"Value Investing is often misunderstood and misapplied. You will make neither mistake if you read Ronald Chan's book on the subject."
—DONALD R. KEOUGH, Chairman of the Board of Allen & Company Inc.

THE VALUE INVESTORS

Lessons from the World's Top Fund Managers

RONALD W. CHAN

FOREWORD BY BRUCE C.N. GREENWALD

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WILEY

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To my wife, Jacinth,
who reviewed this manuscript more times than I did

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Foreword

Students of investing look for a formula, a way of combining accounting and other information that will produce infallibly good investment results. Even Benjamin Graham, the founder and leading spirit of by far the most successful school of investment practice, spent a good deal of his time looking for such a formula. To this end, students read both technical works and the retrospective testimonies of high-performing investors. In both areas, they are largely disappointed.

The technical approaches have a meager record of success. A few notably good books have been written (for example Joel Greenblatt's *You Can be a Stock Market Genius* and *Graham and Dodd's Security Analysis*). But reported technical investment approaches rarely, if ever, lead to consistent, high-level returns (if they did they would be adopted by everyone and would become self-defeating).

Investment memoirs generally also disappoint students. They tend to be long on philosophy and short on advice for how to buy particular securities. However, as the works of successful investment practitioners, the memoirs do have much to recommend them. They describe, however non-specifically, investment approaches that worked in practice. And they capture an important aspect of investment success: that it depends more on character than on mathematical or technical ability. This is the consistent message of investment memoirs as a group.

The problem is that each memoir presents a unique perspective on the character traits necessary for investment success. Different authors emphasize different characteristics: patience, coolness in a crisis, wide-ranging curiosity, diligence in pursuit of information, independent thought, broad qualitative as opposed to detailed quantitative understanding, humility, a proper appreciation of risk and uncertainty, a long time horizon, intellectual vigor and balance in analysis, a willingness to live outside the herd, and the ability to maintain a consistently critical perspective. Unfortunately, an investor with all these qualities is a rare bird indeed.

That is why Ronald Chan has done such a valuable service in writing this book. He has put together a set of thorough and rigorous portraits of a comprehensive range of notable value investors in a manageably short number of pages. His descriptions cover multiple generations from Walter Schloss and Irving Kahn to William Browne, multiple geographies from Asia to the United States to Europe and the full gamut of value investing styles. By combining descriptions of investment approaches with investor background, he illuminates the connection between individual character and effective investment practice. Taken as a whole, the book provides each practical value investor with the necessary material to sift through the historical records to find the style that is most appropriate to them.

Ronald Chan's work is an essential starting point for any nascent value investor and an invaluable reference for experienced investors.

Bruce C. N. Greenwald
Director, Heilbrunn Center for Graham and Dodd Investing
Robert Heilbrunn Professor of Finance and Asset Management

Preface

> Try not to become a man of success but rather to become a man of value.
>
> —*Albert Einstein*

The best advice I have ever received came from my father. When I began searching for a career after finishing college, he advised me to stay away from three potential headaches in business: labor, rent, and inventory.

As any labor-intensive business is likely to lead to office politics, my father advised that I look for a business that requires little manpower. Then, as the high office rents in a world city such as Hong Kong can easily squeeze profits, he said the ideal is to find a business that requires little office space. Finally, as handling any type of inventory requires both manpower and space, an inventory-based business should also be avoided.

Taking his advice to heart and looking for a business that met these three criteria, I found investment management to be a perfect fit. The labor force is my brain, the office need only accommodate a few desks, and the inventory is the investment positions recorded in brokerage accounts.

Although investment management may allow one to avoid the aforementioned headaches, becoming a successful investment manager still involves considerable challenges. It requires extensive knowledge of the financial markets and the ability to react to different market circumstances. It also requires a prudent strategy to achieve sustainable investment returns and a sensible investment philosophy to build the right investment model.

In developing my own investment philosophy, I read the work of Benjamin Graham, became aware of the phenomenal investment success of Warren Buffett, and came to realize that the value investing concept makes perfect sense. As Graham said, a value investment is "one which, upon thorough analysis, promises safety of principal and adequate return."

It is also difficult to argue with Buffett, who asked: "What is 'investing' if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value—in the hope that it can soon be sold for a still-higher price—should be labeled speculation."

After becoming a value investor myself, I began to explore the different types of investment valuation methods for sizing up businesses and investment opportunities. At first, I thought that the perfect valuation formula was the holy grail of investment success, but I soon came to realize that this is not the case. Instead, it is the right investment mindset, or temperament, that distinguishes the fair-to-good investor from the good-to-great one.

That realization prompted me to try to learn more about the mindsets and life stories of prominent value investors. However, all I could find were short profiles of these individuals and their investment track records, latest stock picks, and market predictions. Although the world recognizes their success, it seems that we are interested only in their views on the market outlook and their most recent investment performance, rather than who they really are, where they came from, and how they ended up becoming who they are today.

The thesis of this book, then, began to emerge. If I could hear the life stories, and understand the investment mindsets, of the world's most highly regarded value investors—and learn the details of their upbringing and career history—then perhaps I could begin to see what value means in their eyes. Is value, like beauty, in the eye of the beholder? Why do these individuals, despite age and cultural differences, share an investment philosophy?

Unlike other investment books, this book does not focus on a particular investment ratio or valuation methodology. Instead, it focuses on how life encounters and experiences directly and indirectly affect a person's investment mind-set and strategy.

To provide cultural diversity and demonstrate the international appeal of the value investing approach, the book features five value investors from North America, four from Asia, and three from Europe. Some have experience of different cultures. Mark Mobius of Templeton Emerging Markets Group, for example, was born in New York but has lived in Asia for more than 40 years. Frenchman Jean-Marie Eveillard moved to New York when he was in his late thirties and has lived there ever since. In many ways, the value mindset of these men has been shaped by their cultural experiences.

This book is not an in-depth analysis of the featured investors' track records. They have been in the industry long enough to win their peers' respect, whether due to their personalities and career experience or superior investment returns over the long term. What is of interest to me is how they got to where they are today.

For example, Irving Kahn is 106 years old and has been in the business for more than 84 years. Walter Schloss, who passed away recently at 95 years old, and had been described by Warren Buffett as the "super-investor from Graham-and-Doddsville," beat the market over 46 years.

Although the men featured in this book all have stellar investment records, they come from different walks of life and understand the notion of value differently.

Cheah Cheng Hye of Value Partners in Hong Kong, for example, worked as a journalist for 15 years before becoming a stock analyst and then a fund manager. Spaniard Francisco Paramés of Bestinver became a fund manager by accident in 1993 and has beaten the Spanish market ever since. His appreciation of value has been entirely self-taught.

Tokyo-based Shuhei Abe of the SPARX Group was once a bottom-up stock picker who could not imagine shorting a stock until he realized that Japan was going through a Depression, better known today as the country's "Lost Decade." To survive that decade, he improvised by creating a long-short fund based on the simple realization that if one knows what is underpriced, then one should also know what is overpriced. Abe and SPARX have thrived on the strategy ever since.

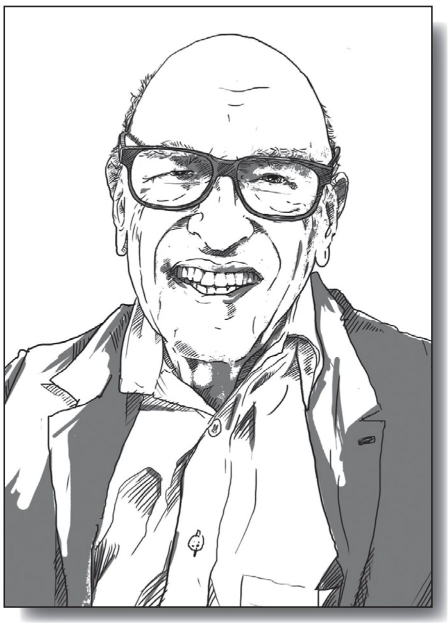
In sum, *The Value Investors: Lessons from the World's Top Fund Managers* shows that value investing is not a staid and old-fashioned investment strategy, but is dynamic and ever-evolving. Although the individuals featured in this book have different stories to tell, they exhibit similar personality traits. More important, they exhibit similar temperaments.

As Warren Buffett argued, "Success in investing doesn't correlate with I.Q. once you're above the level of 125. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Ronald W. Chan
May 2012

CHAPTER 1

Free to Choose in Value Land



Walter Schloss
Walter & Edwin Schloss Associates

What does not destroy me, makes me stronger.

—*Friedrich Nietzsche*

Walter J. Schloss founded Walter J. Schloss and Associates in 1955. A student of Benjamin Graham, the father of value investing, Schloss had been finding undervalued securities in America since the 1930s. Having served as a securities analyst at the Graham-Newman Partnership in 1946, Schloss started his own fund when Graham decided to retire in 1955. Schloss's son Edwin joined the fund in the late 1960s, prompting an official name change in 1973 to Walter & Edwin Schloss Associates.

Charging no management fees but taking a 25 percent share of the profits, Schloss started off with $100,000 capital. At one point, the fund grew to roughly $350 million. From 1956 to 2002, it generated a 16 percent compound return annually (roughly 21 percent before profit sharing) versus the 10 percent per annum generated by the Standard & Poor's (S&P) 500.

Although a difference of 6 percent may not sound like much, the magic of compounding means that over this 46-year period, a $10,000 investment in the S&P 500 would have generated close to $900,000, whereas a Schloss investor would have made close to $11 million on the same investment.

A chartered financial analyst since 1963, Schloss was also the treasurer of Freedom House, a Washington, DC–based international nongovernmental organization that conducts research and advocacy on democracy, political freedom, and human rights.

Walter Schloss passed away on February 19, 2012, in Manhattan, New York. He was 95 years old.

Walter J. Schloss received his famous moniker, the "super-investor from Graham-and-Doddsville," not from any ordinary man but from the most admired and respected investing legend of all time—Warren Buffett—and it seems appropriate to allow the "sage of Omaha" to introduce him here.

Buffett singled Schloss out for praise in his 2006 letter to Berkshire Hathaway shareholders, noting that he had managed a "remarkably successful investment partnership" without taking "a single dime" unless his investors made money. Furthermore, he had done so without attending business school or even college, working "without a secretary, clerk or bookkeeper, his only associate being his son Edwin," an arts graduate, and generally flying in the face of prevailing business theories.

The letter continued: "When Walter and Edwin were asked in 1989 by *Outstanding Investors Digest*, 'How would you summarize your approach?' Edwin replied, 'We try to buy stocks cheap.' So much for Modern Portfolio Theory, technical analysis, macroeconomic thoughts and complex algorithms."

Buffett said that when he first publicly discussed Schloss's remarkable record in 1984, efficient market theory (EMT) held sway at most major business schools. According to EMT, as it was commonly taught at the time, Buffett noted, "No investor can be expected to overperform the stock market averages using only publicly-available information (though some will do so by luck). When I talked about Walter 23 years ago, his record forcefully contradicted this dogma."

Instead of taking the example of Schloss's obvious success on board, however, business school faculties went "merrily on their way presenting EMT as having the certainty of scripture," Buffett stated. "Typically, a finance instructor who had the nerve to question EMT had about as much chance of major promotion as Galileo had of being named Pope.

"Walter meanwhile went on over-performing, his job made easier by the misguided instructions that had been given to those young minds. After all, if you are in the shipping business, it's helpful to have all of your potential competitors be taught that the earth is flat."

Buffett concluded: "Maybe it was a good thing for his investors that Walter didn't go to college."

Living through the Great Depression

Walter Schloss was born in 1916 in New York City. He recalled: "When I was born, the world was at war, and there was a flu epidemic in the United States. My mother, Evelyn, was worried about catching the illness at the hospital, so she gave birth to me at home."

During the next two years, the flu pandemic that started in Europe (known as the Spanish flu) spread worldwide, killing more people than the total number killed in World War I. Fears of the disease prompted the Schloss family to move to Montclair, New Jersey, in 1918. However, "the place was too remote and inaccessible," Schloss said, "so after a while we moved back to New York City, and that's where I grew up."

From a young age, Schloss enjoyed traveling around the city by trolley car. He was so fascinated by the driver and his apparent privilege to travel freely wherever he liked that becoming a trolley car driver was his childhood dream job.

"Sometimes luck puts you in the right place at the right time! If I had been born a little earlier, I seriously would have considered becoming a trolley car driver. Luckily, trolley cars began to fade out and were replaced by buses in the 1930s and 40s, and so I ended up going to Wall Street," Schloss remarked.

Although still in middle school, Schloss was keenly aware of the 1929 stock market crash and the difficulties it unleashed. His mother lost her entire inheritance, and his father, Jerome, who had bought a U.S. company called Mathieson Alkali on margin, lost everything.

"My parents were honest people, but they had trouble financially because they were poor investors," Schloss said. "During the depression, my father learned his lesson and said to me, 'Anything terrible that doesn't happen to you is profit!' I took the advice to heart, so when I entered Wall Street, my goal was to not lose money!"

Turning 18 and finishing high school in 1934, Schloss decided to look for a job. With his mother's help, he found a job as a runner at brokerage house Carl M. Loeb & Co., which later changed its name to Loeb Rhoades, earning $15 per week.

"My father lost his job during the Depression, so I could not attend college and had to help my family," Schloss explained. "The economy was grim, and I remember seeing men on every street corner selling apples for a nickel apiece. Some family friends even criticized my mother for letting me work at a brokerage firm, as they believed there would be no more Wall Street by 1940. That was how pessimistic people were in those days."

As a runner, Schloss's duties included delivering paperwork and stock certificates to various brokerage houses for trade settlements each day. In effect, he was a messenger. Shortly after joining the company, he was promoted to the cashier's department—the "cage," as it was called—looking after and keeping track of stock certificate transfers between stockbrokers.

Schloss recollected, "After working for a year, I asked one of the partners, Mr. Armand Erpf, who was in charge of the statistical department, which is similar to the research department today, if I could become a securities analyst. He said that job wouldn't bring in any brokerage commissions, and so the answer was no.

"In those days, and perhaps it is true even to this day, bringing in business was the priority, and so business connections were more important than investment knowledge. Since a research analyst in those days would not advance very far within a company, who you knew was more important than what you knew."

Mr. Erpf did give young Schloss one very valuable piece of advice. He told him about a new book by Benjamin Graham and David Dodd called *Security Analysis*. "Read that book, and when you know everything in it, you won't have to read anything else," Schloss recalled him saying.

Reading the book gave Schloss the impetus to go to the New York Stock Exchange Institute to take finance and accounting courses. Completing these courses then made him eligible to take "Security Analysis," a course taught by the one and only Benjamin Graham. Paying roughly $15 per semester, he attended Graham's class from 1938 to 1940.

Learning directly from the father of value investing was a life-changing experience for Schloss: "Ben was simple, straightforward, and brilliant. Because he had a rough time during the Great Depression, his investment strategy was mainly to look for stocks that would provide downside protection, such as stocks selling below their working capital. The idea simply made a lot of sense to me, and I fell in love with his investment philosophy."

Schloss was particularly impressed by Graham's use of real-life examples to show which stocks were cheap and which were expensive: "He would also compare companies that came close to each other in alphabetical order. For example, he compared Coca-Cola to Colgate-Palmolive and statistically deduced that Colgate was cheaper.

"A lot of investment professionals took his class just to get investment tips, and they made money off his ideas, but Ben didn't mind because he was more into the academic exercise than making money. Unfortunately, I didn't profit from his ideas [at the time] because I had no money, but I learned a great deal."

The Meaning of Survival

World War II broke out in 1939, with the United States joining the war at the end of 1941 following the Japanese attack on Pearl Harbor. The patriotic 23-year-old Schloss decided to contribute to his country's war effort: "I remember it was the first Sunday of December when America was attacked. The next day, I went into the office and asked my boss whether I would still get my year-end bonus if I enlisted in the military. He said yes, and so I went straight to lower Manhattan to enlist. By Friday of that week, I had taken the oath of enlistment and was sent straight for training.

"I got on a big ship in New York, and we went zigzagging across the ocean so that submarines wouldn't sink us. We passed through Rio de Janeiro, then crossed the Atlantic Ocean to the Cape of Good Hope and the Indian Ocean to Bombay. Then, as the water was too shallow in the Persian Gulf, we had to switch to a British troopship named the HMT *Rohna* to get to Iran. I was lucky because if I had boarded that ship a few months later, I would have been on board when it was hit and sunk."

The Luftwaffe's sinking of the HMT *Rohna* in the Mediterranean in November 1943 constituted the single largest loss of U.S. troops at sea at one time.

Schloss served in the U.S. Army until 1945. He had been stationed in Iran, trained in code decryption, and was later assigned to the U.S. Signal Service Co., based at the Pentagon in Washington.

Having lived through roughly 18 economic recessions in his long life, Schloss felt that life is fragile, and when it comes to survival, money is of