PORTFOLIO MANAGER'S REVIEW

THE MANUAL OF Ideas
SERIOUS IDEAS FOR SERIOUS INVESTORS™

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When asked how he became so successful, Buffett answered: "we read hundreds and hundreds of annual reports every year."

Edited by the
Manual of Ideas
Research Team

"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Top Five Ideas In This Report

Also Inside

About Portfolio Manager's Review

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our managing editor John Mihaljevic is a member of Value Investors Club, an exclusive community of money managers, and has won the Club's prize for best investment idea. John is a trained capital allocator, having studied under Yale chief investment officer David Swensen and served as research assistant to Nobel laureate James Tobin. John holds a BA in Economics, *summa cum laude,* from Yale and is a CFA charterholder.

THE EUROPEAN VALUE ISSUE

► **Snapshot of 100 European companies**
► **24 companies profiled by *MOI* research team**
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European companies mentioned in this issue include
ABB, Acergy, AEGON, Alcatel-Lucent, Allianz, Allied Irish Banks, Altana, Anglo American, ArcelorMittal, ARM Holdings, AstraZeneca, AXA, Babcock & Brown, Banco Bilbao Vizcaya, Banco Santander, Bank of Ireland, Barclays, BG Group, BP, British American Tobacco, British Sky Broadcasting, Cadbury, Carnival, CGG Veritas, CNH Global, Commerzbank, Continental, Credit Suisse, CRH, Delhaize,
Deutsche Telekom, Diageo, DS … son,
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GlaxoSmithKline, Heineken, H… tels,
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Inside:

Exclusive Interview with Max Otte, Ph.D., Professor of Corporate Finance at the Fachhochschule Worms

With compliments of
The Manual of Ideas

Exclusive Interview with Professor Max Otte

Professor Max Otte, Ph.D. is one of the most prominent academics in the field of value investing. Having received his doctorate degree from Princeton University, he is professor of corporate finance at Fachhochschule Worms in Germany. He is also founder of an independent financial advisory firm and a center for value investing in Germany, as well as author of the German bestseller *Der Crash kommt*. The latter was published in 2006 and predicted the financial tsunami caused by the implosion of the U.S. subprime sector.

Professor Max Otte
Fachhochschule Worms – University of Applied Science

MOI: **Tell us a bit about your path to becoming an investor. How did your academic pursuits shape the kind of investor you have become?**

> *"…if you are not born with the gene, you need about two business cycles to acquire the necessary discipline and tools. As Warren Buffett said, it's not so much your IQ and knowledge, but the discipline that is important."*

Professor Max Otte: I can't say that I have been an investor from early on. I probably would have studied history and philosophy. To have something more practical and a more convertible currency, I studied business and economics for my master's degree. I dabbled in stocks during my college years from 1984-86, but lost interest. Michael Kelleher, a financial practitioner, taught security analysis in my MBA class as an exchange student at American University. I found the subject highly fascinating and came out with a top grade, but then wrote a master's thesis on international currency coordination. My doctoral degree from Princeton University is in political economy and theory. In 1990, I withstood the temptations of the dark side (Wall Street) and rejected an offer from Salomon Brothers to finish my degree.

Value investing grew slowly on me. First, though I'm not particularly interested in money, it's nice to have a bit more that a professor's salary. Second, security and the distribution of power were prominent interests in my political studies. Money *is* security and power — and value investing an interesting and unique non-conformist and non-confrontational way to acquire it. Third, couple that with interest in the international economy, industrial dynamics and corporate strategy, and you have a powerful mixture.

I have taught management classes, international economics and corporate finance. I do also have an entrepreneurial side and did start various businesses. In late 1998, I discovered *The Motley Fool* and thought that Germany should have something similar. To make a long story short, now I run a stock letter in Germany, a wealth management firm, and a hedge fund.

Still, if you are not born with the gene, you need about two business cycles to acquire the necessary discipline and tools. As Warren Buffett said, it's not so much your IQ and knowledge, but the discipline that is important. I am now way into my third cycle, and the skills are paying off handsomely. And I think that success — since it was acquired the hard way — rests on a solid foundation and is here to stay.

***MOI:* You teach Bruce Greenwald´s Columbia University seminar on value investing in Europe. Are there examples of value investing theory that have to be "adjusted" in the context of investing in European stock markets? More specifically, are there any accounting or other pitfalls non-European investors should especially look out for?**

Professor Otte: Europe simply is "more messy and complicated" — if you don't have a truly global player, you really have to go country by country. That's ten times the market research you do for a U.S. company. This is a reason why many U.S. investors don't look here too much, which in my view is a big mistake. The legal system is as reliable as in the U.S. (fewer liability suits), and the business culture is generally one of more trust than in the U.S. The firms are generally more global than U.S. firms, which often tend to be run with a U.S.-centric approach.

As IAS/IFRS are taking hold, accounting is becoming very similar. However, in the German-speaking countries (Germany/Austria/Switzerland), we had the conservative principle of the lower value (cost or market) in financial account. This often understated income and assets and created hidden reserves. Some companies that do not need to fulfill the requirements of the major stock exchanges still cling to the old national standards, which I think were much superior in providing reliable minimum figures and stabilizing the economy. Again, those figures were not always "true and fair," but much less subject to manipulation than, for example, GAAP.

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Warren Buffett doesn't like the idea that he has to disclose holdings over three percent in a public company in Germany once he starts buying.

***MOI:* Are there any countries in Europe that you find especially appealing? Perhaps individual sector or company opportunities that have arisen from local macroeconomic dislocation? Are there any European countries you find particularly unappealing?**

Professor Otte: First, Europe as a whole is a rather tremendous place and as attractive as many emerging markets. Multiples are down and often lower than in the U.S., and revenue margins in European companies are generally lower than in the U.S. So many European companies have more fat to carry them through the crisis and can work on their margins.

Since I'm an active investor myself and my time is limited, I stick to what I know. I have a rather small universe of stocks. Over 80 percent of my holdings are in Europe right now, just 10 percent in the U.S., and the rest in Asia and gold.

My favorites are still German, Austrian and Swiss family-controlled "hidden champions" — often world market leaders in niche markets, often with very sound balance sheets, excellent growth prospects and long-term oriented management. Currently, you can buy many of these stocks at valuations as if they would never grow again. I presented three [ideas] at the Value Investing Seminar in Molfetta in 2007 – CTS Eventim, United Internet, and AWD – and investors who bought them below my recommended price would have broken even by the summer of 2009 despite the crisis. More of them: Grenke Leasing, Fielmann, Celesio, Takkt. Among large players, Nestlé looks very good, as do the pharmaceuticals.

Ciccio Azzollini [CEO of Italian investment management firm Cattolica Partecipazioni] points to Italian banks: they have strong balance sheets and deposits, few complex financial products. That sounds like a reasonable place.

Bestinver have been doing fantastically in Spain; Sycomore in France. There are opportunities everywhere.

I would, however, avoid the cyclicals, since they have rebounded strongly and are often valued as if we will reach old profit records in 2-3 years' time. I find that rather ambitious.

Another country to look at is Poland. Poland really is a European country more than an Eastern European one, and it's economy has been doing very well in the crisis.

***MOI:* To expand on the previous question, do you think the value investors' toolkit should change in any way as a result of recent volatility on the macroeconomic level?**

Professor Otte: Not at all, but true value investor´s nerves have to get thicker. Volatility is not risk! Volatility always is risk AND opportunity. So a volatile world economy is good for the value investor (not necessarily good for mankind), like Buffett and Soros I favor effective and strong regulation of financial markets. However, you need even more discipline.

"Another country to look at is Poland. Poland really is a European country more than an Eastern European one, and it's economy has been doing very well in the crisis."

***MOI:* In your 2006 book, *Der Crash kommt*, in which you identified imbalances in the world economy and implications for individual stock portfolios, you have advocated gold as an investment. If you're worried about inflation but want to stay fully invested in the stock market, what types of companies would you recommend to focus on and which ones to avoid? In this context, are gold mining companies a good substitute for buying physical gold?**

Professor Otte: If you're worried about inflation, keep in mind that stocks are real assets and should, by and large, be inflation-protected. Of course it's better to have the usual suspects: companies with a lot of pricing power, high margins and little capital requirements to fuel growth – in other words, typical Buffett franchises.

Gold is less an "investment" but more of a hedge for the worst case. In my PI Global Fund I hold about five percent right now. Gold stocks are no substitute for physical gold in a real crisis, since transactions in such stocks could be frozen. They are more of a raw material speculation – you have to know about reserves, forward sales, mining costs and so on.

***MOI:* When analyzing investments, Warren Buffett is known for saying that if you need a spreadsheet or a calculator to get to an answer, you should probably pass. Somewhat uncharacteristically for a professor, you have also stated your preference for "simple" valuation approaches. Can you share with us some of your favorite investment approaches?**

Professor Otte: Indeed, the longer I invest, the simpler I try to keep my decision principles. Buffett is absolutely right. It's funny very few people are taking him seriously, though he has been repeating this again and again. First, it's all about sorting out and throwing away risky ideas. Then, you have to know that there are indeed different approaches for different stocks. I owe a lot to Bruce Greenwald for having made me see this very clearly.

You have to know that probably about 80 percent of all businesses do not have lasting competitive advantage. That's the nature of capitalism! But should I throw these out and only concentrate on excellent businesses? No! Buffett is not doing that either. When you buy into a cyclical company, you should use normalized earnings (average 10-year or 15-year margins times most current sales) and a reasonable multiple. You also should calculate net asset value at replacement cost as a second data point. (Greenwald lays out a nice procedure in his book, *Value Investing*). Normally, both methods should produce results in roughly the same range.

Simpler still: book value (except for banks and highly leveraged companies) is the single best measure to use. Buffett uses it for Berkshire. When Lufthansa fell below 60 percent of book value in the spring of 2009, I bought. Lufthansa is one of the world's leading airlines, it has supplementary businesses and the Frankfurt hub, and the airline industry would certainly survive the crisis. Considering its net asset value was most likely higher than book value, that was a margin of safety of at least 40 percent, if not 50 percent or more. That was *all* of my research, but I have been flying Lufthansa and competitors all my life and could compare discipline and standards in the airlines.

"When you buy into a cyclical company, you should use normalized earnings (average 10-year or 15-year margins times most current sales) and a reasonable multiple. You also should calculate net asset value at replacement cost as a second data point."

It is not helpful to look too much at *past* financial statements and growth data when you analyze growth companies. If you look for franchises, you really have to think about the growth dynamics: will the business be able to grow without a lot of capital? Will growth in its niche be sustainable or defensible? That often has a lot to do with regional market share or market share in a narrow product space with lasting preferences. Again, Greenwald in his book *Competition Demystified* lays out the logic. Then you add 1) dividend yield; 2) organic growth (inflation, price increases, same-store sales), which does not require capital; and 3) capital-investment driven return (reinvested earnings in percent times return on reinvested capital divided by cost of capital). This allows you to think about the three drivers of long-term return separately.

For franchises, I use Buffett's 10-year bond yield (adjusted a bit up in times of unusually low interest rates) as cost of capital. So if you have a potential 13 percent return — for example, 3 percent dividends and 10 percent growth — at capital costs of 5 percent, that's very attractive.

***MOI:* What is the single biggest mistake that keeps investors from reaching their goals?**

Professor Otte: There is a human tendency to react to the market. Daniel Kahnemann at Princeton received the Nobel Prize for pointing out that the reptile brain is very powerful in money matters — in other words, fear and greed often rule. I and my staff are advising about 250 individual investors and family offices. Sadly enough, even with the most coaching, some panic and change their direction in the middle of a cycle, be it that they panic during a sellout or get greedy in a boom. So the biggest mistake is to discard your logic of yesterday, simply because the market does not immediately do what you think it will eventually do.

“I am also looking at a list of relative losers over five years to find interesting cheap stocks. And sometimes I take home an interesting idea from value conferences or a publication like yours.”

MOI: **How do you generate investment ideas?**

Professor Otte: I’m generally a man of too many ideas. So my challenge is rather how to narrow down my ideas systematically. My discipline is to stick to a rather limited universe of stocks — 200 German, Swiss and Austrian, maybe 100 international stocks — which I follow intermittingly and which change only slowly over time. I’d rather profit from price fluctuations in the securities I know than try to find new ones all the time. I read papers. I read annual reports. I have an excel-database with approximately 150 stocks. Over time, you develop expertise in certain markets. You acquire a “feel” for those stocks, when a sector or stock might become interesting and when its price is getting too high. I am also looking at a list of relative losers over five years to find interesting cheap stocks. And sometimes I take home an interesting idea from value conferences or a publication like yours. That’s not forbidden by law! Success is what counts.

MOI: **What is the last book you have read? What books have helped you become a better investor over time?**

Professor Otte: Patrick Buchanan’s *The Unnecessary War — How Britain Lost its Empire and the West Lost the World* and Nicholson Baker’s *Human Smoke — the Beginning of World War II, the End of Civilization*. There is a lot of interesting thinking against the conventional wisdom in there. What if Churchill had yielded to Hitler’s peace offers and hadn’t started mass bombing German cities to provoke Germany to bomb England with the goal of drawing the U.S. into the war? (Hitler didn’t reciprocate for almost six months). Buchanan argues that maybe even the holocaust would not have happened. History is complex and almost never as simple as the current “truth of the day.” You have to challenge your thinking constantly, as you have to do in investing.

Therefore, the best investment book is still Benjamin Graham’s *Intelligent Investor* which is not a cookbook, but teaches you how to think. Bruce Greenwald’s *Value Investing* is another must read.

MOI: **Professor Otte, thank you for your time.**

About Max Otte

Professor Max Otte, Ph.D., received his doctorate degree from Princeton University. He is a regular professor of Corporate Finance at the Fachhochschule Worms – University of Applied Science and founder of IFVE GmbH, an independent advisory firm that offers financial information services to its clients. Professor Otte is also founder and director of the Germany-based non-profit organization Zentrum für Value Investing e.V., an association of independent and value-oriented funds managers and investors. Professor Otte has worked as a consultant for over 100 businesses and organizations and is author of many books on finance and economics. His 2006 book “Der Crash kommt”, in which he predicted a financial tsunami caused by the U.S. subprime sector, has become a bestseller.