

Interviews for Intelligent Investors

A Conversation with Value Investor Paul Lountzis

Conducted & Edited By: Miguel A. Barbosa

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Complimentary Copy for Mr. Paul Lountzis

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Introduction

I met Paul while I was working as a junior analyst. I was researching a company called Beckman Coulter and a mutual friend recommended I speak with Paul for scuttlebutt ideas. During our conversation(s) I realized Paul was exceptional at applying investigative interviewing techniques to the investment process. Unlike me, Paul was fearless when talking to strangers (on the phone and in person). He had a knack for targeting the right person and coming away with strategic insights that only industry insiders possessed.

Although we became friends over an investment idea, we stayed in touch. Over the years Paul gave me tons of advice. He helped refine my research process and in doing so saved me countless hours.

One day it occurred to me that Paul's advice should be shared with other investors. Particularly, young investors who like me don't have the years of experience and contacts to efficiently research investment opportunities. I called Paul and asked him if I could interview him. He graciously accepted.

The conversation below took place over a couple of hours. We talked about identifying interviewees, preparing talking points, and building relationships with industry insiders. Always willing to talk from experience, Paul shared with me six case studies exemplifying his techniques and research process.

I hope you enjoy our conversation.

Best Regards,

Miguel A. Barbosa
Founder of SimoleonSense.com

Paul Lountzis' Biography

Paul Lountzis founded Lountzis Asset Management, LLC in October 2000.

Prior to forming Lountzis Asset Management, LLC, Mr. Lountzis was employed by Ruane, Cunniff & Goldfarb Inc., New York, New York, a registered investment adviser managing the Sequoia Mutual Fund as well as private accounts. Mr Lountzis worked at Ruane, Cunniff, & Goldfarb from 1990 through 1999 as an analyst and as a partner from 1995 through 1999. While at Ruane, Cunniff & Goldfarb, Inc. he also evaluated several companies for Warren E. Buffett, CEO of Berkshire Hathaway.

Mr. Lountzis was an analyst at Royce & Associates, Inc., New York, New York from 1989 through 1990 where he evaluated small and mid-cap stocks for purchase in institutional accounts as well as various mutual funds including the Pennsylvania Mutual Fund.

Mr. Lountzis received a Bachelor of Science degree with a concentration in Finance and Management from Albright College, Reading, Pennsylvania in 1986.

Part 1: Becoming an Investor

Miguel: Let's talk about your journey as a value investor. How did you become a value investor?

Paul: My journey began when I was in seventh grade. I read about Warren Buffett which led me to learn about Ben Graham and read *The Intelligent Investor* and this stimulated my thinking about investing. Then I continued to learn more about Mr. Buffett and I liked the idea of sitting around, thinking, and figuring things out. It was a pretty solitary and independent way of looking at things and I was always a very curious person.

In college I loved my investment courses with Professor Walter and Professor Martin. We used to talk about Warren Buffett. I also regularly read the mutual fund materials from Sequoia Fund, Royce Funds, Michael Price's Mutual Qualified Fund, and Buffett's annual letters. I was working full-time while going to college and would use my money to buy some of these funds.

When I graduated from college I wanted to work in money management but I didn't know how to do it. I was in Reading, Pennsylvania and took a job at a consulting firm that served Fortune 500 companies. This firm focused heavily on performing competitive analysis. I remember reading Michael Porter's book, *Competitive Strategy* and this combined with all the investment reading furthered my understanding of businesses. My experiences at the consulting firm developed my analytical skills, research skills, and interviewing skills and that was the beginnings of learning how to properly research a company.

After working at the consulting firm for two and a half years I gained the confidence to pick up the phone and call 15 investors who I considered the best value managers in the country. I started with Mr. Buffett and I spoke with his secretary. I called Ruane Cunniff, Chieftain Capital, Michael Price, and several others. I got very lucky both Chuck Royce and Mike Price interviewed me.

Chuck Royce and his partner hired me. I joined February 22nd of 1989 and was with Chuck for a couple years. I learned a great deal because Chuck is not only a very good stock picker but also a terrific businessman- it's a very unique combination. I spent two years with Chuck and had the opportunity to work on many of his larger holdings such as International Aluminum, Kimball International, & Russ Berrie. Chuck owned a lot of securities, which is understandable because they're small-caps but I eventually decided that I wanted to work at a shop that practiced concentrated investing.

I called Mr. Buffett again and he wasn't hiring so I called some other investors including, Mason Hawkins and George Michaelis. George Michaelis was the predecessor at First Pacific to Bob Rodriguez and Steve Romick. George was wonderful and gave me a couple hours of his time and said, "Well, Paul, if you don't want to live out here in Los Angeles, you ought to think about New York. A good friend of mine is Bob Goldfarb at Ruane and Cunniff." It was Ruane and Cunniff that ran the Sequoia Fund, now called, Ruane, Cunniff, & Goldfarb.

I called Bob Goldfarb and again I got very lucky. The Sequoia Fund owned two of the securities that I had spent an enormous time researching while I was at Royce. They owned Kimball and Russ Berrie. I had spent a lot of time ripping apart the numbers and looking at these companies and their competitors. I had met with Doug Habig in Jasper, Indiana, who ran Kimball International in 1989 and I had met with Russ Berrie down at his private home overlooking the

Atlantic Ocean in Boca Raton. I knew those companies really well and I think my coverage stimulated Bob's thinking that perhaps I had some unique insights.

Seven months later, Bob called me, I visited him and I really liked him. I also met Rick Cunniff, who's still a dear friend, and I met Greg Alexander, who's one of the best investors in the world. I also met Bill Ruane and Carley Cunniff. Bob said, "Come back in a week," I did and I stayed there for nine years. I was a partner for five. Ruane, Cunniff, & Goldfarb was an extraordinary place.

I would say many of the investment values I now have, came from reading about great investors, my experiences in conducting competitive analysis (as a consultant), Chuck Royce's ideas in the small-cap space, and from my experiences at Ruane, Cunniff, & Goldfarb.

Part 2: Using Scuttlebutt Interviews to Augment Investment Research

Miguel: You talk about interviewing people to uncover insights. What makes a good interviewer?

Paul: First, you have to love learning. You have to love data, both quantitative and qualitative. You have to love to read and be intensely curious. I have found that the interviewing process is like taking your first exam in school. You should over study because you don't know what it's going to be like.

Miguel: Tell us more about your (interview) research process.

Paul: When I research I try to over-prepare and be knowledgeable about the industry, the market size, the key competitors, & different financial facts. I try to know why one company earns a 25% ROE and everyone else is at 15%. I try to understand what drives the industry. I try to gain a historical perspective and then I dig into the individual companies. So my point is, before I call anyone, I immerse myself in the companies and the industry in which they operate.

When I identify a potential investment (or company), I ask myself a few questions such as:

- What can they do that other people cannot?
- Why do they earn a so-and-so return?
- How do they do that?

I try to understand the business model that drives the business, and the unique aspects of their operations.

Next, having read the financials and having a reasonable perspective on each of the companies, I ask myself the following questions:

- What areas do I need to explore (customers, suppliers, employees, competitors)?
- Which person in the world has been in this industry for 30 years, knows all the players, knows all the dynamics, knows all the inflection points and can give me what I call, 'differential insights'?

Once I identify that individual, I immerse myself in learning everything about them. I know where they grew up. I know where they went to college, etcetera. Then it's a question of getting on the phone with them. I use the phone as a screening tool. The phone is not where I do the interview. The phone is the tool I use to arouse interest in them. I try to communicate my integrity and my authenticity. I tell them exactly what I'm doing. I'm incredibly open and honest. I talk about the industry and get them to recognize that I'm a quasi-expert who wants their help to learn and augment his research process.

While on the phone I also screen them for knowledge. I'm not really interested in leaving my family, office, or team to travel around the world unless I'm really convinced that they have unique differential insights. Once I'm confident I found the right person, then the interview has to be conducted in person. In the meantime, I'll send them literature on our firm and our investment philosophy.

Miguel: You often say, "At the end of the day, when I'm interviewing in person, I only have about five topics that I want to discuss." How do you come up with those topics?

Paul: That's a great question.

First, I read about the company. I read 10 years of financial tear sheets from Value Line. I may even go as far back as 20 years. Then I'll read a minimum of 5 to 10 years worth of annual reports, as well as the annual reports of their competitors. During these steps I try to simplify everything by asking the following:

- How do they make money?
- What are the key triggers in the business?
- How much of revenue is recurring?
- How could a competitor hurt this business?
- If I had a billion dollars, what could I do to them?
- If I was the CEO of the company, how would I run it and how would I allocate capital?
- What would I worry about? What would keep me up at night?

The second thing I do is try to answer Warren Buffett's "Five Points" which he writes about in the [1993 Berkshire Hathaway annual report](#). These five points are the criteria Mr. Buffett uses to select an investment and they are etched in my brain, they are:

1. The certainty with which the long-term economic characteristics of the business can be evaluated.
2. The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows.
3. The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself.
4. The purchase price of the business.
5. The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor's purchasing-power return is reduced from his gross return.

I particularly like the first point. So, If I'm looking at a company and I can't look out several years and have a reasonable idea of where that business is going to be, I just put it in the too hard pile. Otherwise while reading the annual reports, I scribble on them and look for areas of the business that are unclear to me. I ask myself what two or three critical points drive this business.

For example, if you're looking at something like Progressive, it's:

1. How do they price the product?
2. How do they deal with claims, which are \$0.70 of every \$1.00 that leaves your shop?
3. How do they distribute their products? (Obviously now they have independent agents. They have 1-800-etc.)

If it's Mohawk Industries, I want to know:

1. What percentage of Mohawk's business is new housing?

2. How much is remodel?
3. What's their market share?
4. They purchased Dal-Tile. How does that business operate?
5. The difference between the tile business, traditional carpeting, and linoleum? How big is the tile business? Is it more profitable? What are the growth prospects?

After all of my research and analysis, I try to narrow things down to talking points. I never go into a meeting with a huge list of questions. People can be intimidated when you approach them with a list of 20 questions.

For example with Progressive I wanted to know the following:

1. How good are these guys as operators?
2. What's unique about the business?
3. How do they think about compensation?

For example, with LabCorp I might pretend to be the CEO and ask myself, "What should I worry about?"

1. Is it bad debt expense?
2. Is it volume growth?
3. Is it reimbursement?
4. How are the different businesses performing? A lot of the business they do is just traditional testing. It might account for 60% of their volume. So how much is esoteric? How much is genomic? How much is pathology - because with the new Medicaid rates, pathology is getting nailed.
5. Management continuity, in this case, Tom Mac Mahon. I could tell when I met with him that he was ready to retire. Less than a year later, he announced his retirement.

Another example would be research we conducted on one of our holdings, UnitedHealth Group. In this case, I'm very curious about how they think about the new ObamaCare rules. So I'm trying to answer the following:

1. Are they adaptable and flexible enough?
2. Are they reserving appropriately?
3. How conservative are they going to be?
4. Are they going to walk away from business?
5. How are the health care exchanges going to operate?

To recap, I'm trying to uncover themes worth exploring via conversations. But to know what's worth talking about you have to research the company and the industry. Then once you identify two or three themes, you etch them in your brain.

The reason you have themes in your head is to help you focus. But you don't want these points to limit the conversation because the interviewee may say things that surprise you when you give them time to think. Here's an example with Progressive:

I might start by saying, "I'm curious about Progressive's pricing techniques" they might respond, "Paul, you're right. They are better in pricing and here's why. They were the first

to use credit scoring. They were the first to do xyz." I'll say, "Are there other areas outside of pricing claims and distribution and the unique culture that they've built that I'm missing and should be exploring?"

Finally, a thing to remember is that when you interview someone you want the person you're interviewing to drive the meeting. During an interview you want the interviewee to do 80-90% of the talking and you simply want to be a facilitator, an incredibly knowledgeable facilitator, but a facilitator nonetheless. You don't want to go with 20 questions because you want to focus on building rapport. You want to talk to them about their background. Ideally, you want to build a relationship with them and, many of them I'd love to have as clients because then you can build long-term industry knowledge.

Many people try to do this over the phone, which is a different dynamic. You can't get people to share with you on the phone what you can when you're in person. The goal is to get them to trust you, like you, and respect you by being open, honest, and extremely knowledgeable.

Miguel: How do you recommend building relationships with potential interviewees?

Paul: To build a relationship you want people to know that you're authentic, open, and very interested in learning from them. The other important point I would make, and you can only do this in person, is that you want them to gain your confidence and trust. This involves being willing to reciprocate. Here's an example of the type of comments I will say to (potential) interviewees:

"When I've finished my research, I would be delighted to let you know exactly what we've done with that research."

"I appreciate your thoughtful insights, here's what my analysis was. Here's how I evaluated UnitedHealth Group. Here's what I was concerned about."

"We bought LabCorp for our clients and made it a 5% position,"

Miguel: From start to finish, how long does it take you to find, contact, and interview the kinds of individuals that can provide you with unique insights?

Paul: It depends on the individual company but the process can take three months. The reason it takes that long is not because you spend that much time. Once you identify the people, getting them to speak with you can be somewhat of a challenge but that's not the big issue. The big issue is that they might not be able to meet with you for several weeks because they're traveling (or they're busy).

Lamar (which we will talk about during one of the cases) was a week and a half worth of work. In terms of focused time, I spent two or three days to learn the industry by reading all the financials. Then I focused on setting up the interviews.

It's important to travel, to see people, and meet with companies. The magic happens when you are traveling and find what I call an industry 'thought leader' like the gentleman who ran a private billboard company. I met him at the Ritz Carlton in Manalapan, in Palm Beach. He had been in the business 30 years. He knew everyone in the industry.

There is always the issue of research taking a lot of time and effort but because of the way we invest, it doesn't bother us. We hold things for five, six, and even eight years. With this kind of a time horizon it's worth doing your homework and developing unique insights even if it takes a couple of months.

Part 3: Case Studies

Case 1. Freddie Mac

Miguel: Tell us about situations where you applied interviewing skills to learn about companies.

Paul: One example would be Freddie Mac, my first big project at Ruane. I got a call from Bill Ruane on October 19th of 1990, a month after I'd joined. Bill said, "Look at Freddie Mac, the stock has been hit, it went down from \$90 to \$30 and they have some multifamily problems in the Southeast (namely Atlanta), credit problems, and a whole bunch of issues."

To educate myself on Freddie and Fannie I read their financials. I subscribed to *Inside Mortgage Finance*, which is published by Guy Cecala, an industry guru. I also read government reports to learn about the GSE's (government sponsored entities) and the purpose for creating a secondary mortgage market. I did that relatively quickly. I didn't sleep much for a week and learned a great deal.

Next, I spent a lot of my time digging in the field. I met with seven of the top seller servicers and originators in the country. I spent half a day with Angelo Mozilo in November of 1990. I met with Sam Lyons at Great Western. I met with Don Coots at First Nationwide. These are the people that gave me insights into Freddie and Fannie. I flew to Atlanta and met with several of Freddie and Fannie's competitors and learned that the GSE's were the lender of last resort. I also met with some former employees like, Charlie Goetze and Rick Wrigglesworth who ran the multifamily lending operations in the Southeast.

I was probably on the road for eight weeks before Christmas. During that time, we were able to gather data. This was a collective effort so it was everyone at the firm focusing on Freddie. I was doing some of the legwork and others were making calls as well and we basically concluded that the multifamily problems were manageable. Bill and the team bought more stock between \$30 and \$50 and I think the following year, in 1991, it closed at \$136 or \$137. The point is the scuttlebutt process gave us insights and the conviction that the problems were manageable.

Case 2. Progressive Insurance

Paul: Progressive Insurance was primarily a non-standard auto insurer. They were trying to grow the business and the non-standard market was much smaller, maybe one-eighth the size of the standard market. They dealt exclusively with independent agents and they were alienating the agents for a couple reasons. One, they were lowering commissions from 15% to 10%. Two, they wanted to go direct, 1-800-AUTO-PRO, which would bypass agents. Three, they wanted to go into the standard business. So we had three big issues to explore and we did all of this in the field.

First, we tried to understand if the non-standard product might have higher turnover versus the standard auto. For example, with my auto policy, my wife Kelly pays the bills. I don't even know what we pay. I don't pay attention to it. You just pay it every year. Well, it's different with a non-standard policy, when you're paying \$4,000 or \$5,000 a year, you're very cognizant of that amount so the policies turn over much more rapidly because you're constantly calling agents to get quotes. We were concerned because agents were feeling alienated by Progressive due to the lowering of their commissions. Progressive also put pressure on agents to invest in their businesses to improve their technology and hence, have fewer employees. A lot of these agents didn't want to spend the money. We were concerned that Progressive's core business which would finance the expansion into direct and standard might be at risk because as people called for quotes agents would not offer Progressive's products.

We went to Florida and spent six months interviewing several top Progressive agents in the non-standard business. We also interviewed Progressive's advisory board in Florida. That was their largest state and where they carried out a lot of their experiments, so it was a perfect place to go.

Here's what we learned in the field:

First, Progressive was the best in claims, which was reflected in the numbers. We had the yellow books for Florida and elsewhere and we were confident that they had the best claims and were making more money than virtually anyone else in non-standard. They had a combined in the mid to low 80's. Essentially they were taking their competitive advantage in claims and converting that into lower prices, which made it tough for other people to compete. So their prices in a very high-priced product were always 10% less than everyone else. If you're an agent and you don't want to offer Progressive to the client, the client's going to call the agent across the street and they might offer it. That agent might recommend Progressive because he'd rather get 10% of \$4,000 rather than not get anything so they had a pricing advantage that others didn't.

Second, there were many risks that no one else would underwrite so you needed to have Progressive in your shop.

Third, Progressive was forcing you to invest and they were phenomenal technologically and very innovative. So as an agent you could run a more efficient independent agency working with Progressive than you could with Travelers and all the other competitors. You could have less full-time equivalents and be more productive.

Fourth, Progressive was really talented at handling claims. So when accidents did occur, clients would always call the agent and say, "They did a great job."

By the way, we also went to Ohio, which was one of their biggest states and where their headquarters are located. We met with several large, independent agents to create a mosaic (of information) and the conclusion was a profound one - the core business of non-standard auto was not at risk. In other words, agents were likely to continue to write/market Progressive.

Now that we understood the potential downside the questions were:

1. Can they be successful with 1-800-AUTO-PRO in the direct business? Geico dominated this space and Progressive felt the future was going to take place in this market.
2. Could Progressive succeed in the standard market?

We started doing in-depth interviews with many agents and executives.

We heard about Glenn Renwick, who's now the CEO, and jokingly in the scuttlebutt they used to call him Crocodile Dundee because he was from Australia. He was doing a lot of the 1-800-AUTO-PRO testing in Florida in the early-'90s and they were constantly testing it to learn.

One agent was in Ft. Myers. He has six offices. I still keep in touch with him. He sat me down and showed me his whole book and said,

"Paul, I'm on Progressive's advisory board. It's an incredible company. They're very arrogant but they're very, very good. The majority of my business has historically been with Progressive and it's in non-standard. However, as I've grown my business, I want higher quality customers. I want to be able to deal with a higher end demographic and now they're going after the standard auto market and that's something that I really want."

I said,

"Well, can they be successful with 1-800-AUTO-PRO going direct? It's different from non-standard? Can they be successful in standard?"

He replied,

"Look, I've been dealing with Progressive for 20 years. They're very smart. Claims is the same, no matter what the business is, whether it's standard or non-standard. They're going to use their claims capability, and then they're going to figure out the pricing issues because they're mathematically brilliant. They will succeed in standard auto. Furthermore, I wrote \$1.5 million in standard auto with them this year."

He also said,

"We as independent agents know why agents don't like Progressive. They're cutting commissions. They're going direct. They're going more into standard. They don't offer homeowners. They don't offer umbrella policies where you can bundle the product and get higher retention. However, they're going to figure out pricing, they're better in claims,

they're great technologically and there's 50,000 agents out there that are dying for a high-quality standard auto insurer.

We are tired of dealing with Cigna, Aetna, and Travelers who come into our offices and constantly raise the amount of business we need to do in order to give us the contingency commissions. They're constantly in the auto market and out of the auto market. They don't understand how to price insurance.

Progressive is a phenomenal auto insurer with great credit quality. I think that even though they have all these negatives if they offer a great product at a great price, agents are going to want them. So I think they're going to succeed, as they have with me by overcoming all my skepticism in standard."

With regard to 1-800-AUTO-PRO he said,

"They've been coming to these advisory meetings for a long time. They're constantly testing advertising around me and they're not a marketing driven firm. They're a math-driven firm, which is about pricing and claims, but they're going to figure out marketing. Ironically, when they do advertising in Ft. Myers and in Naples and in Bonita Springs, my business goes up. They have been doing these experiments for years. They're going to figure it out and they're going to be successful. And now is the time to do that because the only major player there is Geico."

I know this scuttlebutt might sound crazy because it came from one person. But he was giving me a collectivism of knowledge because he works with other agents and because he was part of Progressive's advisory council. He also recommended some other agents to talk to who also confirmed what he said.

I also might add, Progressive hired three MBA's in 1977 Chuck Chokel, who became the CFO and then the Chief Investment Officer, Mike Krause who work for Carl Lindner, and Jim Pouliot. I interviewed two of those guys - Chuck Chokel was still at Progressive - and they gave me enormous insights into the company's mindset and operations.

So, once again we gained conviction from all the interviewing that we did.

Again, it was a team effort. I don't want to imply at all this was because of me. Andy was with us at the time, Greg contributed, Carley was terrific, as well as Bob. In fact it was originally Bob's idea. When you put all the findings together, it gave us conviction. Consequently, Bill and Bob stepped in and bought a few hundred million of Progressive. I think we made 8 to 10 times our money.

Case 3. Lamar

Miguel: Give us some more examples of talking with industry thought leaders.

Paul: In 2005-2006 I was looking at advertising expenditures in the U.S. (that is measured media) and they were about \$200 billion. Newspapers accounted for \$50 billion and broadcast was a little over \$50 billion and outdoor advertising was tiny 7% of that \$200 billion. I was researching these figures because I was concerned about newspapers and we owned some Washington Post (at the time). So I was looking at the figures and I thought, "Maybe I ought to look at this outdoor advertising space."

I started digging and saw that Lamar Advertising in this space had a net debt to EBITDA ratio just below 5, which I thought was crazy. Then as I dug deeper I realized that in many of markets they had 80-100% market shares, with tremendous recurring revenues. I saw that they were the most aggressive about digital billboards, which meant they could get six ads per minute, rather than one. So this technology would make your billboards more valuable (and it hadn't been deployed on wholesale).

With digital billboards if you're a Honda dealer, you can go online and change your billboard advertisements immediately. The margins in this space were 30% higher. They were 70% versus 40-45% in the traditional business. They also had very low land costs because they were primarily in rural markets. So I looked at their cash flows and didn't like the debt. Then I said to myself, "It seems predictable. It seems stable. They only had two down years, 1970 and 2001, prior to '08, '09. That's my kind of business so I'm going to dig further." Then I asked, "Who can give me unique differential insights into this business?" and I came upon Karl Eller.

I was out in Los Angeles visiting a client. I went to a couple ad agencies and I asked, "Who really knows the outdoor billboard space?" I met a gentleman who was, at the time, working for JCDecaux, the French firm, who was in a different line of business because they're mostly on bus stops and benches. It's much less billboard-driven in Europe than it is in the USA. Anyways, this gentleman had worked for Karl Eller for 21 years so he said, "Paul, tell Karl I sent you," so I called Karl and e-mailed him. Ironically, our oldest son was going to the University of Arizona at the time. Well, the business school at the University of Arizona is called "The Eller College of Management".

I flew to Scottsdale to interview Karl. Before I met with him I read his book, *Integrity is All You've Got*. He built four different billion-dollar companies. He sold Eller Media to what's now Clear Channel Outdoor. The guy running Clear Channel was his former attorney at Circle K. Karl started selling billboards in 1952 when he graduated from the University of Arizona. By talking with Mr. Eller I got a 60-year perspective on the industry. He was also doing all the requests for proposal for Coca-Cola's billboards. He gets all the RFP's from all the players so he knows what's going on even today and he's 83 years old now.

I also learned about another important figure that Karl had brought into the business. That is Arte Moreno who he brought in 1972. Arte was another University of Arizona grad with very poor beginnings. He worked with Karl for several years. Then he partnered with Bill Levine, a very affluent guy in Arizona who owns several McDonald's franchises and a lot of real estate. The two of them built an outdoor company that became a competitor to Karl's and they sold it to Infinity

(now CBS Outdoor) for \$8.1 billion. That's where he made his fortune and now he owns the Anaheim Angels.

I'm telling you this because although I interviewed other people in the outdoor advertising space, Karl's was the one that gave me the most conviction. Because of insights he shared with me and the people he told me to speak with, we were confident enough to start buying Lamar in the high-\$20's, low-\$30's, down from \$72. When the stock got hit in March of '09 it went to \$5, \$6, \$7, \$8, \$9 and we bought more of it. We had the confidence and ended up selling it in the \$30's. So our existing clients averaged down and got their cost into the mid-teens and our new clients were paying \$8, \$9, \$10 for it.

I gained confidence and conviction from my research process. The reason you do scuttlebutt is that it brings the numbers to life; it prevents you from permanent capital loss, and helps you size positions. You want to make sure you're assessing the company appropriately, understand the business model, and know that the numbers are accurate. You're assessing the integrity of management, their ability to operate the business, their ability to allocate capital. You're looking for anything that can help you gain insights. Someone like Karl who had all those years of experience can sit there and tell me about the managements of Clear Channel Outdoor and CBS Outdoor. Karl would even talk about the Riley brothers at Lamar. He knew their father.

I want to make sure to highlight the importance of getting differential insights (via this process). It's not about collecting data. Too many people think you just get on the phone and you call 50 Footlocker stores to find out how Nike's selling. I can hire a high school kid to do that and that's fine. I'm talking about much higher-level analytical and strategic insights.

A lot of people today use expert networks like Gerson Lehrman Group or hire consultants. I never pay people. I paid one legitimate consultant in 25 years. One, and he had a real consulting firm. I don't pay people, not because I'm cheap, but because sometimes it can compromise them.

Case 4. Nike

Miguel: Give me an example of “differential insights” that you can discover via interviews with other industry players (i.e. suppliers).

Paul: Let me give you the example of Nike. Nike, in the mid-'80s, had distributors who carried a broad range of products. Nike only provided one type of shoe. What happened was Phil Knight realized that distributors weren't loyal, devoted, or committed to Nike Products. They were simply order takers and it was the Nike brand that was really responsible for the success. Just like Diageo and liqueur as well as most other companies, you want to control (your) distribution.

Well, Phil Knight didn't have the money to have his own sales force so he made a strategic bet in the mid-'80s. He made this bet as Reebok was moving ahead of Nike because of the women's fitness craze. With respect to the numbers I don't know how accurate I am because this was a long time ago and I'm getting old but they might have been \$800- \$1 billion in revenue and he brought down their revenues in the range of \$400 million to \$600 million. He brought the revenue down to the point where Reebok was actually ahead of Nike.

The reason he made this move was that he wanted to control his distribution. So he went to the distributor in Tennessee and said to him,

"I want to build an in-house sales and marketing team and I want you to run the team. You've got to give up your distributorship and move to Portland. I want you to run the sales force and you have to go talk to all these distributors and either fire them or bring them in-house."

Well, I got lucky and spent a day with this special distributor. The insights were extraordinary. I learned about Phil's thinking as well as the top management team's strengths and weaknesses. This gentleman (even) developed the Nike Outlet concept, which he called "the excretory system".

When I went to a Nike analyst day, Phil Knight gave a presentation and afterward I followed him to his office. I said, "Phil, it's a pleasure meeting you. I enjoyed your speech but you talked about the excretory system," and he actually mentioned this guy's name, giving him credit, and I said, "I just wanted you to know, I spent a day with this gentleman," - Phil had just fired him. Phil's eyes lit up when I mentioned this guy. He said, "How's he doing?" and so we started talking and I spent a good 20 minutes before he got in the elevator.

The point I'm making is calling a Footlocker store is fine but that's incremental information. That's not the level of information that I want. This gentleman (the distributor) could compare and contrast Nike and other similar companies because he was immersed in the business. He was immersed in Nike. He gave me insights into how Phil thought, how Tom Clarke thought, how their marketing team thought, as well as their innovation.

An interesting point the distributor raised (and I must highlight that this was around 1991) was that Reebok would never dominate like Nike. I said, "What do you mean?" He replied,

"Just as Mr. Buffett talks about share a mind with Coca-Cola, Bowerman and Phil Knight are viewed in the mind of consumers as being authentic. Reebok has never been viewed as authentic. The only success that Reebok has ever achieved is in the women's fitness area

and with their old classics. They've never been viewed as the authentic performance, running sneaker, basketball sneaker, football spike, etc."

That was an incredible insight. Unfortunately, I wasn't smart enough to recognize the long-term potential of the insight this gentleman was giving to me. I missed it even as he was explaining the pain that Nike went through to bring their in-house distribution and how it showed Phil's commitment and focus on the brand. He said, "Nike's going to dominate the athletic world," and they weren't very big in apparel at the time, it was mostly running shoes. It should have been clear to me that this was a long-term investment.

Another interview we conducted was with Julie Strasser, who was Rob Strasser's wife. Julie wrote the book *Swoosh* where she identified people that helped Phil start Nike. We interviewed a couple of them and they provide us with insight into how Phil thinks and how he built the business.

I must also say Julie Strasser's ex-husband was Rob Strasser. He was at Adidas (when we were researching Nike) but he's the one credited with the Air Jordan Shoes. We spent a day interviewing Rob and gathered insights on Phil and the Nike Culture. He also shared insights on the competitive environment and other global players.

My point is that there are interviews and then there are *interviews*. It reminds me of a book written about John Lennon where someone said they conducted 700 interviews but they didn't interview any of the other Beatles or either of his wives or kids. Well, you're better off interviewing the Beatles, interviewing his two wives and his kids and a couple of close friends. I like concentrated interviews, that are high quality, and in-depth versus broad-based (or fact checking). Now, that doesn't mean you don't want to do the broad-based stuff but you want to find people that are immersed in the industry, are really smart, and can give you unique insights.

You can tell 50 people about the importance of this type of research. But very few people are going to do what I'm saying and it's not because I'm smarter. It's because so much of what you reap is a result of the work you've done in preparation and very few people have the time or willingness to prepare.

Does that make sense?

Miguel: That makes a lot of sense. As you were describing the Nike situation I could imagine how the market reacting to news of Phil Knights strategic decision(s) to shrink his business. I imagine headlines such as "Nike's losing it!" when in reality, it's becoming a better business and that's your long-term buying opportunity.

Paul: Exactly.

Case 5. UnitedHealth Group

Miguel: As you were talking about Nike, you said, "I should have noticed their long term potential." As you talked about Progressive, you said, "I should have noticed the unique culture and their ability to solve problems mathematically." Value investors often suffer from sins of omission.

Give us a quick example of a situation where you did a lot of work but you were either completely wrong or completely missed the investment opportunity. In other words, give us an example of a situation where you didn't see the implications of your differential insights.

Paul: I think that those are great points. I just lectured at Villanova where I shared some of these experiences. As for my acts of commission, the two biggest mistakes I've made thus far (they haven't been lethal by any means, but I'm not happy about them) are Mattel and Harsco. Those were two acts of commission.

Overall, my biggest mistakes have been acts of omission. When I say "acts of omission", I don't mean that you're upset because you didn't buy something that's up four times. I mean you did the work, understood the key issues, and for whatever reason didn't have the conviction to pull the trigger.

The first one that comes to mind was my in-depth analysis of the HMO industry in the mid-'90s. We flew to Sacramento and met with Foundation Health. We flew to Los Angeles and met with WellPoint. We met with Len Abramson at US HealthCare in Philadelphia. Andy and I decided to find the most heavily penetrated HMO markets in the country (Sacramento & Minneapolis) and we visited them. In Minneapolis, we met with George Halvorson at Health Partners, which was private. Then we went and met United Healthcare run by Bill McGuire along with Jack Schuler, who used to be at Abbott. We had such a perspective from reading the numbers, meeting all the industry people, and meeting competitors. But, I wasn't smart enough to realize that while many of the HMO executives were applying actuarial thinking to healthcare (that is they were numbers driven) McGuire was also a genius at innovation.

McGuire was trained as a physician, born in Texas. His brother died at a young age, which created enormous drive in him. He was acquired by United when he was working in Colorado for another HMO and he was a creative genius. Unlike the others who were constantly using actuarial data to go into healthcare, he would look at the healthcare system three-dimensionally and say, "Here's a healthcare need. We're going to go build a business around it."

If you study the HMO industry between 1990 (which is when McGuire was acquired) to 1995 you will see that United Health was by far the most innovative company. They were often the first to implement new techniques, products, and services. The way McGuire looked at the industry was very unique as were his strategies. For example, he hired John Peshorn to head investor relations. This happened because John Peshorn was a sales side analyst at Piper Jaffray, and Bill called him up and tried to get him to come to United. He's hiring an investor relations person, not only to communicate the United strategy to the investing world but because he's bringing him on as a strategic, thoughtful partner to give him insight on all the competitors. He would say to John, "I want you to listen to the Aetna call and give me insights. I want you to talk to thought leaders in the industry that think about healthcare differently and come back to me with strategic insights." That was unique and I could give you 50 examples of unique tactics practiced by United Health.

I did not extrapolate these unique insights to the long-term potential of the business. In other words I underweighted the significance of United Health (meaning McGuire's) creative practices and had we invested we could've made 30 times our money.

In fact, in preparing for my speech yesterday at Villanova, I printed up my interview that we did with him in 1994. It's incredible. He was a visionary, a leader. He built an incredible culture and that's what it all comes down to. It comes down to firms that are really great and sustain their excellence. It's very simple. They simply have a way of thinking and doing things that everybody absorbs and makes their own. People at these places feel two things. They feel a part of something special and then they also feel individually recognized and you need those two to come together. It's very hard to build and that's why there are very few great companies (that can stay in the lead for long periods of time).

Miguel: Having made these mistakes. How have you refined your investment process? What do you do nowadays that's different than before?

Paul: Now when I research an industry, I'm always looking for people who think differently. So for example, in our business, I do not see us as a money management firm, rather I see our purpose as being to make a difference in the financial lives of our clients. I consider that to be a nontraditional view of the money management business.

Miguel: The parallel being that just as you don't think of yourself as an asset manager some of the best senior managers don't think about their business as "just" a way to make money (say a Nike Store as being an outlet to sell shoes). Rather they think about their business with a sense of purpose.

Paul: I would say Phil Knight thinks about it as, "We want the greatest athletes in every sport to wear our shoe(s). As such, we want to dominate in running, tennis, basketball, etc. We want to be their number one choice in athletic shoe wear regardless of the sport."

Case 6. First USA

Paul: Let me give you an example of what I mean by a management team thinking differently about a business. This time it would be when we were researching Household Finance. During my research, I ran into John Tolleson at First USA. John was an incredible visionary but I didn't know that right away. Let me explain how I came to appreciate the level of John's skills.

As we were researching the space, we met with many of the players in the industry and we also met with HNC Software in San Diego. HNC had a fraud detection system and we asked them who their major customers were and they mentioned everyone; MBNA, Citibank, American Express, etcetera. They didn't mention First USA, which might have been fifth or sixth largest player at the time. So I said, "What about First USA?" They said, "They don't buy our product." I said, "What do you mean?" HNC said, "They view our product as the off-the-shelf product that all their competitors have. They're creating their own proprietary product that does what we do." I know it sounds silly but it said a lot about First USA. In fact, when I met with Tolleson in Dallas I told him about my meeting with HNC (and their comments) and his eyes lit up because it was something that people were overlooking.

The second time I learned about Tolleson was during my conversations with senior executives at Household, MBNA, and Capital One. As we conducted our interviews, we learned that First USA and Tolleson himself was calling top-level executives that he thought were outstanding at Household, Capital One, and MBNA. He was calling these guys, trying to hire them away from his competitors. One of the guys at Household said, "Tolleson's constantly calling me. He wants to hire me," and this Household guy was considered by many to be a marketing genius.

So the next time I met with Tolleson I asked him about hiring great people from competitors and he thought that it was hysterical. My point is that those two little insights added value and led me to taking 15% of my personal portfolio at Ruane and buying First USA. Then I got very lucky. Bank One bought them and I made several times my money. I think John Tolleson sold it himself in the \$600 to \$800 million range. Those are the kinds of insights that help you find talented managers and interesting opportunities.

Closing Thoughts

Paul: One final thing I'd say, that's profound and important today was told to me by Bill Ruane. He said, "In the '60s, '70s, and even in the '80s, it was easier. It was easier to identify great companies. It was easier because things didn't change [as quickly]." The rate of change today and the magnitude of change are enormous. When you look at the newspaper business sales in 2005 were \$50 billion. Today they are \$20 billion. \$30 billion has been wiped out.

I'm bringing this up because the barriers that kept market shares intact are falling. For example you had the old cable franchise license. Well, now you have 32 million customers going to satellite. That just wasn't the case in the '80s. I call what's happening today the commoditization of businesses. Many products and services are becoming commoditized. Two examples are banking and insurance. Those businesses are inherently commodities. They're not that complicated and surely enough the barriers to entry are falling.

Miguel: So besides looking at the numbers how can investors understand which companies will be around in the long term?

Paul: It's understanding the people/culture and the ability to identify a young Phil Knight, a young Howard from Starbucks, a young John Mackey from Whole Foods. It's becoming ever more important. I don't mean identifying one person. I mean identifying a person (or team), like a Phil Knight in '86, who has that unique vision, drive, focus and which as a result of how he thinks, is creating a culture that is different and everlasting. You need to identify management teams that are adaptive and innovative. This is more important than ever because things are changing so quickly that if management teams don't have those traits you are likely to have long-term problems.

That, to me, is a profound point. I'm typically attracted to a company because of the numbers. But what can make you enormously successful for your clients is when you identify qualitative features that have yet to appear in the quantitative results.

The key is to identify these situations early. You still have those opportunities when the companies are small but it's getting harder because there are many smart people looking. For example if you see Progressive generating an 82 combined ratio and making \$0.18 of every dollar on their underwriting before investment income and you might say, "My God, State Farm's at 110. How are these guys so profitable?" Well, the problem is everyone else often recognizes these factors and they're paying enormous multiples for the business.

It is really hard to identify these unique teams and cultures but if can do it or get lucky, then you can do very well for your clients. By having this edge you will avoid overpaying. You are protected on the downside and you have enormous upside because you are piggybacking on a visionary who's building an extraordinary culture with a long run way and because of this "mispricing" you can stay with them (i.e the stock) for 20 years.

Furthermore, because you have done your research you understand how this visionary is building the business and you have the confidence to survive all the vicissitudes of the market. So when they go through tough times, you recognize they have a stable competitive advantage. They've got better people. They're tenacious and they're likely to come out of this stronger.

It's an important distinction that I'm trying to make that the qualitative is becoming more important. I still think qualitative features are subordinate to the business model and valuation but the business model is infinitely more impacted by management (and culture) than it was in the past.

Ultimately, you want to pick companies and management teams that have time on their side. People that are adaptable and innovative (usually) have time on their side. This brings us back to the beginning of our conversation where you suggested that differential insights couldn't be found by just reading annual reports. You have to kick the tires if you want to have an edge.

Miguel: I want to thank you for taking the time to share with us your insights and experiences. If people want to follow you, I will direct them over to your website, Lountzis Asset Management. I wish you and your family the best.

Paul: Thanks for the opportunity.