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."

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Exclusive Interview:

Chris Mittleman, Chief Investment Officer, Mittleman Brothers

With compliments of The Manual of Ideas

Value Investing with a Private Equity Mindset

Shai Dardashti, managing director of The Manual of Ideas, recently had the pleasure of sitting down for an exclusive interview with Chris Mittleman, Chief Investment Officer of Mittleman Brothers. Based in Melville, NY and with $400 million in assets under management, the firm has returned 736%, net of fees, since 2003, handily beating the S&P 500 and Russell 2000.

(The following interview has been edited for space and clarity.)

The Manual of Ideas: Your investment approach was recently referred to by *Barron's* as applying a private equity mindset to investing in public markets. Please elaborate.

Chris Mittleman: The kind of businesses we're targeting are the same kind of companies that private equity firms are attracted to. These are businesses that generate free cash flow on a sustained basis; free cash flows that are, if not predictable, at least somewhat repeatable, so that if I pay 10x FCF for this business today, hopefully in five years' time, the cash flows are going to still be at some semblance of that level in a worst-case scenario.

We're looking at a business based on, if we were to buy the whole company, what would be the cash-on-cash return we will get in year one, two, three, four? That's what private equity does when they scout investments, but the key distinction is that we are not seeking to take control. We're not looking at it from a real private equity point of view, but there is this aspect of it that's like private equity investing. Many of the companies that we've invested in ended up getting bought out by private equity, so you see that they're looking for the same qualities in a business, a key difference being that they have to pay a control premium.

> *"Sometimes the difference between success and failure was not just about our understanding and steadfast belief in the value of a holding, but how long we were willing to wait to achieve that result."*
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> —CHRIS MITTLEMAN

As an asset class, private equity has very good long-term returns, but we've been able to outperform that asset class, on average, over an extended period because we're not paying that control premium.

We're looking for the kinds of businesses where you have a fairly strong sense that the free cash flows are going to be reproducible and will hopefully grow over time, and you're able to pay a low price relative to those cash flows. You're not getting control, but you're paying a much lower price than a private equity firm. Rather than pay 10x EBITDA or 15x free cash flow, we're trying to pay substantially less. Obviously, the valuation depends on the nature of the business, but that's how we end up outperforming the private equity asset class.

MOI: You have the benefit of liquidity, you're not locked in…

Mittleman: Public liquidity is a benefit, but not always. We have at times invested in situations where liquidity might be limited.

We're a large shareholder of **Revlon**. The largest shareholder is Ron Perelman who owns 78% of the stock, whereas we own ~3%, but we're still the second-largest shareholder. Revlon is a sizable company but the float is small because of Ron Perelman's ownership. Although Revlon has a market capitalization of nearly $2 billion, only about 20% of the stock is in the public float. It's liquid, but it's not so liquid that we can sell our whole position in a week. It would likely take us up to a couple of months to fully exit the position without a liquidity event, so we do tolerate some degree of illiquidity because we have a very good, long-term oriented client base.

Our client retention ratio over the course of thirteen years or so is on the order of 98%. Our clients understand the temperament and patience required to invest in a long-term oriented strategy like ours, in which we're looking at every investment with at least a three- to five-year time horizon.

There have been some situations where an investment I thought would work out in three to five years actually took six to ten years to ultimately work out, and that's fine, if you're getting the outcome you expected in the end. But you have to sometimes be willing to endure a period of time that is uncomfortably long to reap the benefits of the investment.

MOI: And that's how you earn the result, by having patience?

Mittleman: Patience is one of the most critical attributes for a long-term investor because you can be right and the market may tell you that you're wrong, and it may tell you so for an extended period of time. It may reach the point where your sanity begins to be questioned by clients and even your colleagues. I've been in situations like that. There were many times where I've been involved in an investment, where it looks like it might not work out, and it ultimately did work out, and worked out wonderfully. Sometimes the difference between success and failure was not just about our understanding and steadfast belief in the value of a holding, but how long we were willing to wait to achieve that result.

There's a quote by Michelangelo, "Genius is eternal patience." But there's another great quote by Johann Wolfgang von Goethe, "Genius is knowing when to stop." Is genius eternal patience or is it knowing when to stop? It's one of those two, or maybe it's both. But we can't expect eternal patience. There has to be some kind of return on our investment at a point in time that's reasonable. But what is that point of time? That's a really difficult thing to say definitively. We can't just say that if it doesn't work out in five years, it's wrong. Because I've had many investments that worked out in year six, seven, or eight. If I had sold in year five, we would not have achieved a desirable return. You really have to be capable of making these determinations about when patience is justified and when it's cowardly self-delusion or denial.

There's this balancing act between being stoic and an investor who's maybe too ashamed to admit they're wrong or in denial about being wrong. It's a risk. If you're so used to being right in the end, and if you're used to your investment thesis working out in the long term, you can always lull yourself into a sense of complacency that everything will work out and that if you seem wrong today, you just wait a little while and you'll be proven right. It can be a problem to trick yourself into believing too much in your own capabilities, if you are overly patient without being as discerning about whether it's justified or not.

MOI: We love to ask managers about the difference between being early and being wrong…

Mittleman: It's so difficult to know because sometimes being wrong is expressed by the stock price not going up. Maybe it's not dropping, but the stock may stay flat for a long period of time and although the business results are coming in okay, the lack of gains can be frustrating. We went through this with our investment in **Icahn Enterprises**. I started buying that when I was a stock broker in the mid-1990s and the company was named American Real Estate Partners. It was $9 per share with $12 of net cash on the balance sheet and another $10 per share of income-producing real estate. I watched it for a number of years thinking that it was going to be a great investment at some point.

I thought the right moment was in 1996 when they changed the charter of the company to allow Carl Icahn to invest outside of real estate. I thought that was the moment it was going to turn into a Berkshire-type situation. I started buying the company in the summer of 1996. Six years go by, and the stock was still at $9. Why is that?

Book value grew every year. They had positive net income and cash flows. But Icahn was trying to keep the stock cheap so that he could buy more of it. He wasn't holding conference calls, he wasn't talking to the public as he increased his stake in the business from 50% to 80% over the course of six years. It was a very frustrating time as the stock went nowhere.

Then from 2002 to 2007, the stock rose from $9 to $130 and we ended up selling at an average in the mid-$50s. The point is that, if you were to judge the success of our investment by the first six years, it was an abject failure. But if you measure success over a ten-year period, it generated a 20+% compounded annual return.

That's an extreme example but how did I know to wait it out? Because I could see the value. This was one of those Graham and Dodd-type situations, where it wasn't about trying to guess what the cash flow was going to be. There was both cash and real estate value piling up. It was easy to see but it was just a question of when that would be appropriately valued and reflected in the stock price. That gave me the ability to be as patient as I needed to be.

It's not always easy and you're not always right. Sometimes I've held stocks up to the end but failed miserably. I can think of a few examples in my career where I held onto a stock for three, four, five years thinking that it's just going to take another year, and then finally realized the business is not coming back.

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—Chris Mittleman

It really behooves you to be critical when the reason that you're wrong is because the business is not performing as you thought it would be. Those are the hard ones to come to terms with because you don't know. It may be a temporary setback, or a multi-year issue. These are subjective judgments that require quite a bit of forecasting and analytical work to determine if the issue is specific to this one company or to the industry as a whole. So, you try to gauge where an industry has gone or where this company is in their competitive position and that's not something that you can always do with supreme accuracy.

When I've been wrong to be patient is when there's been a secular headwind, where I was betting on a cheap valuation. I can recall on a few occasions investing in something where I was paying ~5x EBITDA and ~5x free cash flow, and I thought that as long as this business doesn't contract too rapidly, then I can make a good return. But usually that was wrong.

I did that with the yellow pages company **RH Donnelly** in 2007-2008. It was a business that had been recession resistant. I thought, this business is so cheap that I have to at least give this a shot because the free cash flow is massive. Its EBITDA margins were 40%-50% and it had a very resilient history. But that resilience was being eviscerated by the Internet, and as that "great recession" rolled through, they didn't have the kind of resilience they had in the past because of the alternatives available for local advertising in the U.S. That was something I just didn't appreciate. I thought that I had a contrary view. I thought my view was more likely to be right and it was just wrong. But it took me a few years to realize how wrong it was. Disappointing numbers kept coming in and finally it dawned on me, but it was too late. By then I'd lost 90% of the investment and the stock ultimately went to $0.

Sometimes your patience is misplaced. Obviously, this is part of the learning process. It's when to be patient, when not to. When to move quickly versus waiting around. Sometimes things go so wrong so quickly that you know that your thesis was so wrong, that there's just no point in being patient anymore.

MOI: The private equity approach to investing—does that suggest there are certain business types that you gravitate towards?

Mittleman: Private equity investors look for the same kind of durable franchises that we look for. Usually, private equity is investing with a certain amount of debt. In order to service that debt, the businesses need to have cash flows that they can count on. That's why they're looking for something where there is an obvious franchise value with something seemingly defensible that has strong cash flow characteristics.

We're looking for that too, but not because we're planning on putting leverage on. We're not planning on changing the balance sheet. A business that can tolerate leverage usually should have some if you're looking at an optimal capital structure. A high-margin business with steady free cash flow growth would usually do better to have a bit of leverage. The leverage also provides a bit of tax shelter. We look at the businesses that we've invested in over the years that had private equity-type attractions to them, and they are businesses that you see private equity firms buying and selling over time.

We owned the car rental firm **Avis Budget Group**. That company was in and out of private equity hands five times in less than twenty-five years. We've owned companies like Playtex Products, which was involved in a couple of private equity buyouts. We bought it when they came public in the 1990s. We bought it again in the 2000s. Ultimately, the company was acquired by Energizer. But it is the kind of business you can understand might be attractive for private equity. Playtex had the number two market share in tampons. They had a very good business franchise with the Banana Boat suntan lotion and also baby products.

These are market shares that were around for decades. And when you have a business like that, you can get a sense that the economics and the free cash flows are not going to drop overnight. I think we have that today in Revlon. Revlon has a fairly lackluster long-term track record in terms of their sales growth. But they have 18%-19% EBITDA margins that convert very well to free cash flow. That free cash flow is attractive to us, like it would be to a private equity firm. So, there is definitely this overlap that we often see in our companies where private equity is very interested or comes in as a buyer.

MOI: Arguably, private equity, as owners, have special tools in their toolkit. They can change the balance sheet or the strategy…

Mittleman: Absolutely. That's what they get in return for their control premium. Although not every private equity firm will take control of every investment. There's been a trend in private equity, to take passive investments in certain situations. For example, you see these PIPE deals where a private equity firm buys a big block of convertible preferred stock with an eye towards an improvement in the business, making it worth more, but not with the intent to gain complete control.

We don't gain control but we don't pay for it either, so we're paying a significant discount to intrinsic value, whereas private equity buyers are paying a much higher price that's often close to or at intrinsic value. When I look at private equity transactions, I always look at the purchase price valuation of the business acquired and usually what they pay is around the price at which I would be a seller. Private equity firms are generally paying close to what I consider intrinsic value. But my sense of intrinsic value is often lower than most who might appraise the value of a business because I'm looking to be cheap and conservative in that regard.

> *"[My] mistakes have generally been when an investment was in a business that was ostensibly very cheap, but where you had significant secular headwinds…"*
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> —CHRIS MITTLEMAN

MOI: How have experiences shaped your view on what to avoid in the future?

Mittleman: When I think about the history of my mistakes (and it's a long history), those mistakes have generally been when the investment was in a business that was ostensibly very cheap, but where you had secular headwinds, and those headwinds led to the undoing of the thesis. When I look back on the investments that I sold at a loss, they were bought at a very low valuation. But that valuation was not enough to discount fully what was to come, which was a demolition of EBITDA and free cash flow.

Another issue would be where there's a major concentration in one product line. That would be something that I would be hesitant to do again. I had a couple of experiences where I invested in a business with revenues that were overly concentrated in one product line and that product line was ultimately usurped by something else; a better mouse trap. I would be better off avoiding those situations.

I don't have a strong sense of what the absolute rule should be because every situation is different. Maybe some situations warrant making an exception, and maybe **Apple** was one of those. I thought about investing in Apple. I remember in 2002, or 2003, the stock was trading almost at net cash and I strongly considered it at that time. I thought of Sony in the 1980s and I remembered thinking about how Sony came up with this great, revolutionary product called the Walkman. And soon everyone had one. But then competitors came in with a flow of very similar devices. The profitability of that business was then severely impaired by that competition and they only had a few years of real market dominance.

I thought, what was to prevent that from happening to Apple's iPod? And I was scared away from the consumer products company that was so focused on one or two things, and with Apple my fear proved misguided. It was one very special, revolutionary company, in which the general rule didn't apply well. You just can't be too dogmatic about this. You can't be too absolute, and say, "I'll never do this, or never do that." You need to have an open mind for exceptional situations and I try to be open minded and not overly dogmatic about any of this.

MOI: Are there patterns of how great companies reach a valuation that is compelling?

Mittleman: Yes, I think so. What you're talking about is what makes something cheap and it usually stems from a few different sources. Sometimes it's transitory cheapness that's derived from the short term operating under performance issues, like with the Playtex example that I gave you earlier.

Playtex's stock dropped from over $10 to $5.50 during the period of time that we were buying it in 2002-2003. The reason for the drop in price was that their business was coming under pressure from a competitive product launch from Tampax, which is owned by **Procter & Gamble**. They were introducing a new product line and heavily promoting it, which really pressured Playtex and I presumed that pressure would be transitory because the brand would endure even if it was going to endure reduced market share. I felt that we could get a very good return off the valuation that we were paying which was about 7x EBITDA and around 10x free cash flow and the stock was about $7 a share. Ultimately, we doubled our money on that investment.

But at the time, the business was going down. If you looked at sales, EBITDA, and free cash flow, these were each in a state of significant decline over the course of the year 2003. So, analysts were downgrading the stock and people were saying it was dead money and that Playtex was too small a player with too much leverage on the balance sheet to compete with these larger players. But I felt that we can take advantage of that, and we did. But those situations happen all the time in history. I think about so many situations where a good business just happened to have a bad year or two, for a number of different reasons.

I owned Maybelline in the 1990's, like in 1994, 1995, when the stock had come down tremendously. The private equity firm, Wasserstein Perella, had once controlled it. They had bought it from Schering Plough in late '80s and they brought it public again in the '90s. The company had a misstep when they introduced a new product line targeting older women and it just wasn't selling well. Sales, earnings… all the estimates were missed. The stock fell dramatically from over $30 down to about $15. I started buying it in the teens; I think it was around $18 a share because the franchise was basically intact. It was just a bad year. You had to be willing to look beyond the effects of one bad product launch. Ultimately the company got bought out in a bidding war in 1996 between L'Oréal and Benckiser, which is now Coty, and we made a good deal of money on the investment.

A transitory situation or a bad year can make a stock cheap. Sometimes it's a seemingly scarier thing, which is that there's something wrong with the company, such as malfeasance or an integrity issue. Something like that where the company is maligned as being almost fraudulent. That happened with **Tyco International**. I bought Tyco in 2002 when it was perceived as the next Enron, and many people, such as Jim Chanos, were saying that Tyco was a fraud. They pointed to higher-than-normal EBITDA margins, and they were saying that this cannot be possible. How could Tyco, at this scale produce EBITDA margins that were better than General Electric in similar business lines? I didn't have an answer to a lot of their criticisms, but what I did know, from having followed the company over the years, and this speaks to the necessity of doing research in advance of the crisis point, is that I watched Tyco grow by making acquisitions and I admired the acquisitions they made. They bought companies like Sensormatic Electronics and ADT. They owned a multitude of businesses that had been publicly traded companies before Tyco acquired them. All you had to do was look at the history of these disparate companies, all run by different management teams under the Tyco umbrella who were all free cash flow generators. You can add up the free cash, which I did, in 2002 and come up with what it was on an unaffected basis before it was bought by Tyco. You had substantial value in those businesses.

"[Tyco in 2002] was a scary situation but it didn't mean that the businesses lacked the free cash flow characteristics that they appeared to have."

—Chris Mittleman

I started buying the stock at around $15 in 2002 thinking that those claiming fraud were wrong. And that if there was fraud, there's not so much fraud as to destroy the cash generating characteristics these businesses had, before they were under Tyco. Two weeks after my first purchase, the stock dropped to $7 because the New York Times printed an article that Tyco was going bankrupt. So we bought more and got our average cost down to $11. I ended up selling it two to three years later between $25-$35, which was around what I thought fair value should be.

What gave me the confidence to get involved in a situation where everyone was screaming fraud, and the company's CEO and CFO were stealing money? These guys were apparently helping themselves to the money they were not entitled to, in very large amounts, and they were jailed for that.

Again, that was a scary situation but it didn't mean that the businesses lacked the free cash flow characteristics that they appeared to have. You just had to be willing to do the work and to recognize that even when some very smart investors are telling you the company should be valued at zero and there are hordes of people saying to run away… If you know better, and if you're sure you know better, you have to sometimes be willing to get involved in these situations. So, Tyco is a good example of a situation that got very cheap, very quickly for a reason that was not really as bad as advertised at the end of the day.

MOI: Do you try to stay away from cyclicality?

Mittleman: I recognize cyclicality for what it is and I try to be respectful of that in structuring our portfolio. When I look at our portfolio historically, and this is not done through a top down approach, we've averaged about 66% percent exposure to non-cyclical, recession resistant, if not recession proof businesses that have very little sensitivity to GDP. I think a really good exercise is to look at a portfolio you might want to invest in and see how the businesses performed in a prior recession from beginning to end. That will give you a real sense of what are the cyclical vulnerabilities of the businesses and in the portfolio overall.

Recall the recession of 2008 and 2009, which is the best example because it was the most severe recession since the 1930's. Consumer spending was down for the first time since the 1930's. And yet almost two thirds of the businesses in our portfolio at that time did not see their EBITDA or free cash flow decline during that period from 2007 to the end of 2009, which is remarkable when you think about it given that S&P earnings dropped 40% through that same period. We have a very similar portfolio composition today, with about two-thirds non-cyclical exposure. I don't set out to make it that way but it does provide me with a sense of comfort that, if we do get another severe recession, the same kind of resilience should be there. Of course it doesn't mean that it will be, as not every recession plays out in the same way. There have been different types of recessions.

The recession of 2001 after 9/11 was more of a capital spending type recession. It wasn't so much consumer retrenchment like 2008. 2008 was more about consumers that had overextended themselves and were pulling back in a big way for the first time since the 1930s. 2001 was a very different experience, but it was actually a good recession for value investors. A lot of value managers, including myself, made money through that recession. What that speaks to is the different nature of each recession.

When I say that our companies stood up well in 2008, it doesn't mean with certainty that they'll do so again. And it also doesn't mean that businesses holding up well will protect you in terms of stock price performance. When I look back at 2008, I'm impressed by how well the companies did and am proud of that. But our stocks went down significantly. Our portfolio declined 64.3% in 2008. So, this amazingly resilient portfolio that we constructed did exactly what we thought it was going to do at the business level, but the stocks were decimated regardless. But we survived that period, and ultimately thrived soon thereafter, thanks to our patient client base, as the valuations of our stocks caught up with the resilience displayed by the underlying businesses.

You could be completely right about your portfolio positioning, but the stock market may not care sometimes. It only took a year and a half for our pain to come and go as we made back everything we lost in the 2008-2009 decline by the middle of 2010, but the point is that it can be a harrowing experience, even when you're right about the business.

We are willing to tolerate cyclicality, but I don't like to invest in cyclicals that have a history of going into a significant cash burn mode during the down part of the cycle. The cyclical businesses that we've invested in are such that if you look at their EBITDA and free cash flow profile, you may see a dramatic drop in sales during the period of the down cycle, but you don't see cash burning and that's the key differentiator.

"Recessions are great proving ground because they test your confidence and courage. I've not met anyone who could sidestep a recession consistently…"

—CHRIS MITTLEMAN

Avis Budget Group's stock dropped from $10 to $1 during the Great Recession. But the business didn't enter a cash burning mode because they had the ability as a car rental company to adjust their fleet on a weekly basis and draw working capital cash out of the business, as that's happening. When demand starts to go up again, obviously working capital starts to consume cash again. But, not so much as to offset the free cash flows being generated. So there are attributes to cyclical companies that we look for that defend us against their cyclicality. That kind of countercyclical cash generating capability that Avis Budget had of being able to withdraw huge amounts of money out of their working capital for the purpose of deleveraging and protecting themselves during the challenging period was very handy.

We don't own airlines or automobile manufacturers because when you look at their profile, you'll see great periods of huge free cash flow production followed by periods of significant free cash flow burn.

You can make money in that kind of investing if you time it right, but I prefer not to be in a situation where I'm holding a company that's burning cash and I'm left wondering how long it's going to take for the turnaround. I prefer being in situations where I feel that even if there is going to be an unprecedented, lengthy recession, we can survive it because our companies are not burning cash. I wouldn't have that feeling if I own an airline or an automobile manufacturer, or any other cyclical that has that kind of cash burn characteristics during the down parts of the cycle.

MOI: You've shared with us how each downturn, each recession is slightly different in its own way. Can you share with us how you've improved and learned from these different experiences?

Mittleman: The ongoing lesson in the downturns and recessions is that you can never be too sure of anything. A business may perform the way you expect it to and the stock price may react completely differently. You have to prepare for that psychologically and make sure your clients are prepared as well because unspeakable things can and do happen to stocks. It doesn't mean that you're wrong.

Sentimental extremes can develop and they happen more often in recessions because when people hear the term recession, they start to panic. They begin to think the end of the world is near. There is this pattern of human psychology, a path between greed and fear, a kind of sine wave that begins with complacency and then peaks at euphoria and craters at despondency.

You would think human beings will learn and stop doing that, but it doesn't stop. I know a lot of very intelligent business people who were involved in making multi-million dollar capital allocation decisions. And even they often cannot control the feelings of greed, and/or fear.

Think about how during the Great Recession, when stocks were trading at option value, some of the biggest companies were trading at $1 per share at obscenely low valuations. Where were the buyers of those stocks? Where were the private equity firms who had billions in cash? They weren't buying everything in sight because they were scared too, but they had the cash to do so.

Fear can be pervasive. No matter how wealthy someone is and how smart they may be, they can be completely wrong. If you have an opinion that's contrary to what everyone is thinking, it doesn't mean you're wrong. You have to be willing to sometimes stand there, stoically, while a nuclear explosion is ripping off your skin and you're the only person there.

Carmike is a great example. We were buying the stock during Great Recession on its way from $10 to $1, just like we did with Avis Budget Group. Mark Cuban was also invested in Carmike and ended up selling all his stock in the $5 to $6 range on its way back up. It had not even fully recovered yet but he was exiting his position, at a significant gain versus his cost basis. Some clients were telling me, "Oh, Cuban is selling so maybe we should sell."

Then, in August 2011, Murray Stahl of Horizon Kinetics was interviewed by *Barron's*. I don't know him personally but he certainly has a very respectable long-term track record. But the one short stock that he recommended in that interview, of all the companies he could have discussed, was Carmike. The stock was around $6 a share then and he said that margins were razor thin and that profitability would erode within the next two years.

Anyway, I had to deal with a lot of negative feedback because of these things. Ultimately we were right. The point is you have to be willing to have the courage to stand by your convictions and that can be a very lonely place to be at times. I find myself often times alone in my convictions about these things. And you wonder sometimes, am I crazy? Am I really thinking things through clearly because when I'm the only person who thinks a certain way it can be a little bit disconcerting.

This becomes most apparent in recessions when the extremes really develop, with the all-out panic selling that normally brings good businesses down to levels that we find really attractive.

I think about the most extreme situations of the past 25 years, the recessions of 1991, 2001, and 2008. Then there were recession type scares like the Asian Financial Crisis in 1997-1998 when everyone thought we were entering a recession. Then in 2010-2011, there was this mentality that a double dip was inevitable. I recall industry pundits talking about how the Economic Cycle Research Index, the ECRI, was dropping to a level that it had never reached without a recession following. So, this seemingly undeniable evidence that a double dip recession was eminent was just wrong. People apparently didn't realize that sentiment had become such an overwhelming factor in these economic forecasting indices, and sentiment had become so pervasively bearish that it over impacted the index in a way it hadn't done so before.

> *"Sometimes you have to just remind yourself that there's the other side of the coin, and it's not unlikely that you will experience it again at some point."*
>
> —CHRIS MITTLEMAN

Recessions are a great proving ground because they test your confidence and courage. I haven't met anyone who could sidestep a recession consistently, with any useful degree of precision. It's a waste of one's mental energy to try to do that. We're not looking to jump out of the way of bear markets, but instead focus our time on buying resilient businesses that we believe will endure in good times and bad.

MOI: If you take that one step further, if there is awareness of economic cycles and there's a possibility of a downcycle on the horizon, is there any behavioral change on your end?

Mittleman: I don't try to be reactive or proactive in that regard. As an example, in 2007, leading up to the Great Recession, I was very aware of the imbalances at the time. Even dating back to 2005, Paul Kasriel of Northern Trust was publishing compelling research on the housing imbalances and this was two years before sub-prime really came apart. He was talking about the unsustainability of the system. I read these things and I actually forwarded that one to some clients because I also thought real estate was getting out of control. A number of our individual investor clients were even doing real estate speculation on the side (and taking money out of their accounts to do so), and I was increasingly bearish heading into 2007.

We were not trying to time the market, but cash in our portfolio built up in the Spring of 2007 to over 30% and it did so reflexively, because I was selling stocks as they were reaching fair value faster than I could find new businesses to invest in. So, obviously our portfolio was an indicator that I was bearish in some way even though I wasn't trying to time the market. What happened next was a huge sell off. Unfortunately, I invested all that cash long before Lehman came apart. So, the benefit of our once large cash position was minuscule and didn't insulate our portfolio from the losses that soon followed.

I would not attempt to be too precise about timing an investment relative to economic cycles, because they really can be misleading and you can be completely wrong. Let's say that I had been overly instructed by my bearishness in 2005, and sold everything, I would have missed a couple of big years, and would have endured significant tax hits for taxable clients. I think the best example I can point to of the utter futility of being overly influenced by macro considerations would be if somebody had come to you in 1966 and said, "I'm a psychic and I can tell you with complete certainty that US securities will be the worst place to invest over the next seventeen years," they would have been right. Because in 1966, the Dow had just reached 1,000. Interest rates were ~5%. Inflation was probably ~3.5%. And inflation went from 3.5% to 13.5% over that next seventeen years from 1966 to 1982. The ten-year Treasury went from 5% to 16% or so. The Dow went from nearly 1,000 to just under 600, back to around 1,000 again, then down to the mid-700s then back up to 1,000, then down to 800. Basically, the Dow never really surpassed 1,000 over those seventeen years. From 1966 to 1982, the Dow couldn't get above 1,000 and in real, inflation-adjusted terms, it was destroyed by inflation. Inflation was rampant during that period of time. The US dollar dropped 30% against the major currencies in the world.

It was probably one of the most hostile environments for investing in US equities that you could conceive of outside of the Great Depression. And yet, if you were an opportunistic, value-oriented investor, like Warren Buffett, or Tweedy Browne, or Leon Levy, they made life-changing fortunes from 1966 to 1982. 20% compounded annual returns during a period of time that could not have been worse for equities in general. So, how important is the macro? I just don't believe it's worth my time to spend too much mental energy trying to guess the macro. You don't want to be an ostrich with its head in the sand because macroeconomics forces play a part in gauging the attractiveness of different businesses. So, you have to be aware of what's going on at a macro level and try to estimate how these things might affect the business that you've been involved in or that you might be involved.

I'm not saying don't consider it. I'm suggesting you be informed. Read *The Economist*. Read everything you can. Read the good work of the good economists on the sell side. I read all that I can to be informed about economic matters, but I don't let them dictate my investment decisions.

What drives the decision for me is if the stock is so cheap that I can't resist it anymore. If I have to endure a recession along the way, then I'll just buy more of it if it goes down, and that's usually the way we make more long-term gains. We buy good companies that we know will endure, that generate free cash usually in and out of recession. If they do get much cheaper during recession, we buy more and we'll make something out of that pain.

We endure the pain, but we actually get benefits from it, because we're actually finding more of these opportunities with a lower on average cost. I think that's a fairly simple way of kind of summing up the way we view the macro, but I do think it's important. The analogy I gave is something that very few people I hear talk about. Ever since the great recession, there's this concept of the macro overlay being necessary, which has really taken hold. So, because everyone got so shellacked in 2008, they think to themselves that they will never again invest without having a very strong sense of where the macro is. As if one can have such a strong sense.

Strategies that attempt to reduce volatility are popular these days, strategies that protect you from the horrible things that might happen… but those strategies mute long-term returns. I don't think they're the wisest choice if you're trying to accomplish what we are, which is to generate superior returns over an extended period of time. Macro factors have become more important in people's minds than they were even before the great recession.

Ever since 2008, investors appear to have become more macro-oriented. Everyone's now talking about the correlation between oil and the stock market. Should that really be a factor for an investment whether or not oil is going up or down? Obviously oil's a net benefit at a lower price to the US economy.

The US economy is nearly 70% consumer spending. So it's a net benefit. Any other argument is clearly not true. There's a negative economic consequence, certain aspects of the economy and employment and some of these high paid sectors is going down, but you cannot say that if oil goes down that the stock market should go down with it. Also this concept that the dollar needs to get perpetually stronger because interest rates are going up is something that's been talked about all the time. Interest rates are going up, the dollar is going to go up so sell everything else. Stay away from anything that is not dollar denominated.

That doesn't really makes sense to me because if interest rates are the only thing that matters, if interest rate differentials are so critical, how many times in history has that not been the case? Many, many times. It's not just about interest rates. It's about the current account deficit. We still bleed money in that regard. Every single year, we have a 2% or so current account deficit. We still have a tremendous amount of unfunded liabilities that no one is talking about but will come home to roost.

In 2011, when the S&P downgraded the US debt rating, there was this idea that the US dollar was about to be removed from its premier position as the world's currency reserve. Now, no one is talking about that. Everyone is talking about how strong the dollar is going to be and how perpetually strong it will remain. So, it's not that we've cured those problems. Our fiscal deficit may get a bit better, but all those other things are still there. So, I really question the macro kind of understandings that everybody seems to get swept up in and I remember different periods of history when different things dominated the news flow. I remember in the early 1990s the Federal Reserve released money supply figures, M1, M2, M3. They would come out on a Friday after the market closed. People got so worked up over these things because they thought that if you knew the direction of money growth, then you could discern the direction of the stock prices. This was believed to be a macro fact, that if the money supply was growing, then stocks should go up. If it's shrinking, stock prices should contract.

The reason people don't talk about money supply anymore, and why it's not followed every week is because it was proven to be untrue. You realize that credit was more important than money supply. That credit was driving growth, not the supply of money itself. So, for many years, people thought money supply was worth talking about and talking about it at least weekly by CNBC, by FNN and all the pundits who focused on it when it came out, and the market would move in reaction to it.

> *"We do invest in cyclicals, but I try to limit them to cyclicals that don't go into cash burn mode."*
>
> —Chris Mittleman

I'm not dismissive, but I'm very cautious about macro forecasting as a driving force behind your investment portfolio, because I just don't think you can do it with any useful degree of precision.

MOI: A manager whom we respect made an observation that the industry is inherently pro-cyclical. When times are good, times are really good. There's a windfall—Lamborghinis, Christmas parties, the whole thing. It's human nature, when there's a pro-cyclical atmosphere to inherently respond to the environment. So, if there's a pro-cyclical lifestyle, it's natural that one will get more euphoric and more greedy as the times are good. So, this gentleman's point was that he's actively trying to overlay counter-cyclical forces in his life. He's trying to seek out friendships with scrap dealers—not for investment purposes but for the human purpose. He's having a Christmas party, his friend is telling him to just keep cool. How do you think through this human-level issue?

Mittleman: That's really great. I like that a lot. I guess I'm a bit of a hermit. I have almost no social life, so that accounts for a large part of it. I don't go to the big charity parties or social events. I try to be aware and read a lot, and not just read what's going on in the world of Wall Street and the superrich people who don't even realize how rich they are because they live in this world.

You want to try to be aware of what is going on and look at the facts and figures that can guide your awareness. I do try to keep myself grounded in understanding that the opulence of this area and people who work in this business is not the norm, and if you look at the middle class and the stagnation in wages over the course of the last twenty, thirty years, it's a sad reality. For most people, their situation has not improved for a very long time.

The cyclicality we feel, the ups and downs, that's really a picnic compared to this drudgery that most people are dealing with. That kind of struggle just to be able to pay their rents. And it doesn't get dramatically better for them like it does for those of us in this industry when things are going well. It does sometimes get dramatically worse for them when we have a recession. It may be caused by some ancillary factor, but I am very empathetic towards what the average person is experiencing and I think about those things a lot. By thinking about these things and really considering them, I tend not to get caught up in the euphoria. I also think it's part of your personality. It's a temperamental thing. I kind of get annoyed by people who dance in the street when things are good. Like in football, for example, when a guy runs towards the end zone and starts dancing like crazy, running backwards in the end zone. That really turns me off. It's that kind of conceit of success or that cockiness. They can be funny or amusing, but I tend to not like that.

I prefer the company of people who are more even-keeled and humble, not so showy and flashy. There's an investor out of St. Louis, Missouri who is a very kind, very wise value investor. I probably should not mention his name because he probably wouldn't appreciate me talking about him publicly, but in 1994 he was a big shareholder in a publicly traded company in the shipbuilding business and I also was attracted to the company. They had a lot of value attributes and I bought it. I called him just to talk about it and he really gave me an education in 1994 about value investing in general. But he never talks to press and his track record is phenomenal. He had owned Berkshire Hathaway since it was $26 a share. He is probably one of the best investors who ever lived and yet has no interest in self-aggrandizement. He gives away so much money to charitable causes that he probably doesn't show up on any of those net worth lists and that's the kind of person I admire. That's the type of person I want to emulate. I feel that I'm less prone to the euphoria and despondency pattern of Wall Street because I don't let myself think that way. I don't let myself indulge that way or kind of self-congratulate in that way.

"What drives the decision for me is if the stock is so cheap that I can't resist it anymore."

—Chris Mittleman

This is a business. Business success is about being right more than you're wrong, and to enjoy being right when you're right, but not so happy as to depart from your normal routine. You should be making money at an above-average rate if you're doing it right, but you have to be humble about it and not let yourself get caught up in your success. If you allow yourself to get caught up in a feeling of happiness, you are not going to be as critical as you should be. This element of human nature that allows you to relish the good times also inhibits your skepticism about things.

Sometimes you have to just remind yourself that there's the other side of the coin, and it's not unlikely that you will experience it again at some point. When people think of you so highly that you're getting a request for speaking engagements and all these things, that's when I feel extra skeptical about everything. Because when everyone is singing your praises, it may be time to be a little more skeptical about everything. Especially about what you're doing in particular. I have a sense of my own cyclicality and when I notice the phone ringing from news reporters or things like that a lot, I get scared. When it's not ringing as much, which has been the case lately, I feel better about the prospects for the returns going forward.

You have to train yourself to get a sense of your own cyclicality and how it plays out with your own psyche and the way that you operate. It's a really good point on what you're saying. I really like your friend's prescription for that to make friends deliberately with people who are not dealing with the same cyclical dynamics that we feel on Wall Street.

MOI: When companies appear on the cover of *Time*, the subsequent ten years are not nearly as good as the past ten years…

Mittleman: And money managers, too, if you look at money managers that have been lauded in the press. These are not people I disrespect. I'm just bringing up names from history. Eddie Lampert, for example. He is a great investor and was being most celebrated as the next Warren Buffett around the time that the K-Mart and Sears merger was happening in the early 2000s. There were a number of magazine covers, referring to him as the next Buffett. Fifteen years later, we don't hear that anymore, because his returns were not as great as expected.

There are many examples of money managers that were put up on a very high pedestal, and that moment in time is usually not the best time to invest with that manager. Even Buffett himself. I remember in the late-1990s, there was this surge in the cult of Buffett. I don't know what exactly accounted for it, but there were books and he was on the cover of so many magazines in 1997, 1998 when **Coca-Cola**'s stock price was going through a massive upswing. And Coca-Cola had peaked at around 35x earnings in 1998, it was trading at about eighteen times EBITDA and Buffett was saying he would never sell it. He never did, but that would have be probably been a good time to consider doing so.

What I'm saying is that, that was not the ideal time to invest with Buffett. If you bought Berkshire Hathaway 1998 at its interim peak then of $84,000, it was no higher 7 years later through 2005 before it resumed its upward trajectory.

There's a cyclicality to everything. Businesses go in and out of favor. People go in and out of favor, and as investors, we need to take advantage of that. That's what we try to do. When a person is going out of favor, a respectable investor who is running a public investment vehicle, we may consider investing—the investment we made in Harbinger Group, now **HRG Group**, which used to be Phil Falcone's public vehicle. He was immensely out of favor when we first invested in that stock in late 2010.

He was involved in a scandal with his hedge fund. His company, Lightsquared was in bankruptcy. He was perceived to be untouchable. But the investment vehicle that he was controlling was trading at half its liquidation value and it owned businesses we loved, such as Spectrum Brands.

You can take advantage of these cyclical things that happen to people's reputations and invest alongside someone whose reputation is out of favor, like I did with Carl Icahn's investment vehicle, even though it took many years to work out. Icahn was not considered then what he is today. When we were buying his holding company in 1996, he had just lost TWA to a second bankruptcy. He had just lost Marvel Entertainment in a battle with

Ron Perelman, which resulted in another zero. He was thought of as a burnt out relic of the 1980s, a corporate raider who basically had fallen on hard times in terms of investment performance. Now, he's the activist investor that everyone wants to hear from on TV all the time. And he's a major voice to be listened to.

People go in and out on favor, just like stocks. And sometimes you can take advantage of that if you're investing in the right person. Betting on a person who has a strong long-term track record.

MOI: We always love to ask nature versus nurture, but I'd like to actually kind of switch it a little bit. After multiple decades in the industry, how do you try to improve your nurture. So, what are you working on that could be changed, that could be improved?

Mittleman: Time management is the hardest thing for me, and yet I know it's doable. I know that I can improve in the management of my time. I'm amazed by Buffett, who I wrote a letter to in the mid-1990s recommending a stock I thought he would be interested in. It was Rawlings Sporting Goods, which had just come public and I thought it was a great investment for Buffett because he likes baseball and the stock possessed many of the fundamental characteristics Buffett seeks. I wrote a one-page summary and sent it to him with the company's prospectus.

I didn't really think he was going to look at it but I thought maybe there's some miracle he might do so. And he actually mailed me a short little note back, which I was thrilled to receive. He thanked me for the recommendation and said that he had actually taken a look at before and passed.

It was a very short note, but I was amazed that he actually took the time to do this because I can't find the time to do anything like that. I get ideas sent to me very often and I don't have time to sit down and write back to everyone who sent me something to look at. How does he do that? And I know many people who he's taken a moment out of his day to spend time with and share his time with, without apparently affecting his output much.

"There's a cyclicality to everything. Businesses go in and out of favor. People go in and out of favor, and as investors, we need to take advantage of that."

—Chris Mittleman

There's definitely a better way for me to manage my time. That's the hardest part of it. I know what I want to do and what I need to do, but it's about making it all happen in a more regimented way.

The nature versus nurture thing is really interesting and important. They're equally important because you cannot train someone, to do this well if they don't have that critical temperament. It's not just about intellect. Intellect helps and the ability to process things quickly would be a benefit but having the ability to be temperamentally even-keeled is important. People who get flustered and lose faith just because someone else is selling don't generally produce big returns because they are selling the wrong stock at the wrong time. Temperament is important.

MOI: We had the opportunity to speak with a well-known author, and asked him about topics he's exploring that he might one day cover. His response was there's nothing under the sun that needs to be said; for the most part it's about getting the light re-shined a second time, or a third time. Are there books that you particularly like that deserve more sunlight?

Mittleman: That's a really good question. I have a huge number of books at home that I haven't brought over here yet, but I'm thinking of something that I can recommend as being impressively unique in terms of its impact.

What I find the most interesting and useful are books with examples of a life lived well. There's one book over there, *Personal History*, the auto-biography of Katharine Graham. It's a great story because it shows how this woman persevered through tremendous adversity. Her husband committed suicide and she took over running The Washington Post. She formed a relationship with Buffett, and took his advice on a number of issues and had a successful career and stock as a result.

The anecdotes in history, the decision making at critical moments of history that you get in reading these kind of books, that to me is the most interesting and instructive thing because you're going to encounter some similar moments in life, where you're faced with a critical decision. Her decision to print the Pentagon Papers when the rest of the news world wouldn't do it. That was something that was life changing for that newspaper.

Personal biographies, the histories, are the most interesting. I have Benjamin Graham's personal biography, also the biography of Leon Levy, *The Mind of Wall Street.* These are all great. It's not that they're uncovering something that no one knows about, but these are personal stories about things that they actually experienced in the investment world. How did they deal with the 1973 to 1974 bear market? What did they invest in that worked? What did they invest in that didn't work? What were the mistakes they made? What did they learn?

You're basically absorbing all of this knowledge that's out there and you can learn from it and apply it to your own experiences.

MOI: Chris, thank you very much for your terrific insights.

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