MARTIN J. WHITMAN
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THE AGGRESSIVE CONSERVATIVE INVESTOR

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Table of Contents

Chapter 16 - Losses and Loss Companies

QUALITY CONSIDERATIONS AND TAX-LOSS COMPANIES
ON ACCOUNTING AND INCOME
BE WARY OF ACQUIRING EQUITY SECURITIES OF THE ENCUMBERED FIRM
COMMERCIAL BANKS’ PORTFOLIO LOSSES
THE “TURNED THE CORNER” THEORY

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To Lois, Jim, Barbara and Tom Whitman, and to Julie and Claire Shubik

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Two people worked especially diligently in bringing this book to fruition—Albert Erskine, our editor, and Marilyn Hainesworth, administrative vice-president of M. J. Whitman and Co. Inc., who oversaw the many housekeeping chores involved in preparing the manuscript.

Errors and shortcomings, of course, belong to us alone.

The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those who have been brought up, as most of us have been, into every corner of our minds.

J. M. KEYNES

FOREWORD

I first met Marty Whitman and Martin Shubik while we were students at Princeton Graduate School. We played poker together on a regular basis, often well into the night. I doubt if any real money ever changed hands, probably because we had none to wager, but when we reminisce about that time we each remember being the big winner. While we may have been gamblers at the time, Marty and Martin have taken few gambles since, either with their own money or with the money entrusted to them by investors. I didn't recognize it then, but they were starting to exhibit the tendencies that would make them successful investors. They knew when to take the calculated risk, when the payoff merited exposure, when to cut their losses, and when to raise the ante. I guess it proves the old adage "If a dog is going to bite, he's going to do it as a pup."

Obviously I have known the authors for a long time, Marty Whitman in particular. I know he is smart, honest, and successful, three characteristics I admire not only in business associates but also in friends. That he is successful should come as no surprise and would be a given for anyone who proposes to write a book on investing. After all, who would buy a book from someone with a history of breaking even? But Marty has taken success to levels most portfolio managers are hard-pressed to imagine. For example, since 1984 he has been the principal at Equities Strategies Fund and Third Avenue Value Fund, while Martin served the same two firms as an independent director. During that time, directed by the investment strategies outlined in this book, these funds on average vastly outperformed any relevant market index on a long-term basis, and for a majority of the time.

I can also speak from personal experience. Marty has served on the boards of both public companies of which I have been chief executive officer and today is the lead director on the Nabors Industries board. He is a man of extraordinary wisdom and insight, and I can honestly say I never make a major move without his input. He is the king of due diligence, spending an enormous amount of time collecting and analyzing information before pulling the trigger on any transaction. I have heard it said that he has been extremely fortunate in some of his investment decisions, but I have observed that the harder he works the luckier he gets.

His counsel has served me well on many occasions and in a broad range of situations. For instance, he advised me on a passive investment in a Japanese company called Tokio Marine, which netted the first serious money I ever made. I subsequently sought his counsel on my very first acquisition. I had let my ego usurp my good sense, agreeing to personally guarantee a note we had issued to the seller. Marty told me to get out of the guarantee or get out of the deal, and that if I didn’t take his advice I should never ask for it again. I did, and I still look back on that as representative of the kind of nononsense, pragmatic perspective that has characterized his investment history.

More recently Marty’s financial acumen and market savvy were invaluable in the issuance of a $700 million convertible debenture with zero coupon and zero accrued interest. He recommended that Nabors take advantage of this low-cost capital even though we didn’t need the money at the time. We followed his advice, and it gave us much greater financial flexibility.

So what makes this book unique? It certainly goes against conventional wisdom. For instance, the philosophy of safe and cheap investing ignores price fluctuations for securities and other market risks, guarding only against investment risk, something going wrong with the company, or with the interpretation of securities covenants. Likewise, relying on the “Nifty Fifty” or the top 100 common stocks of large, well-organized companies as the only source of high-quality investments has been abandoned. Discarded also is the notion that a concept of general risk is useful for analysis. Macro data, such as predictions about general stock market averages, interest rates, GDP, and consumer spending, have been abandoned as irrelevant as long as such investments are undertaken in countries marked by political stability and an absence of violence in the streets.

But this book is not about what the authors don’t believe. The nuggets in this book are what they do believe, like the principle of “good enough,” which encourages investors to content themselves when a good return has been realized, even if it is not perfect. Adhering to a long-term philosophy is also bedrock investment advice, which the authors personally subscribe to and encourage, regardless of the age of the investor. Another key principle involves taking advantage of the era of expanded corporate disclosure, closely scrutinizing a company’s public communications to direct or influence investment decisions. Of course, the principle of buying stocks that are safe and cheap is at the heart of this book and is a philosophy every serious investor should embrace.

Who should read this book? The obvious answer would be anyone looking to develop a sound investment strategy, or anyone striving to incorporate into a portfolio some useful ideas that bring value long-term. However, it is equally valuable for anyone who runs a business, or aspires to run one. Many of the principles that direct the Nabors operating philosophy, and that are responsible for the success we have achieved in spite of the cyclical nature of our markets, are direct parallels to personal strategies espoused by the authors. There are many examples. Like the authors, we downplay the macro, refusing to overly concern ourselves with the price of commodities. When prices are up the company has impressive earnings, but when they are down we use our liquidity to make acquisitions, or grow organically if conditions are favorable. We also understand that access to capital is critical for companies in a growth mode, following the authors' recommendation to gain that access before we need it. Simply stated, the time to borrow is different from the time to spend.

The Aggressive Conservative Investor is a must-read for any investor looking to develop a sound, long-term growth strategy and should be a fixture in every business library. The authors have the ability to take complex financial concepts and articulate them in terms that virtually anyone can understand. They describe this as the bridge between Wall Street and Main Street. I think you will find it a bridge worth crossing.

Eugene M. Isenberg
Chairman of the Board
Nabors Industries
July 2005

INTRODUCTION

Dramatic changes have occurred since *The Aggressive Conservative Investor* was published in 1979. The basic thesis of the book—emphasizing financial integrity—remains at least as valid today as it was then, and because of subsequent developments, may be even more valid now. Moreover, changes since 1979 in the disclosure area, it seems to us, have made it easier for a diligent person to become a successful aggressive conservative investor than was possible in the late 1970s.

The Aggressive Conservative Investor includes six major areas that warrant review today:

- Changes in terminology
- Performance data
- The disclosure explosion
- Our changed, or modified, beliefs
- The changed environment
- Troublesome regulatory problems

CHANGES IN TERMINOLOGY

When we initially wrote *The Aggressive Conservative Investor,* we named our strategy "the financial-integrity approach." We now like to think of it as "the safe and cheap approach" (which sounds less pompous and is more direct).

For a common stock to be an attractive investment, *The Aggressive Conservative Investor* outlined four essential characteristics:

- The company ought to have a strong financial position that is measured not so much by the presence of assets as by the absence of significant encumbrances, whether a part of a balance sheet, disclosed in financial statement footnotes, or an element that is not disclosed at all in any part of financial statements.
- The company ought to be run by reasonably honest management and control groups, especially in terms of how cognizant the insiders are of the interests of outside security holders.
- There ought to be available to the investor a reasonable amount of relevant information that is akin to full disclosure, though this will always be something that falls somewhat short of the mark.
- The price at which the equity security can be bought ought to be below the investor's reasonable estimate of net asset value.

These four characteristics describe common stock investment under both a financial-integrity approach and a safe and cheap approach. Especially since there have been quantum improvements in the quantity and quality of information available, these four concepts hold as firm today as in 1979.

The other terminology change is the use of the acronym OPMI (outside passive minority investor) to describe outside investors and passivists as well as non-control and unaffiliated security holders. OPMIs run the gamut from day traders to most institutional investors to safe and cheap investors who do not seek elements of control over the companies in which they hold securities positions. The reason for using the term *OPMI* rather than *investor* is that the word *investor* is one of the most misused and misunderstood words on Wall Street. Most of the time it seems as if those using the term *Investor* really mean short-run speculator—either individual or institutional—so we've mostly discontinued use of the word *investor* in favor of *OPMI.*

PERFORMANCE DATA

Since 1984, the authors have been either the principal, or an independent director or trustee of two mutual funds—Equities Strategies Fund and Third Avenue Value Fund—whose modus operandi has been to follow the safe and cheap approach in investing in securities.

How have the two funds fared from 1984 through mid-2005? They have vastly outperformed any relevant market index on a long-term basis, on average, and for a majority of the time. Efficient market theorists will carp that the funds have not outperformed relevant indexes consistently. *Consistently* is really a dirty word meaning all the time. In investing, *consistently* should have relevance only for day traders, not long-term buy-and-hold investors.

A comparison of the Equity Strategies Fund's performance with that of the Standard & Poor's 500 Index is contained in Table I.1. We took over management of Equity Strategies in April 1984. Prior to that, the fund was invested in options. In 1994, Equities Strategies Fund was merged into Nabors Industries on a basis where each one share of Equity Strategies received 5.84 shares of Nabors Industries common. An investor investing $10,000 in Equity Strategies in April 1984 would own Nabors common stock with a market value of over $286,000, in April 2005. This equals a compound annual return for the 21 years of 17.2%.

Before the Nabors merger, Equity Strategies was a unique mutual fund in that it always was fully taxed as a subchapter C corporation, and never qualified, like all other mutual funds, as a subchapter M corporation. M corporations do not pay federal income tax as long as they distribute all their income and net capital gains to shareholders. Despite being required to accrue a liability for deferred capital gains taxes on unrealized appreciation, a $10,000 investment in Equity Strategies had a market value of $38,643 as of April 30, 1994. A comparable $10,000 investment in the S&P 500 Index had a market value of $23,163 as of April 30, 1994. If Equity Strategies had reported its net asset value the same way M corporations reported theirs, the Equity Strategies market value would have been approximately $52,000 in April 1994 after adding back to net asset value the liability for deferred capital gains taxes on unrealized appreciation. At that point in 1994, the compound annual returns on the Equity Strategies investment was approximately 16.2% before deducting the reserves for capital gains taxes on unrealized appreciation.

Third Avenue Value Fund came into existence on November 1, 1990. Since then its performance has tracked that of Equity Strategies with a compound annual return since inception of 16.8%. The annual performance of Third Avenue Value Fund compared with the S&P 500 Index is shown in Table I.2.

TABLE I.1 EQUITY STRATEGIES FUND V. S&P 500

		Equity Strategies Fund			S&P 500 Index		
		Return	*Investment*	*Value of Investment*	*Return*	*Investment*	*Value of Investment*
1 YEAR	4/30/84		$10,000.00	$10,000.00		$10,000.00	$10,000.00
1 YEAR	4/30/85	5.08%	$10,000.00	$10,508.00	−0.094%	$10,000.00	$9,990.60
1 YEAR	4/30/86	24.69%	$10,000.00	$13,102.43	−1.126%	$10,000.00	$9,878.11
1 YEAR	4/30/87	18.87%	$10,000.00	$15,574.85	22.435%	$10,000.00	$12,094.26
1 YEAR	4/30/88	3.02%	$10,000.00	$16,045.21	-8.439%	$10,000.00	$11,073.62
1 YEAR	4/30/89	17.28%	$10,000.00	$18,817.83	22.689%	$10,000.00	$13,586.12
1 YEAR	4/30/90	29.64%	$10,000.00	$24,395.43	10.658%	$10,000.00	$15,034.13
1 YEAR	4/30/91	21.12%	$10,000.00	$29,547.74	17.541%	$10,000.00	$17,671.26
1 YEAR	4/30/92	−2.61%	$10,000.00	$28,776.55	13.980%	$10,000.00	$20,141.71
1 YEAR	4/30/93	41.25%	$10,000.00	$40,646.87	9.193%	$10,000.00	$21,993.33
1 YEAR*	4/05/94	−4.93%	$10,000.00	$38,642.98	5.320%	$10,000.00	$23,163.38

*S&P 500 Index is as of April 30, 1994.

Besides Equity Strategies and Third Avenue Value Fund, other investment vehicles following a safe and cheap approach also have outperformed relevant indexes. Three of these funds are sister funds to Third Avenue Value: Third Avenue Small Cap, Third Avenue Real Estate, and Third

Avenue International Value. Professor Louis Lowenstein of Columbia University Law School in an October 11, 2004, article in *Barron's,* reviewed the performance of 10 wellregarded value funds from 1999 through 2003. All 10 outperformed the S&P 500 for the period. The other funds compared were FPA Capital, First Eagle Global, Legg Mason Value, Longleaf Partners, Mutual Beacon, Oak Value, Oakmark Select, Source Capital, and Tweedy Brown American. In short, very good performance results have been obtained a majority of the time by those funds that have followed a safe and cheap approach or a reasonable facsimile thereof.

Consequently, during the last 26 years, the efficient market hypothesis (EMH) and efficient portfolio theory (EPT) have been increasingly discredited insofar as EMH and EPT purport to describe a generalized stock market behavior. EMH and EPT just do not describe value investing—never have, never will. Rather, EMH and EPT describe a very narrow special case. EMH and EPT describe financial markets populated solely by day traders vitally affected by immediate price movements in securities. These market participants are strictly top-down speculators devoid of virtually any bottom-up knowledge about a company or the securities it issues. This just isn't most markets and it probably isn't most investors. Not only do EMH and EPT fail to describe the safe and cheap investor, the theories also are utterly devoid of any realistic explanations about the operations and techniques of control investors, a group that heavily influences the dynamics of most financial markets.

TABLE I.2 THIRD AVENUE VALUE FUND V. S&P 500

	Third Avenue Value Fund			S&P 500		
	Return	Investment	Value of Investment	Return	Investment	Value of Investment
					$10,000.00	$10,000.00
1990	8.60%	$10,000.00	$10,860.00	9.43%	$10,000.00	$10,943.00
1991	34.41%	$10,000.00	$14,596.93	30.46%	$10,000.00	$14,276.24
1992	21.29%	$10,000.00	$17,704.61	7.62%	$10,000.00	$15,364.09
1993	23.66%	$10,000.00	$21,893.52	10.08%	$10,000.00	$16,912.79
1994	−1.46%	$10,000.00	$21,573.88	1.32%	$10,000.00	$17,136.04
1995	31.73%	$10,000.00	$28,419.27	37.58%	$10,000.00	$23,575.76
1996	21.92%	$10,000.00	$34,648.77	22.96%	$10,000.00	$28,988.75
1997	23.87%	$10,000.00	$42,919.43	33.36%	$10,000.00	$38,659.40
1998	3.92%	$10,000.00	$44,601.88	28.58%	$10,000.00	$49,708.26
1999	12.82%	$10,000.00	$50,319.84	21.04%	$10,000.00	$60,166.87
2000	20.76%	$10,000.00	$60,766.23	−9.11%	$10,000.00	$54,685.67
2001	2.82%	$10,000.00	$62,479.84	−11.88%	$10,000.00	$48,189.01
2002	−15.19%	$10,000.00	$52,989.15	−22.10%	$10,000.00	$37,539.24
2003	37.08%	$10,000.00	$72,637.53	28.69%	$10,000.00	$48,309.25
2004	26.60%	$10,000.00	$91,959.12	10.88%	$10,000.00	$53,565.30

THE DISCLOSURE EXPLOSION

The improvements in the disclosure scene since 1979 have been dramatic and far-reaching. This has happened in two areas—substantive disclosures and improved delivery systems. As a consequence, there is a vast improvement in the amount and quality of disclosures, especially documentary disclosures, available to those using the safe and cheap approach. *The Aggressive Conservative Investor* seems to have understated the degree of knowledge one can obtain about a company and the securities it issues by relying solely on the public record. The book, however accurate for the disclosure environment in 1979, inadequately describes the quantity and quality of disclosures available in 2005.

The role of disclosure ought to be to provide outside investors the same level of disclosure that is provided to an investor with clout (e.g., commercial bank lenders) who are able to undertake due diligence. The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) seem to have done a pretty good job from the point of view of the safe and cheap investor.

For the vast majority of issuers—excluding Enron and Worldcom—disclosure documents seem to be prepared on the basis that companies, their officers, and their directors do not want to be sued, and especially not sued successfully. Thus, there is a tendency in public documents to disclose all admissions against interest, however remote. Such laundry lists give safe and cheap investors an unweighted for probabilities inventory of what could conceivably go wrong. Almost the first question any safe and cheap investor asks is what could go wrong. Having a carefully prepared list of risk factors helps answer that question. This laundry list of risk factors is contained for U.S. issuers in Form 10-K, Form 10-Q, Form 8-K, prospectuses for the cash sale of securities, merger proxy statements, exchange of securities documents, and cash tender offers. They are also contained in the footnotes to financial statements that comply with GAAP.

Chief executive officer letters and other communications to stockholders seem to have become more comprehensive, more complete, and, in many ways, more honest in terms of what management thinks about long-term promises and problems. Admittedly, most management communications do seem to focus on the immediate earnings outlook, something not of much interest to the safe and cheap investor. Nonetheless, communication seems to have vastly improved since 1979. Top management communications are contained in annual reports to stockholders, quarterly reports to stockholders, teleconferences, investor conferences, and one-on-one meetings.

Principal new disclosures since 1979 that have been a boon to safe and cheap investors both as put forward by the SEC and FASB include the following:

- Integrated disclosure between the Securities Act of 1933 and the Securities and Exchange Act of 1934.
- Disclosure of earnings forecasts under rules that provide forecasters a safe harbor from liabilities for forecasts, which while honestly made, turn out to be wrong.
- Expanded proxy statement disclosures that include (1) existence and functions of various committees; (2) attendance record of directors and committee members; (3) expanded transactions detailing relationships between the company and its insiders; (4) resignations of directors and top officers.
- Environmental disclosures.
- Reserve recognition accounting (RRA) for exploration and production oil and gas issuers.
- Management discussion and analysis of financial condition and results of operations (MDA) implemented and eventually expanded. This is a quarterly filing.

- Expedited use of Form 20-F for foreign issuers (equivalent of a Form 10-K for a U.S. domiciled issuer).
- Summary sections in prospectuses and merger proxy statements.
- Shelf registrations.
- Disclosure of rating agency ratings.
- New real estate guidelines.
- Edgar and other electronic communications—a virtual revolution in delivery systems mightily benefiting safe and cheap investors. In 1979, obtaining documents filed with the SEC but not mailed to securities holders (Forms 10-K, 10-Q, 8-K) tended to be cumbersome or relatively expensive.
- Electric and gas utility guide.
- Financial reporting requirements for banks and bank holding companies.
- Consolidating financial statements distinguishing between guarantor subsidiaries and nonguarantor subsidiaries.
- Increased disclosure of management backgrounds.
- Sales and income by industries sector disclosures.
- Sales and income by geography disclosures.
- Basis for accounting estimates disclosures.
- Cash flow reporting.
- Expanded Form 8-K reporting.
- Reporting comprehensive income.
- Disclosure of information about capital structure.
- Accounting for income taxes.
- Accounting for leases.

Increasingly there has been disclosure of non-GAAP financial measures regulated by the SEC under Regulation G. Non-GAAP financial measures include periodic cash flow data and various appraisal values. Hopefully, disclosures of non-GAAP financial measures, used as a supplement to GAAP, rather than as a substitute for GAAP, will continue to