost a cult-like belief on Wall Street that the only necessary factor in evaluating a company is earnings per share (EPS). In reality, however, more shareholder wealth is either gained or lost through the decisions taken by management to allocate these earnings than any other action.

Most companies, unless they are in hyper-growth mode, produce excess cash flow above and beyond what is required to be re-invested back in the business. It is up to the CEO, along with the Board of Directors, to intelligently distribute this excess capital into one of four buckets: cash on the balance sheet, acquisitions, dividends, and share repurchases. When evaluating a management team we want to make sure that each option is carefully analyzed in order to produce the most shareholder value.

One of the better business books published in recent years, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success* by William Thorndike, Jr., discussed this very topic at length. One of the managers highlighted in the book is the legendary CEO Henry Singleton who founded the conglomerate Teledyne in the 1960s. Despite ownership of relatively mundane industrial assets, Teledyne's stock compounded at an annual rate of 20.4% over a three decade period. This success was almost entirely due to Singleton's masterful and idiosyncratic use of capital: he acquired out-of-favor companies at bargain prices only to turn around and sell them at higher prices, and, more importantly, he embarked on one of the great share repurchase programs in corporate history (ultimately reducing the company's share count by 90%). There is no doubt that Singleton would be a first ballot inductee into the Capital Allocator Hall of Fame.

While the likes of Henry Singleton are rare, we believe the stable of managers currently occupying the CEO mantles at the companies we own are first class. All embody the qualities we mentioned earlier and will likely play a large role in the outcome of our investments.

New Position: Titan International (TWI)

During the quarter we purchased a new core position in Titan International (TWI) at approximately $17/share. Titan is a $1 billion global manufacturer of wheels and tires primarily serving customers in the agricultural and mining industries. The stock price reached a high of $27/share earlier this year before falling to $17/share, and the performance over a longer period of time is not much better – the stock is basically trading at the same price it fetched in the late 1990's.

The current weakness in the stock is based primarily on fears that demand for Titan's products will remain at depressed levels indefinitely. The recent softness in tire and wheel purchases is primarily a result of mining companies reacting to lower commodity prices. In addition, the company suffered several operational issues over the past 12 months which have impacted earnings. While there is some validity to these concerns we are confident that, over the long-term, neither issue will prove insurmountable. This short-term pessimism is creating an opportunity to purchase Titan at an extremely low valuation of just 4.5x 2013 EBITDA.

Furthermore, the current stock price does not reflect the potential impact of several large acquisitions in the pipeline which would more than double the company's revenue. The addition of $1.5 billion in acquisition revenue, coupled with cost-saving synergies, could add approximately $10/share of value to the company.

Lastly, Titan will also benefit from an on-going integration and expense reduction program which should lift organic EBITDA margins from 14% to 16%. While we don't expect the company's end markets (particularly mining) to rebound in the short-term, we do believe that Titan represents an attractive opportunity to purchase a relatively high-quality business at a depressed price.

Positions Sold: Aon (AON) and Harman (HAR)

During the quarter we fully liquidated positions in two long-term core holdings: Aon and Harman. We sold these positions for the same reason we sold Ingersoll Rand earlier in the year: recent appreciation resulted in the stock price reaching our appraisal of fair value. Both Aon and Harman remain rock-solid franchises that have executed exceptionally well over the past several years and their stock prices responded accordingly.

We originally purchased Aon in August of 2010 in the midst of a soft insurance market which caused the stock to remain unchanged for the previous five years. However, we were impressed with management's ability to improve operating margins in this environment and believed that several new initiatives could propel margins even higher.

From the time of our investment three years ago earnings per share grew more than 50% as the company executed on this plan, benefited from an improving insurance market, and moved headquarters to the UK to reduce their tax burden. We sold the stock last month at $75/share and achieved a total return of 111% compared to the S&P 500 total return of 36% over the same time period.

Our ownership of Harman dates back to July of 2008 after the stock plummeted from a high of $120/share to approximately $40/share. The decline occurred following the termination of an acquisition agreement made by KKR to purchase the company. We viewed this as an opportunity to invest in a company with extremely favorable long-term growth prospects in its key Infotainment division, as well as, the opportunity to enhance profit margins by introducing a new “scaleable” product line and shifting its engineering footprint to low-cost countries.

At the time, we didn’t anticipate the unprecedented decline in global auto sales during the Great Recession which negatively impacted Harman’s results during 2009 and 2010. Believing the downturn was temporary in nature we took advantage of the price decline by significantly adding to our position throughout the 2008 – 2010 time frame at prices as low as $14/share. These actions reduced our average cost basis to approximately $24/share.

Harman’s management team, led by Dinesh Paliwal, deserves enormous credit in executing their plan flawlessly over the past five years despite a difficult macro environment. We sold the stock this past August at approximately $68/share and earned a total return of 174% during our holding period compared to the S&P 500 total return of 47% during the same time period.

With these sales cash levels continue to rise and subsequent purchases have not fully offset the reduction in exposure. We do not want to “beat a dead horse” on this topic – as we have written extensively about this in past quarterly letters and addressed cash balances at our Investor Meeting this past Spring. With that being said, we continue to work diligently on your behalf to uncover future investment opportunities that will deliver superior investment results.

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