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The re-education of a value investor

BY Algy Hall

Even those only fleetingly acquainted with the self-help genre will likely know what to do when faced with failure and adversity: embrace the life lesson, learn and grow.

But in such circumstances, it is far easier to deny and evade the issue. The grim reality of failure is often 'shrink and retreat' rather than 'learn and grow' while erstwhile collaborators 'reject and forget'.

There are few professions where the price of failure is quite so punishing as portfolio management. Career risk is an ever-present danger. It can take only a few quarters of underperformance for a fund's backers to head for the exit – particularly ironic given the most important investment timeframes span lifetimes.

This helps explain the lavish praise Larry Pitkowsky heaps on insurance group Markel (US:MKL) and its boss Tom Gayner, the anchor investor in his $298m GoodHaven fund.

The value-focused fund, which began life in early 2011, performed horribly between 2013 and 2019. The dud spell was longer and worse than most institutional investors would stomach. But Gayner stuck by Pitkowsky and backed his plan to reinvigorate performance.

Gayner himself has been described as a 'master of compounding money' in the bestselling book Richer, Wiser, Happier, in which author and journalist William Green profiles investment greats. The faith he put in GoodHaven 2.0, as Pitkowsky calls the revamped fund, proved one of Gayner's masterful calls, as the fund has achieved a spectacular turnaround. The financial benefits have flowed directly to Pitkowsky, too, who is heavily invested alongside many of his close friends and relatives.

The performance since the revamp has been so good that Citywire has classed Pitkowsky an Elite Investor, an accolade awarded to fewer than 3% of more than 10,000 equity portfolio managers globally based on risk-adjusted performance.

Back to the future

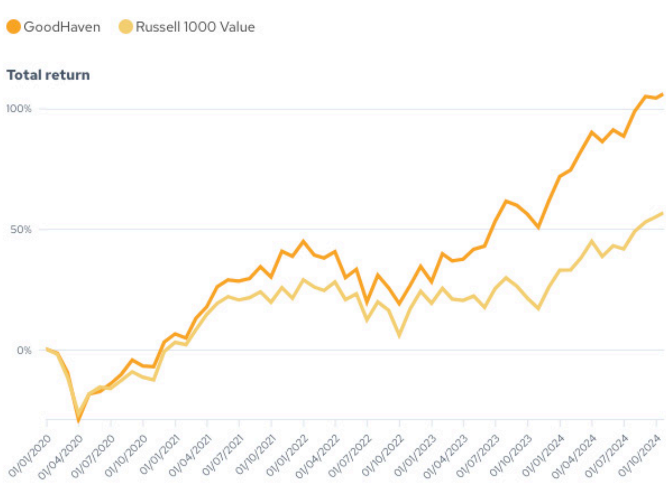
Pitkowsky frames the problem GoodHaven encountered before 2019 as a product of things he and then partner Keith Trauner had lost sight of. Trauner stepped down from co-managing the fund when it was rebooted but remains a minority partner and is on good terms with his former colleague.

'We had to decide if change was needed and how to effect that change,' said Pitkowsky. 'If you're not getting the results and you've demonstrated a

Good grief!
GoodHaven 1.0 lost ground fast.

Source: Morningstar • US dollar total returns

Good times
GoodHaven 2.0 has been making up lost ground fast.



Source: Morningstar • US dollar total returns

GoodHaven's top 10

Name - holding (%)	Elite Companies rating	F'cst price to earnings	Return on equity
Berkshire Hathaway (US:BRK.A) - 12.5%	AAA	23	19%
Alphabet (US:GOOGL) - 6.8%	AAA	19	27%
Builders FirstSource (US:BLDR) - 5.9%	AAA	16	32%
Bank of America (US:BAC) - 5.3%	AAA	12	9.4%
EXOR (NL:EXO) - 5%	A	12	28%
Jefferies Financial (US:JEF) - 4.2%	A	15	2.7%
Devon Energy (US:DVN) - 4.1%	AAA	8	32%
Lennar (US:LEN) - 3.5%	AAA	11	15%
TerraVest Ind (CA:TVK) - 3.2%		23	21%
Vitesse Energy (US:VTS) - 3%		18	-

Source: GoodHaven / FactSet. Holdings data as of 31 May 2024, stock data as of 22 Oct 2024. Forecast based on next 12 months.

long period of success over many years, you've got to look in the mirror and ask yourself why.

'I'm a very big process person. [I wanted to know] why the process wasn't yielding the outcomes it had in the past.

'We had started to focus on areas we were not fully intending to or aware of in some ways. It was about bringing us back to our roots versus changing direction in some drastic way.'

The fact GoodHaven 2.0 has 12.5% of its portfolio invested in Warren Buffett's AAA-rated insurance company Berkshire Hathaway (US:BRK.A) gives a clue to the managers' roots. So too does Pitkowsky's early enthusiasm for writings by and about the sage of Omaha, as well as the works of Graham and Dodd: 'It just made perfect sense to me as a way to think logically about stock prices and businesses.'

Lessons learned

Similar to Buffett's move away from 'cigar butt', deep value investing in favour of backing great companies at reasonable prices, a rediscovery of the importance of business quality has been central to GoodHaven's turnaround.

'Value investing does not mean you have to buy the statistically cheapest companies that might be structurally challenged,' said Pitkowsky. 'There's nothing inconsistent in value investing with trying to own good quality companies that have good returns on capital and are growing at a healthy pace.

'The key is to have a margin of safety and to be roughly right about the future for the business.'

Chiming with the importance he gives to margin of safety, Pitkowsky has been more wary of the leverage of companies within the portfolio since revamping the fund. He also tries to avoid taking a 'draconian' world view. And, while he still backs true specials situations as well as attractively priced quality companies, he is wary of 'stuff in the middle – companies that are statistically attractively priced but with a business and people that are so-so'.

Part of what keeps him away from this treacherous middle ground is not allowing himself to be seduced by clever financial analysis, which he saw as a problem with GoodHaven 1.0. 'There's nothing wrong with jumping over lower hurdles. You don't get extra points for degrees of difficulty.'

Meanwhile, with the 'don't water your weeds and cut your flowers' mantra of Fidelity icon Peter Lynch ringing in his ears, Pitkowsky aims to run GoodHaven's 2.0's winners.

'We were too quick to sell attractive things that had done well just because they were no longer dirt cheap. That could be leaving a staggering amount of money on the table.'

Buy versus hold

Pitkowsky's commitment to running winners but only buying with a margin of safety raises one of those funny contradictions investing is riddled with. Namely, when new money comes into the fund, he will not simply recycle it into existing holdings, even if he thinks they have great long-term potential. Instead, he waits for a really attractive buying opportunity.

'I'm a big shareholder and the people I'm going to see at Thanksgivings are big shareholders,' says Pitkowsky. 'I'm not going to just replicate everything we own even if I still like it over the long term if I can't buy it with a margin of safety.'

This leads GoodHaven to sometimes hold sizable chunks of cash. But Pitkowsky aims to keep this down to a single- or low double-digit percentage of the portfolio, whereas cash holdings often got much higher before the revamp.

Another characteristic of GoodHaven's portfolio is that it is concentrated. It currently comprises only 22 stocks. This has been how Pitkowsky has managed money since he started out at Fairholme, an investment firm founded by famed value investor Bruce Berkowitz, which he joined as a research analyst in 1999.

He regards high conviction investing as a personality trait rather than something learned.

'Knowing more about a small handful of holdings than a little bit about a lot was what I was always comfortable with,' he said. 'Good ideas are rare, and if you find one, you should want a healthy amount of exposure to take advantage of it.'

He is also fine with the volatility that can come with concentrated portfolios. 'I've always been very comfortable not letting the day-to-day squiggles of stock prices unsettle me if I felt comfortable in what I owned and why I owned it.'

Good at heart

A well-documented and pervasive aspect of the human condition is something psychologists call 'outcome bias'. When results from a course of action are bad, we presume the entire process that led to the poor outcome is bad. Our instinct is to throw any babies out with the bathwater.

There's plenty of empirical evidence that fund investors do this all the time, reducing their returns by switching away from temporarily underperforming managers. Outcome bias also makes it particularly hard to look at things afresh when the failure is one's own.

There is plenty to respect in a portfolio manager willing to look beyond a dire run in search of what actually works at the heart of their process as there is a key backer willing to give a manager with a coherent plan another chance.

'Having an occasional differentiated view, a variant perception, and doing something about it in size are softer skills that are very important,' said Pitkowsky. 'GoodHaven 2.0 was just a refocus.'

Click here for standardized performance. Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-855-OK-GOODX (1-855-654-6639).

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Assets Under Management (AUM) as of 10/09/2024.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years). The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics. It is not possible to invest directly in an index.

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The Forecast Price-to-Earnings (P/E) Ratio is a valuation metric that estimates a company's future price-to-earnings ratio based on expected (or forecasted) earnings, typically projected by analysts. Unlike the traditional P/E ratio, which uses historical earnings data, the forecast P/E looks forward, providing investors with an indication of how the market values a company relative to its anticipated earnings.

Return on Equity is a financial ratio that measures a company's profitability in relation to shareholders' equity. It shows how effectively a company is using the money invested by its shareholders to generate profit.

Return on Capital is a financial metric that measures how efficiently a company generates profit from its capital. It assesses a company's ability to create value for investors from both equity and debt financing, providing insight into how well it is utilizing its overall capital base.

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