Mark Sellers Speech to Sellers Capital Investors

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(Excerpt reprinted with permission)

As most of you know, we own two types of stocks in the Sellers Capital Fund. Category one we call "asset plays." These are companies with tangible assets worth as much as or more than the current enterprise value, including any debt that's on the balance sheet. When we can find a company like this, we feel relatively safe buying it because we know there's a lot of downside protection. Over the past few years, our philosophy has evolved to the point where we can kind of sum it up in one sentence: Focus on the downside, and the upside will take care of itself.

What this means is that we spend nearly all our time calculating the worst-case scenario valuation for a stock before we buy it. We do this because we hate, absolutely hate, to lose money. That doesn't mean that when we buy a stock it can't go down further. We've had enough bad months and bad quarters to throw that idea out the window!

No, what this means is that we do everything we possibly can to avoid buying a stock above its fair value. Our goal is to eliminate the potential for permanent capital impairment. Permanent capital impairment is when you buy a stock and it goes down and never comes back up, or at least doesn't come back up for several years.

To us, permanent capital impairment, not volatility, is the big risk in investing. Volatility isn't risk unless you have a short time horizon and might have to sell at the bottom. As long as you can ride out the waves, and are correct in your downside valuation assessment, then you have nothing to worry about. So if we can eliminate the potential for permanent capital impairment, we can essentially eliminate risk.

Let me say that one more time to emphasize the point: If there is no chance of permanent capital impairment, there is no risk as long as your time horizon isn't truncated. You may have to hold onto a stock longer than you originally planned to, but if the fair value remains above your purchase price, eventually you will make money. And so avoiding permanent capital impairment on each stock we buy is the Holy Grail.

Now, when we buy a stock, it has usually been going down for a while and it almost always goes down further after we start buying. We rarely time the bottom perfectly. But this isn't a loss. Just because a stock goes down doesn't mean you have lost any money. A loss is when you buy a stock and it goes down, and only then do you realize you overestimated the company's earnings potential, and so you cut your fair value estimate, and you suddenly realize that even though the stock has gone down, it isn't undervalued at the new, lower price. And that gives us a sickening feeling in our stomachs. We hate when that happens. And so Mark and I do everything we can to not let that happen.

And the way to do that is to calculate the worst-case scenario before buying a stock. We look for stocks that have at least 3 times as much upside potential as they have downside risk, weighted for the probabilities of each scenario happening. So, for example, if the

worst-case scenario fair value of a stock is, in our estimation, $24, and the current market price is $30, that's 20% downside risk. If we're wrong, we lose 20%. So we need to feel comfortable that, if we're going to risk losing 20% on a stock, we expect to make, in a reasonably likely scenario, 60% or more. And so then we weight the likelihood or probability of each scenario happening and decide whether it's a good bet. But for now, let's ignore the probability part of the equation and just assume each scenario is equally likely. In this example, then, we would only buy the stock if we felt the fair value in a likely scenario was $48 or higher. This is what people refer to as a margin of safety. In this case we would have a margin of safety of 38%. Our base-case fair value estimate is $48, and the stock is selling for $30, and that's a 38% margin of safety.

Our fair value of $48 is also 60% above the current stock price, and 60% upside is three times greater than our 20% downside risk. That's a three-to-one reward-to-risk ratio, which meets our criterion for purchase.

In practice, we have ended up not settling for the 3-to-1 criterion; we usually don't really pull the trigger on a stock unless the ratio is higher than this. Once in a great while, you find one with an infinite reward/risk ratio – in other words, the company could be easily liquidated at or above the current stock price, so you have no downside and any upside is just gravy. We felt this was the case with Contango recently after they announced a big Gulf of Mexico find and yet the stock took a while to move up.

So you can see, the upside isn't all that important compared with the downside scenario, which is critical. As long as you don't lose money on a stock, you will, in the vast majority of the cases, make money on it. If you have a whole portfolio of these types of situations, you almost can't help but do better than the market averages over time. You win by not losing. You win the Super Bowl on the strength of your defense, or win the World Series on the strength of your pitching.

And in fact, this is the essence of the Kelly Criterion, which many of you are familiar with because it was described in a book by William Poundstone called *Fortune's Formula*, which my office sent copies of to each investor in the fund. If you haven't read the book, I suggest you read it because you'll understand investing a lot better. Equity investing – and I'm talking about equities but you could attach the comparison to other things like junk bonds or real estate – equity investing has much more to do with minimizing the probability of loss than it does with greedily trying to make as much money as you can on each of your stock picks.

We find these stocks in a variety of ways, from talking to other fund managers, to looking at Edgar filings of money managers we respect, to just reading a lot of different publications. And something I've noticed over the years is that the best ideas come to you, rather than you going out and finding them. So we don't do a lot of work actively going out and searching for ideas. We just keep our eyes and ears wide open and try to let them come to us.

Okay, back to the asset play topic. When a company has tangible, fungible assets on the balance sheet, it gives us a measure of our downside risk. If we can find a company with assets that could be liquidated at the current market cap, or more, and we have confidence that the management team at the company won't slowly erode this asset value over time, we usually take a large position. Note that both conditions need to be present: Tangible asset value supporting the stock price, and a management team that isn't trying to steal the company from under us and isn't incompetent enough to fritter it away accidentally.

Often in these situations, there is no identifiable catalyst to get the stock price up to the fair value. You just have to buy, hold, and wait for something good to happen. But it's amazing how quickly it usually happens even though there is no apparent catalyst on the horizon. Capitalism, like nature, abhors a vacuum and a mispriced security creates a vacuum. It rarely lasts long, especially these days because there are so many hedge funds scouring for mispriced securities.

We don't find these asset play situations very often, they're rare, but a few examples we've owned include Niagara Corporation, Cost-U-Less, Carrizo Oil and Gas, Hallwood Group, Contango Oil & Gas, Home Depot when it sold for $33 a share, and a recent purchase, Angiotech Pharmaceuticals. All of these companies had or still have assets that we felt supported the stock price at the time we were buying, giving us little downside in case things went wrong. And we love situations like that.

The second type of company we own are those companies with wide economic moats. We'll call these "moat plays." This is the part of the strategy I think a lot of people in this room are more familiar with because it's what I wrote about frequently when I was at Morningstar. By the way, Morningstar was a great place to work. I loved almost every minute of it. It was the second best job in the world as far as I'm concerned. It's where I solidified my thoughts on investing and I was extremely lucky to be able to work at a company where I was allowed to do that, in print for all the world to see, every month for almost 5 years. I'll always be grateful to Haywood Kelly, Pat Dorsey, Cathy Odelbo, and Joe Mansueto at Morningstar for allowing me to do it my way, letting me just kind of do my own thing while still getting a paycheck every couple weeks. It was like being an entrepreneur without the downside risk. And at the time I came to Morningstar, I needed that because I had no savings to speak of and needed a steady paycheck.

Anyway, we also do a lot of thinking about moats at Sellers Capital. In fact, it's the first thing we always consider before going further in our analysis. First we look at the moat, then the management team, and then the valuation comes last. I'm not going to go into all the finer details of how to judge whether a company has an economic moat or not. I've written extensively about that before, both at Morningstar and since then. It's as much an art as a science because there is no clear cut line delineating a wide-moat company from a narrow-moat company from a no-moat company. You can go back and read some of the articles I have written about moats, and lots of articles have been written about economic moats by other people as well. Or you can go to the source of the whole idea, Buffett, and read his old shareholder letters where he talks about moats extensively. Most of the things

I've written about economic moats is just borrowed, or stolen, from him. They say good artists borrow, great artists steal. Maybe that's true of investors, too.

But here's a thought that I haven't written about before, and I haven't seen written about by anyone else, either. A moat is, for all intents and purposes, the same thing as having tangible assets on the balance sheet that could be liquidated. You can't actually liquidate an economic moat or sell it off piecemeal, it's attached to a company and can't be separated out, not like real estate or an oil well or a factory. But the concept is the same because it provides a measure of downside protection. A moat allows a company to generate returns on capital above the cost of capital for many years, and that makes it easier to see the future, so the cash flows are more predictable and less volatile, and this makes it easier to come up with a worst-case scenario valuation that you feel confident in. You're far less prone to being dramatically wrong about your fair value estimate as long as your conclusion that a company has a wide moat is correct. With wide-moat companies, as long as the moat is intact and the management team doesn't destroy it, you will have a hard time losing money if you don't overpay for the stock.

This is not the case with a no-moat company. If there is no economic moat, there is nothing to protect a company from the ravages of capitalism. It's very, very hard to feel comfortable that you're accurately estimating the downside risk when a company doesn't have a moat. So we put them into the "too hard" bucket, as Buffett and Munger would do. The downside is just too hard to predict with any accuracy, and so we avoid trying to do so. The only time we'll buy a company with no economic moat is if it has assets on the balance sheet that could be liquidated for more than the current stock price.

So you can think of a moat as a proxy for tangible assets. If a company has neither of these things, no moat and no clearly identifiable liquidation value, we won't buy it no matter how low its P/E ratio or price-to-book ratio might look. We're not smart enough to quantify the downside.

So really, both types of stocks we buy are two sides of the same coin. It's just that the downside protection comes from a different source. We're agnostic about whether it comes from having a moat, as it does with Paychex or Microsoft or Moody's or Morningstar, or whether it comes from an asset value, as it does with Contango. The concept of downside protection applies to both asset plays and moat plays. And that's why these are the only two types of stocks we'll buy.

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