Bestselling Author Avner Mandelman Talks Stock Sleuthing, Shareholder Activists, and the Debt Ceiling

Description

This week I interviewed Avner Mandelman, author of the book *The Sleuth Investor*.

When you pick up the book, right away you realize this won't be like any other investment book you've ever read. First, the cover. There's no cliched bulls and bears — just the stern look of a private detective. Second, this is not a rehash of investment ratios or balance sheets. Mandelman lays out exactly how to go beyond financial reports and press releases to gain the investment edge — or protect yourself from large losses. His approach to investing is more reminiscent of a journalist or an intelligence operative than your typical Bay Street analyst.

In my conversation with Mandelman, we discussed the importance of uncovering physical clues in investment analysis and his take on recent events. Below is a transcript of our conversation. It has been lightly edited for clarity.

Robert Baillieul: For readers not familiar with your work, how would you describe your investment philosophy?

Avner Mandelman: I am a "fundamental" value investor. Yet there are two basic difference between me and a purely numerical value investor who buy and sells only based on "the numbers."

Difference #1: I see investment analysis as a commercial intelligence operation, which, like the military kind, involves information gathering, information analysis, and recommendation for action.

And, as in military intel, here too there are two kinds of information: Signal Intelligence (SigInt) and Human Intelligence (HumInt).

The first is really secondary information — a "reflection" of physical corporate reality: documents, filings, corporate reports, Internet pages, PR releases, etc. (i.e., blips on screen and ink on paper). This is what all investors (including me) peruse. Yet 99% of investors don't consider there's any other kind of info.

But, of course, there is. A corporation also has a physical part: Products, plants, people, etc. This is the primary, physical aspect of the business that generates the secondary, symbolic part: filings, reports, graphs, financial statements, price charts — the screen-blips and ink-blots that most investors consider as the only “information” with which they can work.

Difference #2: This common blindness to the company’s physical aspect is probably due to the fact that most investors see themselves as office-based stock scientists (what in Intelligence is called Boffins). I, however, always saw myself and the analysts I had managed (I ran three institutional research departments) as a combination of stock scientist and street operative.

In other words, beyond doing financial and business strategic analysis on the company’s documentary reflection, I also look at the primary, physical info behind the numbers and documents, so as to get an edge. And in that part, 90% of the info is about the people running the business: Corporate “HumInt,” we may call it.

If for the “SigInt” part of stock analysis one should know finance and strategy and how to read and interpret the numbers and documents, for the “HumInt” part, one better learn how to “read” people and (hopefully) understand their behavior.

During my investment career I’ve often found that this second, HumInt part, is a potent “force multiplier” of the first.

For instance: Say you’ve read in a company’s release that the CEO said “sales will be good.” You may then become bullish, yes? But what if you were present at the meeting when he said it, and saw his two VPs roll their eyes as the CEO spoke? Wouldn’t you then have one more piece of data that home-based and office-based “investors” wouldn’t have?

Now, mind you: This last bit of HumInt is not a “reportable” item, and it certainly is not inside information. It is merely an impression. But it adds something to your gut feel of the business — just as you would add to your gut sense if you had met management at 11 a.m., and they all smelled strongly of vodka …

But just how necessary is it to get such a gut sense of the people who run the business in which you invest your family (or clients’) money?

I’d say it’s not only necessary, it is obligatory. And if you run clients’ money, it’s perhaps even morally obligatory, since your clients pay for your judgement, not just your numerical skills. So don’t you think you owe it to them to base your judgement on input from all your senses, not just your eyes?

After all, you wouldn’t get married after merely “getting to know” your spouse via email, would you? You’d insist on meeting her/him in person, and getting to know him or her using all your senses, not just your eyes. Why then would you invest your family (or clients’) money in a business run by strangers, without first letting your gut tell you whether you find them trustworthy?

As an aside, this is why the justice system relies on face-to-face trials, where a witness' demeanor can be observed, rather than a mere documentary exchange, with jury members and judge sitting at home at their computers.

But, you may ask, can everyone do it?

Yes, some of us may be better (and more experienced) at this than others, but I'm convinced we can all do this: We all have built-in lie detectors in our gut that serve us well — if we bother to use them. And let me tell you: you'd better use yours before you invest, because if you won't, and will simply make do with reading screen blips, it is highly likely that sleuths like me will take your money in the market.

Remember: You have five senses; use them all in your research. Touch the inventory on the plant's shelf to feel if it is dusty. Or observe and see if the president is liked by her subordinates. (The glamorous CEO of a large Bay Area tech company was shunned and disparaged by her engineers, I saw; I shorted the stock. She was later fired.) Or read the labels on magazines in the hall with the CFO's name on them. Is the magazine *Accounting World*, or *Gaming World*? Is the CFO's photo on the hall's wall of him and his cute family? Or of him with scantily-clad bunnies in Vegas? Nothing illegal with the latter, but your gut may sing a different tune in such a case.

To sum up: investment analysis, for me, is both numerical and business analysis based on documented matter (which I peruse and analyze thoroughly), and physical cues. And since that last part is rarely looked for– and almost no business school teaches– it gives an advantage to those who look for it, and use it.

Baillieul: In your book *The Sleuth Investor*, you advocate that investment research should consist of uncovering material, public, but not widely disseminated information. Why is this important? Aren't public filings enough?

Mandelman: It is not "uncovering material," but "uncovering physical material," and "getting a gut feel for the people."

We should understand that in conventional "investment research," the analyst uses only his/her eyes and brain– he /she reads the numbers and letters and watches pictures on a screen, then applies his/her brain and training and education on these symbols, to reach a buy/sell conclusion.

This is similar to what the NSA and CIA do when they try to understand the enemy merely via satellite images and photo interpreters, or deciphering its signals: Using eyes as the single sensor whose data goes to the brain, for interpretation.

But what of the other four senses? What of the hearing, smell, touch, taste? And what of that mysterious sixth sense, the gut, which is often activated after receiving data from all other five senses?

Like which data?

Well does the company plant sound too quiet, with nothing going on? Is the plant smelly and unclean? Is the Sales VP's handshake clammy and his breath alcoholic at 11 a.m.? How do the salesmen seem? No need for any words from them — no inside info needed. Just their demeanor. Do they seem cheerful, or depressed? And what of the cars in the plant's parking lot? Does the president's car's license plate say "MR BIG," or "GZMO MKR?" Is the CEO a huge tipper in restaurants? This might give you an insight into whether he may counterbid higher in a takeover. … And what of the R&D VP? He sure talks a great game. But is he/she a genius, or just a big talker? Ask around. Perhaps ask his thesis professor? Or other R&D folks of your acquaintance, who'd know him? Again, nothing concrete, nothing illegal. Just a human feel, to get that gut sense you cannot put into numbers.

You'd be surprised at how effective your gut can be. After all, you use it in all other aspects of your life, so it must be mostly right, or you wouldn't have much money to invest.

And yet, the very concept of looking for permissible *physical* investment info is one that most investors find hard to grasp. Perhaps because most investors, by nature, are introverts who prefer sitting restfully at an office and manipulating symbols on paper and screen, rather than going into the physical world and mixing it up with people.

The flip side is that because of this, by getting the kind of info others are too lax or too short-sighted to look for, you'd have an exclusive edge on which to act, and thus an advantage.

As an aside I occasionally give talks to MBA classes about Sleuth Investing (in Ivey's biz school in Canada, or in Columbia in the U.S.), and found it odd that very often, the smarter the students, the more difficult it is for them to grasp the idea of physical stock research. And even those who do, usually right away they want to computerize it, automate it, do it with databases, A.I. algorithms …

What most instinctively resist is the hard work of person-to-person contact, and the use of all five senses, so as to generate an un-quantifiable, un-modellable gut feel.

On the other hand, I often find that the MBA students who "get it" fastest are ex-policemen, ex-security (or ex-Intel) people, or ex-journalists. The latter in particular know they cannot report on a story of a fire based on what they've read about it. They know they must go talk to a primary eyewitness, and go see the fire with their own eyes, or they'd be committing journalistic malpractice. Yet most investors — even Wall Street analysts — still seem to think that secondary, documentary sources are all they need …

But as I said, this gives Sleuth Investors an edge, through which they can take the money of those who never leave their home and office and only analyze screen-blips and printed pages.

Baillieul: Everybody knows Coca-Cola is a great business. McDonald's has a wide moat. But are there any industries value investors overlook?

Mandelman: There are plenty. But for this, you have to get out of the house or the office, and do physical research.

Go to any industrial plant, and ask what are (or look at) the standard products they use, without which they cannot function: The industrial abrasives, the special lubricants, the cleansers, the solvents, the sealants, or the variety of odds and ends without which industry will grind to a halt.

A splendid stock I used to own was of a company that collected the burnt oil from hamburger joints, cleansed it, and re-used it in some industrial processes. It was an excellent franchise. But if I hadn't gotten out of the office, I'd not know of it.

Baillieul: Recently, famed corporate raider Carl Icahn announced his position in Talisman (TSX: TLM). Bill Ackman clashed with Canadian Pacific (TSX: CP). Jana Partners made headlines at Agrium (TSX:AGU). Do you think activists represent the best interests of long-term shareholders or the companies they advise?

Mandelman: Some do, some don't, and others fall in between.

Some raiders push management to act usefully, thus raising the stock price and benefiting everyone equally. But even some of these may damage the long-term business of the company– for example, Carl Icahn, who is now pushing **Apple** (NASDAQ: AAPL) to borrow $150 billion (!) so as to buy back a huge slug of stock, is probably demanding too big a buyback. It would saddle the company with far too much debt, and damage its ability to spend on R&D. Do remember, here, that Henry Singleton, the grandfather of stock buybacks, used to object to buybacks with borrowed money. Use only cash on hand, and some of the cash flow, he said.

On the other hand, "greenmailers" usually operate in their own interest, and against that of other shareholders: they want to be bought back, often at a premium, which damages the company that the rest of the shareholders keep owning.

And then there are those in between, like Warren Buffett, who cut himself special deals that take a chunk of value out of other investors' pockets, putting it in his company's, in exchange for providing capital, and the imprimatur of his name. This was the case when he invested in **GE**, **Goldman Sachs**, and others, via a convertible preferred carrying a very high coupon (often 10%), which is a benefit to which other shareholders were not entitled.

So, to answer your question, I'd say that activists and direct investors (PIPE– private investment in a public entity) fall in a wide range, from the good, through the benign, all the way to the harmful. Each has to be examined separately.

Baillieul: In September we observed the anniversary of the collapse of Lehman Brothers. Do you think five years after the financial crisis investors learned any lessons? Did the financial crisis in any way change how you invest?

Mandelman: In my opinion investors never learn any lessons, or if they do, they forget. Certainly not the "public." As an old partner of mine once said: You should always go against the public's sentiment, because the "public" is always wrong, by definition. Since if it were not wrong, it would not be the "public." It would be rich …

As for the collapse of Lehman Brothers: This of course was the best time to invest. (As an aside, at the time I had a an article in the *Globe and Mail* on Feb. 28, 2009, when the Dow was 6,600 or so, in which — based on the extreme panic then — I noted that the Dow would very likely double from that level in five years.)

Regarding what can be learned from Lehman's panic, about today's situation: Sleuth investors always try to look at the people in the situation, and the physical aspect, to forecast what is likely to happen.

In this vein I prefer to analyze companies as if they are political entities, and political entities (and organizations) as if they are businesses.

For example: Panic and public hysteria are the mechanism by which leaders of large groups can force their own constituents to make concessions — saying truthfully that otherwise something worse will happen. Panic is therefore a useful sign that both sides are getting close to a deal.

When Lehman went bust, other banks (and regulators) could finally make the unpopular (and unprofitable) changes that fixed the banks and strengthened the economy. In this regard, then, and perversely, the greater the panic, the bigger the scope for fix-it measures, and so the more robust the fix and the resulting recovery.

Baillieul: Should investors be worried about the U.S. debt ceiling talks?

Mandelman: It looks awful, and seems to augur Armageddon, but in truth (in my humble opinion, and in the view of some Washington staffers I talked to), the panic could be highly encouraging to investors, because it probably augurs a strong fix for some of the U.S. economic problems.

To make this clear, let's analyze what's happening in physical, commercial terms: The Tea Party is acting in effect as a Creditors' Committee, hemming in the management powers of a CEO who borrowed overmuch, spent the borrowed money on his own priorities, created large losses (i.e., budget deficits), and now insists on getting more loans, no strings attached.

Seen this way, the conflict become clearer, since similar conflicts happen every day in the regular economy: A CEO who'd spent borrowed money and wants more, after generating losses, gets a *no* from the lenders. And if he insists, the creditors then insist on *co-signing the checks*, to ensure their own priorities on spending the cash flow. In other words, what the Tea Party is now doing, is demand to co-sign all checks written on the tax revenues, before they'd lend more — in effect putting a lien on the cash flow!

Once seen in these physical terms, it becomes simpler to understand.

And as for the matter of default on U.S. government debt: The true risk is seen as non-existent, since the likely scenario is one of a lien on the tax revenue by any other name.

Specifically the U.S. receives about $250 billion to $270 billion a month in tax receipts. The creditors (the Tea Party) insist on earmarking (encumbering, or putting a lien on) the first $30 billion for interest, the next $20 billion for, say, Welfare, the next $30 billion for, say, the Military, and so on.

The CEO (Obama) resists this, since if this is done, the $270 billion will soon be entirely spoken for by liens, and he won't have any more unencumbered money to spend on what he sees as necessities (and what the creditors see as unnecessary costs).

In other words: The seeming panic now is merely a forced cost-cutting for the U.S. government, done by a creditors' committee. Which, of course, is highly bullish for the long term, if bearish for the short term.

Why the seeming panic? In commercial life, the CEO usually negotiates with the creditors, because if he won't, they will call the loan, then send their representative and a bailiff, who will take possession of the enterprise and run it for their benefit.

Here, however, the CEO (Obama) refuses to talk, and threatens to close the entire plant down. In commerce this cannot happen, because the bailiff would prevent it. Here, though, there is no bailiff. So the creditors (Tea Party et al.) simply keep insisting on co-signing all checks, and refusing to hand out any more loans (which, after all, they would have to repay), before they are allowed to encumber the tax revenues as *they* see fit.

To sum up: Seen in physical terms this way, it should become clear that the Tea Party simply acts like a homegrown IMF — so the end game would probably also be similar to an IMF involvement: some prioritizing of tax revenues, some cost cutting, some chipping away at the prioritizing power of the country's CEO. Some necessary painful medicine taken, at the very last moment.

Therefore as in the case of Lehman, if the market sells off, because of a well-orchestrated panic, this should be seen as a sign that economic imbalances are close to being fixed. In other words, any sign of rising fear and hysteria would be highly encouraging — as was the case in the Lehman crisis. Panic is part of the physical fix.

Baillieul: What keeps you up at night?

Mandelman: Not much, unless I happen to read a good thriller, or the latest court documents of an exciting lawsuit between public companies, where a substantial gain is at stake …

Otherwise, what usually worries me is complacency and lack of worries.

The Motley Fool's top two stock ideas
The Motley Fool Canada's senior investment analyst recently unveiled his top two stock ideas for new money now. And YOU can be one of the first to read his buy reports — just click here for all the details.

Disclosure: Robert Baillieul has no positions in any of the stocks mentioned in this article.

David Gardner owns shares of Apple. The Motley Fool owns shares of Apple, General Electric, and McDonald's.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CP (Canadian Pacific Railway)

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