Welling on Wall St.

www.WellingonWallSt.com

VOLUME 5
ISSUE 10
JUNE 3, 2016

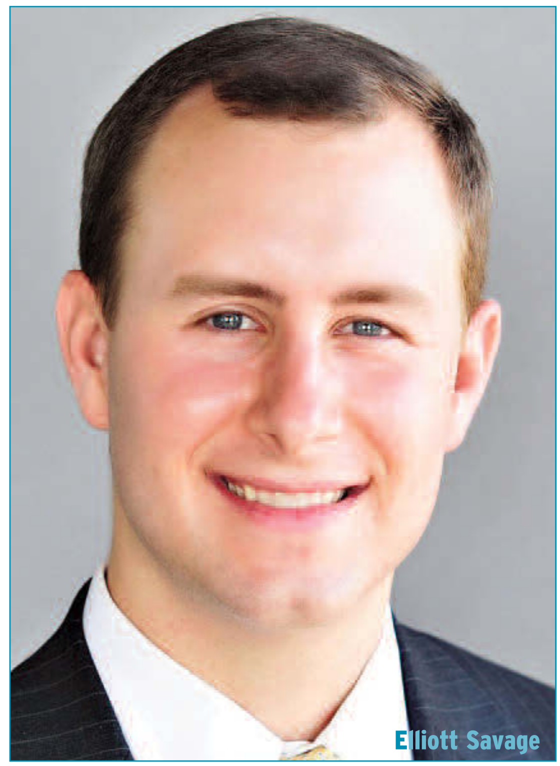
RESEARCH DISCLOSURES SEE PAGE 16

listeningin

Young Fellas, True Disciples

YCG's Brian Yacktman, Elliott Savage Buy Great Businesses, Cheap


Brian Yacktman


Elliott Savage

Among the many savvy investment quotes attributed to the estimable Don Yacktman is, "This passion for investing is like fire in the belly. Either you have it or you don't."

What Don, who racked up one of the best performance records in the annals of active investing over a career stretching more than 40 years, was perhaps too modest to mention is, quite simply, that said fire in the belly is a heritable trait.

Either that, or Don has remarkable prowess as a preacher, as well as an investor, as evidenced in the career not only of his son, Stephen, in whose capable hands Don left the reins to his two giant AMG Yacktman funds when he retired to an advisor role on May 1, but also of that of a younger son, Brian.

Brian Yacktman does not, yet, manage, billions in AUM. But after picking up all the requisite academic credentials and spending a number of years working in the family shop, Brian struck out on his own in 2007, driven by a vision of making the rich vein of investment acumen he'd accumulated at his dad's knees accessible to folks who couldn't meet the $50 million minimum required to get Don's shop to manage a separate account.*

In the years since, Brian has come to appreciate the wisdom of his father's reluctance to take on the

*At the time, Form ADV Part II for Yacktman Asset Management stated that the minimum was $5 million.

Welling on Wall St.
Published exclusively for professional investors by
Welling on Wall St. LLC
ISSN 2332-161X

Kathryn M. Welling
Editor, Publisher & Principal
Kate@WellingonWallSt.com
Office. (631)315-5076
Cell. (973)650-2722

Stuart Schwartz
Marketing Consultant
Stu@WellingonWallst.com
(914)768-3133

Donald R. Boyle
Chief Financial Officer
Don@WellingonWallSt.com
Office. (631)315-5077
Cell. (201)394-1548

Distributed biweekly, usually on Fridays, 18 times a year, by
Welling on Wall St. LLC
PO Box 620
Mattituck, NY 11952

Office:(631)315-5076
Fax. (631)315-5077

headaches of administering multiple small separate accounts. But he nonetheless has produced an enviably consistent record of besting the market for his firm's clients. In 2012, after shortening his company's moniker to YCG Investments to mitigate confusion with his old man's firm, Brian launched a mutual fund.

That same year, portfolio manager and partner Elliott Savage joined YCG. He came out of the Dallas hedge fund scene. But it was over Elliott's youthful immersion in investment classics that he and Brian clearly clicked.

Their thoughtful investment philosophy and strategies, grounded in value fundamentals, spill out in complimentary torrents when the topic turns to the market and stocks. Which of course it did when I phoned on Tuesday. Listen in. KMW

Let's start with an explanation of the "dark secret" that lies behind the initials that constitute your firm's name.

Brian Yacktman: Sure. YCG stands for our former name, which was Yacktman Capital Group.

And you've gone to initials because Yacktman is such a terrible name to put on the door of a financial enterprise?

Brian: Right! [haha] Initially, when I was planning back in 2007 to go off on my own to start a separate accounts business, I realized, man, there is a lot of noise out there. So I asked my dad and my brother, Stephen, who co-manages the Yacktman funds, "How do you feel about me putting 'Yacktman' on the door?" And they both gave me their blessing. I felt like it was a must in order to cut through the noise, so that people could find our firm and I could build a business.

How's that worked for you?

Brian: Well, we opened our doors in November of '07, on the, "If you build it, they will come" principle, like in *Field of Dreams*. Today, we're managing around $300 million in separate accounts and have a bit more than $100 million in our mutual fund.

Your timing was exquisite, I must say —

Brian: Right after the peak of the market, in October of '07, as it turned out. We got our first fee-paying clients by the middle of '08, just in time for the crash that September — which for us, actually, was a good thing — given that our style tends to protect well in down periods. As the saying goes, you make your money during a down market, you just don't know it at the time. So we were able to prove our worth, early on.

"We got our first fee-paying clients by the middle of '08, just in time for the crash that September — which for us, actually, was a good thing — given that our style tends to protect well in down periods."

So you were still mostly in cash when the market got really ugly?

Brian: Not really. But we do look at our record with some pride. Our separate accounts have outperformed the index by a little bit over 2% annually since our inception, thanks to navigating that crisis well. Of course, during the go-go periods of 2013 and 2014, our style lagged a bit, as you'd expect. But last year, as the market got a little rocky, our performance put us in the top 5 percentile in our concentrated large blend category.

Our goal is to outperform the market over an entire market cycle, so we tend to lose ground during the go-go periods, then we tend to make up ground during the rough periods, or just in an average market. Actually, we really tend to make up ground during precipitous declines, when the things we've owned perform well, relative to everything else. Then we can take the capital that has held up well and re-invest it in some of the things that have gotten shellacked, so we also can perform well in the immediate rebound. But once the market gets to full valuations and beyond that, to frothy, we tend to lag until we have another correction.

Because you avoid pricey valuations?

Elliott: Right. I would just add that, when you're thinking about picking an investment strategy, I feel you want to pick something where there's a lot of literature suggesting that it has worked in the past in a lot of different situations, and then you want to understand why it worked, and then you want to understand why it's likely to work in the future.

And yours passes those tests?
Brian: Yes, we employ a time-tested philosophy of buying above-average businesses at below-average prices. We are market cap agnostic and use a bottom-up approach to construct a portfolio we expect to be robust across economic cycles — and over an investment horizon that stretches out for at least a decade.

That might as well be an eternity in today's world —
Elliott: Well, there's a lot of academic literature suggesting that boring, lower beta, higher quality stocks outperform over a long time frame — which is totally contrary to general finance theory. We think that's because of human nature. We think that people in general, in normal time periods, are very impatient. They desire to get rich, and they desire to get rich quickly. At the same time, they are overconfident about pretty much everything in their lives, including their ability to pick stocks.

That leads them, in most situations, to try to find stocks that are maybe a little bit more speculative. They think that they can analyze those and pick the ones that are going to do well and go up quickly. We think that's what has led to the outperformance of high quality stocks over time.

Because the more speculative stocks tend to disappoint, and get dumped by impatient investors?
Elliott: Essentially, yes, we think that's human nature. So we tend to favor high-quality companies because we believe they tend to outperform low-quality businesses over the long term, with less volatility — and they tend to significantly outperform lower quality companies during crisis periods.

What makes a stock high quality, in your estimation?
Brian: In general, attributes like high cash returns on tangible assets, low or no cyclicality, high returns on incremental invested capital, wide and stable profit margins, high market share, pricing power, conservative use of leverage and a growing competitive advantage — a wide moat.

Elliott: As we see it, there are three different types of advantages that you can have in picking stocks. You can have an informational advantage, which is very difficult in today's world, where there's just so much immediate information for everyone — or you have to worry about insider trading. Then there's analytical advantage, which is just trying to be smarter than everyone else and do better analysis — but we're competing against a lot of very smart people, so you don't want to bank on that, either. That leaves behavioral advantage, which is the hardest kind to arbitrage away, and we think is the most likely to be enduring over time.

What do you mean by behavioral advantage?
Elliott: Well, high-quality stocks will likely outperform going forward. But we think we can actually improve upon that, because we've noticed that, in really scary periods, people tend to want to jump in and out of the market, try to predict recessions and things like that. That gives us opportunities to buy businesses, or the whole stock market, at prices that are likely to provide really good returns — because people, in general, fear things are going to get worse before they get better.

So, in a downturn, we're likely to remain fully invested. Or, when a quality stock gets beaten down — for what we see as temporary reasons — we tend to buy.

For instance?

Elliott: Take the case of a stock like a Richemont (CFRUY), which is one of our current holdings that we like a lot. It's a luxury goods company that's under some clouds related to fears about China and wealth in general, because people are worried about a recession. But generally, we think it's a bad idea to jump in and out of stocks. So, if we find stocks that have attractive rates of return today, we're going to buy them. Especially, because we think it's impossible to predict the future. And, if the stocks go down more, we'll just buy more — assuming the company's rate of return remains attractive.

With your focus on quality, how much of your performance is due to just the compounding of yields over the long haul?

Brian: When I look at the reasons for our outperformance — I want to start by acknowledging that really high quality businesses tend to be priced in the market at premiums to other businesses. So it appears as though you're paying more for them, and therefore you would think that you would get a lower rate of return over time.

But two things tend to be underestimated about high-quality companies. One is that high-quality *non-cyclical* businesses — consumer staples, for instance, tend to have cash flows that are very consistent, relative to other businesses'. Investors tend to underestimate that consistent cash flow. They tend to extrapolate most companies' earnings from a peak and just assume they'll only grow from there, without hitting any dry patches.

If only —

Brian: So very consistent earnings streams tend to be undervalued. The other thing that we think is often missed is the value of having a serious percentage of earnings that can actually be paid out in cash to the shareholders. When we look at the numbers on lots of companies, we find many that could only pay out zero to 25% of what they make, because they need to reinvest so much back in the business just to protect their positions.

We prefer companies that are very capital light and just spew cash out. After they reinvest in their business, they still have lots of excess cash to give back to the shareholders. The higher the consistent percentage of earnings going back to shareholders in the form of dividends, or shareholder repurchases, then the more likely it is that the company is going to outperform, over the whole cycle.

So while high-quality non-cyclicals often have higher P/Es than everything else, they also tend to outperform everything else over a full cycle — because of the consistency of their earnings and the high percentage of their earnings they're able to pay out. I call it "cash conversion to create a higher shareholder yield."

Elliott: To put that in real terms, let's take a company like Hewlett-Packard (HPQ). Hewlett-Packard may look cheap, trading at 10 times earnings, but it only pays out 20%-25% of its cash flow, because it has to reinvest the rest. So its shareholder yield is only 2.5%. This means, even if you thought it were going to grow at 5% per year — which is probably not going to happen, because a lot of their categories are deflationary — that would still only be a 7.5% return. Now, contrast that with something like a Nestlé or a Colgate, where virtually all of their earnings are returned to shareholders in the form of cash, and they can still grow because the businesses are so capital light and they have such large market shares. Then that would mean, with even a 4% to 5% shareholder yield, even at 20 times earnings, if they grow at 5% over time, that works out to a 9% or 10% return. So that is higher than you'd get from a Hewlett-Packard, despite the fact that, on a P/E basis, a Colgate or Nestlé might appear more expensive.

Let's back up for a second, before we get too far into how you pick stocks. You now offer a mutual fund, as well as separate accounts, to clients?

Brian: Yes. The mutual fund opened in December of 2012, so it's three and a half years old.

And you run just $100 million in it, versus the almost $14 billion in your father's namesake funds?

Brian: That's correct.

So tell me why, again, you left what was presumably pretty good job security to strike out on your own?

Brian: Well, I had noticed while I was working at YAMCO, which is what we called Yacktman Asset Management at the time, that there were a whole lot of people who would have liked to benefit from dad's asset management services, but who couldn't meet what at the time was the firm's $50 million* in assets minimum for separate accounts.

I figured I'd be managing my own money anyway, using the investment principles my dad had taught me, so why not just open up the business and offer separate accounts to people with fewer assets —

*At the time, Form ADV Part II for Yacktman Asset Management stated that the minimum was $5 million.

Elliott: Like us!

Brian: Like us *and most people* — why not offer an opportunity to invest right alongside me, in the same exact things I'd be doing? But when I asked my dad about doing that under his umbrella, he said, "I think it's a great idea, son, just don't do it here. I don't want the headache of a bunch of small separate accounts."

I tried to reassure him that no, it'll be great, I'll take care of any headaches that come your way, but he said, "No, no. Trust me, son, I'll get headaches. I'd much prefer, if you want to do it, that you do it under a different umbrella. You have my blessings, just do it somewhere else."

So it was not an easy decision for me, because you're right, I did have security, and I was scared, I'm not going to lie. I didn't have an asset base, I was just building it, hoping people would come. I did have a little encouragement from a friend, who said, "Hey, Warren Buffett did this when he was in his 20s, what are you waiting for?" I was 28 at the time, and I think Buffett was 27 when he started.

In either case, pretty young for taking that particular leap —

Brian: True, but I had been hearing my dad say to all of us kids for years, "I hope that I've at least prevented you from wandering in the wilderness for 40 years" — by trying to download his treasure of investment wisdom and experience into all of our brains. He uses that allusion to Moses a lot, maybe because he has been in the business for over 40 years. But by constantly teaching us about investing, he did, in effect, speed up our learning curve, and he did so, he always says, "so you don't have to go through the same mistakes I made, and you can build from here."

Then you quite willingly drank Don Yacktman's investment Kool-Aid — and believe it gives you a leg up?

Brian: Yes, definitely. My dad and I, we talk all the time, and I feel like we're peas in a pod. We both love investing, we both love talking about investing — and we talk about it all the time. We have, for years and years. I remember being on a family vacation when I was five years old, and tagging along with him when he went to a pay phone to buy Clorox —

Having nothing to do with needing to do laundry, I'm sure —

Brian: Actually, I remember that he kept telling me that he had to go out to work — for more than one day in a row. Being a little kid, I was like, "Dad, I want to go to work with you. Let me see what you're doing." So he took me along to the pay phone, and I was like, "What on earth? This is work?" So he explained that he was calling a broker to place a trade for Clorox at 10 times earnings. Of course, I had no idea what he was talking about, but if you hear it enough, you start to figure it out, over time.

I still remember him trying to explain stock ownership to me at a very early age. He kept on saying, "Look, son, you're an owner of a business." I didn't know what he meant. He finally just said to me, "Brian, when we go to McDonald's and we buy you a Happy Meal, our money goes to McDonald's." He went on, "How would you like to be the person who *makes* money when the Happy Meal is bought?" I thought, "Wow, that's pretty awesome." He said, "That's what happens when you buy McDonald's stock, you become an owner and make the money." The lesson stuck. I was like, "Man, I want to make money when people buy Happy Meals."

Elliott, did you also study investing alongside of reading Dr. Seuss?

Elliott: Well, no one in my family was in investing, professionally. But when Peter Lynch's book, *"One Up On Wall Street,"* came out, it attracted a lot of general readership. My aunt gave me a copy because she had just read it, so I read it, and that gave me the bug. I started reading a lot of articles by Peter Lynch. I subscribed to Worth magazine, and that led me to reading about Warren Buffett.

When I was 16, I took my savings from my summer job and bought a share of Berkshire Hathaway Class B. I continued to invest throughout the rest of high school and college, and then did a two-year stint in investment banking in New York, at Salomon Smith Barney. After that, I moved to Dallas to work at a hedge fund, Highside Capital Management, for about 9 years. Then, I got connected with Brian about four years ago.

Brian: Elliott was the kind of kid who started reading every investment book he could, just about as soon as he was able to read.

Elliott: What really hooked me on investing was that I didn't have to pick just one thing to learn about. In investing, the whole world is your oyster. In fact, I describe our business as a profitable think tank. You can take care of your family, but you just learn all day, every day — spend your time trying to figure out where the world is going and why some organizations and some products are more successful. It's just incredibly fascinating — and you'll never know anywhere close to everything — which means that you can be doing it for 50 years and still feel like it's this vast, green field.

Okay, so you're both "Wall Street brats," albeit via different routes. But Brian, there is at least one feature of your investment approach that's decidedly different than your dad's. You employ options in your portfolios?

Brian: Right, our options strategy actually is an outgrowth, in part, of our concept of investing in boring businesses, in contrast to most investors, who, as we said, on average are impatient, avaricious, and overconfident. That behavior leads to a systematic overpricing of options securities. In other words, we generally get paid a premium to be the writer of options. We feel much like the house, saying, "Let everybody else gamble in these options. We're happy to let them overpay us for them, if they'd like to."

How did you get started in options?

Brian: It began back in 2002, when I started to realize that we often were buying into falling daggers, and that we would also tend to sell things that momentum guys would then buy and run away with. In other words, we were buying early *and* selling early. I decided, if we could write a put against something we wanted to own, and get paid for it, that would be like putting in a limit order and getting paid for it. Likewise, if we can sell a covered call on something that we want to trim out of the portfolio, it's like putting in a limit order and getting paid for it.

So I started using options in 2002, and I found that it was adding value to the portfolio, and yet it was also reducing risk because it increased the margin of safety. In other words, you're getting a cushion on the way in — as you're buying things. Then on the way out, you get a cushion against selling early — so you can capture more on the way out. And if the stock does come down, then you have hedged the position. If it's a business I want to own and the stock comes down, I'm happy for it to come down, I'll just buy more. And the put premium is like I've collected a special dividend.

Of course, the Achilles' heel of this strategy is if you write a put on something that you want to own that's beautifully priced, and then the stock takes off to the races. You just end up with the small premium. You're like, "Whoop-de-doo — I wish I would have owned the stock outright."

But that doesn't happen often enough to discourage you?

Brian: No, overall, what we've found is that you get paid such a nice premium to be a writer of options that even after you do a tax adjustment, options are a better bargain than being an owner of the underlying securities. Academics have run empirical studies that show that. Through several decades of time, writers of options tend to make a higher rate of return than the owners of the underlying stocks — which *should* be surprising, since it provides an additional margin of safety. We think the reason comes back to a behavioral advantage, again. Just like it's surprising that you can be paid a premium to own a boring business, you're paid a premium to be a writer of an option — because people are greedy, impatient, and overconfident.

Elliott: Just to elaborate — people fundamentally want to make the quick score, and that's why we think that selling, basically, insurance on stock prices is additive to returns, despite the fact that it actually is a risk reduction tool in our portfolios.

Are you finding that your options strategy is less additive than it used to be, because the options markets have gotten a lot more efficient, especially since algos have started arbitraging them every which way?

Elliott: I would say that, in general, the story of civilization is that everything gets more efficient. If you think about it, everything is getting much more connected and markets are getting much more efficient with the rise of eBay and Amazon and such. And so, too, are the financial markets getting more efficient. But again, going back to our three possible kinds of investment advantages, we think that behavioral advantages are the most resistant to being arbitraged away.

Brian: Just to chime in, there is tons of information out there, there are tons of smart people who can analyze it. We feel like we do those things very well, but that alone won't give us much, or any, advantage, competing against tons of brilliant people. Where we think we can find an advantage is in exploiting behavior. Humans, in general, have a casino mentality and we can profit by investing to take advantage of their systematic errors. The strategies we implement in selecting stocks and in writing options are designed to do just that. And I don't think that the casino mentality is going away any time soon.

Elliott: Right. In fact, I would add, actually, that the rise of vehicles like hedge funds, with their very high fee structures, has just exacerbated that casino mentality.

Because?

Elliott: Because trying to generate returns above the market's over time — while burdened with a heavy fee structure — forces portfolio managers into the more speculative situations.

Brian: You have to swing for the fences.

Is that why, in 2012, you decided to broaden your business portfolio with a mutual fund? Most young hotshots were rushing to set up hedge funds back then.

Brian: In part, it was this feeling that there are a lot of friends from school, friends from church — I wanted to be able to provide a way for them to invest. Just like I started YCG when I wanted to provide separate accounts to people that couldn't reach the $50 million* minimum at Yacktman, I had realized there are a lot of people that couldn't meet YCG's minimums, either. I realized that if I opened a mutual fund vehicle, I could become accessible to anybody who wants to take advantage of our strategy.

But part of it was also that I had started to realize that my dad had been right about smaller separate accounts. It is difficult to grow a business through adding separate accounts. It is much easier and more scalable to do so through a mutual fund. So I realized that, unless I wanted to become a manager of lots and lots of people, which would take me away from my favorite job of analyzing businesses, I would need to find a different growth vehicle. The mutual fund is a way we can scale our business.

Elliott: I would just add that we both know we are really fortunate to be just managing money for a living — like I said, learning for a living. And it does make you feel great to know that you can help, not just high net worth individuals, but everyone achieve their financial goals. Because once they achieve their financial goals, they can have a lot of opportunities open to them.

You have a third partner, don't you?

Brian: Yes, we do. I should add that we have 100% of our net worth in this strategy. We would have 100% in the mutual fund, if it weren't for the fact that we have to pay taxes on all the revenue that comes back. But anything that's not in the mutual fund is literally in the same strategy. We believe in this philosophy, this strategy.

Elliott: Right, and our third partner is Will Kruger. He teamed up with Brian shortly after YCG was founded, as the chief executive. He also does a lot of the client relationship work and marketing — a great guy.

He takes care of all your headaches?

Brian: That's right. When I partnered with him, I said, "I'm willing to do this, if you will let me do the research and portfolio management, and you do everything else." Will likes to joke that he's janitor, compliance officer, CEO — and everything in between.

We also have another Yacktman working with us. Michael is my youngest brother, and I'm not afraid to say that he's the smartest of the seven siblings. He got his MBA from the University of Texas, Austin, in 2014, and is our senior analyst and trader. We love having him as part of our team.

Okay, but tell me why anyone should put their money in your little fund, or under YCG's management, when the brand name Yacktman funds are, obviously, the multi-star-bedecked standard bearers of your Dad's investment philosophy.

Brian: I don't really want to go there — don't want to create dissention in the family. As you know, my dad has just officially retired as co-portfolio manager, but he's still an adviser to those funds. And my older brother, who has been managing the Yacktman funds with dad for years, has taken them over, along with another excellent PM who has been with them for a long time.

I prefer to just show people our own market-beating performance, explain how we created it, and tell them why we think we will continue to outperform in the future.

But what do you say if someone presses you to explain how you offer anything but a clone of the Yacktman Focused Fund?

Brian: Then I bring up something obvious, like that our fee on our mutual fund is actually lower (capped at 1.19%) than the 1.25% fee on their comparable non-diversified fund.

That's it?

Brian: Okay, we also tend to be more fully invested, whereas they hold cash right now. They have their reasons. But the attitude I grew up with is that if you can find prospective double-digit returns, they are preferable to being in cash waiting for some market correction that may or may not hap-

*At the time, Form ADV Part II for Yacktman Asset Management stated that the minimum was $5 million.

pen. We could trade sideways for a decade, waiting for valuations to readjust — and during that time you could make a lot of money compounding in something at double-digits. A lot more than sitting in cash.

Elliott: Another difference is our options component, which they can't implement at their size. But our philosophy on cash may be the critical one — simply that if you can find a great double-digit return, you might as well get invested. Because if you try to time the market by waiting for better opportunities, you tend to subject yourself an investor behavior penalty.

Which is?

Elliott: Empirical evidence shows there's an investor behavior penalty, due to getting in and out of investments at the wrong times. You see it in the historical performance of mutual funds that have produced 10% annual returns — but whose investors, on average, have only earned 4% returns — that's a 6% behavioral penalty.

You can also see it in other ways. One of the top-performing funds from 2000 to 2015 did mid-double-digit returns, yet the average investor in it got negative returns out of that fund — because it was very volatile, and they tried to time it.

But suppose you can't find enough investments that pass your hurdles?

Brian: If you can't, you've got to look at what your opportunities are and whether it makes more sense to invest in cash, in businesses, or whatever it may be. Back in 2007, we built cash, because cash was yielding enough that you weren't getting paid enough of a premium to venture away from it — not when you could only expect an 8% or 9% return from a business. But today, the numbers are very different, when you can only get 2%, basically, in cash, but you can get a 10% or 11% return in a Colgate and a Nestlé. That's 2% in a 10-year Treasury and 25 basis points in cash.

Elliott: It's a hugely different situation. Worse, in Europe, where rates are negative.

Isn't another glaring difference between your fund and the Yacktman funds their massive sizes? You should be a lot more nimble —

Brian: Yes, the silver lining of having just $400 million in assets — in all of YGC — against their billions in the Yacktman funds, is that we can be much more nimble. There are loads of academic studies that show it's just difficult to generate repeatable outperformance as a fund gets larger and larger.

Elliott: A fourth difference, I would say, is that our portfolio is made up, much more, of high-quality businesses. Although we are willing, on occasion, to add contrarian positions to the portfolio, when we believe something has sold off *unreasonably* — we tend not to stretch.

Brian: The thing is, we have gotten burned enough times when buying statistically cheap but problematic businesses in deflationary categories that we have gravitated more and more to the higher quality enduring pricing power compounders. We feel like the evidence of the enduring outperformance of those companies — based on all the academic literature and on our understanding of why that occurs — has continued to deepen. At the same time, the speed of innovation — and our increasing understanding of the speed of innovation — has made us more careful about getting into something in innovation's crosshairs.

All investment disclaimers proclaim that "past performance is no guarantee of future results." So what is it about your investment process that you believe will produce repeatable results?

Elliott: I would say, a couple things. No. 1, just like Buffett always says, temperament is more important than IQ. We think there's a lot of truth to that. Another part of it is just having the firm structurally designed such that we can take a very long-term view and rely upon the behavioral foibles that we talked about to basically buy boring, high quality businesses as a stable base — and then, in big downturns, to opportunistically take advantage of the mispricing of cyclical-but-great-stocks — then just repeat.

Just the ability to be comfortable doing that — and having a stable enough business to allow that — sets us apart from a lot of people. However — it could be just because I'm overconfident — I also think we do generate analytical insights that a lot of our rivals miss —

Brian: I don't mean to interrupt Elliott, but as we said, we don't claim an informational advantage over anybody. We do have a behavioral advantage, because most investors aren't patient enough to follow our process. And where we have something of an analytical advantage is that most people are quick to use shortcuts and come to conclusions quickly. It's just that humans by nature are lazy, prone to conserving energy.

You're not?

Brian: No, what we do well is tear apart the financials, We dig in them to understand — almost like Sherlock Holmes — how much cash is truly being produced? How much excess cash is truly being generated by a business?

We're "detectives" trying to follow and understand 10-Ks to determine what is truly excess cash. I don't think a lot of other analysts routinely adjust for pensions or leases or stock options. I don't think that they really adjust to understand acquisitions — which too often tend to be maintenance capital expenditures in disguise. I don't think a lot of people spend time trying to understand, conceptually, a business, and why it is going to endure for decades to come. That's because people with a casino mentality aren't thinking out 5 - 10 years. They're thinking out 5 to 10 days.

And you're not most people?

Brian: Right, our analytical advantage is being long-term thinkers and investors. Besides, when you're only going to be buying a very small, concentrated portfolio, you're very careful before you buy. You really want to understand, why is the business going to *endure*, before you purchase.

Elliott: I would just emphasize that we feel we've identified certain categories of companies whose value propositions should stay fairly constant — which is no small thing in a world in which the importance of innovation and the knowledge base of civilization are increasing faster and faster. Education, and the super-charger of information technology are spreading faster than ever around the world, and so is connectivity. And the interesting thing about connections is that they scale in a geometric way. So more people than ever have the time, the information, the capability and the connections to come up with good ideas.

At the same time, statistics show that the average life span of a company is shortening pretty dramatically. Perhaps because of all that innovation. But if you're buying stocks, which are very long-duration assets, that's a rather worrying trend. So we've spent a lot of time trying to figure out which businesses are likely, in this world of increasing innovation and increasing change, to endure.

Such as?

Elliott: One of the categories that we've identified are businesses that have to do with status, because status is a relative good. Even if the entire population gets wealthier, there will still be a market for things to show that you're wealthier than the next guy. What I'm talking about are "positional goods," such as a Cartier watch or fine art — things that can actually continue to raise their prices apace with, or faster than, the growth in wealth. So status symbols is one category that we think has very enduring pricing power. Within that, the key is finding the brands that have a unique, or at least very hard to replicate, position.

What's another category of enduring companies?

Elliott: Well, the other thing that we can be pretty sure will endure over time is the growth of money, the growth of inflation, and the growth of wealth. And the reason is that governments have strong incentives to print money to create inflation to make their current debts worth less in the future. So, despite all the current deflationary pressure, in the long term, it's almost certain we'll see inflation grow over time.

I'm not sure it's as linear as that –

Elliott: But if we assume that environment — and we do — you then want to find companies that are toll takers on the growth in inflation and wealth; companies whose services are hard to find substitutes for. And so an example for that would be a Mastercard (MA) or a Verisk Analytics (VRSK), which is an insurance information service, and another would be AON plc. (AON), which — among other things — is an insurance broker that takes a percentage of all the premiums that they represent between a buyer and a seller, like a Coca-Cola that's buying from a Travelers.

Those are the two main categories of companies we think have durable advantages — and it's even better if their products' penetrations are low worldwide. It's great if they have a stable base in the U.S. and then can sell that product where wealth is really growing internationally.

So you look for consistent growth potential, along with little or no sensitivity to the economic environment?

Brian: And at a high level, that means we're looking for companies with mission-critical products with purchase prices small enough to be insignificant in the buyer's budget. Or, for companies that sell products that convey social status. We are particularly excited when these types of companies can do these things while generating a very high return on tangible assets. Even better, if it's not cyclical. These are some of the inputs that we love to look for — that often end up creating a very profitable business that has an enduring moat for many years to come.

Elliott: Because enduring moats are becoming ever harder to find, we would argue, as the world changes faster.

Brian: I recently saw a study saying that over the last 25 years, 45% of businesses generated a zero to negative rate of return. Meaning, they went bankrupt — or should have. The next 35% of businesses merely made up for those losses, which means, if you picked any company among the lowest-returning 80% of businesses, you ended up with a zero return. The authors were trying to make the argument that you need to invest in the top 20% highest returning businesses.

But what I actually got from that study was, *you just want to avoid the losses*. If you can avoid the 45% of businesses that generate a zero to negative return, then you will naturally outperform the market. So we try to implement a process that stacks the odds in our favor, that avoids a permanent loss of capital. If you can do that successfully, and we humbly feel we have a very good batting average proving that, you *should* perform well over time. I should say, we believe — that's my disclaimer — that you will perform very well over time.

Well, how do you do that? What is your process?

Brian: It's just a database that is built up over time. Both Elliott and I have been doing this now for quite a while. I first started looking at businesses in 1998. There was a two-year hiatus when I served a mission for the Church of Jesus Christ of Latter-day Saints, then I went back to it again in 2000. So for more than 16 years. And Elliott has been doing it —

Elliott: Since I was 12-ish.

Brian: We've been doing this daily, for a long time, and as you look at, a business a day, let's say, you start to build up a database of — these are the best, the most wonderful companies in the world. Then you just wait for them to come on sale. The other common way that ideas come to us is through news headlines that turn our attention to a business. Then we need to dig in and ask, is the market appropriately punishing this stock, or is it overdoing it?

Elliott: It's just using filter mechanisms to look at a lot of businesses, analyze them, and build up a raw store of companies that we would love to own — at a price — ones with enduring pricing power, high returns on tangible assets, and with product penetration that is still low worldwide.

But you don't really start out by looking for statistically cheap companies?

Elliott: Both of us, early on in our careers, probably did more looking for statistically cheap companies. But because companies are such long-duration assets and because the incentives for management teams are to grow, grow, grow, those statistics can get distorted. Many times, if a business is experiencing secular pressure, its management team will diversify — or just keep buying things — to try to plug the hole.

So we've moved on from caring about statistically cheap businesses to looking more for situations like a Charles Schwab (SCHW) or a Wells Fargo (WFC) — where the consensus is they are very good businesses, but "interest rates are going to be low forever" so their returns are just going to grind down over time.

So their attraction is, to you?

Elliott: What tends to happen is that, eventually, things improve and if you buy a great business at a cheap enough price, then good things will happen over time.

Another example would be American Express (AXP) in 2008 and 2009. I remember getting a phone call from a broker pitching American Express as a short because credit was going to get worse before it got better. He said something like, "We all know that it's probably going to be a double or a triple over the next three or four years — but over the next six months, it's a short." Anyway, we really want to take advantage of people's desire to speculate in the short term, so we can buy great businesses that are going to do well in the long term — at good prices.

Brian: I want to emphasize what Elliott just said about wanting to buy wonderful companies at good prices. For all our talk about looking for companies that meet our requirements, we're like firemen, waiting for an alarm. We wait for the wonderful companies we find to go on sale. Price is a huge part of the process.

It's been ingrained in my mind — again, since I was a little boy. I mean, my dad is just a very frugal man. That's how he lives. Buys used cars, wouldn't think of driving anything else. So, when you're constantly looking for bargains in the stock market, that habit permeates everything. That habit is very much a part of me, and the YCG team and our processes, too. We research carefully to be sure we are not just buying great businesses, but that we're getting great prices.

Tell me about a few great companies you've been buying lately —

Brian: One that's looking very attractive right now is Nike (NKE). The slowdown in China is really creating the opportunity, finally. In Nike, you have this dominant, high return on capital business that has come down to a valuation that's palatable.

What makes a trailing P/E over 26 palatable?

Brian: Well, it's a function of the amount of cash that the business pays out and the long-term growth that we expect. What we would say is that, if you buy it at this price, we would expect a long-term double-digit return. You can buy a business at 30 times earnings and get a double-digit return. You can buy another business at 5 times earnings and get a negative return.

I guess what I'm saying is that not all P/Es are created equally. We're looking at what is the true cash generated by the business, and how predictable is that cash, how consistent is that cash? What percentage of that cash do the shareholders get to see? And what is the price I'm paying for that? Then, how is that cash flow going to grow at over time? If our analysis says it will give us a double-digit rate of return, and if it's what I would call "a narrow bell curve stock" — meaning its probability distribution of outcomes is narrow — then it is attractive. If it's a high rate of return, but a wide bell curve stock, then we'll want to make sure that the price spread between the narrow bell curves and the wide bell curves is big enough to make it worth venturing into the lower quality fare. So there isn't a specific multiple at which stocks are palatable. All we look at is, if you buy at this price, what rate of return can you expect 10-20 years out?

Elliott: It's basically an inversion of the Gordon growth discount formula, effectively, what is the shareholder yield — the cash flow returned to you per year — plus whatever you think the terminal growth rate is. With a business that we think has enduring pricing power, that generally would be 5% to 6% growth, maybe 6.5% for a very fast grower. But enduring pricing power should be roughly in line with global GDP growth at about 5% — 2% real and 3% inflation over time.

The other thing that we really focus on is comparing that forward rate of return to what's available from other businesses in the stock market — and to the returns available on other assets.

Generally, not much these days —

Elliott: Sure, today, with 2% 10-year Treasuries, it's not surprising that the stock market sports premium valuations, but you just have to look for the best risk-adjusted returns you can find within the opportunity set that you have. As a portfolio manager, you can't just dig in your heels and say, "I'm only going to buy something if it's got a 15% forward rate of return."

You'll accept lower yields, rather than reaching for them?

Elliott: Well, a lot of the times, reaching for yields pushes people into lower-quality businesses at exactly the wrong time. Because ebullient periods are generally followed by bad stretches in the market — when low-quality stocks get hurt the most. So people who stretch for particular rates of return often get hurt the most.

Brian: Let's go through some of the numbers on Nike, to demonstrate what we see.

Good idea.

Brian: Sure. Let's start with its multiple. Yes, Nike is trading at roughly 23 times forward earnings estimates. However, it has the ability to generate returns to shareholders of 100%, almost. Just shy of 100%. Contrast that to a company like Disney (DIS), which we also own, but which is a much smaller position for us, because although Disney is also an opportunity right now in the market, there's a lot more uncertainty surrounding the outlook for its ESPN business, and media in general than there is around Nike's outlook.

Don't forget Disney's management succession issues, either.

Brian: Yes, although I would hope they'll get sorted out fairly quickly. Oftentimes these wonderful businesses can attract and hire the right, talented management.

That's not Disney's history, though.

Brian: So it could be a cost, if the timing is unfortunate. But my point is that Disney only has shown the ability, historically, to pay out approximately 75% of the cash flow they generate to shareholders. What I'm saying is that if you buy Nike at 23 times earnings, then you probably need to be buying Disney at something like 17.5 times earnings to be getting the same value, assuming both were growing at the exact same rate. But of course, Nike should grow much faster as well —

Elliott: Right, right. The reason for that — if you think about status and the way that it works — we feel so comfortable with the quality of Nike's business is that participation in athletics is growing. As people get wealthier, it has become a status symbol. Discretionary time spent on athletics is a status thing. So our view is that, long term, in the U.S. and then globally, athletic activities and athletic wear will be growing markets. People want to be associated with the teams and players that they care about — and they also want to be associated with a brand connoting wealth and quality.

While Nike, Adidas (ADS.DE) and Under Armour (UA) are the big three in that business, Nike is the giant. Adidas is about half its size, and Under Armour is the small up and comer. But Nike can benefit not only from growth in units sold across the world, but also pricing power. And their licensing brawn. Because of the status symbol power of shoes associated with a LeBron James or a Michael Jordan, Nike can keep pricing them higher as people get wealthier, and that flows through to margins.

Nike also has additional drivers of margins. It is a brand that can sell directly to consumers, and Nike has a new app coming out that will basically allow them to give the special access to hot new shoes to consumers. Then too, because it was one of the first companies to sell into China after the Cultural Revolution, they have a very dominant business there, with higher margins than the rest of their business.

Brian: So China makes up just over 10% of Nike's sales, and Nike's operating margins are just under 20%. But in China, their operating margins are over 30%. So Nike is growing at double-digit returns, but in China, they're growing at like 18% a year, on a much higher margin business.

Isn't that precisely what bothers a lot of investors? Vulnerability of the Chinese business, not to mention rampant counterfeiting of luxury brands there?

Brian: You're right, counterfeiting is a huge problem in China, but given the massive growth in Nike's business there, as reflected in its 10-Ks, imagine how much more business they'd be doing if the counterfeiting could be stopped! Besides, the hope is that new technologies, like Nike's *Flyknit* fabric, self-lacing shoes, or simply offering more personal customization of their products, will make counterfeiting much more difficult. But we'll see.

Another point I'll bring up is that Nike's marketing budget is over $3 billion a year. That buys a lot of celebrity relationships. Nike has created the No. 1 millennial brand with that enormous marketing budget. With their massive scale, nobody is better positioned to snare the best endorsements, the best sponsorships.

Elliott: Even if they occasionally miss people, like Steph Curry, who is amazing for the Golden State Warriors, and who ended up with Under Armour after Nike let him go. But over time, if you have the most money, it becomes a self-perpetuating cycle. Nike can afford to pay the best — so the best players want to be associated with Nike. It's very similar, actually, to the status appeal of a Richemont, with its Cartier brand, and others, like Vacheron Constantin, Baume & Mercier, etc.

The Cartier brand has been worn by royalty, for literarily centuries. Its status appeal self-perpetuates. As one of the largest jewelers, it can pay lots for celebrity endorsements — then again, it may not have to, because current celebrities get a lot of value from being associated with its very upscale brand. Rivals can't replicate Cartier's long history, its status association with Paris since 1850. And that is what people buy.

It's not rational, but they do.

Brian: And it's not going to stop. It's enduring, that is our point. The CEO of Richemont says that the best thing that you can say about his brands is that there's no innovation. Because that means people are buying them purely as a means of signaling status. Whereas, if you have a product that's also got a technological performance component, if someone disrupts that technology, that impairs your brand.

For instance, an Apple Watch?

Elliott: That's precisely our fear with Apple. The valuations on Apple for years have just kept us looking at it. Our concern is, you're looking at a deflationary category with a lot of technological innovation, and we can't say that we know for certain that the iPhone will be the dominant technology 10 years from now. More than half of their earnings come through the iPhone.

Brian: Right. So if we don't have clarity on whether it will be enduring, even though the valuation may look more attractive, it would have to get *really* attractive because of that uncertainty.

Elliott: We'd rather try to just build this database of businesses that we think have enduring pricing power — there aren't that many of them, maybe a couple hundred — and just invest in the ones offering the best returns. Then we just hope for dislocations in markets to give us opportunities to buy others at even more attractive prices.

But you can't fill even a concentrated portfolio with those.
No, but we always see things creating other opportunities — whether it's low interest rates currently making Schwab and Wells Fargo attractive, or whether it was the housing slump, in 2009, making American Express, Home Depot and Lowe's attractive, because everyone thought housing was never coming back. So there are always opportunities to buy great businesses undergoing short-term and medium-term cyclical pain at attractive prices.

Let's specify just how concentrated your portfolios are —
Brian: We tend to have around 25 holdings, and to us, a full position is around 5% — but we're willing to hold even larger positions, if we're convinced something is a very enduring business.

Elliott: Assuming we're able to combine that with a very attractive price.

Brian: So, for example, some of our top holdings are Colgate-Palmolive (CL) and Nestlé (NSRGY) In my mind, they are almost cash alternatives, because they're just such stable cash flow generators. We view them almost like a triple-A bond that can pay us a 10% rate of return. But we will deviate away from a Nestlé or a Colgate when we can find something that pays an even more attractive rate of return.

For instance?
Brian: Nike, I'd say, fits our mold almost perfectly. Its products have a short repurchase cycle, it is a high return on tangible assets business that also conveys social status, and it isn't incredibly cyclical. It's more cyclical than a staple, because it does have a discretionary fashion element, but overall, it fits into our mold for "perfect" businesses, and now the stock has come down to a great price.

Richemont also fits our mold in many ways, but it does have a long repurchase cycle, and is more cyclical because its products are highly discretionary. However, its long repurchase cycle is, in part, what engenders the enduring nature of the brand.

Elliott: Nobody wants to risk spending $50,000 on a watch or jewelry from an upstart brand.

Brian: Exactly. So a Nike fits our mold, Richemont fits it, except that it's more cyclical because its so high-status and enduring. But then we also have in the portfolio some that don't necessarily fit the mold as well. They're more contrarian, but offer opportunities for very high rates of return.

A couple of examples are Express Scripts (ESRX) and Western Union (WU). To put it in terms of valuation, when you're looking at businesses like Nike and Richemont, you're looking at getting about a 4.25% shareholder yield plus the terminal growth rate. But we think they could grow at 6, 7, 8% over the next decade. So you're looking at low double-digit returns in great quality businesses.

Compare that with something like Express Scripts or Western Union, where you're looking at maybe an 8-to-9% shareholder yield. But where long-term growth is suspect. At Express Scripts, we think they have a demographic tailwind, but there could be disruptions to the business that could compress their margins or even lead to a complete evaporation of the business — if you go to a single-payer system. So you have to be careful how you analyze the growth there. It has a wider bell curve, but you see the cash now. You're getting a 9% return and they're buying back stock in droves.

Express Scripts is under a cloud because of a messy pricing dispute with Anthem, involving armies of lawyers.
Brian: I think the important thing for investors to realize there is that Express Scripts is already priced in the market as if it will lose its business with Anthem. Yes, that would hit Express Scripts where it hurts in its business — where scale is everything. But my point is that, right now, even if Express Scripts were to lose anywhere from 15% to 25% of its earning power as a result of Anthem walking, the stock is still at a fantastic price. Then you have to ask yourself, "Will a deal be struck?" I think the odds are high a deal will be struck, because Anthem can't really go anywhere else. They are unlikely to go to CVS because they're enemies, and they're unlikely to go to go to Prime Therapeutics. Likewise, they're not likely to take the business in house — then their scale would be way smaller than Express Scripts'. So I think there's a high likelihood of a deal which will mean an asymmetric payoff on ESRX at these levels.

What about Western Union?
Brian: Western Union's shareholder yield is similar, about 9%, currently. International remittance growth should continue growing around the globe at a low single-digit rate, so you should get low dou-

ble-digit rates. They're buying back stock and paying high dividends *now*.

We take comfort in that. Seeing the money being paid out now makes us less concerned that the management might go out and overpay for acquisitions to try to transform the business. In this case, we see the money, and we see it now.

ELLIOTT: Both companies are oligopolistic market leaders in unsexy businesses that are just hoovering up their shares and have long-term growth tailwinds — in demographics at Express Scripts and in globalization, in Western Union's case.

BRIAN: Plus, they are both very capital-light businesses. It almost takes no tangible assets to run either Express Scripts or Western Union, which stacks the odds in our favor that they will have a lot of excess cash to return to the shareholders over time.

ELLIOTT: Of course, with Western Union, like I briefly mentioned with Express Scripts, there could be disruptive technology or regulation. But with global remittances, dealing with cross-border issues is a huge compliance challenge, which actually discourages competition.

BRIAN: The other way you can see it is by looking at their next biggest competitor, MoneyGram, which is also a very large company, but makes almost no money. Cash transfers are an incredibly scale-driven business because of the huge regulatory burden. Governments obviously have an interest in monitoring cash transfers to squelch illicit activities and tax avoidance.

Is Bitcoin a threat?

ELLIOTT: It could be, but one of the problems with Bitcoin — if you're running a business — is not knowing what its value is from week to week. And Bitcoin is unlikely to overlap with the demographic Western Union is actually servicing — people who have so little money they don't have a bank account, at least not anytime soon.

BRIAN: Both, as we said, are contrarian holds in our minds, because we cannot tell you that 10 or 20 years out either company will be minting money hand over fist. But there are a lot of reasons to believe that they will continue to do so in the medium term, and we watch them closely. If it appears that things are starting to go the wrong way, we won't mess around. We'd get out of there.

ELLIOTT: Again, if you buy a basket of very market-dominant, high return on tangible asset businesses that are returning cash very aggressively and are in markets that are growing, then you're very likely to generate good risk-adjusted returns over time.

BRIAN: Elliott's point is precisely what has us worried about our media holdings. We have to admit that they are not returning cash in droves right now, and some managements may be tempted to overpay to buy, say, Time Warner's assets. There are a lot of behemoths in this space going after creators of content. You've got Netflix and Amazon creating their own content, trying to gain bargaining power as distributors. So, while we do have exposure to the media industry, we've done it carefully through what we believe to be the much more higher quality content creators, such as Disney with ESPN and Twenty-First Century Fox, Inc. (FOXA). They certainly fit our model in terms of having short repurchase cycles.

ELLIOTT: They are the market leaders in a business definitely growing worldwide. And despite some competitive disruption, we're getting them at cheap enough prices. At high forward rates of return — significantly higher than in a Colgate or a Nestlé. And so it justifies the positions in those stocks, or at least they have.

So how are your concentrated portfolios divided today, between "almost cash" positions and your more "contrarian" positions?

BRIAN: We have about 45%-ish in the staples. Then, in the contrarian stuff — we have a lot of businesses that are not staples, but that we view as very high-quality, enduring businesses, such as MSCI Inc. (MSCI), AON, Verisk, and even Mastercard. Though we could get into a whole conversation about possible disruption there, we definitely don't think Mastercard's payment system is anything but enduring.

ELLIOTT: Even the unfortunately named "Project Isis" initiative by a consortium of tech companies, which tried to elbow into Mastercard's and Visa's market, ended up deciding, "If we can't beat 'em, we'll join 'em." Anyway, I would say that our truly contrarian positions are only 10%-15% of the portfolios.

BRIAN: I'd put it this way: We have about 40% of the portfolio in staples, then about 50% in solid businesses that we think are very enduring — so "staple-like" — but they generate higher rates of return, because generally people may not understand, conceptually, that they're as enduring as we view them to be. Then only about 10% of the portfolio is in more contrarian positions, currently.

But that percentage could change, in a crisis like 2008-2009. It could creep up quite a bit if you're willing to take on a lot more contrarian positions, because you're being paid for it. But at all times, we still want to have that core stable of enduring businesses, lest you enter into a Great Depression-type era, when you need them to make it through.

Even great consumer franchises were no proof against pain in the 1930s.

Brian: True, they won't be painless during a crash. But they usually rebound quickly. My dad always uses an analogy to beach balls being pushed under water — the beach balls standing for stock prices. You might force it underwater, but if the value of the business is the water level, and it's rising, you're going to have a very difficult time keeping it underwater for very long.

Coca-Cola was a good example in the Great Depression. It took 15 years, I think it was, for stock prices on average to merely get back to their pre-Depression peaks, if you include dividends, which you should.

Elliott: And if you assume reinvestment, it was about eight years.

Though few could afford that!

Brian: Nevertheless, in the decade after the Great Depression, Coca-Cola basically compounded at double-digit rates. The stock tripled in the face of everything else being flat. So it did get beat up in the Crash, but KO's growth and consistency, its high cash conversion rate, and conservative leverage helped it bounce back smartly and compound at high rates of return over the ensuing decade. That's why we keep our core of high-quality staples — diapers, shampoo and toothpaste.

Elliott: But then even moving 20% of your portfolio from those really stable businesses into unusual opportunities, like an AmeriCredit, in the aftermath of the financial crisis, when it was trading at $3 with a $15 tangible book value, can be really additive to the portfolio while still protecting you from a catastrophic loss scenario, which is our absolute number one objective —

Brian: Protecting against permanent loss of capital.

Elliott: Even in a 1-in-100-year event.

Brian: We have been compounding at about 2% ahead of the market on average since our inception, but what Elliott's saying is, even if we only matched the market's return, after fees, we still believe we'd be doing a service, because we we're doing so with a heck of a lot less risk. Which is why you'll very rarely see us with a high exposure towards something like materials — commodity-based businesses with high capital investment requirements and low returns, generally. Against a long-term deflationary backdrop for commodities. Their long-term trend is down, because people are simply getting better all the time at extracting resources more cheaply, figuring out better recipes requiring fewer raw materials, and finding substitutes.

Likewise, we often tell investors that we will rarely invest in heavy financial companies, where we don't feel like there's some advantage or clarity into profitability. But we do have an investment in Wells Fargo, and it's about a 5% stake.

You've mentioned appreciating WFC's leverage to higher rates, but what else is there to like about what is, after all, a too-big-to-fail (and likely, analyze,) bank?

Brian: You may not like the breed, but we think you have to grant that Wells Fargo is the best of the breed, in banking. It's come a long way from the depths of the financial crisis — and we could go into the details on that almost endlessly.

But let's just say that Wells Fargo has proven over time that its culture is very unusual in banking. Even though it was basically at ground zero of the housing bubble — a Western bank, headquartered in California, when California, Nevada and Arizona were some of the worst hit areas — WFC was still solidly profitable during the crisis. That was because they had slowed their loan growth before the crisis hit and had not reduced their standards very much, at least relative to other lenders, which enabled them to be opportunistic in the midst of the crisis — and buy Wachovia, becoming a national bank.

Elliott: Then too, Wells Fargo is the low-cost operator in the banking business, because they've done a better job than anyone else at attracting low-cost deposits. They have also basically cross-sold more effectively than anyone else in banking, so their clients have more products with Wells Fargo than the average bank has. In effect, that's just another way to tie clients into the bank, one that lowers WFC's funding costs and their expense ratios.

Brian: Don't forget, over half of WFC's revenues are fee-generated, too. That's the kind of stable revenue generation we like, with an opportunity for margin expansion on the credit side, if rates ever go up.

ELLIOTT: I'd also mention that WFC has a much smaller derivatives portfolio than other money center banks, like JPMorgan and Bank of America. It's a very just a boring, relatively simple bank. And that's a business which can actually be very profitable, if you have a good culture.

BRIAN: As we said, we think WFC's is great. It sometimes confuses clients that we say we don't normally invest in the sort of financials that create assets with the stroke of a pen and where you really can't know what's on the books — yet our portfolios are now almost 30% invested in financials.

That's understandable confusion, I'd say.

BRIAN: Well, that 30% is made up of positions in Wells Fargo, along with the other financial companies we've mentioned, like Mastercard, AON, Verisk, MSCI Inc. — where we do know what's on the books.

ELLIOTT: And, importantly, what isn't. There is, for instance, no balance sheet risk in those businesses. No credit risk. They are basically just toll takers on global GDP in one way or another. Meanwhile, Schwab has a very simple balance sheet. They basically have assets that they earn a fee on via the asset management products that people buy through them. Then they also have a bunch of cash that they invest in margin debt, which are among the safest loans to make, and they also invest in boring government securities.

And again, Schwab, during the financial crisis, was profitable every year. No one was ever very worried about their financial capabilities or their survival.

BRIAN: We also feel fortunate to be able to find three such high-quality businesses as AON, Wells Fargo and Schwab, to basically hedge our portfolios against the sort of multiple compression that might occur if long-term rates were to go up from 2% to 6% or 7%. All three are highly levered to interest rates going up. Schwab's earnings, for instance, would almost triple if rates were to go back to where they were between 2000 and 2006. AON has historically done very well in periods of higher rates and firmer insurance pricing. And WFC's non-interest margins are significantly compresssed currently, and they're having trouble finding places to make loans.

ELLIOTT: Their loan to deposit ratio was around 100% leading up to the crisis, now it's 75-80%. Their mix has shifted into higher yielding loans versus securities, and if just the general level of interest rates were to rise, they could also invest in higher yielding securities, which would lead to an expansion of non-interest margins and that would lead them to earn, instead of the 14-15% return on tangible equity that they're earning, more like an 18%. Which would be very material, obviously.

Got it. Thanks, fellows. And good luck.