THE MANUAL OF IDEAS™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

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When asked how he became so successful, Buffett answered: "We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

THE SUPERINVESTOR ISSUE

- ► **Screening for bargains owned by superinvestors**
- ► **MOI Signal Rank and top holdings of 50+ top investors**
- ► **20 companies profiled by MOI research team**
- ► **Proprietary selection of Top Three candidates for investment**
- ► **Plus: Exclusive interview with Barry Pasikov**
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Superinvestor holdings profiled in this issue include Alleghany (Y), Barnes & Noble (BKS), Delphi Automotive (DLPH), Dolan Company (DM), Hartford Financial (HIG), Hewlett-Packard (HPQ), Higher One (ONE), Johnson Controls (JCI), Joy Global (JOY), MasterCard (MA), NovaGold (NG), Quicksilver Resource (KWK), SanDisk (SNDK), Sanofi-Aventis (SNY), Superior Energy (SPN), Teekay Corp. (TK), TRW Automotive (TRW), Valeant Pharma (VRX), White Mountains (WTM), and Zale (ZLC).

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Exclusive Interview with

Richard P. Cook and
J. Dowe Bynum,

Portfolio Managers,
Cook & Bynum Capital Management

With compliments of
The Manual of Ideas

Exclusive Interview with Cook & Bynum

We are pleased to bring you the following interview with the principals of Cook & Bynum Capital Management, founded in 2001 and based in Birmingham, Alabama. The firm makes concentrated investments in undervalued businesses across the globe. Prior to founding Cook & Bynum, Richard P. Cook and J. Dowe Bynum worked for Tudor Investment and Goldman Sachs, respectively.

"We were both only 23 when we started managing outside money, and it gave us the opportunity to set our own mandate."

The Manual of Ideas: Please tell us about your background and the genesis of your firm. What motivated you to set up your own firm and how did you decide on The Cook & Bynum Fund as the optimal investment vehicle?

Cook & Bynum: We have been friends since before pre-school, and we developed a mutual interest in the stock market in elementary school. Richard began managing a small investment account in third grade when his parents gave him five shares of five stocks. In fifth grade, one of our teachers further encouraged our interest by enrolling us in the national high school stock market game, which we won by nothing but pure luck. Various business books were always interesting to us, but in our junior year of high school, we discovered Roger Lowenstein's biography of Warren Buffett, and—as Buffett describes it—the value investing inoculation took immediately. We started reading everything related to the subject that we could get our hands on, starting with *The Intelligent Investor*, *Security Analysis*, and *Theory of Investment Value*. Richard ended up moving his final exams to attend his first Berkshire meeting at the end of his freshman year of college. It became obvious to us that this Ben Graham approach as modified by Warren Buffett and Charlie Munger was the right framework for investing. We had found our calling.

We attempted to open a mutual fund during college, even hand-writing a prospectus, only to find that the regulatory costs were going to make it impossible with the $200,000 we had committed from friends and family. After college, Richard worked at Tudor Investments and Dowe worked at Goldman Sachs. We had valuable experiences in both places, but even before joining these firms, we knew we would not be able to invest in a concentrated value style while there. So the first chance we had to start our firm, we went for it. We were both only 23 when we started managing outside money, and it gave us the opportunity to set our own mandate. We have had so much fun trying to understand our world a little better every day.

Since 2001, we have invested money for private accounts. As our business grew, we wanted to be able to offer the same product we were providing in private accounts to a broader group of investors. Because our strategy is long-only and eschews leverage, it is a nice fit for a mutual fund structure. The Cook & Bynum Fund launched in July 2009 with lower minimums, daily NAV pricing, and SEC registration. We apply the exact same strategy in the mutual fund and our private accounts, as we designed its mandate specifically to parallel the private side. We have been happy that The Cook & Bynum Fund has achieved our goal of expanding our accessibility.

MOI: When it comes to stock selection, your criteria include circle of competence, business, people, and price. What types of businesses have you favored historically and why?

Cook & Bynum: We spend a great deal of time focusing on the limits of our circle of competence. Many businesses wind up in the "too-hard" pile because

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we do not believe we have any special knowledge or insight that will let us understand them better than average. We specifically focus on identifying companies with durable competitive advantages that allow them to earn high returns on capital employed for extended periods of time. If a company does not have this moat, its results will be difficult to forecast accurately enough to value the business.

We have typically been drawn to businesses with excellent franchises as they tend to have the most attractive and/or obvious moats. These companies have tended to be consumer product businesses, particularly ones that have characteristics like entrenched brands, strong customer loyalty, and offerings at low price points that tend to enjoy relatively inelastic demand. We are interested in participating in the expanding middle classes around the world, so we have deliberately looked for brands that are either specific to an emerging market or belong to multinationals operating there. It also helps that Richard spent his childhood making store visits with his father, who was a commercial printer. That exposure hopefully gives us some core competency in understanding the retail business and all the vendors selling their products in the stores.

MOI: If a company is extremely cheap but has a less-than-attractive business, to what extent would you consider it for inclusion in your portfolio?

Cook & Bynum: We definitely tend toward the Charlie Munger concept that it is superior to own a great business at a fair price than a fair business at a great price. However, there is a price for everything. If a business is trading at five times earnings, you only need to be able to predict the next four or five years. If a company is selling at fifteen times earnings, we need to have some idea how much money it will be making in twelve years. Our review of business history has shown that it is virtually impossible to see ten years into the future for an average quality businesses, and we always question the double-digit multiples that prevail in the markets for such businesses.

Even when they are very cheap, we believe that the Kelly Criterion will dictate that the position sizes for lower-quality businesses should remain small. Our key takeaway from Kelly is that a position's size is a function of both the expected return of a position and its anticipated range of outcomes (hence this general formula construct: position size = expected return / range of outcomes). The math implies two important points, with the first being more obvious than the second: (i) the larger the expected return, the bigger the position should be, and (ii) the larger the possible range of outcomes, the smaller the position should be. Because an investment in a less attractive business would generally have a larger range of outcomes, including a higher probability of permanent capital loss as opposed to slower-than-expected growth, this approach dictates that such a business would be a smaller position in the portfolio at a comparable expected return to a better business. Furthermore, the logic indicates that the expected return would have to be very high (i.e., as your question implies, extremely cheap would be at a very substantial margin of safety) for us even to consider building a meaningful position in a low-quality business or one with uncertain asset values. We believe the math from Kelly shows that both Ben Graham and Charlie Munger were operating optimally when the former owned two hundred cigar butt businesses and the latter owned three outstanding businesses (at one point in his career). We think carefully considering the range of outcomes when evaluating a business is both critical to investment success and poorly understood within the value investing discipline. In our experience, practitioners are often too quick to use suboptimal mental shortcuts. We have some more information about how we use the Kelly Criterion on our website.

MOI: How do you assess the quality and incentives of management, and what CEOs do you admire most?

Cook & Bynum: We look for companies that are led by management teams who are capable and trustworthy, think and act like owners, employ conservative accounting policies, and make wise capital allocation decisions. In a nutshell, we want to find executives with whom we would want to be partners in a private endeavor. Of course, we particularly love it when they have a substantial portion of their own net worth invested in the company as this is the best way to ensure their incentives are most closely aligned with ours as shareholders.

Whether it is meeting with them in person, reading letters or transcripts, or hearing them present at a conference, we carefully assess our managers' communications to ensure that they are dedicated to improving their competitive position every day. We want them thinking solely about how they can dig their moats deeper and wider rather than focusing on the current stock price, how to prop up next quarter's earnings, growing revenue or market share instead of owner earnings per share, or other irrelevant or counterproductive metrics. We particularly admire CEOs that are willing and able to communicate clearly about both the positive things happening in their business and the challenges that they are encountering.

Besides some of the obvious choices for CEOs we admire most, we might offer: Pancho Garza at **Arca Continental** [Mexico: ARCA], Peter Kaufman at Glenair [privately held], and Truett Cathy at Chick-fil-A [privately held]. We have learned an enormous amount from all of them, and we would recommend a careful study of their respective businesses and communications to try to understand what is possible with outstanding leadership.

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MOI: You included an image of an arch in your company logo, motivated by the Roman custom of having the engineer responsible for constructing an arch stand below it when the scaffolding was removed. What are the parallels between this and the construction of the Cook & Bynum portfolio?

Cook & Bynum: The idea that this Roman custom ensured that the engineer designed and built the arch well beyond minimum standards mirrors Graham's teachings. We consider this to be a highly effective quality control system, and we apply it in two distinct ways. First, we only make investments in companies whose securities we believe provide an appropriate margin of safety – meaning that they trade at a significant discount to their intrinsic values. Hopefully, that difference between price and value will protect our investment when we make mistakes in our assessments. Second, we invest substantially all of our liquid net worth alongside our investors. This willingness to "eat our own cooking" aligns our interests and attention more closely, ensuring that we manage our partners' money exactly how we manage our own. All of our own capital is at risk alongside that of our partners.

When starting the firm, we designed a flexible mandate with which we would be comfortable investing all of our own money, and we believed that we would find partners that were interested in investing alongside us. In fact, we feel it is essential to our long-term success that we have partners who share our goals, so we seek those who are focused on long-term investment results rather than short-term market fluctuations. Having partners focusing on the latter will almost certainly compromise our mutual long-term success.

MOI: How do you structure your portfolio and manage risk?

Cook & Bynum: Before directly answering your question, it is important that we first define our view of risk. We do not believe risk is volatility (meaning we reject metrics like beta), but instead believe that risk is the possibility that a business will significantly underperform our expectations. In other words, risk is a measure of the likelihood that an investment will suffer permanent capital loss.

Given this definition, we "manage" risk in a variety of ways:

- We only invest when we have adequate information. We believe that our fundamental, bottom-up research is critical to a disciplined investment process. International and domestic travel is a core component of this research, as there is no substitute for being on the ground to see how the businesses are really performing compared to both their potential as well as to their competitors. All of this research is done by the two of us and never outsourced to analysts. We would never know what someone else is missing or fails to tell us, making it impossible to make good, well-rounded investment decisions without this primary knowledge base.
- Based on our research, we make concentrated investments when we feel that risk is low and potential returns are high, recognizing that bigger stakes can be taken when information is adequate and outcomes are more certain.
- We continually monitor the companies in our portfolio to understand if their prospects change or their price appreciates to the point that its shares no longer offer an appropriate margin of safety.
- In the absence of compelling long-term equity investments, we hold cash and cash equivalents. It is our obligation to not put partners' capital in harm's way without the prospect of an adequate return, and the call option cash affords can be very advantageous in falling markets.
- Of course, we already talked about Kelly and how that influences position sizing and portfolio construction vis-à-vis risk.

We recognize that this investment strategy may not be the best way to earn high returns in any given year, but we believe it produces a portfolio that avoids the permanent capital loss endemic to short-term strategies and has the best chance to earn the highest cumulative returns over a 20+ year time horizon.

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MOI: How do you generate investment ideas?

Cook & Bynum: Idea generation is a fairly eclectic process for us. We read a variety of domestic and international publications, travel internationally to expose ourselves to new markets and ideas (for example, we have developed some competency in Latin America), and ask executives and managers we meet with who is the best competitor in their industry or what is the overall best business in their geographic region. Because we run a concentrated portfolio and have low turnover, we are only looking for a handful of great ideas each year (which is a good thing because only a few ideas typically survive our iterative process of trying to think of all the ways that a company may "die").

"In addition to the typical share of mind advantages that the Coca-Cola brand enjoys, Arca [Mexico: ARCA] has a substantial advantage in distribution. Points of sale are highly fragmented, and Pepsi cannot generate enough volume to justify wide distribution. In fact, this market fragmentation is what has driven Arca to develop some of the best distribution/logistic practices among Coke bottlers in the world, which somewhat unexpectedly creates a deep moat."

MOI: Would you outline the summary thesis behind one or two of your best ideas at this time?

Cook & Bynum: This requires a preface: to combat typical psychological misjudgments (e.g., confirmation bias) we prefer to think more about what is wrong with a decision we have previously made than what is right. Accordingly, we tend to come off more as skeptical owners of a company than impassioned defenders of an idea. With that joy-killing preamble, we do enjoy telling the story of Arca Continental as we admire the people there so much (formerly Embotelladoras Arca before its recent merger with Grupo Continental):

Embotelladoras Arca was formed in 2000 when three families combined their bottling companies/assets into a single company in northern Mexico. Arca controls what we believe is the strongest Coca-Cola market in the world with per capita consumption 50% higher than the United States. Even while selling Cokes at a 20% premium to Pepsi on the shelves, they enjoy market share well over 70%.

In addition to the typical share of mind advantages that the Coca-Cola brand enjoys, Arca has a substantial advantage in distribution. Points of sale are highly fragmented, and Pepsi cannot generate enough volume to justify wide distribution. In fact, this market fragmentation is what has driven Arca to develop some of the best distribution/logistic practices among Coke bottlers in the world, which somewhat unexpectedly creates a deep moat. In Mexico, about 60% of beverage sales occur in the informal market of "mom and pop" stores. These stores can be converted living rooms, roadside stalls, or small corner shops and are logistically difficult for a bottler to service. Because of their sheer numbers and the low sales from each, being able to profitably distribute to all of these mom and pop stores requires substantial market share and scale. We have visited hundreds of these stores by driving all over Mexico from the large cities to tiny villages. In many smaller stores there will be no Pepsi offering at all, while in larger stores Pepsi will be hot on the shelf while Coke will have bracketed the Pepsi price point in three different offerings, all of which are chilled in a cooler provided by Arca.

The company has subsequently taken its distribution expertise, presentation/marketing knowledge, scale and capital base competitive advantages and brought them to bear on other markets in Latin America. The general business (selling Coke products and snack foods throughout Latin America) continues to be one of our favorites in the world, and we remain impressed with management's execution and focus on the long term (for example, they eschewed short-term profit support in 2009 to increase investment during the downturn, which allowed Arca to pick up multiple percentage points of market share in 2011). Unfortunately, the current price is not extremely cheap, but we hope it trades off so we can have the opportunity to buy a larger stake in the business at an attractive price.

MOI: How has market volatility over the past three years affected your investment process, and have you tweaked your approach in any way as a result?

Cook & Bynum: Market volatility has had no impact on our process. As we alluded to earlier, we do not consider volatility to be risk, but instead welcome it as it provides the opportunity to buy businesses cheaply and sell them dearly. Stagnant or declining prices in the face of solid business performance are simply an opportunity to own a greater proportion of the expected future profits of a business. To this point, one of the few times we have been fully invested since we started the firm in 2001 was in the first quarter of 2009 when markets were bottoming out. Our flexible mandate and willingness to hold cash has allowed us on several occasions to take advantage of favorable price environments when others could not.

MOI: What is the single biggest mistake that keeps investors from reaching their goals?

Cook & Bynum: While we would typically list a few (e.g., having a short-term perspective, overestimating the strength and longevity of competitive entrenchment/advantages, investing with inadequate information), the single biggest mistake has to be investing without a margin of safety (i.e. not buying a company at a large discount to a conservative appraisal of its intrinsic value). By the way, full credit for this idea goes to Ben Graham, who once wrote: "Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, 'Margin of Safety.'"

There is a great quote that is generally attributable to the physicist Niels Bohr: "Prediction is very difficult, especially about the future." At its core, investing is about predicting the future cash flows of a business, which means that investors like us are inevitably going to make mistakes in their evaluation of the quality of a business or the people running it. An appropriate margin of safety serves to prevent permanent capital losses when an investor is wrong and provide outsized returns when he is correct. We only like to play the game when we know the odds are in our favor.

"Another fascinating book we both just finished is Our First Revolution by Michael Barone. We are firm believers in the power of Charlie Munger's "latticework of mental models" idea, and we find understanding the similarities and differences of different societies throughout history helpful in better understanding our current world."

MOI: Can you recommend one or two recent books that have given you new insights into the art of investing?

Cook & Bynum: I am not sure if *Poor Charlie's Almanack* would be classified as recent, but it is fantastic. After *The Intelligent Investor*, it is the best book on investing. *In the Plex* is worth reading for every investor. We believe it is critical to try to think of all the future industry dislocations that will result from the ongoing evolution of the Internet. Another fascinating book we both just finished is *Our First Revolution* by Michael Barone. We are firm believers in the power of Charlie Munger's "latticework of mental models" idea, and we find understanding the similarities and differences of different societies throughout history helpful in better understanding our current world. In addition to books, online video has become an important part of our learning. We watch interviews with great thinkers, take online course offerings from noted universities, and watch local TV commercials for companies we are researching abroad.

MOI: Richard and Dowe, thank you very much for your insights.

Using a pure value investing philosophy, Cook & Bynum makes concentrated equity investments in a select few undervalued businesses across the globe. As determined by bottom-up research, all investments must satisfy four core criteria: circle of competence, business, people, and price. The firm believes that the consistent, disciplined application of this approach maximizes long-term returns while minimizing the risk of permanent capital loss along the way. Founded in 2001, Cook & Bynum is independent, employee-owned, SEC-registered and based in Birmingham, Alabama. The firm manages assets for a mutual fund (The Cook & Bynum Fund, Ticker: COBYX) and private clients.