July 2011

EC Insights # 3 – Sequoia Fund Annual Meeting & Short Biography of William J. Ruane

We recently attended the Sequoia Fund Annual Meeting in New York (the Elevation Capital Global Value Fund of Funds is an investor in Sequoia) and we thought it might be useful to share with our investors some insights from some of the best capital allocators in the world. The meeting was attended by a group of ~250 people where the portfolio managers and analysts proceeded to answer any / all questions that investors asked for a period of ~2.5 hours. The opening remarks by Bob Goldfarb are provided below:

"We are pleased with our results since we met here a year ago. As long-term investors, we're particularly proud of our 41-year record. Over the past decade, our firm has undergone some significant changes. We own less Berkshire than we did for many years; we own more stocks than in the past; and the stocks we own represent a broader group of industries and geographies than in the past.

The most important change, however, is that we have carefully and steadily added to our research team over the past decade. Much of our recent success is due to the enormous contribution of our team. Since 2006, we have added five new analysts, with a sixth new hire set to start in July. Our total research staff is now up to 18 people, double the level of a decade ago. Vastly more important than quantity, however, is the quality of the team we've built.

If there is one take away from today's meeting, it should be that we have added breadth to our research effort without sacrificing depth of focus. We will continue to invest considerable resources in our analytical team. This yields far and away our highest return on investment.

As we noted in our annual letter, in the years ahead we would expect to own a greater number of stocks than we have owned in the past. This is entirely a function of the quality of ideas generated by our research team. We expect to remain more concentrated than most other investors, but less concentrated than in the past. The argument against greater diversification is that your best idea is likely to produce far superior results than your 16th best idea. This was certainly true in the past year, when the idea to which we committed the most money, Valeant Pharmaceutical, produced extraordinary results. At the end of 2010, our six largest positions constituted more than 40% of our assets under management, an unusual level of concentration for most investors.

That said, our recent experience with ideas which occupy places 16 to 25 suggests that our team is producing excellent ideas and strong supporting research that results in good investment performance. I would add that a number of ideas that were proposed and thoroughly researched by our team, but on which we ultimately passed, were pretty darn good ideas which we now regret are not in the portfolios. The quality of our analytical team and the quantity of ideas we are generating today form the basis for our confidence in the future. We do not lack for creativity or analytical rigor. We have always prided ourselves on the depth of our research, but lately we've come to like our breadth, too. We feel this group of analysts does a remarkable job on your behalf."

To provide further insights into the history and culture of Ruane, Cunniff and Goldfarb the Manager of the Sequoia Fund, we have sourced (and edited) a short biography on William J. Ruane written by Dr. Brian Zen, PhD, CFA, the founder of Zenway Group a New York-based investment advisory firm.

William J Ruane (1925 - 2005) founder and former Chairman of Ruane, Cunnif & Co. IN. (as it then was), was an average student at school and had a hard time with engineering courses. He did not invent any earth-shattering original idea for value investing. By studying Benjamin Graham and recognizing the talent of his classmate, Warren Buffet, Ruane became a legend of value investing. Is is a classic case study that success in finance doesn't require extraordinary talents. But Ruane did have the insight to clearly recognize a great idea: Berkshire Hathaway. He also had the courage to back up the truck. Buying Berkshire Hathaway and riding it all along was perhaps the single best idea that turned an average student into a legendary investor. This is the ultimate proof that you only need a few great ideas in a life-time, and you don't need and IQ beyond 125 to become super-investor. You do need, however a religious belief in the power of the Graham-Buffett system and the discipline to follow through over long periods of time and multiple market cycles.

The Fund Manager Recommended by Warren Buffett

In 1969, Warren Buffett was running out of things to buy. He knew that in every bull market Mr. Market gradually becomes used to paying more and more for a business -- and eventually the prices get so high that there just is no smart choice but to stay in cash and wait for the unavoidable crash.

The year 1969 was four years past the 1965 peak of the bull market that started in 1942, but the market was still overpriced, so Buffett stayed mainly in cash and his investors were getting restless. Some were voicing their disappointment that Mr. Buffett had been sitting mostly in cash for a long time and, as a result, they were not making the wonderful 20% plus returns of the past decade. They wanted him to invest. Now what? Should he pay more for a good business or fold the partnership? Would the market do what it had always done and crash, or somehow continue to defy "financial gravity?"

Buffett has always maintained that the only way to invest successfully is to buy wonderful businesses at attractive prices -- and if you can't, don't invest. Therefore, in 1969, he closed the partnership rather than violate the basic valuation principle of investing that had provided him so much success.

At that point, many of the partners wanted to know who to invest with. Buffett told them that they could buy Berkshire Hathaway stock but not to expect him to do anything except wait for better opportunities. But if they wanted to be in the market, he recommended only one fund manager: William J. Ruane, manager of the Sequoia Fund. After management fees are subtracted, the Sequoia Fund returned 15.48 percent annually since inception from 1969 to 2007 compared with 11.68 percent for the S&P 500 during the same period.

A Mechanical Idiot Went to Harvard

William John Ruane was born on Oct. 24, 1925, in a middle class neighborhood in Chicago, and grew up in the suburb of Oak Park, Ill., where he attended Catholic schools and was an average student. He graduated from the University of Minnesota in 1945 with a cum laude degree in electrical engineering. He immediately joined the Navy and was on the way to Japan when World War II ended. After the war, he worked briefly for General Electric (GE), only to discover that he disliked engineering. "I'm a mechanical idiot," he told Forbes in 1999.

He enrolled at Harvard Business School and found his calling when a professor urged his class to read the classic textbook "Security Analysis: Principles and Techniques" (1940), which helped him to focus his interest. Although he knew nothing about stocks, he was impressed with the approach authors Benjamin Graham and David Dodd took to financial analysis. After graduating in 1949, he went to work for Kidder Peabody, where he remained for almost 20 years.

Mr. Ruane recalled interviewing with a Wall Street investment firm and being told that college graduates were paid US$ 35 a week, while Harvard Business School graduates were paid US$ 37.50. "And there you have the value of a Harvard Business School degree in 1949," he remarked in 2004. "Things have changed."

In 1950, Ruane and Buffett sat in on a class Benjamin Graham taught at Columbia University, where they learned that the quality of earnings was just as important as growth in earnings. Ruane and partner Richard T. Cunniff founded their investment management firm in 1969 after raising ~US$ 17.5 million from investors. Most of their customers came to them on the recommendation of Warren Buffett, Ruane's former classmate and a close friend.

By 1982 the Fund had grown considerably and Ruane was concerned about protecting returns for his existing investors so the Fund was closed to new investors. This restriction remained in place until 2008. The restriction created a thriving "secondary market" for shares of Sequoia, which at one stage saw shares listed on EBAY for US$ 1,000 per share (versus the 29 April 2011 price of US$ 146.86 per share) to enable investors whom wanted to acquire one share to join the Fund, then qualify to invest additional money at NAV. This must be the ultimate compliment for an investment manager!

Ruane passed away in 2005, but his legacy and philosophy lives on at the firm and fund he co-founded to this day.
(Note: His daughter spoke at the 2011 meeting as an investor in the Fund.)

Ruane's Four Rules of Investing
During a class he taught at Columbia University, Ruane laid out the four rules that guided his investment career:

1. Buy good businesses. The single most important indicator of a good business is its return on capital. In almost every case in which a company earns a superior return on capital over a long period of time it is because it enjoys a unique proprietary position in its industry and/or has outstanding management. The ability to earn a high return on capital means that the earnings which are not paid out as dividends but rather retained in the business are likely to be re-invested at a high rate of return to provide for good future earnings and equity growth with low capital requirement.

2. Buy businesses with pricing flexibility. Another indication of a proprietary business position is pricing flexibility with little competition. In addition, pricing flexibility can provide an important hedge against capital erosion during inflationary periods.

3. Buy net cash generators. It is important to distinguish between reported earnings and cash earnings. Many companies must use a substantial portion of earnings for forced reinvestment in the business merely to maintain plant and equipment and present earning power. Because of such economic under-depreciation, the reported earnings of many companies may vastly overstate their true cash earnings. This is particularly true during inflationary periods. Cash earnings are those earnings, which are truly available for investment in additional earning assets, or for payment to stockholders. It pays to emphasize companies which have the ability to generate a large portion of their earnings in cash. Ruane had no taste for tech stocks. He stressed the importance of understanding what a company's problems might be. There are two kinds of depreciation: 1. Things wear out. 2. Things change (obsolescence).

4. Buy stock at modest prices. While price risk cannot be eliminated altogether, it can be lessened materially by avoiding high-multiple stocks whose price-earnings ratios are subject to enormous pressure if anticipated earnings growth does not materialize. While it is easy to identify outstanding businesses it is more difficult to select those which can be bought at significant discounts from their true underlying value. Price is the key. Value and growth are joined at the hip. Companies that could reinvest at 12% consistently with interest rate at 6% deserve a premium.

We hope this commentary provides some insights into the quality of just one of the managers Elevation Capital has selected in the Elevation Capital Global Value Fund of Funds.

We look forward to providing further insights in the months / years ahead.

Yours sincerely,

Christopher Swasbrook
Managing Director
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Note: You can source the complete transcripts for the 2010 and 2011* [*soon to be released] Sequoia Fund investor meetings at: http://www.elevationcapital.co.nz/funds/elevation-capital-global-value-fund-of-funds/gvfof-fund-reports/ecgvfof-reports-2013

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