Richard Lawrence Jr.: An investment guru who believes in the rise of Asia

It's no surprise that Richard Lawrence, Jr. went into investing. His father was a money manager and encouraged his interest in stock prices at a young age. Lawrence eventually went on to establish Overlook Investments in 1991 and The Overlook Partners Fund L.P in 1992 to invest in high-quality listed equities that sell at bargain valuations across Asia, excluding Japan. Lawrence spoke with the editors of the Ben Graham Centre's Newsletter about his early days in value investing, investing philosophy, and his method of investing.

BG: Can you tell us more about yourself and how you became a value investor?

RL: I was originally from New York and my father was a money manager so I started looking at stock prices when I was 12. We had a deal where, if I memorized a poem, he would give me a share in a mutual fund that he ran. It made me interested in share prices. After college, I worked in a firm called John Bush and Co. and I was trained to be a broker and researcher. At a young age, I was head of research for a brokerage firm. John [Bush] taught me how to look at stocks and I spent the next few years searching for good companies to invest in.

Eventually I moved to Hong Kong in 1985, about a year after the joint declaration was signed where Hong Kong became a part of China. It was the early days for the markets in Asia. When I first arrived, there was the Pan-Electric crisis that happened in Singapore that caused the Malaysian and Singapore markets to be closed due to a corporate crisis. Since then, I have been investing in Asia and developing myself as a value investor.

BG: What is your investment research process like?

RL: We start out by filtering the companies we want to see. We have a funnel where we meet 400 companies a year, do serious analysis on 40, and only invest in four. I like my odds because I'm buying one in 100.

We're also disciplined with internally customised spreadsheets that focus on important things like cash flow, free cash flow, profitability, investment allocation, reinvestment of capital, and long-term track record. It's a combination of soft skills and hard skills.

BG: Many students are going into the workforce soon and will have disposable income for investments. What are the steps they should take if they want to invest in value stocks?

RL: What we use is public information so students can do similar analysis, too. You have to build this investing process into your life. You need to find what fits you individually. The sooner you start doing it, you'll make mistakes and get better at it. You can not really learn this business without making mistakes.

BG: Can you explain more about the Overlook investment model?

RL: The model contributed to the success of the firm and it has six components. It is a mixture of investment philosophies, business philosophies, as well as principles that we follow. For example, as a business philosophy, we only have one fund where there is one key decision-maker instead of having multiple funds with our money spread out. For investment philosophies, we only invest in superior businesses that have good managers that can run a company and consider minority shareholders. We look to invest in bargain valuations and only invest for long-term gains.

We believe that success is measured by capital-weighted returns as they show the returns for an investor, as compared to time-weighted returns. There is typically a significant difference in both numbers and many managers do not release data about capital-weighted returns.

It's critical to manage a bear market, as there are huge opportunities in bear markets. While bear markets are times of redemption, selling, panic, and fear, you have to blank out the doubts on the investment philosophies. You need to have a pool of capital willing to step up during a bear market. To be successful in a bear market, you just need to be a buyer. Normally, when you buy the stocks, prices will continue to plummet until a certain point where they will turn back up. The internal rate of returns (IRR) that you can generate on stocks during a bear market are always the highest.

BG: How do you get additional capital during a bear market?

RL: We control the capital that we raise. In our fund, more than 75 per cent of it are gains we have made over the years and only 25 per cent are new subscriptions. During times like now, when everybody wants in as stocks are going higher, we turn away potential investors.

The problem is that fund managers raise money when stocks are trading at high prices and eventually they leave as the fund loses money. Limiting our intake of cash helps to build credibility and, during bad times, we can call up people and they will back us up.

BG: We have seen the U.S. market and most recently the U.K. market reaching record highs. However, in Asia, developed markets like the Singapore and Hong Kong markets are lagging behind. What do you think are some of the reasons for this occurrence?

RL: I don't invest in Singapore and Hong Kong these days as I don't find as many attractive companies in them when compared to China. I do not think about the index when I invest in Asia. The best way to perform is to ignore the index as investing indices guarantee mediocrity. I always look at individual stocks and that helps my performance.

BG: In the past, Overlook Investments invested in small companies in Asia, excluding Japan. Is this still the current strategy? If not, how has the strategy transitioned over the years?

RL: We raised $30 million in 1991 and have grown over time. One of the rules we have is that we invest in firms that have a market capitalization higher than the assets under management (AUM). We owned a portfolio of more than 20 stocks and today we invest in companies that have a market capitalization of more than $4 billion as we have grown much bigger.

The rule was important for us as it ensured that we did not get caught, especially during a bear market, where you have to liquidate good assets in order to pay for redemptions.

BG: When you're looking at Asian stocks, how does your research method differ as compared to American stocks?

RL: There are some fundamental differences, but, for the most part, the methods we have will work equally well anywhere. One key distinction with Asia is that there are many controlled corporations, where family members control the corporation. These corporations take on the characteristic of the management and its attitude on risk and return. By looking at the track record over a period of time, I would know how aggressive or defensive the management is. This is a huge contrast to American firms where CEOs are motivated differently and may cause conflicts of interest. However, there are also downsides to these controlled corporations as they are more conservative. As the baton is transferred to the next generation, the business is weakened. The first generation of leadership has the responsibility to instil discipline and processes and train the next generation.

BG: We've learned that the subprime mortgage crisis in the U.S. resulted in negative repercussions worldwide. Can you tell us how it affected Asian markets, and specifically if the companies in your portfolio were influenced?

RL: In 2006, there was a huge bull market in China, where steel companies were priced at 10 times their book value. We decided to sell out of China and Hong Kong then. As soon as we left China, the U.S. subprime mortgage crisis occurred and caused China's market to tank. We were down by about 35 per cent that year. However, the problem was not with Asia and thus we went full force back in the China and Hong Kong market. We were fortunate that we were helped by the timing.

BG: What concerns should one take note of when looking at oil companies right now? Is oil an out-of-favour industry, or are there serious risks, since the return of oil prices to previous levels is not warranted?

RL: I do not like investing in commodity firms as you have to make two decisions: when to go in and when to go out. To do that, you have to buy high price-to-earnings stocks and sell the ones with low price-to-earnings ratios. This is not aligned to my investment philosophy and thus I do not invest in commodity firms. I made an exception during the early 2000s, when commodities had gone down for 20 years straight. At that time, you could easily identify the low-cost commodity producers in Asia as they were the ones who could still make a profit when everyone else was losing. That gave me a margin of safety. We are not in that situation now as commodity prices have only been down for the past five years and it is still early in the cycle.

BG: A lot of companies have been pulling investments out of emerging markets. What would make the emerging markets unattractive and do you think that your willingness to stay in these markets is what differentiates you from other investors?

RL: We need to be cognizant of the external environment. But I do not fear this as, when times get tough, good companies gain market share. You need to focus on the type of business you're in and be able to have a margin of safety to get through whatever the external environment throws at you. We do not know when conditions will change so we have to have a high margin of safety and wait it out.

BG: Can you provide an example of when you invested in a company and the investment did not go well?

RL: There are so many examples. I bought this Korean company and it was run by one of the giants of the textile industry. The management did vertical integration and, what set the manager apart, was that he depreciated his assets heavily. It caused his earnings to be artificially depressed and caused people to badly price the stock. He built a petrochemical plant for more than $450 million and depreciated it over 2-1/2 years, revalued it, and depreciated it again. It definitely helped to reduce the tax burden of the firm. Unfortunately, he passed away and his son took over. His son refused to continue the legacy and we were unsuccessful in bringing an outsider onto the board. The end result was that the son got himself arrested five years ago and we made no money on our investment.

BG: What is your outlook on emerging markets?

RL: It's really critical to not ignore the numbers in emerging markets. Is the economy cash flow positive? If there are current account deficits (negative net sales abroad) or capital account deficits (money is flowing out of the country), that's when devaluations (the lowering of the value of a country's currency) happen. Anybody with debt in a devalued world gets crushed. When you look around the emerging market world today, you see a lot of those things. Brazil has a terrible current account deficit. Turkey; South Africa; India, a couple of years ago, and Russia – these countries had a lot of current account deficits. They need funding during bull markets. When commodity prices turn down, the dollar strengthens and these current account deficits are very hard to fund. When you look at emerging markets, put your money into countries that are cash flow positive. The bulk of our money is in Asia. Asia is generally running with a current account surplus and capital cash surplus and that gives us a big margin of safety. In 1997/98, we were in a current account deficit in Asia and we got slaughtered so I know firsthand the importance of the economy being cash flow positive.

BG: What is the profile of a typical value investor?

RL: One of the really important things is to be contrarian. You have to build moral fortitude and have certainty to be able to buy when stocks are down. Being contrarian is not just about buying when stocks are down. You really have to work at learning all that is involved from day to day in being a good contrarian. I sometimes feel uncomfortable when buying a stock. I now recognize that feeling and I don't mind it because then I know I'm on the right track. Being contrarian is hard to do and greed and fear can get in the way. Read literature about being a contrarian because it helps you to overcome these natural inhibitions you have to being a value investor.

BG: What triggers are you looking for to prepare for a bear market?

RL: When you get into bear markets, only balance sheets matter. Forget about price-to-earnings (P/E), because there are no earnings. There are companies that have the muscle to get through a bear market if it starts tomorrow. You have to be prepared every day for that to happen. It's almost impossible to predict bear markets. There are so many unpredictable things. Don't predict markets at all. Just prepare your portfolio to have a margin of safety and keep trying to improve it. Your time is so much better spent on that than trying to predict the future of the markets.

BG: Who are your greatest teachers and what were the key lessons?

RL: I've been fortunate to have had mentors like John Bush (Senior Officer at Fairfield, Bush & Co.), who was a great investor and a very generous teacher. Others include Marc Faber (Director of Marc Faber Ltd. and publisher of the *Gloom Boom & Doom Report* newsletter), and Jeremy Grantham (Co-founder and Chief Investment Strategist of GMO). The great part about it is you don't have to know them individually or personally because most of these great guys have written books. There are so many great investment books. When you read these investment books, you'll find you have like-minded cousins. They're like distant cousins because these guys did things in a way that makes sense to you. You have to get connected and keep searching. Dog-ear the page where someone says something that you connect to. Chances are, in 20 years, that's going to be an important part of what you do. I have a policy where every other book I read does something to help me in my business. When you see a really good investment book for you, you'll know it and you'll relate to it. You'll piece what you learn from these books together. It's a journey of discovery to find the components of value investing that really make sense to you.

BG: We have noticed that you've been involved with many philanthropic projects such as Proyecto Mirador in Honduras. Can you tell us a little bit about that?

RL: There was a hurricane in Honduras and it wiped out much of the infrastructure there. My kids and I went down with a group of doctors and helped out as translators. We saw that many kids had lung problems, but we were baffled since no one smoked there. We finally realized their stoves were causing the problems. There were no chimneys to release the smoke from the stoves and the walls of the houses were covered with soot. We started building stoves for the families and we calculated that the net present value of these stoves was much higher than the cost.

BG: Have you found that there any characteristics of the value investing philosophy that are translatable to your role in a project like this?

RL: For a long time, I felt like I was a Chinese guy in a manufacturing plant in Guangdong, China. We outsourced components and helped to create jobs in Honduras. We ran it as a non-profit organization, but operated the project like a business. We installed Salesforce.com to ensure that the stoves were used properly and to find the locations of the stoves.

BG: What is the most important thing you've learned in life and investing in the last 30 years?

RL: I think greed is corrupting. When you start down the road of your career, you don't need to be greedy. Let the next guy be a greedy fund manager. You can do that because what you should be doing is something you love and you're going to want to do it for 25 or 35 years. If you can be a good investor for eight years, you'll have all the money you need, so you don't need to be greedy. Investing can be a passion and can address your inner needs. It can serve you well in life and then you can give up greed.