March 16, 2017 ~ Paul Lountzis, President, Lountzis Asset Management, LLC, Wyomissing, PA

Ben Graham Centre (BG): Could you tell us a little bit about yourself and your journey to becoming a value investor?

Paul Lountzis (PL): I was born and raised in Reading, Pennsylvania. My parents were Greek immigrants. I'm the fourth of five. I have three older sisters and a younger brother. And you guys will love this. I went to a Catholic high school and I'm Greek orthodox.

I graduated and got into some good schools (Villanova, waitlisted at Notre Dame, etc.), but I had no money, so I went to Albright, which was local college, and I commuted. It took me 8 years to graduate! I worked at the hospital in the lab. I drew blood and did lab tests on it; I really love health care and I did that from age eighteen to twenty six when I graduated.

I read about Buffett when I was twelve. And I thought that was really interesting, but my parents didn't have money. I couldn't go to the Ivy leagues so it wasn't easy to break into money management. I had three choices in my mind: the first was to get my C.P.A. (I had a finance degree). My professor looked at me said "Paul you like accounting so you can understand Financials. You'll never want to do accounting, you'll have a nervous breakdown." And he was right, so I didn't do that!

The second was to get into a bank management training program and move over to the trust department. When I look back now, I think I'd last in the trust department for about three minutes. They'd fire me, so I didn't do that either. Then I got lucky. I ran across Mike Rowe, whom I had lost touch with years ago, and he said "Paul, there's a local consulting firm that does Fortune 1000 consulting." Everyone there had a technical undergraduate degree from one of the best schools; MIT, Carnegie Mellon, Cal Tech, and an M.B.A. from one of the best schools. I had neither, but I really worked hard. They started out in the chemical industry but they broadened out all over and the guys were just brilliant. Even though I was older as a student - I had just graduated from college at twenty six which obviously is older, those guys were in their thirties. We did competitive analysis so we would fly around the country and evaluate businesses for Fortune 500, Fortune 1000 companies and what a blessing it was for me. I developed the unique skillset to go out into the field and interview people to really get to the crux of the important things, and I really enjoyed it. After three months there I was presenting to Fortune 500 companies along with the senior guys! I was there for three years and in a three year period I learned an enormous amount from the people that I worked with and from the research I did. I did work in ammunition, in rifles, in pharmaceuticals, in medical devices, in specialty chemicals, in managed care, consumer products.

After I did that for two and a half years, I made up my mind that I had a skill set so I picked up the phone and I called Buffett. I spoke to maybe ten or fifteen of the best value oriented money managers in the world (Bill Ruane, Mason Hawkins, etc.) I just cold called them all. Having said that, one thing I will say is I had read a lot. As much as a kid could. I didn't just call them and say "hey." I read their letters, etc. This was the summer of 1988 and I got lucky. Chuck Royce

interviewed me and Michael Price interviewed me. He said “you know, Paul I just hired five analysts, if it was six months ago I would have hired you.”

Then Chuck Royce hired me and I got lucky again. Chuck was great to me. He's one of the pioneers in small cap along with Ralph Langner out of Chicago. I worked for Chuck for a couple years and when I was with Chuck he had 1000-1200 stocks because he’s small cap. I didn't want to own that many stocks. I called George Michael who runs First Pacific, and he said “you got to call Bob Goldfarb at Ruane; he's going to love what you do because they only own six or seven stocks. So, I did! Bob took my call. Now Ruane, Cunniff, and Goldfarb ran the Sequoia fund which Buffett helped start and I joined there. I was there for almost a decade. I was a partner for six years and I got to really work with and learn from them. It was just a great experience because what I did was a little different. I spent a couple hundred nights on the road because what we would do is we would talk to competitors, customers, and former employees to make the numbers come to life. The business is so competitive, and I'm never going to be as smart as Mr. Buffett by sitting and just reading annuals. In general terms, it is very hard (excluding of course 2008-2009 where anyone could have made money). It's so competitive today that sitting around and just reading the numbers isn't enough. You've got to get out there and really bring the numbers to life. A lot of the big positions at Ruane were Progressive, Harley Davidson, some that we never bought like Nike and others. I flew around the world and got to learn about businesses. It was great. It was very hard on my family, but it was great to learn. Then, they allowed me to live in Pennsylvania. I lived in Greenwich Connecticut for a period of time.

Our second son was born there and Chuck said, “Paul I don’t care where you live” because I was traveling all the time. I said to Chuck, “I'm never in the city and I'm meeting you up here in your satellite office in Greenwich”. I knew my family was safe; my parents were there, her parents were there and then I just galivanted around. And after they made me a partner, four years later they wanted me to move to New York, and I said “guys, I'm going to be traveling all the time -- I’m not going to dislodge my family”, and they agreed.

Then after almost a decade there, I decided I wanted to do my own thing because I was generating my own ideas. I made the decision I don't want to deal with product. I didn’t want to deal with mutual funds or hedge funds; I think “two and twenty” is ridiculous. You’re not building a long-term business; the moment you don't produce, people leave! So, I wanted to build relationships with families, therefore I focus on separate accounts. The beauty of a separate account is that the *clients* own the security, and I'm a conduit through which they own it. You can be very tax efficient this way. If you create a product (e.g. a mutual fund or a hedge fund) you would have to have a strategy, and strategy is self-limiting (long-short, small-cap, big-cap, etc.). I like a separate account for a couple reasons. One, you can manage a more meaningful amount of money for the family; two, I decided to do fixed income, which was a great decision, rather than just equity. Equity alone will wane because when you couldn't find stocks we just left it in treasuries, but you can do better than treasuries!

I can go into any geography, although I don't invest in India and China, I can’t add value there, but I’ll go into the developed world - I've been to Europe and elsewhere - so I have no limitations geographically and I have no limitations market-cap-wise so I have enormous freedom in the public markets which is a real blessing for your clients. I think you can build a better business

that way because the family is looking to you to help preserve and grow their capital - they're not giving you one tenth of one percent of their money hoping to compound it forty percent a year, and that we charge a flat 1% of 25 basis points a quarter (whatever your assets are at the end of every quarter just multiply by 0.0025). We run pretty concentrated portfolios. We only own ten to fifteen stocks in most cases where the top ten are probably fifty to sixty percent. And then for fixed income, we do the same thing. If we really like a fixed income security - I own some fixed adjustable preferred now - one issue is fifteen percent of the account, so we concentrate.

That's basically been my journey. Our four kids are grown now so we moved to the city. I kept my back office in Pennsylvania because I have great people there, but I live in New York City now. That's where I want to build a firm. We have about one $160 million under management, and we have a great client base. We just want to grow that, and build upon that!

BG: How do you think the investment environment these days is different in comparison to twenty years ago, and where do you see the biggest inefficiencies these days?

PL: When I joined in September of 1990, Bill Ruane was telling me back then that the game was getting harder. It's even harder today. What I would say is: there's a lot more really smart people out there. The number of stocks has gone down from nine thousand to under four thousand; so, there's fewer securities.

It's just a much tougher game, but ultimately at the end of the day, you're looking for anomalies. It's that simple. The business is all about insights and judgment. It's generating unique insights, what I call differential insights, then having the correct judgment, and then finally the toughest is the courage to pull the trigger. So, it's insights, judgment, and courage. Those are the three things you really need, and they're hard because basically what you're saying is you're trying to balance confidence and arrogance, as well as humility and fear. You want to be confident, but not arrogant, because you make mistakes. And you want to be humble because you make mistakes, but not fearful because if you're fearful you'll never buy anything. It's kind of as if you're on a seesaw and you're balancing humility with fear over here and confidence with arrogance over here. You've got to be careful because you know on the one hand, you're basically telling the world "you're wrong" because you're buying it.

Right now, we're in the eighth year of a bull market. 2015 was the toughest without dividends reinvested. The S&P and DOW were both down a little, but it was up with dividends reinvested. It's eight straight years up and six of the eight have been up double digits! So, in my year-end letter I told our clients, "look, the next eight is not going to be like the last eight". I mean we had years where we were up 40-50%. That just can't go on! With several indices, the great majority of the gains have not been revenue and earnings growth - it's really been multiples expansion. You look at the three things: dividends, earnings growth, and P/E. It's really been a phenomenon with the P/E. And part of that's been fueled because of the lower interest rates. The lower the interest rate the higher the P/E. In terms of opportunities, we're having a tough time in the equity markets right now, but we're doing a lot in the fixed income space with those fixed adjustable preferred that I was talking about.

BG: With the interest rates so low, is it not very challenging to buy fixed income products?

PL: What happened was I got lucky again. I was reading the U.S. Bank annual, and they were issuing a fixed adjustable preferred, and I had never bought a preferred stock in my life. The reason I didn't (I'm overgeneralizing), but a lot of companies, when they issue preferred, they don't want to issue equity because it's diluted. They don't want to take on more bank debt because they're debt companies, so they issue preferred. So, when you look at many preferred issues, their balance sheets are terrible. If you have a bad balance sheet I won't even look at you! However, I was reading this in the U.S. bank financial reports and I saw that it was non-cumulative and perpetual - both of which I didn't like. Then I saw the coupon was six and a half which was 3-4 times the 10-year T-bill; it's called the January fifteenth of 2002 and this was 2012. Then I saw that the dividends were taxed at capital gains rate, not ordinary income. Big difference! I saw that if you hold it to the call date you get wonderful (tax qualified) dividends. At the call date, if they don't call it, they've got to pay me! So, at the call date, it's a floating rate security. There's a lot of them that are fixed only, and if they are, and rates go up a lot, when you go to redeem it you could get killed. All the income you got over the prior ten years could vanish. But that can't happen to us, because with what we have is adjustable.

I went to my trader, and he said "this is too good to be true" so we only made it a five percent position. And knowing what we know now, we would have made it ten or fifteen percent! The reality is though, we didn't buy it for the appreciation. Last summer when the 10-year changed, that $25 security was $32. He wanted me to sell it, but I didn't want to sell it because we would have got maybe 3.5 years of dividends up front. But the last couple of years we wouldn't have had any cash flow - and I bought these for cash flow. We own sixteen of them and five of them are $25 ones the other 11 are $1000 ones, and they are a little different. The $25 ones pay interest quarterly. The $1000 ones trade like a bond with accrued interest, and they pay semi-annually. I bought them for cash flow and income, the interest rate protection at the call date, and the qualified dividends. And so, we sold in 2012 all our muni's and corporates and we bought all these. And at the end of the day they're just phenomenal securities!

BG: Can you elaborate on the iterative process between doing the research at home with the annual reports and then meeting people?

PL: What would I like to do is segment it into trying to understand the business model. For example: what's noble and important? Understand the management, and how good they are as operators, capital allocators, and if they shareholder oriented. For the shareholder-oriented, a lot of that you can tell from the proxy. For capital allocators and operators, you can tell by the numbers. You know how they compare relative to their peers which is not that hard.
So, business model, management, and the third thing that I try to look at is the valuation, and then the fourth thing that I think is important is industry structure. The industry structure and the business model are intertwined, so I try to understand the industry. How big is it? What's the *runway* you're look at? Like Amazon: retailing in America is four or five trillion and they're at a 160 billion. It's frightening; who's going to stop them? They operate at low cost with replicable convenience. So, you compare that with Google and Facebook. Global advertising is

probably 800-900 billion. I'd rather be in Amazon's shoes! The market caps of Google at 400-500 billion, and Facebook at 350-400 billion.

I really like to understand industry structure because it drives business models, and I like to understand how big an industry is, what the runway is -- is it global? How does it work? And then I try and study all the individual companies and read all their angles and go back many years. I might even go back twenty years! I may not read all twenty years but I go back twenty years and read twenty years or eighteen years just to get a sense. Then I look at their income statements and balance sheets trying to understand what's different.

Then I say to myself: what two or three people on the planet can give me *differential insights*? Who knows this industry cold? And then I approach that. I already know the numbers though, and I know the industry. Every industry has guru publications, and I'll call up and get the annual issue and get a couple years worth. Then I just zoom through and that's where you find some great names as well. I also look at the back of annuals and see CEOs who have retired or people who are missing. Once you find one former employee, they all know each other! Once you embed yourself in an industry, everybody knows everything.

I'm looking for the insight! The numbers have given me questions. For example, why did Progressive in the 80's and 90's have returns on equity of thirty percent plus? Everyone else in auto insurance was half that or less. With the work there in 1977 they were doing $45-$50 million in premium. Peter Lewis made the decision that he wanted to build a great firm and Peter was a little crazy, but he was great! He hired three MBAs, and I met with two of them; their insights were unbelievable. They told me all about Peter Lewis, the culture, their claims, etc. They made the numbers *come to life*!

People just don't do that. They're not going to do the research. Another important point is Ruane had quasi-permanent capital so they had clients that left them alone. So, Bill could invest over five, ten, fifteen, twenty years, and that's getting harder and harder to do these days.

BG: You talk about how Amazon still has a huge growth potential, so how do you factor growth into your valuation of companies?

PL: One of the things we do is focus on the downside. I learned that from Mr. Buffett, from Bill and Rick and Bob and the team. I'm always focused on what could go wrong. It's the exact opposite of how most people look at things. I try to put myself in the position of other people, whether it's my client or a CEO of a company. At the end of the day when I look at a business, if I can't look out two three four or five years and have a reasonable idea of where it will be, I can't project the cash flows. If I can't project the cash flows, I can't value. If I can't value, I can't buy it. For a lot of businesses, if I can't look out three to five years and have a reasonable idea where that business will be, I put them in a "too hard" pile.

For example: my daughter would come home from high school and get onto her laptop to watch Hulu, so I decided to go to the National Association of Broadcasters conference in Las Vegas in 2007 and I met with Jason Kilar [founder of Hulu]. Back then nobody knew who he

was, but nowadays everybody knows Hulu! I went out there because I was terrified for the cable companies. It was one of the best businesses because they had dual revenue streams; they got paid per member per month by the distributors whether was DirecTV or dish or the big cable guys, and they got the advertising revenue. I was really looking out five to ten years thinking these guys are all in trouble; and it was all stimulated by my daughter! When I went out to Vegas, Jason Kilar said 'Paul, people aren't going to subscribe to cable. The only lock cable is going to have is the broadband. They're not going to give a damn about the phone.” And then the final product is their video product. I thought that whole video product was at risk but I thought this way ten years ago, and I was right! Now, I’m not trying to brag at all! So what am I trying to tell you with this story? I went out into the field to confirm it. In the end, what did I do? I avoided all the cable programmers, and I avoided all the cable companies because when I look out, I have no idea!

BG: Can you tell us about your biggest investment mistakes, and what you’ve learned from them?

PL: One of them was a Mattel. The stock went from the mid-forties to $23. Jill Barad who had built the Barbie brand to a couple billion since 1982 did a great job as an operator. It was a four and a half billion dollar company at the time and Barbie was $2 billion. With hot wheels and matchbox, and all these other products that they had, it came up about $4.5 billion.
It was just a great company from that perspective. They made Jill CEO, and she felt kids were growing out of toys quicker, so she bought the Learning Company. Learning Company made these books for kids that they could touch and the book speak. She paid $3.5 billion for an $800 million in revenue business; they didn't do their homework. My mistake was: she was a great operator but she wasn't a good capital allocator. There's very few CEOs that are great at both, so that was a really good lesson. We paid $24 and we held it for several years, and it went to $10 and we never had the conviction to increase it, and we sold it for maybe a gain of a buck or two. But the opportunity costs for our clients was huge!

Another one was Harsco. Harsco was in several businesses and one of them was global scaffolding. Scaffolding was a real local regional business, but they were one of the few companies that could go to Saudi Arabia and help them build a nuclear power plant. What happened was the bottom fell out of that industry and I didn't realize that they had several companies in Europe but they never brought them together under the Harsco name. So, when that industry got hit, they were doing $3 or $4 billion, and they went to half that. With the stock, it wasn't good, but we lost only a few bucks. We might have paid $20 for clients and then we ended up selling them right around there.

The biggest mistakes I've made are mistakes of omission, not commission. I went to the Gabelli Automotive Aftermarket conference for many years in Vegas where a lot of companies come, and I met the people at O'Reilly Automotive, and I liked their business model. They were middle-America which I liked, 50% went to auto dealers to fix cars 50% or were do-it-yourself through retailers. I liked a lot of what I saw and back then the stock was $40 and I never bought it. It went almost $400 but for whatever reason I just never gained the conviction to buy it!

BG: Regarding your point on the differences between operator and capital allocators, how can you differentiate between them when you're evaluating management?

PL: It's really hard, but the operator is easier to evaluate than the capital allocator because a good operator is reflected over many years in the numbers. The capital allocator gets harder because what if they've never made any big acquisitions. In most companies that I really like, I don't like acquisitions; I like organic growth. I would pay more for high quality organic growth. Every time you make an acquisition, you're taking big risks because the seller always knows so much more than the buyer. I've read in many different industries, 60-80% of mergers really never work for the acquiring institution. There's cultural differences, there's technology, integration issues, compensation issues, geographic issues. It's much easier to build things from the ground up.

BG: If you could do it all over again what would you do it differently?

PL: No. I dealt with the hands I was dealt, so I did the best I could given where I came from and I have no regrets. I loved every minute of it. It's been very hard but that's good.

BG: How many hours do you work a day?

PL: It's all day. It never stops and there's no segregation. I don't even know what days off are except when my assistant puts it on my calendar. If it wasn't for my family I wouldn't know when Christmas is. Now I'm being serious I'm not saying that I work all the time, but pretty much all the time. But it's not work! It's fun. What you'll find is if you really enjoy it there's limited segregation. If I didn't really love it, I couldn't do it.

BG: For those that are already aspiring value investors, what advice would you have for us moving forward?

PL: I would read everything I could. I'd read the mutual fund reports from Southeastern Asset, Seth Klarman, if you can get his letters. I'd read everything I could from the really great managers. I'd really study those managers. Just read and read! That's how you learn! See how they do it. I've studied 20-30 firms and how they make investment decisions. One firm operated on three principles: they spent no time marketing; they would only make five percent or bigger investments in a company, less than that and they didn't think it was worth it; and all three had to agree when they made a purchase. On the sale only two of the three had to agree. I studied these firms in all these areas just to see what I want to do.

For example, on the actual picking of stocks, I don't think you should have more than two or three people in the team. I have no interest in having fifteen analysts. You don't need fifteen analysts. It becomes disruptive because you segregate them by industry. This is the way a lot of firms are structured. They tell you that you're covering railroads and industrials. You do this for three years and what are you going to do? If you can't buy, you're bored out of your mind. If

you're on the sell side, you cover ten companies in technology and you do that for two years. You've talked to the CEOs, you know the industries. That isn't fun! I've just been blessed and lucky I worked with marvelous people that gave me a lot of freedom. I learned an enormous amount working with them thinking with them all the time. So I would say read, learn, think, and then be really proactive. Seriously just pick up the phone call these people. Say "Mr. X, I've been reading your annuals for twenty years. I'd really love the opportunity to come down and meet you". You have to step up but really do your homework.

March Madness is coming in, and I love March Madness! Let's say you would want to become a division 1 coach someday so you read everything about you can about coach Krzyzewski [Duke University basketball coach], you learn all about the industry, you're passionate about it. He has a summer camp so you drive down and you meet him and say to him "Coach, I've studied your career and have enormous respect and admiration for you. I really would love to begin my journey to becoming a division 1 basketball coach like you. Are there any opportunities here at Duke to sweep the floors?" One of two things are going to happen. First of all, how many people do you think have ever done that to him? Very few, if any at all. Second, if you're really knowledgeable and approachable, and thoughtful, assertive (not aggressive), two things are going to happen. One, he's going to look at you and think "this guy's a jerk," in which case you don't want to work for him then anyway! The second thing is he's going to look at you and see himself in you, and if he can't find you an opportunity, just think of who he knows! He can call hundreds of coaches and get you a job. Then what you do is you just keep building a relationship. Every two or three months you e-mail him and say "Hi coach I'm still interested, so please just keep me in mind if anything comes." That's how you do it. You've got to take charge and control of your life.

The biggest challenge is trying to figure out what you want to do. It's very hard to help someone if they don't know what they want to do. I was fortunate after reading Buffett, I kind of knew what I wanted or thought I knew, because you don't really know until you do it.