



Michael D. Axel, CFA



Jacob D. Benedict, CFA



David J. Manger, CFA

Let's Fly North?

Jacob and David headed out to New York for a week to meet with managers and attend the one-day Columbia Student Investment Management Association (CSIMA) Conference. Our best idea from the trip: quit travelling northeast during the winter! Weather once again nearly wreaked havoc on us (last year we almost got stuck in a blizzard), but fortunately only one of our meetings was cancelled.

Prior to the Friday conference, we met with two hedge funds and four mutual funds; our planned meeting with a private equity firm in Greenwich, CT had to be cancelled due to weather. Several of the funds we visited we currently partner with and the meetings were intended to update our research files; the others offered a chance to meet with prospective partners and discuss investment ideas.

The CSIMA Conference is a well-known value investing conference that features an impressive roster of speakers each year. This year's group included Bruce Greenwald (professor at Columbia), Bill Ackman (hedge fund manager), Kyle Bass (hedge fund manager), Tom Gayner (CIO at Markel Insurance) and Joel Greenblatt (former hedge fund manager and writer). The conference also gave us the opportunity to network with other value investors and asset allocators, offering a rich vein of idea generation and debate.



Jacob and David with Bruce Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management at Columbia Business School and a prolific writer on business strategy and value investing.

Some takeaways from our trip:

- We continue to believe that alignment of interests is an integral part of any business relationship. We consider this both when we partner with external fund managers and when we buy individual investments. Not only do aligned interests encourage managers to do the right thing, they signal that managers are the kind of people that we want to work with. Great investment success is typically built on good decisions during stressful periods – managers that have aligned interests and a high quality investor base are the ones that have the courage and the support to make these tough, high value-add decisions. As Bill Ackman put it at the opening of the CSIMA Conference, “It really matters who your partners are.”
- We had a chance to visit with several short sellers. Shorting a stock entails betting that its price will decline as opposed to increase and is a tactic used by some hedge funds and a small number of mutual funds. One fund we visited ran several short-only funds. Some people view short sellers as villains and believe the practice is un-American. In our opinion, however, short selling is a vital cog in a well-functioning capital market system. It’s important to point out that not all “shorts” are the same. Shorting a stock and then spreading false rumors about the underlying company is both wrong and illegal. We also aren’t huge fans of “active shorts,” where short sellers press their case overly aggressively in public venues. But short sellers that seek out broken or fraudulent businesses, take a short position and inform the marketplace of their view can provide a lot of value to both the market and to individual investors. There are numerous examples of short sellers that stopped companies from defrauding future investors or customers or destroying even more economic value, effectively playing the role of the Securities and Exchange Commission (SEC). A recent academic paper actually concluded that the short sellers they researched “are information producers who help correct mispricing and thereby help make markets more efficient.”¹ We once heard an analyst remark that if investors were allowed to “short” Bernie Madoff, the fraud would have never progressed so far. Further, because few investors short stocks, it can present attractive investment opportunities (i.e. there are potentially more market inefficiencies on the short side than the long side). By allowing both long and short sales within financial markets, stocks should be priced more efficiently over time, which is good for investors. While we don’t currently have much exposure to shorting, and would not do it ourselves, we think it is worthwhile to visit with short sellers. Their opportunity to add value to investment portfolios is worth exploring and perhaps more importantly, we typically find the work of short sellers both diligent and informative. They are often skeptical by nature and challenge conventional thinking. We’d much rather sit down with someone shorting a company we are researching than someone buying it – it’s more useful to have someone try to convince us we are wrong than have someone tell us we are right.
- Our belief that our dual-pronged approach to building investment portfolios – picking individual stocks ourselves and working with a handful of aligned partners with the same approach – was again strengthened. We believe that in order to truly understand if a fund manager is talented, we need to be able to speak with him on his terms. Because we engage in our own stock research, we can dig into a manager’s individual positions. One of our favorite approaches is to pick some of the smaller positions in a manager’s portfolio and ask him to walk us through his thesis. We did this numerous times on our trip and found the responses highly informative. We’ve been able to find very few stock fund managers that we are willing to partner with, as most over-diversify, shirk on research and avoid deep thinking about potential risks.

You Don’t Always Have to Fly

We’ve recently been doing work on the aerospace supply market, which appears to have several interesting and attractive characteristics. To learn more about the industry, we visited Roy Williams at Airframe Components in Kendallville, Indiana. Started by Roy’s father Paul in 1967, Airframe rebuilds damaged small and mid-size airplane wings and control surfaces. They receive wings from every continent outside of Antarctica! Roy was able to validate certain parts of our initial analysis and point us towards areas for further research. He walked us through the dynamics of his business and his impressive warehouse of aerospace parts. This kind of “scuttlebutt” research provides an irreplaceable cog in our investment analysis.

¹ *How Constraining Are Limits to Arbitrage? Evidence from a Recent Financial Innovation*, Alexander Ljungqvist, Wenlan Qian.

How About South?

Unfortunately, Indianapolis doesn't count, especially when the temperature is below zero degrees. But Mike and Jacob headed down to the capitol anyway to spend a day trading ideas with a successful entrepreneur, a like-minded value investing firm and the chief investment officer of a large investment organization. We talked about a host of topics, including the importance of being a humble investor, building "robust" investment portfolios that can withstand a variety of economic environments, embracing simplicity when constructing portfolios and our efforts to focus on working with the right partners. We also had the chance, thanks to a good friend, to make a detour to the Butler vs. Xavier basketball game. Hinkle Fieldhouse is our kind of place! But who would have thought that the best collegiate basketball team in the state this year would be the Indiana State Sycamores? Viva la Larry Bird.



Roy explains to Mike and David Airframe Components' process for refurbishing damaged wings.

Flying West!

David and Jacob just booked their flights to the Berkshire Hathaway annual meeting in Omaha, NE the first weekend of May! Mike first made the trek in the early 90's when attendance was just one to two thousand. He actually got a front row seat. This year, "Woodstock for Capitalists" will likely attract over 40,000 attendees. The event has turned into a weekend-long spectacle. While the day-long question and answer session conducted by Warren Buffett and longtime partner Charlie Munger is usually transcribed on the internet for all to read, we are hoping to take advantage of the convergence of like-minded value investors and all of the ancillary events that occur over the weekend.

Berkshire Hathaway just released their annual report this past weekend and we are still working our way through it. We are looking forward to hopefully tough questions for Buffett and Munger, who will face inquiries from attendees, three financial news reporters, two stock analysts and an investor who is "short" Berkshire shares. We look forward to sharing our trip with you this summer. We've once again challenged David to get a photo with Warren.

We imagine you are as excited as we are for spring. We look forward to updating you on our coming research travels in a few months.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
David J. Manger, CFA

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