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«Price Matters Again»

Thomas Shrager and Robert Wyckoff, Managing Directors of New York-based value boutique Tweedy, Browne, are finding new opportunities in the current market turmoil. They share what they have bought and why they are holding on to Novartis and Roche.

By Gregor Mast, themarket.ch, 28. Juni 2022

Value stocks are experiencing a revival. Since the beginning of the year, they have outperformed growth stocks by a wide margin. The recovery follows a dry spell of more than fifteen years during which cheap stocks lost out.

The signs of life delight Robert Wyckoff and Thomas Shrager, both members of the investment team at Tweedy, Browne, a New York-based value boutique which has been in the business of identifying undervalued securities for a century, having worked with and for value icons such as Benjamin Graham, Walter Schloss and Warren Buffett.

«With interest rates and inflation on the rise and with risk asset valuations coming down, price once again matters. That has not been the case in a long while», says Wyckoff. Thanks to market volatility, there are a lot of opportunities. «We found a lot of new ideas over the last year and increasingly so over the last two or three months, especially in the smaller and mid-sized space», adds Shrager.

The two specialists explain what they have bought, at what level Alphabet will be interesting again and why they are holding on to Roche and Novartis. They also reveal what value investing has in common with duck hunting and which indicator they are currently following particularly closely when selecting stocks.

Mr. Wyckoff, Mr. Shrager, given the market turbulence, as value managers you must feel like a kid in the candy store. Have you been buying recently?

Robert Wyckoff: The market would appear to be coming to us, as value managers, volatility has surely been great, but the rise in risk asset valuations was also great prior to the current melt-down. Yes, on a stock-by-stock basis, we are finding new ideas. The correction is heating up right now, but our view is that it is not a fire sale yet. There is a chance this sell-off could become somewhat chaotic as the idea that interest rates and inflation may stay higher for longer could pose a real problem for markets in the near term. But in our view, this is a great time to be looking at new ideas and refreshing the portfolio.

Tom Shrager: The big correction has happened in stocks that have no earnings or have very few prospects of having earnings in the near future, but that is not interesting to us. We try to value companies, which means they need to have earnings to begin with. There has also been a significant correction in the stocks everybody thought should be owned by everybody, the Apples and Facebooks of the world, the so-called FAANG stocks. For companies that have earnings and can grow, the correction has been much smaller than one would expect. Having said that, we found a lot of new ideas over the last year and increasingly so over the last two or three months, especially in the smaller and mid-sized space.

Wyckoff: We probably added 20 to 25 companies or more to our portfolios over the last year or so. Many of them are smaller companies which may have a position size of 50 or 100 basis points in the portfolio.

You are known as bottom-up investors. To what extent does macro matter?

Wyckoff: With interest rates and inflation on the rise and with risk asset valuations coming down, price once again matters. That has not been the case in a long while. With zero to negative interest rates, an investor looking at risk assets that were trading at 80 times earnings could argue its earnings yield of 1,25% – the reciprocal of the PE – is still better than zero. In my view, there was an untethering of valuation considerations which was brought on by zero interest rates. Now with interest rates on the rise, money is no longer

free, and rates could even normalize at higher levels than what central banks are anticipating.

What does that mean?

Wyckoff: There is a rerating in the multiples used to value risk assets. Particularly long duration growth assets suffer, as the far distant cashflow is discounted with a higher rate. For a value stock, earnings are much more near term, so it holds up better in a period of rising rates. And it is an environment which allows us to keep an eye on really good companies we seldom have the chance to buy because they are usually too expensive. You could very well see Tweedy, Browne adding a technology company as a clear value stock in the near to medium term given the chaotic market volatility.

For the most part, tech stocks are not quite cheap enough as of now?

Wyckoff: We own Alphabet, formerly known as Google. We bought it in 2012 when it was struggling to move its search technologies from computers over to mobile devices, so we had an opportunity as the price came down. We have owned it ever since because the compounded intrinsic value kept up with the stock price. Right now, the stock is also correcting. At 2000 $ or below – say 1800 or 1900 $ – it could attract our interest again.

Robert Wyckoff.

What about other FAANG-names such as Meta, the former Facebook, which have also come down markedly?

Wyckoff: We looked and talked about Meta, and absent the poor growth and earnings report they had, at today's prices we may have been interested as it is trading around 14 times earnings. However, privacy settings on Apple phones have had an impact on their advertising revenue, and the slowing growth in their user base is a worry. They invest a lot of money in the metaverse, Mark Zuckerberg's project. We will continue to watch Meta.

Shrager: We are not against technology stocks. We analyze a tech stock like we analyze anything else. What is the moat around the business, can it grow, what is the competitive environment, and most importantly, is it at a valuation that will allow us to make money? Value investing is essentially duck hunting. In duck hunting, you sit in a blind, and there is a guy with a whistle who calls the ducks. If the ducks come, you shoot them. If they don't come, you don't have anything to shoot. If the ducks come in the tech sector, we will be buying them.

So where have you been finding new opportunities?

Shrager: We found some new ideas in Japan and China. There are ideas in the pipeline in Europe and even in the US, which is a rather new development.

Can you name some of the stocks?

Shrager: One name in Japan we like is Nabtesco, an industrial company that makes all kinds of precision machinery that are used in landing gear systems for aircrafts, brake systems for trains and all kinds of gears for industrial robots. It has set a pretty good record over the years. We were able to buy this company at roughly 8 to 8,5 times enterprise value to normalized Ebit, and it has a 2,5% dividend yield, which is pretty high for Japan. It is pretty rare to find a company of this quality with this kind of growth record at such a reasonable valuation.

What else did you buy in Japan?

Shrager: Another company is Nifco. It makes a very simple product: plastic fasteners that go into cars and all kinds of industrial applications. It is trading at around 8 times enterprise value to operating income and has paid a dividend of around 2%. It has set a record of growth and it has a very strong balance sheet with more cash than debt.

Thomas Shrager.

What are the opportunities in the US?

Shrager: We bought FMC Corporation, one of the largest producers of agriculture chemicals such as insecticides and pesticides. They are not in pesticides for corn or wheat or soy, they are more in chemicals for smaller crops like cabbage, lettuce and tomatoes. We like it because the company has a significant moat which comes from the need to register these chemicals in each individual country even in the European Union. A registration in Belgium does not mean you do not need to register in Portugal, for example. The second moat is the fact that every couple of years, the authorities ask to register the products anew to make sure they are in compliance with new environmental regulations. The third moat is that the products are patent protected. The company sells worldwide. All this makes this market very difficult to penetrate for newcomers. We bought it around 10 to 11 times Ebitda, and 12 to 13 times earnings. Acquisitions of comparable companies in the recent past had been done at high teens Ebitda multiples. Since we bought FMC, it has moved up in price, but we are still very excited about its prospects.

Is there anything else in the US?

Wyckoff: We bought Federal Express which is part of an oligopoly with DHL in Europe and UPS in the US. Since 2010, Fedex has grown its revenue and earnings before interest and taxes at 10 to 12% annually on a per share basis, but since 2015, it has had some stumbles on the profitability front. As a result, the share price suffered, which allowed us to buy the stock when it was trading at approximately 8,7 times one year out enterprise value to Ebit and 9 times forward earnings, and this was on what we believe are depressed operating margins.

Shrager: What depressed the share price is that they tried to be everything to everybody. They tried to chase everything packaged that can be delivered. In the process they invested an enormous amount in warehouses and in expanding the network. They have done it in an undisciplined fashion and that has resulted in less free cashflow generation and significant hick-ups.

Will these issues be fixed?

Wyckoff: Chairman Fred Smith, who founded Fedex, stepped back as CEO. He passed the leadership baton to his number two, Raj Subramaniam, who has been at the company for a long time. Subramaniam should begin to address the profitability issue at the company's upcoming analyst day. Recently, activist investor D.E. Shaw pushed for changes at the company.

Has that already had an impact?

Shrager: Fedex has raised the quarterly dividend by more than 50%. It has nominated two directors to the board, and a third one will be nominated by mutual agreement. One of the directors is Jim Vena who was the COO of Union Pacific. Railroads have improved logistics dramatically over the last ten years, and that is exactly what Fedex needs to do. It needs to rationalize its network. We are hopeful the new directors and the new CEO lead to change as the problems in our view are entirely fixable.

Wyckoff: After the D.E. Shaw announcement, the stock price bounced. Hopefully this will serve as a catalyst. The great thing about value investing is when you see an attractive business which appears to be extraordinarily cheap while the fundamental problems are fixable, someone may step in and apply pressure on the board and the management to address the issues.

What have you been buying in Europe?

Wyckoff: We added a couple of companies in Northern Europe. In Finland we invested in a company called Kemira which makes chemicals that are used to clean waste water and make drinking water cleaner. What interested us is that there had been a lot of insider buying from the CEO and his family office to the tune of more than €50 million over a couple of years.

Shrager: We bought the stock at around 6,5 times Ebitda. It has a 5% dividend yield. As a company that treats municipal waters as well as the water from industrial companies like paper and pulp producers, it fits within an ESG framework. They hope to be fossil fuel neutral by 2030. Valuations are very cheap – a lot of deals in the industry have been done at 12 to 14 times EV to Ebitda. The balance sheet is very strong with net debt to Ebitda at 1 for a company that has had very stable and predictable earnings and has been a cashflow generator.

What else can Europe offer?

Wyckoff: Another stock in the Nordic region is Sweden-based SKF, one of the largest producers of ball bearings in the world with a 20% market share. It is partially owned by the Wallenberg family who hold approximately 14% of the company, and they have spent more than $50 million to add to their position. We got interested in the stock when it was trading at approximately 8 times normalized pre-tax operating income, 6 times normalized Ebitda and a normalized PE of around 9,5. It is a good business – ball bearings are used in almost anything that rotates, it has had very good returns over time, and it has been a strong free cashflow generator. The competitors are generally weaker companies with more leveraged balance sheets.

Shrager: The interesting thing is that ball bearings are relatively inexpensive compared to the value of the machinery they are put in. Think about a ball bearing that goes into the landing gear of an aircraft relative to the value of that aircraft. Because of that, there is a little bit of pricing flexibility. Then there is a barrier to entry as you need the know-how to build the machinery to produce a perfectly round ball. SKF is a supplier to the car industry that is not going to be affected by the move to electric vehicles. Having said that, there is some cyclicality in the business, but it is a good business.

You have not talked about Swiss stocks. Are they not valued attractively enough?

Shrager: No, unfortunately not. But that does not mean we are not looking.

Wyckoff: Switzerland's weight in a typical international portfolio is still significant. We for the most part still have positions in Nestlé, Novartis, Roche, TX Group, Phoenix Mecano and Coltene.

Roche and Novartis are not trading much higher or even below the levels seen in 2015. Rather disappointing, don't you think?

Shrager: The pharmaceutical sector in general has not done so well in the last couple of years. One of the reasons is Covid. People were afraid to go to the doctor which had ramifications for the sector. But as this pandemic will be overcome, things look better, and I am hopeful that things change for Roche and Novartis as they have the products. At Novartis, it's primarily an execution problem.

How do you mean that?

Shrager: There have been some significant misses by the management of Novartis. They started well by simply divesting businesses, but then they lost focus in pharma. Nevertheless, existing drugs start to do ok after a weak period. What makes us still optimistic about Novartis is its pipeline which contains products with tremendous potential.

Such as?

Shrager: The most overlooked drug in the pipeline is called Pelacarsen. It is in phase 3 clinical trials and targets Lipoprotein A which is a form of cholesterol that is inherited. There is no existing drug that can treat it, and if untreated, it can result in a heart attack even if your cholesterol is fine. If it proves effective - and there is a phase 2 clinical trial that suggest it would be -, it has a sales potential of more than $10 billion. But unfortunately, the enrollment has been delayed, and the date of the clinical trial has been moved from 2024 to 2025. I frankly don't know what is going on there.

What about Roche?

Shrager: They recently had a disappointment in a cancer drug that targets a form of lung cancer in combination with Tecentriq, but the study was not conclusive. It does not mean the drug will not work. We will know that by the beginning of next year, and if it does - and I believe it will -, the underperformance of Roche will probably reverse. Roche’s management has done an incredible job by more than replacing sales of around $35 bn which were lost due to drugs for which the patents have expired. The pipeline looks good, and they offer a dividend yield of 3%.

You mentioned that you found some opportunities in China. Is this market still investable after all that has happened?

Wyckoff: Yes, we believe it is still investable, but you have to be aware of the regulatory, political and macroeconomic risks. Therefore, the price you pay has to compensate you for these additional risks. That is why we often adjust the multiples we use to value Chinese companies, and yet we will still demand an additional discount of roughly a third from our conservative estimation of intrinsic value. We are further managing risk by committing no more than 5 to 10% of a portfolio at purchase to China in total. Today, we are around 7 to 8% invested there.

Do you still own shares of internet companies such as Alibaba?

Wyckoff: Yes. We believe they are trading at extraordinarily cheap levels compared to their peers in the US. We own shares in Tencent, Baidu and Alibaba. In many of our portfolios, we probably have 3 or 4% of total assets in those three names. And then we hold other Chinese

names that trade in Hong Kong such as Dali Foods which produces baked food and snacks. It's cheap and growing. And we are invested a high-end instant noodle company called Uni-President.

Don't you worry that China is turning more market-unfriendly?

Wyckoff: We believe, although we cannot be sure, that president Xi Jinping is not going to turn his back on the economic miracle that occurred over the last 25 years which brought 800 million people out of poverty. The most important concern of the Communist Party is political stability, and to take the economic miracle away could cause social unrest. Xi wants to be declared president for life at this fall's 20th Party congress, and we are hopeful that after that election, government regulation will not be as heavy handed as it has been of late. There is evidence that it is getting better already.

What evidence do you see?

Wyckoff: Liu He, one of Xi’s most trusted economic advisors, has recently made public pronouncements that perhaps the regulatory scrutiny of the platform companies has been too intense. He has suggested that perhaps it is time to step back and let these companies perform. They play an important role in China. Those conciliatory comments have led to an increase in optimism.

Shrager: Of course, all our companies in China are suffering because of the economic slowdown, caused by the lockdowns, the restructuring in the real estate sector and policy pronouncements such as the Common Prosperity drive, which have increased the pessimism of individual companies. But it is not only Liu He, but also prime minister Li Keqiang who was stressing the importance of economic growth. Our companies are affected by the slowdown, but we believe they are trading at valuations that are ridiculously low by any standard. We are being presented with companies such as Baidu which we believe are trading at half of a reasonably calculated sum of the parts valuation. Many of these companies have net cash and are buying back shares.

You have mentioned insider buying several times. How important is it in your stock selection?

Shrager: There are studies which suggest that you can outperform for two to three years if you combine cheap valuations with significant insider buying. This is sort of common sense. Why would the CEO or CFO buy shares in his company if he did not think the company will do well? Two to three years is the time frame over which they generally know the company will be doing well or not. This has been a significant signal for us to start looking at a stock.

Wyckoff: We have been using insider buying for more than 30 years. It has become even more important of late because of the high uncertainty in markets. It just provides additional comfort when looking at a security we believe to be undervalued to know material purchases have been made by very knowledgeable insiders who know more than anybody about the business.

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The Largest Holdings in the Funds of Tweedy, Browne

Top 20 Holdings, per May 31, 2022

International Value Fund (CHF)	International Value Fund (EUR)	Global High Dividend Value Fund (EUR)
Berkshire Hathaway	Berkshire Hathaway	Nestlé
Nestlé	Alphabet	Diageo
Diageo	BAE Systems	TotalEnergies
Alphabet	AutoZone	BAE Systems
Alphabet	Heineken	GlaxoSmithKline
GlaxoSmithKline	CNH Industrial	Johnson & Johnson
TotalEnergies	Nestlé	Unilever
United Overseas Bank	Safran	Trelleborg
Roche	DBS Group	Safran
BAE Systems	United Overseas Bank	Roche
CNH Industrial	Scor	Scor
Heineken	Trelleborg	Rubis
Safran	Alphabet	Zurich Insurance
Rubis	Diageo ADR	BASF
SOL	Rubis	Jardine Matheson
DBS Group	TotalEnergies	Intel
Scor	SOL	United Overseas Bank
Fresenius SE	Diageo	Munich Re
Novartis	Nestlé	Kemira
Heineken	Fresenius SE	Fresenius Medical Care

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