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This investor is worth studying for his focus on business models. Notice his focus on business that can compound returns at high rates for a long time—Nirvana!

**Chuck Akre Value Investing Conference Talk:
'An Investor's Odyssey: The Search for Outstanding Investments'**

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This is Chuck Akre's talk from 8th Annual Value Investor Conference in May 2011, Omaha, right before the annual shareholder meeting of Berkshire Hathaway. The upcoming 9th Annual Value Investor Conference will be held May 3 – 4, 2012, again in Omaha. The conference is organized by Bob Miles, author of several books including "The Warren Buffett CEO: Secrets of the Berkshire Hathaway Managers."

Thank you Bob, and it's great to be here. My chat today is called "An Investor's Odyssey: The Search for Outstanding Investments." It's a loose summary of my experience in the investing business. I won't tell you how many years I've been in it, Bob just did. I didn't, obviously, start yesterday. I want to thank Bob for both asking me to come and for his comments. Some years ago Bob asked me to do a presentation in an earlier conference he was hosting, and I turned him down. I said then that I just don't do that. Of course, I didn't recognize what an honor it is to be included in this group, so you should treat my remarks with appropriate suspicion. I might also add that paybacks are hell. You notice that he scheduled me today opposite what's called the wedding of the century.

I've gained enough weight and lost enough hair over the years to be able to allow me to write up some thoughts about investing, so today I'm going to share with you some of these thoughts, which collectively have added value in my career. Many years ago when I started my investing career in Washington D.C., I was puzzling with several questions about investing, and mind you that as Bob suggested I came into this with a BA degree in English Literature, having also been in a pre-med program, so I actually had a great many questions. Among the questions are, "What makes a good investor?" and more to the point, "What makes a good investment?" Today we tell all of the clients in our firm that our primary goal is to compound their capital at an above-average rate while incurring a below-average level of risk. So I usually ask my friends this question: Which would you rather have, \$750,000 today or the outcome of doubling a penny a day for 30 days. What do I hear? Penny. So that's the question. Compounding our capital is what we're after, that's what makes it a great investment for us. What's the value of compounding? Well the answer in this case is simply astounding. Doubling a penny a day for 30 days gets you, who knows, \$10 million, \$737,000 change.

The reason why we use the notion of compounding our capital at above average rates is that we can think of no better method of measuring the success of any business. Think for a moment about that, if you will. How else is someone able to judge the success of a business enterprise than through some measurement of the growth in real economic value. Granted, we all know about the importance of customers and employees and community, and obviously they're important, but throughout my odyssey I've been trying to identify and measure financial success in a manner other than whether the share price rises or falls. In fact, in a private business one is not afforded the luxury of share price discovery, so that some other method of measuring success must be present. I've heard... send the check to Omaha. This of course, is what happens when one is unable to compound their

capital. As an aside, Albert Einstein has often been credited with the following quote: “Compound interest is the eighth wonder of the world. He who understands it earns it, and he who doesn’t pays it.” Likewise, I read over the years that the eighth wonder line is attributed to Will Rogers. My own research cannot connect Will Rogers to any such quote. Finally, an authority called Miller’s Philmore Bathtub, honest, a website which holds itself out as a prodigious checker of facts, in which was entirely unknown to me as recently as two weeks ago, says, with confidence, that “Albert Einstein never wrote or said anything about compound interest.” So not only is compound interest/compound return poorly understood, we can’t even say with confidence who we should credit with these pithy statements. It remains an enigma.

In 1972, I read a book that was reviewed in Barron’s and this book was called “*101 to 1 in the Stock Market*” by Thomas Phelps. He represented an analysis of investments gaining 101 times one’s starting price. Phelps was a Boston investment manager of no particular reputation, as far as I know, but he certainly was on to something which he outlined in this book. Reading the book really helped me focus on the issue of compounding capital. Also, from Boston, you all know Peter Lynch, who often spoke about ten-baggers. Here was Phelps talking about 100-baggers, so what’s the deal? Well Phelps laid out a series of examples where an investor would in fact have made 100 times his money. Further he laid out some of the characteristics which would compound these investments. So in addition to absorbing Phelps’ thesis, I’ve been reading the Berkshire Hathaway ([BRK.A](#))([BRK.B](#)) annual reports since I’ve made my first purchase in 1977, so this collective experience moved me along to a point where I’ve developed my own list of critical insights and ingredients for successful investment.

Again, compound return really is the center point, and ultimately we spend much of our time trying to identify those businesses which are most likely to compound the shareholder’s capital at an above-average rate. Were we simply a pure value investor, we would be regularly looking to unload those securities, which appreciated to some predetermined notion of present value, and we would lose out, in our minds, on the opportunity to compound our capital because of these sales. Further, we have our operational costs and tax costs for those accounts, which bear tax liability. Continuing this quest, I found the data, this is EBIDTA data, relating to returns in different asset classes, across nearly all of the 20th century. You all know the figures; common stocks outperformed all other asset classes on leverage across most of this time period. You notice that Robert and his last talk had a slide that went back to the 19th century, ended up producing the same type of data. The annual compound return number falls in the neighborhood of 10%.

So I’d like to have you examine these numbers, which are in ten-year intervals. And the obvious conclusion is that both an annual return as well as a ten-year number is unknowable. So my takeaway as it remains today is that while the number is in the vicinity of 10%, 10% itself is not precisely the point. Might be 9 or 11, generally in the neighborhood of ten, and by the way I just tell you that as an aside I feel exactly the same way about earnings estimates and outcomes, and that for us, the precise number is never the point.

My next question then is, “So what’s important about 10%?” Over the years I’ve considered a lot of reasons for the 10% figure and I ultimately concluded that the 10% numbers bear some relation to what I suspected was the real return on... capital, that is across all companies large and small, leveraged and debt-free, manufacturing service oriented, hard assets, cloud assets, across all these businesses, my surmise was the real return on the owner’s capital adjusted for all what I call the accounting garbage, was in the low teens. Today... suggested that they are correlated.

Throughout most of my career, it’s been popular to believe that the RVs of all American businesses are in the mid-teens, and again Robert’s last chart showed it varies from the mid-teens to mid-single-digits and so on. However, I’m suggesting that without any academic support, that the number

unencumbered by GAAP accounting is in fact lower. And you all know that GAAP-accounting does a reasonable job helping us with these judgments, but it clearly has its deficiencies.

So now it's the case of intuition, perhaps common sense, that I propose the following hypothesis: One's return from an asset will, over time, approximate the ROE, given the absence of any distributions and given a constant valuation. So one of you will jump and no doubt say, ... fool, everyone knows there's no such thing as constant valuation in the stock market. I'll get the valuation in a minute, but I'll just say here we're very stingy. When we speak of ROE, what we're really thinking about is the free cash flow return on the owner's capital. Free cash flow in our thought process is simply GAAP net income + dna minus all ...

Of course, there are examples that are more complicated, but as a business owner this is what interests me. How much cash does the business produce and make available to the management, for them to make the reinvestment choices? So now I have this hypothesis, where's the proof? Well return on capital really matters. I don't know if you can see those numbers or not but just take an example: Start with a \$10 share price, \$5 book, 20% ROE produces a dollar's worth of earnings, you know the metrics are easily ten times earnings, two times book, 20% ROE, we'll add the earnings of the book and have another look, the new book is \$6, keeping the valuation constant, providing no payouts of earnings, apply 20% ROE, the new earnings are \$1.20, ten times that is \$12, two times the new book is \$12, so our point is the share price is up 20% consistent with 20% ROE. So in this example, one's return does in fact mirror the ROE, where there are no distributions and the valuation is kept constant. And this generalization has been very useful to me in thinking about ... expectations. One of the acknowledgements I think we'll all gladly accept is that high return businesses have something unusual going on which in fact allows them to earn above average rates on unemployed capital. Often these special circumstances are referred to as moats. In our firm is the properly identify what is the nature of the moat; what exactly is it that's causing this good result. And to us this is a really critical point. Because the investment business can have so many issues that upset the apple cart, being confident about what it is exactly that's causing the results is a huge advantage for us. In point of fact, we have on occasion been able to add to positions in time of turmoil, because the confidence in understanding a business allowed us to see through all the noise in the marketplace.

Now it's time to go fishing. The pond I want to fish in is the one where all the fish are the high-return variety. Naturally, if my returns are going to correlate to high ROEs, then I want to shop among the high-return, high-ROE businesses. In our firm we use this visual construct to represent the three things that we focus our attention on. This construct in fact is an early 20th century three-legged milking stool and before I go on to describe each leg to you I want you to see that the three legs are actually sturdier than four, and that they present a steady surface on all kinds of uneven ground, which of course, is their purpose in the first place.

Leg number one stands for the business model of the company. And when I say business model, I'm thinking about all the issues that have come into play that contribute to the above average returns on the owner's capital. Earlier we called this the moat. You know the drill: Is it a patent, is a regulatory item, is it a proprietary business, is it scale, is it low-cost production, or is it lack of competition? There are certainly others but for us, it's important to try to understand just what it is about the model that causes the good returns. And what's the outlook? In our office we often say, "How wide and how long is the runway?"

Let me tell you a quick story. About 25 years ago I had an intern working with me and I gave him a box of articles I'd saved relating to businesses which had caught my eye but which I had done no work. And he came back some days later with a piece on a company called Bandad, which was located here in the Midwest in Muskoteen, Iowa, and my intern explained to me that we should look at the business

that had 20% ROE, low valuation, growth opportunities and so on, and I said “What business is it in?” And his reply was that it was in the tire business. And so I said that’s interesting, why don’t you go look at all the returns in capital and all tire companies? And he did and he came back and he reported that all those companies had returns on the owner’s capital in single-digits. So here we were with a business which described itself as the largest independent truck-and-bust tire recapper, but our quick return analysis said no way, it can’t possibly be in the tire business.

So our mission therefore was to discover what was the real source of the earnings power for the business, allowing them to have such returns. Well if you went to Musketeen to meet with the CEO, who by the way, greeted us with his feet on the desk eating an apple. I won’t bore you with all of the bizarre history – and it is indeed bizarre – but we concluded that the company’s tie to its independently owned distributors and service centers was at the core of its business value. And those independently owned business men were incredibly loyal to Bandad, especially because of the outstanding way that they’ve been dealt with by Bandad during and after the 1973-74 oil embargoes. It turns out that each of these independent business men who typically work from 6 a.m. to 8 p.m., unlike their Goodyear stores who had managers who worked from 8 a.m. to 6 p.m., were enormously grateful for what the company had instituted called the power-fund during the oil embargo. They put this in place to collect all of the excess profits that the company made when the price of oil began to decline, and they made a deal with all of these independent managers that they would return money to them in direct proportion to the sales. You know, they bought the tire tread, which was an oil-based derivative, from Bandad, and used it during the recapping process. So, the independent businessman wasn’t allowed to go buy a new Cadillac, but he could buy a new shop, build a new shop, get new equipment, whatever, all through this power fund that Bandad had put in place. And so this power fund in fact really lost its economic underpinnings and the company ran into difficulty and years later, it was later acquired actually, in 2007 by Bridgestone. We owned the shares for several years and had a very profitable investment, but sold them when we lost confidence in the business model. It was unique, but my point is, simply trying to understand what it is that’s causing the good return, and how long is it likely to last. It was a profitable investment for us, but not a great compounder. Another quick story along these lines relates to Microsoft (MSFT), during the early years. According to [Bill Gates](#)’ first book, “The Road Ahead,” he and Paul Allen tried to sell the company to IBM some years earlier and they were turned down. And so... hindsight my inescapable conclusion is that neither party of the proposed transaction understood what was valuable about Microsoft. In my mind it’s a huge irony at least because in my point of view Microsoft became the most valuable toll road in modern business history. **But here again, even the people running the company at an early stage did not understand what it was that made it valuable. And it wasn’t even visible to them. So my point here is simply that the source of a business’ strength may not always be obvious.** Therefore, understanding that first leg of the stool, the business model, has its own level of difficulty. It’s also where the fun is, I might add, and we believe it is absolutely critical. As I said, we spend countless hours at our firm working on these issues every week.

The second leg of stool is what we describe, is the Peevol model, and what we are trying to do is to make judgments about the focus around the business. We often ask ourselves, do they treat public shareholders as partners, even though they don’t know them? My good friend Tom Gaynor who you heard from yesterday describes it this way: He said do they have equal parts skill and integrity? What we’re trying to do is get at is this: What happens at the company level also happened at the per-share level. My life experience is, once someone puts his hand in your pocket, he will do so again. And presumably, we’re examining the company in the first place because we already determined that the managers are killers about operating the business. And because we run concentrated portfolios, we literally have no time to mess with those managers about who we have real questions about in our real experience.

Here's another story: About 30 years ago, I owned a very, very, very, let me emphasize, very tiny interest in a company called Charlotte Motor Speedway, which over the years has come to be called Speedway Motorsports. And the principal shareholder then, and possibly still is, is a person who had a negative history with the SEC. The agency had barred him from having any association with the company for a period of several years. And this was perhaps 35 or 40 years ago. At any rate, this majority shareholder returned to the scene, and by the mid-'80s had accumulated 70% of the stock of Charlotte Motor Speedway, and he ... tendered for all of the minority shares that he didn't own. When I joined ... in Charlotte, North Carolina, which after discovery was successful in getting us a settlement that was several times the proposal going private price. This issue confined the CEO, which in all likelihood caused him to settle with a long list of misbehavior including improper valuation, failure to include corporate assets, a lack of independence of outside opinions, and so on. Quite naturally he demanded that a settlement be sealed and it was. I've never since held a position in any of that CEOs public or private companies, because he had indeed put his hand in my pocket.

Following my Charlotte Motor Speedway experience I bored down a new holding in International Speedway (ISCA), and I discovered that it was in fact the best out of the three public companies involved in NASCAR racing. And my experience in International Speedway was a good example of our approach. When we first invested in ISCA in 1987, the metrics were as follows: The ROE was in the mid 20% range, the income margin was over 50%, book value per share had a CAGR 28%, there was no leverage, it had a modest valuation, it had attractive growth prices, and there was huge, over 50%, insider ownership. We owned shares in International Speedway for a good many years, and had good experience of compounding our capital at generally between 10 and 20 times our cost, depending on when the shares were purchased. We later sold all of our shares when we became concerned with the management's approach to all aspects of the business. The CEO had died, and other family members were running the show, and in addition we were concerned about the runway for their business, as times were changing. So our sales decision was judgment relating to the second leg of the stool, the management model, as well as our view of the business model itself.

We refer to the third leg of the stool, which quite obviously gives it its stability, as something... as the glue that holds the opportunity together. My next question, therefore, is does an opportunity exist to reinvest all the excess cash generated by a business, allowing it to continue to earn these attractive above average returns? My experience tells me that the reinvestment issue is perhaps the single most important issue facing any CEO today. As it is one place where value can be added or subtracted quickly and permanently. So this really relates to both the skill of the manager, as well as the nature of the business. One of my favorite questions to ask a CEO is, "How do you measure the ways in which you are successful in running a business?" And I can tell you that very few ever answer that they measure their success by the growth in economic value per share. Not surprisingly, we hear that the increase in the share price is the answer, rather simply say chief incorporate goals established in conjunction with the board is the answer, and some say that ...accomplishments relating to customers and employees and the community and the shareholders are all the answer. Personally I'm deterred in my view that growth in real economic value per share is the holy grail. Just look at the opening pages of the Berkshire Hathaway annual report, and what do you see? You see a record of growth in book value per share, for 40 years. Forty years. Incidentally, in Berkshire that number, you know, is 20% a year for 40 years, and so it's no wonder that Warren shows up here as the top of the Fortune 400 list.

After we've identified a business that seems to pass the test in all three legs we refer it as our compounding machine. And as we describe it, our valuation discipline comes into play here and we describe it here as simply we are not willing to pay too much. Volatility is not part of our analysis of risk; rather we view it as an opportunity generator. What we say for our purposes is that risk involved the exposure of permanent loss of capital. Occasionally, we view it more narrowly. And we're watching for

a possible deterioration in the quality of the business, or any of the three legs of our stool. Is the economic moat getting smaller, are the managers behaving badly in some way, or is the reinvestment opportunity diminished or being abused?

Theoretically, if we have the three legs correctly identified then our only risk is the loss associated with the dying value of money. In practice, it never happens exactly this way. But we believe firmly that if we've identified the key ingredient for both preserving and enhancing our capital, we'll be in good shape.

Another story, if you will. Many years ago, I owned a position in the list company that was based in Long Island, New York. Now you don't see many, or even any list companies that are in the public market because they mint money. A list company, as you may know, collects and sorts data about people and subsequently sells the list to various users. A good example is Gillette, which collects data about high school senior boys. And the reason was, that their research showed them that while a boy was still at home, his mother purchases razor blades. And once he graduated from high school, with the likelihood that he was going to leave home, he would begin making choices about what razor blades to buy. So Gillette would buy these lists of high school seniors and mail them free razor blades, getting them used to a brand before... now this company, which was called American List, was run by a founder who had some years earlier sold a controlling interest to a New York private equity firm. And the CEO was a very decent guy, and in exchange for partial interest he had sold he was able to put his money into double digit-return bonds, and he was in investment heaven. At any rate, the company had 50% net margins. Either because the New York firm had control of the CEO, or because he was so risk averse, or perhaps he wasn't imaginative enough. The CEO could never find a place to reinvest the excess capital he generated in order to compound the shareholder's capital. So he paid it out in dividends long before we had a 15% dividend tax rate. Incidentally, someone else by the name of Dan Sneider, had a public company those days and he purchased all of American List. My great regret at the time, of course, was that I didn't have a vehicle to purchase all of American List. It was a pure send-a-check-of-Omaha kind of business. The opportunity ended up simply being... money lost for us, as the reinvestment portion of the triangle was missing. Even that loss was offset by the rich dividends.

At our firm we have this quaint notion that in certain economic environments and in certain stock market environments both of which we have an abysmal record of predicting, we are well served by owning things which were a modest valuation, at least to start. There's an old Wall Street ad agent attributed to Goldman Sachs...which says, "Something well bought is half-sold." Taking a completely different tact, if we had properly identified the compounding in machines and had bought them at modest valuations, we would be set up for the famous Davis double play. That is, the business... will compound our capital at an above-average rate, and we're in line for an increase in market valuation, but double play indeed. So we have shared our experience relating to business models which fade, core executive behavior and reinvestment.

Now let's look at a business success that we've had. Incidentally, our compliance folks have asked that we make sure you understand that not all of our investments turn out as well as American Tower. I'm about to discuss, and not to mislead you, we have indeed had others which have not done so well. This first slide gives the share price detail from the time it was created out of American Radio in 1998 to the market bottom in 2002. And between those periods, we have bought and sold shares and essentially broken even on our transactions. By June of 2002, we had accumulated a half million shares at the cost of \$5, and as we like to say, we were proud of our holdings. By September the share price was \$2, and we got on a plane and went up to Boston to see the CEO, and founder, Steve Dodge. The market was focused on \$200 million convertible debt issue, by the way out of a total of \$3.3 billion in dollar debt, which was to come due in November of 2003, more than a year later. It was payable both in cash and in shares of the company's option. As a shareholder, my risk was massive delusion.

So Steve Dodge, the CEO, discussed his thought process about handling the debt issue in the following year. Further, we could take a full measure of both his pride and his anger relating to the share price and the market action, and we came away believing that the debt issue would be managed successfully. Along with an increased level of confidence in the business, we were better prepared as the market tanked in October of 2002. Market liquidity disappeared. Many of you will remember and the shares traded at an inter-day low of 60 cents per share, finishing the day on October 9th at 71 cents per share. The circle on this chart, marks the point at 80 cents per share where we took a larger position, several million shares yet still not significant to our assets. So what was the market seeing in 2002? Among other things, the company had a ratio of debt to EBITDA greater than 16 times. You can see on the right hand column, 16.4 times. Not unexpectedly, it was showing huge net losses in income as well. You can see that in 2002 alone, it lost \$350 million. What did we see? We saw a basic business model in its simplicity, which is more towers, more tenants per tower, and more rent per tenant. What else did we see? Well we saw that tower level... margins were about 90%. We saw that cash flow margins were approaching 50%. The 2010 experience for American Tower was EBITDA to margin itself was 68%, and the free cash flow margin was 46%.

So back to the basic business model. Tower count remained flat in 2004, and the company improved its balance sheet. Beginning in 2005, tower count began to rise both domestically and outside the U.S, and from 2005 to 2010 tower count grew by 133%. What happened after 2002? Well beginning in 2003 EBITDA began growing again. In 2005, free cash flow turned positive, debt to EBITDA fell to below 6 times in 2005, and from over 16 times to just 4 times in 2010. Free cash flow reached 46% of revenues. So this is what I call the "aha" event. Return on invested capital from 1997 to 2010, that should be 1998, was 30%. Compound return on investment from the market low in October 2009 was 66%. While the return periods did not exactly overlap, the point is the same. The difference, the excess return is the very definition of the Davis double play. So an important observation to us is that price matters enormously. The starting price has everything to do with your compound return, and here we see that the difference between buying the shares in February 1998, March of 2000, October of 2002, and January of 2003, and if you can't see the chart very well, from February of '98 to present, there's an 11% CAGR. From March of 2000 to present, it's a 3/10% cagr, from January of 2003 to present, it's a 38 and a half percent cagr, and by the way, from the market bottom, October 9th, 2002, it's a 66% cagr. So that is indeed the Davis double play.

Now, if you will, just get to the point that I enjoy most, let's have some questions.

Question: What's your biggest investment mistake?

Akre: Umm...I've often said, **Bob, that my biggest investment mistake was not buying enough of the ones that were really good.** And, that's looking at it from kind of a different way. Like every other speaker who's been here since yesterday afternoon, 2008 is made an indelible impression on me, and I think of my clients and I have adjusted the way that I look at things to try to better incorporate my world view into my overall security selection in portfolio construction, still very much a bottom-up stock picker, but just trying to be wiser about the process. A great story along those lines: In 2005, in our office, we hired a consultant who'd been a commercial vendor to the national homebuilders in Chicago. And we said, as it's related to the housing industry, this is 2005, look, we don't even know what the question is, but we just feel like there's some bad stuff out there, would you do some work for us and help us understand this? And he came back with 120 graphs of information. And it didn't resonate with us in a way to allow us to preserve our capital in the market experience in 2008 in our mind, in ways that I would have liked to. After all, we've gone through the 2000-2002 experience, up across that three-year period. And here we were in 2009, with significant decreases in value in our portfolios. The experience of the balance of 2009 to 2010 has showed us very clearly, that market decline wasn't as

bad as it felt; it felt awful. But, we're just trying to be better at that. But the other way I answer, as I started, is simply not owning enough of those that are really great.

Any other questions? Yes, sir?

Question: So you're thinking in the summer of 2008 with the financial... in motion... imagination... what were you thinking at the time, from summer 2007 to summer 2008, what was your thinking?

Akre: Well, my thinking between the summer of 2007 summer of 2008 was not nearly as good as it ought to have been, because I didn't see the train wreck coming, per se, even though my instincts were on the right track. I went to back to '05. We in fact, in our offices – our offices are 45 minutes west of Washington D.C., out of the country. We're in a town with one traffic light, and between our town and Northern Virginia, every major national homebuilder in the country was building houses, and we actually, in early 2007 and '08, we actually referred to it as ground zero for the national homebuilders. We had some analysts going out on a weekend and posing as buyers and trying to get data, what sales were in every place, and we still didn't bring that in to our overall portfolio construction and risk management and all that sort of stuff. So, it wouldn't do you any good to know exactly what I was thinking, because it didn't have a good result.

Yes, sir.

Question: What is really exciting today... a thousand baggers today?

Akre: Well, we're looking for them every day, and of course, it's simple arithmetic. And what I mean by that is, is the higher compound return on capital that you can get, the more likely you are to have a... by the way, I don't mean this any other way than...when I mention that I first bought Berkshire Hathaway in 1977, my recollection was that my price was \$120. So I've got a thousand bagger on those, by the way, two shares, that I bought at that point in time, and the great thing about compounding is that in order for it to be a thousand bagger it was only a five hundred bagger just halfway before there, and a 250 bagger and so on. We are very interested in a couple of very large cap companies here, that have been under duress, and that's Visa (V) and MasterCard (MA). And these are extraordinary businesses. We've done an enormous amount of work in this space, what looks like a very simple business on the top is hugely complicated below the surface, and not transparent. And the thing that has bothered these businesses of course, is being... and the... amendment, and the... which is not yet settled. But I will just say is that the businesses have net margins which are north of 30% today, and so lots of bad stuff can happen to them, and instead of being truly extraordinary businesses, they just become very terrific. And they're selling at pretty modest valuations, both on the kinds of growth and the kinds of return on capital they have, and when I say modest I'm talking about sort of 16 times free cash flow, something like that. That's a great example. Something that everyone in this room could go buy.

Yes, sir?

Question: You made a critical point about the importance of adjusting the price you pay for what you get, the quality of the business. I was wondering if you would give a little bit of insight as to how to mentally run through that process, in terms of quality of the business, potential compounding, all those factors come together in deciding what price is too high and reasonable?

Akre: Sure. So quite obviously, growth is an important part of what we do. In order to create value we have to have growth. In order to get businesses that can compound the owner's capital at, let's say, 20%, you know, you have to have a hefty level of growth in order to do that. So, it's really just going through the mental process over and over again about the three legs of the stool. And we recently had

a business in a portfolio whose name I won't mention, but it had a great international royalty business in our judgment. And, of course, royalty businesses are something Warren talked about for 40 years, and the royalty in someone else's economic activity. And, stock was probably appropriately valued in the high teens, free cash flow maybe... but when we continued to do work on it, what we discovered was that in our minds, the CEO was making very poor reinvestment decisions, producing a huge amount of cash as we expect, but making poor reinvestment decisions in a way in which he was unable to sit and talk intelligently about the reinvestment process. He made comments that said, he was making those decisions because his group of shareholders demanded X, or demanded Y, instead of what it would do to the economics of the business... so, let's reexamine the issue of the three legs of the stool, is hugely important, and I gave you examples of several companies that we've owned and sold because one or more of the legs changed over a period of time, and so as we have discovered, nothing's forever. We saw Warren spend much of the last two decades acquiring businesses which were designed to benefit from GDP plus growth in large scale consumer businesses, whether housing materials, or furniture, or all kinds of things like that, and it appears that he shifted now to buying industrial and, that sort of stuff, he's had a whole... but we all go through those things, and you know, none of us are very good at predicting in advance where we ought to be, and then we run into the experience in the last decade, where in the last decade we had two major market declines. Two in one decade, and the second one, of course was a doozy. Charlie has commented in print in last year's meeting that we were within days of a total collapse of the financial system worldwide. None of us can protect against that, and so when Robert was talking about Buffett's call in the market bottom of October of 2008, and it kept declining, the analysis is simply, these things are so cheap that I have to buy them here, and if I'm wrong, it's because we've had a total system of collapse, and it won't make any difference. You know, that's a really interesting kind of take away from that. That's my take away from it, but any other questions?

Question: Identify compound machine, trying to buy when they're cheap. When do you sell them? Is it only when the legs get weak, or is there some...to what you're selling?

Akre: Well that's a great question, and it's one every appropriately asks us, and the answer is first of all, if the three legs are intact, if we believe the business model is going to continue to compound our capital at these high rates, and we recognize that number will go up and down for normal business experiences, but their... we want to hang on to the business, because the really great ones are, A, too hard to find, and B, too hard to replace. Every now and again we fool around with taking a little bit of something off of the table because we think it's gotten too rich. My sort of life experience is that if I sell a stock at \$30 because it's too rich, and I set in my mind that I'm going to buy it back at \$23, inevitably, it trades to \$23 and an eighth, or \$23 and one, or whatever it is. Oh yeah, whereas if it trades at \$22.98, you know it trades 300 shares there, or something like that, and I never get back. And then the next time I look, instead of being \$30, it's \$300. And I missed it up. So the really great compounders are really hard to find and identify, and you know, I talked about International Speedway. Robert H. actually wrote a book about that whole experience with NASCAR racing, and it was an extraordinary business. I mean the family that controlled the company owned NASCAR outright. And, the dynamics of the growths of this business were just unbelievable, and as I repeated those financial characteristics of the company who bought it, it was great. And then the management beyond Bill Franks Jr. just overplayed their hand, and got too greedy, and you know, the economy changed and the business, we were fortunately gone by then. Another business that is way more controversial that I didn't mention, that we've made 10, 20 times our money on in recent years is a company called Penn National Gaming (PENN). And it's in a business owning and operating casinos. It was a regional operator. It wasn't not in Las Vegas. It was not in Atlantic City. And we took our position way down in that company some while ago because starting about three years ago, visits per casino were down, and plays per visit were down. And to go to that question that I answered to Bob, our view is that the consumer is constrained. And is going to stay constrained. And we'd love to be able to... our way out of this economy but with 9% unemployment rates, it's not going to happen. And with, I think, north of 80% of all households have

every dollar of income spoken for it. And with higher food and energy prices, which are not deferrable expenses, there's less to go around everywhere else. And so, at the same time, Robert H., the lowest expectation group in his chart was somewhat discretionary, yet in our portfolio we owned Dollar Tree (DLTR), and Ross Stores (ROST), and TJ Maxx (TJX). Consumer discretion items. But those three businesses are businesses whose model is trying to help the consumer who's trying to stretch every dollar go further. They sell stuff for less. And they sell a lot of stuff that people need. And they do it for less. So we've had good success in those names in this environment, and you know, the financial characteristics of those businesses are all terrific, and the valuations are modest. The balance sheets are basically net debt free, and the returns on capital are in the high teens, and compound growth and economic value per share in the high teens, mid to high teens, you know. So, we look around at all of these and when the business models stays intact, we tend to stay there, and we try enough to understand when they don't. But that's really hard. I'll just finish those up.

I grew up in the Washington area and for years, if you'd ask me or others in Washington, D.C., "What's the best public company here?" people may have well said the Washington Post. And friends like Tom Russell who will be here later and others and I used to talk about this around a decade ago. We'd say, you know, circulation's declining in all the major newspapers, but it's a modest number. It's two or three percent a year. It's really not hurting the economics. Look at these things. And then about five years ago, they just went off the cliff. Went completely off the cliff, for something that most people didn't expect, which was the Internet completely disintermediated their economic edge... and so, there was a huge change in economic model, business model, which had been intact for 70, 80 years, and in one day, bam, for reasons which snuck up on most people. And so, I made that point in the beginning, how important it is to try to understand what's causing that good result and how difficult it is to understand, and why you have to constantly keep looking at it, and keep asking the question, having this curiosity about these things. Yes, sir?

Question: What you said about being from the Washington, D.C., area – how do politics play into your environment as far as your decision making and changes that are coming up, and you know, from a living standpoint or changes in administrations and the... long-term look at the process.

Akre: All right. Well, of course, it's the business of Washington. Actually, you don't really want to get me started on politics. It doesn't add in to our process much at all. I mean, in our... in Visa and MasterCard, we've had people... and so on, that related to that area, you know, flip a coin on their advice. It is what it is. We just try to deal with things which we know.

Long-term trends, or banking area, lending process?

Well from a political point of view, we've had periods in the United States where personal tax rates were 90%. You know, from a political point of view, right now we have a time where our tax rates on both capital and dividends are the lowest they've been in over a century, maybe ever. Who would have predicted that? Yes, sir.

Question: Can you talk about how your early investment career and how you came about to the philosophy you're using now, were there early... and you talked to us about that, perhaps that transition?

Akre: Sure, picture a piñata party, blindfold on. As I said, my undergraduate studies was in English literature, pre-med student, so I had all kinds of questions and I had no preconceived notions when I got into the investment business, and the firm that I joined, when I joined it in 1968, there hadn't been a single most important brokerage firm in Washington, D.C. It brought everybody like Geico, and did all the financials to the drug stores and the utilities and it had gone through a change where the principal

owner had died, and so in going through a change, it actually at a time, Merrill Lynch had one office in Washington, and this sort of stuff. The business was changing dramatically and this firm didn't change a lot, and in a kind of perverse way, it allowed me to pursue the stuff that I gravitated to, which was trying to figure out how to be a good investor, and what was a good investment, and so it was just a very slow, you know, I'm a charter member of the slow learners, and it was a process that slowly led me to the point where instead of trying to manage money from brokerage clients, I began to manage money for fee-paying clients in the mid-80's, so it took a long time...when I was operating as a broker.

Question: So did you learn primarily by reading about Buffett?

Akre: Yeah, I have a very... and I'm curious, and I try to read and learn from people that I perceive to be smart and successful, I was telling the guys in the office a story yesterday, that I'd read about this fellow named Henry Zeny, once who had studied under the legendary... I can't even remember who that was, who... one of the great wholesale, OTC brokerage firms. He'd been very thoughtful and specific in parts of the business that he wanted to go and learn specifically, then he came out and took a lot of his money and invested it in commercial laser company in Springfield, Virginia, and I said "Aha!" He's on to something. So I invested in that laser company, which went to zero. So even the coattail investing has its pitfalls. You have to have your eyes open all the time, and, I have this motto, "In life as well as in business, which is every day, I'm lucky if I have learned something new, and I'm doubly lucky if it hadn't cost too much." Yes, sir?

Question: Yeah, you mentioned several people/clients in moats, and I wondered, what lasts the longest?

Akre: Well I have no idea. I mean, I don't. Obviously, what we all know in this room is that when you have a business that has very high returns on capital, it attracts competition. And so, the best way to have one is... that's protected by patents, and as Warren used to say, is fattening and you know, I think he used to use some other things in his examples, but you get the idea, that people want badly and protection from competition between one another, they're all unique, they're all interesting... I can't tell you which one's going to last the longest. Yes, sir?

Question: Inquiring about an appropriate level of portfolio concentration?

Akre: Well, only as it related to what I do, and we currently have four positions. I'll speak about our private partnership, not our public mutual fund. We have four positions that are between 10 and 20% each, the largest of which is 20, 21%, so we have another three positions that are about between, 7 1/2 to 8%, and the few beyond that, don't make a lot of difference. And so they're sort of what I call workbench, and they're either going to get larger or smaller. And we, you know, the point is, if we have a high level of confidence in the three legs, and we want to make sure that we have enough capital allocated to that that is going to have an important effect on the portfolio. Remember, I started this whole presentation by saying that the hypothesis is, my return on an asset will approximate the ROE, or the period of years, given the absence of distribution and constant valuation. So, if I own a business that's got a 20% ROE, 20% free cash flow return on the owner's capital, and I find that by their reinvestment they are compounding value at something like that, and I think that the runway is long and wide, I want to have a lot of capital there. If, on the other hand, I'm uncertain about how the business is going to behave or if I'm uncertain about both the reinvestment history as well as the discussion by... then I don't want to have as much capital, you know, but we've always run concentrated portfolios, and as Robert pointed out, our returns on the upside... higher, and quite possibly they'll be more negative on the downside... Net-net, just like averages, are returns over a long period of years, over 20 years have been significantly above the market average, after all fees, incentives, and everything else. So that includes 2008 experience.

Thank you very much.

<http://www.gurufocus.com/news/150194/chuck-akre-value-investing>

Answers from GuruFocus' Q&A with Chuck Akre; Discusses LAMR, AMT, MA, MKL, PENN, ARO
Jun. 06, 2011 | Filed under: [LAMR](#), [AMT](#), [MA](#), [MKL](#), [PENN](#), [LEXG](#), [ESV](#), [ROST](#), [TJX](#), [ARO](#),

Recently, GuruFocus readers asked successful investor [Chuck Akre](#) their investing questions. In his comments, he discusses LAMR, AMT, MA, MKL, PENN, LEXG, ESV, ROST, TJX and ARO.

We will also be hosting a follow-up Q&A with Chuck. If you have further questions for him, post them in the comments below, and he will reply.

1. I have a couple of questions for Chuck on Lamar ([LAMR](#)).

What does he think the ultimate ratio of digital billboards to total billboards will be for the company? I have heard anywhere from 3%, 5% or 10% over the next decade. Also, does he think smart phones hurt billboards or enhance them? I believe this important because an iPhone is really just a mini personal billboard. It could hurt the overall appeal of billboards or could be used to interact with them. Lastly on capital allocation, the Reilly's seem very capable but at the top of the last cycle they paid a special dividend and bought back stock at prices above today's stock price. Do you think they learned a lesson and that capital allocation going forward will be different? Would love to hear his thoughts. Thanks.

[Akre] Three questions: a) I have no idea what the ratio of digital boards to the total will be, but I do know that there is a very large upside opportunity. B) Smart phones are indeed mobile boards, and again I have no view on whether they will supplant fixed boards, or rather enhance them through a mobile link of some sort. Lots of possibilities. C) Certainly in hindsight the special dividend and share repurchase was fuzzy thinking. More recently the option strike repricing (although the dollar amount remained constant) continues to reflect poorly on a corporate governance philosophy. Fortunately the

business seems to be run reasonably well. I am told that Brent McCoy's role at the firm is to oversee capital allocation issues, and so we might expect improvement.

2. How much do you think your returns would have increased in 2008 if you considered the macro picture into your stock selection?

[Akre] Munger and Buffett said at the 2010 annual meeting that they would not be attracted to any manager who went to cash during the crisis. However, they held 20% to 30% cash during the crisis, giving them great opportunities and reducing their exposure to the downside. Our returns of course would have been better if we had had the insight and courage to go to cash, but we did not. What I have said is that I want to better incorporate my "world view" into my security and portfolio decisions, with a view that we might better. What the balance of 2009 and 2010 have taught us is that things were not as bad as they felt at the time, as portfolio values have recovered nearly all the lost ground. It just felt awful going through the "troubles."

3. I also own Markel ([MKL](#)) shares and I really like the company and consider it a permanent holding (unless it trades at 3x BV).

What is your estimated range for the BVPS growth rate over the next 10 years?

What's your opinion on the companies that comprise Markel Ventures? Have you verified the prices paid? How about the quality of the individual businesses and their competitive advantages?

[Akre] I think under their current structure (especially investments to book value) they should be able to compound book at a low- to upper-teens annual rate. I have not examined the Ventures businesses closely as MKL has had limited disclosure. I have spoken with the CEOs of several at various functions and they are the types you would expect. Several are growing rapidly, and several are the types I call "send the check to Omaha."

4. I noticed you scaled back your position in Penn Gaming ([PENN](#)). What are your thoughts of this company going forward?

[Akre] Peter Carlino (CEO & chairman) is the best in the business at compounding the shareholders' capital! We continue to believe that the triple head-winds (competition, taxes and sluggish economy) just make it more difficult now.

5. As a student dreaming of a career like yours, I was hoping that you could give me some advice on finding some good topics for writing a thesis/essay about. Of course, I'm looking for topics that would help me in a stock-picking career.

[Akre] Compound returns!

6. Recently I have been watching stocks with absolutely no company revenue take off on "paid promotions." Most notably LEXG went from \$0.10 to over \$10 and back down. Jammin Java was similar in its performance to a high of \$6.35 from below \$1. What do you consider to be the single most important factor in considering investing in stock, technical analysis, due diligence or news? If news is the most important, how can one "predict" that a stock will run, or is it simply risk?

[Akre] Fundamental analysis is the most important. One needs to know what one owns as an investor. Of course if speculation is your game, you can try anything.

7. I'm planning to take CFA and learn to become a good value investor. I'm about to start my job at PwC and after three years to enter into an investment bank and was wondering, will auditing help me achieve my goal? Thank you.

[Akre] Accounting is the language of business, so anything you do to improve your understanding of

accounting is valuable. I don't personally believe that an investment bank role will help you become a better value investor, as their focus (rightly so) is on creating transactions.

8. In a past shareholder letter, you expressed concerns about the so-called recovery (high unemployment and weak consumer). Would you please share your current view on this topic and how it relates to market expectations moving forward? Also, would you relate this same question to your expectations for the portfolio's performance?

[Akre] I continue to believe that the current high levels of unemployment and underemployment will continue to hold back recovery. This backdrop quite logically will affect the investment climate. Further, I have no prediction about how any of our investments will perform over the balance of the year (or even next year for that matter), but I do know that each will gain in economic value per share both this year and next. How the market values that is unknown.

9. Now that you are beginning to think of the macroeconomic factor, what are the most key factors you are looking at?

[Akre] I have always tried to be tuned in to what is happening in the world around me, but since the end of 2008, I have been trying to better integrate that view into individual security selections.

10. Having lost a bundle this year on a delisted stock, I have to be very cautious of both company-specific risk and macroeconomic risk. In your opinion, should a risk-averse investor wait to see if the FED ends QE2 in the next weeks/month before deploying cash that is quite limited? I am also of the age (mid-50s) where I should have a much smaller percentage invested in riskier equities compared to someone 20 years my junior. I am thinking of staying in cash for at least a month, then venturing back depending on the outcome of FED changes before the end of summer. I will never make up for the 90% downside I experienced, but if I catch a bottom in commodities just after a QE3 (if such happens) or after the market is finished worrying about the ramifications after QE2 ends, 2012 might be a good year for another oil stock run since it is

a presidential election year.

[Akre] Perhaps your personal financial goals aren't suited to your plan of speculation, and at the same time you cannot reach your goals without speculation. If that is the case you have a real dilemma. As an investor, I have found very little success at trying to time my portfolio purchases and sales around macroeconomic events. Instead, I try to understand the business (using my three legged stool model) and make purchases when the valuation is attractive.

11. My first question is on portfolio management. You run a very concentrated portfolio with a very low turnover — 24 stocks with 75% of assets in top 10 holdings with an average turnover of 12%. How do you manage to maintain such a low turnover concentrated portfolio when your assets are growing, without compromising the price discipline required of a value investor? Put another way, I imagine that when a new position is initiated, the margin of safety is large. But, say, as new assets roll in over time, your top 10 positions have moved up. Then adding to these positions lowers the margin of safety, and adding a new position dilutes the portfolio concentration. You have managed such a portfolio very well. Can you give us your thoughts on this topic?

I recently heard you say that you believe that MasterCard ([MA](#)) has the potential to be a 5-10x bagger over the next decade. Can you tell us more about your thoughts on MasterCard and why it has the potential to be a multi-bagger?

Can you tell us about another one of your favorite multi-baggers that you held in the past but you do not hold anymore or is now a smaller position? Why did you decide to lower the position size (or eliminate the position)?

Lastly, can you tell us about one of your larger positions in the past that did not work out as expected? What went wrong?

[Akre] You have hit on a very important issue which affects all portfolio managers, and that is how one puts cash to work, especially when valuations are less attractive. And further, you correctly understand that the margin of safety is lower when the valuations are extended. My experience is that I have tried several methods, a) allocating funds across the portfolio, b) placing funds in only the top few that are cheapest, and c) holding cash for extended periods. The results...They have all had their pluses and failures. One simply has to continue to look for the characteristics which attract them and strike when they are attractively priced. It certainly distorts the relative concentrations in the portfolio, but that is the outcome of a dynamic portfolio.

Re: MA. I do not recall saying that MA was a potential 5 or 10 bagger; however, I do believe that is possible. Examine the net margins of both V and MA and dream a little. So the key then is reinvestment. It will be very hard to find things to spend their money on that have the types of returns that they already developed internally!

See question #4.

12. Teenage clothing is a tough business. Significant market shares are gained and lost based on merchandising decisions. How did Aeropostale fit the "three-legged stool" model of Akre Funds? Can you tell us more what attracted you to this business?

[Akre] We believe the shares are remarkably cheap. The company has no debt and a very long history of success in the preteen and teenage. They will either get the current issue straightened out or they won't. If they do not, I believe we are well protected in our purchase price, and if they get it right, we will be well rewarded.

13. Hi Chuck, I am just beginning to know about your new fund and your positions and the three-legged stool in investing. I would appreciate to know more about it.

1) How you can define the integrity and capability of management by reading their writing and

watching their actions? Do you often talk to them or use a scuttle-butt approach (like Phil Fisher)?

2) How do you decide that the company has reinvested the excess cash profitably with high return?

3) For the famous position of your fund in American Tower ([AMT](#)), I have scanned their performance over the last 10 years using Morningstar. Their return on equity is not high, the long-term debt level is nearly double the amount of equity, and now the free cash flow stays at \$670 million. It definitely is not very attractive at the first look. How do you calculate the return on owner's capital for AMT? And with this price valuing the company at \$21 billion, is that too expensive? What's the calculation to determine it?

[Akre] First question. Investing is about gathering data points (good MBA word) and digesting them in your own neural network. If you have prepared yourself well, then the outcome (your judgment) will be useful. Charlie and Warren are always talking about lifetime learning. This is what I mean by preparing yourself well. So, after a while, you begin to recognize aspects of human behavior which you've seen before. You learn to pick it up from conversations, speeches, writings, etc.

Second question. It is an outcome from simple observation. You can do either a precise calculation, or an approximate calculation based on the information the company supplies.

Third question. Re: AMT — the incremental returns on capital are off the charts at AMT. For example once beyond 2.1 tenants per tower, the returns on incremental capital are in the 90% range. Second, we have actually had a change in management at AMT, where the founder, Steve Dodge, and at least two CFOs have moved on to other opportunities. The business is so good that it has prospered under new leadership. The current chairman and CEO, Jim Taiclet, is world class. Third, their reinvestment has been a mix of adding new towers, both greenfield and by acquisition, and the balance has been used to strengthen their balance sheet, and then pursue share repurchases. The net result has been a

growth in economic value per share which we calculate to be a mid- to upper-teens rate since 2002. The proof is in the growth in the business' cash flow, tower count, etc. Its current valuation is at the top end of our appetite, and the company is in our mind one of the best business models extant today.

14. I know that you are a "bottom-up" investor, but do you think that there are any companies that you would look at more closely due to the "baby boomers" shifting their money into retirement accounts or spending their money?

[Akre] The investment management business is one of the best businesses to own.

15. Quite impressed with your approach to investing where you look at growth and value both. My questions are:

1) How does a retail investor conduct the kinds of research you do in terms of talking to management, suppliers, competitors etc.?

2) If you have a business that historically generated high returns on invested capital and is available for a reasonable or cheap price, but the management has made some expensive acquisitions in the recent past and its re-investment efforts have either failed to produce results or the management appears clueless about this, would you pass on such a company? What would you recommend to management of such a company? Buy back shares like crazy? Pay out 75% of FCF in the form of cash dividends? I am sure you can guess many names that fit this description.

3) What kind of moat, pricing power, competitive edge do you see in the discount retailers in your portfolios like Ross Stores Inc. ([ROST](#)), TJX Companies ([TJX](#)) and Aeropostale ([ARO](#))?

4) Coming to American Tower, which has been a multi-bagger for you, does valuation come into the picture in terms of selling... or as long as you see the growth and re-investment

opportunities, you are a patient share holder?

5) Why did you sell Ensco Plc. ([ESV](#))?

[Akre] Question one. It may be a little more difficult for an ordinary investor to get access to all the things you mention, but the financial filings are always going to get you most of the way home. You also certainly have the opportunity to check with suppliers, etc., just as a so called professional would.

Second question. We are always trying to understand how the management thinks about the reinvestment issue. We will make observations, and occasionally unsolicited suggestions. But human behavior comes into play, and if they just don't "get it" we move on, or reclassify the opportunity.

Third question. The moat for the discount retailers you mention is shallow and narrow, and in our mind consists of a rock-solid balance sheet, and a well-developed merchandising skill.

Fourth question. See Q #13 above.

16. Can you tell us how you get comfortable with Lamar's huge indebtedness of 5x Debt/EBITDA? As management is reviving back its capex to 100 million, it seems unlikely that paying down debt is a high priority going forward.

The long-term opportunity from digital billboards is huge — only 1,200 off the 146,000 billboards are digital today. Lamar can easily get to 5% or 7,300 of these boards being digital over the next few years. That is about 6x. The economics of digital are amazing with about 10x higher revenue, break-even in less than a year, and very high incremental EBITDA margin relative to traditional billboards. So, when the local advertising markets recover, they will be ready. My question is — is this similar to your take on Lamar? And if so, what is Mr. Market missing here?

[Akre] Re LAMR. The business can easily support a leveraged balance sheet. The management has in

the past chosen to leverage up the business through a share buyback and a special dividend. In hindsight, it was a poor decision, as they nearly broke a bank covenant in 2008, and the refinancing to remedy was (is) very costly. But the facts remain that it is a wide moat business; advertising spending in the US is growing again (albeit better in the national than local markets), the digital opportunity is very attractive, and the shares are modestly valued by the market. I suspect that the market is reacting to two things at least. One, that the management has a spotty record on reinvestment, and two, that the “local” market is lagging the national ad market in recovery. Also see answer #1.



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