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The SaratogaRIM Story

SaratogaRIM.com — 2007 Quarterly Report — May 4, 2007 — Q1

SaratogaRIM.com — 2007 Quarterly Report — October 31, 2007 — Q3

SaratogaRIM.com — 2007 Annual Report — February 1, 2008 — Q4

SaratogaRIM.com — 2008 Quarterly Report — October 29, 2008 — Q3

"Clear!"

SaratogaRIM.com — 2008 Q3 Research Note — September 10, 2008 — Q3

SaratogaRIM.com — 2009 Quarterly Report — July 14, 2009 — Q2

"A Cigar-Butt Rally"

SaratogaRIM.com — 2009 Annual Report — January 20, 2010 — Q4

Think Outside the Box

SaratogaRIM.com — 2010 Quarterly Report — April 23, 2010 — Q1

A Strong Defense

SaratogaRIM.com — 2010 Annual Report — January 25, 2011 — Q4

PLEASE NOTE:

The "SaratogaRIM Story" that follows was written in 2011. Since that time, SaratogaRIM has continued to grow and evolve, as has our story. The content within this publication should not be mistaken for our "complete" story. We plan to create an updated version with our continued story when time permits.

History

Our firm's history began in May 1995, when my brother Jim and I resigned from Smith Barney. We did so to start a little firm that would eventually grow up to become Saratoga Research & Investment Management. I had spent the prior decade within portfolio management groups at Prudential and Smith Barney via Shearson Lehman. In those early years I was an old-fashioned Graham and Dodd-style value manager. I owe that to a man named Greg Phipps, who took a young pup barely a year out of Santa Clara University under his wing. Greg trained me and became my mentor. He passed away a few years ago, but I will never forget him and I still have the first book he ever gave me - *The Intelligent Investor*, by Benjamin Graham.

That book inspired me. For starters, it was thoroughly unlike anything the Jesuits at Santa Clara imparted on me, or the curriculum in the "1985 J" training class at Prudential-Bache. Graham was brilliant. I learned that (in total contradiction to the efficient market hypothesis) the value of a business is "separate and distinct" from the price it trades for in the market. And that it is wise for any investor to consider what the underlying business is worth when weighing the purchase of a stock certificate, given that it represents nothing more than a percentage ownership of that very same business. Also, Graham drew a clear line between speculating and investing that pretty much comes down to intention. If stocks are bought or sold as "bets" on directional moves in stock prices, then the intention is speculative. If, on the other hand, stocks are purchased at a price sufficiently below intrinsic value, such that a margin of safety can be thought to exist, then an investment motive is apparent. But it was actually an appendix to that book, a reprint of a talk at Columbia University delivered by Warren Buffett in 1984 commemorating the 50th anniversary of *Security Analysis*, written by Benjamin Graham and David Dodd, that really put the hook in me. The title was *The Superinvestors of Graham-and-Doddsville*.

In it, Buffett chronicled the records of the greatest investors of his era, observing the amazing truth that most of them had studied in old Ben Graham's classroom at Columbia University. So began my career as a value investor. I spent years studying all things Graham & Dodd, and from almost the very beginning I applied the knowledge I was accumulating into my investment management approach. Outside my studies, there were two other early battle scars that influenced my attitude and perspective about risk and investing indelibly. One was stock-specific while the other was a market event.

My grandmother had given my family a few hundred shares in General Foods, which was a fine old blue chip company that paid a steady dividend. Around that time, one of my clients took a flyer on a stock that he had read about and it shot up from the second he bought it. Within months he had doubled, then tripled, his money. This wasn't an exciting IPO or even a tech or bio-tech name. Believe it or not, it was a carpet cleaning business. Barry Minkow, the founder and CEO, was momentarily one of Wall Street's darlings. He was everywhere, from the Oprah Winfrey Show to the top of Fortune Magazine's prestigious list of the 40 Richest Americans under age 40. In my inexperienced eyes, he had achieved something admirable.

Well ... I sold Grandma's stock and bought the high flyer. And it worked great for a couple months. But at 1:03 p.m. on July 3, 1987, the newswires reported that the whole company was a fraud and the stock immediately went to zero. At the age of 25, I had wiped out Grandma's gift with one stupid trade.

Furious with myself, I vowed never to let anything like that happen to me again. Over the next several years, I studied financial statement analysis. I learned how to read and understand income statements and balance sheets. I came to appreciate how cash flow ties everything together.

The second event was the stock market crash of 1987. Nothing in my formal training or experience had prepared me for such a downturn, and nobody else in Prudential-Bache saw it coming. I still have my client statements from the crash and

I peek at them occasionally to remind myself how dangerous the stock market can be. These early experiences forced me to think of risk differently than I had been taught in the classroom - it wasn't just volatility. From very early on I learned to think of risk in terms of losing money - or as I would soon learn to say a little differently, in terms of permanent loss of capital. It was in the immediate aftermath of the crash that I first read Graham's book.

The Intelligent Investor inspired me to study the entire Graham canon and to begin watching Buffett. From the onset, Warren Buffett confused me, he still does sometimes. I was dumbfounded when he bought Coke. Based on everything I had studied, it didn't look anything like a Graham stock. I wrote Warren several letters asking him to explain the move, but he returned them with handwritten notes saying things like, *"Dear Kevin, Too many requests not enough time. Good luck with your career – WB."* It was obvious that Warren's investing process had evolved beyond Graham's. But how?

Throughout the early 1990s my style was Graham & Dodd. Returns were fine and we stayed out of trouble. That changed when Robert Hagstrom's fascinating 1994 book, *The Warren Buffett Way*, helped fill gaps in my understanding of how value investing could be interpreted differently. In addition to Graham, Hagstrom introduced three additional influences: Philip Fisher, John Burr Williams and Charlie Munger. I found Tom Price on my own later on.

Before we get into Fisher and the others, a little background is in order.

To wit, old Ben's approach was extremely quantitative. Basically, investing to him was an endless hunt for cheap stocks, one undertaken without much care for what a company did exactly, or who managed it. If he thought it was worth sufficiently more than it was trading for at the time, he would make an investment. End of story. In Graham's eyes, the difference between what he paid and what he calculated a given share was worth represented "the margin of safety." He figured most of his investments would work. Since he felt that the odds on each individual move were in his favor, due to his margin of safety calculation, through diversification his many stock winners would more than cancel out the few losers. It was not unlike the mindset of a casino owner concerning his roulette wheel (the odds of which are tilted slightly in favor of the house).

But it's important to understand a couple of things about Graham. When he was running his investment firm, Graham Newman, he would sometimes buy a whole company, fire everyone, pay off the liabilities and pocket his profit. He was willing to be a liquidator. Though he would probably turn in his grave if he heard someone say it, some of the LBO firms of the 1980s were clearly using his playbook.

His favorite valuation metric was to buy when the price of a stock was trading below current assets minus current liabilities minus long term debt. Do that, he figured, and you got an operating company for free. This presents a problem for value investors who either can't or don't want to be liquidators. In short, they not only need a different valuation metric than Graham's – but an approach that views a business not as a corpse but as an ongoing concern.

Philip Fisher, who along with Tom Price is hailed as an intellectual forefather of the growth school of investing, was Graham's contemporary. But he looked at a business quite differently. Fisher fixated on all things qualitative – the way companies worked, how they earned profits and their long-term prospects for profitability and growth. He strove to understand how a business competed within its industry and how that industry was likely to evolve in the future. And he focused heavily on the quality of management.

Fisher is an important influence on our approach because we're long term investors and because we think of ourselves as business owners (as opposed to the holders of little pieces of paper, the prices of which move up and down in the financial pages every day). With that perspective, it's not enough for a stock to be cheap. History reveals capitalism to be inherently unstable, and subject to recurrent yet unpredictable inflationary and deflationary cycles. Factors like the company's financial position, the capital intensity of its business model, the quality of management and its sustainable competitive advantages are extreme-

ly important to its longevity. If you buy a lousy business, or one particularly vulnerable to stressful economic environments, even if you pick it up cheap, sooner or later economic reality and the fundamentals of the business will likely catch up with you.

Hagstrom also highlighted Munger, who later was briefly a pen pal of mine. Charlie was the one who helped Buffett appreciate how quality trumped low P/E ratios. And he helped me too. He really is a very good teacher. Most people don't realize that Buffett was originally uninterested in what became one of his hallmark acquisitions, See's Candies. It was Munger who convinced him that the deal was sweet. And See's is a textbook illustration of why it is vital to consider not just cash flows into a company but also outgoing cash flows. That's because companies with low maintenance capex requirements tend to perform much better than more capital intensive businesses, especially during prolonged inflationary environments.

John Burr Williams was a pioneer of discounted cash flow analysis, the process by which the value in today's dollars of all the expected future earnings of a business can be estimated. As I studied the works of Williams and the others, it became very clear to me that there was a process that would be far superior over the long term to the old fashioned brand of value investing that I had been practicing. It entailed seeking out high quality businesses, determining what they were worth and making long term investments in them, but only when that could be accomplished at a price significantly below intrinsic value to achieve Graham's "margin of safety."

It was a Eureka moment! I knew what I wanted to do with my career, and that I could build a business on that foundation. Shortly after this realization, my brother and I resigned from Smith Barney and started this firm.

The first thing we needed was a robust stock database and software with which to screen raw numbers. We chose Standard & Poor's (S&P) Compustat for the database and Research Insight (previously called PC Plus) for the quantitative screening software. I worked with a consultant from S&P to develop the screens we would use to filter out businesses that did not possess the characteristics we were looking for. The consultant who helped me set up our first set of code brought in one of his Chicago colleagues who had been working on a similar project for David Braverman, head of quantitative research at S&P. Together, we built the original quantitative screening portion of our investment process.

Shortly thereafter, Barron's ran an article titled *"Son of Buffett"* proclaiming that S&P had built a computer model based on a set of screens – virtually identical to our screens according to our consultant – that had actually outperformed the sage of Omaha-based investor in backtesting. While the S&P version had a weak valuation model bolted onto it, the security selection front end was, again, according to our consultant, identical to the original set of screens we built.

Our screening process has evolved significantly over the years, though the basic structure and objectives have never changed - to identify high quality businesses that share a set of five uncommon characteristics:

1. They must be financially sound. They must have solid balance sheets. Our screens are very biased against excessive leverage. We prefer little or none but certainly no more than moderate. We have always believed that the companies we invested in should be solid enough to survive a depression.

2. They must have high quality owner earnings. We're looking for real cash earnings not accounting fluff. We define owner earnings as cash flow minus maintenance capital expenditures (mcapex). Owner earnings are the dollars that, if you owned the entire business, you could choose to pay yourself as a dividend without impacting the competitive position of the company. MCAPEX is the portion of a company's capital expenditures that are required simply to maintain its current competitive position. It is not an item that is broken out in financial statements. It was Charlie Munger who actually explained this concept to me in a six-page handwritten letter. Unlike Buffett, if you catch Munger in the right mood and ask him intelligent questions, he will answer.

In Munger's explanation, he said to imagine that you owned an apartment building. The money you set aside monthly for the roof - that needs to

be replaced every decade or two - is a maintenance capital expenditure. But if you expand the apartment complex, the money you spend building additional apartment units would be growth capex. You don't subtract that from cash flow to determine owner earnings. Charlie's explanation helped me to derive a formula to estimate maintenance capex by examining and relating a company's sales and property plant and equipment accounts over time.

[Interestingly, just as our avoidance of companies with heavy leverage did not benefit us until the 2008 stock market crash, we have yet to reap the benefits of avoiding business models with disproportionately large maintenance capital expenditure requirements. The importance of this likely won't become apparent until the economy enters a prolonged inflationary environment. Given that an entire generation of money managers has no experience managing in an inflationary environment, we believe that limiting our investment universe to those companies least likely to be damaged by the ravages of inflation will eventually prove to be a huge competitive advantage for us.]

3. They must be currently profitable. We view profitability from three angles: net income as a percentage of sales, return on assets and return on equity.

4. They must demonstrate above average long term profitability. We seek businesses that have demonstrated a propensity to earn above average profit margins over time and through different phases of the business cycle and economic environments.

5. They must utilize retained earnings efficiently. We eliminate companies that have not generated at least a dollar of market value for every dollar of retained earnings over time.

The overall screening process helps us to eliminate most of the roughly 10,000 companies in S&P's Compustat database. No fewer than 150 or more than 200 companies have ever made it through our screening process. The result is a low turnover, small pool of very high quality businesses. This pool is our favorite fishing hole.

Our screening process is just the starting point. Going forward, we change gears and turn to qualitative analysis for more weeding. To begin, we eliminate pure commodity businesses and companies with business models we're not comfortable with. Commodity businesses are those that compete purely on the basis of price. The weakness of a commodity business is that even the smartest management team is only as smart as their dumbest, or lowest cost, competitor. If a competitor undercuts prices to grab market share, a commodity business is forced to do the same or see sales suffer. Historical track records of such businesses can be rendered meaningless almost instantaneously. The reason for avoiding a business that we don't understand is simple. Unless the business model makes sense to us, we won't have confidence in any valuation work. At this stage, we study the remaining businesses and postulate what each of them might look like in the future. We think about how each company competes within its industry and why it has been able to earn such high profit margins without excessive leverage. Basically, we determine whether a company has sustainable competitive advantages. Buffett refers to this concept as "the business moat." The stronger the advantage, the wider the moat. Through our qualitative work, we narrow our search to 50-100 companies (out of the 150 to 200 companies that make it through our screening process) that we would consider investing in if the price was right. Note that we still have not even peeked at the stock price! This is when we begin our actual valuation work.

Our primary valuation model is essentially a discounted cash flow analysis. We say "essentially" because we prefer to think in terms of an equity bond. Basically, we value a company's stock using the same math that would be used to calculate the price of a 30-year bond substituting a conservative estimate of the company's future "owner earnings" as a proxy for the coupons.

The first step is to establish an initial growth rate that makes sense to us. We start with the concept of a sustainable growth rate, which is the fastest a company can grow without raising new equity capital or using leverage. In the text books, the formula for sustainable growth rate is:

Growth = ROE x (1 - the payout ratio)

We modified that formula after thinking about the implications of MCAPEX by creating what we call a capital intensity ratio which is the proportion of cash flow eaten up by MCAPEX yielding our modified formula:

Owner's Growth = OROE x (1 - PR - CIR)

Where:
PR = Payout Ratio
CIR = Capital Intensity Ratio

We analyze the company's return on equity and payout policies over the last 15 years and make a reasonable estimate for the initial growth rate. As a check, we also compare our estimate with the consensus 5-year growth rate from the analyst community. To be conservative in our valuation model, we typically start with whichever number is lower. We also assume that earnings growth rates will slow (fade) for all companies as they get larger due simply to the law of large numbers. What we end up with is a conservatively derived estimate of future owner earnings that we are comfortable with.

We then use a company specific risk adjusted discount rate to calculate the present value of our conservatively estimated future owner earnings projections, add them up and divide by the common shares outstanding to estimate intrinsic value per share. We then apply Graham's concept of a margin of safety and establish our maximum purchase price with a minimum margin of safety which provides us with the first of our two critical valuation numbers. A sufficiently large margin of safety protects us on the downside because we can still end up with a reasonable outcome even if our projections of future cash flows turn out to have been overly optimistic. Meanwhile, it also enables us to potentially earn outsized gains if our assumptions turn out to be right, and the market eventually corrects the mispricing, or if our initial assumptions eventually prove to have been overly conservative.

As a sanity check against our DCF work, we have built a second model to establish an alternate maximum purchase price based upon a minimum expected rate of return adjusted for risk. Our maximum purchase price for each candidate on our focus list is established by whichever is lower.

Let me raise an important analytical point. Our valuation approach itself, like every other part of our process, is mostly a defensive construct and we attempt to be conservative with all of our assumptions. Through both quantitative and qualitative analysis, we have already determined that all companies left under consideration at this point have solid business models and favorable long term prospects. Frankly, we believe that if you threw 25 darts at this list and owned them for a whole market cycle, you would likely outperform the S&P 500 Index. However, we don't throw darts…. In constructing our valuation models, we are more interested in making sure we don't overpay than in trying to identify a potential ten bagger.

To sum up, we look for high quality businesses and establish maximum prices that would be attractive to us from a long term investment perspective. We monitor our inputs, make adjustments for the business cycle, and build portfolios by investing in great businesses when we think they're cheap relative to their underlying intrinsic values.

What we do isn't for everyone. We will bore some people. We're not traders and we're not interested in participating in the short-termism that has come to define modern finance. New clients must understand that we won't be rushed to put money to work if we can't find compelling opportunity. Historically, this means that we have tended to underperform somewhat during frothy market environments. We'll also underperform anytime the market favors the riskier, lower-quality end of the spectrum. These tradeoffs are part of our process and we not only accept them, we embrace them. The patient application of our process has allowed us to outperform both the markets and the vast majority of our peers over timeframes spanning at least a complete market cycle - measured either peak-to-peak or trough-to-trough.

You may have read Charles D. Ellis's tennis analogy about how to beat the markets. Ellis contended that investing is a "loser's game" in which long-term track records are determined more by errors than by successes. He likens this to amateur tennis, in which participants lose some 80 percent of their points due to unforced errors. Unlike

the pros, who beat their opponents through superior skill, the winner in amateur tennis is the person who makes the fewest mistakes.
So too in the stock market, we believe the smartest way to outperform over the long term is to generate reasonable returns when times are good and avoid huge losses when times are bad. You don't need to make a hundred percent just to get back to even if you don't lose fifty percent in the first place. Munger summed it up wonderfully when he said: *"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."*

As a business owner, it's hard to argue against growth – but only so long as it happens the right way. In recent years the assets SaratogaRIM manages have risen dramatically, which clearly benefits our clients, our consulting partners, and ourselves. I've been able to assemble a wonderful team of people, make significant investments in a new office and in technology, and to lay a foundation for my team to reach its fullest potential.

Reaching one's potential – individually and collectively – is something that was instilled in me by two great men, both of them football coaches; Benny Pierce at Saratoga High School and Pat Malley at Santa Clara University. Coach Malley once told our team: *"The saddest thing in the world is a guy sitting in a bar, twenty years after the fact, watching a professional ball game and pointing up at the TV and saying, 'I could have done that.'"* In my career, it's always been very important to me to perform to my capability, and since the day I started this firm my goal was to build a small team comprised of smart, hardworking people that I trusted implicitly and enjoyed being around. Not as an end unto itself, mind you, but to help me reach my own full potential as an investor.

I also envisioned mentorship, coaching, and construction of a business structure sturdy enough to survive me. By teaching protégés exactly what we do, involving them in every aspect of the process and ultimately handing the controls to them, I can assure continuity at the firm level for long after I've ascended to what our dear friend, the late John Dolan called *"the great boardroom in the sky."*

Don't worry. I don't have any plans on going there anytime soon. It's just that I have tried to be forward-thinking in every aspect. Fortunately, one of the differences between investing and football, or any young man's game really, is that as a money manager you have a much longer window within which to reach your potential. There's no eligibility to expire; you don't lose a step, succumb to injury or simply fail to deliver 110% anymore as the opportunities fade. Investors take longer to become what-might-have-beens. In this business, a little grey hair is an asset, not a liability. What I've come to learn over the years is that potential is a moving target, and much more a journey than a destination.

Since day one, we have sought to avoid attracting "Hot Money." We've worked very hard to educate our clients and our consulting partners about what we do, how we do it and why it works. In fact, for most of the firm's history we never publicized our performance data, preferring instead to discuss our investment process. To this day, we hope it's not our track record, but how we achieved it that is the big draw.

Perhaps as a result of our approach, we rarely ever lose clients. I have always been proud of this fact and have believed it was a direct reflection of our clients' belief in what we were doing for them, as well as of their reasonable expectations. We can't – and don't ever intend to – compete in short-term performance derbies, preferring instead to stay on the long-term trajectory that has served us so well over time.

Our firm surely won't maintain today's growth rate forever. But I'm certain that the benefits of our having grown from being a two man shop just a few years ago to the investment management firm that we are so proud of today will accrue for years to come to our clients, partners, friends and families.

In so many ways, growth is good.

Respectfully,

Kevin Tanner
President & Chief Investment Officer