January 25, 2017 ~ Josh Tarasoff, General Partner, Greenlea Lane Capital Partners, LP

Ben Graham Centre (BG): Can you tell us about your background and how you became a value investor?

Josh Tarasoff (JT): I founded this fund called Greenlea Lane Capital. First, I'll go back to my first job out of college. I was at a Wall Street investment bank. I kind of ended up there by default as I didn't know what I wanted to do with my life. I learnt the basics: finance, accounting, and excel there, but what we did didn't intellectually resonate with me, so I left after a couple of years. Then I started reading about investment approaches. When I read about value investing, it was kind of enlightening, because I have seen capital markets enclosed in my job, but I did not really have a sound intellectual framework of thinking about what was going on. When I read about value investing -- that decisions to invest in companies can be based on a real analysis and judgment, I was hooked immediately like so many people are. It's been most of what I thought about ever since. I decided to do it as a living, although I didn't have a clear idea of how. So, I decided that going to Columbia Business School would be a good idea as they have this program. I live in New York, and it is very lucky to know people who get in and do the value investing program there. Sometime in my second year at Columbia, I became convinced that there were compelling reasons to try to do it on my own, which were that a lot of the investment operations that exist in the world are compromised by concerns about asset gathering, essentially earning fees. If you can be not so focused on that, you have huge advantages as an investor. The second take is that there would be a huge advantage to tailor my investment approach to my own idiosyncrasies, interests, strengths and weaknesses. So, I just wanted to try to do it as soon as possible. I started out in 2007 with $2 million of capital from myself, friends and family. That's how it started.

BG: You started in 2007, then you had the great recession in 2008. What are the things you did to keep yourself on track and make yourself so successful?

JT: It happened right away after I started. The main question I asked myself before I started was, "would you be comfortable being down 50%?", because if you're going to follow the strategy that you intend to follow, which is long only a handful of stocks, then the likelihood is you'll be down by a lot multiple times in your career. You have to be comfortable with that. And I guess there's something about my temperament that makes that not really bother me. Of course I didn't know that (when the crisis would come) for sure, but then it happened right away. In retrospect, that was the best time for it to happen because I only had a few partners. You learn so much from an experience like that, so it's good to have it early. You get that insight and understanding and it compounds over time. We were actually down almost 50%, 51.8% in fact, and I think in retrospect, there are certain investments that I should have been more concerned about because their businesses were affected more by what was happening with the economy that I appreciated at the time.

What we did was we were fully invested, and I was heavily gravitated at that time towards small-cap and micro-cap companies. I thought the inefficiency there were much more prevalent than in larger companies. And I actually had this belief that really great, big companies don't get cheap enough for me to want to buy them – that just will never happen in my career. Then, it started to happen. They were right there in front of me. And we bought Starbucks and Ebay in the midst of financial crisis. They were upgrading the quality of the portfolio. That's basically the only reaction in mind – to upgrade the quality of the portfolio when these opportunities were presenting themselves. I don't think that experience fundamentally changed the way I did things. The way I've done things has changed, but I don't think that's because of the crisis. I *do* think that it hammered home some lessons and disciplines that you want every single investment to be able to weather any conceivable and reasonably possible set of circumstances that aren't being controlled by the companies – any interest rate environment, any economic environment, any financial market dislocation. We haven't been tested since then, so we'll be interested to see next time.

BG: You mentioned that the way you've done things has changed, and on your website, you say "my goal is not merely to do well enough, but to live up to my full potential as an investor for the benefit of Greenlea Lane". So, what are the most helpful experience you have been through over the past few years, and what advice would you give to people who want to be value investors?

JT: First, let me try to explain how I've evolved, and then the second I'll try to tackle the question of advice, which is so hard. For the first 5 years, 2007-2012, I really view them as my building years, during which I was finding myself as an investor. It'd be accurate to describe my strategy on day one as "focusing exclusively on high-quality companies". Basically what everybody thinks of as high-quality companies: defensible business model, sustainable competitive advantages, high returns on capital and reasonable capital allocation. It's just what everybody would say it's a good business. And I wanted to buy them cheap. That's a reasonable strategy. The thing is, there're so many ways to actually pursue that strategy, and I just didn't have a specific idea of what I wanted to be doing. I would buy companies that were compounders that could invest capital and you could own for a long time and make really great returns over a long period of time. And I would also be willing to buy more mature companies that weren't good in every way, so some didn't have that reinvestment opportunity and so they weren't compounding their own intrinsic value at a very high rate. Over time, what I found was that I really like the compounders more. I was more interested in researching them. And I don't like buying and selling. I found it a high maintenance proposition to have these mature companies that you bought at a multiple that you thought was low, and then you planned to sell them for a multiple that you thought was fair.

Let's say you're buying a good company at 11x free cash flow and you thought it should trade for 16x free cash flow. And, what happened is that you would buy it, and then it would go to 13x. So now, it's a little cheap but not very cheap, and you have to determine how big this position should be, the returns aren't that great, and what if it goes out of favor again. But, if you have these companies that are intrinsically compounding at 15-20% or more, you don't really have to worry about those because you just look out to 5 years or 10 years from now and it will just be worth so much more. For me, it's such a better way to do things. And it is more tax-efficient too. So, by 2012, I really realized that I wanted to do compounders. So that's the first big evolution. It's not certainly the best way to do things, it's just the way that works for me. The second is that I started to define my circle of competence in terms of business models. Instead of looking at every new idea and saying "is it in my circle of competence?", I had a pre-conceived notion of what my circle competence entails in terms of business models. I won't go outside there. Now I'm trying to expand my circle of competence and add new business models, but that's a separate matter.

So, those are the 2 big shifts. By 2012, those things really crystalized, and I really was doing that. When you're more focused and you're doing something that really works for you much better, your potency goes up. The amount of learning, the amount of ground that you can cover, and the efficiency that you can sit through ideas, are just so much higher. So, I think that's something every investor needs to come through in order to be the best investor they can be. It's really just a process of maturing and finding out who you are. It's critically important.

BG: What was it in your mind that told you "in 2012, that's when I hit my stride"? Is there something specific that happened in that year?

JT: I just think that that's when it happened, and that's when I realized it. And I had myself write it in my letter. I think that over time, it's become clearer and clearer how important that step was.

BG: You mentioned that when you started off, you asked your friends and family for their participation in your partnership. How did you convince them and make sure they take a long-term view as you did, and what is the advice you can give to those who have a plan to start up their own value investing business?

JT: In my case, I have 2 kinds of investors. There's a spectrum between people who are just investing with you because they respect you, trust you, and believe you can do a good job, and people who are sophisticated investors who are professionally finding the best managers they can find. I have both, so the reasons they invest with me are different. There are good things and bad things about each. When I began, it was just the first kind, which is my friends and my family. One rule I have with this group is I am always repeating to them: "this is very volatile, and this is probably going to be more volatile than the stock market, and we can be down 50% tomorrow”. That would actually turn away people who are not comfortable with that. Another thing I do with the friends and family campus is that I don’t let them invest more than 20% of their money. Ideally, it’d be much less than that. That’s a good rule because it helps them stay less emotional.

The only thing I would say is that I don’t actually think that convincing people is what you should be trying to do. I think you should be trying to find people who are like-minded. In the beginning, I felt that way too, and thought I should try to get people invested in my fund, but I don’t think that’s what you should try to do. I think you should try to find people who *should* invest in your fund. So, that’s what I’m trying to do now.

BG: In what way does your investment strategy differ from the majority of the value investing community?

JT: I’d say there’re 3 ways. The first way is that in very common value investing culture, value investors tend to be comfortable with betting on consistency, and uncomfortable with betting on change. The classic Buffet thing is: are people going to buy this product 50 years from now? Is it durable? Are people still going to drink soda, and will Coca Cola have the biggest market share? Is Geico still going to have the lowest cost? And, to bet on change is more of the growthy temptation that if you do it, you’re undisciplined, imprudent and risky. What I believe is that, certain changes can be as certain and predictable as certain constancy. It just depends on the situation. For example, in my portfolio, I think more shopping being done online overtime is as certain as many constancies that I’d be willing to bet on, like consumer brands. I think that, traditional on-premise IT moving to the cloud is certain as one needs it to be. I think that more people having pet medical insurance is as certain as one needs it to be to prudently invest in it. There are certain patterns and frameworks that when there’s a way of doing something that’s both better and cheaper simultaneously, it will happen. Online retail is that, cloud computing is that, and probably electric vehicles are that. That’s one thing.

The other one is that when there’s a new way of doing something where if you do it that way instead of the old way, it’s a win-win for every party involved and no one loses, then that’s certain to happen too. I think pet medical insurance is an example of that, where if the pet owners can’t afford to pay $5,000 to save the pet’s life, then paying $40 a month premium in order to be able to save the pet’s life benefits the pet, the pet owner, and the veterinarian who gets to do the highest-level procedure to make more money. It’s truly a win-win. Even in cloud computing, there’re losers, who are the incumbents. And there are losers in online retail, who are the incumbents. There’s literally no loser in pet medical insurance. So, there are certain situations where change is inevitable, so I’d love to invest in that. It’s a little bit different than the normal value investing mentality.

The second thing is that, most of the time, the companies that I invest in are not statistically cheap by normal rules of thumb for what statistically cheapness is. We have these rules of thumb that say 15x is a middling multiple, 10x is getting cheap, single-digit is really cheap, 20x is not cheap, and over 20x is really expensive. We have these rules of thumb for a good reason which is, on average, right. The market as a whole is an average of all businesses. If all of the companies in the market are homogeneous with respect to their future earnings growth and returns on capital, then you can apply these rules of thumb to every single company. But, in realty, companies are so ridiculously different from one and other. What I'm looking for is the outliers in the 99.9 percentile of great companies, and what is cheap for those companies is so far from these rules of thumb. I invested in Amazon in 2011, and it was trading at 200x P/E, but actually the multiple of what I thought was normalized sustainable free cash flow is in the 30-40x range. And I thought that was cheap! That's very different from what most value investors do. This might not be accepted by many people. I've had phone calls with prospective investors where I actually would explain the Amazon thesis and I would say "I think it was at 30-40x free cash flow when we bought it", and the other guy was like "13-14?". And then I said "no, no, 30-40". And then it'd be a weird pause, and I knew that the conversation was over. There's a lesson in that we are getting back to one of the things I said about the advantage of not telling your investment strategy to something that you can sell to other people. I think that most people, whether they admit or not, or whether they know it consciously or not, are making compromises on what they do to make what they do salable. Whenever you do that, you're trying to appeal to the lowest common denominator to the prospective investors, and by definition, you're becoming a consensus investor. You can't do that and expect to have good results. I think that there's almost literally a direct conflict between salable as an investor and being good as an investor. That's what it is.

The third thing is I think there's another common belief within the value investing community that things may get cheap temporarily but then in the few years they become fairly valued and they need to be sold. And holding things that are fairly valued is not being a value investor. And there's this presumption that every investment thesis will play out over 2, 3, 4, or 5 years. I think that's usually the case, but not always the case. And the difference between "usually" and "always" is like night and day, just like it is within the efficiency market theory. The difference between "always efficient" and "usually efficient" is night and day, and it's the same thing with this. Sometimes there are some companies that are systemically undervalued for decades. You can look and see what they are. Just look at Walmart, Berkshire Hathaway, Amazon, Netflix, a lot of these really amazing compounders. You could have purchased for excess returns 90% of the time in the past 20, 30, 40 years. Buffett didn't stop getting excess returns at his Berkshire Hathaway 40 years ago when people figured out that he was really good. He still is getting excess returns. That's just a weird thing. So, what are the reasons for that? I think the reasons for that is: number 1, the most exceptional compounders are by definition doing something idiosyncratic and weird, and people are fundamentally not super comfortable with that; number 2 is that, they usually look statistically not cheap. A lot of times it's because people do give it some sort of premium because they understand that it's good in some way, but sometimes it's because the economics of the business are represented by GAAP differently than the conventional businesses. It's true for Berkshire Hathaway and a company in my portfolio called Markel because they generate a lot of value by having unrealized gains in their stock portfolio which don't flow through the earnings. For Markel, one-third of its value creation over time has been unrealized gains in its investment portfolio, and that has never shown up in earnings or ROE. If you just look at the accounting or its ROE, you would have ignored it because you have ignored one-third of its earnings power. Or with Amazon, which has businesses that are more mature and profitable, and businesses that are losing money. You don't see the breakdown because they don't want their competitors to know what they're doing. So, it looks like they're not making money when they are. They're just re-investing. So, often the financials of these companies look strange, and the valuations just don't look statistically cheap; number 3, what's special about these companies is the long-term excess returns. It's the returns that you'll get from owning them for 5 years, 10 years, or 20 years, which are irrelevant to most market participants who care only about a shorter period of time. So, there are really obvious reasons why these companies can be systematically undervalued. My approach is to have a permanent attitude towards all of our investments.

BG: You mentioned earlier the importance of the culture of companies. How do you go about dissecting and really understanding the culture of a company?

JT: The most useful thing I can say on this subject is that in general understanding the culture of a company is really hard, but sometimes it's not. I do the ones where it's not. The patterns that I have noticed is that, I have 11 companies, 9 of them are founder-led, and the other 2 are basically founder-led with the CEO being there for 20 years and is fully married to the company. These have founders who are really the person behind the company. That's not an explicit criterion. It's just how it's worked out. In terms of tangible steps, I read everything, I talk to former employees, I try to make as much as contact with the manager and the company as I possibly can, and sometimes it seems obvious to me that it's an extraordinary culture. The hardest thing for me and the places where I've made the most mistakes is where it's a border-line case that it looks like a good culture but I didn't have high conviction about whether it's really up to the bar that I want. I would spend too much time on it, or I would buy it and then later I thought I was really just compromising there and I would sell it. These're the hardest things, the border-line ones. So, in terms of what you look for, there're things that companies can do that just show their mission-driven nature. They would be things like improving their customer value proposition without needing to because of competitive pressures. They just do it because they want to. It'd be things like turning away opportunities to make money in order to preserve some disciplines or quality that they think have longer-term value. It'd be things like making investments in the businesses that look bad on the paper but are good for the whole business. And also, high insider ownership, things like that. In reality, what you need to assess can vary very dramatically from case to case. For example, I think Berkshire Hathaway is great and fits my bar, but I've never met Buffett or any other Berkshire employees in any meaningful way. But, it's just that there's enough of track record and they talk about the important things they have done for decades, which is obvious. And it's same with Amazon. I've talked to investor relations and employees, which is not really necessary. Amazon is just good enough. With Trupanion, the pet insurance company, it just hit IPO in 2014, and I needed to get to know the management a little and speak with former employees and to do a lot of work in order to make a judgment. It's hard to say anything more specific and systematic than that.

BG: Some people don't recommend talking to management because they're top sales people and they can sell the company well to you. How do you stay objective while you do these fact-finding missions?

JT: I think it's really true that there are good things and bad things about developing relationships with management. For my kind of investing, what you get by doing that is so important that I have to deal with the bad stuff, which is the biases that I can form. I've built in certain things in my process that try to counter that, but there's no silver bullet – it's still a problem. I think that if you're doing the kind of investing that's more opportunistic and shorter-term, there's a stronger argument for not interacting with management because it just doesn't matter that much. If all that you care about is that the company earns this much within the next 3 years, then that's different from "are they going to be this great company 10 years from now?". The kind of information you need is just different.

BG: Sometimes you share publicly your investment theses. Would you be afraid that it'd make you biased? For example, if you publicly support an idea, then you find that you're wrong, wouldn't it be much harder for you to sell?

JT: Yes, very true. I've stopped doing these presentations, and I started to say no to almost all interviews a few years ago. Not that there're a lot of requests, but it's just something that I've started to think differently about. One of the main reasons for that is commitment bias, and it's a big problem. So, I don't like to talk about ideas anymore. In the same way that talking to management has good things and bad things, talking about your ideas has good things and bad things, so I do talk about some of them, it's just I'm much more careful about it and I usually wait a long time after I've owned it. I try to wait longer. I think for a lot of people, they'd talk about their most recent idea, because you are always most excited about your most recent idea, which is a huge bias, by the way. It causes a lot of portfolio turnover. One of the biggest factors in how excited and enthusiastic you are about an idea is just how recent this idea is. That doesn't correlate with how good an idea is. There's no logical reason for it to be the case. So, I worry a lot about commitment bias now.

BG: Do you have a group of other investors that you go and share ideas with?

JT: Yes, there are a few people. Over time, I've narrowed the group down just because there're only a few people I think are really like-minded to what I'm trying to do – it's basically buying these companies at high multiples and holding them forever. Not many people want to do that. I found that it's really unproductive to talk to people who don't have a very like-minded approach. I used to do it all the time. I'd just talk to all my friends at business school about ideas, and it didn't make sense. It took me a while to realize that.

BG: What advice would you give students and new value investors, say when looking at a company's 10-K or annual report?

JT: I think digesting all of the information you can get your hands on is important, and that of course includes the financials. Different investment approaches will put emphasis on different things. For example, cigar butt investors will care a lot about the balance sheet. The balance sheet is still important to me, but it's just a piece of the puzzle. I place a lot of emphasis on qualitative and dynamic factors, so the point-in-time nature of a balance sheet will miss a lot of what I am looking for. In fact, the financials alone don't capture the essence of what I am looking for. Shareholder letters from the CEO are hugely important to me. So it's hard to give general advice about what to pay attention to, except to say devour everything and then focus on what's most important to you.

BG: Fellow value investor Guy Spier spoke to us last year, and he talked about constantly finding new ways to overcome human limitations. What are some strategies you employ to counter your own weaknesses and biases?

JT: There're 2 main tools. For the longest time, I felt like I was trying to overcome challenges and biases by engineering this process that would counteract. For example, I'd look at a company 90% of the way there. When you go through a process and you find 90% of what you're looking for, you're probably going to get very enthusiastic about it. Then, I'd just compromise and I'd want to buy. Then, later after the emotional momentum was off, I'd come to my sense and say "this is really a compromise and I don't want this", and I'd sell. So, I built into my process a phase where after I finish my work, I don't make a decision and I don't think about this company for a certain amount of time. It actually has another advantage as a by-product, which is that when you don't think about something and your mind works on it subconsciously and you come up with things you wouldn't come up with if you were consciously thinking about it. It's such a weird thing. It also lets your excitement wear off. This is just an example. Eventually, I realized that the process is super important, but it's not enough. Developing self-awareness and the willingness to change and to admit your weaknesses to yourself is also really important. So, I try to practice mindfulness and do meditation. It's about understanding what's going on with yourself. It's like enabling yourself to be your own coach. The other super important thing would be having mentors.

BG: Can you tell us one investment mistake, maybe not the biggest one, but the one that changed your process?

The worst investment mistake I've ever made analytically and in terms of losing capital, was this company called Ambassador Group. It's a company that used to do student travels. They provided high-end programs where middle school students would travel to a foreign country and have enriching activities and meet with members of that country's government. It has a long history which is established by Dwight Eisenhower, and this has been going for decades. It's a ridiculously profitable business as they make 40% gross margin and 20% operating margin, and there's no tangible capital. You pay for the trip in advance so there's negative working capital. They've been raising prices at double-digits annually in the past few years. It's a great thing. It had this amazing record for 10 years up to 2007. And then, they had this bad news that the enrollment was down after being up 10-20% for 10 years. So, I did my analysis in typical value investing fashion and asked "is it temporary or permanent?". Next, basically the business crashed from 2007 until last year, and then they just shut it down. It's the worst possible analytical mistake – you think it's the best business in the world, and it ended up that they liquidated it. That's how bad it was. It was at $40, and after the enrollment went negative unexpectedly, it went down to $20 in a single day. I bought it for something around $19, and essentially 4 years later I sold it for something around $11. They liquidated for less than $3 another 4 years later. The thing that I learnt from that is sometimes the way something looks on paper is the opposite. And the way that manifests itself in my investing now is some companies look like they have really bad numbers but they're really amazing, like Amazon or something like that. The second one is that I have to be more careful about my circle of competence. The way that this company and its basic model for growing and winning customers is something that I didn't have a deep fundamental understanding of. Now, I'm very explicit and careful about the business models that I invest in. Even until now, I don't have a good understanding of why this company ended up not being viable anymore.

BG: A common trait for value investors is that they tend to locate themselves as far away from Wall Street and all the noises as possible. Do you find any benefit in operating in New York, and how are you able to not let these noises affect you?

JT: In the first 7 years of my partnership, I lived in Queens, which is a very different environment. There's no office buildings, no taxi cabs, those sorts of things. It's very different, and that's very helpful. Now I've moved to Manhattan, and I honestly don't know if it'll be better to live elsewhere. It's easy to put too much emphasis on these tools that you use outside of yourself, like your process and your environment. If you just force yourself to deal with your biases and emotions directly, it’s very powerful. It might be better to move elsewhere, but I really am not sure about my case. One thing is that I don’t have an office, and I work from home most of the time. I think that helps a lot and filters out the noises.

BG: What is the most important thing that you have learnt in life and investing?

JT: I’ve come to think about investing and everything in life as a matter of seeing reality as it is, undistorted by your own mind. That’s the challenge in investing – to see things as they are, undistorted by your own mind. We all live in our own personal echo chambers that are filled up with all these ideas and concerns. To the extent that you can quiet that down, and come to direct contact with the reality, you’ll be successful. That’s how I come to think about things. It’s probably completely inapplicable and impractical, but it’s nonetheless how I come to think about things.