Exclusive Interview with Allan Mecham

We recently had the pleasure of interviewing Allan Mecham who heads Arlington Value Management. The firm has established an impressive ten-year record, including a positive return in 2008 despite no reliance on short selling. We are pleased to bring you this interview exclusively in *Portfolio Manager's Review*.

Allan Mecham
Arlington Value

The Manual of Ideas: Over the ten years ended December 31st, 2009, the S&P 500 delivered an underwhelming return of negative 9.1%, equaling a 1.0% annual loss. Bruce Berkowitz's Fairholme Fund achieved a net annualized return of 13.2% during the same period, while your fund returned 15.5% annually net of fees. Berkowitz's record has made him somewhat of a "rock star" in the investment business. How come you are still flying below the radar?

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Allan Mecham: Ha! Good question… I'm eagerly awaiting *The Little Book on Becoming a Hedge Fund Rock-Star.* In all seriousness, it's likely a combination of factors (Salt Lake City-based LLC, only $10+ million under management for the first five years with no serious marketing), but certainly my limitations marketing Arlington are partly to blame. Additionally, and probably the biggest reason for our obscurity, stems from our fanaticism about accepting the "right" capital. Maintaining a culture that's conducive to rational thinking and investment success has been the top priority since inception. We have turned down significant sums of money on many occasions because of this stubborn commitment. As I said in my most recent letter, we get far more satisfaction from producing top returns than from the size of our paycheck… though we're hopeful this distinction won't need to be highlighted for much longer!

Many potential investors require monthly transparency into the portfolio and are overly focused on short-term results. Accepting "hot" money would endanger the culture and my ability to perform. My partner Ben [Raybould] considers it his most critical job to cultivate and maintain a culture that minimizes emotional noise and short-term performance pressures, to which I must say he has done a fantastic job. We believe patience and discipline are critically important to investment success. Taking emotion out of the equation, or at least minimizing it as much as possible, is vitally important and difficult to do if you have investors peering over your shoulder in real time, questioning ideas. That's like telling someone what's wrong with their golf game in the middle of their backswing — it's the last thing you need when you're trying to concentrate and execute a shot.

MOI: We could conduct this entire interview simply by revisiting quotes from your past letters, which are a *tour de force.* You recently didn't hold back on your view of certain types of institutional investors: "Many times these gate-keepers of capital have expressed admiration for our results. Yet for them to invest we would need to not only continue to find undervalued stocks, we'd

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need to find more of them; additionally, we would need to identify overvalued stocks – and short them – as well as find ideas across the globe in both large and obscure markets. Such comments are flattering, yet we see nothing but wild-eyed hubris attempting to outsmart people, more often, in more ways, and in more markets, as opposed to sticking with what produced top-tier results in the first place." Clearly, the proliferation of investment vehicles whose partners' interests are at odds with those of the ultimate owners of capital has resulted in misallocation of capital. Do you see owners waking up to this inherent conflict and demanding a more sensible approach to investment? Is it feasible for a fund like yours to bypass the agents and go directly to the owners of capital?

Mecham: I think it's possible to gain traction but I'm not optimistic about change on a large scale as there are multiple factors at play. Bypassing the agents is a laborious process that's difficult for a two-man shop like ours. The fees throughout the financial system are crazy and make no sense when thinking about the industry as a whole. A lot of financial intermediaries and hedge funds operate using a form of the "Veblen" principle — where status is attached to the high cost and exclusivity of the product. The financial middlemen satisfy the clients' emotional needs more than the financial needs. The comfort of crowds is strongly at play throughout the system. At the end of the day I think managers are giving clients what they want — peace of mind and smoother returns, albeit at the expense of long-term results.

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MOI: Short-term thinking seems to be alive and well in the investment industry despite overwhelming evidence that a longer-term perspective yields better results. You have alluded to the fact that good ol' career risk may be the culprit: "Non-activity in the face of short-term underperformance is simply not tolerated, even though realistic assumptions (you can't outsmart other smart people all the time) and basic math (lower frictional costs) confirm its worth. Most fund managers' capital would not stick around long enough so they simply comply with more standard methods of operation in the spirit of keeping their jobs." Incentives are one of the most powerful forces driving behavior, so it's little surprise investment managers have adjusted to the prevailing industry incentives. What could be done to better align career risk with investment risk?

Mecham: I am a strong believer in the power of incentives. That being said, I'm not sure I have a silver bullet on how to solve the problem. You need investors to think and act like owners, rather than short-term renters, and to judge performance over longer time frames. I remember reading a talk that Mark Sellers gave at Harvard a few years back. He basically said good investors have the right temperament by age 15, and there's not much one can do to improve later in life. So I don't think arguing the merits of one's philosophy is going to gain a lot of traction — it seems people either get it or they don't. If you could somehow get investors to accept annual reporting (which is arguably too often), or some type of soft or hard lock-up, that may help, but again, it's a hard problem to solve as you're dealing with human nature to a large degree.

We are fanatical about partnering with compatible investors — those who "get it" — and we still have soft lock-ups at Arlington Value Capital. The sophisticated family offices (and others) often ask, "What's your edge?" I firmly believe it is our investor base — they act and think like owners rather than traders, which enables us to wait for exceptional opportunities. Such an investor base really adds value when you go through periods of distress and

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underperformance; precisely the time when you need confidence and stability is apt to be the time when investors are rushing for the exits and questioning the approach. Our investor base is unique: despite above-average volatility we've had minuscule withdrawals over the years. Part of the genius in the structure of the Buffett partnerships (which has largely been maintained at Berkshire), is the culture and environment Buffett created and insisted upon; Buffett wouldn't disclose positions and reported just once a year — he created an environment where nobody was questioning how or when he swung the investment bat.

MOI: Let's switch gears and discuss the investment philosophy behind your track record. Help us understand the kind of investor you are, perhaps by highlighting a couple of examples of companies you have invested in or decided to pass up. What are the key criteria you employ when making an investment decision?

Mecham: It's really quite simple. I need to understand the business like an owner. The firm needs to have staying power; I want to be confident about the general nature of the business and industry landscape on a longer term basis. I'm big on track records, and generally stay away from unproven companies with short operating histories. I also believe a heavy dose of humility and intellectual honesty is important when looking at potential ideas.

"When looking at ideas, I have a Richard Feynman quote tattooed in the back of my brain: 'Don't fool yourself, and remember you are the easiest person to fool.'"

There's a strong undercurrent constantly percolating to buy something — it's fun, exciting and feels like that's what you're getting paid for. This makes it easy to trick yourself into thinking you understand something well enough when you don't, especially if you are in the investment derby of producing quarterly and yearly returns! When looking at ideas, I have a Richard Feynman quote tattooed in the back of my brain: "Don't fool yourself, and remember you are the easiest person to fool."

Ultimately, what tends to cover all the bases is the mentality of buying the business outright and retaining management. Critical to implementing this approach is, again, having a compatible investor base. "Whose bread I eat his song I sing"… An owner's mentality forces you to think hard about the important variables and makes you think long term, as opposed to in quarterly increments. In fact, I think very little about quarterly earnings and more about the barriers to entry, competitive landscape/threats, the ongoing capital needs and overall economics, and most importantly, the durability of the business. Over the years I've come to realize the importance of management, so we look hard at the people running the business as well. And, obviously, the price needs to make sense.

The criteria bar is set high; we really try to avoid mediocre situations where restlessness causes you to relax investment standards in one area or another. We also stress test the business under various economic scenarios and look to a normalized earnings power. We passed up many seemingly attractive ideas over the years as we would ask, "What happens under 7-10% unemployment (when unemployment was in the 4-5% range) and 6-8% interest rates?" And we would ask, "Is the business overly reliant on loose credit extension and frivolous spending?" Many names didn't hold up under these stress test scenarios, so we passed. We bought AutoZone [AZO] a few years back as it held up under various adverse macro scenarios, and in fact performed exceptionally well throughout the Great Recession. I constantly try and guard against investing in

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situations where the intrinsic value of the business is seriously impaired under adverse macro conditions. We prefer cockroach-like businesses — very hardy and almost impossible to kill!

MOI: You have said that "analysts tend to overweight what can be measured in numerical form, even when the key variable(s) cannot easily be expressed in neat, crisp numbers." Can you give us an example of how this tendency occasionally creates an attractive investment opportunity for the rest of us?

Mecham: Sure. In a generic form, I think there are many instances where a company hits a speed bump and reports ugly "numbers," yet the long-term earnings power and franchise value remain intact. Oftentimes a key cog of value is in a form that's difficult to measure — brands, mindshare/loyal customers, exclusive distribution rights, locations, management, etc. Sometimes it's the location of assets that can be hugely valuable. Waste Management [WM] and USG [USG] both have assets that are uniquely located and almost impossible to duplicate, which provides a low-cost advantage in certain geographies.

Reputation is valuable in business, though hard to measure in numerical form. Reputation throughout the value chain can be a strong source of value and competitive advantage. I think Berkshire Hathaway's reputation is very valuable in a variety of areas, most obviously in acquiring other companies.

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The various cogs of value differ between companies, but many times the key variable(s) are difficult to capture in a spreadsheet model and/or are not given the weight they deserve.

MOI: You wrote recently that your "appetite is paltry for risky investments, almost regardless of potential reward. Theoretically this stance is illogical as 'pot odds' can dictate taking a 'flyer' — where the potential payoff compensates for the chance of loss — however these situations are difficult to handicap, and can entice one to skew probabilities and payoffs." You put your finger on an interesting phenomenon: Many investors systematically overestimate the probability and magnitude of favorable outcomes. We recall the countless times we have read investment write-ups that peg the expected return at 50-100%, yet virtually no investor manages to achieve even 20+% performance over any meaningful period of time. What kinds of situations do you consider too risky or, more appropriately, too susceptible to the skewing of probabilities and payoffs?

Mecham: I'm not sure I can categorize the situations... Any time you are paying a price *today* that's dependent on *heroics tomorrow* — fantastic growth far into the future, favorable macro environment, R&D breakthroughs, patent approval, synergies/restructurings, dramatic margin improvements, large payoff from capex, etc. — you run the risk of inviting pesky over-optimism (psychologists have shown overconfidence tends to infect most of us), which can result in skewed probabilities and payoffs. We want to see a return today and not base our thesis on optimistic projections about the future. Many early-stage companies with short track records fall into the "too risky" category for us. Investments based on projections that are disconnected from any historical record make us leery. Investments dependent upon a continued frothy macro environment (housing, loose credit) are prone to over-optimism as well — how many housing-related/consumer credit companies were trading at 6x multiples growing 15%+ inviting IV estimates 5x the current quote?

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Many times I think it can be a situation where you just don't understand the business well enough and the bullish thesis is the nudge that sedates the lingering risks you don't fully grasp. It's important to keep the litany of subconscious biases in mind when investing. Charlie Munger talks about using a two-track analysis when looking at ideas. I think that's an extremely valuable concept to implement when looking at investment opportunities. You have to understand the nature and facts governing the business/idea and, equally important, you need to understand the subconscious biases driving your decision making — you need to understand the business, but you also need to understand yourself!

MOI: How do you generate investment ideas?

Mecham: Mainly by reading a lot. I don't have a scientific model to generate ideas. I'm weary of most screens. The one screen I've done in the past was by market cap, then I started alphabetically. Companies and industries that are out of favor tend to attract my interest. Over the past 13+ years, I've built up a base of companies that I understand well and would like to own at the right price. We tend to stay within this small circle of companies, owning the same names multiple times. It's rare for us to buy a company we haven't researched and followed for a number of years — we like to stick to what we know.

"The average stock price fluctuates by roughly 80% annually (when comparing 52-week high to 52-week low). Certainly, the underlying value of a business doesn't fluctuate that much on an annual basis, so the public markets are a fantastic arena to buy businesses if you can sit still without growing tired of sitting still."

That's the beauty of the public markets: If you can be patient, there's a good chance the volatility of the marketplace will give you the chance to own companies on your watch list. The average stock price fluctuates by roughly 80% annually (when comparing 52-week high to 52-week low). Certainly, the underlying value of a business doesn't fluctuate that much on an annual basis, so the public markets are a fantastic arena to buy businesses if you can sit still without growing tired of sitting still.

MOI: You have stated that your "old fashioned style embraces humble skepticism and is wary of most modern risk management tools and ideas." Give us a glimpse into how you construct and manage your portfolio — and how you protect it from the kind of upheaval the markets experienced in late 2008 and early 2009.

Mecham: There's no substitute for diligence and critical thinking. It's ingrained in my DNA to think about the downside before any potential upside. We try and stick with companies we understand, where we have a high degree of confidence in the staying power of the firm. We spend considerable effort thinking critically about competitive threats (Porter's five forces, etc). We really stress long-term staying power and management teams with proven track records that are focused on building long-term value. Then we always "stress test" the thesis against difficult economic environments. As I said earlier, we try and guard against investing in businesses reliant on some type of macro tailwind.

If you have the above, combined with the freedom to take the long view, managing the portfolio is based more on intellectual honesty and common sense rather than any sophisticated "tools," "models," or "formulas." If the financial crisis taught nothing else, it showed how elegant financial models that calculate risk to decimal point precision act like a sedative towards critical thinking and even common sense — "risk models" were like the bell that told the brain it was time for recess! I also think risk management by groups can have similar effects.

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Being diligent, humble and thinking independently are key ingredients to solid risk management.

MOI: What is the single biggest mistake that keeps investors from reaching their goals?

Mecham: Patience, discipline and intellectual honesty are the main factors in my opinion. Most investors are their own worst enemies — buying and selling too often, ignoring the boundaries of their mental horsepower. I think if investors adopted an ethos of not fooling themselves, and focused on reducing unforced errors as opposed to hitting the next home run, returns would improve dramatically. This is where the individual investor has a huge advantage over the professional; most fund managers don't have the leeway to patiently wait for the exceptional opportunity.

"Most investors are their own worst enemies — buying and selling too often, ignoring the boundaries of their mental horsepower."

MOI: What books have you read in recent years that have stood out as valuable additions to your investment library?

Mecham: I enjoy all the behavior psychology stuff and would recommend *Predictably Irrational* [by Dan Ariely], *Nudge* [by Richard Thaler], *How We Decide* [by Jonah Lehrer], and *Think Twice* [by Michael Mauboussin].

The Big Short [by Michael Lewis] is a good book and a very entertaining read. Roger Lowenstein's new book, *The End of Wall Street*, is very good as well. I'd also recommend *The Relentless Revolution* [by Oldham Appleby]. I like reading history of all sorts and think it's beneficial to investing.

MOI: Allan, thank you very much for your time.

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