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Ben Graham Centre for Value Investing

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Arnold Van Den Berg is the founder, Chief Executive Officer and Co-Chief Investment Officer of Century Management. Arnold spoke with the editors of the Ben Graham Centre's Newsletter about founding Century Management, his perspectives on the current economic environment, and finding purpose in life.

Can you share with us your story of becoming a value investor?

I first started working with no formal education, which put me way behind others who were also getting started. I started by selling mutual funds through the 1968 to 1974 bear market. The expertise was left to the mutual fund portfolio managers, I was just a salesman. I did not know much about the market, and if I had, I would not have entered it at the top of the cycle. But I did enter it, and I rode that market all the way down to the bottom through the six-year downturn. It was agonizing.

Through the downturn, I questioned the portfolio managers of the mutual funds on their decisions. As time went on, I noticed that some funds were outperforming the market. A common trait across these funds was that the managers were Benjamin Graham enthusiasts and followed his value investing philosophy. In the middle of the market downturn, I found a philosophy that I could live with: the value investing school of thought. While I studied Benjamin Graham, the market was at historical lows; it was selling at five to seven times earnings with a seven percent yield. From history I knew that these lows were only last seen during the Great Depression. Three months before the bottom of the market downturn, in September of 1974, I decided to start Century Management. At Century I could finally apply the techniques that I learned from studying the outperforming fund managers, and Benjamin Graham's teachings.

Can you elaborate on your switch from selling mutual funds to value investing?

It was a big switch. I had six years to think about it, six years quite frankly, of suffering. Once I realized how cheap the market was, I knew it was literally a once in a lifetime opportunity; there only was one other time when stocks were as cheap, at the bottom of 1974 and in 1929. It felt to me like I was starting the business at the bottom of 1929. I remember telling my wife; we're either going to make a lot of money for our clients, or the world is going to end.

> “In the middle of the market downturn, I found a philosophy that I could live with: the value investing school of thought”

The decline was so bad that it really sounded like the world was going to end. But you know what happens; people end and the world keeps moving. I knew from studying market history and Graham that we were at, or close to, a bottom. Because of this I started Century Management in September of 1974 and the market hit its bottom in December that year. If you start a business three months from the bottom, you don't have to be that good of a stock picker; stocks are so cheap that they just go up. In that situation, you think you know what you are doing, but it takes time and a bullish market to confirm your hunch.

When I started, I didn't have many clients. There were many years of struggling to pay the bills and keep going. But at least I knew that I had started at a good time and that I had good discipline. I studied religiously, at least three hours every night. I would make goals to finish books by a certain date. Most importantly, I set goals. That's what started everything.

What are the most important lessons for value investors that are not taught in schools? What were your greatest sources of learning?

One of my most important early lessons was from private market valuations. Somewhere at the bottom of the market one of my companies was bought out at a huge premium. The average acquisition multiple at that time, which was the bottom, was around 13.6x (P/E). Usually at the top of the markets, the acquisition P/E multiple is around 22 to 24x. But companies were trading around 5 to 6x. When a company was bought in these markets, investors would get a premium of 50% to 75%. This delighted me, but I didn't understand why companies would pay such premiums when buyers could purchase their outstanding shares in the public markets. Through interviews and research, I learned about private market value. Companies that have had recent exposure to the private markets face certain restrictions and so forth. I ultimately used this private market value theory in combination with the Benjamin Graham framework.

I studied every money manager that I could find. I kept files on them, their techniques, and their actions. I used this research, especially on Graham, to build formulas for myself which would help me decide what I would pay for stock. A lesson I strongly believe in is to develop a system that suits your values and to follow it.

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Investing is all a matter of experience. A good analogy to describe it is: if you don't know how to drive a car; you can go to a very prestigious school and learn all about the mechanics of the car. Until you get into a car, you'll never learn how to drive it. Once you've learned the basics of business, the only way you can get better at investing, is by practicing. Study great athletes, because great athletes develop disciplines and procedures and things that really help them stand out from the crowd. I learned the great lessons of hard work and discipline as an athlete when I was in high-school.

A great way to learn how to invest is to invest a small sum of money in many different stocks. By doing this, you can start to learn about different industries and businesses. You don't have to put a lot of money in, today commissions are cheap. Buy different stocks, write down your reasons for buying them and what you are expecting from them.

In the past, you have attributed your speed of learning about investing to your ability to focus. How did you find the drive to focus so intensely?

I was never a quick learner, in fact, I never did well in school. There were problems in my youth, and I had a lot of trouble learning. What I could do to make up for this was to focus as best I could.

My mom and dad were both in concentration camps. One winter, my dad was in a death march, and weighed only 85 pounds. He was only one inch shorter than me and I weigh about 152 pounds. The march took place in subzero temperatures and there was snow halfway up the knee. The prisoners had to march 24 hours with no breaks, and limited food. Most importantly, they had to march consistently. If a prisoner's knee touched the snow, the soldiers would beat and shoot them. Prisoners needed immense motivation to focus on their legs. I remember my dad saying: "The most important thing was to focus on moving my leg, and I made sure that I locked it because snow was slippery, and I didn't want to slip and fall. So, I would lock my knee, and concentrate on putting my leg down. And the more I concentrated, the more I realized something strange about the human mind. When the mind focuses, it really focuses. I wasn't thinking about anything; how cold I was, how hungry I was, how angry I was, how far I had to go. I could only think about moving my legs. When you focus that much, the mind creates its own energy. The mind creates a special power."

> "Once you learn to focus, you can accomplish things you wouldn't imagine. Focus is the key"

Focus was an important lesson for me from a very young age. I relied on focus when I became a high-school athlete. Because I grew up in an orphanage, where there was a lot of malnutrition, I could barely walk at the age of 6 or 7. In high-school, I was still pretty weak. In becoming an athlete, I had to develop strength. I overcame my physical weakness through complete concentration on my event. Once you learn to focus, you can accomplish things you wouldn't imagine. Focus is the key.

In a world with an increasing amount of distractions, what advice do you have to students to stay focused?

That is a great question, especially for your generation. Everyone has about 15,000 to 50,000 thoughts per day. I recommend filling those thoughts with your goals, and it helps if you define your goals as early as you can.

I once met a girl who asked me to go on a date on a Wednesday night. I had a schedule, a self-study program. If I missed a day I would fall behind, so I postponed our date. In gest, she asked if I was studying to be a monk. The greater the focus, the more concentrated one's thoughts become. This makes it harder to fall for distractions. You must make your own set of rules and stick with them. I condensed my own set of rules into three things:

1. Never compromise your integrity or values
2. Never be satisfied in who you are but rather who you can become
3. Never give up

By following these principals narrowly, distractions became simple to solve: if they didn't fit in, they didn't deserve to be in my thoughts.

Century's coffee mugs are adorned with a quote from Prentice Mulford: "To no force in the universe belongs such power as that of minds united in one purpose" — a reflection of Century's company policy that all employees and principals invest alongside their clients. What effect has this created internally at Century?

All of our employees are invested in Century. This aligns their goals with the company and client's goals, rather than their own personal gain. We have a united vision that doing good for the clients and is rewarding for ourselves.

The past three decades have seen a significant shift in assets from active to passive investment strategies. How does the growth of passive investing affect active investment strategies if at all? What sort of implications does this trend have for the future of value investing?

The trend towards passive investing has been enormously successful and the performance of the index fund has outshone most value managers. It doesn't change our value-strategy. Our strategy is still to buy good companies at a discount and in areas that indexes might overlook. If I were to project the performance of the over the next 10 years for the S&P 500, I don't think it's going to be as strong as the last 10 years. I think the growth in passive investment has reached its peak recently or maybe even has a little more to grow. However, I predict that the trend will revert to active management in the next market downturn.

> "I wish I was starting all over again because right now, we're at the bottom of the cycle for value investors"

I think the next 10 to 15 years are going to be the golden years for value investors. I wish I was starting all over again because right now, we're at the bottom of the cycle for value investors. The first 10 years after I started Century in 1974 saw probably the best performance we ever had. Many clients came to us because of our performance during this period. I wasn't soliciting anyone; they found Century through referrals. Value funds will always outperform in these downturns. This isn't to say that passive investing will disappear; there's room for both investing styles in the market.

Given the state of the market cycle, have you found fewer well-priced opportunities in the past decade? Have you had to adjust your screening criteria or portfolio accordingly?

To be a value investor you must be willing to go against the crowd. You need strong discipline. Being a contrarian is uncomfortable, and very challenging. I had a very trying period right before the 1987 crash. I was selling stocks during the market upswing, and near the peak, roughly 50% of our funds were in cash. For reference, usually Century holds 15 to 20% of our funds in cash. Many clients were disappointed in this because the market was growing so quickly, and we weren't capturing the gains.

Even my greatest mentor told me that he went to a seminar on economics and thought that the market was going to double. He was subtly trying to shake me out of my decision to hold on to so much cash. I asked for and studied the documents that he shared from the seminar. I could easily find faults in the presenter's assumptions, which only strengthened my conviction. Still, I had a lingering fear that I could be the one at fault, that the market was only going to continue its run. At this point in my struggles, my principles reminded me to trust myself. These principles gave me immense peace.

Then one morning I walked into Century's offices and the market was down 23%.

The whole experience was very lonely, very painful. It was not pleasant at all, but it is the price you pay to stay true to yourself. At the end of the day, that is what is most important. Even if you're wrong, you're going to learn and be a better person for your mistakes.

What characteristics do you value the most in management of the companies you analyze? How do you assess them and measure these?

The hardest part of investing is assessing the performance of managers. This is something I have struggled with for many years and have developed a couple of guidelines to help with. For the most part, I assess managers on two pillars. The first pillar is their expertise, and the second is their character. Character is the most important, because without strong character, managers eventually burnout. Character can really only be analyzed by looking at the manager's lifestyle, and how they treat those around them. Without character, the manager and company cannot have sustainable performance.

Managers can most reliably be assessed if they have a long track record. A company that has had the same manager for 20 years has a lot more data points that you can use to judge their expertise and character. Using their timeline, you can assess the volatility in a company's management. A company with many scandals in this time will likely have a self-destructive management.

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This is a framework you can use to assess your friends as well. You should assess your friends, because you are shaped by people around you. So, if you decide to build your expertise and character, you should surround yourself with people who value the same things.

What is your approach to assessing business quality and competitive advantages, and is high quality necessary for you to invest?

Companies look very different to an investor when the business is 20 years old and 60 years old. Be aware of trends, because trends don't last. The hottest companies in one decade often don't look the same in the next two.

To avoid unsustainable businesses, ask yourself about the price you are paying. If a company checks all boxes, and they're selling at a huge premium to the market. How do you resist it? The first question you must ask is 'is this performance sustainable?'. Is the growth going to continue or do you want to mark the growth down a little bit? If your hunch is that the business will not grow as quickly, mark your multiples down and wait until you can pay the price you have determined.

The S&P 500 index in 2000 was a 17 multiple over the average stock price. I remember asking myself if the companies that were pushing the index higher were really twice as good as everything else.

An analogy I like to think about is buying three Chevrolet's for the price of one Cadillac. Likely two or three Chevrolet's are going to take me further than one Cadillac, even though the Cadillac is the best way to get there.

Quality must still, however, be considered alongside price. Warren Buffett would rather buy a great company at a fair price than a lesser quality or a mediocre quality company at a great price. That's probably true but you still have to figure out which one is going to be great in the future, and which one is going to be overpriced. Peter Lynch has said that there are only two kinds of companies that he likes to invest in; the ones that are doing poorly that are going to do better and the small companies that are going to grow into big companies. There's nothing easy in this business, and every decision requires a lot of analysis. But by developing proper valuation guidelines and paying the right price, it's doable. There is no easy answer. I wish there was.

Do you have any final advice to share with us?

When I started my rope climbing career people were telling me that I would never make it. I would work twice as hard to reach the same physical strength as an average guy who had never tried rope climbing before. It was very discouraging. Still, I kept going. Once I was very close to quitting, until I asked myself 'why would I quit if my goal was to get stronger and I'm getting stronger?' So, I kept pushing and became champion at rope climbing. I broke the school record and the league record. I won the league three years in a row, climbed in national competitions, and placed ninth as a high-school climber among college seniors. I became a successful rope climber only because I kept working hard and I believed in myself.

The second thing I would like to share is that I got married at an early age to my high-school sweetheart. Our marriage lasted about five years, until my wife left me. I learned a very important lesson from this: to pay attention to your spouse. If you do not pay attention, somebody else will. This was a very important lesson for me, and I really struggled with it. It was very painful for about six or seven years until I finally figured it out. Then I married my present wife. We've been married 47 years, so I definitely learned something from the first experience.

> "Never let a failure stop you from continuing forward. You learn more through failures than from successes"

When I got into the investment business, I first entered a partnership which only lasted about six months. My partner and I weren't aligned philosophically. I started over again with the three thousand dollars I had left, which is roughly the equivalent of fifteen to twenty thousand dollars today. It wasn't much, but it was enough.

There are two moral to those stories. The first is to never let a failure stop you from continuing forward. You learn more through failures than from successes. The second moral is that I really believe that hard work and total commitment to a goal will overcome any shortcoming one may have. Whatever you do in life, just remember, you can do anything you put your mind to. Believe in your goals and make a commitment to them.