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Rethinking Elements of Portfolio Management

[Asset allocation, diversification, value, growth – words that immediately connote investment concepts drilled into our brains by tradition and habit, established interpretations of financial research, and a form of "common" sense. But the evolution of the asset management industry and the investment process has demonstrated how many former money management concepts can be challenged by uncommon thinking, a variant perception, or can just slip into being applied in a vastly different way.

Questions can and do arise leading to new thinking and approaches – Does asset allocation and portfolio diversification, as applied by most, really reduce risk? Are growth and value stocks really that distinct? How important and effective is incorporating a top-down, macro level of research and analysis to your stock selection process? When the macro backdrop is extreme, how does a stock picker alter (or not alter) their investment approach in such a period?

*To explore these topics in real world application, we were introduced to **Larry Pitkowsky**, Co-Founder, Managing Partner of registered investment advisor Goodhaven Capital Management & now sole-Portfolio Manager of a public no-load mutual fund Goodhaven Fund (ticker: GOODX) and managed accounts since December 2019 with the retirement of his co-manager Keith Trauner. Prior to forming Goodhaven, Larry was a Portfolio Manager of the Fairholme Fund.*

While his investment style can be characterized as a value manager, there is a lot more going on here below the surface. We wanted to explore further with questions digging into his thinking and the changes made to his portfolios over the past few years that seems to be putting a new spin on old established investment concepts.]

Hortz: ***What are your views on portfolio management and why have you said that it should not be conducted as an IQ test?***

Pitkowsky: IF some IQ threshold was the sole determinant to long-term portfolio outperformance, then everyone involved who met that threshold would achieve those results – which obviously is not the case. If it was about access to minute-by-minute financial information or the amount of money spent on research, then every subscriber to such information services would achieve great long-term results. But decision-making skills, judgment, and perhaps, most importantly, the right emotional temperament are the soft skills that, while harder to measure, are more important over time to outperformance.

We believe successful value investing is owning quality businesses run by exceptional leadership that can be purchased at a price significantly below intrinsic value. Our core belief is that markets can be inefficient and successful investing requires pattern recognition and understanding behavioral factors like greed and fear, as much as a strong analytical understanding of the fundamentals.

Our investment process is rigorous and highly selective. We approach each existing position or prospective investment with a business owners' approach and a bias towards businesses with durable competitive advantages that can generate attractive normalized earnings and free cash flow. We invest with a multi-year mindset because it allows us to focus on the long-term, particularly in businesses that we feel are at or close to a positive inflection point that is material and underappreciated.

We only allocate capital to our highest conviction ideas because we believe that a rigorous underwriting process is the most important risk management tool if we define risk not as volatility, but permanent loss of capital.

Although the pace of change in our industry continues to accelerate and we strive to be nimble and agile, we remain focused on simplifying the complexity and constantly adjusting our biases and positioning, even if it can be psychologically discomforting. We love to learn and we are continuously learning as we invest.

Hortz: ***Why do you feel that the value and growth style of investing are more connected than distinct?***

Pitkowsky: We are constantly looking for areas where we can have an edge over the market. There is a common misconception that value investing is about finding the cheapest statistical stocks where the absolute cheapest stocks on a screen are considered value and the most expensive is considered growth. The reality is that growth is a component of a company's valuation and if we can pay an attractive price for a business that has a significant runway for growth, that is considered value. To us, a growth business with strong competitive advantages and high returns on invested capital could be more attractive as an investment than a statistically cheaper commodity business that faces increased competition. We aim to find opportunities that are good businesses led by great management and can be purchased at a good price. Having said that, our current portfolio is statistically cheaper than the S&P 500 on a Price/Earnings ((P/E)) basis and has in recent years had faster top line earnings per share growth than the S&P 500.

Now, the key is to buy such a company – growing or not – at a margin of safety for an approximate appraisal to intrinsic value. The hard part is finding a company where you think the nature of the business gives you confidence in predicting future growth – after all it is a competitive world. Finally, if that predictable future growth is already well recognized, you may not be able to invest with a margin of safety. Predicting and assuming rapid growth as your thesis may work out fine if all goes perfectly, but it is a long way down if you hit a bump in the road.

As an example, a business that we acquired shares in during the COVID-19 pandemic is KKR & Co (KKR). They are a good example of a high-quality business with a strong track record of success and growth tailwinds, and we purchased it at a discounted price that we felt was a significant value. We paid a price that reflected market expectations of a severe economic slowdown which ascribed little value for its franchise, tangible assets on balance sheet, and potential for increased fees and earnings as a result of aggressively deploying assets under management ((AUM)) during the dislocation. We paid between about $16 and $24 for our KKR shares during March of 2020.

Today, KKR has approximately $19/share of balance sheet investments and a run rate of over $4/share of distributable earnings/share. Only two years after our buys, we in effect paid for their balance sheet investments and got the business which has approximately $371 billion of fee-paying AUM, for nothing. Although we were unable to precisely predict the probability of a prolonged economic slowdown at the time, we were comfortable with having a different view from the market which we felt was significantly undervaluing the business.

Hortz: ***What are the dangers you have mentioned of letting macro thinking creep too deeply into your investment process?***

Pitkowsky: As a fundamental investor, we focus on what is knowable and important. There are a lot of things that are important, but not knowable. Predicting interest rates, recessions, and the like, fall into that category. It would be great to be able to predict them with a high degree of confidence. But we are confident we cannot make those predictions and we are suspicious of anyone who thinks that they can. It is not what you don't know that can lead to bad decisions, it is often not knowing what you don't know that does. What we focus on instead is trying to have a thoughtful, deeply researched and perhaps differentiated view about a not too long list of companies and invest in them for the long-term where we have an initial margin of safety between our purchases and underlying value.

Although we do not have strong views on which scenario will play out in the economy in the next few years, we respect the possible different macro scenarios and have exposure to some of these risk factors. We continue to hold a modest exposure to gold through our holding in Barrick Gold, a well-run gold miner led by CEO Mark Bristow that also has a material exposure to copper mining.

In a higher rate environment, financials stand to benefit and we have positions in banks including Bank of America where net interest income will expand and earnings should continue to grow even if the US were to experience a more typical economic slowdown. Finally, we discuss potential macro scenarios internally as a way to stress test the positions in our portfolio and generally avoid businesses that are consistently over levered with debt. It should be noted that the above exposures were established before the recent rise in interest rates and inflation, when few were talking about such things.

Hortz: ***Why have you chosen to dismiss broad diversification and continued developing your fund as a non-diversified concentrated portfolio?***

Pitkowsky: We would rather know a lot about a smaller number of things than less about a longer list of holdings. In addition, as we strive to outperform over the long-term, to achieve a different result than the broad market you really must look different than the market. Hence our desire to have a higher concentrated "active share" of distinctiveness in our structure. Finally, as with everything we do at GoodHaven, this investment approach is how we are wired, how we are comfortable investing, and how we would invest if there were no clients or shareholders and it was a family office.

Our thinking is *why would you want to own your 30th best idea when you can own more of your favorites?* From a risk standpoint we do not think volatility is the same as risk. Risk to us is the risk of a permanent loss. Risk as defined by others is a measure of volatility. We fully expect more volatility with a concentrated portfolio, but we also think our deeper knowledge of each holding leads to less actual risk. Having said that, we also paid very careful attention to how we size our holdings, and which holdings deserve - from both a risk and a reward standpoint - to be the bigger positions.

Hortz: ***What is your strategy around fixed income securities and "special situations" you mention in your prospectus and how do you deploy them into your portfolio construction?***

Pitkowsky: Leaving aside our ownership of fixed income securities, such as Treasury Bills, which are a cash equivalent. There are infrequent moments where distressed or higher yielding fixed income securities can offer equity like returns, and a margin of safety. We have invested successfully in these areas in the past and are comfortable fishing in those waters opportunistically. In addition, we maintain the flexibility to invest in "special situations" which might include a company that does not meet some of our usual criteria but has other attributes making it suitable for the portfolio and if sized appropriately. In addition, workouts, liquidations, or other "time value of money" investments fall into this bucket and are long consistent with value investing and may be employed periodically and opportunistically.

As an example, we currently own a basket of different series of preferred shares issued by Fannie Mae. Our cost is a material discount from the stated par value in each instance and the dividends have been suspended. While the company has been in conservatorship since the great financial crisis, we feel we have material upside and manageable downside should any move to recapitalize Fannie Mae (and Freddie Mac) materialize which has been discussed and tried from time to time.

Hortz: ***How have you deployed your thinking into Goodhaven portfolios since you became sole portfolio manager at the very end of 2019? Can you give us some examples?***

Pitkowsky: During the market crash surrounding Covid-19 in February and March of 2020, we used that period to upgrade the portfolio, adding capital to some new and existing high-quality growing companies, all purchased at prices significantly below our conservative estimates of intrinsic value. This list includes: KKR, Berkshire Hathaway, Progressive Insurance, Bank of America and more.

In addition, we have maintained a material weighting in energy given our view of the unusual circumstances present in that industry today. We also previously increased our holdings to companies that might benefit from higher interest rates, ahead of the recent moves up in interest rates. Finally, we have tried to be aware of the macro backdrop, but not let it hinder us from searching for new investments. All of this appears to have served us well given our results since early 2020 versus comparable indexes and peers.

Other changes in the last few years include a smaller weighting in gold, less cash on average, portfolio holdings that are less levered, and additional businesses that have sustainable competitive advantages and attractive tailwinds.

I would like to add that it is significant that GoodHaven's anchor investor and largest minority partner since inception is Markel Corp based in Richmond Virginia. In 2019, Markel materially added to their assets managed by GoodHaven fully supporting GoodHaven's continuing evolution.

Written by Bill Hortz, Founder & Dean, Institute for Innovation Development

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