Berkowitz: Bruce Almighty

When you read about or watch interviews with the investing greats, it's always difficult to know what's the truth and what's putting a gloss on things. Few clients are comfortable hearing their money manager being uncertain, of not knowing; confidence sells better! Most fund managers don't have the luxury of having 'permanent capital', so must reassure their clients – especially during periods of poor performance – that they are doing the right thing, or risk seeing them divest. So it's probably fair to say that *necessarily* investors are not always completely truthful with their clients.

Of course, clients can hardly complain. Most are fickle and will be quick to think that their manager has lost his touch after a period of poor performance, a situation that all investors will find themselves in sooner or later. This is a tricky time for the long-term, contrarian investor, as nuances in his style and each of his investments will undoubtedly come under scrutiny. Intelligent investing is a multi-faceted discipline that almost lends itself to cheap criticism (*'What – you own that piece of junk?'*). It's for this reason that a good many hedge-fund managers don't disclose their positions to clients.

Having said that, managers can hardly complain either. Let's face it, how is a client to know whether a manager really has what it takes? A long-term investor generates relatively few independent data points for a client to make a statistically-sound assessment of his ability. Ten years of performance data is too short, perhaps also twenty years. Who could blame the (many) doubters along the way?

Currently facing the spotlight is Bruce Berkowitz of Fairholme Capital. In so many ways he's a role model for the investment industry. He is a contrarian value investor and has a truly excellent long-term track record (over 10% p.a. after expenses over the last 10 years; the S&P500 over the period returned 1% p.a.). And he's heavily invested in his fund alongside his clients – perhaps the best way of ensuring his incentives are aligned with his clients'.

Having been awarded the title of Morningstar's *Fund Manager of the Decade* as recently as 2010, Berkowitz has been under considerable pressure as a result of a couple of years of poor performance (largely unjustified in my opinion).

Berkowitz's style is to invest in relatively few positions. He considers investing in financial stocks as *"right in his circle of competence"* – and it would appear that he has form to back up this claim. He invested in **Wells Fargo** in the early 1990s, when most investors believed that the bank's loan book could turn sufficiently sour to require a dilutive equity issuance, or worse. In a memorable 1992 interview with Berkowitz in the *Outstanding Investor Digest*, the interviewer's tone was decidedly tongue-in-cheek (if not disrespectful: *"Does a vivid imagination run in your* *family?"*), at a time when it looked like the investment in Wells Fargo wasn't working out. Berkowitz had the last laugh though, as the investment turned out to be a seven-bagger for his investors. Years later, Bruce avoided the worst of the financial crisis by having a zero weighting in financial stocks. Then in 2010, with many financial names beaten down and recapitalised, Berkowitz deployed significant capital to a select group of financials, including **Bank of America** and **AIG**. The lacklustre performance of these stocks, and others, since then has led many of his investors to ask for their money back. Having reached $22bn in assets in 2011, his fund has shrunk to below $7bn currently due to a combination of performance and outflows.

Berkowitz recognises that *"today we look like bums"* but that this is to be expected when you *"ignore the crowd"* (his firm's tag line). He has worked hard to re-establish the many merits of his investment approach.

With all that in mind, I listened with interest to a twenty-odd minute interview given by Berkowitz on Consuelo Mack's *Wealthtrack* in October 2012. He is obviously incredibly smart and a very serious investor who does very serious analysis. And he's got his money where his mouth is, so he clearly believes strongly in his analysis. Yet in my opinion, some of the things he said in the *Wealthtrack* interview are puzzling and in some cases a misrepresentation of the facts. How much of this is down to his need to inspire the confidence of his clients is tough to know.

The first thing that jumps right out of the interview is his absolute level of confidence and conviction. I counted twelve the number of occasions he mentioned the word "facts" in the interview. In my experience, there are seldom times when an investment can be termed factual. I would see investing more as a confluence of often conflicting pieces of information that need to be considered for risks and opportunities, but that's just me…

In his discussion on stock concentration, he says:

"Why would you possibly want to buy your 10th best idea if you can buy more of your best idea. I understand if you're not confident or you feel ignorant about what you're doing…but if you believe…and the facts are telling you that you are right, then I don't believe you need any more than ten (holdings)."

I agree. Similarly I could also ask: why would you possibly want to buy your 5th best idea or indeed your 2nd best idea if you can buy more of your best idea? I guess the point I'm making is that knowing and ranking your ideas from best to worst is fine in theory, but highly complex in reality. Among the many value investing greats there's a range of views on portfolio concentration, each with its own merits and drawbacks. To describe as "ignorant" portfolios that are less concentrated than his is, to put it mildly, unfair. And as we discussed in a previous article here, portfolio concentration has its risks.

Moreover, when investing in financial stocks, one's ability to confidently and accurately analyse is diminished. Berkowitz has invested around three-quarters of his fund in financials. I've written before about the difficulty of investing in banks here, so I'll just briefly summarise my view. Banks are capitalised with just a sliver of equity, making the valuation of that equity highly sensitive to assumptions and outcomes. Moreover, an analyst's ability to understand and evaluate banks is made all the more difficult by the complexity of their business models. In short, the margin for error is large.

On Bank of America he said: *"You have to understand the facts. The facts are we bought companies after they turned. Their values, their book values, liquidation values, bad debt ratios, RoEs, RoAs, whatever you want to look at, were improving…The fundamentals, the facts."* He went on to say: *"We look at book values, we look at more stable measures, we look at performance ratios and we know that eventually the facts cannot be ignored."*

The value of following trends in RoEs and RoAs is debatable. They can be manipulated and can tailspin on a change in the economic environment.

[If you don't take my word for it, take it from Baupost's Seth Klarman (number 16 on his *Twenty Investment Lessons of 2008*): *"Financial stocks are particularly risky. Banking, in particular, is a highly leveraged, extremely competitive, and challenging business. A major European bank recently announced the goal of achieving a 20% return on equity (ROE) within several years. Unfortunately, ROE is highly dependent on absolute yields, yield spreads, maintaining adequate loan loss reserves, and the amount of leverage used. What is the bank's management to do if it cannot readily get to 20%? Leverage up? Hold riskier assets? Ignore the risk of loss? In some ways, for a major financial institution even to have a ROE goal is to court disaster."*]

And for many of the same reasons, book value measures of value are far from stable. It is probably the best metric to use, but is it sufficiently robust a "fact" in which to place 75% of one's trust?

Berkowitz talked a lot in the interview about his successful investment in financials during the late 1980s. *"This is what happened in the late-80s and through the 90s and I thought it was a replay and it is turning out to be a replay…it is a replay."* But how much does the late-80s period count for in predicting the future? The environment turned out to be relatively benign and Wells Fargo survived. So what – it's just one data point, right? What does that say about banks' ability to survive the next crisis, whenever that may be?

Berkowitz believes he has an extra layer of safety having *"bought systemically-important companies, at a fraction – say less than half – of their liquidation values."* To me this is an important point to address – in my opinion, buying "systemically important companies" is a weak crutch. No doubt some financial institutions are systemically important, but that doesn't necessarily mean that equity (or bondholders) will be protected from losses. It's a twisted logic: the financial system is so intertwined that it could trip itself up, so there's safety in the most intertwined of them. I prefer to get my margin of safety in other guises.

I believe his most controversial statement was the following one, when he summed up the Bank of America investment case:

"So here you have a company that is, last time I looked, $9, that has a book of 20, that's trading for less than the cash they own in the bank – what am I missing?"

[This was not the first time he made such a statement: in his 2011 Wealthtrack interview he said: *"…I see companies selling for below liquidation value, for below the cash that they own, that they had in their own bank and in other banks…"*.]

I was gob-smacked to hear him say this; perhaps more gob-smacked that Consuelo Mack didn't pull him up on it. He inferred that equity holders were entitled to ring-fence the cash assets on the balance sheet for themselves. Unfortunately as a common equity holder you're last in the queue! You've got to wait for the other $1.9 trillion liability holders to pick over a $2.1 trillion carcass. Instead of risk-free cash, you are entitled to the dregs of the company; risky, illiquid and difficult to value assets that might have to be discounted heavily to entice a buyer. Berkowitz knows this. I can only assume that he wanted to present an investment case for Bank of America that is rosier than reality.

His description about what went wrong at AIG struck me as a naïve presentation of the situation:

"AIG is a victim of a set of circumstances, from Hank Greenberg leaving, to two little small divisions that were no longer being watched by a smart manager, almost blowing up the company – because of liquidity issues – Hank Greenberg would never have let that happen."

How can he pooh-pooh "*two little small divisions*", without acknowledging just how much damage "*two little small divisions*" can inflict on a risk-taking, leveraged financial company? How can he be sure that there aren't any more such divisions buried deep in the bowels of current day AIG? I would also be sceptical of his claim that such an event would not have happened under Greenberg, but I digress.

Again, he takes comfort in AIG's systemically important place in the financial system. *"You're becoming a large owner of a systemically important company that has to exist, after it's been refurbished."* That AIG 'survived' the financial crisis is cold comfort for those investors who were diluted down by over 90%.

And finally on AIG *"You're buying (net) tangible assets for less than 50c on the dollar"*. This might be true, but it doesn't acknowledge the risks around that. While banks' assets may be incorrectly valued on their balance sheets, at least their liabilities are a known quantity. Insurance companies are more complex again because their liabilities are also an unknown quantity. With AIG'S 5-to-1 leverage ratio, a mere 10% fall in the value of its assets (or a similar rise in its liabilities) would put the stock back at book value, and leave the company twice as levered. Such is the scope for errors in valuing financial companies.

I'd like to reiterate that I have a lot of respect for Bruce Berkowitz, his approach and his success. He may well continue to generate excellent fund returns, especially if a certain set of favourable macro conditions play out. And in a way it's incidental that this article discusses him at all, because my main aim was to highlight how our investing heroes can present themselves and their investments in a too-favourable light. It's a sales pitch that highlights all the positives and few of the negatives. By all means, read what they say; just receive their words with that in mind.

Not convinced about what I'm saying yet? How about one last one quote (from the same *Wealthtrack* interview):

"You only need a few good ideas in a lifetime to do unbelievably well."

Yes; and only a few to go horribly wrong for you to do unbelievably poorly.

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