Larry Sarbit on Warren Buffett's Investment Philosophy, BlackBerry's Competitive Advantage, and Management "Sociopaths"

Description

Larry Sarbit is not an investing celebrity. Based out of Winnipeg, Manitoba, he's located far away from the hustle and bustle of Bay Street. Yet over a 30-year career, Sarbit has amassed an impressive track record by applying the time-tested investment principles of Warren Buffett and Benjamin Graham.

In part 1 of my conversation with Sarbit, we discuss how to go about finding wonderful businesses and identifying sustainable competitive advantages. Below is the transcript of our conversation; it has been lightly edited for clarity.

Robert Baillieul: Thanks again for taking the time to speak with me today, Larry. For readers who aren't familiar with your work, could you describe your investment philosophy?

Larry Sarbit: Well, I like to call it a business approach to investing. Which means we view the purchase of individual equity securities as if we were buying a large portion of the company or the whole business in its entirety. And we kind of approach it in the same way that a private buyer or a buyer of a private company or a nonpublic company would purchase a business.

So there are no stock prices going up and down. There's no volatility. The value is there. And the question is, What's the value? Can we identify it? Is this a predictable business?

Very simply, what we're looking for is what Warren Buffett coined in the 1970s: an equity bond. We're looking for companies where we can identify the coupon that the business has. And I guess what I've learned, Robert, is that all investments have coupons. Every investment has a coupon. You just don't know what they are. In most instances, you don't know what the return is going to be.

"Equity bond" is a great term because with a bond, you know what the coupon is. You know what the return is going to be if you buy the bond at issue or at any time during its outstanding period. And you will know what that return is going to be if you hold it to maturity.

Baillieul: What are the characteristics of an equity bond?

Sarbit: Now there’s no maturity on an equity. But if you can figure out what that return is over the next three to five years, you’re doing very well. If you can look out that far with a business, first of all it’s unusual. But it can be extremely profitable if you have a very high-probability event. And that’s how I would describe it — very high-probability events where the range of the coupon is knowable. And that’s what we’re looking for. If we find one, we put a lot of capital into it.

I’m not a big believer in diversification. It runs contrary to what stems from business. Businesspeople are focused first and foremost on not losing money. Any investment they make, in their business especially — any time they’re going to invest, whether it’s in their own business or to buy a competitor, or whatever it is within their business — they’re thinking rationally. And they’re thinking about it as all businesspeople do, about not just what they can make but what they can lose when they enter into a proposition like that.

So that’s really the key element in anything we do. And what I’ve learned from people like Ben Graham and Warren Buffett is: don’t lose money. That is the foundation of every successful investor that I’ve ever studied or been involved with. That’s what they do.

Baillieul: I think lots of investors try to adhere to the investment philosophy that you just described. They’re looking for cheap stocks maybe on a price-to-earnings or price-to-book basis. But then I’ll look at a company like BlackBerry (TSX: BB, NASDAQ: BBRY) a few years ago or the banks before the financial crisis. They looked very cheap on all of those multiples but turned out to be disasters. The point I’m trying to get to is, How do you avoid value traps?

Sarbit: Well you know the wonderful quote from Buffett, I think when he was talking about **Berkshire Hathaway** the textile manufacturer, and he said, “I went in search of cheap stocks and I had the misfortune of finding them”. And I thought that really summarized the issue of what you’re talking about. Ben Graham would’ve bought those companies. And Buffett learned over the years that those could be highly risky ventures. And they may look cheap but they may have a value of zero.

And how do you avoid those things? Well, you buy companies that have the characteristics that I’m looking for. They have what Warren and Charlie [Munger] have been saying over and over again — what they’re looking for is a business that has a *sustainable competitive advantage*. Emphasize all of those words because sustainable is very important. Being able to hold your position in the marketplace for long periods of time is as important as having a competitive advantage.

For example, you mentioned BlackBerry. BlackBerry had a competitive advantage at one point in the marketplace. But it wasn’t sustainable. And so one of the other characteristics that we’re looking for is that the basic business model is stable. It doesn’t change a lot over time. So you can look at it five years ago and it’s the same business.

We own a company called **Cedar Fair** (NYSE: FUN), which is an amusement park company. Youknow that business hasn't changed. They built a park Sandusky, Ohio, I guess about an hour awayfrom Windsor, Ontario. They built that in 1870. So this park was built five or six years after the civil war ended. This park has been operating since that time — 143 years of doing exactly the same thing. Now the rides change. The food that's consumed. All that stuff has changed. But the basics of what the park does and what it delivers to customers is exactly the same. I love stability in a business, and that's got it. And it's going to be doing pretty much the same thing, I would think, in five years.

I don't think I can go much beyond five years in any business. I don't think anybody can. You ask any businessman if can they look out five years and they have a hard time. Any businessperson does.

But if you know your business is a requirement and you know the technology isn't going to destroy that business and you continue to have what Buffett calls the share of the mind of the customer, then you know you can continue to generate revenue and profit. And we love businesses that have a repeatable revenue base. The mutual fund industry has that. **Coca-Cola** has it. And so does Cedar Fair. It's very consistent. Very predictable.

And it's a good business that's growing over time. And it doesn't require a lot of capital. You don't have to reinvent Coke. You don't have to reinvent the amusement park. You change the rides every few years. But the basic park doesn't have to be reinvented.

Stuff like technology companies — the BlackBerry story is a good example — you have to keep changing. You become the company responsible for creating the future. And with a lot for businesses you have no idea what that future is going to look like. The world keeps changing faster and faster and it becomes more and more difficult. And that demands a lot of capital. And you have an expensive business to be in.

And when you get to the marketplace, Robert, you're often faced with heavy competition. So that's sort of the worst business you want to be in — the one where you've got to spend a ton of money, continually upgrading the business, re-creating it, reinventing it every few years. And then when you get to the marketplace you get cutthroat margins because there are a lot of people selling the same product. That's an awful business to be in.

In the businesses that we have, where you have that competitive advantage, you usually have pretty good profit margins. You have that repeatable revenue. People constantly need the product or the service. Doesn't require a lot of capital. So the end game is earnings. And more specifically, free cash flow. Capital generated by the business that never has to be returned to the business. So it can be taken and used for the shareholders' benefit in any number of different ways.

And the last thing is management. Management is absolutely critical. I'm always amazed that people in my business don't spend more time on that aspect because, going back to the business owner mindset, if they were to take on a partner in their business, the most critical question that they would be thinking about is whether this guy is a good guy. Or does he have a flawed personality? Is he a sociopath?

Baillieul: An empire-builder.

Sarbit: Well, is he a crook? Let's just get down to the basics. Is he going to fleece me? And that's just so important. I've been through those sort of experiences where the people were, shall we say, less than desirable.

But you know you read Buffett's letters to the shareholders and when he talks about a company, he talks about the *people*. You don't see him talking about the business. He talks about how terrific the people are. That is a very important asset that he has acquired in the people who have built the business and will continue to run it for him. And who are going to do it in an ethical, honest, and decent way.

So we spend that kind of time in asking those questions and looking for those kinds of answers.

Coming up next
In part 2 of this series, Larry explains the benefit of holding cash and his outlook for the broader stock market.

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Disclosure: Robert Baillieul has no positions in any of the stocks mentioned in this article. The Motley Fool owns shares of Berkshire Hathaway and Coca-Cola.

CATEGORY

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Date
2025/07/06
Date Created
2013/10/30
Author
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