The Opportunities in Value Investing – With David Einhorn, Founder & President of Greenlight Capital

Simon Brewer

Oscar Wilde defined a cynic as somebody who knew the price of everything and the value of nothing. And I wonder in the tsunami of passive investing, whether in fact, it's created a feast for the diligent value hunters.

David Einhorn

A feast or a famine? I don't know. But that's actually a really good quote because I don't think it describes the value investors, but I think it describes the vast majority of market participants. First of all, thank you guys for having me. I was flattered to get the invitation and I was a little startled to realise that there's still value investors left. This is really, really wonderful. I was glad we're not at the Natural History Museum or something with the dinosaurs. I've made the comment before that the value investing industry has had irreparable damage is unlikely to recover in a material way. But the corollary of that is that value investing for those that remain, I think is an extraordinarily exciting time. The key is to recognise how the landscape has changed and not continue trying to do things the old way that aren't going to work in the current market structure but are much more likely to work that are opportunities that are created from I would call it the defects and the opportunities that are created by the new market structure. Let me explain the way that I would tend to have looked at things a long time ago, which is our business was buy things that are sort of cheap, figure out that they're going to be a bit better or maybe quite a bit better than the world generally understands, often purchasing at times of dislocation, like around when a spin-off happens or when there's extraordinarily bad news relating to a particular company and people are being emotional and selling, figure out that things either aren't that bad or they're a little bit better, and then patiently wait for three months to go by, six months to go by, the world to see that it's not quite as bad as you thought, and have the traditional long-only retirement funds, the big mutual fund complexes and whatnot, come in and buy the stocks. And they were so big in the market. Those were the dominant forces in the market, that once they started buying, it was going to take them six months, nine months, a year to accumulate their position and you could just ride that flow the whole time. So the very simple is if you think it's $10 and the world thinks it's going to earn a buck, and you think it's going to earn $1.15, we were never really in the beat-it-by-a-penny business, but beat it by 15% is pretty good. And then you wait forward a year and they've made $1.15 instead of a buck and now it looks like they'll earn $1.35 the following year, and you get a 13 multiple on the dollar 35 and you paid a 10 multiple on the 10, you've just made 60%, 70% over 12 to 18 months

as that's played its way through really was what our business was. But the problem is that those buyers aren't there anymore. They don't have new money. They don't have daily flows. They've been turned passive. The fees that they have for their active business had been cut dramatically. So they've cut their research staffs, they have to sell something to buy something. They're not looking for that new opportunity the way that they had when they were getting constant positive flows. So if you play out that same story and it's supposed to earn $1, and it turns out to earn $1.15, and you think now it's going to earn $1.35, maybe the stock is going to be 11 at the end of that 18 months and you'll have made 6% on your money, which beats losing and it's better than cash and so forth. But it's not really the exciting result that you were able to get a year and a half ago. So what's changed? What do you do if you're not going to be able to do that? And so I would caution people not to continue doing that because those subsequent buyers, they're just not there and they're not there with capital. The capital that's trading in the markets are passive flows, there are index flows, there are ETF flows, there are sector rotations, there's correlation trades with there's times when the machines are going to want to buy a particular sector or an industry and one day the financials are up and the next day the oil companies are up and so on and so forth. This is where the actual trading in the market is. In addition, all the algorithms which are just trying to figure out what everybody else is doing and how their positioned and try to trade at one nanosecond before you and be right 56% of the time and never have a down day. That's what the market now consists of. Those big, long-only behemoths, they don't have the footprint in the market that they did.

David Einhorn

So what does that leave for us and how have we adjusted our strategy, which is we're not doing what we were doing anymore. What we're doing now is we're saying what do we have to do to make a good return if a tree falls in a forest and nobody is there to hear it? What happens if there aren't other investors who are going to bid up the stocks and figure out what we have figured out after we've figured it out? Because that's what we used to do. And so what you need is companies that are earning. The result of this, though, is that you have this enormously bifurcated market, where there's this wasteland of companies where literally nobody's paying attention and nobody's following, and maybe there are sell-side analysts, but sell-side analysts don't matter. They don't have any money. They don't have any customers. And the fact that they don't have any customers with any money is the important thing. It doesn't matter if there's 10 analysts recommending a stock if they don't have any customers that are going to follow the recommendations. The point is there's no buyers. And so you can have these companies that are essentially at a wasteland valuation, you have a bifurcation. Index investing, by definition, overweights whatever is most overvalued, underweights whatever is most undervalued. Money coming out of active put into passive is two trades. It means that there's a sell of the undervalued things

and a buy of the overvalued things and you have a divergence from fair value as opposed to a convergence to fair value. And then people do this for a while and then they realize, look at that, the index already was overweight the things that did better, so let's get more money in the index and let's have more redemptions from active managers. And then at the very end of the cycle, they say, who was the active manager that already owned all the overvalued things because that went up the most? That's your performer. And then you redeem from the value people and put it into the innovation people or something like this. So you saw how that all ended, and that's all played itself out. The good news is, I think that most of the active managers who are going to be fired have been fired. Those switches have happened. All of those active equities mandates have converted to passive. I don't see the negative half of that trade continuing, but you have these washed-out securities. And if they're trading now instead of buying it at 10 times earnings because you think that they're going to be, you can buy that same type of situation at four times earnings or five times earnings, and then you may not know whether it's going to be. If you're wrong by 10%, a 5 multiple becomes 5.5. There's nobody who cares anyway. Nobody's going to sell because they missed by 10%. So you don't really have to get your forecast right. You need to just start at such a low value. And if you do it in unlevered companies that are taking the vast majority of that earnings yield and giving it to you in dividends or buybacks, this has to work itself out over time in a favourable way. If you are buying back 15% of your company, the stock goes up or in six and a half years, there's no stock left. The last share is the golden share, and that's what we want to own.

Simon Brewer

So you said, and I wrote it down, that you have built a portfolio of companies that are so cheap and so unloved it will be difficult to lose. And you've done this for a while. So we’ve seen market cycles, headline valuations in the US are still very high, and yet we've had a bear market in a whole raft of the market. So how excited are you relative to the periods in which you've invested?

David Einhorn

It's very exciting because you don't get these valuations except at the bottom of bear markets or in the middle of recessions. And when that happens, you have different alternatives that make you decide you don't want to buy these things at these prices anyway, because the stock might be down 80% because there's some collapse and you're wondering if the world is coming to an end. And you look at the bonds and the bonds are trading at 55 cents, why buy the stock? You can just buy the bonds, and you'll make a nice teens return and all you have to get is solvency. You're probably not going to lose another. If it's down 80%, it can go down 90%. You can lose 50% really quickly. Those bonds trading at 55, if you're remotely right, are going to be a good investment. So you have

that alternative. You don't really have that right now. These businesses are not collapsing. The economy is not collapsing. You do not have the distress cycle in corporate credit the way that you would normally do when you're looking at companies that are performing reasonably well at three, four, five, six times earnings. And so I find this to be a very exciting time.

Simon Brewer

Could we just touch on the short side? You and I have something in common, which is we both shorted Tesla and both had to retreat. I think that's fair to say. What have you learned about the world of shorting which has forced a lot of people simply to give up as well?

David Einhorn

Everybody said to give up shorting in early 2021. You had the meme craze and nobody wanted to be short, because we hit the peak. All people were doing was looking to see well, what are people shorting just by that. You had things that were obviously in the headlines of the newspapers, but you also had lots of things where there were just a bunch of people short that went up 20% or 30% or 40%. It didn't make it into the newspaper the same way and people were just hunting for short interest. So look, we've reacted to that. That was our worst month ever shorting and we didn't have the headline ones. When the right tail is different, it used to be the worst thing that happened with short as the company gets bought out and you lose 30%, but then you're done losing at least. And here, you can lose lots more really quickly and you don't have time to adjust and think it through. So you have to take smaller positions or avoid those types of situations in the first place. Essentially, that's what we've done. We've also made it a little harder for people to figure out what we're shorting because sometimes it feels like they're looking for you. And so we've stopped talking about what names were short. Last year, I thought was a great environment for shorting. I don't think this year is as good. We've taken down our short book considerably in the first part of this year.

Simon Brewer

So you used almost a T.S. Eliot quotation when you talked about the wasteland of companies. Can you just give us a sense of has that been a shift to lower market cap or is there no specific way you're finding it?

David Einhorn

These things tend to be under 5 billion, but they're not micro caps. You can buy them in decent size. Many of them actually have reasonable trading liquidity because there's ETFs algorithms and other things whipping these

stocks around a fair amount. We've got a whole portfolio of things that are mid-single digit type PEs with double-digit capital returns, which is really a nice dynamic, and very little if any financial debt. So we're not looking at companies that are going to blow up.

Simon Brewer

If the active management community has withered, the private equity community which has been the destination of capital is also, and we sit here in the UK, looking at some of those very companies. Would you expect therefore your competition or your buyers of names in your portfolios might increasingly be those agents?

David Einhorn

It could easily turn out that way. Last year, we had one stock called Atlas Air which we owned, and it was really frustrating because it was trading at three times earnings and 55% of book value and they seemed to be doing great and creating a lot of cash and beginning to buy back stock. A private equity firm came in and from the time they began their discussions to when they brought it, private was about at 85% or 90% increase in the value and they bought it therefore it six times earnings and a little bit less than book value. That's a really, really good price for them. In a different environment, I would look at something like that and go look at all that return that they're stealing from us because this thing's clearly worth another 40% at least. In the current environment, I'm real happy. You take that premium, we had a nice day in our fund, you redeploy it. There's plenty of other things that look very much like the thing that they didn't buy. And so it's not such a big deal if they want to come and do that, particularly if they pay a nice premium.

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