MicroCapClub Investor Transcript

Bill Nygren – The Oakmark Funds

"Value Investing Principles and Approach"

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Saurabh Madaan: Hello and welcome, everyone. Today we have a very special guest with us here today, Bill Nygren. A quick round of introduction for Bill. Bill has been a manager of the Oakmark Select Fund since '96, Oakmark Fund since 2000, and Oakmark Global Select Fund since 2006. He is also the Chief Investment Officer for US Equities at Harris Associates, which he joined in 1983. He served as the firm's Director of Research from 1990 to '98. Bill has received many accolades during his investment career, including being named Morningstar's Domestic Stock Manager of the Year for 2001.

I would just add a footnote to that. A lot of people who earned that distinction, if you talk to them kind of 10 or 15 years down the line, there are very few who are still performing as strongly as Bill has been.

He holds an MS in Finance from the University of Wisconsin's Applied Security Analysis Program and a bachelor's in Accounting from the University of Minnesota.

Just personally speaking, I've read a lot about investing over the past few years, but I think Bill is unique in his ability to talk about the story of value investing in technology. We are very, very honored to have you here with us today. Thank you for being here.

Bill Nygren: Thank you. Great to be here.

Saurabh Madaan: Excellent. I thought we might begin by just asking you to talk to us about what got you started in value investing and maybe we can pick up the story from there.

Bill Nygren: Sure. I, as a kid, was always more interested in numbers than words. That quantitative bias led me to baseball as an interesting hobby, because baseball, same situation recurs so many times, you get good quality statistical samples. Statistics mean something. Somebody who hits 300 is a better player, more valuable than somebody who hits 250. I was always interested in baseball statistics. Growing up in St. Paul, Minnesota, in our newspaper, the stock quotes were always right next to the baseball box scores. I was very interested because there were all these numbers, they moved around every day. When I asked my dad what they were, he said they represented money. It got really interesting.

I started getting interested in all kinds of different ways that you could put capital at risk, and whether that was in things we'd call gambling, like slot machines. There was a family trip to Las Vegas, where we were visiting one of my cousins who is in the Air Force. My dad took us across the street to, I think it was a Kroger grocery store. My older brother and I, he's like, "Kids, I'm going to show you why you don't want to gamble." He puts five nickels in his hand and starts putting them into the slot machine. The first one that he puts in, seven come back out. The next one that goes in, more comes out.

This object lesson gone awry was turning me into a slot machine fanatic. It took him half an hour to get rid of all the nickels that came out. It was like he was getting madder, madder. I'm like, "Dad, you should stop, we're way ahead." He's like, "No. I'm going to show you this is stupid," he keeps putting the money in. That fascination then was, why was gambling stupid? I knew my dad was smart.

I started investigating to see that the casino keeps 15% of the take on blackjack, 1 1/2% on craps, about the same on blackjack. Horse racing is something in the upper teens percentage. Then there are these things called stocks, that if you did average in stocks, your money was worth maybe 8% or 10% more a year later rather than less. That distinction between gambling investing, putting capital at risk either way, but in investing, expected returns were positive.

From the time I was in high school, I started reading everything I could about investing. I'd go to the local library, take a couple of books home. Back then the investing section was probably just this wide, so it wasn't heroic to think you could read everything about investing that was available. As I read about investing, of course, all kinds of different approaches, the ones that made sense to me were the value ones. Because I grew up in a middle class family, going shopping with my mom, if grapes were on sale this week, we'd buy more than we usually would, and if cherries weren't on sale, we'd wait until they went on sale.

This idea, that as a consumer you could get more for your money if you paid attention to price, was something that was very appealing to me. Of course, that's what value investing is, it's being patient and wanting to make sure that you're actually getting more value than you're expending to make a purchase.

I thought that if I wanted investing to be a career that it only made sense that I would learn the language of business, which to me was accounting. I got an accounting degree as an undergraduate. It still surprises me today how many people go into finance and don't have a good solid understanding of accounting. I think it's been very helpful through the course of my career.

Then got a master's degree at the University of Wisconsin; was part of their Applied Securities Program. Worked a couple of years at Northwestern Mutual Life. During that experience, really learned how important it was that, if you're going to be a valuable research analyst to portfolio managers, you have to have the same investment philosophy they do. What they did at Northwestern Mutual was quite a ways away from value investing.

When I'd look at a company say, "Hey, nobody on Wall Street is recommending this. The assets, the real estate they own looks like it's worth more than the stock price." They would say, "Well, let's wait a while. Let's see if we can get a couple of Wall Street recommendations on this first." Then a year or two would go by, the stock would have gone up somewhat. It was becoming a little more popular, they'd asked me about it again. I'd be like, "Well, at this price, it's not very interesting to me, because it's no longer a value story. I can't tell you the real estate is worth more than we're paying for."

Saurabh Madaan: Hold on, let's just pause there for a second, because this reminds me of something that I had to ask you and maybe it will be entertaining for the group as we move forward through the conversation. I'm going to phrase my question trying to be in a more entertaining way rather than necessarily factual. I'll let you sort the facts out later.

One of your analysts wrote to us. They said that Bill really likes and remembers the facts when you present something to Bill. They presented a stock to you at $10. About six years later, when the stock had grown 20 times, you still remembered the presentation, and you liked it even more so you purchased the stock at $200.

Bill Nygren: I did. Thanks for reminding me.

Saurabh Madaan: Is that correct?

Bill Nygren: Yeah.

Saurabh Madaan: What is the message you're trying to send here?

Bill Nygren: Well, things change over time. The stock that we're talking about is Netflix. One of our analysts presented it about seven years ago. His story was basically everybody's focused on the wrong numbers here. What you should look at is the market thinks HBO subscribers are worth, whatever the number was, I don't remember, $800 a sub. Netflix subs are worth a small fraction of that in the market. It seems like that's wrong. Netflix is growing so rapidly; HBO isn't.

At that time, we knew a lot of people in the media industry because of investments that we had, we talked to them. They said, "Netflix is hugely risky. HBO spends about three times as much on programming as Netflix does. They could basically squash it any time they want to."

By the way, look at their churn statistics, especially in the month of February, when they released House of Cards. This is a one-show company. Most of the media companies that have sold programming to them regret the decision. They had no idea it would be sold to so many people. They're going to see enormous increases in programming costs. When House of Cards goes up for rebid, they'll easily be outbid by one of the bigger studios.

We looked at it and said, "The stock's cheap, but it's really at a very risky stage of its lifetime." One of the things we do at Oakmark is, the risk and reward have to be in balance to make something interesting. You can't go into a high-risk situation for a small reward. You'd only want to be in a high-risk situation if the reward is very, very large. As we looked at it, the risks were just too high.

As I was saying earlier, I don't even think of this as a mistake. I think you learn a lot about investors by what they look back on and say were big mistakes. A lot of people would say this stock went up 10-fold, 20-fold maybe, not buying it was a big mistake. Well, it didn't meet our criteria. When we researched it thoroughly it didn't have the risk return profile that we were looking for.

Fast forward to just a few months ago, one of our young analysts comes into a large room. There are about 20 of us, the investment team, that sit around the table. He'd written a report on why we should buy Netflix. I'd gone through it. Of course, it's hard to get out of your mind that you missed buying it at 5% or 10% of the current price. The report didn't really jump out at me. We go into the room and he starts by saying, "People subscribe to HBO now and they pay $15 a month. They subscribe to Spotify, they pay $15 a month. Sirius XM, more like $20 a month." Those same people, when they rate the services they subscribe to say Netflix is more valuable to them. That if Netflix, instead of charging $10 a month charged $15, it would be selling at 13 times earnings.

It was like the bell went off. It's like that's a way of thinking about the business value there that I had never thought of. That the willingness of Netflix to sacrifice current income by not charging as much as they could for their product, to instead grow their subscriber base 25% a year, get to the point today where the moat has become almost so large that it's impossible to think of somebody displacing them. Eight billion dollars a year on programming, that's almost now two to three times what HBO spends on programming. And because the sub base is growing so rapidly, the cost per subscriber is going to be substantially less for any programming that Netflix considers buying compared to HBO.

Now clearly, that's a stock most value managers won't touch. It sells at almost 200 times earnings, markets at 18 times earnings. It's just a name they don't even think about. But I think as value investing has evolved more of the interesting opportunities today are coming from these businesses that the P/E ratio does a really poor job of assigning value.

We've talked about companies that have non-earning assets. I was asked not to talk about this company, so I won't. But there are companies that have a lot of cash on their balance sheet that earns almost nothing today. So the P/E investor really is getting cash for free. There are companies that are investing in unrelated businesses. It's costing them current income. The accounting doesn't set up an asset to represent the venture cap type, investment that they're making. There are companies that are investing in largely unrelated businesses, like a Netflix, sacrificing current income to grow scale.

When you can find companies with those characteristics that happen to have large P/E ratios, you get in kind of this weird area where most value investors won't buy it because the P/E ratio is too high. Sometimes growth investors aren't excited about them anymore because they aren't in that upper decile of growth rates.

I think of it as kind of an overlapping area between growth and value, where the growth rates are higher than value investors are used to, the prices are cheaper than growth investors are used to. The names kind of fall through the cracks there. You find a lot of our portfolio at Oakmark has large pieces of hidden value in assets that aren't currently earning anything.

Saurabh Madaan: Just to take that thought one step further, a lot of companies, and I'm thinking Amazon, for example, which have a large user network, are also in a position where they can invest in content. I'm not necessarily posing this as a question of Amazon versus Netflix, but I'm just wondering about Netflix's moat in general, independent of their valuation, could there be danger to Netflix from other people who could come in and compete with them on as big a scale as Netflix has?

Bill Nygren: Right. I think that is a risk. But when you look at the scale that would have to be today, it's a pretty small number of companies. Amazon is probably large enough to do that, maybe Facebook, maybe Alphabet, maybe Apple, but to go in and say, "We're going to commit $10 billion to programming without an obvious revenue source to offset that," there aren't many companies that can take that kind of risk.

Then I would also add, people are paying today $100 to $150 a month for their cable TV subscriptions, this doesn't have to be a winner take all market. You can have a $15 Netflix subscription, and maybe a Hulu subscription, and Amazon Prime, there's no reason to think that it has to be one versus the other. I think there are a small handful of companies that will be disruptors relative to the current cable TV model that we have and there'll be more than one winner.

Saurabh Madaan: All right. I know I paused you there while you were continuing your story, so I just want to throw the gauntlet back at you.

Bill Nygren: We had kind of this different style of investing. When I got an opportunity to interview at Harris Associates, and all of the companies that they were talking about were the same companies that I had been doing research work on and you could see kind of a meeting of the minds, I knew that was a way that I would be able to maximize my value as an analyst, is working in a shop where other people were like-minded.

I think that's been one of the biggest reasons that Harris and Oakmark has been as successful as we've been, is our brand means something. Oakmark, anybody who hears that knows it's long term value investing. It doesn't matter if it's our international fund, if it's a domestic fund, or funds that combine stocks and bonds to have more of an income element, it's all long term value investing. That helps in sort of multiple ways, a network effect where smart analysts know that other value analysts are at Harris Associates so they want to come there to be in like company. Investors know that the Oakmark Fund is a value fund, so maybe they should look at Oakmark International, if that type of investing works for them.

One of the big advantages we've had is, because of that environment where everything we do is value investing, we don't lose a lot of people. Our top investment decision makers, from the time I've been there, have always worked with each other for more than a decade. When you work with somebody that long, you get to know their strengths and weaknesses, you know their biases, you know what you can learn from them, bouncing ideas off of them. It effectively gives us a moat because you couldn't just take a similar group of talented people, throw them in a room and have something as successful as Harris and Oakmark is because the group has worked together, and that's a big asset.

You think of most mutual fund companies, it's almost like they're trying to fill the Morningstar style boxes: they'll have a high turnover growth fund, they'll have a long term growth fund, they'll have a value fund, they have all the different boxes filled. But when you do it that way your brand loses value, both in terms of attracting customers attracting employee talent. I think that's something that's really helped us.

Saurabh Madaan: Do you see that this philosophical evolution in value investing is going to a different level now? People were talking about this in 2000. I think I ask this question with a lot of humility in fact and skepticism, because in 2000 when people were investing in technology companies, there was a case to be made that value investors, they were saying they were not getting in on the internet. What you're saying is that there is a similar case today, but the situation has changed where these companies are big enough, they're producing cash and real earnings. Lay that out for us. Help us understand what the reality is now.

Bill Nygren: Sure. To that specific question, and I want to go broader with that in a minute, but when I started in the business in the early '80s, most of the companies we think of as tech leaders today were of a size that the ability that they could be displaced by someone else was a very real risk.

I used to joke about two high school kids in a garage coming up with an invention that would eliminate one of the industry leaders. You think today of the market position that companies like Intel have, or Texas Instruments, or Microsoft, two kids in a garage aren't going to displace these companies. One of the things, as a value investor, you're always thinking out like five to seven years into the future. How is the company likely to change? How will its market share change? How will cash flows change? How does the addressable market change?

The tech companies back in the '80s, your vision got really cloudy fast because the industries were changing so much. I think now that companies are of a scale that that can't happen. But the evolution of value investing, I'd like to take back to more just the evolution of investing. If you think this asset category called stocks that got me interested in investing because it had such a high expected value, 50 years ago maybe, the only way you could access that was your local stockbroker. That was a pretty high cost way to access.

Then came along mutual funds, which was a much lower cost way to access this wonderful asset category. Just by being a mutual fund and passing along the cost savings you got by aggregating all the customers was a tremendous advantage for the customers and gave mutual funds a big leg up on the local stockbroker.

Then, you take that to a farther extreme and indexing came along. Just aggregating isn't enough to add value anymore. That's not enough to charge your active management fee. Because we can aggregate, do it in a no-cost way, pass the savings on to you and we will be better than the average mutual fund. So then value investing says, "Well, we can one-up that. We'll just buy the lowest quartile of P/Es." That probably still worked in the '80s domestically, maybe in the '90s internationally. You just put a portfolio together of all the low P/E stocks, you be patient, you hold them until they're not low P/E anymore, and that was enough to work.

Then the ETFs came along, said, "We don't need to pay stock pickers to get low P/E stocks. We can get a computer program to pick low P/E stocks. We'll give that to you for almost free." To earn an active management fee, you've always had to stay one step ahead of the computers.

I think one of the frustrations you hear with a lot of value managers today is, what I did 20 years ago isn't working anymore. I think that's always been the case. What worked 20 years ago very rarely still works today. Twenty years ago you could just buy low P/E, low price to book value stocks, and that was enough to be attractive. Now, you can do that for almost no fee and the computers have gotten smarter about combining low P/E, low price to book with some positive characteristics - book value growth, earnings growth. The simple, obvious stocks that look cheap generally deserve to be cheap.

When I started at Harris 30 years ago, we were one of the earliest firms to do computer screening to find ideas. Once a month, we would pay to have a universe of 1,500 stocks rank ordered by P/E ratio. As analysts, the day that output came in, we would all be crawling all over it to look at what the new low P/E stocks were. Today, any of our administrative assistants could put that screen together in a couple of minutes. Because it's become so easy to get, it's not valuable anymore. I think it's probably not just investing, that's through a lot of industries, as information becomes more easily accessible it loses its value.

Today, the more interesting ideas, to me, at least, are these ideas where a P/E ratio misses it, or there's a non-earning asset. We talked about cash. We talked about unrelated investments. We talked about income statement investing where you're offering the customer an unusual bargain to grow scale and grow the size of your moat. That's kind of evolved into the technology area today because these companies have become big enough to think about what they might look like five to seven years down the road and think, it's really not much riskier to try and guess what Intel will look like five years from now than it is to try and guess what Procter Gamble will look like five years from now.

All industries are undergoing rapid change. The idea that technology is outside of my sphere of competence, because it changes so fast, I think has become an outdated idea. We own a lot of technology names at Oakmark. Most of them follow the idea that there is a way to look at the assets kind of piece by piece that gets you to a core that you're not paying nearly as high a multiple on as it appears on the surface.

Saurabh Madaan: I see that in your portfolio, you not only have technology companies, but you also have the traditional value investing names. I'm thinking, for example, Citigroup and AIG. Could you, maybe for the purposes of our audience, in maybe your professor's hat or teacher's hat, and walk us through one of these thesis as to how do you analyze it in a way that maybe we can all learn from?

Bill Nygren: We felt that the financial sector became very attractively valued after the financial crisis. Obviously, the stocks had been horrible performers. There's always a tendency of investors to look too much out the rear view mirror instead of trying to guess what lies ahead through the windshield. Financial stocks had been a disaster, so a lot of people didn't want to own them, even value investors. You'd often hear something like, "I really made a mistake owning the financials in 2007 and '08. I had no idea what they were doing. They're too opaque. We're just never going to buy them again."

That never really resonated with us. To us, we didn't see the housing crisis coming. I wish we'd been smarter on that; we weren't. But if you think about what banks do, I mean, they take in deposits, they generally lend mostly against real estate, if you knew real estate prices were going to fall by 20% or so, you'd know you don't want to own banks. It didn't matter what kind of securitization happened, the main asset category that they owned on a levered basis suffered unprecedented decline.

Saurabh Madaan: Right.

Bill Nygren: We said you don't have to be afraid of banks if you don't think the same circumstances are going to recur. On a price to book value basis, banks used to sell at two times tangible equity, pretty consistently. They vary around that. They'd be cheap at one and a half; they'd be expensive if they were much more than two. Most of them were selling in the marketplace at a large discount two tangible book. So our interest was piqued, because it was contrarian and the pricing was out of line with historical guidelines and very much out of line on the cheap side.

We started talking to executives of those banks. You could see a dramatic change in behavior. That they realized they'd made mistakes going into the housing crisis. They were lending without taking into account the probability that the person they were lending to would pay them back. It was more just saying, "This house is worth $1 million. We'll lend 800,000. If they don't pay us back, somebody else will, we don't have to worry about it." But they're getting back to good old-fashioned lending standards.

One of the other reasons banks had gotten riskier was the dollars of assets that they had relative to the dollars of equities. That ratio just kept growing and growing. Very quickly, the banks - partly of their own accord, partly because of regulation - dramatically increased the amount of capital they had relative to the amount of loans outstanding. So instead of 5% equity against the loans, they were at 10%. So if you have twice as much capital, there's half as much risk.

People were afraid that with the regulation that the companies weren't ever going to be able to get capital out to shareholders. One of the things we heard a lot as we were trying to explore bear cases for this industry was they're going to get regulated to the point that they basically trade like electric utilities.

Saurabh Madaan: Wow. Okay.

Bill Nygren: We looked at it and said, "The average bank is at about half of book value, the average electric utility is at about one and a half or two times book. It wouldn't be so awful if they started trading like electric utilities. So we started to not be too concerned about regulation and thought, we're buying at less than book value, absolute worst case, if overregulation makes these companies not want to be in these businesses, they can stop making new loans, their loan book can run off. In company after company, as we started penciling out what that would mean for cash flows, we said in this downside scenario, we still come out okay, given that we're buying at such a discount. On the upside, if earnings get back to where the companies can earn 15% on equity and sell it book and a half or two times book, there's very significant upside.

One of the things that was important to us, as we started interviewing management teams and listening to presentations that they'd made, was that we were invested with management teams that were okay with growing through shrinking. So taking capital reducing the equity base. Because it's dangerous, if you're financial, to go out just try grow your assets. When you really try push the accelerator down on growth, you often make mistakes with who you lend to. But growth through repurchasing your shares at half a book value, that increases the book value of the remaining shares, it decreases the risk profile of the company.

We're always focused on trying to invest with managements that want to maximize long term per share value. In this case, we thought that meant having a willingness to repurchase shares. So we started investing in the companies that were repurchasing shares. That became a more popular way for the banks to reinvest their capital. So what started out as an investment in JP Morgan quickly became JP Morgan, Bank of America, Citigroup, Wells Fargo. We didn't own all of them, but we owned most of the major banks with an entry price significantly under book value.

As this story progresses, last year after the elections, regardless of what you think of the politics, there was more confidence in a growth outlook that is good for banks now. It means higher interest rates. It means higher asset values, which helps the loans that are on their books already. Probably means less regulation in terms of being able to get capital back to shareholders. We've seen a tremendous run in these names.

But still, most of them are selling at less than 150% of tangible book. Most of them will still see earnings growth if interest rates normalize to a 2% or 3% inflation level. Most of them still have significant excess capital on the balance sheet that either ought to be valued by investors through requiring a lower discount rate, because these are less risky businesses, or could potentially be returned to investors, which then it's dollar for dollar that you realize value for excess capital.

Saurabh Madaan: Some of them also have deferred tax assets, right?

Bill Nygren: Right. The deferred tax assets, another non earning asset, along that theme. They're both deferred tax assets. And excess capital really aren't generating much today in the way of income, so you miss that if you're just looking at the banks selling at a 12 or 13 times P/E multiple. Now there's some risk with the tax bill that the House passed yesterday that would take corporate rates down to 20%. You might see write offs on some of these deferred tax assets.

The flip side of that is the financial industry in the US is one of the highest taxpaying industries, paying quite close to the statutory rate. Normally, it takes a number of years before a competitive industry returns a change in tax policy to the customers. Even though a large holding for us like Citi would see several dollars a share of book value go away if the tax laws end up getting passed, like the one did yesterday, we think that would be more than made up by the increase in their after-tax earnings that they would benefit from until the banks start competing that away from each other.

Saurabh Madaan: So along those lines, we talked about tech companies, we talked about financial services companies, but you also have high-quality compounders in your portfolio. I'm thinking companies like MasterCard and Visa, for example. Talk to us a little bit, Bill, about a company like Visa and MasterCard. We know that most of the transactions in the world are still based on cash. I think about 80, 85%, somewhere in that ballpark. The market understands the value the growth that is possible. But these are not selling at low multiples right now. So why do you continue to hold these? Will there come a multiple in terms of valuation where you will say that, yes, this is overvalued?

Bill Nygren: Sure. Going back to our previous discussion about Netflix and can there be competitors, even though card processing, payment processing, is just as much a network business as companies like Visa and MasterCard, it's a great example, but they're not fighting each other, they're both fighting cash, and they are two big winners.

Saurabh Madaan: Yes.

Bill Nygren: The way we look at trying to assign values here is, in any company, we make a projection out two years, all of the financial statements, and then for the five years following that, we assign an estimated growth rate in operating earnings for the company, make an estimate of what the cash needs or cash production of the company will be if they meet our targets, and then get to a growth rate in business value per share.

We say our crystal ball gets too cloudy after about seven years for any company to make much of a forecast beyond that time period. So the assumption is that at the end of that seven year period companies sell at pretty similar multiples to each other. We've made estimates, starting with how much of world commerce is being done by cards today and what an extrapolation of those trends would likely produce for revenue growth for MasterCard and Visa. What kind of incremental margins these companies are capable of having? Again, if they aren't investing in adjacent technologies.

Based on that, and just on mathematical model that we use, produce what kind of premium to the normal P/E this company would be deserving of selling at today. Despite MasterCard Visa selling at pretty strong premiums to the market, they still haven't gotten to that level that we would call fully valued. Now I would say we got a little bit lucky here, where the market gave us a great opportunity to buy these companies back when regulation called the Durbin bill-

Saurabh Madaan: Credit card act.

Bill Nygren: Yeah, was going to dramatically reduce what they could get on debit cards. Both MasterCard and Visa fell to prices that they weren't much of a premium to the market at the time we bought them. So we've benefited from business value growth and stock prices both growing at a pretty similar slopes, with the stocks never getting to a level that we would be wanting to sell them.

Most of this time, they haven't been cheap enough that we'd say, "If new money came to us today we had to start a portfolio from scratch, would we buy this company?" But they've kind of stayed between buy and sell targets for an extended period of time. As each year rolls by, our analysts then start to look at a new year, the new year that seven years out, the confidence hasn't wavered at all that these two companies are going to continue to dominate payment processing as much as they do today.

Saurabh Madaan: Let's put some numbers so that we get some ballpark to what you just said. Let's say their revenues keep growing at double digits for five years and they keep getting some operating leverage in the business. So earnings grow at, say, around 15%, let's say, for five years, so that would mean the earnings have doubled roughly in five years.

If the multiple goes, let's say, from 30 to 20, because you say after seven years you're approaching market multiples, so you get 100% upside and then 50% contraction due to the multiple. That net 50% in five years, does that cross the hurdle? How does one think about it? Where would you say that ... I'm just putting some numbers to ask the question where would one make the call and say "I'm going to sit in cash and not stay invested."

Bill Nygren: The answer gets pretty complex and quantitative, but if there's ever a group that wants to walk through it that way, it's probably this group. We start with the idea that if you want to invest capital at no risk for seven years, the US government bonds for US investors is the way to do that. If you do that today, you're earning something around 2%, maybe a little bit less than that. To take the risk of a normal equity, you need to earn a premium to that.

We start, let's say, the 2% level, well, we actually make an adjustment and say, "A 2% seven-year doesn't really make sense in a 2% inflation environment, so we're going to pretend that those bonds are at 3%." We don't want to be investing based on an interest rate for that bond that we don't think is long term rational.

So if we say the bond would be at 3%, we want about a 4% premium, which is in line with history for stocks, we'd say, "We want a stock to earn 7% a year to call it fairly valued. We want to sell a stock at about 90% of what we think is fair and buy it at about two-thirds of what we think is fair."

When we go through that math of saying, "Based on our seven year forecast for MasterCard, that we think it makes sense that it would sell at 20 times pre-tax earnings two years from now," the math behind that would say, "Then you would still earn your appropriate risk premium to the seven-year bond if it today sold at that price.

So on our math, something with the growth characteristics of a MasterCard or Visa is worth something on the order of 20 times pre-tax, even though the rest of the market sells it somewhere around 12 or 13 times pre-tax.

Saurabh Madaan: Even five years from now, you think?

Bill Nygren: Our five-year from now guess for the market would be based on a seven-year that's at 3%, and it would still be at about that level.

Saurabh Madaan: I see. Because these are high quality compounders?

Bill Nygren: No. I'm saying market would still be at about 12 times level. If five years from now we still thought we had seven years of runway ahead of us for supernormal growth at MasterCard and Visa, then we'd still have a very high relative multiple on it. But the way our math works today, we're assuming that as each year that goes by that they're growing 15% or 20%, the years, eight years out, nine years out, those are normal growth years.

One of the reasons it's been such a good holding for us, we've held it five years or so, is as every year goes by we start that you're worried about disruption risk from alternative payment processing systems. At the end of the year, we end up saying the moat that MasterCard and Visa have is just as strong as it started at the year, so we don't have to lower our multiple. If the company's growing 15% a year and you aren't lowering your multiple, your business value is growing 15% a year. You're putting yourself in a position to get lucky if you buy these companies that have disruption risk and then that disruption doesn't happen.

Saurabh Madaan: Yeah, I see what you're saying. Great, thank you. I mean, this was a great example, just to sort of walk through as to where you bought, what was the motivation, how you think about long term, short term valuation, and what happens in the course of holding an investment, how you make a decision. So moving on from there, a couple of related questions and then we'll open up to the audience. I wanted to ask you, who are some investors that you personally admire or look up to, or that have been influential for you?

Bill Nygren: I would start with what I jokingly refer to as the "usual suspects." You talk to any value manager and they're going to tell you they were strongly influenced by Warren Buffett, Benjamin Graham, John Templeton. Those are my heroes. I've read almost anything that they've written. They have had a very dramatic impact on my way of thinking on Harris Associates and Oakmark.

I think value managers especially tend not to go a lot broader than that. To me, that's a mistake. After you've read a few books about Warren Buffett, you read the next book, and maybe you learn what his breakfast habits are or what TV shows he likes, but you really have the foundation for what's made him a successful investor already. It's like comfort food. You know it's not really good for you, but there's something about reading another Warren Buffett book that makes you feel good as a value investor.

The investors who are very different than us tend not to want to emulate their style of investing. But I find I learn more when I read books about some of the great hedge fund managers, a Paul Tudor Jones, a Michael Steinhardt, George Soros. It's not that there's not nearly the overlap of the circles with Berkshire

Hathaway and the way we differ from them. I mean, there are differences at the edges, but it's a very similar thought process. The circle with Michael Steinhardt still overlaps, but it's not nearly as much.

I've never read a book about one of those great investors who weren't value investors that hasn't made me think about some detail of our investing process. For example, Mike Steinhardt was famous for never wanting to make an investment until he'd sat down with the person he thought was the smartest bear on the stock and understood their case.

We try to do that in our process at Oakmark by whenever somebody is presenting a new idea to us, we assign the task to someone of saying "Your job is to now come into the room and explain why this person is wrong. We want you to argue to the best of your ability to prevent us from making this investment." Hearing the two sides argue with each other is a much more productive atmosphere for learning about an investment than just hearing the bullish case.

Paul Tudor Jones, there's a famous picture of him sitting at his desk and pinned on to the bulletin board behind him is a sign that says "Losers Average Losers." How many times have you heard a value investor say "The stock's down 20% today, but my estimate of business value is only down 10%. So it's really cheaper today than it was yesterday."?

One of the great things about data analysis having become so cheap, and us having the history that we have, it's really easy to analyze our own history now and be more data driven in our own decision making. We can look at it and say, "Okay. We've got 20 years of history here, about 130 stocks on our approved list, what happened when this fundamental started to deviate from what the analysts suggested were those good opportunities to add?" We looked at it and said, you know what, that was really more of an indication that we were off base in our analysis and it was going to get worse after that, before it got better.

Adding some guardrails to our process, of saying when things start to go negative on the fundamental story, we don't ever want to be the investor that says "If the stock falls 20%, it's an automatic sale." But if the fundamentals start to deviate and the story isn't playing out the way we thought it would, the fundamental story, we want to increase the pressure on the analysis, to make sure more people in the firm are thinking about it, forcing more meetings with the management team, forcing more of a devil's advocate thought process, with the idea that one of the most productive ways we can add to our performance is to get rid of our losers earlier.

I get teased, and we're not momentum investors by any way, shape, or form, but I do believe there is such a thing as fundamental momentum. That companies that are performing well are more likely to continue performing well, and companies that are performing poorly are more likely to continue poorly.

Saurabh Madaan: Newton's first laws of motion.

Bill Nygren: Yes. So it's not a new concept, but at Oakmark, it's applying something that's thousands of years old. You can take these nuggets. George Soros, with his theory of reflexivity, which was written up in a book hundreds of pages long that I find very difficult to follow, but way, way oversimplified, says that what's going on emotionally in investors can actually influence the real economy and that psychology has a real effect on the economy, and when direction changes, a simple psychological change can be enough to bring about a real change in the economy.

When you go through tough cycles like '08 '09 and people are always saying, "Sure, if things get back to normal, then everything out there is really cheap and the names you own would be the right basket of names to own." But what can ever change to make things get better? Just thinking that things could change to get back to normal can be an impetus to start that process happening. In the same way that if you've gone through an extended recovery that's created tremendous excess in the economy, just people starting to worry that things go back to normal could be enough to slow the speculation, slow price increases and bring things back to normal.

Those are things you don't usually read in books about great value investors that I think can really help refine a value approach. Like I say, I think I learn more reading about how great investors who weren't value investors invested than I do by reading the 200th book about value investing.

Saurabh Madaan: That's a very good suggestion. Final question is, what does your day, what do your routines look like? What are some of your reading habits? Any advice you have for those of us here and people who are going to be watching you on YouTube, how they can be better investors?

Bill Nygren: So the alarm goes off at 5:52 in the morning. That's so that I can watch the top 10 plays of the day on Sports Center before I get started on the business part of the day.

Saurabh Madaan: Good.

Bill Nygren: I read The Wall Street Journal, New York Times' business section, Chicago Tribune, CNBC's top stories of the day, Real Clear Market's top stories of the day. Do most of that before I go into the office. Do some of it while I'm riding an exercise bicycle in the morning. Always trying to multitask. Try to get into the market a good hour before the market opens, which is 8:30 Central Time - we're in Chicago - so that I can see if investors have given us new money to invest, have taken money away. We have to figure out how to manage cash flow changes. Want to make sure I've had a chance to read the important first call notes on the companies we're invested in or considering investing in.

Then most of the day at the office ... I mean, you see movies and they show pictures of what asset management firms look like and you see this trading room, people are on two phones and they're getting angry throwing things. Our office is more like a library.

Saurabh Madaan: Ten different screens.

Bill Nygren: Yeah, all the screens all around them, everything electronic flashing. You walk into our offices and it's mostly people sitting at a desk reading, with a pile of papers stacked on their desk. Most of the day is reading. It's reading about companies we're invested in. It's reading about companies that are trying to challenge those companies or disruptors. It's reading stuff written by other investors that we admire, of companies that they own that we don't, trying to see if we missed anything, if we can learn something from what they wrote. It's sitting around in a room with other analysts bouncing ideas off each other.

Which again, is one of the great advantages that we have at Oakmark, is either direction outside of my door, I can walk all the way around the office and find another value investor who's got a slightly different perspective on things, who knows me well enough, who knows Oakmark's way of investing well enough, that we can really learn from each other bouncing ideas off each other.

You hear about like the investment banking firms where people are still at their desks at midnight. One of the nice things about reading being a big part of what our job is, is you can do that anywhere. I've had the good fortune of being able to have a lifestyle that I'm home at dinner time almost every night, but I might be reading an annual report before I'm falling asleep.

There is a tremendous blurring. It's probably true in any industry where people are really passionate about what they do. Tremendous blurring between business time and private time. I might be at the office having a personal conversation with my dad or somebody else in the family. You can say, "Is that really fair to your employer to be taking that time?" But at home, I'm watching a baseball game and reading annual reports, or other reports by other investors that whole time. I go shopping and I can't help but see what new products are out and how they're priced compared to old products? Or if you're in an off-price store, that there's suddenly a tremendous amount of inventory from Nike that there wasn't before, does that mean something?

It's just I think to be a successful investor, it has to be something you love so much that you can't ever really turn it off. You don't want to turn it off. You get enough enjoyment from it. It doesn't create stress in a way that you feel you need to get away from it to relax. So those are my days.

Then every once in a while, it's traveling. It's going out to meet managements. We like to sit across the table from the CEOs and CFOs of the companies that we're invested in, hear in their own words what's important to them, what their goals are.

I was out in New York the past couple of days meeting with the managements with a lot of the cable TV investments that we have, we own QVC, the TV and internet shopping network, Charter Communications. Recently meeting with the management GE, which has been a breath of fresh air, in terms of the change at the company, but not entirely pleasant for us because it's been a position we've owned for a while.

But to us, there's no substitute for the sitting across the table and getting a feel of what's really important to these people. Again, along the lines of to earn an active management fee, you've got to be able to do something that a computer can't do. After you've interviewed 100 investment - not investment, 100 corporate management teams, you really start to have an ability to say, "These guys are really above average. These not so much." You don't have to be perfect with it, but if you can be better than 50/50 at how you bucket them as above average and below average, it can be a tremendous addition to what's largely a quantitative approach to investing.

Saurabh Madaan: Great. I think your love and passion and enthusiasm for investing is very obvious and it's very contagious. Thank you so much for sharing your thoughts with us. If you have any last minute questions in the audience, we're open. Yeah. I'll just repeat the question. There was this talk about is there a bubble in the market, everything seemed overvalued. Other people are making a lot of money out of bitcoin. What do we do right now?

Bill Nygren: We're generally in the camp that if you can't understand how something is priced, it's better not to talk about it. But intellectually, I'm more in the camp with Jamie Dimon, that I have a very hard time understanding why Bitcoin is valued at whatever price it ends up being valued at. You're not going to find it in the Oakmark portfolios.

I don't think markets today are in bubble territory. P/Es are only slightly higher than they've averaged in the past 30 or 40 years. I think, with interest rates as low as they are, inflation as low as it is, it makes sense that P/Es would be somewhat elevated. Not to mention the things like all the technology companies that are making so many investments in areas tangential to their basic business, that are depressing current earnings.

One of the statistics I put in the last commentary we wrote was that if the four FANG stocks weren't in the S&P 500, the S&P multiple would be about a point a half lower. Which when you're talking about a multiple that's maybe two or three points elevated relative to history, a point and a half is a big deal. I don't take the FANG stocks out just because they look expensive on a P/E basis, but P/E is such a bad metric for measuring the value of those four companies.

We don't think the market's really elevated. The recovery is nine years old, but the magnitude of the recovery has been relatively trivial compared to historic growth of the economy. Recessions come about to correct excesses in the economy. It's hard to see those excesses being created.

To me, the more fascinating part of your question is, how do you deal with a bubble like 2000 where a strict disciplined valuation approach to investing just says "None of these names make sense to us. We can't figure out the value," and how do you keep people invested with you when you're holding the line that says these names just don't make sense?

The Oakmark fund assets peaked at about $10 billion in 1997, '98. Even though our net asset value had been about flat for the following two years, our assets were down to $2 billion. Because we refused to buy anything in the technology space, people took 80% of the investments away from us. That's a tremendously difficult time when you're running a business and you've got people to employ, that you want to have continue with you and you're seeing your revenues fall by 80%.

I remember a conference call I was on. One of the advisors, who was in the process of selling out of the fund was, pleading with me, saying, "Won't you please just own one technology stock? Because if you buy one of them, then I can go back to my investment committee and tell them that's okay." I remember saying to her, I said, "If we could find one that fit our value criteria, we'd happily own it, but we can't. Because of that we won't." I said, "I'll bet you something else. There is going to be a time in the future that you're going to say, "It's not that Oakmark's incapable of buying technology, but when technology is out of favor, we're going to own more than the market weighting in it." I said, "You're probably going to be just as upset with us then as you are now, because we're investing in something then that would be unpopular." It's tough. But if you don't stick to your discipline ...

There was a Chicago firm that was known more for growth investing that was still a pretty strong fundamental value firm, but they applied it to growth stocks. About February of 2000, they threw in the towel and said, "We've lost too many of our investors. We're going to start buying these very high priced internet names, even though they don't work under the way we used to invest." So they didn't write the market up, they wrote it all the way down. It put their firm out of business.

You mentioned earlier, I was named Morningstar Manager of the Year in 2001. It wasn't that we did anything different in 2001 than we did in 2000, or '99, or '98. It was the market suddenly corrected valuation excesses and the traditional companies we'd owned through this whole period went up in price significantly, while all the tech names came crashing down. But it was the discipline to say, "We're going to keep doing the same thing. We know if we're fundamentally right on the analysis, the stock prices will eventually follow. We're not going to try and placate investors who want to see us invest in the current bubble."

I remember being on CNBC back then talking about how high priced we thought technology names were and I hopped into a cab on my way home from work. I can see the cab driver looking in his rear view mirror, he's like, "I think I know you." I'm like, I kind of got my head down, "No. I don't think so." He was like, "Yeah. Yeah, I do. I've seen you on TV." I'm like, "Maybe." He's like, "You're that guy on CNBC. My portfolio's kicking your butt." I'm like, "You know what, it's not that far to my house. Why don't you just drop me off here? I'll walk the rest of the way."

But when things get that popular, it's very rare that they end up being good investments. As long term value investors, we get a lot of comfort from the history of seeing bubbles grow and bubbles pop. The people who weather those bubbles well are the ones who had a philosophy that grounded them they didn't change it to reflect bubble level pricing.

Saurabh Madaan: Great. Well, thank you so much. I really appreciate all the time that you took being here.

Bill Nygren: Great, thank you. Thank you all.