“Identifying Great Capital Allocators” presented by Tom Gayner
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Markel CIO Tom Gayner's Transcript

Below is the transcript including questions and answers of Tom Gayner's sold out talk at the 11th Annual Value Investor Conference held on May 1 and 2, 2014 in Omaha, just prior to Warren Buffett’s Berkshire Hathaway [NYSE:BRK.A] annual meeting.

Miles: It takes a great investment manager to know one, so we asked our next presenter to help with “Identifying Great Capital Allocators.” Tom Gayner is President and Chief Investment Officer of Markel Corporation [NYSE:MKL]. He currently has approximately $18 billion in assets under management. Please welcome Tom Gayner.

Gayner: Thanks very much for having me here today. I’m always humbled to be asked to speak. At the same time I appreciate the invitation very much, even though it means that I have to do a bit of homework. I also recognize that I’m the guy who is standing between you and drinks right now. It’s always an uncomfortable place to be, so I’ll try not to dawdle. As I said, I’m grateful for these periodic but not too frequent homework assignments, because they cause me to spend some time reflecting and considering what I’m going to say.

I start with the basic proposition that if I’m going to say something, I’ve got to actually believe it. The good news is the process of getting ready for a talk helps me to examine my beliefs. I check to see whether they’re still viable and what might need modification, adaptation or further clarification.

I’m also thankful to Bob Miles specifically for assigning me the topic of ‘Identifying Great Capital Allocators’, because this proposed title for the talk helped me to crystallize some thoughts about investing. My time today is limited so I’ll share a few comments on the topic and then as quickly as possible get to your questions. To do so, I’m going to share some comments with you from my most recent quarterly memo that I write to our board at Markel when I give them an update on our investment and capital allocation decisions. Here is what I wrote in my most recent memo.

I am delighted to report to you that we are off to a good start in 2014. The results from any single quarter, and in fact for any time period less than about 5 years, resemble what Buffett said about college graduation days i.e., “Security profits in a given year bear similarities to a college graduation ceremony in which the knowledge gained over 4 years is recognized on a day when nothing further is learned.”

That said, graduation ceremonies are more pleasant than picking up your child when they’ve flunked out of school, and it is always more fun to report the results from quarters when we make money than those in which we don’t.

Over the years, we’ve consistently discussed our four part investment process of searching for profitable businesses with good returns on capital, run by honest and talented management teams, with reinvestment opportunities or capital discipline, at fair prices. I believe that each and every word of that distilled statement packs incredible freight. As such, I’m reluctant to pick any single notion as more or less important than another. They all tie together.

That said, if you held a gun to my head and said which of the four ideas is *most* important, I would respond with point #3, reinvestment opportunities and capital discipline.

One of the reasons that I propose such a simplification is that the idea of reinvestment and capital discipline embeds the other concepts. If the business is not profitable, there is no money to reinvest. If the management team is not talented and honest, there will either be no money to reinvest or it will be hived off by the management before it ever gets to the shareholders. And finally, and this is the most nuanced and misunderstood aspect of investing, a fair price may be a lot more than you would think if profitable reinvestment really can take place.

I suspect that you will intuitively agree with me on the notions of profitability, integrity and talent as important and fundamentally embedded in the idea of reinvestment. The “fair price” concept might not jump out at you so much. Consequently, in this letter, I’d like to address what “fair” might mean when it comes to point #4 and our statements about fair value.

Consider first the case of Berkshire Hathaway. Warren Buffett took control of Berkshire in 1965 and at the time it was a struggling New England based textile manufacturer with a share price of roughly $19. The company was a high cost producer in a declining, commodity business and I can’t think of any particular financial analysis or quantifiable number that would have suggested that buying the stock at $19 was a particularly shrewd move. Buffett himself describes his purchase of Berkshire as something of a mistake and a partially irrational emotional act.

The only thing that made things better was that Buffett realized his error and set about the task of reinvesting whatever funds Berkshire produced into more economically productive assets. He did that relentlessly and continually and continues to do so almost 50 years later. Today, that activity goes by the business school buzzword term “capital allocation.”

Clearly, I wish that I had purchased Berkshire shares in 1965 at $19 per share. I entered kindergarten that year and my mother made the error of buying me some husky pants at JC Penney [NYSE:JCP], and school supplies from Woolworths, as opposed to a few shares of Berkshire stock. Oh well. It took me until 1990, 25 years later, to realize the mistake and acquire some Berkshire stock. The 1990 decision falls into the category of “better late than never.”

The price of Berkshire in 1965 was $19. The compound annual growth rate from $19 to the current price of $190,000 is just over 20% per year. That is amazing and the world’s greatest current example of great long term capital allocation and business performance.

Here’s where “fair price” comes into the picture. As I suggested earlier, the $19 stock price of Berkshire was probably not justified at the time. There weren’t any numbers or analysis of the history of the company or even its prospects in the textile business that would have made you think you were getting a great deal by buying the stock at $19 at the time. However, if you had paid 10 times as much, or $190 per share, you would have made 15% per year on your money and still had something special to brag about at a cocktail party as the stock rose from your 10 times price of $190 to $190,000 over the last 49 years.

Most of the time and effort in the investment business is spent trying to figure out what something is worth in a very short time period. Professionals are consumed by questions such as, “Can a security be traded for more or less in a few nano-seconds through high frequency trading mechanisms?”, “Are interest rates going to move up or down and what will that mean to this security trading price?”, “Is Putin going to invade Ukraine, or Poland or ……… and what will that do to stock prices?”, “Will we reduce the federal budget deficit?” and so on and so on and so on.

While those are all important questions, they pale in comparison to the task of finding a manager who can successfully produce earnings from a business, and reinvest those earnings profitably over long periods of time. As the example of Berkshire shows, there is no more important business task.

The great financial writer John Train once said that if you had been on the property committee of the Sistine Chapel and tasked with getting the ceiling painted, you shouldn’t have focused on the training of various painters, what kind of paints they used, where they went to school, how many were on the staff and what kind of process they followed. Instead, you should have gone out into the world and asked the question, “Are you Michelangelo?”

We continue to spend all of our time trying to find the Michelangelo’s of today. Sometimes they are specific individuals. Sometimes, they are teams and systems that produce incredible results over time. The biggest single, and most important, sector of our portfolio of individual security holdings represents a congealed pudding of our vision of companies and leaders that fit this idea. If we get just one or two ideas right in this area, we will continue to produce outstanding overall investment results. To give you an update, as of the end of the first quarter of 2014, and 24+ years into the process, so far so good.

The other aspect of “fair price” that scares investors is the question, “Okay, assume I’ve found a great business with great management, what if something horribly bad happens, or one of those macro level events occurs which makes the stock price go down a lot?”

To answer that, consider the experience of American Express [NYSE:AXP] over the last 50 plus years. Buffett connects to this story as well.

By 1963, American Express had already been a successful business for over a century. It was founded in 1850 by Henry Wells and William Fargo (yes, same guys). The company evolved from a trusted carrier of physical assets to a trusted carrier of financial assets over the years and any shareholder who bought stock in 1850, or just about any single day for the next 100 years made a good decision. The company prospered and shareholders benefited accordingly.

In 1963 though, American Express did something very stupid. They lent a large amount of money based on warehouse receipts for salad oil to an operator named Tino De Angelis. This was incredibly stupid and reasonably preventable. By this time, De Angelis was 47 years old, had already bankrupted one company in the 1950's, and successfully bilked multiple governmental programs prior to his rapid rise in the salad oil business. Didn't anybody suspect anything? Character counts.

As always though, con men possess some combination of charm, intelligence and bullying that causes people who ought to know better to part with their money. De Angelis had done it before, and he did it again to American Express.

When the scheme collapsed, a market panic ensued. American Express was viewed as potentially bankrupt, as were several brokerage firms that had traded with De Angelis. Just to add to the distress, the scandal broke only 3 days prior to the Kennedy assassination, and all of America, not just American Express, was in turmoil.

At that time, Buffett brilliantly decided that American Express could work its way through this debacle and successfully rebuild its financial performance. He purchased as much stock in the company as he could possibly afford and the subsequent spectacular success of the company served as one of the fundamental building blocks behind the investment record of Berkshire Hathaway.

Bold, daring and brilliant are fair words to describe Buffett's action at the time.

What if you had purchased American Express stock the day before the scandal came to life? You probably would have thought of yourself as the absolute opposite of bold, daring and brilliant as the news came to light.

The good news is that while you couldn't ever claim that you were as smart as Buffett about the purchase, your investment returns came closer and closer to his with each passing day. Today the difference in total investment return is not worth arguing about. You and Buffett both compounded your capital at wonderful double digit rates. The excellent reinvestment decisions made by American Express over the last 50 years meant that even if you bought the stock at the worst possible time, you enjoyed spectacular returns for decades.

Consequently, we spend the vast majority of our time focused on finding and owning businesses that can reinvest their capital over decades. It is the most important investment process that exists.

I’m also pleased to report that Markel Corporation continues to produce its own wonderful history and we remain dedicated to continuing to do so in the future.

To do this we will need to think about qualitative factors just as much as things that are more easily quantified. We will also need to remain focused on long term time horizons.

I am incredibly optimistic about our future. While we have to compete hard on quantitative measures every day, the qualitative factors of our culture and values as people, along with our focus on long term time horizons remains rare. I believe these are substantial and sustainable competitive advantages for us. I suspect that will continue to be the case.

Thank you again for your commitment to our approach and the consistency of support through good and bad markets. To finish with an apocryphal quote from Michelangelo, when he was asked how he made the statue of David he said, “I started with a big piece of marble and chipped away everything that didn’t look like David.” We continue to chip away at everything that doesn’t look like a financial David to us, and we look forward to continuing to do so.

That’s the end of the memo that I wrote to our board last quarter. I am grateful to be at Markel because they have remained resolute and steadfast in supporting our investment approach and capital allocation decisions. I’d also like to thank those of you in the room today. Some of you are Markel shareholders and have been for some time. You’ve become personal friends and your ideas, counsel and support are real components to help to produce the result we’ve enjoyed over the years.

I also thank Bob Miles and the others in the room as you’re dedicated thought leaders in the discipline of investing. You’ve demonstrated by your presence here today that you’re hard at work, seeking to improve and learn. I benefit from hanging around all of you. I thank you for your expertise and diligence. With that I look forward to answering your questions. Thank you very much.

Question: Give us an example of a false positive, someone you thought was a good capital allocator, you were wrong and you learned something. The qualitative part of it is very hard.

Gayner: We all have different ways of dealing with mistakes. I struggle really to come up with a name on the spot. Probably later on, if I get a drink or two in me, I’ll be able to think of one. Sometimes we benefit by reviewing our mistakes and doing what-are-the-lessons-learned analysis and we do that. Sometimes we deal with our mistake by denying they ever happened. Just obliterating the memory of it, and I think this just falls into that category. Now mathematically, something very wonderful happens to our mistakes over time. The phenomenon happens in comments I hear about a focused portfolio and criticism that says, “Hey, you’ve got a hundred names in your portfolio. How do you track them all?”

The practical answer is that the top 20 names represent about 70% of the portfolio, so it is indeed effectively concentrated. The other names, sometimes which are very small positions, cause me to think about them by owning them, owning little positions causes me to look at more companies and at least give them a shot at becoming a major league player later on. Mathematically if I’ve made a mistake, fortunately I can’t think of too many that were in the major league team. The mistakes diminish over time because they become less and less valuable and less and less as a part of the portfolio. While stuff that maybe I just accidentally stumbled into getting it right, becomes larger and larger. The bigger mistake that I make, and I think it speaks to what our previous speaker, Rob Vinall talked about, it’s what you talked about as well, it’s so hard to appreciate a good capital allocator.

All the reasons for inefficiency we’ve spoken of are very real and very well-articulated. What I have come to adopt as a practice is if I think somebody is a good capital allocator, give him the benefit of the doubt. Put him in the portfolio, just a little. Because then each and every day that goes by, you get to see whether your initial judgment was right or not. If it is, practice of regular ongoing investing really helps. I keep buying more of a good idea over time.

One change that is different about me today compared to what would have been the case 25 years ago is how I look at the list in the Wall Street Journal of the new highs and new lows.

I looked at that list every day and I always used to look at the new low list first. Because that is where you see what’s beaten up, what’s cheap, what’s on sale? It’s just my natural inclination to do that. I think 25 years ago I didn’t even look at the new highs, because if I owned something that was on there, I would know if it was up even without looking at the list in the paper. Today I still look at that list every day, but I look at the new high list first. Because I think there might be more informational value in that than the new lows. The new highs might be showing you where somebody is doing well. Maybe, just maybe they can keep doing it. Ask me again later and I’ll try to give you some specific names. Question up there, someone is going to sprint up there and try to get you a mike.

Question: In line with the similar thoughts of the last few speakers, obviously the qualitative is quite important and that would lead people to social and technological trends. Either changes in those that lead to a capital allocator seeing what the future might be or certain resilience that a good capital allocator will know that those will not change. If it leads to the fact where a lot of people see good investors are seeing around corners, can you speak to that skill? What you think one needs to look for to be able to analyze qualitatively in order to anticipate the future better than other investors?

Gayner: Two components there; one, the business that's resilient. For instance, we've been long-term shareholders of Diageo [NYSE:DEO]. You look at a bottle of Johnnie Walker scotch, that label says, 'Since 1820.' That gives you some indication that that's a resilient business, so it makes the task of the capital allocator somehow easier when you're dealing with that. When you think about somebody who sees around corners, earlier the name John Malone [Liberty Media NASDAQ:LMCA] was mentioned. For a long time I made the thumb-sucking error of not understanding what he was doing and thought it was too complicated and I could never make heads or tails of it and who knows. I finally came to the conclusion way too late that John Malone is smarter than I am, so probably he deserves a spot on the team and he's proven it for a long time.

Give people like that a try. Give them a chance. If you're running by definition a 10 stock portfolio, that's what you represent your clients and you would only do that when your mandate is limited there, it's tough to do that. To run a portfolio like that and maybe you have some other mechanism by which you've traded smaller positions to determine whether you're going to make it part of your team. I have no way to know. I can't see around corners, so I just try to be aware enough that when I see somebody seemingly able to do that, I get them on the team.

Question: Thanks Tom for the great presentation. My question is on again capital allocators, what if they turn out to be worse than you might have thought when you first buy them? We have holding companies for example, in India and I think here, where the management's very interested in increasing their own stake, but either they don't pay cash out as dividends. You're not happy with the capital distribution decisions. Do you just cut your loss and move on or then do you start thinking about how cheap something is? Because I think that if you're just focusing on good capital allocators and you don't want to waste time on anything else.

Gayner: Right, well I'm guessing from your accent that you probably know a lot more about India then I do, so I can't really speak to the nuances and practices that might exist in the country. I think it's unrealistic to think that you're going to have a portfolio with only these wonderful capital allocating businesses that we talk about. I think if you get one or two in your lifetime, you will have a great investment career. In the lesser business where you don't have someone who's been able to just reinvest or figure out how to reallocate that capital all the time.

If they're paying it out to you that's fine because in essence what they're doing is they're giving you another shot to make capital allocation decisions yourself. That's why we go to work every day and read and learn and talk to people and study. Because by having that cash flow … For instance within the portfolio, it's not wrong and it's not out of keeping with what we do every day to own some trading ideas. Because some of those trading activities and things of that which are not the forever ideas, they can produce cash flow which once you can see something or while you're groping and grasping around to try something else. That's a real world, good thing.

Question: Thank you. I've been to the Markel breakfast for about eight years. I've never got the opportunity to put my hand up, so this opportunity was just too good to miss. Berkshire Hathaway is probably the most admired and written about company in the world. In a couple of days about 40,000 people are going to be traveling to Omaha to visit it. It's not entirely unknown as the modern successful investment model. If I survey the landscape, as far as I can see, Markel is the only other company in the world that has tried to replicate this incredible cash-generating machine. How on earth can that be the case? Why is it only Markel that's tried to replicate what Warren Buffett has done?

Gayner: I think some of the things that our first speaker, Pat Dorsey, talked about, why capital allocators are hard to embrace and why they're underpriced. It's not part of the flow. It's not what people do. It doesn't fit the quarterly earnings thing. There's no forward guidance. There are all kinds of peer pressure to do things that all your peers are doing so that you're going to do something different than all your peers are doing. By definition, you have to be willing to be a little anti-social to do that. We're human beings; we don't like to do that. I don't like to do it either but I can't think of it in any other way to get the job done.

I think there are all sorts of essentially qualitative social factors. You're also taking great personal responsibility. Again it's been said, "There's an old saying that, you don't get fired if you're the IT guy for going with IBM [NYSE:IBM]. Failing conventionally, you're amidst a herd and you will not be singled out. When you choose to do things that are different from what everybody else is doing, if you're wrong God help you, because you're completely vulnerable and you're taking career risk to do that.

We're structurally lucky in that we started down this path when we were a tiny company. I was 29 years old and my wife worked. We didn't spend much money, so I could take the shot. Now we've been doing it for 24 years. It's got crazy momentum of its own. It would be hard if I was 52 as I am right now and with 3 kids in college.

Question: I believe there are some other insurance companies like Fairfax Financial [TSE:FFH]; would you care to identify maybe even a few others?

Gayner: You identified one of them. They think about capital allocation very specifically. They have an investment operation, and investment thought is a key component for them. They have a different style than the way we would go about it, but that's one of them. For a long time, this goes back into history, Cincinnati Financial [NASDAQ:CINF] did so. They had a big equity commitment to Fifth Third Bank [NASDAQ:FITB].

They're not focused on that today, the way that they used to be. There's a new list of companies saying they're doing it. The hedge fund crowd has recognized this and is starting to get some reinsurance companies marrying investment thinking to them. We'll see how that works in the fullness of time, but yeah, there are some other firms that are thinking along these lines to some degree.

Question: Maybe to just add on to that, there are not that many insurance companies but there's dozens of capital allocators out there that are creating value without that co-insurance business, creating value on the other side of the market.

Gayner: Right, earlier you had Brookfield [NYSE:BAM] up there as a lesson and we've owned Brookfield for 20 years and it's a company that goes along that line. With that, thank you very much. I look forward to speaking with you later. Thank you.

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