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An Interview With Jim Barksdale
President and Chief Investment Officer, Equity Investment Corp.

Investing, Ted Williams–Style

by Lawrence C. Strauss

When Barron's interviewed Jim Barksdale nearly a quarter-century ago ("Growth at a Price—The Key to One Money Manager's Solid Performance," Sept. 19, 1988), he was running nearly $10 million for his clients. Today, Equity Investment Corp., which Barksdale launched in 1986, oversees nearly $4 billion, mostly in separate accounts.

The performance of the Atlanta firm—Barksdale [illegible] president and chief investment officer—has remained [illegible] even during bear markets. For example, in 2008, a [illegible] annum for equities, the company's all-cap value composite was down 23.4%, versus a 36.3% decline for the Russell 3000 Value Index. Since the firm's inception in 1986, the composite's annual net return is 11.3%, compared with 10.6% for the value index and 10.2% for the Standard & Poor's 500.

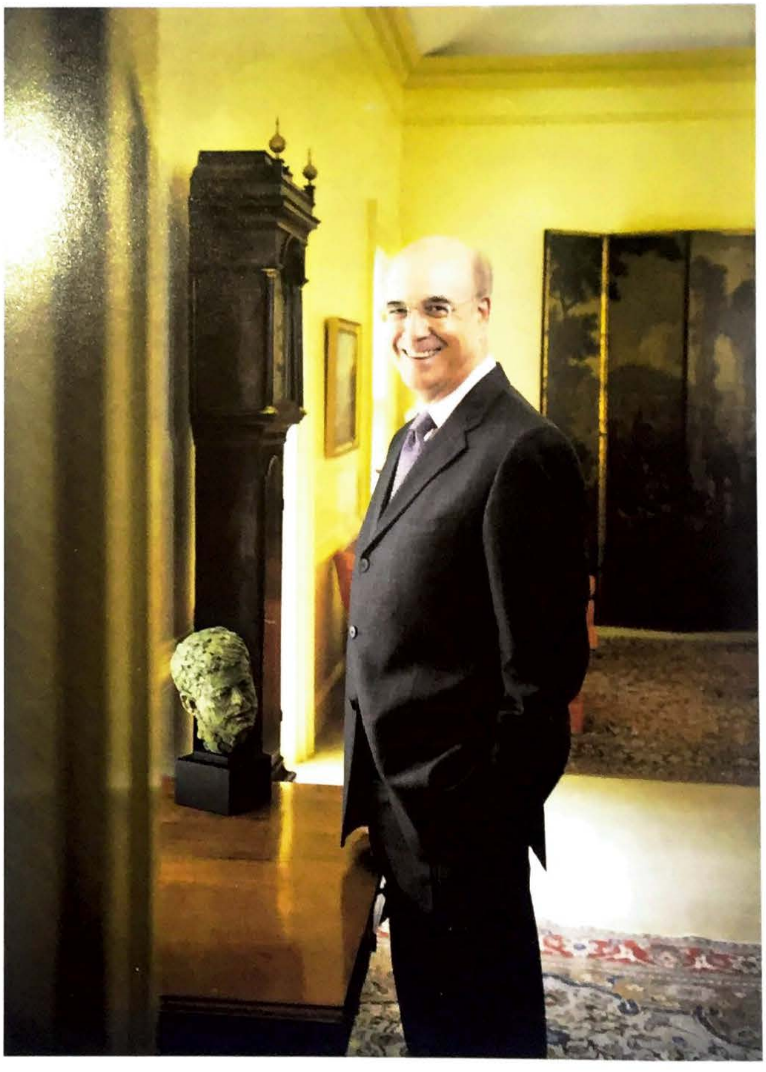
Barksdale, 60 years old, a value manager who seeks to invest in companies operating in what he considers to be stable businesses, maintains that keeping a lid on a portfolio's volatility is crucial for long-term success. Last week, Barron's spoke with him by telephone.

Barron's: What are some of the key mistakes that investors make?

Barksdale: I'm borrowing from Warren Buffett, who once said, "Rule No. 1 is never lose money. Rule No. 2 is never forget rule No. 1." But another big piece of this discussion is about how investors have been very misled by the idea, which is part of modern portfolio theory, that when you take more risk, you get a higher return. Those two ideas are exact opposites.

What's wrong with the assumption that you get paid to take more risk?

It is flawed for a number of reasons. No. 1 is simply time horizon—that is, most people don't have an infinite time horizon. Sometimes, modern portfolio theory may work and be relevant, and sometimes it may not, but people may have finite objectives that they have to reach, especially if they have a shorter time horizon, say five years, instead of 25. That theory is also flawed because once everybody



Craig Bromley for Barron's

"The reality for most people is that when you take more risk, you reduce your success rate." —Jim Barksdale

(over please)

Barksdale's Picks

Company	Ticker	Recent Price
Wells Fargo	WFC	$44.41
U.S. Bancorp	USB	37.07
Becton Dickinson	BDX	102.98
Baxter International	BAX	73.10

Source: Bloomberg

starts following it, it invalidates the theory.

For example, if everybody subscribed to the theory that you get what you pay for, so they don't have to pay attention to the quality of the goods, then all of a sudden, you don't get what you pay for. That is part of what happened with the theory of risk and return. Everybody thought they were getting paid for the risk they were taking. So they didn't really feel like they had to pay attention to it, and they thought they could manage risk via correlation by using different equity style boxes, like large-cap growth or small-cap value. And so they ignored the other risk-management peg, which is called low volatility. The reality is that too many investors were taking risks that they weren't getting paid for.

Why is low volatility so important?

As I mentioned, most people felt that if they took more risk—that is, taking on more volatility—they were going to get paid for it. So it was something they wanted, and they didn't worry about the downside, because they thought they had it covered via the low correlation among the different equity style boxes. But they didn't get more return by taking more risk. Because they weren't inspecting the goods they were getting and they weren't properly evaluating whether they were getting paid for taking that risk, they actually ended up not getting a higher return for taking that risk. And by taking on that higher volatility that they thought they had managed via low correlation in the down markets, they found they really hadn't reduced the downside risk as much as they had hoped.

What else concerns you about how investors think about risk?

The other part that is flawed stems from the whole ex ante [before the event] versus ex post [actual] return analysis. If you look ex post and purely at the winners—that is, the stocks that have made money—you can say, "Sure enough, they might have had a lot of risk or taken a lot of risk." But if you start at the starting line, rather than the finish line, and measure everybody who starts down that pathway, you get a better assessment of what it really means to be taking more risk. The reality for most people is that when you take more risk, you reduce your success rate. That's really the way people need to think about their portfolios. That's why I use the analogy of driving. If you drive faster, you get to your destination sooner. That may be true for all the people who drove fast and made it. But if you went back to the starting line, there would be a lot of wrecks, depending on how fast people decided to drive.

Why is relying on equity style boxes for correlation a flawed assumption?

Too often investors hang their hats on one peg, notably low correlations [among different portfolio holdings]. The view is that if their equity assets are spread across the style boxes, then they have managed their risk. But, unfortunately, that tool becomes much less robust exactly when you need it the most. When fear is running the herd toward a down market, that fear permeates every sector. So the correlations are much higher in down markets than they are in normal markets. The risk-management peg that everybody has chosen is less useful at the time investors most need it. But everybody has kind of ignored the other peg: managing risk via low standard deviation of the underlying strategy.

Could you be more specific about how volatility impacts returns?

We put together a presentation a few years ago that showed how much you have to increase a manager's mean to compensate for a fat tail. By fat tail, I mean a return that is one or two standard deviations outside the norm. Assuming a mean return of 11.4% for the S&P 500, and a standard deviation of plus or minus 16 percentage points, you have about 60% odds of earning an 8% annualized return or greater over a five-year period. If you keep the same volatility and want 80% or 90% odds of earning that 8% annual return, you need to increase the mean annualized return of the index to 15.3% or 18.1%, respectively; that means alphas, or outperformance, of 3.9 and 6.7 percentage points, but I don't think those exist.

It's true that those numbers I cited apply to a one-asset portfolio, and people will argue for a multi-asset approach. But when dealing with style boxes and high downside correlations, the argument isn't as powerful as people hope. To sum up, reducing the tail is more likely to be the driver than increasing the alpha, because tails are large versus mean returns, while alphas are small. Maximizing odds of success in a client's time horizon is the key, not maximizing return over an infinite horizon.

OK. Now, let's talk a little about how you analyze companies.

We call ourselves structural investors, rather than informational investors. Most of the world is focused on hearing what the information is, believing that the most recent information is very important for the future and that, somehow, getting attached to a narrative around that information will help figure out the way the future is going to roll out.

We have a very different approach. First of all, everybody has that information, which is very available, and there are really no unique insights into the information, in our view. There's very little clairvoyance or predictability about the future. One person might get it right this time, and another person next time. But trying to live an investment life via prediction is a nonrepeatable approach.

So what do you focus on?

We are trying to say, "Beware of that information, and put it in the context of the underlying structure of that business and whether that structure is a long-term and repeatable structure that will be able to survive." Now, we don't always get it right. But, in general, the idea is to de-emphasize our and everybody else's ability to properly discern what the information is going to mean three to five years from now. We try to rely more on whether the structural elements of a particular business are going to stay in place.

It seems like avoiding big mistakes is an important part of reducing a portfolio's volatility. Would an apt analogy be that you're striving to shoot par and trying to avoid a double bogey?

I would liken it more to another sport, baseball, and that old book by Ted Williams called The Science of Hitting. Williams had a pretty-well-defined strike zone, in which he had a reasonable chance of getting a hit, versus a ground-out or another kind of out. He only swung at a pitch when it was in that zone; for everything else, he just stood there. So you basically improve your odds if you don't take on those things that have a lot of risk or, as Ted Williams would say, have high odds of failure. I would put it slightly differently, from the standpoint of stock investing: Your odds of being right are inversely related to how difficult the decision is to make. So if you are constantly making very difficult decisions that have very incalculable outcomes, you have very high odds of being wrong.

Turning to your holdings, one of the worries about banks is weak revenue growth, and loans in particular. What's to like about that sector?

From a structural standpoint, these banks, including Wells Fargo [ticker: WFC] and U.S. Bancorp [USB], have pretty strong nonbanking contributions, whether it is wealth management, trust management, mutual-fund management, card-processing—that type of thing. This goes back to Buffett, who talks about owning businesses over very long periods and how much you earn as an owner of the business. So we are really looking at ourselves as being very long-term owners of these businesses. And the short-term swings of revenue today, versus over, say, five to seven years, are not as important to us as they may be to a lot of folks. But with the banks, the reality is that in some respects, it is just a much better environment than we've seen for some years. They are putting out loans with very rigid, prudent underwriting, so the reserves that you are seeing are probably very reflective of the true earnings power from those loans. In contrast, with the loans we were seeing in the mid-2000s, the earnings power was overstated, because they were very bad loans. Today, the earnings that you are seeing are legitimate, and, to a certain extent, they are below normalized earnings, because the banks are making these loans in an environment that is reasonably adverse, thanks in part to their lower net-interest margins.

What's your investment case for U.S. Bancorp?

First, it is just an extremely well-run business. Half of the revenue comes from the non-interest side, and their return on equity [ROE] has been in the 12% to 15% range. We are asking ourselves, "OK, what can they grow?" And we don't really know what they are going to grow. They probably grew faster in that 2000s decade than they can sustain now. So if you notch down their earnings growth to a more conservative 5% to 6% range and then you look at the current normalized earnings, we would put a value on the stock in the $50 range, versus a recent price of $37 and change.

What's the upside for Wells Fargo?

Wells Fargo is another extremely well-run business. Their ROE has been in the 12%-to-13% range, and their earnings are below normalized levels, even though they have benefited from the ramp-up in the mortgage side of the business. They may have some more slowdown in that business, as we've already seen. A few years from now, they should be able to get a better net-interest margin, and their ROE should move upward. We believe it's worth about $50 a share, compared with $44 late last week.

Let's turn to another sector where you see some value.

Becton Dickinson [BDX] is a major medical-technology company. Their products include devices and systems. We've owned it for a long time. And it has earned good returns on the capital that shareholders have put in. They have been able to grow earnings roughly 8% per year, and we value the stock at $117 to $120. It was close to $103 last week. It is just extremely well run. They have done quite a lot of share buybacks, and that's actually pushed up the earnings a little bit. From 2010 through 2012, they spent just over $1 billion on dividends. This is one of those back-office health-care companies that are making the stuff people need—things like blood tests, scalpels, needles, and injectable products. These are things that are repeatable, and the items are very consumable. Our thesis is that a lot of the uncertainty in the health-care arena is making these types of stocks look a lot more attractive.

Let's wrap up with one more selection.

We also like Baxter International [BAX]. With these companies that I'm talking about, I don't want to paint a picture that everything is rosy. They clearly have got head winds, and we are not unaware of it. We're just saying that even when you factor in those head winds, the odds are reasonable that the market price already reflects those fears sufficiently and that you are getting a good price. So Baxter has pretty good odds of growing its normalized earnings at an 8% annual clip. The stock is around $73 right now, but we value it in the $96 range.

Thanks, Jim. ■