



**THE
MANUAL
OF
IDEAS**

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

Year VIII, Volume VI
June 2015

When asked how he became so successful, Buffett answered:
"We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.



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THE SUPER- INVESTOR ISSUE

- ▶ Screening the Top Holdings of 70+ Superinvestors
- ▶ MOI Signal Rank and Top Superinvestor Holdings
- ▶ 20 Companies Profiled by The Manual of Ideas Research Team
- ▶ Proprietary Selection of Top Three Candidates for Investment
- ▶ Exclusive Interview with Global Endowment Management
 - ▶ 10 Essential Screens for Value Investors

*Superinvestor holdings analyzed in this issue include
AerCap Holdings (AER), American Eagle Outfitters (AEO),
Ascent Media (ASCMA), Baxter International (BAX), Brink's Company (BCO),
Chesapeake Energy (CHK), Devon Energy (DVN), DISCO Systems (DISCA),
Envision Healthcare (EVH), Genzyme (ZNY), Google (GOOG), HCA
Intercontinental Hotels Group (IHG), Intel (INTC),
Qualcomm (QCOM)*

Inside:

*Exclusive Interview:
Mike Smith, Campbell Wilson
and James Ferguson,
Global Endowment Management*

*With compliments of
The Manual of Ideas*

- ▶ Tom Welton
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- ▶ PREMIUM: Mich

Interview with Global Endowment Management

We had the pleasure of interviewing the investment team of Global Endowment Management, based in Charlotte, North Carolina, this month.

The Manual of Ideas: Please tell us about the genesis of Global Endowment Management and the principles that have guided you since the firm's founding.

Mike Smith, Chief Investment Officer: Global Endowment was founded in early 2007 by Thruston Morton, the former CIO of Duke University's investment office. The original idea and what we continue to do today is to manage a fully-discretionary pool of long-term capital primarily from US endowments and foundations. Our ultimate goal is to generate at least a 5% real return so that our investors can continue to fund their operating expenses and grants in perpetuity (since US endowments and foundations typically spend around 5% of their endowment capital each year).

MOI: How do you typically partner with clients that have an existing in-house investment team?

Campbell Wilson, Head of Public Investment Team: The majority of our endowment and foundation investors outsource 100% of their capital to us, so most of our interactions are with their board members, investment committees, and/or operations staff. However, we have some family office and sovereign wealth fund investors who only invest a portion of their assets with us, and we often do have a dialogue with those groups' in-house teams: where we are finding interesting opportunities, potential co-investments, best practices, etc. (Operational reviews of managers are one topic that has come up recently, for example). Additionally, we've had some of those investors join us on research trips, such as our annual public investment team trip to the Berkshire Hathaway meeting in Omaha.

MOI: Please describe your underlying investment philosophy.

James Ferguson, Associate, Public Investment Team: Like most value investors, our investment team was introduced to investing through reading some combination of Graham, Buffett, Klarman, Schloss and Fisher. Buffett's quote, "Price is what you pay. Value is what you get," succinctly captures our investment thinking. We spend the majority of our time identifying and investing with value-oriented managers around the world. We're focused less on fulfilling a search in a particular country or region than we are on finding great investors with whom we can partner, wherever they happen to be located. In an ideal world, we'd find 20 Buffetts from the 1960s dispersed across the globe, and spend all of our time building relationships and investing with them. If we could identify and invest with such a group, the best thing we could do is get out of their way and let them compound. Easier said than done, but it's what we focus on constantly.

Campbell Wilson: We also focus on markets where truly mispriced securities are more likely to be found—where we're not as likely to find thousands of smart, hardworking, highly paid investors competing with us every day. One of our favorite quotes is from Julian Robertson, who said "With hedge fund investing, you get paid on your batting average irrespective of the 'league' in which you're playing. So go where the pitching is the worst." ([Graham and Doddsville](#), April 2012). We agree with that completely so we spend a lot of time trying to find great investors who focus on less efficient markets, and have small enough asset bases to take advantage of the inefficiencies that exist.

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—CAMPBELL WILSON, GLOBAL ENDOWMENT MANAGEMENT

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—MIKE SMITH, GLOBAL
ENDOWMENT MANAGEMENT

MOI: How does your investment philosophy shape your target asset allocation and manager selection criteria?

Campbell Wilson: “Invest bottoms up, worry top down” sums up our asset allocation vs manager selection philosophy. We believe manager selection is the key to sustainable outperformance, and our bottom up, value-oriented approach since inception has definitely explained most of our outperformance of relevant benchmarks. We deal with asset allocation concerns top down—at the overall pool level, addressing concentrations in particular factor exposures and portfolio risk through hedges and overlays. One of the nice things about having Mike focus on the portfolio from a top down perspective is that it allows our public and private investment teams to concentrate on finding great investments.

MOI: You seek to deliver a minimum 5% real return over the long term. How do you think about inflation and how are inflation considerations incorporated into your investment process?

Mike Smith: The history of most fiat currencies, and certainly the US dollar, is one of consistently eroding value over time. Consequently, we want to build a portfolio that preserves the purchasing power of our investors’ capital, regardless of the type of macro environment we encounter. We are thus biased towards investing in higher quality businesses that have the ability to increase price, somewhat independent of the overall inflation level. We’re not confident in our ability to predict a single macro variable like inflation. But by constructing a portfolio across asset classes and geographies, focusing on businesses that have pricing power; we’ll have a better chance of achieving our ultimate goal. We’re quite aware that there are no absolute certainties in investing, but we believe that this approach is not only the most prudent, it also increases the probability of success.

MOI: You seek to “capture illiquidity premia when they exceed the opportunity cost.” Could you provide an example of a situation in which you judged an illiquidity premium to exceed your hurdle.

Mike Smith: This is basically dense language for the opportunity cost question, i.e., does the return justify the illiquidity. Unlike most endowment investors, we don’t have a target allocation to private investments. Instead, we think about overall equity risk and, at any given time, in what forms are we being best compensated to accept it. Our private investment commitments ebb and flow based on expected return premiums relative to public investment opportunities. That being said, there are specific situations where the private market tends to be more appropriate than public markets. An example would be turnaround situations requiring significant operational change where reported numbers can get significantly worse before they get better.

MOI: What is the typical process you go through with an investment manager prior to entrusting the manager with your capital?

James Ferguson: In an ideal world, we would be able to spend several years building a relationship with a prospective manager, to underwrite both their process and their temperament. In our humble opinion, the former is much easier than the latter. We would like to see an investor work through a variety of market environments, and in particular how they react to adversity. If you look at challenging market environments throughout history, going back to the early 1920s, it’s amazing how many “great” investors did not have the emotional fortitude to withstand severe market drawdowns.

While we have spent years getting to know some of our managers before investing with them, it is often impractical to do so. Consequently, our ability to speak with

people who have known the individual for a long time and have seen them in a variety of situations is a key part of our process. Besides personal vetting, we spend a significant amount of time going through individual portfolio companies to understand how the manager developed their thesis and identified areas of concern. The more in-depth the discussion we can have around the manager's thinking about a company's competitive dynamics, industry characteristics, and overall moat, the easier it is to underwrite the substance and sustainability of his or her process.

The second step of our approach is that we think it's important for a prospective manager to know how we will behave in challenging environments. Given the inherent fragility of an investment partnership, a manager's confidence in their investor base could help reinforce their ability to withstand a significant drawdown. We encourage prospective managers to speak with our current managers in order to get a sense of how we respond. It's a common bromide in our business to say you're a long term investor. Reality is that career risk and human psychology often intervene in the short term to derail that long term focus. We think we are good long term partners, and that we do what we say we're going to do. We want prospective managers to get a sense of that. Time and talking with others can go a long way in building that trust. Once we have conviction in a manager as an investor, we then conduct a thorough operational review in order to get comfortable with the controls and protections that are in place.

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MOI: What characteristics make an emerging investment manager appealing to you as a long-term partner?

Campbell Wilson: What we're ultimately looking for is a skilled investment analyst with the discipline and temperament to succeed in different environments. Importantly, they must be able to transition from analyst to portfolio manager—we have seen many who cannot. Creativity, persistence and humility are key traits—people who are confident in their abilities but clear-headed and forthright about their weaknesses. Seth Klarman described it well when he said "You need to balance arrogance and humility". And maybe more than anything else, we're looking for fanatics who are extremely passionate about the pursuit of investing. Given the monetary benefits of working in the financial industry, it is often difficult to discern "passion for investing" from "passion for making money", but understanding a manager's motivation is a key requirement for us.

MOI: What are some common mistakes managers make early on that make it more difficult for you to partner with them down the road?

Campbell Wilson: At a high level we often see young managers compromise their investment ideals or approach in order to raise assets. They might, for example, agree to hold more positions than they would prefer. At the end of the day, we want our managers to manage our funds like it was their own money and they didn't have a client base to worry about. Decisions made for the sake of the business or client base are often detrimental to long term returns in our opinion, and it's very difficult for small, young managers to say no to someone who wants to give them money. Our advice is to give yourself as long of a runway as possible to stick to your guns.

More specifically, there can be structural elements that make it difficult for us to invest. The first is a fund with co-portfolio managers. This isn't an absolute 'no' for us but for managers with multiple senior team members we prefer when there's a clear driver and a clear passenger vs. a 50/50 partnership. Investing is a personal endeavour with decisions based on imperfect information – two smart people trained by the same person and armed with the same set of facts will frequently come to

different conclusions. We're all wired differently, and the best investors tailor their portfolio to match their own psychology – but that also makes it important to have one person ultimately responsible for pulling the trigger.

A second structural impediment is a particularly challenging seed investment arrangement. We're not opposed to firms that have seeds —we have made a few select seed investments ourselves. However, we've seen funds where the benefits brought by the seeder are de minimis and the costs are high. A particularly challenging form of seed is one where the seeder is in business to benefit from the seed itself, rather than as an investor in the fund. It's tough for us to invest in partnerships with seeds from big asset managers or financial institutions simply because the incentive to grow can overwhelm the incentive to create a great track record. Given our focus on investing in less competitive markets, it's important that our managers stay small enough to retain their ability to invest in less efficient situations.

The third categorical mistake is a partnership that is not selective on the types of investors that they allow into the fund. This may sound a bit arrogant but it's really important that there are similarly-minded investors in a partnership, as any sort of hot money can be a detriment to the entire partnership. We've seen it happen that a manager loses money and, while our conviction in the manager hasn't changed, enough other investors submit for redemption and then the entire fund goes into wind-down.

Another behavior that typically turns into a mistake is a fund hiring a big team early on. While this is inevitably sold as a reflection of seriousness and commitment, it forces the fund to raise more assets to support the operating costs of the team, fancy office space, etc. We would rather invest with a manager that runs a lean start-up in order to focus on investing, and then slowly raises money (a) over time and (b) appropriate for the strategy.

MOI: What are some of the ways in which you have sought to improve alignment of incentives between your firm and the investment managers to whom you entrust capital?

James Ferguson: The first piece of alignment is ensuring that managers have most of their own net worth invested in their strategy alongside us (hopefully closer to 100% than 50%). While that's a good starting point, it's not enough to ensure alignment in our opinion. For example even if a manager has 100% of their net worth in the fund, if the fund is large and the fees are high enough they likely will profit more from raising additional assets than from staying small and focusing on returns.

For terms broadly, our ultimate goal is to create a structure that incentivizes and rewards long term behavior for both the manager and investor. There are a variety of different ways to do this, and certainly no one size fits all, but terms that reward the manager for outstanding performance and discourage short term investment thinking are two key goals. For example, funds with too much liquidity for their strategy (e.g., monthly liquidity when investing in small companies) often cause the manager to spend too much time managing their business rather than investing. (On the other hand, poor alignment can also be found at the other end of the spectrum: some funds have excessively long lock-ups just because “they can”, even when the strategy does not warrant it. The key is that terms are appropriate and fair for the strategy employed.)

On fees specifically, we believe the management fee should be used to keep the proverbial lights on and that performance fees paid for exceptional long term returns

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ENDOWMENT MANAGEMENT

should be the primary wealth creator for the manager. As a result, we like to see management fees scale down once the manager is covering the basic overhead associated with operating a fund. For performance fees, we think these should reward truly outstanding performance rather than serve as a call option on markets. Consequently, we prefer performance fees that are paid on a multi-year basis, often over some sort of hurdle. While tying performance fees to multi-year periods is not a widely used practice in our industry, we think it's imminently reasonable – for example, most investors would readily admit that one year is not a meaningful length of time to measure performance, and yet most performance fees are based on annual returns. Rolling three year performance, for example, is how Warren Buffett compensates Todd Combs and Ted Weschler. Stepping back, there isn't a perfect set of terms, but there are a variety of levers that can be used to achieve good alignment.

Just as managers often comb proxy statements of listed companies looking for corporate managers that are well aligned with shareholders, we seek investment partnership terms that work for everyone.

MOI: What advice would you give to a recent graduate whose goal it is to set up and manage an investment fund?

James Ferguson: This contradicts Buffett's advice but we think it is possible to start a fund too early. One of the key challenges is finding the right time to launch a fund, considering a multitude of factors, including experience, capital, the fundraising environment, and others. However, if a young investor launches a fund prior to getting their experiential and structural ducks in a row, it can be difficult to raise money and create a viable business and client base. Our advice would be to find the best investor you can and find a way to work for him or her, regardless of the pay or any other factor. If you can learn from a truly world class investor, you will have a bright future.

Campbell Wilson: And when you do launch your own fund, let us know! We're always looking to speak with interesting investors we don't already know. Feel free to email us at managers@globalendowment.com or you can find more information at www.globalendowment.com

MOI: Would you discuss your policy on direct investments? To what extent do you employ direct investing and how does it add value to the overall portfolio? (Perhaps you could provide a related case study.)

Campbell Wilson: While partnering with other managers will always take up the majority of our time and capital, direct investing is an additional and important tool in our kit. Today over a quarter of our public equity portfolio is invested in individual companies and we're active direct investors in other areas of the portfolio as well (private equity, real estate, etc.). The key to our approach is that we try to invest directly in a way that is complementary to our manager investing activities. We do a few different things along those lines, including co-investments where we might buy something directly with input and support from our managers, as well as investments in certain types of securities that we think fit within our circle of competence to analyze ourselves. Examples of the latter include businesses such as asset managers and listed investment vehicles, which include different types of investment funds that trade publicly.

One investment that will win us no points for creativity, but I think is a great example of our direct strategy, is Berkshire Hathaway. To us the company is essentially one big investment vehicle that happens to trade publicly on an exchange, so in that regard it's "analyzable", since picking investment vehicles is what we do. In August of 2011,

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we noticed that the valuation of the company was right around its lowest levels of the modern era, despite the fact that the company itself was firing on all cylinders. We think about the company's valuation a couple of different ways, but for simplicity's sake, start with price/book. At the time we bought it, it was trading at only a slight premium to stated book value, and Buffett himself has long said that book value is meaningfully understated due to how they account for certain assets (for example, GEICO's book value is held at cost, even though it was fully purchased in 1995 and has grown significantly since). Since 1990, Berkshire had traded at an average of 1.7x book value and never traded below book value for any meaningful amount of time – not even during the height of the tech bubble or the depths of the financial crisis. So overall we thought we could buy into the most successful investment vehicle ever, run by an investor who is likely the greatest capital allocator of all time, at a very attractive valuation given the quality and growth prospects of the assets the company owned. At the time, we thought Berkshire offered both higher expected returns and significantly less risk of permanent capital loss than other investments we were looking at, and was particularly a no-brainer for institutions such as endowments and foundations to own given that risk/return profile. It's worked out nicely for us since and we remain happy shareholders today.

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GLOBAL ENDOWMENT
MANAGEMENT

Ultimately our direct investing will add value to our clients only if it leads to higher overall returns for our portfolio. One clear advantage direct investing has is that it reduces the overall fee drag on returns. Our favorite example of how fees can hurt long term compounding is actually from looking at Berkshire Hathaway itself. If you were smart and/or lucky enough to invest in Berkshire when Buffett took it over in 1965, \$1 invested into the company would have grown into over \$7,500 of book value today. Now as a reminder, Buffett doesn't charge fees like a hedge fund – he simply owns a large share of the company alongside his investors and takes a \$100,000 annual salary. So we ran the numbers on how much that \$1 would have turned into if Berkshire were a hedge fund with 2% and 20% fees (plus 0.2% in additional annual expenses), and the answer is less than \$700! The difference between \$7,500 and \$700 would have essentially been pocketed by Buffett along the way at his investors' expense.

While we are happy to pay fees to invest with truly world class managers, we think our direct activities create a healthy competition for capital that raises the overall bar for the portfolio. For example, when looking at a hedge fund charging 2% and 20% we can ask ourselves “is this really better than Berkshire Hathaway at 0% and 0%?” We also think that studying a business like Berkshire actually makes us better manager pickers, so it's complimentary to the rest of our investment activities. Finally, we think our direct activities help us stand out amongst our endowment peers since many of them are constrained by institutional policies and boards that don't allow investments into individual securities, regardless of the value those securities might represent. The typical endowment, for example, might hire a private equity fund, a public equity fund, and a hedge fund betting on insurance-related risks, paying high fees along the way; but they could not buy Berkshire at any valuation, even though it is essentially a world-class combination of those three strategies and does not charge fees. Our independent structure allows us to avoid non-sensical constraints like that. We simply constantly ask ourselves what makes the most sense from a risk/return standpoint for our clients. And back to alignment, we all have large personal investments in our portfolio alongside our clients, so we eat our cooking.

MOI: Thank you very much for your insights.

The *Manual of Ideas* research team is gratified to have won high praise for our investment idea generation process and analytical work.

"I highly recommend MOI — the thoroughness of the product coupled with the quality of the content makes it an invaluable tool for the serious investor."

—TIM DAVIS, MANAGING DIRECTOR, BLUESTEM ASSET MANAGEMENT

"Wonderful."

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