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{ INTERVIEW BY KHAI NGUYEN }

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: A Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business (Management) (1999).

Khai Nguyen: *Tobias, welcome and thank you for joining us.*

**Tobias Carlisle**: Khai, thank you very much.

*KN: You started Eyquem Investment Management in 2011, a fund rooted in deep value investing. Why did you decide to launch your own fund and why deep value?*

**TC**: I started Eyquem in Australia basically sitting at the desk that I had sat at previously at an activist hedge fund. The initial version of it was an Australian legal structure and it operated for 20 months until the end of 2011. I then moved to the U.S. because I had met my wife in San Francisco while working as an attorney. I decided to set up in California and the reason for setting up was to work for myself and establish my own track record so it's been operating continuously since then.

My background was in corporate advisory law and in mergers and acquisitions. This was at a time when the market was right for that sort of transaction work and capital raising was also kind of bread and butter stuff. There were some more unusual things that occurred like activists harassing companies and I'd never encountered that before. I didn't really know what it was before I started working as a lawyer but I had read Security Analysis and The Intelligent Investor when I was in college and law school. I would see these guys approaching these companies trying to extract some value and it was difficult to understand what value proposition they could see in the companies because they were all struggling and not particularly attractive looking businesses. I went back to Security Analysis and reread the chapters on liquidation value investing and net-nets. I then realized that what

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they were trying to do was more of a balance sheet approach and I just found it fascinating. The research that I did showed that the returns to it were very good possibly because it's such an unusual style of investment. Through a lot of work and given the opportunity to employ legal skills and the transaction work that I had done, it just seemed like a better fit for me than the franchise style investing that a lot of other value investors try to employ.

*KN: What's been the most difficult part of being a deep value investor?*

**TC:** All value investing strategies will underperform for periods of time. In order to beat the market you have to be prepared to depart from it. I like to think of it as counting cards at the Blackjack table and trying to bet heavily when the odds are in your favor. Even when the odds are in your favor there's no guarantee that you'll outperform. So you can bet heavily when the odds are in your favor and still underperform.

*KN: In the value investing world you're best known as the author of the popular website Greenbackd.com. What is the story behind the blog?*

**TC:** I started Greenbackd in late 2008 because I had been fascinated by net-net, liquidation value investing, and activism for a very long time. There really hadn't been a large number of them around. I used to read a blog called Cheap Stocks written by Jon Heller and he had this 7 or 8 year track record of picking these net-net stocks that generated extraordinary performance. When the market got very cheap in late 2008 it seemed like a good opportunity to start writing about them because they were out in number. I was buying them personally and I thought it was an interesting idea that you don't see a lot of at that stage. I started writing it because I wanted a very long term public track record of picking these sort of positions like Jon had achieved with his site. Blogging and writing is an excellent way to hold yourself accountable for decisions that you make. If you write it down and you revisit it 12 months later, you can actually see your reasoning and learn where you made your mistakes. I think for me that was really the beginning of a rapid evolution as an investor.

*KN: How does running a well-regarded value investing blog play into your investment process?*

**TC:** In its initial incarnation it was just stock picks as regularly as I can put them out. As it's evolved it's become more focused on strategy. Where it was initially wholly focused on net-nets, I realized that there needed to be some sort of evolution to deal with markets where net-nets weren't available. I had some research that I had kept from when I was a legal research clerk way back in the early 2000s in the dot-com bust that talked about all these small companies that were struggling to find attention. That research contained this metric called the enterprise multiple which a journalist described as the "acquirer's multiple". He called it that to make it understandable so I always thought of it as the acquirer's multiple. It works in a very similar way to the net current asset value rule in that it looks for a cash rich balance sheet. It penalizes companies for holding debt, having large minority interests and preferred stock that need to be funded, and underfunded pensions and off balance sheet liabilities. It rewards them for having cash on the balance and strong operating earnings. It's the same metric that activists, private equity firms and leveraged buyout firms use to target companies. It has this dual effect where it finds these very undervalued companies and allows you to also look at the same opportunities that are targeted by these other firms. Those firms create catalysts and I think that's part of the reason that the returns to it have been so strong.

*KN: You've been on the record as saying: "A wonderful company will earn a market rate of return if the stock price fairly reflects its intrinsic value. You don't get paid for picking winners; you get paid for identifying mispricings." How then, do you find mispriced opportunities?*

**TC:** That's a good question. I use the acquirer's multiple exclusively to screen for them. It's a truth that is sometimes ignored by investors—even value investors. There's a fairly well known behavioral error where you like a product or admire a company and you have good feelings about the stock so you buy the stock on that basis, regardless of its valuation. That leads to underperformance. The opposite of that approach would be to find things that are obscenely undervalued on a simple metric and then to buy a basket of them. This is something that anybody can do really. You find in that basket that it's filled with stocks you really don't want to buy. Right now it might be filled with iron ore miners, gold miners, or energy companies. It's whatever is the most frightening industry or sector at the time. It forces you to buy these out of favor, frightening industries and that's where you find the mispricings. It's the shunned, the feared, the disgusting because you look silly when you buy them and you look particularly silly if they go down afterwards. That often happens even among value investors. If all those things line up then there's a good chance that what you're finding is mispriced.

*KN: While we're on the subject of opportunities. Can you go over two companies that you've identified as undervalued and qualify as deep value stocks?*

**TC:** I have two in my Harvest portfolio. The first one that has really underperformed is AGCO Corporation (AGCO). It makes agriculture equipment, heavy machinery, and stuff like tractors and combine harvesters. It's been beaten up. In 2013 it got into the mid $60s and now it's in the mid $40s. On an acquirer's multiple basis it's trading a little bit north of 7 which ordinarily I would say is fairly expensive. But in this market there's just not a great deal around so it's relatively inexpensive compared to other things that are around. It's got a market capitalization of a little bit over $4 billion and it's carrying a little bit of debt but it's got very strong operating earnings of around $1 billion. Its gross profits on total assets, which is another ratio I look at in deep value, runs around 30%. It's probably worth 50% more than where it's trading at the moment. It pays a little dividend and it's in competition with Deer, Caterpillar and companies like that. The thing that makes it most interesting is that it has a holding in an Indian company that's not being accounted for in that acquirer's multiple.

The other position in my Harvest portfolio is Argan (AGX). It's one I've held for a while. It's in my portfolios currently. It traded as high as $40 earlier this year but it's off to the low $30s now. On an acquirer's multiple basis it's currently a little over 2 so it's very cheap. But it's a smaller company with a market capitalization of only about $500 million. It's a power construction and engineering type business. It does a number of things like telecommunications infrastructure services and project management, largely to telecommunications and electric utilities. It's the sort of business that should be a little bit cyclical. It's so cheap that even if the earnings and operating earnings do come off a bit there's a possibility of a 50% plus return from here. Those are the two positions that I favor, AGCO and AGX. They're both in my Harvest screen and they're both off from where I picked them up.

*KN: In your experience what characteristics or attributes are advantageous for a value investor to have?*

**TC:** You need to be willing to stand apart from the crowd. I think a naturally contrarian instinct is a good one. It's a double-edged sword. My wife would say that I'm contrarian about everything all the time. So that might not seem like a good attribute but in an investment sense it is. It's not being contrarian for the sake of being contrarian. Seth Klarman describes it as a contrarian with a calculator attached. You need to be willing to ignore popular stocks and look at things that are very unpopular. You need to run the analysis to see if they are in fact cheap and then act on it, which often the most difficult part. To buy them and to hold them in size and if it goes down be prepared to buy more and if it goes to zero to be prepared to look silly. Those are the things that are rare qualities and probably the most important.

*KN: And with that, I want to open it up and ask you questions submitted by the Harvest investment community.*

*Which individual served as your biggest influence as an investor and why?*

**TC:** It's got to be Benjamin Graham because his writings are so lucid. Anytime I thought that I found something original I've gone back to Security Analysis or The Intelligent Investor and found that Graham got there first. In the process writing Deep Value, my most recent book, I had an opportunity to go through

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that to see if I could find some pertinent quotes or ideas that he had. In the course of looking at the Magic Formula and Buffett's investment methodology, I went back and looked at some of the things Graham had said and he'd already said that it's incredibly difficult to separate out the performance of a business due to the underlying business conditions to the industry and the quality of the management. This is one thing that I had always struggled with. How do you examine a management and determine whether they're good or bad simply on the performance of the business? Buffett himself has said that good jockeys will go well on good horses but they'll struggle on broken down nags. So how do you know that you've got a good manager when they might just be the benefit of a particular good business condition? So for me it's Benjamin Graham but I got to Graham through Buffett so Buffett's had a huge influence too.

*KN: There have been several discussions on Harvest lately from funds talking about diversification is de-worsefication. Is there an ideal number of stocks to have in a value portfolio?*

**TC:** I'm currently working on a new book that will be released in late 2016 or early 2017 that looks precisely at that question and right now I'm deep in the theory of it. Munger would say that any more than 3 stocks is a crazy merry-go-round, but Greenblatt might say that the ideal number is somewhere between 20 and 30. I'm a little bit in the Greenblatt camp. I think the theory depends a bit on you as an investor. If you're a Kelly betting type investor and you can identify those opportunities that are substantially better than the others then you're well paid to investor more heavily in those positions. I think that Kelly, in isolation, will make you over bet. Kelly betting in a value investing format means you're going to have a number of positive expectation bets so you can't just bet like you're at a Blackjack table where you can put 40% of your stake into a single very good position. You have to put them over a number of other positive expectation bets. That Kelly betting investor can go very well but you also have to remember that there's a lot of randomness in any given position. A very good undervalued position can still go down a great deal and other positions that are less good can outperform. So diversification can capture to your own benefit some of that randomness. If you tested it empirically, I think the number falls out to somewhere between 20 and 30 positions. 30 might be too many for the average investor but I think 20 is fairly manageable. That might be 2 positions a month or if you're holding for longer periods of time that could be a single position a month which should be manageable.

*KN: As a value investor, how do you decide what allocation of the portfolio to keep in cash? Cash as dry powder for*

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**TC:** That's another question I've tested empirically. Market timing is impossible to do. What you're saying when you're holding cash is that you're waiting for a time where you're going to be able to find another position that you can put into the portfolio. Every single backtest that I have done has shown that simply being fully invested all the time leads to the best outperformance and it leads to the best risk-adjusted outperformance. So I don't advocate carrying cash in a portfolio but you have to realize that the corollary to doing that is huge volatility in your performance. You'll be in a 2000-2002 type scenario or a 2007-2009 type scenario where you draw down with the market. So that means that in 2007-2009, if you're in the cheapest acquirer's multiple decile, you were down along with the market which was 60% in the 20 months or so from July 2007 through March 2009. The good news is that by June 6, 2009, which is a little under 3 months from the bottom, you would have recaptured everything that you'd lost and made enormous gains thereafter. Buffett and Munger have both said that they'd rather have a lumpy 15% than a smooth 12%. I think that's why they've also said that you shouldn't be in the market if you can't stand a 50% drawdown. What they're saying is that if you're fully invested you're going to have a lot of volatility and big drawdowns like that. You can lessen those drawdowns by carrying cash but it hurts returns. Of course, if you can't find a position to invest in then it makes sense to hold cash instead but I don't think you should set a fixed proportion of the portfolio to hold in cash waiting for some better opportunity.

*KN: Given your style of investing, as well as stylistic biases, what is the ideal size for your strategy across investment vehicles? At what point would you feel concerned about your ability to execute on the strategy?*

**TC:** It's a question I've examined and discussed with a lot of other people. It depends on how the strategy is executed. If your strategy is to hold all the positions for a year like in a Magic Formula type sense, and rebalance once a year, I think that at the moment the capacity is somewhere between $500 to $1 billion. Some people are surprised that the number's so low. Even limiting yourself to the S&P 500 universe there's much less liquidity there than most people realize. Having said that, there are a number of different ways that the strategy can be implemented so it could be just investing a small part every week so that you're averaged over the entire year. That is a much larger number. It could be as much as $10 billion. The other possibility is that you're looking for individual positions to move in and out of a model and that number will depend on the size of the positions. Again, that's somewhere between $1 and $2.5 billion. I think they're extraordinarily large sums to generate good returns that reliably exceeds the return on the market.

*KN: Which market environments are most challenging for a value investor?*

**TC:** Very expensive markets that are continuing to strike ahead. The current market is incredibly challenging because there are few positions that pass my absolute screens and staying out of the market means that you're underperforming by a wide margin. One of the ways of implementing this strategy is to remain fully invested in the cheapest relative portion of the market and that strategy performed very well in 2013. It doubled the return on the market and this year it's pacing the return on the market still. If you're implementing it like a traditional value investment strategy where you're looking for the absolute positions and there are very few that meet the absolute screens then it's always going to be this type of market—very expensive and still moving up. That means the opposite kind of market is best for deep value guys where the markets are crashing, cheap and continuing to fall. It's ideal because you can get set in lots of great positions.

*KN: Have you ever had to override your approach because of changing security or market dynamics?*

**TC:** No, I'm very careful not to do that because that's a key error that a lot of investors make. There's good research out there that says that experts underperform their statistical prediction models and rules. They continue to underperform when they're given the benefit of the statistical prediction rule. What that means is that when you cherry pick from your model you invariably pick things that will underperform the model and you miss the things that outperform. The reason is that things that outperform are often the most frightening looking securities. This is known in literature as the "Broken Leg" problem. Suppose you have an algorithm that predicts whether John will attend the theatre on Friday. If we know that he has a broken leg, so the argument goes, surely we should be able to override the model to account for it. The answer is no and the reason is that we identify more broken legs than there really are. There is going be an error rate in the model but the model's error rate is known and likely better than the error rate flowing from your own ad hoc decision making. So I'm very careful to follow the stock screen religiously.

*KN: What are your thoughts on the concept of a "value trap"? How long will you hold onto a non-performing position?*

**TC:** I have some unconventional thoughts on value traps. Investors think that they can identify these things prospectively but I don't think you can. If you're applying a systematic process that's based on research and statistical analysis of past positions and it doesn't perform, it doesn't necessary mean that you've made a mistake or that you've invested in a value trap. Any decision that you're making has to be repeatable over lots of other positions. Some positions work and some don't. It's very difficult to identify beyond what you've put into the screen what makes those positions perform and what doesn't. I do think that you need a good buy and sell rule. My rule for selling is if it's a fixed period of time after I've bought it, no less than 12 months, and I find that it's no longer in my model then I sell it and I don't worry about it at all.

*KN: I read your blog post last year on value investing in Japan's bear market. Do you still see the same opportunities and what is your outlook on the country given its recent economic setback?*

**TC:** That's a really good question. Japan is one of those great tests of this type of investing. It has worked. Since the 1990s when the Japanese market was trading at 100 times cyclically adjusted earnings, the U.S. traded at 44 times cyclically adjusted earnings in 2000 to put that in comparison. So Japan was more

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than twice as expensive as the U.S. It's basically fallen since 1990. If you'd invested in very simple value strategies in Japan like buying the cheapest 10% of the market based on price to sales, price to book or price to earnings, it returned something like 20% a year which is phenomenal. On top of that the currency was generally strengthening against the U.S. dollar over that time so you had a slight tailwind in addition to that 20% return. That research was done by a Japanese university. The currency has been a tailwind to U.S. investors although that's not been the case more recently. The question is what happens if Japan goes into this so called Keynesian end times where they're printing so much money the government can't fund its own debt and they enter into hyperinflation or high inflation? I think if that happens then those business will certainly be hurt but you'd be better served as an investor holding a business than you would be simply holding the currency. Potentially the stock market could perform very well under those conditions. Whether you'll do as well in dollar denominated terms is yet to be determined. It's a very interesting opportunity. I still think Japan's very cheap. If I run my global models I could buy almost 100% of the stocks globally that are cheapest are in Japan so I have some limits. I limit my portfolios to 40% Japan simply because I don't know what's going to happen there but I still think that's a very big allocation to Japan. So that's a very good question. I don't really know the answer but it'll be interesting to see.

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