March 17, 2016 ~ Lauren C. Templeton, Founder and President and **D. Scott Phillips Jr.**, Principal; Templeton & Phillips Capital Management, LLC

Ben Graham Centre (BG): We read that you started investing at a young age, having been influenced by your father and Sir John Templeton. Would you be able to share any important lessons that you learned during that time that you still carry with you today?

Lauren Templeton LT): Just to look at investing as buying a share in a business, and that you're not trading or speculating in the market. You should look at yourself as an owner and buy businesses with characteristics of those that you want to own. It's very different from trading or speculating in the market.

BG: Can you walk us through your idea generation process?

LT: We start with a screening process like most traditional value managers – traditional value screens such as PE ratios, PEG ratios. We're looking for the bottom decile of stocks. We run the screens every day with big spreadsheets built that we look at every morning. It's usually the same stocks in the bottom decile, but occasionally, we'll see something new that will get our attention. Once we see something like that, we will use a variety of models such as the discounted cash flow model or the dividend discount model. We're looking for 50% upside to intrinsic value before we employ capital, and if that's the case, we do qualitative analysis, which means talking to competitors or different people in companies along the value chain. We then see if the company earns a spot in the portfolio – whether we have cash or if we have a company we want to replace. We only replace a company if there is an opportunity that is 50% better than the current one, which is defined by the upside to our intrinsic value.

BG: What's the rationale behind the 50% margin of safety?

LT: I think we need it, because we're not always right. We're modelling companies in different scenarios – the base case, best case and worst case, where we're basically modelling a recession. As you know, the models are a little finicky towards the assumptions you put in and there are a lot of moving parts. For the margin of safety, 50% upside is something that has always worked well for us.

Scott Phillips (SP): It just seemed like a good stringent discipline. You need some room for mistakes in your forecasts.

LT: It gives us a lot of room. The typical 30% margin of safety is not a lot. It's very easy to model 30% if you just change a few things in your model. 50% makes you work a little harder and it's harder to find those bargains.

SP: What we're doing within that context is we're running three different DCFs under three different scenarios and taking an expected value of the three. In a normal business cycle, we'll just equal weight them. However, if for instance 2008 or 2009 when we were modelling companies, we were weighting towards a more normalized business cycle. The other great thing about a DCF model that we like to do is solve for what the market is thinking. We would back into the assumed operating margins and sales growth rate to see how reasonable the market's forecast was. What we found was during 2008/2009 when we went through those exercises, it was modelling negative growth into infinity and recession-like margins into infinity. At that point, you just have to take the stand that this isn't a permanent condition. Even if it is, I'm being compensated for it.

LT: In terms of the replacement idea where we replace companies if there is an opportunity that is 50% better, that is something that my uncle had in place. That was his criteria. We try to replicate his investment policies as much as possible. We've spent 15 years doing nothing but studying his investment philosophies and seeing how we can take what he did and apply it to our business. Most of it is still applicable, so we learn directly from him.

SP: It keeps your turnover low, which is a good by-product that comes out of that.

LT: I don't think he used discounted cash flow models much.

SP: He said that he used a hundred different measuring sticks, so I think he was open to any type of creative valuation metrics. I don't think he stuck to just one.

LT: No, but he used rankings. He didn't have any screens back then, so he would go through the numbers by hand and write down all the valuation metrics, and then rank the companies. If he saw a consolidation of cheap stocks in Japan, he'd dig a little deeper into Japan. That's how his investment research philosophy was driven, but he didn't have the benefit of bulk downloads from Bloomberg.

SP: He basically said that they were using quantitative processes before any of these quant funds existed. It was more along the lines of Greenblatt's Magic Formula or Ben Graham's Formula.

LT: It was great because now, it's hypercompetitive with the data just there. The job is much harder. I'd much rather manage money when he did it when there wasn't Bloomberg, bulk downloads, and you had to go through the company filings and make metrics yourself. That's why he made so much money and did so well for his investors. It wasn't a hypercompetitive environment like today. It's very hard to manage money these days.

SP: There was a lot more inefficiency in the market. Today, we suffer from too much information, so it's a matter of discerning what matters and what doesn't.

BG: You mentioned earlier that you go to competing companies if you were interested in one business. We've heard from a few people who refuse to talk to management in general. We were wondering what your thoughts are on that.

LT: We don't refuse to talk to management. I think that can be a little silly to refuse to talk to management. Scott used to be a sell-side analyst and runs our investment process. I oversee top-down portfolio allocation. He basically sees the research process, so we are very cognizant of the type of information you get from a company and how biased it is. They are only going to show you the rosiest of pictures and what management wants the company to be. However, everybody knows that, so I don't think you need this refusal to talk to management. I wouldn't say it's very high on our priority list. Although analysts at Templeton did go do that, Uncle John would be the first to tell you that you have to be super careful that you do not hang out and play golf with management.

SP: However, there is some usefulness. In those conversations, you can learn what their orientation is towards stewarding the company over a longer period of time.

LT: You can discover if they're super myopic or if they're thinking about the long-term more. That's an important thing to discern from management. Competitors are great, because if you're talking to a competitor, you get some really good information that way. Those calls are much more helpful. However, you do get an idea of corporate culture when talking to management, and you can just tell if somebody is being too short-term focused. In that case, you wouldn't want to own those companies.

BG: A lot of the students here pursue a dual degree, meaning that you do business alongside another discipline. We read that you [Lauren Templeton] did your undergraduate degree in Economics and Scott did his in English, so we were wondering how your particular disciplines helped you in finance.

SP: I think the important thing is to be a critical thinker, to go beyond the face value, and to be rigorous. A lot of people can go in and pick up the nuts and bolts of finance and economics. It really comes down to what Sir John described as the doctrine of the extra ounce. What he meant by that was the person who was willing to do a little bit more than his competitors would be one to get ahead in whatever his discipline was. If you are a curious person and you know the basics of finance and investing, having a broader perspective is a really good thing.

LT: I don't think a business major is very helpful, but a finance major would be. However, it would teach you a very technical dissection of a company, the income statements and balance sheets, and how to build models. That is a very small portion of value investing. You can hire a lot of people who can do a discounted cash flow model and rank stocks based off their metrics. It's really more of the behavioural finance that you need, and that's a personality thing. In value investing, it's not the textbook, the discounted cash flow model, or the metric. It's the doctrine of the extra ounce. Scott reads a disgusting quantity of material from all fields. When you're investing, particularly in equities, there are so many components that can filter into a stock's valuation at any given point. It can be something geopolitical, something related to monetary policy, something that the business is doing from a corporate governance perspective. You have to be a person with a wide lens who's willing to dive into all of these subjects at any given time since it's far more expansive than a DCF. When I talk about those value screens and the bottom decile of stocks, if you are one of those students who's so focused on those models and not a thinker who's willing to go outside your discipline, it's harder to look at those stocks. The more knowledge you have and the more you read, the more dots you can connect in the bottom decile. There were people who came to work for us who were extremely intelligent and could model, but were horrible at making stock recommendations, because they were so focused and couldn't connect it all. We both went to liberal arts colleges, and I'm so glad that I ended up being an economics major. I think I could have been an art history major and still learned economics. I grew up in a family where businesses and stocks were discussed, and I began buying stocks at a young age, so I don't think I needed it, but the average person might need a finance major. The common language spoken in my home was the language of business, and I grew up speaking it pretty fluently.

BG: In one of your investor letters, you talked about Chinese companies, Baidu and Qunar specifically. These companies are fast growing, and don't fit the typical value stock mold. How would you balance the growth aspect and also being prudent when investing?

LT: Uncle John always liked growth stories, and the trick is just to not overpay for it.

SP: You want a growing enterprise, and what's key to that discussion is that whenever we're talking about a growth story, we're usually talking about it amidst a pretty significant correction or panic in the market. That's when we buy those stocks, because they get discounted and people tend to forget about the long-term prospects, how long internet penetration is in China and all the different parts of the business of Baidu that are like Google is some way. There are a lot of exciting things with that business, and you need to find those moments when the market isn't thinking about that. With Baidu, the multiples are high, but when you peel off all those stakes that weren't producing cash, you're paying 8x for the search engine which is a bargain buy. The prospects for buying long-term are significant enough that warranted a purchase.

LT: You really find value stocks in two categories: those that are neglected and those in the midst of a crisis or correction. Generally if you're looking for companies with a little more growth prospects, you're going to find them during a correction. These are not neglected companies. You have to be even better at managing the behavioural aspect if this is your approach.

SP: Another thing that comes to mind since you mentioned Baidu is that the stock had fallen out of favour because management was investing heavily into new ventures. I think in the technology space, that's important. If you're not investing and developing new businesses, you're going to get left behind very quickly. With regards to companies that most value investors would classify as a value investment, a low PE tech stock such as Hewlett-Packard. Several years ago, we bought HP, and that was an interesting ride to say the least. We held the stock, averaged down, and it worked out over time. However, they were cutting expenses to a bare minimum and weren't investing in the future. This was catching up to them in marketing and different aspects of the business. It goes back to the stewardship. Is management willing to take the risks and maintain a leadership position by investing at the sake of short-term profits to ensure longer-term returns on capital? That's the kind of mindset you have to look for. However, it goes back to the market environment, and that's what enabled us to buy those shares at that price.

LT: That's why Uncle John always said to keep a wish list, and we actually have a wish list in our desk of companies we love. That's a great mechanism to use during a sell-off, because it's very empowering when, instead of focusing on all the money you lost, you get that list and all of a sudden your perspective's changed. You're focused on the list and buying these attractive companies at discounted prices. It has a profound impact on your shift in psychology, and worked especially well during the 2008-2009 financial crisis.

SP: With all the information nowadays, it gets scary during a market correction. However, you have to take advantage of these times to get a bargain.

LT: It's hard being a value investors, because even though your clients may say that they understand it, they get really nervous during a market correction. We have to assume the role of the leader and shepherd them through these times knowing that it's in their best interest. However, you should be careful of which vehicle you use. Uncle John managed a mutual fund, which is the least advantageous vehicle to manage if you are a value investor, because people are always giving you capital and taking capital at the wrong time. Instead of getting to take advantage of your wish list, you have to manage the outflow of capital. Specifically, you have to think about how to meet these redemption requests without blowing up the portfolio. Berkshire Hathaway is the complete opposite, so that is a terrific way to set up a business that ensures that you always have cash coming in and can invest regardless of what's happening in the market. Hedge funds are also advantageous because you do not have daily liquidity and have the right to a lockup during a market correction. Furthermore, you have two levers you can pull by employing leverage or covering your shorts. Both are ways of getting more net long. In that sense, you have more tools with managing a hedge fund than with managing a mutual fund. Vehicle is very important. We always tell investors that it is a partnership, meaning if you are going to invest after a great streak of performance, and then I draw down and you take money away from me, you're going to have bad results. You have to believe in the process and be secure in the process. Peter Lynch's Magellan Fund annualized returns in the high teens, but the average investor in his fund only made a return of less than 5%. In that sense, there is a difference between value investing and being a value investing manager. As a manager, you have to be a value investor and manage a value investing business, which are two different things.

BG: Can you share with us a lesson you learned from the financial crisis? Has your strategy changed at all?

LT: No, the strategy has not changed at all. I look back on it, and it was good. It drove our returns and expanded our business in a lot of ways. It all came down to the behavioural aspect of investing. There wasn't anything special we were doing from an analytical standpoint, but we were willing to walk the walk as a value investor. We bought all the way down because we can't time the bottom. Every day, I went in and entered orders which were usually profitable by the end of the day.

SP: The biggest lesson is that during those moments, the analysis itself is very simple and easy. When you're at the top of the market, it's so difficult to find a business that is mispriced. You really have to work hard to find them and locate them. When the bottom falls out of the market, they're easy to see. You just have to have the nerve to buy them.

BG: Do you have any advice for the hopeful, young value investor of today?

SP: If it's what you want to do, don't give up on it. The market is going to come in and out of favour. There will be times when the market's high and it's easy to get a job compared to when the market's low and it's hard to get started. If it's what you want to do, go after it and don't stop. It's challenging, but it's also very rewarding when you find success. You're in a unique position to have a positive impact on your clients' lives. Last year, Lauren and I were at the Value Investing Congress at Berkshire Hathaway. A man drove six hours to meet us and said that when he read "Investing the Templeton Way", he learned that the best time to buy is during these bear markets. He started investing more in his 401Ks during then, and by doing so, it reshaped his family's life.

LT: Just start now. It has to be real money, not reading a textbook. You can read textbooks and investment letters, but as much as you can, enter the market right now. You need to maintain a book of all your trades. My dad has a ledger where he records when and what he bought or sold. Using this, he would be able to recall his trades and what he learned from them. When I graduated from college, I borrowed money from my dad to invest in a hot tip I had gotten from my friend. I lost the majority of the money, and I called my dad to tell him what had happened. He said, "Great, that's exactly what I had hoped for. You never take a hot tip, and that lesson was worth every penny." Uncle John started me with 30 million dollars when I was 24, which was a lot of money. He understood that you start young with real money. It doesn't matter if it's 30 million dollars or 30 dollars, because you will learn more with that 30 dollars than you will reading a book. Don't be afraid to make mistakes as long as you learn from them.