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listeningin

Paul Lountzis: Value Maven

Have You Heard The One About The Traveling Analyst? He's No Joke

I didn't speak with Paul Lountzis today, even as stock and bonds across the market slipped, slid and sagged in what the talking heads inevitably described — in tones that would have been suitable for contemporaneously recounting the evacuation of Dunkirk — as "the worst market selloff since Brexit."

But I'm pretty sure Paul, whose youthful visage graces the first page of this publication this week — far from quaking — was eagerly combing his screens for long-followed stocks that, just perchance, were falling into his buying zones. That is, if Paul wasn't flying hither and yon to meet with someone — anyone — who might shed light on the proclivities of the movers and shakers at companies whose numbers have caught his eye. And if Paul wasn't at his screens, his investment team most certainly was.

For the founder and owner of Lountzis Asset Management LLC — its headquarters newly relocated from Wyomissing, PA to NYC — is a relentless searcher for value in stocks, as well as the occasional preferred or bond. When we recorded this interview on the first day of September, there was nothing Paul lamented as soulfully as the bloated market multiples that were pricing "so many great, high ROE companies" out of the reach of his clients and him. And, having started raising cash — and cleverly parking a good bit of it in some unusual fixed incomes for his conservative clients — some two years ago, Paul has plenty of assets to deploy back into stocks when valuations again prove tempting.

It's a drill Paul's SEC-registered advisory firm, which he founded in 2000 after stints at not one but two of Wall Street's legendary value shops, has accomplished before, most notably amid the global selloff in 2008-2009 — producing handsome returns for early clients, in return for their patience.

Paul Lountzis

With Lountzis now boasting $140 million in "quasi-permanent" capital from institutions, family offices and wealthy individuals, all managed in separate accounts, Paul is determined to make it a habit.

I wouldn't bet against him. Listen in, as we explore his ideas.
KMW

Hi, Paul. I see you now have an NYC office. When did that happen?
Paul Lountzis: I officially moved in July 1st. But I've been coming up here since '89. I started working for Chuck [Royce] beginning in '89, worked there for a couple of years, and then I worked for Ruane [Cunniff & Goldfarb] for almost a decade

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before founding my firm in late 2000. So I've been up here a lot.

But you ran your own firm out of Pennsylvania for quite a while —

About 16 years now. I really started managing money in June/July of '01. I have great people in my Wyomissing office and plan on keeping my back office, our servers and all our technology and my team back there. But even when it was my only office and my family all lived nearby, I was never there anyway. I mean, I was always traveling — researching, meeting people —

Going out constantly to kick the tires at possible investments?

Yes. This is a really competitive business and essentially the only way to differentiate yourself is to try to see things and understand things that others don't — and it's hard. There are lots of really talented and really smart people out there. One of the few ways to do that — that I've been able to figure out — is just going out in the field and creating external mosaics of what you're looking at, because people already know the numbers —

Everybody has the same access to all the same numbers these days. That wasn't so, years ago.

That's right. Bill Ruane, whom I loved, and Rick Cunniff, whom I loved — Ruane Cunniff was a great place — and Bob Goldfarb and Carley Cunniff — they told me it's just getting harder and harder and harder. Especially, Bill and Rick, who had a lot more experience than me. They told me that in the '50s and '60s, it just wasn't like this. There weren't so many smart people combing over companies and knowing the numbers.

But there's another issue with the numbers, ironically —and it's something foundational: the numbers tell you about *the past*, and the problem is you're investing *in the future*. At the end of the day, it's a formidable challenge. When you combine that with the short-term orientation of so many investors today, the game has gotten much harder.

I doubt anyone, even someone armed with a battalion of computers and algorithms, would dispute that.

It's hard. So I spend a lot of time out in the field, really trying to create external insights and tie them into the numbers. Then we put the two together and tie that into valuation, which is critical. But it's exceedingly difficult to find something that meets all our criteria. Especially now.

> **"A lot of competitive advantages that used to exist are falling by the wayside. And the one that remains is the quality of your people."**

So all your travel isn't just because you're a masochist hooked on frequent flyer miles?

Hardly! I do all the quantitative analysis. I've created quite a few screens over the years, plus I've just been around — you know, I'm *old* —

Whoa, whoa, whoa!

Now, you're reminding me of a time when I called Bill [Ruane]. I was going to meet Mr. Janssen, of Janssen Pharmaceutica — part of J&J in Europe — and I said, "You know Bill, it's hard getting on his calendar, he's pretty old." That's when Bill said, "Whoa, whoa, whoa!" because Bill was like 70 and I was 32 or so at the time. You just reminded me of that.

Well, I'm definitely not 40 years your senior — but you're not *old* because that would make me older!

Right. I'm *so* young! But my experience somehow spans a lot of years. I used to do a chunk of work for The Washington Post Co. because Bill was on the board — so I got to know Don Graham and Alan Spoon, who's up at Polaris Venture Partners now in Waltham, MA — and some other great people in your business. I followed newspapers for a long time and it's a really interesting proxy or case study when you see that the business was $50 billion 10 - 11 years ago. Some $30 billion of that revenue came from run of press advertising and $20 billion was from classified. Of that, $10 billion was help-wanted ads, $5 billion was autos and $5 billion was real estate.

That entire $50 billion business today — I'm guessing — is probably $15 billion. You, and all

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the great journalists out there, have all been victims of technological change — and the readers have all really suffered as a result.

I'm not sure. Can you be oblivious and suffer at the same time? They're certainly entertained, if ill-informed.

I just think the rapidity and magnitude of change in business models is frightening. Industries used to take 30 years to decline — the steel industry or whatever. Now it happens with a rapidity and at a magnitude that are just mindboggling. As a result, in my experience — I don't know if I'm right, but this is what I'm seeing — a lot of competitive advantages that used to exist are falling by the wayside. The one that remains is the quality of your people.

I did a lot of work on Progressive Corp. in the early-'90s — and it turned out that in the course of that research, I interviewed two out of the first three MBAs that they hired. This was 25 years ago, and one was running Viking Insurance in Madison, Wisconsin and the other was working for Carl Lindner in Cincinnati. Going out and talking to people in the industry really gives you insights into the business, into the companies. Think about it. Why was Progressive in the late-'80s, '90s and beyond — why were they always earning 25%, 30%, 35% returns on equity, with not a lot of debt, in the auto insurance space? Obviously, they were non-standard — but everybody else was earning a third of that.

What answer did you come up with?

It's a commodity business. Progressive simply hired better people. They were able to price better and they did a better job on claims. The older I get, the more I'm finding that the people, the culture, if you will, is really becoming a more permanent competitive advantage than things like cable licenses or broadcast licenses or whatever. It just seems that a lot of competitive advantages are going away.

That's ironic, given the discounts people used to apply to businesses whose assets went up and down in the elevator daily. All the more so, considering how little regard many corporations show for their employees these days.

Yes, that's true. Journalism is one of the places that have gotten like that, and that's really unfortunate.

If they've stayed in journalism, most relics like me have either reinvented themselves as independents — or are hanging on by their fingernails at a Murdoch publication or worse.

That's a good way to say it. It is by your fingernails. Maybe by two fingernails, not 10.

While being required to multitask to the point of irrelevance in a never-ending social media "stream." The entire process militates against any thought, much less depth, in reporting — but I'll get off my hobby horse.

No, you're right though. It's a great point. It's sad.

But you are right, too. The economics that underwrote the "luxury" of thoughtful research are no more.

So it has been a turbulent decade in the newspaper industry, and that experience is being repeated in industry after industry.

Has that observation changed your research process?

I'd say it informs it. What we try to do is really look at businesses. We have hundreds and hundreds of securities that we have followed for a long time, on which we've created screens. We follow the numbers. But what varies is the breadth and depth of

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our knowledge on those companies — which ranges from pretty familiar on many of them to intimately familiar with others.

The ones you own, presumably?

That's the idea. The numbers are a guide, a tool, that create the interest. But if we like the numbers, we try to piece together the external mosaic — talk to competitors, customers, et cetera. We want to be able to dovetail the qualitative on top of the quantitative — to bring the numbers to life, if you will, to gain a greater understanding. We want to know, "Is it sustainable, why are their returns so much better than everyone else's, how are they achieved?"

So the numbers are our starting point, then we ask a lot of questions, trying to go beyond them. We try to be creative, in the sense that we ask ourselves things like, "What individuals can we find, who have been in the business 20 - 30 years, who potentially could give us unique, or differential, insights?"

That could be like searching for a needle in a haystack —

Well, rather than pick up the phone and make 40 - 50 calls, we'll try and identify one, two, three, four people that really know the industry. That might include a retired CEO, it might be an industry consultant, whatever. Then, *before* talking to them, we try to become as knowledgeable as we can about the industry, and the companies that compete within it, as well as the target company. We will read the trade literature and all the trade materials we can get our hands on, so that we're as prepared as possible before going to see the persons we're going to see — and then we interview them, *in person.*

Gosh, that sounds like a lecture I used to give to young reporters.

We just think a personal interview is worth a lot more than doing it over the phone. I don't like the idea of calling people cold and trying to extract information from them. I try to build relationships with them. When you do it in person, I tell them, "Look, when I'm done, feel free to call me. I'll tell you exactly what we've done. I'm not going to discuss anything until we've made a decision, but once we're done call me and I'll be happy to tell you what we bought, what we didn't buy, why. You were kind enough to share your time and insights with me and I'd be delighted to reciprocate."

That must elicit some surprise. I doubt they hear that often.

That's probably true. The other thing that helps us is our long-term orientation. We made the decision a long time ago — even though I came primarily from large equity shops — that we'd run all separate accounts. We're an SEC-registered investment advisor running $140-plus million — all long-term, in customized portfolios for family offices, wealthy individuals, institutions and retirement plans.

Go on —

We have just one tiny partnership, where I have all my money, so that I don't compete with clients. I don't have a brokerage account anywhere else. We just like the flexibility of working this way. We buy 10 to 20 securities per portfolio. We also made the decision many years ago to do fixed income — and now almost half my assets are in fixed adjustable preferreds, because we've sold a lot of equities.

We love the freedom of operating this way. We'll invest almost exclusively in the developed world — we'll look at Japan and Korea, the U.S./Canada/Western Europe, but that's really the limit. And we're *heavily* focused on capital preservation in all of our separate accounts. We're *very* conservative.

Clearly, if you've been selling into this bull market —

We have, even though it could continue for another couple of years. We are just not going to pay 22 and 24 and 25 times earnings for slow-growing mature businesses. We're not going to do it. So it's been a godsend to go into fixed income.

Despite vanishingly low rates?

I got really lucky. I wish I were this smart, but I'm not. What happened was that four years ago, in 2012, I was reading the 10-K of U.S. Bancorp. It's a bank I'd followed since the late-'80s, early-'90s, since back when Jerry Grundhofer merged U.S. Bancorp with Firstar to create the banking organization we know today. I've followed it ever since. It's just a great bank.

What caught your eye in their filing?

So I'm reading the U.S. Bancorp (USB) annual and it said they were offering a noncumulative — which I didn't like — perpetual preferred — and I didn't like that either. I didn't like noncumulative and I didn't like perpetual. But then I saw that the coupon was 6.5% — multiples of the 10-year. And that it was really 10-year paper because it's callable in January of 2022.

Now, I'd never bought a preferred stock — ever — because most of the preferreds that we had looked at over the years came from companies that didn't

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want to issue common because it's dilutive and they didn't want to take on more bank debt because of their covenants.

In other words, a lot of the companies that issue preferreds have bad balance sheets. And well, outside of understanding the business, balance sheets are the next thing we look at. If it's a bad balance sheet, we're not interested.

But this, I realized, was a 10-year piece of paper and I felt that U.S. Bancorp's credit was almost as good as the government's, and so I read further. Then I saw that the dividends were *qualified* — meaning taxed at capital gains rates for individuals — and then I saw that it had an adjustable component. As I said, even though it didn't have a maturity date, it was callable in January of '22 — and if they didn't call it, they had to pay me 3-month LIBOR plus a spread of 4.468%. This rare adjustable rate feature reduced both the interest rate risk and the security's duration. I decided, "I don't care if they never call it."

Now LIBOR today is, I don't know, 40, 50, 60 bips, but back in '05-'06, it was 5.5%. So you're getting interest rate protection. First, you had great credit quality, second, you got interest rate protection on the backend, third, you had dividends that are qualified, and fourth, you got a multiple of the rate on the 10-year. Essentially, we'd be locking in very solid cash flows for our clients for several years going forward at rates much higher than we could get on 10-year or even 30-year Treasuries, with only minimally more credit risk.

So you immediately started looking around for similar truffles?

Absolutely. That was the beginning of our buying these fixed adjustable preferreds and it's worked out. I'm not this smart — I bought them for the reasons I just enumerated. But what's happened in the last six months is they've gone nuts. We own 13 of them and we can only really buy two of them now, because their yields to call have been driven so low. The yield to call on the one I just mentioned was 5.53% in January of 2014, for instance, but it's probably only 1.5% today, because its price has run up to $31 now. Far above $25, where we bought it.

Are you selling?

Well, it has worked out great for our clients and we've sold one of them. We are debating, now, what to do with the others. If we can get four, five years of dividends upfront today — that certainly impacts the cash flow our clients are getting. But the yields to call are so low — so we're trying to stay flexible. Staying flexible is also why we're market cap agnostic and we're industry agnostic.

No one is going to box you in?

We want to be able to go wherever the opportunities are, and that's possible in the public markets today. I think you should be able to go wherever your capital base and your knowledge will allow. That's another thing, the product-based side of the business is getting much tougher today, whether it's a hedge fund and its high fees or mutual funds — it's much tougher to manage money because you're pigeonholed. When you have a product, people put you in a box; limit your ability to be unconstrained. You could be small cap or mid cap and then they want you to do all value. Then they limit you by market cap size.

You'll consider securities regardless of market cap?

We've owned things with a $1 billion market cap, and we own Berkshire Hathaway, which is a $350 - $400 billion market cap. It's a big advantage. And that gets back to our clients.

How so?

We really try to get clients that are truly long-term oriented. When we meet with them, it's really about getting to know them — we don't even talk about money initially. I want build a long-term relationship. I tell them, "Look, on the equity side whatever your allocation is — 50, 60, 70, 80% — if you don't have a five-year horizon, don't give us the money."

We ask, "What's the purpose of the pool of capital they're looking to give us? What's the timeframe? And what's their risk tolerance?" They shouldn't exceed their risk tolerance threshold emotionally or financially. There are some people with a lot of wealth that emotionally shouldn't be in the market at all. Then there are other people with a lot less wealth but who emotionally are fine with equity risk. They say, "Paul, here's 80% or 100% of my liquid assets. I want you to put the majority in stocks and I'm not going to worry about it. I trust you." Everybody's different.

True, but it's a real trick to find clients willing and able to be truly long-term, especially when the market starts going against them.

Not only that, saying they're long-term is one thing. Doing it is something else entirely. You're 100% right. That is why I think running separate accounts and building a deep, embedded relationship with clients — so they know you're exclusively focused on what's best for them — gives you an

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edge relative to someone running an investment product where the money may have come from a middleman or a third party.

A lot of managers consider "hand holding" a distraction or worse —
Then they don't appreciate the value of quasi-permanent capital. I came upon this belief over the years I've spent studying Mr. Buffett. I started reading about him when I was 12 or 13 and then obviously began following him much more closely as I got into my 20s. Now, he's many, *many* multiples smarter than I'll ever be. But one of the advantages he has, in addition to his genius, is that he has quasi-permanent capital — which allows him the privilege and the blessing of doing almost whatever he wants. And then he also has the greater privilege of *doing nothing*. That's something that a lot of people in the investment business just don't have the opportunity to do — nothing.

But rightly or wrongly, over the years, we've sometimes done that.

For instance?
Well, take '06 - '07 — not that I was smart enough to predict what happened in the fall of '08 up through March of '09. But I *did* know that things were getting crazy. We did know people were using their homes as ATMs. I had done a lot of work on Freddie, I'd interviewed Countrywide and Angelo Mozilo and Norwest and Mark Oman. We knew the origination business, we saw the low-doc/no-doc loans, we saw private equity firms borrowing 98% of the purchase price — we knew in our minds that these things were not conducive to a good environment. Prices were getting crazy, private equity was creating a floor on all prices. So we didn't budge. Which meant there were accounts we had that were 30, 40, 50, 60, 70% cash. *Cash*, going into the financial crisis. It was really hard, but we thought it was the right thing to do. Our clients could have pulled their money, but didn't.

Your clients didn't complain that they pay you to invest?
No. Our clients are almost all — about 65 - 70% small business owners, and they view me and our firm as their safe capital. Around 15% are executives I've met over the years and another 15 - 20% are older, often widowed, women. The common denominator is that they just trust us.

That's not to say it wasn't hard to sit with that cash. The business was a lot smaller back then than it is today, and it was hard sticking to our guns. But we really try to focus on long-term capital preservation and protecting the downside.

So you sit in cash a lot?
No, But sitting in cash — people focus on cash and view it as a four-letter word. The reality is there are a lot of benefits to cash. It gives you the opportunity to be patient and then exploit opportunities when many people can't. There are a lot of good things that you can do with cash.

The optionality of cash is horribly undervalued.
That's a great word and that's a word I've used in my client letter — that's how Buffett looks at it — cash provides the optionality to be able to do things. Anything you may have given up in the short run you can make up very, very easily, which is kind of how we're looking at the adjustable preferreds. So clearly there are times when holding cash is appropriate. At other times, we preserve capital by holding onto — or even adding to — positions when Mr. Market is temporarily irrational. A great example is Mohawk Industries (MHK).

Do tell.
We were introduced to Mohawk *many* years earlier and we'd followed it for years. In the early 2000s, we were buying the stock at $20, $30, $40, $50 — and then we watched it go to over $100.

Until the housing crisis hit home —
Exactly. During the crisis it went back down into the high-teens for a brief period and then traded in the $20s and $30s. We had the fortitude — it was really painful, the stomach was churning — but we had the fortitude to buy some more at those prices — and we've held on.

I had no idea that it would be trading at $212 today. I'm just not that smart. Besides, we don't really focus on the upside. We just focus on protecting the downside. The upside, over time if you're doing a good job, will take care of itself. And I did know that Mohawk was worth a lot more than $20-ish a share.

Why?
They have an oligopoly with Shaw. They dominate in the flooring space — carpet, tile — they've made many acquisitions — Dal-Tile and Unilin in Europe for vinyl and then wood flooring, among them — so that they and Shaw have dominant market shares domestically. Jeffrey Lorberbaum, Mohawk's CEO, has done a *great* job on every front. It's a very different company today from the

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one we bought 10, 12, 13, 14 years ago.

But the point is that you tend — and this is counterintuitive — you tend to do really well when you're buying things while your stomach is churning. It's unfortunate but that's how it is. Like right now, we're selling and we're really concerned — not that I'm implying the market is a bubble, but at the end of the day valuations are just not compelling in most cases for us. The market is not crazy, but it's fairly valued.

And you're not into buying *relative* values?
No. We don't compromise our standards. For instance, we bought *one* new stock in 2015, and that was Precision Castparts, which went from the high-$200s down to $185. We certainly didn't get it at the bottom, but we started buying it close to the bottom. Then, obviously. Mr. Buffett bought it out.

In addition, we did add to 4 - 6 of our existing holdings in 2015 and the same applies in 2016. For new accounts this year, we probably bought three to six stocks that were existing holdings, but no new ones. The upshot is that in almost two years, we've only bought one new stock. But we've bought a lot of these fixed adjustable preferreds. So many accounts might have 30, 40, 50, 60% in fixed adjustable preferreds.

We think the 4%, 5%, 6%, 7%, 8% returns on them — more than that now, if you count appreciation, which I don't want to count, we didn't plan on that, I was just buying them for safety and dividends — are reasonably attractive returns, *with much less risk*, given the current levels of the equities markets.

That's going to be pretty hard to top—
What we are telling our clients is that the returns we've generated since March of '09 — there's no way they are going to be replicated. We had some *phenomenal* years, with something like Mohawk going from 18 to 212 over the last six, seven years. Our results going forward in a low-growth world are going to be *much* tamer.

You've been reading Jeremy Grantham's GMO white papers.
Yes. Actually GMO has done seven-year asset class return forecasts for a long time. And if you look at what they projected back in 1999-2000, they were right on. Research Affiliates and Rob Arnott, in all the data he publishes, are saying much the same. It's a pretty common thought that the returns going forward on the equity side, counting dividends, are going to be — what 6%? 8%? My guess is that they are *not* going to be 15% to 20% over the next five years.

I'm afraid that's probably a pretty safe bet.
Unfortunately.

The starting point matters. Price matters.
Price matters a lot. The markets are so competitive and there's so much liquidity in the world — with the central banks' enormous balance sheets — there are very few attractive places to put your money. This is the least-loved bull market that I can recall in my 30-plus years of experience —

Except for "TINA" (There Is No Alternative) investors holding their noses and buying.
Yes, this is a really unique time, we're dealing with interest rate levels that are unprecedented — we've never been in uncharted territory like this. It's a scary time in my mind. It's not like the bubble — things trading at 40 times earnings — it's just there's so much artificial in this environment that isn't predictable. And we've never before been so interconnected, globally.

So you're battening down the hatches?
We are always trying to balance risk and return and we're really cautious now. So we sold all our long-standing holdings in Mercury General (MCY) and Bed Bath & Beyond (BBBY) during the first half of 2015. Throughout last year, we lightened up our positions in many of our big holdings that we've been very fortunate to do well in, as I wrote about in my year-end letter — LabCorp (LH), Mohawk, Martin Marietta Materials (MLM), UnitedHealth Group (UNH), Lowe's (LOW) — the retailer — PepsiCo (PEP), Bank of New York Mellon (BK), Progressive (PRG), U.S. Bancorp, Wells Fargo (WFC). As they keep rising, we've sold 30% to 70% of all of those positions.

Well, that answers the question I was going to ask about how high you'd watch Mohawk go before selling, this time around. Especially after your gut-wrenching experience with it during the "Great Recession."
You would have to ask that. Selling, for me, is *much* harder than buying. And I don't think I'm alone in this — I learned that from Bob and Bill and Rick and from Chuck Royce, who was great to me.

Mohawk, again, is a great example. We were very lucky, we held on. And when it got back up to $130, $140, $150, I'd say to my trader, "I never thought it would get here." But then we'd aggressively listen to all the conference calls, reread the transcripts, study all the quarterly reports. And

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they were changing the company, making acquisitions globally, doing a good job of paying down debt, cutting costs — I mean, Lorberbaum and his team were doing a great job.

So you hung in?
Right, every time we would revisit it — which is what we continually do with all our holdings — we would decide, "We're not selling it."

What changed?
Well, last summer, I think, it broke above $200 a share, and we sold about 30% of our position. Most of our sales were above $200. It's $212 now, but got as high as $215 recently.

So it was purely the price?
Well, we felt that the multiple of trailing earnings got steep and then when we looked at forward earnings, with a multiple of 18 - 22, depending on where earnings come in, on a cyclical security — as great as the management is, we just felt that we had to take some money off of the table, and that is what we did. We just felt that the stock had really done well, and we remembered in the back of our minds how it had fallen all the way into the teens in the financial crisis — and it's client money. It's not mine. I guess today that we probably own a Mohawk position that is about half the size it once was.

What about something like Lowe's?
We've sold 70%-plus of that. We paid $17 up to the low $20s for Lowe's many years ago — and I don't like retailing at all — the only two retailers I've ever owned are Lowe's and Bed Bath. Anyway, when Lowe's got into the high-$60s and then broke $70s, we started selling. Over time we've probably sold 70% or so of our original position.

And you've put at least some of the proceeds into those fixed adjustable preferreds? Despite the not-insignificant risk that rates will rise — eventually?
Exactly. We've tried to educate our clients — I've written about it in our letters — that we did not buy these for appreciation. We bought these for the credit quality, the cash flow, the tax benefits of the qualified dividend and the interest rate protection on the backend. So with rare exceptions — we did sell one yesterday — our plan when we bought 90%-plus of the adjustable rate preferreds was to hold to the callable date. We wanted the cash flows.

But they've appreciated so much, so fast, you're in a bit of a quandary?
As I said, we've gotten very lucky. I'm not that smart. Wish I were. We had been able to buy laddered portfolios of these fixed adjustable preferreds, callable between '17 and '24, and we'd paid, generally 102 - maybe as high as 106 for some, but the yields to call were quite attractive.

Then, they started cratering in January, hitting bottom around Feb. 11 or 12, when everyone was afraid that all the banks, really, were in trouble again. Credit risks were permeating the environment.

But this is why you need great clients. For example, Wells Fargo has a 7.98% coupon, callable March 15 of '18. We had paid generally 102, but as high as 106, for it. When that issue dropped to par on Feb. 11, I called clients up, raised several million dollars, and we went in and bought, right around par. So now we have clients getting almost an 8% yield to the call — at the time, it was two-year paper — now it's 1.5-year paper — and it's Wells Fargo paper. You're protected on the backend, the dividends are qualified — it's a phenomenal return.

That doesn't sound like much of a quandary.
No, but these securities have all appreciated meaningfully again since February 11. So that Wells paper, for instance, is at 106.5 today. On some of the older paper that we've held for four-plus years, we're up 25%. So the question becomes whether to sell. Do you want to just ignore that appreciation? As we've explained to our clients, if rates go up a lot prior to call date, they'll lose all that appreciation. It could go back to par. So what do you do? That's the dilemma. On the USB paper, for example, you could get close to four years of dividends paid up front, if you sold it now. You could argue we should sell it and just sit in cash until this paper comes down again — or you find something else. Maybe the equities markets will get hit.

True. How do you balance the risks?
It is a balancing act. One of the things Bill Green talks about in his terrific book, T*he Great Minds of Investing*, are three qualities the great ones share. The first is the willingness to be lonely; the second is the power of humility, which is so enormous, and third is the ability to withstand pain. All three, I've lived, and they're just so true. But that second one — I don't care how hard you work, I don't care how smart you think you are, at the end of the day, investing is just so humbling.

It's kind of like — I played quarterback in high school. When I'd think I knew what I was doing, I'd get killed. But when I went in there humbly and thought, "I'm just going to react — be prepared —

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know the defensive secondary and how they respond and just do my best," I did well. You just have to be humble because you never know enough — you can't know the future.

The central problem of investing.
It is. And if you can help me I'm open.

If I could, would I be writing about it after all these years?
No, you wouldn't. You'd be running the Welling Foundation with about $10 billion in it.

Not a chance. I can't take the pain and I know that.
Investing is really humbling. When you see people like Bill Ruane and Rick Cunniff and Bob Goldfarb and Chuck Royce — and many other great investors who have been doing it for a lifetime — make mistakes, you just realize just how humbling it is.

It's like you're on a seesaw as a little kid. On one side is confidence, knowledge, consistency and on the other side, humility and patience. You have to strike a balance. Emotionally, it's between courage and fear. If you're too courageous you're going to really get hurt with client money, and if you're too fearful you'll never make an investment. Buffett has said, "Temperament is more important than IQ or intellect," and he's so right about that.

Then there's the psychological research saying winning portfolio managers are often sociopaths —
There's a lot of truth to that in the sense that when buying a security, you're basically saying, "I'm right, not the market. I don't care what the market says." But, having said that, it's a bit of an oversimplification.

The reality is you always have to focus on who's selling to you. You always need to keep an open mind and listen to people who disagree with you. Indeed, you should cherish and welcome and seek out people who disagree with you — to help clarify your thinking — assuming they're smart and honest. I find those discussions really helpful. But at the end of the day, making portfolio decisions is a lonely place to be. It just is.

Ever think that you spend so much time on the road, interviewing people, as an antidote?
The one derivative of the way I do research is that I love the resulting relationships, with clients, with folks in the industries I follow. I've found I get enormous insights and generate enormous ideas from them. Some of my best ideas have come from being out in the field.

What I'm really doing is listening, and it took me a long time to realize how important it is to be a good listener. I started out in consulting, doing competitive analysis, and because of that blessing was able to develop a unique skill set, which is why Chuck hired me — and how I ended up at Ruane. But at first, I just wasn't a good listener. Like most people, I liked to hear myself talk.

Eventually, though, I started realizing there are a lot of really smart, talented people out there worth listening to. I also realized that over the phone wasn't the best way to do things.

You use the phone to screen for knowledge, to communicate who you are — and before I call them, I try to really know the industry, the company and the companies they compete with, and so forth. I also try to find out a lot about their background. Where they went to school, where they grew up. Then, on the phone, I try to build a relationship — and only after that, do I go meet them.

What's left to talk about?
Everything, really. When I sit down and meet with people, I'm trying to really get to know them. I'm totally transparent, open and honest — and try to treat them as if our roles were reversed. The only way to do that is to meet them in person.

I'm lecturing next Wednesday at Villanova — something I've been doing for a long time — and I also lecture at the University of Arizona, the University of Alabama at Tuscaloosa and University of Kentucky, because I really love the kids. One of the things I invariably say to them is, "If you're looking for a career, one, you need to really learn to listen actively. Really listen. Two: learn to think analytically "What do the numbers mean?" And third, which I've seen with my own kids, is that you need to be able to communicate — both verbally and with the written word.

But what I'm getting at is that listening is critical — and it's a developed skill. When I do interviews, what I do — this is silly to tell you, you're phenomenal at it — but I just make note of two or three themes before meeting with the CEO, the former president, the former employee, the competitor, the customer, the industry thought leader — whatever. And, of course, I've already studied the company and its industry as intimately as possible.

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So I'll just raise a question and then shut up. *I shut up*. I let them guide the conversation, because they may raise issues I've never even thought of.

You're making it sound too easy!
Here's a great example. Back in the early '90s, I was studying Coke. There was a company called Cott Beverages that was run by Gerald Pencer, which was aiming to create a full turnkey private label soda business.

Remember? They went to Wal-Mart, and to a grocery chain in Canada, Loblaws, and said, "Look, we want to upgrade the quality of your syrup, we want to upgrade the packaging — we want to upgrade your private label carbonated soft drinks." And that's what they tried to do.

Well, around that time, I was doing work for Ruane on soft drinks with a colleague and we had started traveling. My colleague told me he'd found a "flavor guy" in Chicago, who seemed pretty interesting. I thought, "Why does he want to fly to Chicago to meet a flavor guy?" It definitely wasn't my idea. But you never know where insights will come from.

So I went to Chicago to meet the flavor guy. When we met with that gentleman, it was unbelievable. He was making the private-label syrup for a lot of the chain drug stores, a lot of the chain grocery stores. He knew Cott intimately. He knew Loblaws. He knew Pencer himself. The insights he gave us were unbelievable.

Such as?
He told us about the challenges Cott would face, etc. One was that a lot of the two-liter bottles of private label soda sold for 69 cents. Even when comparable Coke and Pepsi bottles were on sale for 99 cents, that 30 cents was a meaningful difference. He said the problem was that for Cott to sell its higher-end cola — with better packaging and higher-end syrup — they weren't going to be able to sell it for 69 cents. They were going to have to charge 89 cents.

Then the question became, with all the marketing dollars Coke and Pepsi spend, would that 10-cent difference on the price be enough to get customers to trade down? He was right. It wasn't.

The point I'm making is you just never know — He gave us insights on Cott, he gave us insights on the management, he gave us names of all these private label head guys at the grocery stores and at the drug stores. A wealth of information.

That just shows how dumb I am. I asked, "Why do we want to go see this guy?" It turned out that he helped us do the whole project and guided us in our analysis. He's still a friend. And by the way, he's also a client now. Has been, probably for 15 years. That's another wonderful derivative of building relationships.

So there's nothing superficial in your approach to research —
No, it's not mere channel checking — and I don't want to dismiss that. But what we try to do is at a whole different level than calling Foot Locker to ask how the Nike Air Jordan is selling. We dig in to get to know a company, gain insights into the management. And we realize that even if a guy left Nike five years ago, he may be able to share enormous insights into what drives Phil Knight.

That sounds like a story —
An old one. About when I talked to a former Nike employee — he had built their sales organization. This is another story that illustrates my lack of intelligence, which is really depressing. But when I was a young analyst at Ruane, we were doing a lot of work on Nike. We met Julie Strasser, who wrote "Swoosh: Unauthorized Story of Nike and the Men Who Played There," and who used to be married to Rob Strasser, who developed Nike Air Jordan in '86. He was a lawyer by trade and then went to work at Adidas. And I met this former Nike sales guy.

Who told you all Nike's secrets?
Well, he explained to me that Phil Knight, in the mid-'80s, when Nike was doing $800 million - $1 billion in sales — and when Reebok was coming out of nowhere with Paul Fireman riding the women's fitness craze — said, "Look, we've got all these distributors carrying our product but not loyal to the brand, even though they're making a lot of money. I need to bring in distribution and create an in-house sales force. So I need to find someone to go around and give these guys ultimatums."

The former sales guy was that guy. He told me Knight allowed his sales to decline in the process of bringing distribution in-house. He knew it would be painful, and Reebok surpassed them in sales, but Knight was looking out 20 - 30 years. By building his own captive sales force, he was able to better protect the brand. And along the way, this gentleman came up with the Nike outlet concept to help small stores with their inventory turns.

At the end of the day, when I sat down with him, the

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sales guy's insights into Phil Knight and into how he looked at the world were priceless — even though this guy had been gone from Nike for years.

If only I'd been *really* smart, I'd be the one with the $10 billion foundation today. But I was young, only in my early 30s then, and didn't fully grasp the implications of what he was saying about Phil Knight and what he was trying to build. He didn't care about Wall Street; didn't care about getting killed on revenues or earnings, because "I'm doing the right thing for the next 30 years."

You're telling me you didn't buy Nike way back then?

Yes, exactly. I didn't listen actively enough. But I'm also contrasting that experience with someone who calls "thought leaders" on the phone and tries to extract bits of information to try to make short-term trades in a security.

Instead, I want to find something that has a long runway. Something we can buy and hold for 5 or 10 or 15 years, led by a great and visionary management team — and that's getting harder because of the rapidity and magnitude of change in business, as I said earlier. You have to be very careful.

Which makes it all the more crucial to size up the people who run the businesses you invest in?

Managements and people today, in my experience, are more important than ever. Their ability to see around corners, their ability to be flexible, to adapt, to modify and clarify their thinking, it's just so important. And it wasn't as important back when Tom Murphy and Dan Burke ran Cap Cities. It just wasn't. And I'm not diminishing them at all, they were brilliant. But it is harder today.

Change really is the only constant. And it's constantly speeding up.

It is. Making it all the more difficult to piece together what it really means. As a result, you have to be raising questions all the time, speaking to some of the best minds in business, or the best you can find. I'm always trying to find people to challenge me and to make me better so that we can do a better job for our clients. I'm never satisfied.

I'm always looking and thinking "What am I missing? What haven't I seen? Where could I be wrong?" We spend a lot of our time on that.

Does it help you that so much of the investment world is focused on the opposite these days? On doing a quick channel check for a scrap of information that might turn into a profitable short-term trade or two?

I would say the answer is yes. One of the things that I have found — again, in studying Mr. Buffett and Mr. Munger — from whom I've learned so much just by reading and rereading what they write — is that the way the assets are raised and the quality of your assets are inextricably tied to what you do.

For example, we have a client in Seattle who gave us a sizeable amount of money on December 23, '05. My firm was a lot smaller then and I was afraid he would leave. He's the only client we've ever had who wanted to be 100% in equities to start — and he still calls me "the king of fixed income." As I said earlier, in '06 and '07, I certainly wasn't smart enough to predict the market debacle in the fall of '08. But for those almost two-and-a-half years, we were 40, 50, 60% in cash — and I was charging clients on the cash.

Now, the cash back then was probably earning 60, 70, 100, 110 bips. It wasn't like now when it's zero. But my point is because we collectively own the firm and we don't have to answer to anyone but the clients, we held firm. And thank goodness our Seattle client stuck with us and thank goodness we had the courage, even though it was scary, to not budge. We were able, when the market got hit, to step in. Now those portfolios are wonderful and we have three accounts from that client.

My point is we're trying to build personal relationships and get what I call quasi-permanent capital. The best way is your own capital; the second-best is long-tail reinsurance like Mr. Buffett has — I'm just not smart enough to do that — the third-best comes from families, individuals and institutions that really understand long-term. And act that way.

Easier said than found.

You are right, but we try. We try to really screen when we meet people. If we think they're short-term-oriented or not a good fit — no matter the amount of money — we walk away. They won't be happy and we won't be happy. That's why it has taken us a long time to build the asset base we have. But we think — hope and pray — it's a better business for it. And finding potential clients like that are the second derivative benefit I referred to earlier, of our relationship-focused research process.

You mentioned liking to be challenged constantly on your investment ideas —

I'm always asking myself, "What are we seeing that

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others don't? Where could we be wrong? Why are we buying a Mohawk or a Lab Corp when other people are selling? Where do we disagree with the market? What do they do that's unique and special? What do they do that others couldn't easily replicate? Why are they better? How? Is it sustainable?"

It's all about asking those kinds of questions and following through with the answers. You're trying to kill your idea.

That's not natural behavior to many people.
Well, like Charlie Munger always says, "Invert, invert, invert." One thing I've learned to always ask over the years is what's going to change? If I can't look at a business and say, "In five years, this is roughly where this business will be," I remove it from my list.

Now, that doesn't mean it won't change at all during that time. But if it could possibly undergo a huge transformation — then projecting the cash flows isn't worthwhile because they're not going to be the same. And if you can't project the cash flows, you can't value it; if you can't value it, you can't buy it.

So I was very interested not long ago to read about Jeff Bezos saying, "because technology changes a ton, what I focus on is what won't change." Especially interested because — though I'd never compare myself to Bezos or Munger — years ago I'd taken Munger's advice to "invert" and applied it to my observation that everything is changing very rapidly. So I started also asking myself, what won't change? As a consumer, I love change — it increases transparency, it lowers costs, — I love it. But as an investor, it terrifies me. That's how you lose people's fortunes.

Has asking what won't change led you to invest in any companies?
Yes. Martin Marietta Materials is an example. Tom Russo mentioned it to me probably in the late-'90s - early-2000s. He was very knowledgeable, he's a great investor and a great person. So — this is pathetic, but I watched it for 11 years. Then, in August of 2011, it fell to $60 from a high of probably $160, and we bought gobs of it. We own it today. It broke $200, and now is around $180 - $185. I would never have told you in August of '11, that five years later, "It's going to more than triple." I didn't know.

What I did know — and this gets back to your question — is that MLM owns quarries. They're in the aggregates business, they compete with Vulcan — Vulcan was a little bit bigger — but now they have bought Texas Industries so MLM is bigger now. But my point is, in 20 years none of that changes — a quarry is a quarry.

It gets $10 a ton for crushed stone. The business is 50% commercial and residential and the other 50% is government. They are going to need aggregate for roads, and you can't economically transport it beyond 100 - 150 miles from the quarry. So as long as you own that quarry, you've got nothing to worry about. You can't get the permits to build new quarries — no one wants one in their backyard. That's my kind of business.

But you waited 11 years to buy it?
That's right. I had to wait for the right price. That's how we can look at things — because we have long-term capital. It's hard to accumulate, and I've paid a price. But I just think, life is short. If you really want to build a good foundation, the way to do it is brick by brick. If you do a great job, word will spread, and you'll have a great foundation.

So many of my friends work in more "normal" firms, where the money comes via third parties, maybe in hedge funds that charge 2 and 20. Well, they might get a very small portion of a client's money — 1% or one-tenth of 1%. Then, because of the high fees and performance orientation, the moment they don't perform, the client is gone. Investment is hard enough. Why pile those extra burdens on yourself?

For the money, clearly.
What that does is it incentivizes you to generate really attractive returns — so people take more risks. I will never invest borrowed money. I learned that from Bill Ruane. Bill said, "Paul, you're not rational when you're investing borrowed money because you could lose money you don't even have." I listened and I'm never going to do it. I don't need to disprove Bill.

That may also explain why you haven't brought up the idea of selling short some of the securities you've sold as too pricey.
What Bill and Rick and Carley and other smart people taught me is that what we're trying to do, which is hard enough, is get the analysis right. Our hope is that over a two- or three-year period — though sometimes longer — it will start coming to fruition. The problem with selling short is not only do you have to get the analysis right, you have to get the timing right. I don't know how to do that.

Very few, if any, do.

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It was Keynes who said — "The market can stay irrational longer than you can stay solvent."

He apparently learned that the hard way.
Yes. Then he became a value investor. One of the big themes that I want to communicate is the importance of finding clients that truly have a long-term orientation. Because the quality of your assets will dictate the success, long-term, of an absolute value-oriented investment strategy. If you don't have those types of clients, you're simply not going to be able to do what we're doing over the long haul.

I'm not interested in three months or six months. I'm looking at five years and 10 years and 15 years. Some of our holdings we've owned 10 - 12 years. Some we've owned since inception — the summer of '01. So I would guess our turnover is less than 5% on the equity side. On the bond side, it's probably even lower because, with few exceptions, we hold to maturity or the call date.

How much time do you spend worrying about the macro environment, instead of digging into companies?
Almost none. Yet one of the things I did — even before the Great Recession — was always object when people described us as bottoms-up. As I've mentioned, we own Lowe's and Mohawk — *not* because of any top-down judgment about the economy. But how could you own those stocks and not keep a fanatical eye on the housing industry? It'd be crazy.

So we know the size of the remodeling market, we follow originations of new mortgages and re-fi's, we follow interest rates. All those macro factors that are specific and tied to an industry in which we may own companies, we follow. We try to tie that into their quarterly earnings and look to the future.

However, we never ever have made, nor will we make, investment decisions based on those factors. We'll never say to ourselves, "We think housing starts next year are going to rise sharply, so we should buy housing stocks." We never do that.

Nonetheless we do believe we need to know the larger picture and have at least a perspective on what's going on in the larger market to the degree it impacts our companies and the industries in which they compete.

As basically an equities guy, how did you get comfortable going so heavily into adjustable preferreds?
What I realized was that fixed income analysis is a natural extension of the kind of research I've done all along. I mean, if you know Progressive Corp., have read their financials for the last 20 years, why can't you buy a Progressive corporate bond? You already know it.

The security analysis — because we're balance sheet-oriented here — is *very* similar. So it was a natural extension to buy fixed income. Besides, we have the great benefit of our trader's 35 years of experience in fixed incomes, and it's always great to bounce ideas off him.

So, for example, because most adjustable preferreds outstanding — 70%-plus — are issued by financials, our holdings of that kind of paper are concentrated in financials. But we won't buy any adjustable preferred securities issued by the investment banks — even though I have enormous respect for JPMorgan, and Jamie Dimon. We simply won't buy any adjustable preferred from JPMorgan, Morgan Stanley, Goldman Sachs, Citigroup — even though they are probably safe.

Because their balance sheets are impenetrable, I'm guessing?
That's it. My attitude is, if I wouldn't invest in the equity because I don't understand the derivatives exposure and their own proprietary trading, why would I buy the fixed income? That said, we have tried to spread our commitments to adjustable preferreds across a number of issues to try to reduce risk. Even so, some of these individual adjustable preferreds that we own are 8, 10, 12, 15% of an account. In one issue. That's concentration.

Do you limit portfolio concentration at all?
We try not to go above 15% in one issue. Now, Berkshire is an exception in some cases, but we try not to go above 15% in any individual issue. So we own 13 different preferred issues, spread across five institutions: Wells Fargo, U.S. Bancorp, State Street, Bank of New York and PNC. I'll just point out, too, that there are a lot more fixed-only preferreds in the market, which we'll never buy. Without the adjustable rate feature, they obviously lack the back-end interest rate protection of the adjustables.

Do you really see nothing in the wide world of equities you're tempted to buy?
We came close in January and February — when the market declined 10 - 11% — we were very close to pulling the trigger on a couple of issues. We're looking at all the areas that you can imagine — energy, which we've never done anything in, really, but we've

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followed for 30 years. We're looking at technology, we're looking at health care, which has gotten hit with these pricing issues. We're looking everywhere.

The challenge is that a lot of these companies aren't growing, and a lot of them are trading at reasonably high multiples. It is making it *very* difficult, given our strict disciplines, to find compelling opportunities. Now, having said that, several stocks we looked at, at the beginning of this year, are up 20% or 30%. So you could make a case I should have bought them. But with many of them now selling at multiples of 25 and above, I wouldn't be comfortable. Even in January-February they were expensive, given their future prospects.

Good examples are the "defensive" consumer staples people are buying today — the high-dividend stocks. The P&Gs, the Clorox's, the Colgates. They're great companies, especially Colgate and Clorox. But their P/Es are in the mid-20s. If we get a multiple contraction to 15 — a more normalized level — you could lose 40% of your money. So who cares about the 3% dividend?

Just to be clear, which stocks are left in your portfolios?
Obviously, given our size, we'd really like to distinguish ourselves in smaller market cap stocks — and a number of our holdings that we've been luckiest with are ones that had market caps under $5 billion when we initially purchased them. Names like Mohawk, LabCorp, Mercury General (which we've sold), Bed Bath — even Progressive, *many* years ago. We really like the $1 billion to $10 billion space. But it's been frustrating for us for quite a while —

Because it's a shrinking universe?
And those stocks have been the most expensive. But that's where we would love to be. Instead, we've been more in the large caps in recent years, because that's where we found the cheapest stocks.

So our big stock holdings are Wells Fargo, U.S. Bancorp, Zoetis, which we bought in the $29 - $30 range, World Fuel Services, United Health. We own a tiny bit of Thor (THO) and TJX Cos. (TJX) — nowhere near as much as we should. We also own a big position in Progressive, big ones in PepsiCo, and in Mohawk. Martin Marietta Materials is sizeable position, as is Lowe's, the retailer. We also own a stake in Loews (L) — the Tisch family business. It's a back-ended way to participate in energy — and they have a lot of cash. LabCorp's another big holding, as is Brown & Brown. Then Berkshire is our biggest. We also own some BB&T (BBT) and some Abbott Labs (ABT).

How big are those positions?
Those basically are our core, if you will, equity holdings, except Thor and TJX are quite small. The others are probably 5%-10% positions. And that's pretty much it. And as I said, we've been paring positions, not buying. We're just having a hard time finding things that really meet our criteria.

But we do have a long list of stocks we'd like to buy, at a price. Thankfully, hopefully, we have patient capital.

When did you last scoop up a number of values?
Our last big buying foray — though we've bought a lot of stock since, mostly in the 10% corrections — was way back in August of '11. That was during the debt ceiling crisis that took stocks down nearly 20%, almost into bear territory.

At that juncture, we were able to buy PepsiCo at $60, Martin Marietta at $60, U.S. Bancorp at $19, Wells at $23. I wish I'd had $5 billion back then! Now, multiples have expanded so much that even a 20% correction won't make them terribly cheap. Stocks are pricey. And that does limit your upside. I don't want to understate the fact that we want to beat the averages. But capital preservation is paramount to us. And as Ben Graham said, the biggest risks, ironically, are during times of favorable business conditions or favorable market conditions. That's where we are now.

The time to really become concerned — and not to be complacent — is when things have done very well.

So how often do you review your equities positions?
All the time. Every day I go in and I ask myself, "Buy, sell or hold?" Every weekend I review every account. Many times, more often. And a valid answer to the question, "Why am I holding this?" *cannot* be because there's nowhere else to put the money. We've raised a lot of cash before, and we'd be heavily in cash again, if we hadn't found the adjustable preferreds. Because the last thing we want to do is watch a Mohawk go from $212 to $20 again. That can't happen. It can't.

It was obviously a searing experience.
Yes, but what scares me here — and these are macro factors, so I don't invest based on them, but we do have to consider them — is that we're in a low-growth world in which practically the only thing that

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is growing is debt. Two, we have aging demographics globally in the developed world. In the U.S., our fertility rate 1.5 - 1.6. It needs to be 2.1 — maybe it will get back up there if we allow immigration. But Japan's got 130 million people. Projections are that in 20 - 40 years, they could be at 70 or 80 million. And 6 or 8 countries in Western Europe are going to have fewer people at the end of this year than they did at the beginning.

Now why is that important? It's important because older people spend less, and don't consume as much of pretty much everything — except more health care. And I could do a whole report on the demographic — and financial — challenges of pension funds.

Massive underfunding and exalted expectations?

It's abysmal. Most are using 7 - 8% return assumptions. It's bogus. When you put all that together, my point is that there are a lot of economic headwinds today, instead of the tailwinds enjoyed in previous decades. Even with central banks holding rates as low as they are, economies just aren't reviving much. We're down to 12 million manufacturing employees; we used to have 20 million. Middle-Americans have not seen real income growth in 10 years, in some cases, 20 or 30 years.

I also worry that so many companies have taken advantage of low rates to pile on debt, using the cash to pay dividends and buy back stock at elevated valuations. I worry about those debt levels. And, needless to say, the dysfunction in Washington that makes it impossible to address the nation's long-term budget issues is not a good thing. Again, the demographic clock is ticking.

Yet, despite all that, while this may be the least-liked bull market in history, it hasn't given us many buying opportunities. Even the 10% corrections have come and gone in a flash. So — I'm not predicting this — but I wouldn't be surprised, if the market keeps rising and we break 20,000 on the Dow Jones Industrial Average and maybe even 2,500 on the S&P 500.

You're clearly not inclined to participate from here, however —

Not when we've had about five straight quarters of earnings declines. Granted, a lot of that has been because of the energy sector's woes. But I don't know how the market goes significantly higher unless earnings significantly improve. The alternative of significantly expanding the multiples terrifies me. A lot of the gains we've had over the last few years have been because of P/E multiple expansion — and that's when the risks start rising. We need more earnings — true earnings growth — and I mean GAAP earnings. I don't mean perpetually adjusted earnings to remove anything bad.

Gosh, you sound like an old fuddy-duddy.

And proud of it.

You forgot to mention that corporations have been the biggest buyers of their own shares in recent years, pushing their own multiples higher.

Yes. When I thought about selling some of our Lowe's shares, that was very much part of the calculation. They've been buying back $3.5 to $4 billion-plus of stock every year — if you remove the impact of that share shrink from their EPS, the difference is telling.

Even so, the decision to pare the position didn't come easily. When it got up in the $50 range, we started watching very carefully. But rather than saying, "Look, we paid $17, we've made three times our money," I dug into every conference call, I read all the 10-Qs, and what did I notice? During the crisis their margins were 6%. But they can do 10% now. We asked what we were missing and saw not only the improved margins, but that the dividend and buybacks were supporting earnings — though we recognized that wasn't true earnings growth, just finance. So our selling function was very patient, and thus far, it has worked out. We sold almost nothing in the $50s.

Then when did you start selling?

Once it got into the high-$60s and low-$70s, we began selling. The point I'm making is you have to keep your eyes on what's going on. We tried to be thoughtful and think about why it was trading at those levels. And we were lucky, too. But in the end, Lowe's earned $3.30 last fiscal year. It ends January. This year they should do $4. But the stock is at $77. It's only growing the top line by a couple of percentage points. Should it be selling at over 20 times earnings — earnings that are overstated by their huge buybacks of the last several years? These are hard decisions. But we're absolute investors and don't want to slip into thinking about relative valuations. That's when you'll make mistakes and really start having problems.

You've alluded to your strict criteria a number of times, but I haven't asked for specifics. Do you look for catalysts, for instance?

No, though I know Mario Gabelli — who's just a

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really successful, terrific investor — looks for them. A lot of times, catalysts relate to companies being bought out and I've never been able to focus on external catalysts. I'm just look for really good businesses that I can understand. So the first question we ask ourselves, like I said earlier, is "Where will this business be in five years?" If I can't answer that in a reasonably good way, because I don't understand the fundamentals, like how they make money, how sustainable the business is, I just put it in the too-hard pile.

The second thing I look at is management. How good are they at operating the business? — which the numbers tell you. How good are they at allocating capital? — which the numbers tell you. Those are two very distinct and different skill sets — and very few managements are good at both. Then, how shareholder-oriented are they? — which reading the proxy tells you a lot about. How much they pay themselves; how that compensation is structured, etc.

What are your other criteria?

The next thing we look at is the valuation, versus the purchase price. Then the fifth question is, as Buffett always says, "What are taxes and inflation?" We have a long list of great companies with high ROEs that meet all these criteria — except valuation. Articulating what we're looking for is easy. Finding it — at a price we're willing to pay, isn't. I just hate paying a high multiple, because the first thing that happens in a market downturn is that multiples contract.

So which few stocks have you bought for new accounts this year?

Wells Fargo, U.S. Bancorp, World Fuel Services (INT) — and all of those are existing holdings. Many of our other existing holdings — including Martin Marietta, Lowe's, LabCorp, Zoetis — we won't buy for new accounts. We just don't think they're cheap enough.

What's your case for World Fuel? We haven't touched on that somehow —

It is a global leader in fuel logistics, engaged in the marketing, sale, distribution and financing of aviation, marine and land fuel products and related services. The company provides one-stop shopping for customers in that highly fragmented industry.

World Fuel Services was founded in 1984 and by 2015 generated $30.4 billion in revenue and $186.9 million in net income. We believe the company has a long runway to continue to grow organically by expanding its customer base, geographic reach and additional product and service offerings — as well as through acquisitions.

Didn't it do one earlier this year?

Yes, in early February, the company announced the purchase of ExxonMobil's aviation fueling operations at 83 airports in Canada, the UK, Germany, France, Italy, Australia and New Zealand.

So World Fuel is a way to dip your toe into the energy sector without a lot of commodity risk?

You've got it. At the end of the day, you want the way you configure your business to reflect well on you, your family and the whole firm. I've read often about how Berkshire is a reflection of Warren and the way he wanted to build his life. Well, that's what Lountzis Asset Management is. Although I don't dare compare myself to Mr. Buffett, Lountzis is a reflection of me. I love company founders, because they have a different philosophy than someone who becomes CEO, who knows he or she will be there only for 5 or 8 years. The professional CEO wants to make as much money as she can, as quickly as he can. And that is just not how I look at our firm. That's not how Peter Lewis looked at Progressive. That's not how Phil Knight looked at Nike.

So I love to find owners, founders, whatever. They just think differently. At Lountzis, I've been told I'm an idiot to charge only a 1% management fee. But you know what? I think 1% is fair. It puts a lot less pressure on me than 2 and 20 would. I'm very comfortable with this. I learned that working for Bill Ruane, who closed the Sequoia Fund to new investors in 1982. It stayed closed for 26 years.

He left a lot of money on the table —

How many people in the investment business would do that? He didn't care, because he didn't think it was what was best for the client. Most people can't do that. But I think that's the right thing to do. Bill always said to us, "It's good to stay small." So I don't want to run $100 billion.

I don't want to sound holier than thou, but Bill and Rick left an incredible and indelible mark on me: "Try to do always what's right for the client and as a byproduct of that you benefit." Period.

If you publish that, I'll become the laughing stock of every investment bank in Wall Street. But it's how I feel. "What about the client?"

I'll risk it. So tell me what investors should be asking potential investment managers?

A friend asked me that recently. I came up with

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five things to look for. First, impeccable integrity. Second, I'd ask about their research process — something no client ever really probes. But they should.

Third, I would never — or rarely — give money to firms that aren't owned by the principals.

Fourth, I would ask what the managers do with their own money — and would want them invested alongside clients. Virtually all of my liquid net worth is in a small partnership at Lountzis. I have no separate account anywhere. And the partnership buys only *after* we've bought for all of our separate accounts.

Then, the last things prospective investors should look at are performance and fees — but they are what everyone asks about.

Thanks, Paul, for sharing your insights. And enjoy your new digs in the Big Apple.

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WellingonWallSt. interviewee disclosure. Paul J. Lountzis serves as President of Lountzis Asset Management, LLC, which he founded in 2000 and is based in Wyomissing, PA and New York, NY. He has more than twenty-seven years of experience in the investment industry. After working as a consultant out of college, Paul began his investment career with Royce & Associates, the New York City-based investment advisory firm managing the value-oriented Royce Mutual funds. Paul then spent nine years, including five years as a partner, at Ruane, Cunniff & Goldfarb, an investment advisory firm managing more than $9 billion, including the Sequoia Mutual Fund. At Ruane, Cunniff & Goldfarb, Inc., Bill Ruane assigned him to conduct a number of specific research projects for the consideration of Warren E. Buffett, Chairman and CEO of Berkshire Hathaway, Inc.

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