Getting It

Value investing success is predicated on minimizing the impact of mistakes. Rich Pzena describes a new tool he's employed to help him do just that and what it's telling him about risk – and opportunity – in today's market.

INVESTOR INSIGHT

Richard Pzena
Pzena Investment Management

On what to avoid: "The world used to call them boring, but what's bubbly today are high-dividend-yielding stocks and shares in stable, quality companies."

Editor's Note: *In the lead interview of our very first issue of Value Investor Insight [VII, February 22, 2005], Rich Pzena recounted the tough late-1990s market for value investors. As Internet and telecom stocks went to the moon, slower growing businesses in any number of other sectors generated little, if any, enthusiasm. As he said in the interview: "People would say, 'You just don't get it,' and I'd finally say, 'You're right, I just don't get it.'"*

Having come through that dark period for his value-investing strategy with flying colors, darkness fell again in 2007 and 2008, when Pzena found himself over-exposed to financials like Fannie Mae and Citigroup at exactly the wrong times. In a testament to the resilience of his deep-value strategy, his $28 billion (assets) Pzena Investment Management has again bounced back nicely and continues to sport enviable long-term returns. The John Hancock Classic Value mutual fund Pzena has run since 1996, for example, has earned a net annualized 9.5% over the past 15 years, vs. 5.1% for the S&P 500.

We caught up recently with Pzena, joined by analysts Miklos Vasarhelyi and Matt Quigley, to discuss the strategy change he made following the crisis as well as where his discriminating value discipline is identifying opportunity today.

You've made one material change in your investing strategy since the financial crisis. Explain what it is and how you arrived at the decision.

Richard Pzena: Our long-standing philosophy has always been that excess financial leverage was not a good bedfellow with value investing. It's difficult to estimate the time frame involved in a business's recovery, so taking too much risk that creditors come knocking at the door before the recovery takes hold has always struck me more as gambling than investing.

So in our analysis of banks during the crisis, we did as we always do, which was to run stress tests to see how well the banks could endure credit losses from a very weak lending environment. We concluded that many of the business franchises were more than capable of surviving a terrible economic environment, and in fact, the actual credit losses incurred were nowhere near the levels we tested. It wasn't that we didn't conceive of the downside case.

What we got wrong is the way people reacted to the crisis. They panicked, leading to near systemic financial-market failure. We didn't foresee that and the permanent impairment it caused to some of our holdings. The challenge from an analytical perspective, then, was what else could we bring to our process to objectively decide on a company-by-company basis whether we're taking inordinate risk of permanent impairment? Looking at debt-to-equity ratios or debt-to-cash-flow ratios wasn't enough, and we thought too often led to the systematic avoidance of excellent opportunities due to excess caution.

What we found – much to my surprise, I should add – was that extreme share-price volatility is an indicator of a company's potential financial failure. When you look at the data, you see that as trailing-12-month stock-price volatility rises, so do future stock-market returns – but only up to a point. As you get to the top quintile of volatility, the whole thing falls apart and the most-volatile stocks detract from performance. People do actually systematically overpay for the highest-volatility stocks, and those stocks have a much higher probability of financial failure than stocks in the other quintiles of volatility.

We looked at our performance over the past 20 years. If we had never owned the stocks in the most-volatile quintile within their universe at the time and reallocated the money to the rest of the stocks we owned, we would have added 250 basis points a year for 20 years to our performance. That was staggering to me.

So we adopted that. When we're considering a company in our research process, we'll do the full analysis, do an earnings forecast and arrive at a valuation. But we also now highlight the trailing stock-price volatility and whether it's in the most-volatile quintile. We haven't laid down a blanket rule: there are times when you have a lot of volatility in companies that don't have debt, and the odds of going bankrupt when you don't have debt are small. But for stocks that are volatile for financial-leverage reasons, we will either outright pass or at least limit our exposure more than we would have before.

We've looked over time, not just 2007-2008, and *all* of our big losses have resulted from excess financial leverage. We make a lot of mistakes, but if you make a mistake and the company doesn't go bankrupt, you shouldn't as a value investor lose that much money. The key is to double your money on the ones you get right and when you get something wrong, only lose 20%. Do that a majority of the time and you'll have a great long-term record. Big losses throw off the dynamic – we're obviously trying to make the chance of that happening as small as possible.

Is the market's increased volatility of late sending off warning signals?

RP: Not so much in our work. A lot of volatility today is in stocks with crazy valuations or that are sensitive to interest rates or currencies. The most-volatile stocks for the most part aren't distressed companies near bankruptcy.

Where we do see some higher volatility in companies on our radar is in energy. Here we're completely vetoing any levered E&P company that is in the top quintile in volatility, even though many of them screen as very cheap stocks. That's not an issue in companies like Exxon Mobil [XOM] or BP [BP], but more in some of the oil-shale names and deepwater offshore drillers. There is arithmetic that tells us in the long term we need higher oil prices than today to generate an incentive to drill or otherwise we're going to run out. But there's no arithmetic that tells you the oil price six months from now is going to be $30, $50, $70 or $90. If financial leverage is an issue, we want nothing to do with that.

How do you view financial stocks today?

RP: Financial services in my opinion offers the single best risk/reward tradeoff in the market today. With banks, so many people are focused on the extent of regulatory change and the risk of permanently lower return on equity, but everything we look at suggests that is just wrong. The reason returns are low is because interest rates are low, not because regulation is tough. To us that results in a skewed tradeoff. If interest rates stay low, you make an 8% return because big banks are earning about an 8% return on equity and they trade around book value. If interest rates pop up, you double your money. Downside is 8% per year, upside is a double. You obviously have to take into consideration bankruptcy risk, but the volatility data is telling us there is no issue there.

A perfect example is Citigroup [C]. It's middle of the road in terms of volatility, it's earning $5 per share, and the stock's at $52. If three things change – the deposit spread returns to its long-term average, trading volumes on fixed income return to their long-term average, and expense ratios return to their long-term levels – Citi earns something like $8.50 per share. When that happens, the multiple won't be 10x, but probably closer to 14x. So the stock more than doubles in the upside case and you're probably still looking at a reasonable return in the downside case.

ON OPPORTUNITY TODAY:

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Probably 80% of our cheapest stocks today are in finance, energy and big-ticket industrials. What's bubbly are high-dividend-yielding stocks and shares in stable, quality companies. Those low-beta stocks are trading near all-time record high valuations, while high-beta stocks are trading near all-time record low valuations. The world used to call consumer staples, real estate and utilities boring, but now they're considered quality. Higher-beta stocks – banks, investment banks, consumer discretionary, technology, energy, construction – used to be considered exciting. Now they're called risky.

Describe the thesis behind one of your favorite energy stocks today, BP.

RP: The stocks of big oil companies behaved very differently in this last cycle than those of the smaller independents. The smaller companies attracted all the interest because they were making the U.S. energy independent and growing production rapidly. You started to see small exploration and production companies trade on the future value of drilling locations, not reserves. You'd see 30x multiples for businesses that weren't even earning good returns on invested capital. That, of course, was at $100 oil.

In contrast, the big oil companies like BP were taking all their money and building things like gigantic LNG projects or massive deepwater development programs that take five years to complete. The valuations of big oil slipped lower and lower because free cash flow turned negative, there were no production gains, and returns on equity were deteriorating. Even before oil prices collapsed the stocks were at record-low valuations.

Our thesis for BP was, and is, pretty straightforward. These big investments will generate returns, in many cases for a very long time. At the same time capital spending is declining, these projects come onstream and production and returns on invested capital start increasing. As that happens, the market will eventually take notice.

How has the oil-price collapse changed your analysis?

RP: When we originally made our BP investment we used $80 per barrel as our normal price. Now we use $70, but we're also building in lower costs, so the numbers haven't really changed much.

You mentioned how difficult it was to judge the timing of a return to normal. How do you think about that?

RP: We're not making a short-term call, but the amount of excess capacity today is substantially lower than in past price collapses. In the early 1980s the market was so out of balance that there was 15 million barrels a day of extra capacity on 60 million barrels of demand. Today there's more like four to five million barrels of excess capacity on 100 million barrels of demand, and the market is already adjusting supply. It shouldn't take that long to work that off.

Two BP negatives are its remaining exposure to Gulf-spill liabilities and its exposure to Russia. How do you process those?

Matt Quigley: There's only one big slug of Gulf-spill liability still talked about, which is a Clean Water Act penalty. The courts just made a determination on the number of barrels of oil for which BP is liable, and they're now deliberating on the penalty per barrel. The maximum penalty is $4,300 per barrel on the already determined level of 3.19 million barrels. That would result in a maximum $13.7 billion penalty, which is what we've assumed in our models. The company has $29 billion of cash on the balance sheet as well as a lot of debt capacity, so we think that gives them plenty of headroom to be able to digest this and hopefully put all of this particular problem behind them.

RP: The primary Russian exposure is a stake in Rosneft, which at today's market value accounts for less than 10% of BP's market cap. In our analysis we just give credit for Rosneft's current market value, but we think that's vastly understated. We believe the actual value is maybe three times the current market value.

From today's $41.35, what upside do you see in BP's shares?

RP: We consider BP's businesses separately to arrive at an estimate of fair value. First, we determine a liquidation value of the reserves, backing out Rosneft, and assuming oil prices averaging $70 per barrel and operating costs that are something like 15% lower than current costs. Then we separately value the earnings potential of the currently non-revenue-producing capital projects coming on line in the next couple of years. Finally, we look at the downstream and upstream natural-gas marketing businesses and ascribe a fair value to those. Add all of these together and we arrive at a fair share value today of around $60.

Is the dividend, now paying out at a 5.8% yield, safe?

RP: Management swears that no matter what they won't cut the dividend. I've heard that before, but we do believe they have enough financial flexibility that they won't have to cut the dividend.

Turning to a construction-related idea, describe your interest in Terex [TEX].

Miklos Vasarhelyi: Terex operates in a variety of construction and industrial equipment sectors, the big needle movers of which we consider aerial work platforms, cranes and what it calls "materials handling and port solutions." All of these are good businesses, with top three market positions in their respective markets. Aerials, where it is a global leader, is a particular strength.

It's very much a global company, with roughly two-thirds of its business in North America and Europe, where non-residential construction has been relatively weak. Based on long-term data, we believe those two markets are operating at 20-25% below trend, so at a basic level Terex is a play on a return to more normal activity. The equipment the company sells tends to last a long time, so customers can delay purchases without major adverse impact in the short term. But when we go sector by sector and do the replacement-cycle analysis, there's considerable pent-up demand for the types of equipment Terex sells. When that starts to be realized, earnings can increase substantially.

INVESTMENT SNAPSHOT

BP
(NYSE ADR: BP)

Business: Global integrated energy company with upstream exploration and production as well as downstream refining, chemical, lubricant and retail operations.

Share Information
(@2/26/15):

Price	**41.36**
52-Week Range	34.88 – 53.48
Dividend Yield	5.8%
Market Cap	$125.46 billion

Financials (TTM):

Revenue	$353.57 billion
Operating Profit Margin	2.8%
Net Profit Margin	1.1%

Valuation Metrics
(@2/26/15):

	BP	S&P 500
P/E (TTM)	13.3	20.5
Forward P/E (Est.)	13.1	17.5

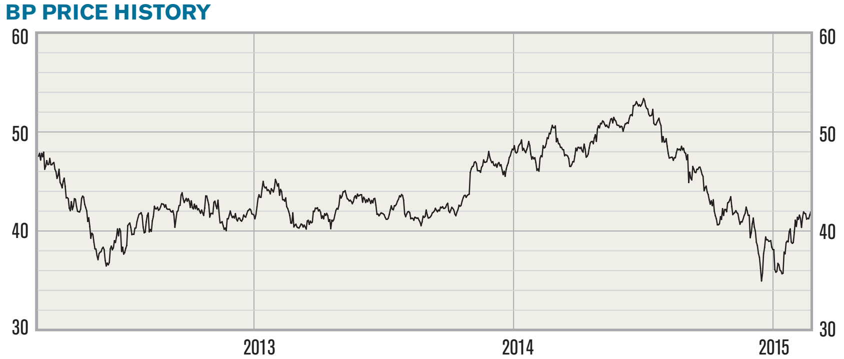
Largest Institutional Owners
(@12/31/14):

Company	% Owned
Franklin Templeton	1.5%
State Street	1.0%
Barrow, Hanley, Mewhinney & Strauss	0.9%
Dimensional Fund Adv	0.6%
Pzena Investment	0.4%

Short Interest (as of 2/13/15):

Shares Short/Float	n/a

BP PRICE HISTORY



THE BOTTOM LINE

The market is far better at discounting the company's challenges than the performance improvements at hand as heavy investment spending in recent years starts to pay off, says Rich Pzena. Valuing separately the company's reserves, its capital projects coming on line and its marketing businesses, he arrives at a fair value today of $60 per share.

Sources: Company reports, other publicly available information

Is energy-related activity a concern?

MV: Our best guess is that maybe 5% of the business is tied to direct downstream energy spending and another 5% is indirect energy-related activity. This exposure could slow a bit the benefit from the overall recovery in non-residential construction, but it's not big enough to stop it.

Are there any operating initiatives of note?

MV: The company has a number of self-help measures underway. It's trying to re-domicile some of its earnings in order to reduce taxes. It's refinancing debt to reduce interest expense. It also has a broad-based efficiency program that it says can increase operating income by $200 million over the next two years. We're actually incorporating very little of that into our models – if they're successful, it would be incremental upside.

The stock has fallen steadily over the past year and now trades at around $27.40. How are you looking at valuation today?

MV: The current run rate of earnings is around $2.30 per share, so the stock trades at a 12x P/E on depressed earnings. Our estimate of normal earnings, based exclusively on end-market demand returning to normal, is closer to $4 per share. With a reasonable 12-13x multiple on that, the stock would trade at around $50.

What is Terex's share-price volatility telling you?

RP: This is one impacted by our change in strategy. It's probably one of the ten cheapest stocks in our world, but we've limited our exposure because it's been a highly volatile stock. Before we would have done our downside analysis – stress-testing each business in a terrible economy, studying the debt/equity makeup, understanding the debt covenants – and concluded the company is not going to go bankrupt. We would have taken a full position and there's a very high probability, at least in terms of financial-failure risk, that we'd have been right. But the volatility data tells us there is a not-immaterial chance we're wrong, and the cost of being wrong is a zero. Today we handle that by not making Terex one of our largest positions, but a relatively small one.

Value investors spend considerable time trying to identify what's "normal." You've been at it a long time, has that become harder to do?

RP: It's always been hard to assess things like technological shifts, so we try not to play when that's of outsized importance. When we buy tech, it's not because of the technology, but because we can evaluate a company like Microsoft as a consumer and industrial franchise. Betting on new technology or a new drug being approved is out of our league, but it's always been out of our league. When we get to the point where we just can't figure it out – I'd say retail is one such area today – we'll look elsewhere for ideas.

To answer your question directly, no, I don't feel like all of the sudden it's a new environment where assessing what should be normal is harder than it used to be. It never has been, or will be, easy. VII

INVESTMENT SNAPSHOT

Terex
(NYSE: TEX)

Business: Global manufacturer of a wide variety of construction and materials-processing equipment, including aerial work platforms, cranes and rock crushers.

Share Information
(@2/26/15):

Price	**27.37**
52-Week Range	22.01 – 45.46
Dividend Yield	0.9%
Market Cap	$2.91 billion

Financials (TTM):

Revenue	$7.31 billion
Operating Profit Margin	6.2%
Net Profit Margin	4.4%

Valuation Metrics
(@2/26/15):

	TEX	Russell 2000
P/E (TTM)	11.5	59.3
Forward P/E (Est.)	12.4	19.8

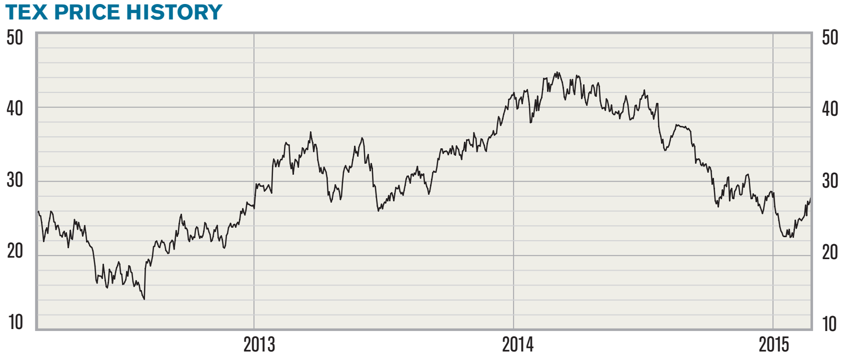
Largest Institutional Owners
(@12/31/14):

Company	% Owned
Vanguard Group	5.7%
BlackRock	5.7%
TCW Asset Mgmt	3.6%
Goldman Sachs Asset Mgmt	3.6%
Pzena Investment	3.4%

Short Interest (as of 2/13/15):

Shares Short/Float	6.2%

TEX PRICE HISTORY



THE BOTTOM LINE

The company's performance is highly levered to non-residential construction activity that in the majority of its markets is running 20-25% below long-term trend, says Miklos Vasarhelyi. At 12-13x his $4 estimate of normalized EPS, the stock would trade at closer to $50. "Self-help" measures underway, he says, provide potential incremental upside.

Sources: Company reports, other publicly available information