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The Wide-Moat Investing Issue

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The Latticework Podcast: Amit Wadhwaney, Moerus Capital Management

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Amit is a portfolio manager and co-founding partner at Moerus Capital Management, and the founding manager of the Moerus Worldwide Value Fund. Amit has more than twenty-five years of experience researching and analyzing investment opportunities in developed, emerging, and frontier markets, and has managed global investment portfolios since 1996. Prior to founding Moerus, he was a portfolio manager and partner at Third Avenue Management.

Shai Dardashti: I'm familiar with your background and your expertise. Will you please share a bit more of your personal journey, and how you got to your current role?

Amit Wadhwaney: Shai, the journey begins not in the United States and not in New York. It starts in Canada, where I initially began to study economics. I already had a couple of degrees, one in engineering and one in mathematics, and economics became an interesting sort of pursuit in my spare time. I got a couple of degrees in economics. During my pursuit of these degrees, I encountered a fascinating book written by an economist and, in hindsight, I realized he is also an extraordinary investor.

The economist in question is a gentleman by the name Martin Shubik, a mathematical economist, and the co-author of the book is Martin J. Whitman. The book I'm referring to is the Aggressive Conservative Investor, which was originally published in 1979, and which was really my first introduction to, I'd say, deep value investing. It actually predates my encounter with Ben Graham's The Intelligent Investor and much else that followed. That was the beginning. I had never taken any courses in accounting, so much of that book was a mystery to me. I got my master's in business, where you study accounting, finance, and such. And I realized much of what I was learning at the university was completely counter to what I had read in that book. What I was also curious about was what was in the book, the ideas of value investing articulated in the book were very, very different from what one learned. And in fact, it was much more intuitively reasonable to pursue an investment path, personally initially and subsequently professionally, based on the principles laid out in the book.

I had the good fortune of winding up working with Marty Whitman starting in 1990. I was at Third Avenue Management, in a couple of stints, until 2014. That was where I suppose I cut my teeth in value investing, à la Third Avenue, and we began to adapt it to non-US investing starting in the late 1990s. And we built the international business at Third Avenue. What was interesting was, there's an approach to investing, value investing, where there's one end of the tent, I suppose, the value investing tent, where you focus on great cheapness. And the measurement of cheapness is what differentiates this approach.

Usually there are a variety of definitions of how people measure cheapness. People look in terms of prospective growth and discounted cash flows. Our approach is to think about cheapness in the here and now. It's a bit more of a straitjacket – it lets through far fewer securities as potential objects of interest, but it's nonetheless a very conservative approach, which obviously appealed enormously to me. I left Third Avenue in 2014, and a group of us – three of us, members of the (then) International Team of Third Avenue – founded Moerus Capital Management in 2015. And that's where we are now. All we do is one thing; we run a global portfolio – the entire globe, developed and developing markets. By 'developing' I mean emerging and frontier markets. And that's how we approach the world.

Dardashti: How do you unpack the phrase 'Intelligent Investing in a Changing World?'

Wadhwaney: Let me drop intelligent from there. Let me address, 'Investing in a Changing World" – and be mindful that we will see whether, ultimately, these thoughts are intelligent or not.

When you've been doing this for a couple of decades you've seen a lot of things. The 'lot of things' you've seen involve tremendous amounts of upheaval, upset, dislocations. Changes are really a par for the course; changes are expected. Changes usually have an element of surprise, and the element of surprise often causes discomfort – and discomfort, in turn, presents opportunities. So, the way that we've approached it – is to effectively coexist with this sort of stuff.

Let me talk about how we coexist with it. When you invest, there are a number of things that are – I don't want to use the words 'controlled' or 'controllable' because there's very little that's ultimately controllable other than your decision to own something, or not own something. That is the one decision you have to make – but, you have to do this in an environment where things change and the changes are usually the unexpected changes – that are often the source of discomfort, and as I said before: opportunities.

So, how do we deal with it? Well, first we have the core investment discipline, and the discipline really attempts to guide us to the direction of extremely cheap securities. Not just cheap, but cheap as well as companies that have a very high likelihood of passing through difficult times unimpaired and unchanged; largely unmodified, undamaged, if you will, through hard times. Meaning, you always prepare for difficult times; an anticipation of hard times, whether they come or not. If they come, well, you've largely prepared yourself.

When you buy something that's cheap, there's always a reason why it's cheap. If the reason why it's cheap has something to do with inherent fragility of the business, you just don't do it. On the other hand, if the cheapness is a function of some sort of unpopularity or being in some kind of unusual business that is utterly out of favor, or it's in a corporate structure that's analytically complex – you already have cheapness built in. Now, alongside the actual cheapness – in terms of value – you should always determine if there's anything unsafe. The lack of safety, blow up risk of a company can stem from factors internal to a company or external to a company. Once you've analyzed these things, and disposed of them as being things that could have a likelihood of hurting your company, then you have something that is probably robust enough to be held through good times and bad. The good and bad times – by which I mean things that are anticipated, and things that are not anticipated.

When we invest, we invest with at least a three- to five-year horizon. Historically, we've invested over six-year time horizons – and over six years of holding, lots of stuff could happen. Over a short period of ownership, fewer things happen. But over a longer ownership period of a given security, the extent of variability in environmental circumstances, the industry, the business, the politics surrounding a company can be enormous, and the amplitude of the variations can be enormous. So, you prepare yourself. You start off with a very defensive posture, and you stay that way, and that's how you protect yourself.

Now, this recent period has had all sorts of upsets. Brexit is something that, I think, turned the world on its head – for many people and many companies. Our approach to Brexit was not, "What's gone down, based on Brexit, right here and now, in United Kingdom?" Our approach was slightly different.

The opportunity that presented to us was: Brexit – the vote – happened, and the decision that Britain was going to leave , was announced. Well, what that did was – there were a whole slew of very cheap securities in Italy, in the financial services sector. They were probably some of the cheapest things out there in the spectrum of European securities. When news of the Brexit vote came out – credit spreads in Italy widened, enormously. What was very cheap before – became extremely cheap, and that is the nature of the opportunity that a little upset provided us. And again, that was the starting point of our investment in Italian financial institutions.

Again, the company in question that we bought – there was no question whether or not it was going to be a survivor. It was very solvent, very well capitalized, deeply undervalued and clearly going to be a survivor through many different situations and scenarios of adversity that we could think about. All the Brexit vote did was present us with an opportunity to buy this very cheaply. Upsets and discomfort provide us opportunities, and uncertainty is not to be shunned or fled from. Think of uncertainty, and a sort of discomfort, as a source of opportunity for you; that's historically what it's done for us. It's presented us with opportunities, which is one of the reasons we've seen places where there's enormous amounts of uncertainty – the crystal ball looks quite murky – those are very interesting places for us.

Dardashti: History might not repeat but it could rhyme; could you elaborate on your observations?

Wadhwaney: There are things that sort of resonate or echo; let me give you one very quick example, a sense of déjà vu. Early in my professional investment career, one of the first financial market crises I encountered was in 1997-1998. In 1997 – the starting point was a teetering that began in Thai banks. Thai banks had lent money quite recklessly to all sorts of real estate developers, the creditors of the Thai banks started to pull their money, and the whole thing began to slowly spiral and there was tremendous amount of denial in other parts of Asia. Everyone sort of said, "Well, this is a problem with Thai banks. Thai banks have been engaging in foolish lending, and of course it's only a Thai problem." Well, as history will tell you, a year later in

1998 most of Asia was sucked into a black hole called 'The Big Asian Crisis.' You had runs on banks, financial companies blowing up in Korea, and so forth – there was a tremendous amount of stress in many of the countries, arguably much greater in the lesser developed one – places like Indonesia, Malaysia, South Korea, and Thailand.

Fast-forward a decade later. Now take the locus of the drama, which shifts to the United States. Again, the big difference – the United States is a big, very large, deep capital market. It would seem hyperbolic to assume that all the stuff that happened in Thailand, and in Asia during the 1997-1998 period, can recur in the United States. Well, the United States may have been a large capital market – with a diversity of financial products to finance all kinds of things. However, starting in 2007, you start to see that housing related – the residential mortgage-backed securities market – start to teeter. And you saw that happening not just in the United States, you also saw that happening in the United Kingdom. And of course, at this time, in the developed markets, there was a lot of tut-tutting that came out of Europe saying, "Oh, it's the Anglo-Saxons who are doing this. This would never happen here." And again, as we know, in 2008 the Global Financial Crisis sucked Europe right into it. And of course, their banks were stressed, and there was trouble there as well.

The same canary gagged the second time, and you could see that happening, the denial that people engage in. So always be very, very wary when people say, "It can't happen here." Well, amazingly, it happened in the United States. I will confess, the echoes were certainly there. We certainly did not see lines of people waiting outside banks to pull their money out in the United States as we saw in Asia – when I visited Asia in the middle of 1998 the Asian crisis was in full blossom. But certainly it was a scary time in the United States, which also provided tremendous opportunity – yet again.

Dardashti: You've lived through multiple market cycles.

Wadhwaney: I would not describe any ability on my part to predict or forecast. I certainly wouldn't do that. However, as a price taker – you've always got to be ready. Usually, the way we operate is we read lots and lots of things about many different companies. You learn about companies then just basically put it aside, for whatever reason. Oftentimes things are not cheap enough, often time we think there's some deal-breakers; maybe something's wrong with the balance sheet, so on and so forth. There's always reasons why something is less than perfect to be included in a portfolio.

However, sometimes a lot of things come together. And usually when things turn ugly in downturns – that's when you find the opportunities become most attractive and most available at the right price. And which is why we rather price takers; market cycles, market fluctuations, provide those opportunities to us, rather than us thinking in terms of, "Will there be or won't there be…?"

For example, the last time one of the great opportunities occurred to buy securities in India was in 2013. There was a huge taper-tantrum when Bernanke started making noises that he was going to raise rates; India's capital position was poor. Of course, since then they've had elections; everything's done very well. I have no idea when the next opportunity might occur. Of course, if I had some prescience about the cyclicality of the market there, I would be ready and waiting because there could be great opportunities. But generally, as a price taker it behooves one to be very aware of the world in which you're investing – in terms of circumstances in given markets, how securities are being valued –and take advantage of that.

Dardashti: I'd love to elaborate on your global perspective.

Wadhwaney: Collections of countries have been impacted, for a variety of reasons –not the least of which is, I suppose, is the commodity related exposure. Let me speak to two countries in particular. One country is Colombia. Colombia is not the top of the hit parade – as it was for a number of years, post the early 2000s, when Colombia began to de-risk; the government was very much in charge of taking care of the security situation, and oil was doing very well. Oil has, of course, since then tumbled enormously.

So what's this all got to do with Colombia? Well, as the security situation in Colombia became better, and oil prices rose, the realization dawned that there were enormous parts of Colombia that were hydrocarbon rich and had not been explored. There was a tremendous oil-boom that took place. It was so large that at one point in 2014 oil accounted for more than half the export earnings of the country.

Well, then oil collapsed. Oil prices collapsed and down went the export earnings. The export earnings tumbled, the currency tumbled, and in turn inflation went up and interest rates went up. So, that's all from the perspective of a consumer. That's pretty toxic stuff. Your purchasing power tumbles, interest rates go up and inflation goes up – it's kind of messy. So, that presents a class of opportunities.

For example, retailing. Retailing in a young, growing country is an interesting business. However, these sorts of consumer-related companies in developing markets usually are quite expensive – because, I think, the great theme that most people invest according to is, 'When you buy emerging markets, you buy emerging market consumers" – and investors often really pay up. Well, the company in question is one I've known for more than a decade before we put our first dollar to work there – a company called Exito, which in turn had been pummeled because of tumbling purchasing power, rising interest rates, and rising inflation rates. There are a whole bunch of other interesting opportunities stemming from the same larger phenomenon of a tumbling currency and a slowing economy, and so forth; Colombia has a collection of opportunities. Exito is not just a Colombian company – it is a pan-Latin American retailer; it controls the largest Brazilian retailer, and as a result, Exito is the largest pan-Latin retailer there is.

Which takes me to the second interesting location of opportunity. Now, oil has a part of the story here; oil – it is not just oil prices. Brazil is a country which has a gigantic company called Petrobras, which is largely controlled by the government. Now, when you have a large company controlled by the government, which has an extraordinarily enormous exploration program underway, there is the opportunity for a lot of mischief – for shenanigans and siphoning cash away. Suddenly but suddenly, an investigation of all these activities began. Brazil is going through a period of self-examination, with even the utmost iconic of their leaders being convicted of engaging in illegal activity; receiving some sort of assistance towards the purchase of a beachside apartment in Rio. So, this is remarkable – it's quite extraordinary, and this is sort of a first in the history of Brazil; the extent to which this corruption probe has uncovered people, it has ensnared major business leaders, major politicians. So, there is a tremendous cleanup underway.

But, what does this have to do with stock market? Well, basically, this has resulted in a tremendous paralysis in terms of contracting for the exploration program, amongst other things, and to some degree, a paralysis in terms of doing business the traditional way – which in turn feeds into a slowness, a slowing, a reluctance to engage in capital expenditure lest you do something which runs afoul of what is "appropriate behavior". This has really deepened an economic slowdown, which shouldn't have been as deep as it has become – because of these other investigations. Brazil presents a number of sources of opportunity. It's a much more broad-based. It's a much larger market than Colombia, and so the opportunity set is much, much, much broader.

Dardashti: The concept of investing bottoms-up, but worrying top-down -- how do you begin to worry?

Wadhwaney: Every company that we think about -- the analysis is very centered and focused on the individual company that we will be investing in. It's very important for us to know how the company makes money, what circumstances under which the company would lose money, and so on and so forth. So, you have a good sense of how the world, macro factors particularly, affect the business. We really don't think of ourselves as having the ability to forecast macro; I would argue we are quite macro myopic. That said, while we are macro myopic, we are not oblivious – or blind – to macro factors.

Macro factors are what can really take apart a company. For example, when you think about a company, you do not think about the company in isolation. You think about how different macro factors, if they were to change in an adverse manner, affect the business itself. Companies can be affected by interest rates, inflation rates, and exchange rates – meaning, you think in terms of "what is a plausible scenario of adversity, that changes in any of these variables could cause you?"

Now, understand that we own things for a number of years. So, it's a different kind of band, how much interest rates could vary, for example, over the next year versus over the next five or six years. If you are to think in terms of four, five, six years – you should imagine that it could be subject to much higher interest rates, than if all you did was hold it for six months or a year, for example. So, you effectively do some sort of stress-testing in terms of adverse development in factors macroeconomic.

Similarly, you have to think in terms of, "Other than macroeconomic factors – what other sources of adversity could hit your company?" It could be changes in governance, in regulation – any number of factors that can affect you. Again, the attractions are often on a bottom-up basis – but you have to make sure, to be sure – that the companies are not going to be hurt by the adverse shifts in macro-economic factors and other environmental factors, top-down factors.

Dardashti: Are there patterns in what you're trying to avoid?

Wadhwaney: We try to avoid business models that are less than robust. For example, there are some business models that are very good and function really well in the normal times – when things are good, they do great. However, in bad times, they break down – and break down very badly to the point that the company goes bust. As a case in point, think about a business model requiring a good credit rating, all the time, just to stay in business – this was a requirement for companies like Bear Stearns and Lehman Brothers. They had to have a good credit rating; when times turn bad and the rating agencies downgraded them, they suddenly lost access to the commercial paper market and short-term financing, and the business model blew up. That's the kind of fragility of a business model that we'd like to avoid.

Dardashti: Are there commonalities in the macro concerns?

Wadhwaney: Sometimes a recurrent source of trouble, that sort of ensnares people again and again and again and again – and it's very odd – is currency mismatches at the sovereign level and the corporate level. By which I mean, you often have times when borrowing in one currency is so cheap; a currency which is different from the currency of the issuer. An example would be the Mexican banks –Mexican government issuing paper, issuing debt in United States dollars in the early and mid-1990s. That in itself led to the big 'tequila crisis' when there was a run on the peso and the peso collapsed; the currency mismatch, at the level of banks – many of the banks went bust.

The same thing happened in 1998. In 1997 and 1998, Thai banks, Malaysian banks, and Indonesian banks – they borrowed lots in United States dollars. because it was very cheap to borrow in United States dollars. And then, it was turned around and they lent the money to local borrowers – in the local currency. They assumed that all these things could be repaid at a fixed rate; unfortunately the currency was devalued – so the size of the liability ballooned, and ballooned massively.

You saw that in 2000-2001 in the case of Argentina – when the link with the United States dollar and the Argentine peso was severed, and the peso dropped like lead; from being worth one dollar, to twenty five cents – liabilities multiplied by four-fold. So, that's a theme that has just recurred – again and again and again. Now, what's the most recent version of the same theme? Here is a guess, I've worried about this since 2013 – those chickens haven't come home to roost – but they may well do, and hopefully they won't. There's been a tremendous amount of borrowing in United States dollars, unhedged – financially-unhedged or operationally-unhedged – by the issuing companies, which typically don't have operations which produce United States dollars.

If, for example, you are a Turkish construction company – and I mention Turkey not because of anything other than the fact that there are lots of Turkish construction companies – private companies – whose revenues are totally Turkish Lira, but have borrowed in United States dollars. Were the Turkish Lira to come under pressure, their liabilities would start to balloon enormously. And, being a Turkish builder – with your business largely in Turkey – you do not have a built-in currency hedge, based upon the nature of your business itself. That exposure continues to this very day. I have no idea if and when it gets worse, which precipitates the next sort of crisis.

Dardashti: I'd love to steer the conversation towards you, if we could. You're very generous in sharing your wisdom with our community. You're providing us so much of your time. What's motivating you to be so giving?

Wadhwaney: Well, let's talk about the source. The source – I think of lots of thoughtful conversations, ideas, and thoughts about investments and investing. And really, it goes beyond just individual investments. MOI has been the source of a great deal of education for me. In my few words, hopefully I can leave behind something that's useful, something in kind that is symmetric with what people have done for me over the years – having read MOI and watching various interviews and conversations that you've had with people.

Dardashti: We hope that Latticework 2017 becomes a conversation, and that this podcast might inspire some people to reach out to you. What type of dialogue would be a value-add?

Wadhwaney: What we do is stuff that is obviously second nature to us. It may be different, or it may be an outlier in terms of other people's thinking. Hopefully, I have given people food for thought, as many of your other commentators and your guests have over the years. And if people would like to talk about it, to further the conversation, I'd be happy to hear from them. But, really, this is what we do – this is what I know; I know a little bit about this, not much about other stuff. This is what we do. Our approach is very narrowly defined, but I am happy to discuss it with those who are interested.

Dardashti: Are there profiles of people who you'd like to meet?

Wadhwaney: I'm certainly happy to hear from people with whom my comments resonate – that is probably going to be a source of some two-way intellectual stimulation. I mean, you don't have to agree with me; that's fine – in fact, it's preferred. It's always worthwhile having our ideas, our thoughts, subject to scrutiny and criticism; that's very important, otherwise we would stagnate. Where we've gotten to be – is in great part because of thinking about what we do, hopefully refining it over different episodes. Hopefully, we have got it down – sort of. But I'm sure there's always going to be circumstances under which we will learn more; circumstances are usually of adversity. So, if other people have experiences and would like to share them, or have comments about what I've said so far today, I would love to hear them!