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Transcript of Episode 52 of The DIY Investing Podcast

Voice Over: Do you want to learn how to manage your own investments? Are you ready to stop paying investment management fees and start building wealth? The DIY Investing Podcast is dedicated to providing with you the knowledge, skills, and resources you need to be a better investor. Learn how to make investments through the use fundamental analysis, mental models, and business management insights. Now, here's your host, value investing expert, Trey Henninger.

Trey Henninger: Hello and welcome to The DIY Investing Podcast. My name is Trey Henninger, and I'm your host. This week I have a special guest on the show, Tobias Carlisle. Tobias is an author of four investing books, The Acquirer's Multiple, Quantitative Value, Deep Value, and Concentrated Investing. He is also the chief investment officer at Acquirers Funds LLC, where he manages the ETF ZIG. Tobias, welcome to the show.

Tobias Carlisle: Hey, thanks for the great introduction, Trey.

Trey Henninger: So, I recently read your book, The Acquirer's Multiple, and I really wanted to dive in and discuss this book, and so I was wondering if you could just begin with kind of a brief introduction of what you consider kind of the core concepts you were trying to communicate with The Acquirer's Multiple book.

Tobias Carlisle: The book is about deep value investing, so just to contrast that with other types of value... So, Buffett, Warren Buffett practices franchise-style or sort of compound value, where the idea is that you're trying to find companies that grow at a very high rate, or have very return on investment capital, sustainable returns on invested capital, and they're probably recognizable brands for the most part. He's trying to buy that at a discount where he calculates the intrinsic value to be, and he describes those companies as wonderful companies that he can buy at fair prices. So, I practice something a little bit different. It's called deep value, and the idea is that you may not be getting a lot of growth from these business; they may be businesses that are going through a difficult period, they might be cyclical, and they're available, though, at very discounted prices.

Tobias Carlisle: So, to contrast Buffett's wonderful companies at fair prices, they're fair companies available at wonderful prices. Anybody who's read any Buffett will know that he prefers wonderful companies at fair prices to fair companies at wonderful prices. So, why do I practice this deep value stuff? There's a great book, The Little Book That Beats the Market, written by Joel Greenblatt, where he takes this simple quantitative version of Buffett's strategy... So, he says a wonderful company is a company that has a very high return on invested capital, and a fair price is a low price by enterprise value to EBIT, and he calls that the earnings yield. He ranks every stock in the universe on both of those metrics, then he sums together their rankings to get a combined ranking and tries to buy the best 30 of those, and that's the process that he describes in that book.

Tobias Carlisle: He finds that that outperforms the market over the period of time that he looked at, which is about 12 years or 14 years from sort of 1994, I think, to 2006, something like that. We tested that again in Quantitative Value, using... We tested that to the academic gold standard, which means you lag the data, so you use a point in time database, which means that there are no... Any position that any company that failed stays in the database, so your backtests can still buy that company, and if it buys it and it fails, then it reduces your returns. We also then lag the data, which means we assume that you can't trade until June on the K data, which is the year end data. So, that means that all of that information should have been disseminated to the market so it's not look ahead bias or it's not trading on information that the market didn't have.

Tobias Carlisle: Then, we market capitalize this and weight the companies, which doesn't make a lot of sense. It's not the way you would construct a portfolio, but we do it that way because that's how market indices are constructed to make it comparable to an index. So, we found in that book that the magic formula, which is Joel Greenblatt's formula, does, in fact, beat the market, and it's got better risk-adjusted return, so that's a good thing. What we found, though, just to complicate it a little bit, is that the return driver of the magic formula is all the values side of it, so that's the EBIT on enterprise value, what I call The Acquirer's Multiple, and the return on invested capital portion of it actually reduces return. So, just getting rid of that wonderful company, high return on invested capital requirement improves your returns on both a raw and risk-adjusted basis. So, that's volatility adjusted.

Tobias Carlisle: So, that's basically the thesis. It's just the mechanics of why that is the case, and I say that it's mean reversion in the underlying business. Managers don't just sit there and let the business fail. They sort of try to do things. Activists come in, private equity firms come in. These will push up the prices of companies and industries that are suffering, so if you invest buying these sort of businesses, you should be able to expect, over the long run and on average, pretty good returns that beat both the market and magic formula style businesses. So, that's the thesis in the book.

Trey Henninger: Deep value, then, is a strategy. How would you define your target audience, either of the book or the strategy itself? Is this all investors, just professional investors? Is it individual and professional investors? Kind of what's your target audience for this strategy?

Tobias Carlisle: The book is written to a fifth grade reading level and you can read it in about two hours, and it's full of charts. So, the idea is that anybody can read this book. It's not necessarily going to appeal to everybody, but it has this great line where it says value investing is like an inoculation; it either takes it or doesn't. So, for many people, they don't like the idea of buying bad businesses because you have to have some faith that the underlying business is going to turn around. Some people like the Buffett style more because you're finding businesses that are doing very well, and then you're trying to buy them at a discount to their fair value.

Tobias Carlisle: So, it's really for anybody who that style of investment appeals to. So, they tend to be... It's a contrarian style investment strategy because you look at the data, you might look at a series of annual reports from a company, and they might indicate that the company is losing money or earning less money year after year, and you have to believe at some stage that this mean reversion is going to kick in. So, I wrote it very simply so anybody can read it, really, but it does tend to be a particular personality type that it appeals to. It's not necessarily professional amateur; that's not the distinction. It's just some personality types don't like it, and others love it, that's what I've found.

Trey Henninger: Yeah. I mean, I think... The reason I ask that question is, as I read the book, one of the key components that you've discussed in terms of what makes certain implementers of deep value work... Because you spend time talking about Buffett, Icahn, Einhorn, different managers who have used deep value to great success, and I think one of the components that they use is this concept of controls situations, and what I struggled with as an investor managing smaller sums of money is, although the strategy is clearly backed up and you give a lot of data around that, it's like, well, am I going to be able to implement that strategy to the same degree because I don't have the ability to take control of a company with a lot of excess capital sitting aside? Are individuals at a disadvantage implementing this strategy, or should that component just be something left to professionals, and then you can still implement other parts? Does that make sense?

Tobias Carlisle: Yeah, that's a great question. I use those examples to show that, in many instances, the deus ex machina... One of the potential ways that you can see these businesses succeed is through the intervention or the intercession of an activist or a private equity firm, or an investor like Icahn or Einhorn, and that's happened many times in my investing career. I've bought a position in a company without an activist, and that's when it looks the absolute worst, it looks like management's going to keep on running this thing into the ground, and then the activist appears and has many of the same complaints that I would

have as an investor who's not big enough to influence these companies myself, and then they turn the companies around and say...

Tobias Carlisle: A great example of that, which I talked about in real time on Twitter, and this happened several times and I detail it in the book, is Apple. In 2013 Apple was one of the cheapest companies in my large cap screen, and I bought it and held it, and then, famously, Icahn and Einhorn both bought positions in it and lobbied to have them return some capital, which they did through a buyback, and then the company, of course, went on to have this great run thereafter. It happened again in 2016. A company got very cheap, I tweeted about it again after buying some, and the company ran away again. So, that's happened more recently again. I own some Hewlett-Packard in the fund, and Icahn is now lobbying to have them merge with Xerox.

Tobias Carlisle: So, it's something that... It happens regularly, and this is part of the reason that I invest in the market that I do. So, I focus on mid cap. Mid cap's about a billion up to, say, 10 or 15 billion, somewhere in that vicinity, because that's policed or trafficked by activist firms and professional private equity, and I think that those businesses are also sort of big enough that they can survive little downturns in the market, and they've got professional managers. So, that's a good part of the market to be in because if you're investing in there, you'll find that anything that gets really cheap is pursued pretty quickly by one of these professional firms. That's one mechanism for generating better returns. For the most part it's just going to be mean reversion in the underlying business, which you don't need to be a professional investor or a big investor to take advantage of.

Trey Henninger: I think the Apple example really resonated with me, because although I didn't follow you at that time, I invested in Apple in 2013, and I invested in Apple in 2016, both times before the activists started getting involved.

Tobias Carlisle: That was Buffett in 2016.

Trey Henninger: Yeah, Buffett was in 2016, but both times I had gotten in just before those things became public, and certainly, in 2013 it was interesting how that performance worked out and the activists... It wasn't part of my strategy for those activists to be there. It's like, oh, this company's cheap and affordable, but of course, it worked out really well when they came in and did it. But I guess that was... So, you're kind of shopping in an area where you expect activists to be, so you're... To be paying attention as well, so then you don't have to be that activist yourself. Is that right?

Tobias Carlisle: Exactly right, and I would never... I just don't have the personality for it, so I would never find myself in an... Well, unlikely that I would find myself in an activist situation other than sort of defensively. But I like the fact that they are there, because it stops these management from running it like it's their own private domain. They are answerable to the shareholders, and there are shareholders who will enforce shareholder rights in that area. So, I think it's a

great part of the market to be in, and I think that protects some of your downside.

Trey Henninger: Yeah, so, I mean, it certainly protects your downsides when the activists get involved, but do you still have protection against the potential for a sale of the stock at a low price, so if you're hitting a 2008, 2009, the market's crashed and you're buying in, could you get trapped with... Someone tries to come buy the whole company at a price that's well below what you think that value is, then, because you don't have the resources to file a 13 D&B, 5% shareholder, or is that just part of what diversification is for or something?

Tobias Carlisle: Yeah, so of course that could potentially happen at any point in the market. It doesn't have to be a 2007, '08, '09 type scenario. But the thing that I would point to is that I have pretty extensive backtests in there that show how this strategy would have performed over very long periods of time, and it has been one of the better-performed strategies out there. So, part of the book is just describing why that is, and a lot of it is people are just afraid of buying these companies because the business looks so bad.

Tobias Carlisle: So, you have to do some analysis to make sure that the business can survive. It needs to be either a robust balance sheet or generating some free cashflow with something like that. But these are businesses that... This is a method that has worked very well over an extended period of time. It goes through periods of underperformance, so we're going through one right now where it hasn't really worked since about January 2018 to date, but it's not because the companies have been taken under, it's just that the more expensive part of the market has run away, which is not something that is uncommon at the top of a bull market.

Trey Henninger: So, as a deep value investor, you spend a lot of time talking in the book about how the strategy beats the market, and the question I have today, especially in a time where the market is performing very well... If you look at the last 10 years, the market's performed extremely well in terms of better than its history, so it's not earning 10% a year, it's earned something on the range of 15% a year, and so the question is do you have... What is your goal as a deep value investor? Are you just trying to beat the market in terms of relative returns, or do you perhaps also have an absolute return that you're trying to hit? It doesn't matter that I beat the market, I also want 10%, 15%, or 20% a year? Or would you be okay earning 5% a year if the market was losing money over a 10-year period or something like that?

Tobias Carlisle: So, there's no return objective for me. It's more that I like to know what's in my portfolio and I like to know that... I like to be comfortable with the characteristics of the companies that I own, so if you think about what the market really is is an index, a market capitalization wedded index. What that means is that bigger companies get more capital, and everything else being equal, bigger companies tend to be more overvalued, so if you have two

businesses, both earning $100 million a year in net profit each, one's on 20 times earnings, that's a $2 billion company; one's on 10 times earnings, that's a $1 billion company. So, in the index, the $2 billion company attracts twice as much capital as the $1 billion company. As a value investor I would rather own the $1 billion company than the $2 billion company.

Tobias Carlisle: So, what I'm trying to do is maximize the amount of free cashflow, assets, earnings, buybacks as I possibly can on a per-share basis. So, I'm trying to create a portfolio that has as much future return embedded in it as I possibly can, and if I went... I would never construct a portfolio the way that the index is constructed, because it just doesn't make any sense to me. The only logical approach to doing it is the way that I do it according to... I use an unusual style, but there's no return expectation in any given year. Your returns are always going to be dependent on the opportunity set that you find in front of you. The market is extremely expensive, value hasn't participated as much, where value has done reasonably well over the last decade too; it's just relative to the market it hasn't done as well.

Tobias Carlisle: So, the opportunity set is... In 2019 the opportunity set is wholly different to the one that I had in 2009, and so my return expectation in 2009 was much, much higher than my return expectation now. So, I can tell you in my own portfolio, my return expectation for the portfolio for the next 12 months, given the portfolio characteristics at the moment, is somewhere between 10 and 15%. I think that the return expectation for the market is something in the order of 2% including dividends. Now, that doesn't necessarily mean that that's what happens, because there's a lot of noise, but that's my expectation, and every year I'm trying to construct a portfolio that has the optimum kind of full return, and whatever you get is what you get.

Trey Henninger: Yeah. I mean, you can't control your returns, you can only control your process.

Tobias Carlisle: Right.

Trey Henninger: So, your process is driven by what you call the Acquirer's Multiple, which is EV divided by operating's earnings.

Tobias Carlisle: Right.

Trey Henninger: What's the importance of using the enterprise value instead of just the market cap, like most people do with a price-to-earnings multiple?

Tobias Carlisle: It's a great question. The reason that it's called the Acquirer's Multiple is we're thinking like an acquirer, which means we're thinking about buying the company in its entirety, and what happens when you buy a business in its entirety is that you become responsible for the debt that it has. If it has any preference shares, then you're responsible for the preference shares. If it's got an underfunded pension, you have to be able to top that up. If there are convertible notes

hidden in the notes, then you're responsible for those. So, what we're doing when we're thinking like an acquirer is looking at all of the debt and liabilities that come attached to the business that aren't reflected in the market capitalization.

Tobias Carlisle: The reason that's important is you can often have something that's heavily indebted that it has a small market cap, but a great deal of debt, which is why it looks optically cheap on a market capitalization basis, but it's not, in actual fact, cheap, because there are all of these liabilities that the company is responsible for. So, it's just a... It's a holistic approach to looking at the purchase price. So, I use that terminology a lot on my pager. I often think in holistic terms. I want to look at everything that it owes, everything that it owns, and then I want to look at the cashflow statements to make sure it's generating lots of free cashflow, make sure the earnings match the cashflow, make sure that the balance sheet is healthy and we're not overpaying because we're missing some liability that we should be taking into account.

Trey Henninger: So, do you have a target Acquirer's Multiple? Like I only like to buy companies below an Acquirer's Multiple of 10, or five, or... I mean, is there a certain threshold you're seeking, or is it just always by the lowest? Kind of what are you looking for in terms of an Acquirer's Multiple?

Tobias Carlisle: Yeah, so you want to buy the lowest that you possibly can, but in terms of a rough rule of thumb, I think 10 times is a reasonable rule of thumb to be buying, and then you want to sell, potentially, somewhere between 15 and 20 times. But I like to buy below 10.

Trey Henninger: So, one aspect that you talk about, then, in terms of... You say 10 times Acquirer's Multiple, so that'd be... The enterprise value is 10 times the operating earnings? Is that right?

Tobias Carlisle: The other way around.

Trey Henninger: Or, sorry, yeah, yeah.

Tobias Carlisle: No, no. You're right. No, sorry, you're right. You think about it on a yield basis too, so you're paying the enterprise value; that's your cost. And you're getting back in return the operating earnings. So, you want an operating earnings yield of roughly 10% or better.

Trey Henninger: Okay. So, you talk about, in your book, negative enterprise value companies, which would seem to be the key definition of the cheapest you can get. I mean, these are also what Ben Graham would have called net nets, right?

Tobias Carlisle: They're not quite net nets, but yes, it's the same philosophy. You're really relying on mean reversion in the business, mean reversion in the stock price relative to the underlying value. You're not relying on performance in the

business; it's not a compound or it's not growing. You're really trying to get something for free.

Trey Henninger: Yeah, so would you be comfortable filling your portfolio, then, with only negative EV companies? I mean, because they would-

Tobias Carlisle: Absolutely. If I could find them I [crosstalk 00:22:33].

Trey Henninger: Yeah.

Tobias Carlisle: You look at the long-term returns to negative enterprise, value is spectacular.

Trey Henninger: So, is the struggle, then, simply that there aren't any of them or many of them in that $1 billion range or 15 billion, whatever you had that's-

Tobias Carlisle: They're very hard to find. That's exactly right, because you think about what it means to have a negative enterprise value. The only way you get a negative enterprise value is if you have more cash than all of the other liabilities and the market capitalization. So, that would be a business that has $1 billion in cash, a market capitalization of 500 million and no debt, that has a negative enterprise value of $500 million dollars. They just don't exist, because it's free money and there are people trying to pick those things up all the time. The only time that you find them, really, is in a big market dislocation like the 2007, 2009 event.

Trey Henninger: Yeah, I mean, I think that's certainly true for larger companies, so I actually spend most of my time focused on where the micro-cap space... Where they tend to be more available. So, I guess the question would be is, would you be willing to go into companies that were a lower market cap because they were a negative EV? Or are you staying focused in that mid-cap range for reasons that maybe, let's say, the mean reversion's better, or something along those lines?

Tobias Carlisle: Yeah, so the ETF has liquidity restrictions because it's... So, that's the reason that the ETF can't go down below that level, but in my PA and in other times I've hunted for negative enterprise value companies alongside hunting for net nets and those sort of opportunities because in my mind, that is the real... That process by which those companies tend to outperform the market is the... Really describes the mechanics of value investing, because what you're looking for is a big discount to a largely static value, so they're easy to calculate, and the only way that they sort of perform is by other investors paying more than you did for that position, and sometimes you get some mean reversion in the underlying business; sometimes they recover.

Tobias Carlisle: But for the most part, all you're doing is buying at a discount to a static value that somehow, over the course of the year, through mean reversion, between the price and the value... That gap closes, and that is probably one of the best-performed strategies out there. It's just that they're very hard to find. They're

available in micro-caps. They're available internationally, as well in Japan. They're just hard to find and hard to invest in.

Trey Henninger: All I'm trying to get to is that for other investors, I have a lot of individual investors in the audience in my podcast, you'd recommend that strategy of, say... If you could find a portfolio of 20 net nets or 20 negative EV stocks, that would be a good portfolio because maybe they have a different opportunity set than you.

Tobias Carlisle: That's a great portfolio. You have to understand what you're buying and why you're doing it, but that is a great portfolio because you have to realize that the business is going to be terrible businesses, but if you can find them, I think they're great opportunities [crosstalk 00:25:59] over time.

Trey Henninger: Well, they're terrible businesses, but the concept that I gleaned from your deep value strategy is that you're spending less time on how good the business might be and more time on just buying the cheapest stuff. Is that right?

Tobias Carlisle: Exactly right, exactly right.

Trey Henninger: Okay. So, one question I had... When I was reading through your book, you had this statement on operating earnings, where, if two businesses have the same operating earnings, they should theoretically be worth the same amount, even if they have, in terms of enterprise value, even if they have a different mix of debt and equity. I was just hoping you could explain that to me, because when I was thinking about it, it wasn't intuitive that... Let's say your enterprise value is $1 billion for both companies and they're both earning $100 million in operating earnings. Why should those companies have identical enterprise values if one is all equity and the other one's 50% equity and 50% debt? Because it seems to me that it's worth more if the company can hold debt to an equity investor. Does that make sense?

Tobias Carlisle: Why is it worth more?

Trey Henninger: Because if the company's able to support debt due to reliability of earnings or something, then they could potentially pay out higher dividends or something along those lines. That's my thinking. Now, I'm open to being wrong, it was more just it seemed counterintuitive, that idea.

Tobias Carlisle: Well, you just need to... I'm saying that there are two businesses that are identical. They're growing at the same rate, they have the same level of earnings. For all intents and purposes, they're identical businesses, and they both have the same enterprise value of, say, $1 billion relative to $100 million in earnings. If one has $500 million in debt, they're market capitalization, because we know what the enterprise value is. It's $1 billion. The market capitalization must be $500 million.

Trey Henninger: Gotcha.

Tobias Carlisle: And the other one has no debt; the market capitalization will be $1 billion. You shouldn't assume that the one that is $1 billion in market cap is twice as valuable or is twice the price of the one that is $500 million. They're identical prices because they have... One has debt, which is just... That's a decision that management makes. You could take that company private, you could make it $900 million in debt, $100 million in equity. You can take it public again and you can replace that debt with all equity. These are just decisions that the owners, the managers make about the business, and it shouldn't impact your evaluation of it as an investor. Of course, having debt in there then makes the company slightly riskier. There are other things to consider.

Trey Henninger: Got it.

Tobias Carlisle: I'm simplifying it for the purpose of demonstrating just that you need to be aware of the debt on the balance sheet.

Trey Henninger: That makes sense to me, so I guess it's the idea that because the CEO or the CFO has decided this is the balance, it's also something they could change their mind on tomorrow, so you need to judge the business in terms of the EV you want to pay, regardless of it, because they could change their mind, basically.

Tobias Carlisle: We just need to be aware of the debt is what I'm saying. So, if you find something that's trading at $500 million, it's not necessarily half the price of the thing that's trading at $1 billion. You don't know what the situation is until you include the debt.

Trey Henninger: Okay, so would still take that difference into account when you're building your portfolio with your ETF, though? You're going to say, "Okay, how are these companies different?"

Tobias Carlisle: Yes. The thing is that I... It would never become an issue in the portfolio, because I'm always looking for the highest ratio of operating earnings to what I'm paying, which is enterprise value.

Trey Henninger: Oh, okay.

Tobias Carlisle: So, the things that are marginal are so far out the universe or the screen that I'm actually looking at, the things that I'm looking at are going to be incredibly cheap on both... They're going to have a low enterprise value relative to very robust operating earnings, and so the question is always, for mine, why is this mis-priced? What's the issue with this company?

Trey Henninger: Okay. So, in terms of this strategy, it seems like the entire strategy depends on mean reversion, so if we were to use Charlie Munger's idea of inversion, the whole weak link, then, is mean reversion. The question I have for you is what

could cause mean reversion to fail or stop working permanently, and how can you be confident that mean reversion isn't simply perhaps an artifact of the most recent 150 years of history, and that maybe some other set of market circumstances could cause mean reversion to stop?

Tobias Carlisle: Let's invert it and think about it from the other perspective. What makes it work? So, that was a question that was posed to Graham when he was appearing before a subcommittee following the 1929 bust, and they said, "Once you get one of these positions, how does it come about that the market recognizes that it's undervalued?" Graham said at that time, "It's one of the great mysteries of the business." So, he was being a little bit coy because the real answer is it's microeconomics. When something gets undervalued... So, you identified Apple as being undervalued in 2013. I identified it as being undervalued. We both bought it, and that mechanism, fundamental investors, value investors buying something that's undervalued, creates the floor in these things.

Tobias Carlisle: As more and more people buy the company, and then the next person pays a marginally higher price than the last person, that is how mean reversion comes about. So, for mean reversion to go away would mean that fundamental investors and value investors were no longer doing what they were doing. So, I think that mean reversion is going to persist. I think it's almost like an [inaudible 00:32:10] of nature, and I don't know what circumstances would arise for it to go away. It would have to be the stock exchange shutting down, or full-blown communism or something like that. I think that mean reversion is one of the things that you really can rely on.

Trey Henninger: So, in terms of... You mentioned the stock market shutting down. So, this is definitely an area where your strategy would differ significantly from Warren Buffett's current strategy, not his old strategy of being a deep value investor, where he says you should buy stocks that, if the market shut down for 10 years, you'd be happy to own them? That is not the strategy we're implementing here?

Tobias Carlisle: No, I'd be happy to buy these companies and hold them for 10 years. It's just that if you do a backtest on the Russian stock market prior to the communists coming to power, the backtest doesn't look really good because there's a point where everything goes to zero. That's true of any country where there's been a complete revolution; the backtests aren't going to look great. The US has a great long-term track record because the US stock market has existed... The first part of that is that the US stock market has existed continuously through that entire period. I'm more than happy for... You think about what you're buying. I'm buying an oil company right now that I think is incredibly undervalued. Do I care whether the stock market's open so I can trade it? No. I'm relying on mean reversion in the underlying business and in the discounts of the cashflow, the discounts of the intrinsic value closing.

Trey Henninger: But you would agree that your returns could be higher if that mean reversion occurred quicker?

Tobias Carlisle: Sure.

Trey Henninger: Right? I mean, that would be the benefit of having the market open and having that market constantly available, is maybe it mean reverts in a year versus five years or 10 years.

Tobias Carlisle: Which is what tends to happen. I'm not relying on mean reversion to generate the returns. Sorry, I'm not relying on mean reversion in the stock price to generate returns. I'm relying on mean reversion in the underlying business to generate returns, but in most instances there's mean reversion in the stock price as well, and that occurs faster than the mean reversion in the business, because as soon as the business turns around, the stock price sprints ahead.

Trey Henninger: So, to capture what you just said, you're saying okay, if the business turns around instead of dropping earnings 30%, earnings rose 10% this year?

Tobias Carlisle: Right.

Trey Henninger: So, you're going to capture that 10% growth from the earnings rise, but you might also capture an additional 40% from the stock price rising?

Tobias Carlisle: Right.

Trey Henninger: Okay.

Tobias Carlisle: Not in those exact figures.

Trey Henninger: No, I mean, I'm just [crosstalk 00:35:00] trying to...

Tobias Carlisle: Yes, that's the idea.

Trey Henninger: Just to get a sense of it.

Tobias Carlisle: In The Acquirer's Multiple, in the book, there are these charts at the front that are just representative of what I think occurs in the business, so I try to show that there's a cycle in the business, but then the cycle in the stock price far overshoots the cycle in the business. It wasn't that long ago that oil and gas companies were very, very popular, and they were trading at prices that suggested that they weren't cyclical and that they were going to continue to grow at the rate that they had. Anybody who's been an investor for one cycle knows that oil and gas price. Oil and gas companies are cyclical, and you don't want to be paying a peak price on a peak multiple one, peak earnings for an oil and gas company. Now we're in the reverse situation where they're trough earnings and at trough multiples, so I think oil and gas is pretty cheap right now,

but I know that the earnings will get better a little bit in the future. The stock price will go up probably more than is warranted, at which point I'm a vendor.

Trey Henninger: Yeah. So, when we think about how this strategy's working and the idea that this strategy beats the market over time, or beats, let's say, investing in wonderful companies at fair prices. So, let's compare deep value to Buffett's strategy here for a second. What I've thought about is what I'm going to call the backtest problem, and what this would be is that the backtest makes some assumptions which can affect one strategy differently than the other, so in terms of your assumptions reading the appendixes that you're rebalancing monthly of this 30-stock portfolio that's equally weighted. But when you think about how a practitioner of Buffett's strategy actually invests, it tends to be a lot more concentrated with very little rebalancing. So, do you think that that could have impacted the nature of that result so that it might beat that strategy? Because it doesn't necessarily beat, let's say, the returns that Buffett actually received. Now, he's considered the best investor in the world by some, so it's maybe not a fair comparison, but I wanted to pose the question.

Tobias Carlisle: Yeah, so we tested in quantitative value. We used a different rebalancing methodology where we rebalanced on an annual basis, and that yielded the same results. It's not so much a question of how often it's rebalanced. I think that the question that I often get from Buffett-style guys is, "Well, what if we take the rebalancing out to five years? Does that then improve the returns?" And it doesn't. Backtests are imperfect, and they could be improved in any number of ways. Every time I run one I get... Every time I write a book I get, literally, hundreds of folks suggesting some variation.

Trey Henninger: Sure.

Tobias Carlisle: We test all of those variations in preparation for the book, because we're trying to find a representative way of showing what we've discovered. It doesn't really change much. If you run a backtest, assuming five years of rebalancing... And then you can do that on a rolling basis. So, it's 60 opportunities to rebalance if you're rebalancing on a monthly basis. So, you rebalance 1/60th of the portfolio, and then you hold that 1/60th for five years and you don't rebalance until the end. You still get a bulk of the return coming in the first 12 months, because that's the point where the undervaluation is the most stretched, and the bigger the undervaluation, the better the returns, everything else being equal.

Trey Henninger: Okay, so it's less about those individual assumptions and more just you're really having the return, then, driven by that mean reversion? It's what you talk about, but if it's occurring quickly, then it's becoming... It's the mean reversion of the business and the price that's giving you that return and less, let's say, a compounded return.

Tobias Carlisle: Yes, so the compounded return... For long-term investors who hold businesses over extended periods of time... And I forget the exact proportions, but you

have two, five, 10 years, your long-term return becomes your return, the sustained return on invested capital over the period that you hold it. So, for a long-term investor who's looking to hold for extremely long periods of time, they should focus on sustainable return on invested capital, because the higher that number is, the better their returns will be. The problem is that there are very few companies that can sustain high returns in invested capital. Most companies, 96% of companies will mean revert over that decade to, basically, the mean.

Tobias Carlisle: So, the challenge and what Buffett's great genius has been has been to identify these companies that do have these moats that have a competitive advantage that resists mean reversion. It's about 4% of companies. Michael Mauboussin has done, I think, the best work in identifying them, and even Mauboussin will say that they're hard to identify prospectively. They're easy to identify after the fact, but you don't get paid for identifying them after the fact. You only get paid for identifying them beforehand.

Trey Henninger: Sure. So, I guess that underlying assumption tends to be that the skill of identifying the companies that are durably profitable is rare? So, do you think that's a skill that's teachable, or is it just ingrained in certain investors?

Tobias Carlisle: So, I would take... Mauboussin is the one who's done this sort of scientific, replicable approach to it. Otherwise, what I'm saying is that there's probably a lot of luck in it.

Trey Henninger: Okay.

Tobias Carlisle: Because you and I can identify what we think are the ones that will be sustainably growing over the next decade, and one of us will be more right than the other, but does that mean that one of us has done a better job at identifying, or one of us got lucky? It's very hard to tease out the difference between skill and luck in something like that. If you focus on them and you buy lots of them, it's likely that you're going to find some that do materially outperform over a very long period of time. I think a more sustainable, higher hit rate way of doing it is just to identify things that are very undervalued. That's not to say that the other style doesn't work, I just think it's harder to do.

Trey Henninger: Okay, so you think it's harder, and Buffett's going to be more the exception than the norm?

Tobias Carlisle: Well, when you look at what Buffett's returns have been since he's been identified as being a great investor and he's got other problems like having lots of money to invest, having too much money to invest. His returns haven't been that great. All of the best returns that he got were when he was a deep value practitioner looking for net nets, and then, very undervalued companies, moving like an activist or a liquidator in some instances. Since he's been either through the weight of having too much money to invest or he's transitioned to

this franchise compounded style, the returns haven't been as good. Even though they've been very good.

Trey Henninger: Okay. No, that makes sense. So, I guess it leads me into, potentially, a challenging question, but I'm interested to hear your thoughts. So, if the business analysis doesn't matter in terms of helping you differentiate between which companies have more moats and you shouldn't focus on the moat of a business, then it seems like you can really quantify and break down this strategy into very simple rules and formulaic analysis. So, if that's true, then what value does the portfolio manager provide over, say, a computer? Could a computer implement a deep value strategy and have an ETF that charges five basis points, and how does the portfolio manager in 2019 and beyond provide that extra value?

Tobias Carlisle: It's conceivable that a computer could do that, because to invert the question again, how are you making these assessments of the quality of management or of the business absent from the financial statements? Because the way that I think about it, if you're doing that you're double-counting, right, you're looking outside what's reflected in the financial statements to find something that... What management's telling you, or your own views on the industry. So, I think that, yeah, it's conceivable that a computer could do it. The issue for any investor, though, is not... All of this stuff is simple. The Buffett stuff is pretty simple. None of it is particularly hard to do. The problem is not one of intellect, the problem is one of emotion and behavior.

Tobias Carlisle: You have to be able to under perform, you have to be able to hold positions that don't do as well as the rest of the market with sort of equanimity, because you understand the underlying logic of what you're doing and you think that that's a better way of approaching the problem than the other options that are out there. So, I think that there's nothing particularly complex about what any of us do. You just have to be behaviorally suited to having long periods of under performance, some negative performance, this tracking era, as it's called. You have to be able to articulate why this strategy can outperform in the future, even though it's not performing now, and you have to be able to articulate to yourself, and that's a challenge.

Trey Henninger: So, in terms of this temperament you're talking about, is this something that you think investors can teach themselves to control their emotions in that way, or is it something that you really need to know? Buffett's philosophy is that he thinks that you're either born with it or you're not.

Tobias Carlisle: I think you can learn. I would certainly not say that I had it initially. I think that I've developed it, and I think that the way that you develop it is that you don't focus on the stock price, you focus on the underlying value of the company, and that doesn't change that often. That changes, at most, on a quarterly basis. So, if you do a valuation, you watch the valuation. You need two data points to work

out whether your valuation's going in the right direction, so you need one quarter, and then you need the following quarter.

Tobias Carlisle: So, your minimum holding period is three months, or maybe a little bit longer than that, and you really only need to check twice in that period of time to see how your assessment is going, so I think that Taleb has this great line in Fooled by Randomness, where he says that it's not moralizing or trying to hammer in this sort of chiding yourself for behaving badly, because you're just going to fail. You have a finite amount of willpower, self-control, and it's a depleting asset. What you have to do is just find some way of tricking yourself into doing the right thing. So, that's what I do. I just trick myself into doing the right thing. I focus on the underlying value, and I rebalance the portfolio on a quarterly basis, and I have rules around how I do that. So, it's not temperament on my behalf, because temperament can fail. Human beings are fallible, but the process is so fixed and ingrained and public that there's just no way that I can do anything but follow the process.

Trey Henninger: So, then, as a professional investor, is the hardest part managing your emotions, or the emotions of your investors?

Tobias Carlisle: Yeah, part of it is making sure that you attract investors who view investment the same way. I've been writing publicly for a little bit over a decade, and I think that you know what you're going to get from me. It's going to be a particular deep value style, and the process is all public, the holdings are transparent. You can replicate my portfolio and not pay me a fee, if you'd like to do that. So, I don't think it's really either, because I have a process that I have to go through, and the investors are going to get that process. You come to this restaurant, we serve a particular type of food. If you want a different type of food, you have to go to a different restaurant. The restaurant is not going to change the food that it serves. So, we advertise a particular type of food and we serve that every single night. Sometimes it works, sometimes it doesn't.

Trey Henninger: No, that's a good explanation. So, my last question for you, then, is... In particular in your backtesting, you talk about excluding... You exclude financial companies, and so I'm just wondering how you apply the Acquirer's Multiple to financial companies, because I noticed in your current top 10 holdings you own some financial companies.

Tobias Carlisle: Right. As an investor I like holding insurance companies, and I like banks. They're not as amenable to an Acquirer's Multiple valuation as other industrial type companies are. So, there has to be some change to the process to do that. The traditional way of valuing insurance companies and banks has been a valuation. So, that's what we do, and then we have to make it an apples to apples comparison to the Acquirer's Multiple. So, that's some of the work that we have done to marry up. That's not something I've sort of discussed publicly a great deal, because I think some of it... It's a little bit of the magic that we're trying to put into our portfolio, but that's something that we do, and the traditional way

of valuing those things is [inaudible 00:49:11], but I think that you can have a marriage between both of them that generates pretty good results.

Trey Henninger: Well, thank you for taking the time to come on the show. If you'd like, take a minute to promote your fund or anything else, how you'd like people to follow you, how you'd like people to reach out if they would like to reach out to you.

Tobias Carlisle: Sure thing. So, I'm on Twitter all day long on... My handle is Greenbackd, which is G-R-E-E-N-B-A-C-K-D, and I have a website, acquirersmultiple.com. The firm is Acquirers Funds, plural, dot com. The ETF is the Acquirers Fund. The ticket is ZIG, and you can see the holdings and the performance and so on on the website, acquirersfund.com.

Trey Henninger: Well, thank you for coming on the show. Really enjoyed it.

Tobias Carlisle: Thanks for having me. Those were great questions, Trey.

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