Value Investing 101

By Matt Logan
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Warren Buffett, Michael Price, Mario Gabelli, Walter Schloss, and Charles Royce are not the typical guest lecturers at a business school class. Then again, the Columbia University Graduate School of Business isn't just any business school, and professor Bruce Greenwald's class is anything but ordinary. Greenwald teaches the value investing course at Columbia and also authored *Value Investing: From Graham to Buffett and Beyond*. In part one of this five-part series, Greenwald shares with Fool contributor Matt Logan the three steps of value investing.

TMF: Perhaps one of the more controversial areas of value investing is the term itself. Some think of value investing as low price-to-book, low P/E, etc. Others think it's more **Berkshire Hathaway** (NYSE: BRK.A)(NYSE: BRK.B) Chairman Warren Buffett's approach. And then you have people, like Bill Miller at Legg Mason, who really stretch the term. What is value investing?

Greenwald: Value investing consists of three things -- three things that you have to do to be a good value investor. To some extent, they are all rooted in the way Ben Graham approached things.

The first thing is you have to understand the extent to which markets are efficient. It's just inescapable that whenever you sell a stock, somebody else is buying it; and whenever you buy a stock, somebody else is selling it. And one of you is wrong. Only in Lake Wobegon can more than 50% of the investors outperform the market. So there's an absolutely fundamental sense in which you've got to start off thinking that markets are efficient. You want to structure things so that you're on the right side of the trade, that the people on the other side of the trade are, in some sense, doing irrational things.

I think what Graham saw was that the best indicator of irrationality -- sort of a systematic, statistical indicator of irrationality on the other side -- is when things get oversold. And the way we talk about this in the course [the course he teaches at Columbia] is the search strategy. You look for cheap stocks, but you look for more than that. You look for obscure, because you don't want to be in a race with 60 analysts all looking at **Microsoft** (Nasdaq: MSFT). You want to be in a race where, ideally, you are the only one looking at the stock. The boring and ugly are good. Because I think Graham understood that psychologically, people just shied away from those stocks, and they, therefore, tended to get oversold.

Robert Heilbrunn, who actually endowed my chair, tells a story about that. He went to Ben Graham with all these high-rated bonds, and Ben Graham told him to sell them. Then he went to buy some deeply discounted bonds that were questionable. He went to his broker to buy them on Graham's advice. And his broker said, "We're not the kind of broker that buys bonds like that." And boy, that's the person you want on the other side of the trade -- is somebody with that kind of stupidity.

Ugly, traded-down, cheap, boring -- as opposed to glamorous, respectable, lottery-ticket type stocks, and prominent stocks -- are things that you want to be set up to look at as a value investor. So that's the first part of it. That's the search strategy. Unfortunately, in modern language, that's almost gotten to be the whole thing in a certain debased way. It is true that low market to book all over the world -- every place -- has outperformed the market in every extended period at least by 3% to 5%. So that gets you a long way. But I think to do better than that, as a real value investor, you have to not just look for cheap and take advantage of the historical statistics. You have to ask, "Where, within this universe even of cheap stocks, can I find trades that I'm going be on the right side of?" I think that's a question that modern value investors of whom I think the best of which are like Seth Klarman and Glen Greenberg -- even though he'll claim he's not a value investor -- they're always asking that question.

So that's the first step in value investing. It's to have a search strategy, so when you think you locate a bargain and you have to ask yourself the question, "Why me God? Why has God made this bargain available only to me?" You can answer it terms of market mob psychology, or that you're the only one looking at it, or you have some sort of rationale for why this bargain has come to you. And that's the first thing. And, unfortunately, that in a debased form is what gets called "value investing."

The second thing you have to have is a good technology for valuing what you're buying. I don't know if you've read the book that Judd Kahn and I and other people wrote [*Value Investing: From Graham to Buffett and Beyond*].

TMF: Yes, I definitely did. It's a great book.

Greenwald: What you want to do is to have a technology that brings all the available information to bear, so you can cross-correlate the asset values with the earnings-power values, with your judgment about whether there's a franchise here. That if you're going to buy growth, you're absolutely certain that the franchise is there so the growth is going to be valuable. So the second thing -- you've located a promising stock -- and then, what a good value investor will have is a first-rate valuation technology.

The Graham technology is starting with the most reliable information, which is asset value, then looking at the second-most reliable information, which is current earnings -- with all the appropriate adjustments and getting an earnings-power value -- and then looking at those two and see what they tell you about the extent to which you are buying a franchise, which is value in excess of assets. And then, only then, looking at the growth. I think that's far superior than doing an undiscriminating cash flow analysis, where you can't really tell what the crucial assumptions are. So good value investors then bring a first-rate valuation discipline to the market. And that's the second part of it.

If you've got somebody who's only talking about growth prospects or short-term earnings prospects, you're going to be in trouble. And if you listen to Bill Miller, for example, he is very much an old-fashioned, low P/E guy. First of all, he doesn't buy tech stocks that are in fashion. He does tech stocks that are out of fashion. Secondly, he's pretty careful about valuation. I don't agree with his story about **Amazon** (Nasdaq: AMZN), but he is careful about taking out the amortization of the various stupid acquisitions that Amazon has done in the past and looking at the real profitability and real earnings power.

So if nothing else, this discipline of starting with what you know, which is the assets, then the earnings power, then the franchise -- whether it's there or not -- and then the growth; that whole sequence of things at least makes you look very carefully at what you're buying rather than getting caught up in the moment.

So you've got a decent search strategy. You've got a decent valuation strategy as a value investor. And the third thing you have to have is discipline and patience. In the story I'm going to tell you about discipline and patience and the value strategy is about Paul Sonkin -- his name is on the book -- who was put into business by a set of value investors, myself among others. He's just performed phenomenally. He's been in four and a half years, and you can't really tell on a four-and-a-half-year record, but his returns after fees have averaged about 25% with a market around 3.

TMF: That's incredible.

Greenwald: He has a strategy of very, very small stocks. So if he buys half a million dollars, then he has to file a 13D [required when you buy more than 5% of a company's stock] in some of these companies. But that means he's the only one there. So he satisfies the first criteria. He's got the basic valuation methodology. But one of the things we did in looking at his trades is that we looked at what he would have made if, when he made the first purchase of the stock -- the first time he bought it -- he just bought it there and he'd sold it at the first sales. So that he'd just done one buy decision and one sell decision, as opposed to buying it first, finding out, oops, the stock has continued to go down, but continuing to buy on the down side, having confidence in your valuation judgment. Of the 25% return, about 22% of it came from purchases at lower prices than the initial purchase. We've got Walter Schloss's archives, and it looks like -- we haven't got the numbers yet -- a large percentage of Walter Schloss's returns have come also over time from knowing that you're buying something worth buying. And then when it goes down, not getting frightened and dumping it, but continuing to buy. And then selling on the way up. Looks like that does a lot better than just averaging down.

TMF: I recently spoke with Mary Chris Gay, who is Bill Miller's colleague. That's their strategy, she said: Lowest average cost wins. I suppose that's confirmed now.

Greenwald: That's exactly right. But notice what that depends on. You have to have confidence in your valuation. And you have to have the discipline to stick with it, that if this is a good stock and nothing has changed about the underlying value of the company, then if it's a good stock at 8, then it's a better stock at 4, rather than people who will see a stock go from 8 to 4 and say, "Oh crap, something's going on here that I don't know about."

TMF: And there are a lot of people who think like that.

Greenwald: Who would think that and dump the stock. So the valuation rule is very important, which is part two of value investing. The discipline part of it is equally important. And it's important not only to persist when you see bargains, but also not to do stupid things. I think most value investors got in trouble to the extent they did --

and not a lot of them did -- in the boom because they just didn't have anything to do. There weren't bargains out there. And it's a big problem for them right at this moment. And they're tempted to do stupid things. So you have to have what I think of as a default strategy. When there's nothing active in value to buy, you have to think about what you want to do with your money. And it's not simply cash. You can do better than cash with various long-short strategies. If the market is really crazily overvalued, I think value investors have got to start to think about balancing things with appropriate short conditions. You have to have a well-articulated strategy of what you're going to do when you don't know what to do. And that's really the third part of value investing.

Now Warren Buffett has this wonderful example that he always quotes in which he says look, the nice thing about investing is that every day the pitcher throws you a ball and you don't have to swing. So you can wait for your pitch and then hit it out of the park. And that's the good news that is always true. But what he doesn't tell you is that for most money managers, they run up the score whether you swing or not. So you have to think about what you're going to do, if you're going to be disciplined in that context.

So I think of value investing as three things. A search strategy, which we talked about, which is where the low P/E, low market to book comes in. But it's not all of it, by any means, even of the search strategy. A valuation strategy. And a discipline approach to taking advantage of the information that your valuation is telling you about and having a default strategy when it's telling you it doesn't look like there's anything there.

TO HOLD CASH OR NOT

TMF: Mason Hawkins, Jim Gipson, Bob Rodriguez, **Berkshire Hathaway's** (NYSE: BRK.A)(NYSE: BRK.B) Chairman Warren Buffett -- I could name plenty more standout managers -- are sitting on a ton of cash. And then you have someone like Bill Nygren, whom I spoke with a couple weeks ago. He said he's not going to sit in cash right now. He'd rather hold some fairly valued, high-quality names, because he doesn't want to fall behind.

Greenwald: I think that actually the right answer to this is that when you don't know what to do, that's what modern portfolio theory is for. It tells you what you should do is buy a mix of the market and cash, because you just don't know. The value fraternity is so strongly biased in favor of cash, that I think Nygren's answer is more the right one.

I'd say to this student of mine, "Look, what you should do is pick a mix of cash and the market. And even if it's a global market, you're investing in a global market." He'd say "No, no. It's gotta be cash because if everything is overvalued, you're stupid. You're stupid to buy overvalued stocks, on average."

Every so often value investors -- like Warren Buffett in 1968, like Bill Ruane in 1986 -- will come out and say there are just no stocks here worth buying. It's just not worth doing. So, what I wanted to have that student do was look over the next three years at how buying the market would have performed relative to holding cash in those cases. And in almost every case, buying the market beat the cash alternative.

We've never had valuations of the market as high as they are now. And you can do calculations that indicate that the market return is somewhere between 6% and 7%. And they've always been higher than that. But in general, you don't just want to throw away the market because you don't see particular values. Especially if you're an equity manager -- what's your risk? It's deviation from the market. So if you have nothing to do, you might as well minimize risk and buy a full market portfolio, and that's that.

If you're managing, like Seth [Klarman] is, family money, then you're very risk averse. And when you don't know what to do, you'll hold mostly cash. But it's a decision that you want to make in broader terms than, "Oh, I don't see value. I should do cash." So I think Nygren is essentially right about this one. I think Bill, for his position as an equity manager, it's a risk-minimizing thing for him to do, too.

TMF: Is the flip side of that, though, that Seth Klarman and other folks holding lots of cash are just a little too focused on short-term paper losses?

Greenwald: No, no. They're not too short-term. The thing is, they're too risk averse. Seth is the world's most risk-averse person. The problem with the stock market is if it goes down 30%, you lost the 30% forever. So if you're an absolute return person, the fact that -- supposed that there's a 50-50 chance of up 40 and down 30. Well, that's a pretty good average return, right? So if you were just average return and you thought over the long term it would average out, you'd go ahead and buy some mix of the market in cash. But if you really are managing family money, and they're living off it, and they live psychologically off sort of the value over the next two to three years, they don't want to risk the 35% loss. I don't think it's just short-term risk. I think if you wait long enough, you're right. If you have a 30-year horizon, it may be short-term risk. But I don't think anybody thinks long-term is a 30-year horizon. If you've got a four- or five-year horizon, it could be a very risky thing to do. Just look at what happened between 1965 and 1980. Actually, that's a 15-year horizon, where stocks were lower at the beginning of 1980 than they were at the beginning of 1965.

TMF: So it comes down to your risk tolerance and to your time horizon, which is basically what everything comes down to for investment managers.

Greenwald: Right. But I think the right way to think of it is how you're being measured, which determines your risk tolerance. If you're being given institutional funds that the institution wants to allocate to equity, you got a different risk profile on the returns on those funds than if you're managing a family's entire wealth where they care about absolute returns.

THE ART OF SHORTING

TMF: In the past, Bill Miller has put shorts on to lower his net long exposure.

Greenwald: Oh yes. I would also do shorts.

TMF: What's your feeling about shorting as a hedging technique?

Greenwald: Yeah, let's talk about shorts. I think the value discipline is so good, that you don't want to restrict yourself by a lot of these formulaic rules that they [the value crowd] have. And one of the most restrictive is the no short selling. And you understand why they're nervous about short selling. One is the tax treatment of short gains is just ridiculous. It's all ordinary income. Second thing is that there is this property that, as the stock goes up and the short goes against you, your risk goes up as opposed to going down. When you're long and the stock goes down, it's a smaller part of your portfolio. When you're short and the stock goes up, it's a bigger part of your portfolio. But I don't think that that argues for not shorting, I think that argues for being careful how you short.

But I think there are two rules that you want to apply to shorts. One is you don't want to cover a short for a long time because of the tax consequences. And as long as you're doing that, the paradox of short selling is that in short sales, you have to be much more long-term oriented than in long because you don't want to cover. You don't want to trade out of it. What that means, I think, is that as a rule, the shorts you want to do are the shorts where the intrinsic value of the stock is essentially zero, relative to the price at which it's trading. Now it could be 20% of the value at which it's trading, but you don't want to short asset-rich stocks or stocks like **Microsoft** (Nasdaq: MSFT) that have a lot of value there that could go up or the perception of it could go up. Because you're going to get killed. You want to do the Winstars of the world, where there's no value there at all when you analyze the competitive situation. And it's got a market cap of $12 billion. And it's got $14 billion in debt.

So the first rule of shorting is that you have to take a long-term view. And you have to have a big margin of safety. You want to make sure that there's relatively little value. Yeah, but there are a lot of opportunities like that.

The second thing, again, to manage the risk of the short, is you really want to be able to handle at least a double in the price after you short the stock. You want to run a test, you've really got to stick with it with a short. You don't want to bail. Well, I guess you could bail out and take the short-term loss, but you really don't want to be forced to sell out at a ridiculously high price. You want to stick with it.

So I think that you want to be much more circumspect about how much you're going to short. Right now, people are 50% in cash. They're value investors. They're sort of 50% in cash, and they've got 50% in other things. I think a 20% short position would not be bad. I think a *big* short position is much more dangerous. Because if it goes against you and the mania is persistent, you could get killed.

The third thing is -- and this is sort of an aspect of modern value investing, and it's a risk control measure with respect to value investing -- looking for a catalyst. What Mario Gabelli actually looked at -- you know, he was going to buy these stocks on private market value where the valuation information starts to get a little dicey because private market values, which are takeover values (which is what Bill Nygren does), are in fact related to market values. And if the market is crazy, the private market values may be crazy, too. So what he looks for whenever he takes that risk is for what he calls a catalyst. Somebody, some event that's going to take him out -- a recapitalization, a stock buyback. On a smaller scale, a takeover, a change in management. He's always looking for something like that. Whenever the risks are high in a value investment, you want to try and look for a catalyst that's going to get you out of it.

So suppose I'm going to short something like -- this is actually a short I did; I really don't invest much myself -- **Juniper** (Nasdaq: JNPR), there was no way it was going to be worth anything because it was going up against **Cisco** (Nasdaq: CSCO). If it got into the market against Cisco, it meant there were no barriers to entry, and everybody else was going to be able to follow, and that Juniper would just be dead, too. If it didn't get in against Cisco, it was dead anyway, so there was no way Juniper was going to make a big amount in the long run. And they had a huge market cap. So I shorted it at about 180 and it went to 280. I think it actually went to about 330.

TMF: Ouch.

Greenwald: Exactly. And then, of course, I shorted more because the value rose. I didn't do a lot of this. Now it's down around $23 a share.

TMF: It worked out in the end.

Greenwald: It worked out in the end. But I think the mistake I made was -- and this is the last point I'd make about shorting -- in shorts, much more than longs, you obviously want to look for a catalyst. You want to look for something that's going to undermine the stock price. Paradoxically, in shorts, you're in for the long term. You want to short things you're going to hold for 20 years once you do it. But also, that's where you want to do short-term earnings forecasts. Because in the shorts, they're mostly *very* overvalued, and what you're looking for is an earnings disappointment. So that *there* [as opposed to long investments], you do want to look at short-term earnings, just to see what's going to happen. And it's not because you're going to short based on the short-term earnings forecast, but you're going to pull the trigger when you think there's a reasonable prospect that earnings are going to be disappointing. So the value is not going to be there. And you look, say, in the case of Winstar, you look at the telecom industry. And you look around at a surrounding event where profits in telecom are going to evaporate, because you think that's the sort of news that will undermine Winstar.

TMF: So you're not just looking for the typical, overvalued and yet growing company? You don't want to short **eBay** (Nasdaq: EBAY), for instance, just because you think it's rich?

Greenwald: No. eBay is the classic case of something you don't want to short. Because eBay, there's real value there.

TMF: And if you wait long enough, the value will catch up with the price.

Greenwald: Exactly, so you can't short that one forever. You want ones that really are essentially mania stocks. I think **Google** is a better one, because we know that there has been a succession of search engines. eBay has big competitive advantages. It would be hard to compete against eBay. Google, on the other hand, if you have a better search engine -- we went from **Yahoo!** (Nasdaq: YHOO) to AltaVista and then finally to Google. But if you go to another one, the appeal of Google will evaporate fairly rapidly.

TMF: Right, and the boys in Redmond are busy working on its competition.

Greenwald: Exactly. So in one case, there's real value underlying it. In the other case, the value is really highly problematical. So eBay might be worth a half to a third of what it's trading on. But Google is probably worth about 10% to 15%. The values of these things do grow in general for the eBay-type thing, so you don't want to risk shorting that, because you can't do it forever. The second thing you want to look for is a collateral earnings disappointment, something that would take the bloom off Google, so that you at least thought about the risk that Google could triple in a month. And that is a risk.

TMF: I have one question that goes back to the old Buffett partnership. In those days, Buffett made a lot of money through investments he categorized "relatively undervalued." Are you familiar with what his strategy was?

Greenwald: No. I've got the old partnership letters, and I've read them. The interesting thing about his strategy in the old days is he played it pretty close to his vest. If you read the old partnership letters, you'll see that he has a lot of blind -- he says a company and then he sort of describes it, but he doesn't tell you what it is.

I'll tell you what I think went on there. Don't forget, those were the days of the "Nifty Fifty." Even second-tier company stocks were pretty illiquid. So that, for example, for years if you just shorted **General Motors** (NYSE: GM) and bought **Ford** (NYSE: F), that was a good investment, just in dividend yield along. Ford was like 7%, and General Motors was like 3.5%. In the long run, you know they're not that different. They're both big auto companies. The economy of scale went away for both of them at the same time.

So I will bet you that if you look closely at what he was doing, he was shorting the big glamour stocks that were overbought. And this goes back again to these three legs of value strategy. He's looking at the ones that everybody is looking at, that everybody is piling into, where the herding is taking place, and he's shorting those. And he's buying sort of the second-tier companies in that area. The only word of caution I would offer is that Ben Graham used to try to do that. It didn't work out as well for him. He'd do railroads, but railroads then, some had lots of natural resources, they had a lot of real estate that was differentially valued. So you have to be pretty careful, I think, to do that properly.

IDENTIFYING FRANCHISES

TMF: You mentioned earlier -- and your book says it, too -- you first look at the asset value, then the earnings power, and then you see if there's any value in the growth of the business. Can you talk about that? In your book you say a lot of times growth is not worth paying for.

Greenwald: The way to think of growth in the simplest possible terms is *growth requires investment*. Everybody on Wall Street sort of talks about scalability and growth without investment, but if you look at the history of any growing firm, the amount of capital they put in grows with the growth in the firm. It just tends not to be scalable.

So now I'm going to grow. Let me not look at the growth in sales. Let me just look at the process of putting in money. So I'm growing and I put in $100 million to fund the growth. Now, there are three possibilities. One is that I'm beating my head against a highly competitive market where other people are frankly better positioned than I am. Suppose my cost of capital, what I had to pay to raise that $100 million, was 10%. Well, I'm going to earn a lot less than that 10% in that market. So I'm going to pay 10 million a year, which is 10% of 100 million to raise the money. I'm going to invest it at 8%, which is 8 million a year. I'm going to lose 2 million a year. So the growth destroys value in that case for the existing shareholders. And the way it gets disguised, of course, is that they are taking it away from themselves. They don't go out and raise the money. They just reinvest their earnings in a way that loses money. Anyway, but it still dissipates value.

So if you're growing at any kind of competitive disadvantage, you're going to lose money. That's value-destroying growth. What people are going to earn in a competitive market is the cost of capital. If the returns are above it, there'll be a lot of entry, and returns would be driven down. So now I invest the 100 million. I have to pay these people who provided at 10 million a year. I earn 10%, because I'm going to earn my cost of capital. So I earn 10 million on the new business, the growth. I pay 10 million to fund the growth. And I'm left with nothing. So growth without a competitive advantage has zero value.

The only growth that has value is if I put in the 100 million, I make 20 million a year, and I only have to pay 10 million to the investors. Well, when do you make 20 million a year on a $100 million investment? It has to be where people can't copy you. Because if everybody could do that, everybody would do that, and those investments would not earn 20 million a year. So the critical thing is that if you're going to buy the growth, there better be a franchise there. There better be some protection against entry that's going to eliminate the value.

TMF: Are franchises harder to find these days? I just want to share a little fact and that's that **Wal-Mart's** (NYSE: WMT) own brand of dog food right now is the best-selling dog food in the world, according to *Fortune*. It beat out Purina. Wal-Mart's doing the same thing in other categories with its other private-label brands. What that means to me is that low cost and distribution means a lot more than brands in a lot of cases.

Greenwald: I'll tell you what a franchise is. A franchise is clearly something that you can do that your competitors can't. And there are really only three possibilities. In the sense I'm using it, I don't think they're disappearing, but I think people are going to have to look more closely at where they are. The first thing that is increasingly rare in a rapidly changing world is that I've got technology that they can't match. That I can do it at a lower cost than they can. Those things go away very quickly, because people can copy technology. It's usually only in very complicated process industries that you have -- and some pharmaceuticals where you're patent protected, that you have technological advantages.

The second possibility -- we talked about the cost side -- is the demand side. Remember, it must be something that somebody else can't replicate. People can replicate brands. So what it means is -- what a franchise means is you have to have captive customers. Customer captivity is probably going down a little. The Internet makes it very easy to compare prices. It's the enemy of profitability in that sense. But if you look at repeat purchase behavior, it probably hasn't changed all that much. So the second thing is customer captivity.

The third thing that they can't match, which is the absolutely crucial thing, is they can't match my cost, even though they've got the same cost structure, because I have economies of scale and they don't.

TMF: And that just compounds in their favor.

Greenwald: And that compounds. The smaller the competitors are and the bigger you are -- but the thing about economies of scale is you also have to have customer captivity to some degree. The reason for that is if there was no customer captivity, people could just come in and steal your scale.

So the real franchises are cases where there's some customer captivity, and you've got a competitor in there who has big-scale advantages in a particular market and is aggressive about keeping everybody else out. Now the question is, where are economies of scale achievable? The answer is: increasingly rarely on a global scale. The economies of scale that you can achieve now -- and this is essentially both the Wal-Mart and the **Microsoft** (Nasdaq: MSFT) story -- are local.

Wal-Mart started dominating local areas; its fixed costs were determined by the distribution infrastructure in that area. If it had the dominant share in that area, it was very hard to compete with. Their distribution is a classic case of local economies of scale. And then they just metastasized. They spread out from Arkansas, and like an inkblot, they took over the world.

Now, just as Wal-Mart and a lot of other profitable can do it in geographic space -- and by the way, as services become a bigger and bigger part of the economy, services tend to be produced and consumed locally. So you want local dominance in distribution and advertising and in management. Microsoft did the same thing in product space. And the good thing to think about is the comparison between Microsoft and **Apple** (Nasdaq: AAPL), that Apple tried to do the whole PC industry, and there was no way they could dominate the whole thing. Microsoft started with a very small part of it, with the Arkansas of it, which was the operating system. And it dominated that. And then it moved to the adjacent states -- to Excel, to Microsoft Word, and out.

So I think the answer is that franchises are different now, but I don't think they're any less present. And people aren't as good at managing them. So the irony is that where these franchises are concerned, where you've got a dominant market position, that in a global world -- because it's almost impossible to dominate big global markets (the example people got undermined are the auto companies) -- but in a big global world, you have to think locally. Because the only markets that you're going to be able to dominate are local markets. And the only exception to that that I can think of, is -- I'm going to talk about telecommunications in a second, because it bears this out -- is **eBay** (Nasdaq: EBAY). Because everybody wants to come to eBay, because that's where the people agglomerate. On the other hand, if you were going to compete with eBay, the obvious way to do it would be to pick a specialty. It's not widely known, but eBay makes a lot of money in a small number of categories that they dominate. And they protect those pretty fiercely. They know what they're doing.

If you look at telecommunications, if you look at cellular -- the most profitable cellular companies are the old Baby Bells -- **Southwestern Bell** (NYSE: SBC) [Cingular] and **Verizon** (NYSE: VZ). Because they have the fixed infrastructure in the Northeastern United States. And they have 40% of the customers to bear the cost of that infrastructure. Whereas the national companies, like **AT&T Wireless** (NYSE: AWE), which is a disaster, have the same costly infrastructure. And they've got like 3% of that market to bear the cost.

The only exception to that rule, that the most profitable are the most concentrated, is **Nextel** (Nasdaq: NXTL), and they've picked a market concentration. They've gone after the business customers with features. It'll be interesting to see if they can sustain that advantage. The landline companies are much more profitable than the longdistance companies. So even in leading-edge, like telecommunications, what people don't seem to have learned, and the Cingular acquisition of AT&T [Wireless] is just the most recent example of this, is that franchises are increasingly going to be based on the Wal-Mart model, which is local dominance.

TMF: And it's probably not a coincidence that Bill Miller is a big shareholder of Nextel.

THE ONE INVESTOR TO BET ON

TMF: What's your favorite book?

Greenwald: If I were going to start off as an investor, I would start with Ben Graham's book, *The Intelligent Investor*. It's not because he really lays out all the really good ideas that he had perfectly, but it's just a terrific introduction to the attitude it takes to be a successful investor. I know that's a boring answer, but I think that's the best answer I can give for a beginning investor.

TMF: Boring is not a problem. A lot of people turn down value investing because it's "boring." Boring can be very profitable. What's the biggest mistake you see investors making?

Greenwald: Oh, it's clear: They buy lottery tickets. That they want to talk about what they've done. And that's psychologically been true all over the world in every period of time. It's that they want it and they want to get rich quick. They want to invest $10 and have it be worth a million two years from now. And they all want to do that. That is clearly the biggest problem in the market.

TMF: In the classes you teach, what's the most important lesson you teach your students?

Greenwald: I would say it is this systematic three-part approach, which is search strategy, valuation technology, and a structure that allows you to be patient. Now that's three. I don't think you can get by on any one of those.

TMF: Yeah, it's really the combination of all three. And a lot of people do think they can just do one -- they can just be patient or they can just sit there screening all day. They don't know what to do once they find the information. They're at a loss.

Greenwald: Right. And if you make that point, you'll do a worldwide service to investors. One of the problems with value investing is that people sort of get their hands on one of the three or two of the three, and they don't see the complete system.

TMF: You know a lot of the great investment managers out there. Who are your favorite managers, your favorite funds?

Greenwald: Look, there is one phenomenal fund. It's a hedge fund. First of all, I've got a lot of money in Sonkin -- the kid who did the 25% a year. They're not mutual funds, unfortunately. There's a fund called Brookdale at Weiss Asset Management [where Andrew Weiss is president and chief investment officer]. He's a guy I've known for years. My wife thinks he's crazy, so she won't let me put as much money as I want. But the fund is like up 14% this year, and it was up like 50% last year. I've known him since we started investing together in 1976, and he is a *very* smart guy. And if I had to pick one guy to put the money in, I would pick him. He may still be open is the thing.

TMF: And what is his strategy?

Greenwald: He's a quite distinguished economist. He's actually at BU, but he's there because he wants to be in Boston. He was at Columbia. He's a fellow at the Econometric Society. So he asked himself what's his comparative advantage. And his comparative advantage is incredibly complex situations. They've got these splits in London on the Exchange, which was sort of complicated multipurpose funds. And there are many different tranches of value you can buy there, like complicated dual-purpose funds. They also own shares in other splits, which complicates it further. There was a complete disaster. The whole market melted down. And these things, when the market melted down -- because they supposedly were offering safe returns at the first tranche, and then they defaulted on those safe returns. So it's a market that's a disaster. And it's a market that's very hard to understand. That's his kind of market.

Other things he does -- again, he tends to do funds. There was a period when Brazil was a hot economy, if you believe it. There was a Brazil fund that was trading in the United States and was actually briefly trading at a slight premium. Well, he found that there was a Brazil fund that was trading in Argentina that had essentially similar assets that was trading in Argentina at like a 30% discount. So, of course, he shorted the New York Brazil fund, bought the Argentina Brazil fund. And he does a lot of complicated sort of funds like that in obscure places. So his talent is dealing with complicated situations and processing a lot of obscure information. That's his strategy for being places where nobody else is. And he's very good at valuing those sorts of things, because he has the technical ability to sort of value the option values and all the other things because of his training. Again, he has a terrific search strategy. He's good at valuation and he has a good valuation approach. And he's a very disciplined guy. Now, my wife, as I say, happens to think he's crazy. I don't think he is. I think he's crazy about some things, but not about investing. So the discipline might be a problem, but of all the people I know who are open, I would say that that was the best fund.

TMF: Well, that's probably a good pick. The last question for you is you've had a lot of great investment managers come to speak to your class. Is there one story that stands out for you that they've told?

Greenwald: I don't think it's the stories that are so useful. I think it's the people knowing what they're good at. I'll tell you two stories -- one where I was wrong and the person was right. There's a guy called Glenn Greenberg who absolutely says he's not a value investor and is just about the best value investor out there -- I don't know if you know him.

TMF: He's with Chieftain Capital, right?

Greenwald: Yeah. He's got a phenomenal record. So he came and he talked about a company called **Iron Mountain** (NYSE: IRM). Iron Mountain is a document storage company. He talked about how they were rolling up the industry and buying local things. I said, "Oh, a national strategy -- a waste of time." But of course it wasn't. What they were really doing was they were doing a **Wal-Mart** (NYSE: WMT) strategy. They were dominating one region at a time. And he invested in it on very favorable terms. He actually discovered it by accident. It worked out. I think he's had a lot of investments like that. And I think Seth does that, too.

So I guess the things that most impress me is that the people that I think make a lot of money are the people -- now Glenn is closed and Seth is closed -- but they are people who really understand the areas that they're doing. So Glenn does seven to 10 companies, but he *really* understands the economics. He's just a brilliant, sort of natural industry economist. And he's just naturally good at judging these franchises, almost unconsciously so. And I think that's the thing I would find most impressive. I think Seth (Klarman) has it. I think Glenn Greenberg has it. I think there's some other value -- and, Buffett, obviously also has it.

TMF: And Buffett also has owns a stake in Iron Mountain, through **Berkshire Hathaway** (NYSE: BRK.A).

Greenwald: Right. Right. So I think when they come, that's the thing I'm most impressed with. And I think in his own obscure field, Andy Weiss, who also speaks in the class who does Brookdale -- also has that facility. I mean he's just very good at articulating how he's going to lay off the risk. And these are very technical things. They're not industry understanding. I think when you hear that, you really know what you're dealing with. And that's the most impressive set of things that I think I hear in that class.

TMF: It's been a pleasure talking to you. Thanks so much.