

CONSUELO MACK | WEALTHTRACK



Program #625
Broadcast: June 18, 2010

On this week's *Consuelo Mack WealthTrack*: a finalist for Morningstar's Fund Manager of the Decade Award. "Great Investor" Don Yacktman explains how his penny pinching ways have translated into exceptional long-term returns for investors in his five star Yacktman Funds.

Guests

Don Yacktman
President, Co-Chief Investment Officer
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CONSUELO MACK: this week on WealthTrack's Great Investors series, award winning large cap fund manager Donald Yacktman explains how his penny pinching investment style keeps finding hidden gems no matter what the market climate. Next on Consuelo Mack WealthTrack.

Hello and welcome to this edition of WealthTrack. I'm Consuelo Mack. As advocates of long-term investing we, have had many of the most successful practitioners of the art on WealthTrack. Legendary figures such as FPA's Robert Rodriguez, Fairholme's Bruce Berkowitz and First Eagle's Jean-Marie Eveillard are all proud to call themselves value investors. They share many traits. They are patient investors, willing to hold stocks for many years until their value is recognized in the market. They, along with Warren Buffett, like to invest in straight-forward businesses that they can understand, that have favorable long-term prospects. They also like to buy stocks when they are shunned by others and are selling at deep discounts to their intrinsic values. And they are not afraid to buck the herd and hold cash when others are buying.

This week's guest is no exception. Great Investor Donald Yacktman, the long-time manager of the Yacktman Fund, says his time horizon is ten years. He likes growth companies at low prices and buys a stock when it sells for less than an investor would pay to buy the entire company. This investment philosophy has put the Yacktman Fund in the top one percent among funds that invest in large-cap value stocks for the past three, five and ten years. Over the past ten years, the Yacktman Fund has returned more than 13% a year. But his patient, contrarian investment style has had its critics. In the late 1990s during the tech-stock boom, the Yacktman Fund lagged the market and his board actually tried to oust him, while investors fled. Then the dotcom bubble burst and vindicated his caution. Yacktman topped the S&P 500 Index by 34 points in 2002.

In recognition of his stellar long-term performance, Don Yacktman was a finalist for Morningstar's new Domestic Equity Fund Manager of the Decade Award last year. According to Morningstar, "Yacktman has been a consistent and adept investor whose stock picks have put him head and shoulders above peers, not only in this decade, but throughout his 17-year tenure on the fund." We should also note that part of that tenure includes his son Stephen, who has co-managed both the flagship Yacktman Fund and its younger Yacktman Focused Fund since 2002.

Unlike some other value funds, the Yacktman fund avoided big losses during the market downturn of 2008, besting the market and its peers by 11%. In a recent interview, I asked Don Yacktman how he managed to do that?

DON YACKTMAN: I would say that it was a result of having a very small exposure in the financial area. We did have an investment in AmeriCredit... AmeriCredit is a sub-prime used car lender, which sounds horrible--

CONSUELO MACK: Sure does.

DON YACKTMAN: But, it has a business model that really is a very profitable business model. And I can go into it in depth, but the bottom line is the information is readily available online and can be studied, and it's a simple company relative to say, a New York bank that has-- it's sort of like a black box, I mean, they're almost like the ultimate junk bond buyers because of the nature of them and the

complication that they have. So, we just don't like those kind of things. We feel like we're buying a business. We want to understand what we buy, and want to have a comfort index, and we just didn't.

CONSUELO MACK: For our viewers who are not familiar with the Yacktman Funds, what's your investment philosophy?

DON YACKTMAN: Well, the best way I can describe it is that we think of stocks as though they were bonds. And let me try to explain that and use a triangle in the process. The base of the triangle is a low purchase price. And what we do is we try to put a forward rate of return on a stock looking at it: cash generation power, its growth, its profitability, its re-investment, and taking into account inflation. So, we come up with a compounded rate of return that one would have if they were to buy it and hold it indefinitely.

CONSUELO MACK: And that's your own metric, you're not taking that from any other agency or research analyst, that's your analysis of what this rate of return is for each company that you invest in.

DON YACKTMAN: Correct. And then by doing that, we just think it's easier to make a comparison objectively, with other companies as well as with other parts of the capital structure, whether it be a bond, even a building for that matter. But then, there can be quality ratings put on it. For instance, Coca-Cola may be a AAA where, say, AmeriCredit is a BAA; and so, there is a higher hurdle rate that would be required to buy the lower grade bond. And I can mentally picture all these yield curves with various grades on them just like a bond buyer would and buy it, in effect, try to buy the best risk adjusted rate of return that's out there.

CONSUELO MACK: Using the bond analogy, going a little bit further in that, do you only buy investment-grade stocks? Or, you know, do you actually go into junk ever because it's, you know, the reward might be greater at a certain price?

DON YACKTMAN: Well, that's a great segue into the last couple of years. Because in effect, if you go over, let me use, say, the last three years as a cycle. The high grade companies stood out to us, say, in early 2008, as being the place to invest money. And we do this with bottom up investors, looking at them one at a time. But those were consistently where we were investing money. But, by the end of 2008 and into early 2009, the spreads, in effect, opened up between the AAA and, say, BAA or below investment grade.

And as my son Steve likes to refer to us as dumpster divers, at that point, it really did pay to downgrade, so to speak, or to buy things that had more economic sensitivity or more risk- perceived risk- to them or lower grade bonds, whichever way you tend to look at those things. And so, that meant moving into things that had, in effect, enormous upside when the recovery came. And it benefited us dramatically.

CONSUELO MACK: Was it unusual for you to find yourself in effect, trading into other names after or during the financial crisis of the last couple of years?

DON YACKTMAN: It's not our normal style. But I think what it really boils down to is being

objective. And that's what we try to do. We try to be incredibly objective. And think in terms of what will provide the best long term rate of return for our investors. And so, that's why we're driven toward those directions.

CONSUELO MACK: Before we went on camera, you mentioned that it's hard because sometimes you get pigeonholed as a fund manager, you know, your value or your growth or whatever. But you are known for your value bent. So, what does value mean to the Yacktman family?

DON YACKTMAN: First of all, I think the nomenclature tends to be overused. I don't know of anybody who goes out and says I buy overpriced stocks. Okay? But I think that there are these kind of pigeonholes-- I think what we think of as value means we really don't want to lose money. As somebody once said, there are two rules in this business: the first one is don't lose the client's money, and the second rule is don't forget the first rule. So, we think of risk as permanent loss of capital. And we really work very hard to avoid that.

CONSUELO MACK: And how do you avoid that?

DON YACKTMAN: By doing research and by being objective, and thinking in terms of, that we're buying a piece of a business, so we really are businessmen, we're trying to understand the business so we understand what we're buying, and that we buy that at a price that's less than its value.

CONSUELO MACK: And at this particular juncture, after we've had a pretty good run in the stock market off the market lows of 2009, what's the value proposition out there? Are there still values out there that are attractive to you?

DON YACKTMAN: There are. But we're now kind of back in the same part of that cycle, so to speak, that we were back, like, two, three years ago where it's the very high grade businesses that seem to be the best values. I mean, our biggest holding, for instance, is PepsiCo. And I think PepsiCo is a wonderful business, and I think it's at a good price. But, most people are not going to be very revved and say, how can you out perform the market owning PepsiCo? Well, on a risk-adjusted basis, to us it looks like a really excellent value.

CONSUELO MACK: You know, I'm looking at your top five holdings: PepsiCo, News Corps, Coca-Cola, ConocoPhillips, Viacom. Those are five very different names, but clearly, they all have something in common. And is the quality factor what they have in common?

DON YACKTMAN: Yes. I think Conoco probably stands out as being somewhat different because it has a lot higher fixed asset component, where the others have low fixed asset components. And both Viacom and News Corps have more economic sensitivity and Conoco, to some degree, does, too. The other two, really, I think, are just classic. Most people would consider them, I think, defensive stocks. But I think their valuations are very good. I mean, Coca-Cola, 12 years ago, Coke sold as high at \$89 a share. Now it's in the low 50s. And people think, well, it can't continue to do well because carbonated beverages aren't doing particularly well in the United States. 80% of their earnings come from outside the United States. And it's really an excellent value, again.

CONSUELO MACK: So, are there themes that you're identifying, investment themes that are working for you, that have worked over time, and any that are working for you in particular now? I mean, you just mentioned the fact that if 80% of earnings from Pepsi and Coke come from overseas, so is the overseas consumer, for instance, a big theme of yours? I mean, what are some of the major investment themes?

DON YACKTMAN: I think maybe a better way to look at it is this. We think, like I said earlier, the triangle- another side of that triangle is to look at buying a good business as well as buying it at a good price. The third part, by the way, is buying good management. And trying to get as much of the last two, the management and the business, but making sure you get a good price.

Almost any business, can be put on a grid, if one axis is fixed assets and the other is economic sensitivity. And we have found that businesses that tend to have low economic sensitivity and low capital requirements tend to be the prizes- if you can get them at the right price. The problem is these are usually great businesses, and most people identify them as great businesses, whether it's Coke or Johnson & Johnson or are PepsiCo or whatever. But occasionally they do. And occasionally, they come down and show up at good value. And now happens to be one of those times.

CONSUELO MACK: Explain that. I mean, why do you think that-- it's so interesting that the major, blue chip American companies are the most undervalued, it seems, if you look around the globe. Why is that?

DON YACKTMAN: I think partly is because, as you mentioned, we've had a dramatic rise in the stock market over the last, say, 15 months. And these stocks, because they were defensive stocks, did not go down dramatically in the period before that. And so, they didn't go up that much in the period that we're going through. 70% of investors, I would say, are momentum investors- they buy what has been good. And so, they look at the last nine, ten, 15 months, whatever, maybe less than that, even, and they say, well, those stocks aren't moving, therefore I don't want to own those stocks. And that's exactly why they turn out to be good buys.

CONSUELO MACK: What are the lessons that you learned from the financial crisis? Or what lessons do you think that we all should learn from the financial crisis?

DON YACKTMAN: I think the danger of leverage is one of the things that comes up. And I think that's shown itself, and it's reared its head. This time I think it did with long term capital. I think, go back to 1990 when there was another scare in the financial community, the S&Ls, and it keeps coming back to leverage. I mean, it's fine if people want to risk their own money. But when they risk money that has got a guarantee on it, you know, we're in a world where if you are going to have the guarantee, then there has to be some regulation and control. As much as I dislike the idea, I think the reality is you can't have it both ways. But, you know, if they want to risk the money with enough capital so that it's their loss and not the public's loss, that's fine as far as I'm concerned. That would be my opinion.

CONSUELO MACK: Okay. Have you found yourself shifting in any way in your focus in the Yacktman Funds towards different business models or, you know, towards exposure to many other markets than you would have, let's say, ten years ago?

DON YACKTMAN: It's ironic you say that, because we're just in the process of finishing up our new prospectus and that allows us to do more investing in the foreign arena. Again, objectively, a lot of the companies, the big companies in the United States and Europe that are ADR are really international companies. And for a company to be a great company over the next 50 years, I think it's almost impossible for them to do that without becoming international in nature.

CONSUELO MACK: Are there any opportunities out there now that, or is just the market across the board pretty fairly valued or over valued? Are there any segments of market, except for the high quality stocks that you mentioned earlier, that represent real bargains?

DON YACKTMAN: The best way I can put it is that from where we're sitting, it seems like there are very few of the non-high quality bonds, so to speak, that are selling at a big discount. And so, in effect, if you think of it in bond terms, the spreads have narrowed. And now is not the time to stretch to get higher yield. It's better to stay in the high quality and be willing to settle for a little lower yield and comfort and sleep well at night.

CONSUELO MACK: Let me ask you about yield. Because we are in a low, low yield environment. And dividends certainly, the pay out ratios are lower than they have been in I don't know how many years. And the yield on the S&P 500 is, you know, extremely low as well, still. How important the yield to you in your returns? I should say dividends, however.

DON YACKTMAN: Well, we're really more concerned with the capacity to pay a dividend rather than the dividend itself. I'd much rather see a company reinvest their cash flow. Again, that's the third part of triangle, so to speak, is the manager. Think of, with a bond, a bond buyer reinvests all the cash; with a stock, a lot of it is reinvested for you by the management. And so, how they reinvest that over a period many years can make a difference in the rate of return the investor receives. But the reality is, if they have opportunities to make high returns on their investment, I'd much rather see them doing that than paying it out to the shareholder in dividends. So, it's the capacity to pay dividends, not the actual dividend that makes a difference.

CONSUELO MACK: You know, it's so interesting. Because there have been a number of studies done showing that companies actually that pay dividends out to shareholders as opposed to using the cash for acquisitions, for instance, or that the best stewards of capital tend to be those who are willing to pay the shareholders cash. But you're saying not.

DON YACKTMAN: Again, I think it depends on objectivity. There are basically five options a manager has with the cash that a company generates. They can put it back in the business and protect the crown jewels, do R&D marketing, cost reduction, distribution, whatever. That's the best use of cash, if they have opportunities. The problem is, most of the businesses we have are so profitable, they can't generate enough units, unit growth, to absorb all the cash. So they have to examine four otherwise.

The next one is acquisitions. But acquisitions are a little like trading baseball players, you know, it can be dangerous. It works great if there's synergy and they don't over pay, but unfortunately, a lot of times,

the egos get in the way of objectivity. And so that's why sometimes they're better off to do one of the others, which would be either buy back shares, pay a dividend or pay down debt, or just sit on it, which is basically the same thing as paying down debt.

CONSUELO MACK: Now, one of your holdings is News Corps which has a pretty good history of a lot of acquisitions. I mean, Dow Jones, being one. As a former employee of Dow Jones, a lot of my former colleagues felt that they really over paid for Dow Jones. But when you look at a News Corps, I mean, they're investing in the company, but they're acquiring a lot of companies. Do you think that Rupert Murdoch is kind of doing the right thing in his--

DON YACKTMAN: I think Rupert Murdoch has a great track record. And while Dow Jones was very expensive, and I'm not sure that he got it at a bargain, what is interesting is how you keep seeing, like recently where they got this big chunk of cash for selling off a piece. I mean, they continue to find ways to get back money from that acquisition. And Dow Jones has been one of the few papers that has been able to get a subscriber base to pay online which is really the way the news business is moving. So, I mean, you look at what he's done with the news side, the cable news side of that business and how they have really taken market share dramatically from the others, and the profits they have generated over the last decade, I mean, it's phenomenal. And Fox, which was a nothing, is now the number one, or certainly vying for the number one position in the networks. I mean, yeah, I think he's pretty impressive.

CONSUELO MACK: You don't pay attention to the macro picture, so it doesn't matter who's in the White House, it doesn't matter if there's more deregulation or regulation, I guess. You know, so what does matter to you? What really does matter- in the greater world around you, besides just looking at a stock?

DON YACKTMAN: That's a good question. We really are looking, I think the best thing that I could say is that we're really looking for those negative events that occur that send a stock down so that we can start looking at opportunities. Think of it this way: think of it as though it's a storm that comes through an orchard and it shakes the fruit tree, and some of the fruit drops to the ground. What we're starting to look at is which pieces of fruit are worth picking up. But, until you get the storm, they aren't on the ground. And it's a lot easier to pick them up off the ground than it is to go to the top of the tree and get them.

CONSUELO MACK: So, do you have to wait for a storm to come before you guys go out and buy something?

DON YACKTMAN: No. No, but, I mean, clearly we're buying today, but that creates the real opportunities, the dramatic opportunities. I mean, like, if you go back to '02 and we bought Tyco and some Quest bonds- I mean, they were four peas in a pod: Worldcom, Enron, Quest and Tyco, and we said these two make sense. These two, we understand.

CONSUELO MACK: Tyco and Quest make sense to purchase.

DON YACKTMAN: The Quest bonds.

CONSUELO MACK: Right, Quest bonds.

DON YACKTMAN: Right. The other two, no, had no interest in them. And that's a classic example of what I'm talking about. But it doesn't necessarily-- it could happen in a good period. I mean, a company could suddenly have a terrible thing happen to them and that would send the stock down because people panic. And that's when objectivity comes into play and the ability to make decisions. There is no substitute for knowledge. And so, the critical variable is to have really, an understanding of the business and a comfort index of buying it because that's what allows people to buy it when the stock is going down. We like to buy things when they're going down not when they're going up, because we're bargain hunters.

It's no different than being a good shopper. If a shirt went on sale and you bought one and you said that was a good buy and then two weeks later you went and the shirt was selling at 25% less than what you paid for it, you may say, I wish I waited. But, objectively, buy another one.

CONSUELO MACK: Again, I'm thinking of your being a value investor, but one of the things that you also said to me earlier was that one has to be humble in this business. And because, you know, you're not always right. And I mean, how often are you right? How important is your batting average in this business?

DON YACKTMAN: I would say you're always wrong, almost, because nobody buys at the bottom and sells at the top. So stay humble and understand that that's just the way the world is. But the secret really is to avoid permanent losses of capital. That's where I really feel badly, is if I've lost somebody's money and I know it's not coming back. It's another thing to buy something that you know is worth a lot more and it goes down and you buy more of it. And that's why that research, that understanding really is critical.

CONSUELO MACK: So when you're doing your research, do you have kind of a list of companies that you, at the Yacktman Funds, know really well, that you're constantly kind of going in and out of depending on any given time period whether they're cheap or not? Or are you constantly combing the new low list, for instance, to see if other opportunities-- I mean, what's the process?

DON YACKTMAN: I think what happens, at least for us, is the database just keeps growing over time as we familiarize ourselves with more and more businesses. And then usually what happens is one opportunity leads itself to another and so then that triggers looking at that company, and that triggers looking at something else. And a lot of times, those are triggered by some negative headline that shows up in the paper.

CONSUELO MACK: Does it make a difference being in Austin as opposed to-- I don't know if you've ever worked on Wall Street per se, but being outside of the main kind of, you know, the caldron of Wall Street, the firm out of Wall Street, does that make a big difference, do you think, in your attitude to be able to distance yourself from the financial frenzy that sometimes occurs?

DON YACKTMAN: It's interesting you would ask that question. We moved from downtown Chicago

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out to the suburbs before we moved to Austin. And we found with each one of those moves that the further away we got from Wall Street, the better. It led to higher objectivity. And we got fewer people wanting to bother us, so to speak and give us their ideas. We want to be proactive about it rather than the other way. We're not going to move to Fiji, though.

CONSUELO MACK: Or the Bahamas like Sir John Templeton did.

DON YACKTMAN: No.

CONSUELO MACK: Right. Well, Don Yacktman, this has been a treat to interview are for WealthTrack, so thank you so much for joining us.

DON YACKTMAN: Thanks for having me. It's been real fun.

CONSUELO MACK: And that concludes this edition of WealthTrack. If you want to watch this program again, just go to our website, wealthtrack.com, to see it as a podcast or streaming video. And check out our WealthTrack Extra feature, offering extended interviews with some of our Financial Thought Leaders and Great Investors. Thank you so much for visiting with us. Make the week ahead a profitable and a productive one.