Value Investor Larry Sarbit on the Rise of Shareholder Activists

Description

Larry Sarbit is a money manager for the **IA Clarington Sarbit U.S. Equity Fund**. He's also an advocate of a commonsense, business-like approach to investing (which is quite Foolish!).

In part 3 of my interview with Sarbit, we discuss the rise of shareholder activism in Canada and where he sees new investment opportunities emerging. (Here's Sarbit on what he thinks of holding cash and the market's valuation right now; here he is on Buffett and **BlackBerry**.) Below is the transcript of our conversation; it has been lightly edited for clarity.

Robert Baillieul: One thing I wanted to touch on was your new Sarbit Activists Opportunities Fund. In most of our discussion so far you've talked about buying wonderful businesses. But in this fund, you're looking for companies that have a problem.

Larry Sarbit: Exactly. Here we're going back to the Ben Graham days. And Ben Graham was often looking at those cigar-butt-type of companies that we alluded to before. And we've avoided those kinds of companies in our discipline in our U.S. Equity Fund. But with this fund, what we're seeing is a way to make money at last from companies that are trading at cheap prices but where the value is locked inside the company because of things being wrong. Management [is] being deficient. The shareholders' rights and considerations are at the bottom of the list.

We have found what we believe is a way to make money because that value is not going to stay locked up inside that business forever. Without an activist, I probably wouldn't touch any of these companies. I probably wouldn't buy any of them.

So we end up with two mutually exclusive funds in terms of the holdings — in the sense that one looks nothing like the other. There's no crossover between what I'm doing with this very strict, business investment philosophy and this fund where we're saying here's a very cheap business or a very cheap stock, a mismanaged company where the activists are all value investors. Every one of them is a bargain hunter. That's who they are that's how they think.

Baillieul: Can you give an example of the type of companies that you're looking for?

Sarbit: What we're looking for is a company that on a very broad basis where they're fundamentally cheap, where they may be sitting on a lot of cash, but where the company has not been utilizing the assets of the company the company to the shareholders benefit. So this shows through the stock going nowhere for years, or assets being misallocated or just plain being stupidly used. And that's a business wouldn't touch. But enter the activist. I see the value. And I see the problem. And I also see the solution.

When they get involved in the company it's not just identifying the value and buying into it. It's doing that, certainly. But it's also saying that we have a way of deriving the value out of the business. We have a plan. We have a battle campaign outlining how this is going to go. They've studied everything. These guys have studied not just the structure of the company, they know who the players are inside the company. The members of the board of directors. The executives of the company. They've studied this. They've undoubtedly talked to other competitors in the business. So they really do a deep amount of homework on this.

They generally put a large chunk of their assets into a few of these holdings and expect to get big returns. Because big returns are what their investors are interested in. They're not interested in 5% to 10% returns. These guys are investing in private equity firms or hedge funds, they're looking for big returns in order to justify the fees that are charged on the profits that are produced. They've done a lot of works and they've narrowed it down to a few names where they have said, "Yes, we can get this done."

Of course I'm going inside the heads of these guys. But I'm sure this is pretty close to how they think. And we've talked to a number of them already. And we're getting to know they play. We're getting to know the activists. You know the really great players that have a track record. And there are new ones popping up all over the place. And there will be more capital going into this area.

But there are some guys that know how to play this game and play it very, very well. And they do it as cheaply as they possibly can. Because this can get very expensive and very time-consuming. So if you're planning to push onto the board or try to get a board seat or fight a proxy battle, well, that gets to be a very expensive process. And so you spend all that money, which they don't necessarily want to do. Most of them aren't looking for a fight. They're looking to get this done in as friendly a fashion as possible. And in many instances, after getting the shock of seeing activists involved, [management] will go along. They don't want a battle. They do want to do the right thing in many instances.

And in some instances their behaviour is just reprehensible. So it depends. Each case is on its own. I think the outcomes favour the activists in general. Not every case. But they've planned this out remember. The activists have planned this out and the activists know they're not going to win every battle. But their objective is to win the war. If things get really nasty.

Baillieul: Some investors and other stakeholders might see Carl Icahn coming in at Talisman (TSX:TLM, NYSE:TLM) or Bill Ackman coming in at Canadian Pacific Rail (TSX:CP, NYSE:CP). I think a lot of people are wondering if these guys are working in the long-term interests of the company or just looking to making a quick buck.

Sarbit: Sure, and again it's on a case-by-case basis. You can't draw generalizations about activists. There are activists out there who want to become shareholders, they want to get on the board, they want the company to improve. The company wants to own divisions that it shouldn't own that don't fit. They might be sitting on cash that they're not deploying in a shareholder-efficient fashion.

And then there are guys that are looking for a fight. They're combative. I won't avoid combative situations. But you prefer to be in a situation where improvements are more likely to happen and get done without all of this fighting and battle that can occur in some of these situations. Because it takes longer. Because it becomes very expensive. And because there's less certainly about the final outcome.

Baillieul: You attract more flies with honey than you do with vinegar is the old cliche.

Sarbit: Well, some of these guys go in and make a presentation about what we think should be done and if the company wants to take ownership of our plan and implement and take all of the glory, nothing would make us happier. We're not here for the glory. We're here for the returns. They don't care about getting their names up in lights. They want to come in and do this in as friendly of a fashion as possible. And other guys are willing to put the boxing gloves on. Or the brass knuckles. Whichever fight you want to give.

So each case has its own story. Each activists play is going to look different. Each has its own story and we're just trying to pick the ones where we think the activists are very good at what they do.

I own 10 stocks in my U.S. Equity Fund and here we got 16. I'm more invested with this one with 70% invested. And there are more ideas. I guess the lesson is that there are a lot more ideas…there are a lot more poorly managed undervalued stocks out there than terrific companies trading at cheap prices. And that's why there's a difference between the two funds. They are looking for different things. But the one thing that is constant throughout everything that I do is value. We're looking for bargains. And if we can't see it, then there is no point. I won't buy any business that's not cheap in any fund that I manage. But how we get a return is quite different.

Baillieul: Thanks for taking the time to speak with me today, Larry. Just as we wrap it up, is there anything you would you like to tell our readers?

Sarbit: Well, my advice is to have patience. If you're patient you can get extraordinary investments. And if you're not willing to practice that patience than you're going to have to find somebody that can and who's willing to do that.

And try to take the emotion out of the investment process. Don't think with your heart. Don't think with your gut. Think with your brain. Your brain, your numbers, the criteria, and being a real business owner have a way better chance of attaining success.

And watch which way the current is going. In our business you can see it going. When you see everyone going one direction in a very meaningful way where everybody was panic-buying, you should sit back and ask whether that is rational. There are times when the extremes are so great that it really become very obvious what can happen.

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

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