06-23-2016 MoneyLife Interview of Brian Yacktman by Chuck Jaffe Transcript

Chuck: And, we really want to learn how to invest better. We want to learn from savvy money managers, and we got one for you today. His name is Brian Yacktman. He is the founder and president of the YCG Funds. And yes, if his last name sounds familiar, well, it's because he is part of the Yacktman family, which Yacktman Funds. He's got his own firm, it's YCG Investments. You can learn more about it at ycginvestments.com. You can learn more about the funds at ycgfunds.com. It's been a little while since we've had Brian on the show, but I'm pleased to say, Brian Yacktman, welcome back to MoneyLife!

Brian: Thanks! Glad to be back.

Chuck: We always start each interview by talking about methodology, because at some point we're going to evolve to what you like and what you dislike. But a buy, sell, or hold recommendation is completely worthless if somebody doesn't know the methodology. So explain what it is that you're looking for and what makes something stand out to you versus what makes something unappealing to you.

Brian: Sure. Well, in short, we're looking for above average businesses at below average prices, ideally. And the reason for that, just about a month ago I came across a study, I think was Longboard, that showed about 45% of equities over the last couple of decades produce negative returns. And the next 35% offset that, meaning that the bottom performing 80% of stocks produced zero returns. And so their conclusion what that all performance could be explained by the top 20% and it might make you feel like, oh you got to find the best performing, up and coming Apples: Netflix, Facebook, etc. But to us it just means you need to avoid the permanent losses. And so, we have a process that I think really stacks the odds in our favor that try to help avoid permanent losses and find businesses that are enduring. And so really for us, it just all comes down to, "What are you buying? And what do you pay for it?"

Chuck: Ok. But then you take a look at a market like we got right now where value, at least thus far this year, has out performed growth. That means that the "what are you paying for something" component has been changing. And I recognize your "bottoms up, let's go find the right things" but I'd imagine it's a little harder to find things right now. Isn't it?

Brian: Absolutely. I think the market in general is getting pretty frothy. But I do think that if you're looking for values, the best values when you look across all asset classes is going to be found among the equities. And that's something I like about our process, is we look at forward rates of returns and then that makes it more comparable across all assets, and you can say, "If I put this capital here, what type of rate of return do I believe that I can expect to get from this price level?" And so, yes, it is getting more strained, and I think the high quality businesses and the low quality businesses are trading more in tandem, which is making high-quality look much more attractive, because you're not really getting paid much of a spread to venture into a lower quality fair.

Chuck: So, for you, does that necessitate holding more cash? Do you wind up responding to those kinds of market conditions by saying, "I'll hold more cash?" Or does it change what you're buying and make you say, "Hey if I can't get the same kind of values, I'll lower my standards because I want to be fully invested?" How does that play out?

Brian: Well you never lower your standards. That's for sure. Because we are absolute oriented. We want to make sure that, number one, we don't lose money. And then as Warren Buffett said, rule number two is don't forget rule number one. So you don't lower your standards. Does it mean we're holding cash? No. To be clear, yes we have cash, but that cash is indirectly invested through our option component of our strategy through cash-secured puts.

Chuck: Ok. So give us an example of a stock or two that come through the process and are worth holding right now.

Brian: Sure. So one that comes to mind is Nike. Nike is a very dominant, high return on capital business. And finally, we feel that the valuation is more reasonable. From a high level, think of Nike, you know people value fitness, and they value living long. And so there is this trend towards increased sports participation and wearing of athletic clothing, athleisure. I guess what I'm saying though is it's a company that produces something positive to society. On the last show I talked about Colgate and it's similar to that where it produces value to society as opposed to say something like Coke, where it might be argued that you're giving poison to your children. And having said that I actually own a small position in Coke, but...

Chuck: And so do I, so I need to disclose that as well. But I haven't ever quite looked at it that way.

Brian: Sure, and there's a whole other host of reasons why we do own Coke, but you get what I'm saying, is here's a company that produces something that is arguably doing good to society and they still have great emerging exposure like Coca-Cola does. And when people are participating in fitness they want to associate with high-status individuals that are in that sport. And the fact is, Nike's created the strongest brand. I've read that they are the number one millennial brand recognized by Millennials. And they've done the by partnering with the best. So they're able to get these great endorsements because they have the most to pay celebrity athletes. Just to put that in perspective their marketing budget was over $3 billion in 2015. I think it was $3.2B if I recall, about 10% of sales. Compare that to Under Armor who also has a marketing budget that's 10% of sales, but in absolute terms is only about $400 million. So if Under Armor, their top line revenues about $4 billion last year. If they had the same total marketing budget that Nike has, instead of being 10% of sales it would be 80%, it would eat up 80% of sales. So they have the ability to really partner with the greatest celebrities and create this ongoing brand with the Millennials and in many ways, on our last call we talked about Richemont, which I still think is attractive, and Richemont is a social status company that does luxury jewelry. And Nike is the same kind of thing where, social status, it's something about we're able to command resources and say, "I'm wearing the newest expensive Jordans," or whatever it may be, that lends itself to pricing power, and I love that it's just a short repurchase cycle, evergreen type business. The key here what's created the opportunity is China. So, with the concerns in China, and the growth driver for Nike is particularly any of these emerging markets like China, they're already the leader there, and in China it's a very high margin business. It's over 30% margins compared to the rest of the business it's about 17%. So as they grow in China, it means that the margins at Nike can continue to increase as well because it's more profitable there.

Chuck: Ok. Let's flip it around for a second, quickly, what's something that you've had to move away from? What's something that shows the sell discipline?

Brian: Well we don't, to be honest if we've done our job right we're not selling very much. We're very low turnover. I will say, having said that, we did make some sales, we eliminated our Verizon position last February when everything was collapsing. So what happened there is, so I should first preface that we first got in to Verizon because, what we loved is that the spectrum is a limited, scarce resource. The old Verizon business was the wire line, and once you had put all this capital in the ground it became, you just need to get volume on your lines, get revenue out of it. And so heavy price wars let to almost 0-2% type margins on the business. Contrast that with the spectrum wireless business, where it's a scarce resource. Data consumption is compounding at high double-digit rates. I know that because I have children and I can see it happening in my own household. But data consumption's going through the roof and so the thought was this could lead to pricing power over time. Whoever commands the spectrum will be able to command pricing power and earn great rates of return on that spectrum. However, there were two things that made us eliminate our Verizon position. First off, was the fact that when the market was collapsing Verizon actually went the other direction, and so it's forward rate of return was declining because the stock price was going up whereas everything else the stock prices are dropping and the forward rates of return are looking more attractive elsewhere. So, that alone made us want to look to reduce and trim the position to reinvest that capital in more attractive businesses that were getting shellacked.

Chuck: Ok.

Brian: The other thing was that the business itself, the management. We're just concerned with what's going on over there. We're not confident that all the cash they are generating, that we will get to see that it will be reinvested in a favorable way. They seemed to be getting their fingers into all sorts of things: AOL, and now it's looking like Yahoo and many other businesses they're trying to get more into media and get eyeballs, and we were looking into them for the wireless business not to get into the media side of things.

Chuck: Now we're going to find out how you feel about some stocks that my audience is particularly interested in. It's "Hold It or Fold It" time with Brian Yacktman founder and president of the YCG Funds. If you want more information ycgfunds.com, ycginvestments.com. You know how hold it or fold it works, we're late getting to it so we'll jump right in with a request we got from Kirk in Huntsville, Alabama for Valeant Pharmaceuticals the ticker symbol is VRX.

Brian: So with Valeant, it's been quite the controversial story and I'm sure many understand their strategy that was cutting on profitable Research and Development, lowering tax rates, aggressive price hikes on these drugs that they were purchasing. I won't get into all the details there, but there are real products with profitable revenue streams there. The question is under a scenario now where they can't execute the strategy that they had planned to do, did they now over pay for these businesses? In other words, is quite possible that the value of the debt that they used to buy these businesses exceeds the enterprise value of the entire company. In which case, of course, all the value will get chewed up by the debt and the stocks headed to zero. But, inherent with leverage, if things work out the equity can perform quite nicely from here. So, frankly I just think it's very difficult to see into the future on this one I just think it's a gamble, a speculation that's not my cup of tea to speculate, and so I'd fold it.

Chuck: Yeah, a speculation? That's a fold on Valiant Pharmaceuticals VRX. Joe in Colorado Springs wants to know about Priceline Group PCLN.

Brian: Priceline is actually one that we've been looking at. We do not own it at the moment, but still doing more research here. But what I'd say is that Priceline, what's very interesting, the strength here is the Boutique Hotels out in Europe, that regulations are preventing that from becoming rolled up in all the Marriotts and the Hiltons, etc. With all these boutique hotels, Priceline has formed all of these relationships and it really has created this network effect that I think will have an enduring business. In fact Google has tried to break into that market and they backed down. So clearly, the Priceline network requires a lot of time and expense to build it out. I think it's going to be an enduring business. It's growing very quickly, very capital light, recurring revenue stream, I actually really like it, so I'd consider it a hold.

Chuck: Ok, so as you pointed out, it's something you're looking at, you haven't yet bought it, that puts it in the hold category. But looking to make the move potentially on Priceline Group PCLN. Joe had a second request it was for Noodles and Company class A, NDLS.

Brian: So, Noodles and Company is one where I think your looking at the restaurant industry in general it's just been known for ending up in the graveyard. It's fad-like.

I think it's difficult to create a big moat around these types of businesses. And Initial Public Offerings are notorious for being overpriced at the get-go, and I don't think that Noodles was any exception. Now that they've been hammered the question would be. well do you believe that it's going to endure? I just don't see why I can believe that 10 years from now Noodles and Company's going to dominate relative to any other competitor that might try to be a knockoff or whatever else. So I love the food, but I don't think an investor will end up loving the returns.

Chuck: That's a sell on Noodles and Company NDLS. Dave in Beaverdams, New York wants to know about US Bank Corp, USB.

Brian: So US Bank, speaking of restaurants, it kind of reminds me of Chipotle after the bacteria scare or any other restaurants where after you have that happen, such a traumatic experience, then everyone avoids it like the plague. Even though chances are that's right at the moment when things are the best. And I don't think that the banking industry is far off from that example, where humans are focusing and remembering this impactful, memorable crisis of many years ago in the banking industry and yet the bank’s balance sheets are in the best shape that they've been. So I think there is an opportunity here created from that recent crisis, and while we don't own US Bank we do own Wells Fargo and if I were to look at the banking industry those are the two banks that I would be most attracted to because of the great cultures, because of the conservative underwriting, and US Bank has a very heavily fee-based business as well that is solid and enduring. So I actually really, I think it's priced great, I think it looks like a great investment from here.

Chuck: Ok, so it's a buy on USB, US Bank Corp. And thrown in there was sort of a buy or an inherent buy on WFC, Wells Fargo. Last, for Dale in London, Ohio JC Penny Company. That's JCP.

Brian: With JC Penny, just like the restaurants, the graveyard is littered with retailers. You might say, well JC Penny's been around forever so has K-Mart and Sears and we've seen what's happened there. And many, many businesses have ended in the graveyard. So, there is one statistic that I came across recently that I found very interesting. America has, I believe it was 50 square feet of retail space per capita. Contrast that in the UK, I think it was around 10 square feet per capita. Keep in mind that the UK is a country that has the most retail space per capita. So what that means is, in my opinion, I think in America, we're looking at a bubble in retail square footage. Particularly as we're facing a shift to online retailing. I just think there's too many retail stores, if it was me, I'd be getting out.

Chuck: Yeah, that's a sell on JC Penny, JCP. And speaking of having to let it go and give up, well unfortunately we've come to the end of our time and so we have to give up Brian Yacktman. But Brian, this was great. I hope you come back and do this with us again in the not too distant future.

Brian: Well, thank you very much. It's always a pleasure.

Chuck: Brian Yacktman is the president of the YCG Funds. Ycgfunds.com, ycginvestments.com

Disclosures: References to other mutual funds should not be considered an offer to buy or sell these securities.

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Definitions:

Spread – the difference between two numerical or qualitative factors.