An insider's look at Charles Brandes and his mentor, Ben Graham

Charles Brandes was working at a stockbroker (sell-side) firm in California before founding Brandes Investment Partners, an investment advisory firm that adheres to the value investing philosophy pioneered by Ben Graham. He was inspired to open his firm in 1974 after meeting Graham, himself. Brandes spoke with the editors of the Ben Graham Centre's Newsletter about his early days in value investing, investing philosophy, and the secrets to his success.

Q. How did you get started as a value investor?

I was working in a stockbroker (sell-side) firm in La Jolla, Calif. when, one day, an older gentleman walked in. It was Ben Graham, who was the dean of all Wall Street security analysis and the father of value investing. I knew who he was, but I hadn't really adopted or followed his particular philosophy or teachings. After meeting him, I read his books and talked to him some more. That's when I realized, I'd had some experience with both bull and bear markets early on in my career and that's some of the best experience you can have. As a result, everything Graham said made a lot of sense to me. During that period (1971-72), the market was taken with a new concept called the Nifty Fifty. This meant you would invest in the 50 greatest growth companies in the world. It didn't matter what price you would pay for them because they were supposed to grow forever. Well, *no* company grows forever! And you don't pay 40, 50, or 60 times earnings for these companies. If these companies could grow forever, then that's a pretty cheap price. But they don't grow forever. I realized I was a Graham and Dodd (Graham's collaborator, David Dodd) person now. I realized you want to buy companies below book value, you want low P/E ratios, and you want good balance sheets. So 1974 came along and there was a very severe bear market. I was ready for value investing. I realized, the cheaper the markets become, the better off you are as a long-term fundamental basic investor. So I took the opportunity then to start my firm in 1974 based on Graham principles and we've been doing it the same way ever since.

Q. You spent some time with Ben Graham. Can you share something you learned about him that we can't find in his books?

He was interested in a lot of other things besides finance and stock market investing alone. He was interested in languages and literature and the classics. He was interested in understanding what's happening in the world, and not necessarily just trying to pick stocks. He didn't really have a lot of interest in making money just for the sake of making money. He even wrote a Broadway play. It closed after two days. So he wasn't as successful in that as he was in the investment world!

Q. Is it true that he was also very interested in philosophy and mathematics?

Yes, although I don't know how much. I didn't actually talk to him about mathematics or philosophy much either because I was a young stock broker who was trying to learn about investing.

Q. Can you tell us more about your investing process, from idea generation to due diligence to carrying out the investment?

Our firm has research analysts working in seven different industry groups. Each group is responsible for understanding its particular industry. We look for companies that might be potential investments because they're trading at prices that seem to be discounts from their long-term basic intrinsic value.

We screen around the world for those types of companies. When we find companies that fit the Graham-Dodd criteria, our analyst group will study the company and create an internal research report. The analyst brings that research report to our investment committee. We have seven investment committees, each with different specialties. The investment committee will look at the analyst's report, talk to the analyst about it, and, as a group, they will decide on the value of that company from a basic fundamental standpoint – not the stock market value. Then it is time to build portfolios. The investment committee looks at all the potential companies it can put into a portfolio and puts the best bargains together into a portfolio that is diversified.

Q. How are you different from other value investors, whether it be through your company, process, or strategies?

We don't do some of the extra, fancier things that some of the other firms will do. We have a basic Graham and Dodd philosophy. Some companies look for catalysts or invest in specific areas or industries. We really stick to the basics, which is looking for low price to book, low price to cash-flow, and low price to earnings, and balance sheets that are sustainable. We stick to the basic fundamentals.

Q. Have you developed some habits that help you make better investment decisions?

Graham said you only need to know two things to be a good value investor. First, you have to think fundamentally and understand the economic wealth-producing capability of a business. Forget about everything else that investors traditionally consider. Forget about the volatility of the stock market and forecasting where the stock market is going to go. Forget about concerns regarding political and economic growth. Simply remain fundamental as a business analyst.

Second, to be outstanding, you can't think the way everyone else is thinking. You have to think differently from the crowd to outperform the crowd. That makes sense to me. It makes sense to me to think about investing in the company rather than investing in the stock market. I'm built to be contrarian – to not be part of the crowd. I don't even like riding buses because then you're part of the crowd! If I had to choose between riding a bus or taking a taxi, I would take the taxi. A lot of people have those kinds of personalities. Graham said you *can* think differently from the crowd and you can also be right! That part of Graham's teachings really fit my personality.

Also, I am only part of a *team* that makes investment decisions. It is better to have different people, points of view, and experiences at the table when it comes to determining the true value of a company. After you know the true value of a company, all you have to do is watch its prices. Estimating the true value is the difficult part. Of course you can't forecast the future and that makes it difficult. I don't make the decisions alone. I am part of a couple of investment committees, and we work as teams.

Q. You mentioned earlier to look at the business fundamentally and ignore a lot of the noise in the market. Specifically, has the recent volatility in the 2008-09 financial crisis affected your investment process at all?

No, not a whole lot because it hasn't been *all that* different. Everyone is saying that it is different, but it's not. It's always the same in a lot of ways. What causes the volatility is always different, but the nature of the volatility is always the same. But a few things have happened that haven't happened before. The credit crisis of 2008-09, for instance. I have never seen a credit crisis like that in my whole career where financing just totally disappeared, and everybody was scared to death, and banks wouldn't

lend money to anyone any more. I've never seen that. Even normal turnover of debt couldn't be done at all. Everything was frozen. I've never seen that happen. I also think it's a black swan and it doesn't happen very often. I've also learned some things about short-term government actions used to mitigate some of the problems. This includes taking money away from business owners when the government feels the business needs to be protected. That is something new.

Q. In a recent interview you said Russia is heavily undervalued in terms of price/earnings ratios. Do you think it's still a good time to get into Russia? If so, what metrics, besides the price/earnings ratio, should investors consider?

When we looked at Russia at that time, we did not consider the risk of the ruble (Russian currency). We have been hurt so far in our Russian stocks, mostly because of the ruble decline. The price of the ruble in relationship to the euro (currency of the eurozone) and the U.S. dollar follows the price of oil completely. When we first started buying in Russia, we didn't know the price of oil was going to go from $100 to $45/barrel. So we got hurt. But on a limited basis, considering Russia's economic problems with the oil price dropping, I still think the risk-reward ratio for stocks from Russia are still about the same. You shouldn't allocate a big part of your portfolio to it because there are a couple of risks. First, the price of oil might not rise for a while. That's a smaller risk for the companies that we own, but definitely a risk for Russia's economy. Second, will the government try to take money from big Russian companies like Gazprom, Lukoil, and Sberbank? That's a risk. Lukoil may still trade significantly below the in-ground valuation of its reserves *only.* The company does business around the world, but most of it is in Russia. It's trading at about four times earnings so it is a very good company balance-sheet-wise. So, in light of the particular risks I mentioned, does it make sense to buy it? I think it does because the risk-reward ratio is pretty good.

Q. You previously mentioned good hunting grounds include out-of-favour industries. Do you think oil is a good hunting ground?

Oh yes. It wasn't necessarily a good hunting ground when it was at $100/barrel so we have only had a few oil companies in our portfolio, but now it's a good hunting ground.

Q. It seems that the stock price for a lot of energy companies is dependent on the price of oil, so would that not require having to time the market? Isn't that something value investors advise against?

Only partially. Oil companies' economics are not 100-per cent correlated to the price of oil. More than the price of oil, we look at the rates of return on equity for the oil companies. As the price of oil comes down, oil companies' revenues go down, but their costs also go down by quite a bit. So you have to look at all those factors in analyzing oil and gas companies – the valuation of their reserves, and their actual costs of doing business. It's not always a forecast of where the price of oil is going to go when analyzing oil and gas.

Q. Is that the same case for all commodities?

Yes, it is.

Q. What factors do you look for when investing globally?

We look at active share, which is how different you are from the index. Active share should be high. The statistic for our global accounts is 91 per cent. We want to be 91 per cent different from the index. Sometimes we will be overallocated. We were once overallocated in Japan and we were severely criticized by some of our institutional clients for investing in Japan three or four years ago. The Japanese economy was not good, sovereign debt was high, and the population was elderly. But we saw that there were some high-quality companies located in Japan that did business all over the world. We invested in them. We did pretty well. After that, the yen (Japanese currency), which had been overvalued, started to come down and everybody started to look at Japan. But we were there first. Today, there is a similar situation in Europe. The European economy is not doing well, but there are some cheaply-priced companies because of that.

Q. Have markets become more efficient because of the large amount of information we have access to? If so, how does that impact value investing?

It is a lot easier to obtain information about companies so there is no doubt we've become more efficient that way. On the other hand, human behaviour tendencies have not changed. It's human behaviour to think short term and to be part of a group. That inefficiency is not going to go away. Value investors have opportunities due to that inefficiency. The bottom line is value investing works.

Q. When you are evaluating a company, how much do you take into account companies' strategic changes or other factors that might change the future dynamics of the market in relation to the company compared to how it has been performing historically?

You definitely have to take into account other factors. This involves forecasting the future, which is difficult. You will sometimes be wrong. An example is the newspaper business. It used to be a great business to invest in. But a few years ago, people were forecasting the newspaper business was going to deteriorate because of the rise of the internet. We thought this, too, and we estimated how long it might take. Our estimation was wrong. We continued to buy stock in newspaper companies when it was low because we thought they would have more time to have economic value than they actually did. That's a prime example that you have to think about changes to industries, especially with speed of technology. And you have to be more conservative than we were in the case of newspapers as to how fast these changes might be.

Q. What is the worst decision and the best decision you've made?

My worst decision was to not back off in a bull market. Ben Graham talked about that. He said you need to back off in bull markets and be very careful about your investing. His advice was, when stocks are cheap, you should have 75 per cent of your investment assets in equities and 25 per cent in bonds. When stocks are expensive, you should change it to 25 per cent in stocks and 75 per cent in bonds.

My best decision was to adopt the principles of Graham and Dodd and to stick with them for the past 45 years.

Q. What is the most important thing you have learned about life and investing in the past 45 years?

Think for yourself, be independent, and think long term.