



4th Annual Value Investing Seminar in Italy

August-26-2007

This is the part II of the notes taken by Anastasios Dimopoulos during the 4 th Annual Value Investing Seminar in Italy. It includes the talks given by speakers: Roberto Russo, Mark Sellers, Fransisco Garcia Parames.

Roberto Russo

Mr Roberto Russo is the portfolio manager of Duemme Sgr. He spoke about IFIL which has operated as the investment vehicle of the Agnelli family (a wealthy Italian family) since the 1950's. Unfortunately the presentation was given in Italian and I wasn't able to accumulate the information through the simultaneous translation. What I learned is that you can make investments as complicated as you wish by using financial instruments. The investment thesis included going long one company while going short six other companies in order to create just that part of the IFIL company which is the desired investment.

Mark Sellers

Mr Mark Sellers of Sellers Capital made a brief introduction of his investment philosophy and then concentrated on the subject of bet sizing and the Kelly Criterion in particular.

Sellers Capital philosophy

1. Buy two types of companies, wide-moat companies that are out of favor and small-cap companies selling at or near tangible liquidation value.
2. Hold a very concentrated portfolio (5-15 stocks).
3. Make big bets.
4. Don't diversify much but monitor the correlations within the portfolio.
5. Permanent capital impairment equals risk and not volatility.

Bet sizing and the Kelly Criterion

Mr Sellers gave a very informative presentation on the subject of bet sizing using the Kelly Criterion which also included a spreadsheet where we did a bet sizing exercise. The Kelly Formula suggests that you should never bet unless the odds are in your favor. If you are trying to maximize your wealth over an investing career the formula will tell you what your bet size should be in each position. If you do exactly what the formula suggests you will end up with maximum volatility but also maximum gains. Betting half the amount suggested by the formula reduces the volatility by 50% but the expected return by 25%. The problem is that like every other model you get out of it what you put in "Garbage in, garbage out". Since most human beings are bad at estimating probabilities like the ones needed to use the Kelly formula you shouldn't take a position if you are pretty sure that the odds are in your favor (think "Margin of safety"). The Sellers Capital policy is to bet when the expected return exceeds 20% and the upside potential is 3 times greater than the downside risk.

An example of a real life scenario was given and it was about Contango Oil & Gas Company. The stock was at \$21 and they believed that there was a 20% probability of the stock going to \$17, a 60% probability to go to \$30 which was thought as the fair value, and again a 20% probability to go to \$55. According to the calculations using the spreadsheet the optimal bet was 400% of the assets. They eventually put 50% of the assets under management in this position and they did pretty well because the price has doubled since then. Actually as Mr Tilson informed us when introducing Mr Sellers, Sellers Capital was up 47% just in the last quarter.



Mr Sellers also talked about using leverage and his point was that although leverage isn't inherently bad it shouldn't be combined with other leverage. For example it is not good to use margin to buy options or companies with lots of debt.

A seminar participant made a comment about the Kelly Formula that it should be used according to theory only when you have one bet at a time. That means that you invest in one position and the rest of your portfolio is in cash. That's why at the end very few portfolio managers use the Kelly Formula as it is supposed to be used and just have it as one more part in their investment allocation decision. If the formula shows that they can put a very large amount of their assets in a certain position like in the example of Contango above, that helps them make a relatively big bet (10%-20% of assets) and run a more concentrated portfolio.

Francisco Garcia Parames

Mr Parames is the Chief Investment Officer of Bestinver Asset Management and he was recently featured in a Bloomberg article about giving stock tips to Mr Buffett. He manages €6.5 billion in several mutual funds. His investment philosophy is based on value investing, and in the funds they have long only positions and make no use of derivatives. The funds are invested 90% in equities. The Bestinver Spanish equities fund has a 23.56% average annual return since 1993 and the Bestinver international equities fund has 15.26% average annual return since 1998.

Their investment philosophy is to seek profitability in absolute terms and not relative to benchmarks. As most value investors they don't see volatility as risk and they are patient. The difference between other funds is that they have a very high absolute turnover which is equal 150%. This happens because they take full advantage of their favorable tax status as a mutual fund and they get in and out of positions as their prices fluctuate. This changing of positions happens between the companies they have analyzed and if the turnover is measured on terms of different names in their portfolio it is about 25%.

The Spanish equities portfolio has a P/E of 11.1 compared to 16 for the Spanish market. Their target valuation is at a P/E of 15 which represents a 35% upside. They hold 35 stocks and their biggest positions are Telefonica, Arcelor, Repsol, Acciona, and Mapfre.

The international equities portfolio has a P/E of 8.8 compared to 16 for the MSCI World Index. Their target valuation is at a P/E of 15 which represents a 70% upside. They hold 101 stocks and their biggest positions are MetallZug, Linde, Neochimiki, Fuchs Petrolub, and BMW.

One of his investment ideas was the German automaker BMW with a market cap of €29 billion compared to his valuation estimate of €59 billion. The numbers he used to arrive at this valuation are a projection of 2008 which includes €3.5 billion net cash from industrial operations, €5.5 billion for the financing activities valued at 1.1 times book value which is a lower multiple than what General Motors got for its financing subsidiary, and €45 billion for the core operations valued at 15 times €3 billion free cash flow. A very knowledgeable investor I met at the seminar tried to come up with these numbers after the presentation but couldn't manage to arrive at the same results. The lesson is that Mr Parames probably is right but you should always invest in what you understand.

A second investment idea was leading Swiss appliance manufacturer Metalzug with a market cap of 1.66 billion SFr compared to his valuation estimate of 2.64 billion SFr. The number used for the valuation were 750 million SFr of net cash, 450 million SFr of after tax real estate, and 1440 million SFr for 16 times a 90 million SFr free cash flow. One of his somewhat funny comments on this company was that he doesn't understand why people would buy such expensive appliances but this doesn't stop him from investing in such a company. What I got out of this is that it's better to be an equal opportunity capitalist and don't make discriminations based on your tastes.