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Growth at a Price

The Key to One Money Manager's Solid Performance

JIM Barksdale—James F., according to his birth certificate—is hardly what you'd call a mega-money manager. He runs just shy of $10 million in other people's money from his Atlanta office. But that's a lot more than he started with, as recently as 1986. And most of the growth in his portfolio has come the hard way, in the market, which he has handily outperformed—both while the market was heading for the moon and since last October.

Something of a stickler for numbers, Jim has devised a highly quantitative approach to investing, one that borrows heavily from the traditional Graham & Dodd school without, he insists, enrolling. Jim's twist on the process: He insists on buying shares only in companies that consistently earn a return on equity that will give him a healthy real return over a four-year investing horizon.

When we talked with Jim last week, he explained the whys and wherefores of his formulas, and then got down to the nitty-gritty: which stocks right now look underpriced to him.

—Kathryn M. Welling

James F. Barksdale

Thomas England

BARRON'S: Jim, how long have you been investing other people's money?

Barksdale: I started Equity Investment Corp. in 1986, after short stints with Merrill Lynch in New York and Management Asset Corp., the big value investing firm, up in Westport, Conn. Prior to that, basically, I had been in the corporate world, professionally, but I bought my first stock when I was 12 years old. And I went to Wharton with the idea of specializing in investments. Unfortunately, they were awfully convincing that no one could add any value above a dart board. So I didn't go the conventional route of going and doing a journeyman's apprenticeship with one of the big investment managers who interviewed there—I felt that if none of them were going to better the market, what was I going to learn? That's why my first position was as the security analyst contact for IC Industries in Chicago. There, I had one foot in the security analyst's world and one foot in the corporate world. From there, I spent seven more years at IC, doing everything from treasury to corporate finance to accounting to planning. I was international controller in Frankfurt and then in London for a few years, before I decided to come back to this country and break into professional investing.

Q: And you had continued to buy stocks on your own all along, despite what you'd learned at Wharton?

A: Oh, yes. Although, about the time that I started with IC, I read an article by Warren Buffett that changed the way that I invest my personal money.

Q: You mean you joined the value investing crowd?

A: No. I consider myself a value investor of sorts, but I don't really consider myself a Graham & Dodd-type investor. That phrase is so over-used. Frank Russell, the pension consulting firm, has a manager category it describes as "growth at a price." To me, that is what I am. Value managers tend to have low return on capital stocks and low P/E stocks in their portfolio. I certainly have some low P/E stocks, but I also have some that look more like what a growth manager would have.

Q: In what way?

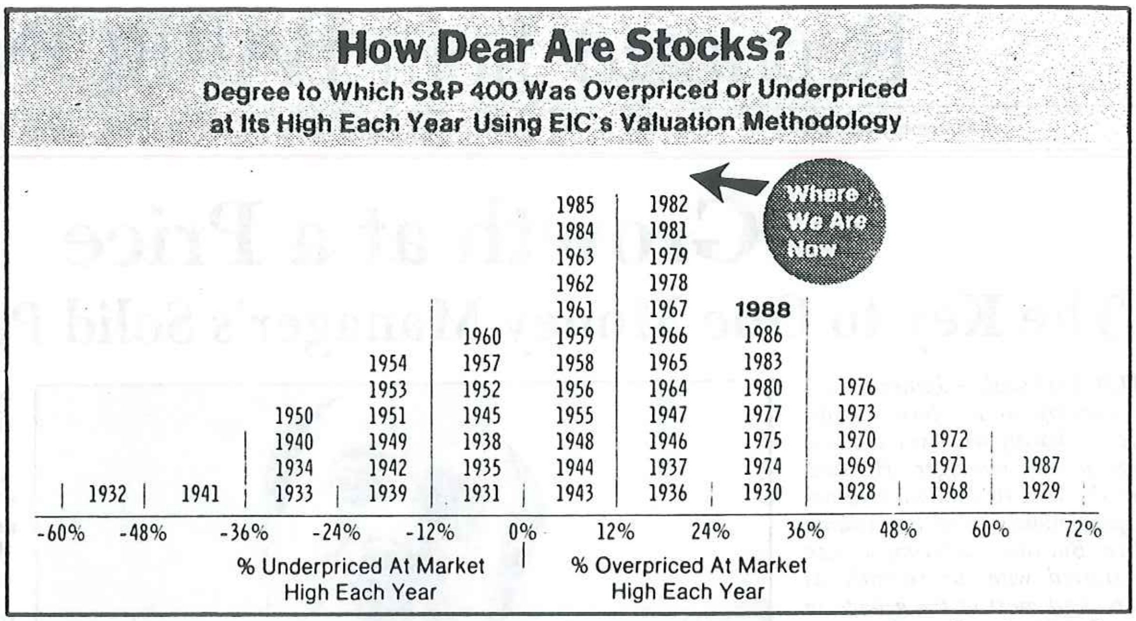
A: There are some stocks in my portfolios that have very high returns on capital and high rates of growth that would look more like a growth manager's stock.

Q: Can you explain what you mean by "growth at a price"?

A: What I am doing is treating a business as though it were a bank account. When I buy a business, it's as though I am becoming a depositor in that bank. So that the return on equity that the business generates is, in effect, the interest rate that I am generating on my capital in my bank account. I only want to take my money out of cash and put it into this business bank account when I have confidence that I am going to increase the purchasing power of my capital.

Q: Because—

A: Because, after all, holding cash gives you a 100% probability of capital preservation. But over a lifetime, cash provides a very low probability of purchasing power growth. Owning a business, on the other hand, gives you a very low level of confidence, moment to moment, of capitial preservation in terms of the quotational value of your portfolio. But over a lifetime, it gives you a high level of confidence that you will increase your purchasing power. So to me, everything evolves around this "bank account." When I deposit my money, can I have confidence that it's going to increase the purchasing power of my assets or my capital? If it will, I am willing to take my money out of cash and sacrifice moment to moment capital preservation to gain a high probability of capital growth above the inflation rate.



Source: Equity Investment Corp.

Q: Where does Warren Buffett come into all this?

A: He wrote a piece back in the late 1970's, called "How Inflation Swindles the Equity Investor," in which he pointed out that the stock market's return on capital was stuck at 12% in an era of rising inflation. But what really struck me about the piece was his comparison of a stock to a bond with a perpetual maturity, whose one advantage was that it gives investors the right to automatically reinvest a part of the company's retained earnings at book value (its reinvestment rate). The key here is that to be a good investment, the company has to be consistently producing a return on capital equal to the inflation rate, whatever that might be, plus a decent real rate of return.

Q: How does all this translate back into "growth at a price"?

A: Let's go back to my bank account analogy. If you had a bank account paying 20%—

Q: We'd wonder when the bank was going to be closed!

A: It would sound very good, but if you also knew that inflation was 20%, you would all of a sudden say the bank account was not so attractive after all. It would not increase purchasing power, just keep you dead even. And after taxes, it would not even do that! The value of that bank account is a function of how much your return is after inflation—your real return. Now, let's say inflation falls from 20% down to 3%, and the people with money in those accounts could retain a guarantee of 20% for infinity. But the bank stopped offering those bank accounts.

Q: We wouldn't be surprised.

A: When inflation was 20% and the bank account was earning 20% and someone had $1,000 in an account, you might have been willing to pay only one times par to get it from him. But now that the bank stopped offering the accounts, and all of the sudden you see that it would generate a tremendous return on your capital, you might be willing to pay two or three or four times par to get on board that stream of 20%.

Q: Of course, the more you pay. . .

A: If you paid one times par, you'd step into his shoes, earning 20%. If you paid two times par, you'd earn 10%, if you paid 10 times par, you'd only get 2%. That's all my methodology is doing. It's a way of determining how much it's reasonable to pay for a given level of return on capital.

Q: How about a real-life example, Jim?

A: Take IBM. I start with the return on equity it has generated over the past two business cycles.

Q: Are you predicting that is what it'll do in the future?

A: I'm not trying to predict what they're going to earn in the future. I don't believe that anybody can tell me what IBM is going to earn on your capital over the next five years; nobody can predict it.

Q: Lots of people try.

A: Well, I got into the econometric modeling business when I was there at Wharton. They were big on that. After you study those kinds of things for a while, you learn that none

Barksdale's Picks

Company	Ticker (Abbr.)	Exchange	Recent Price
Shared Medical Systems	SMED (ShrMed)	Nasdaq	18½
Tandy	TAN (Tandy)	NY	41⅞
Whirlpool	WHR (WhrlPl)	NY	24¾
Dunkin' Donuts	DUNK (DunkDn)	Nasdaq	24¼
Ogilvy Group	OGIL (OgilGp)	Nasdaq	26¾

Company	Ticker (Abbr.)	Exchange	Recent Price
Tecumseh Products	TECU (Tecum)	Nasdaq	146¾
General Electric	GE (GenEl)	NY	42⅝
A.G. Edwards	AGE (Edward)	NY	17⅝
Block Drug	BLOC (BlckD)	Nasdaq	30¾
IBM	IBM (IBM)	NY	113⅞

of them can predict anything. I'm the kind of a person who doesn't like to make mistakes. And when you're involved in trying to predict things, you've got to live with eating your predictions. Those who consult the crystal ball are destined to eat glass. . .

Q: While you prefer, instead?

A: To make my first cut, I look at what a company actually earned, in terms of its return on equity, over the past two business cycles. For IBM, it's like 19.9%. Then, I look at how much is reinvested. IBM is like that bank account in my analogy, except that they pay out half of that ROE to me as dividends and I have the reinvestment risk on that money. But they reinvest the other half for me. And that half that they reinvest earns that same underlying return.

Q: Once you have those two numbers, what do you do with them?

A: I use the company's historical return on shareholder's capital, plus its reinvestment rate and today's inflation rate—I use the trailing 36-month average—to work through a long set of formulas that give me the price to book value ratio that I can afford to pay for each stock. In IBM's case, that price-to-book multiplier is 3.08.

Q: What kind of magic is in those formulas?

A: What they basically do is say, mathematically, that if you paid this price-to-par ratio for this stock, and it earns this return on capital over the next four years, and it reinvests that percentage of your capital at that rate, when you close your books after four years, you're going to have earned the rate of inflation, plus a fixed premium above inflation on your initial purchase price of $197 for IBM, and on all the capital that you have reinvested.

Q: Are you saying you'd pay up to $197 for IBM today?

A: No. I say, "Okay, I don't want to assume they're going to earn the same return on capital in the future that they've earned in the past." I want to provide a margin of safety.

Q: How do you decide how big a safety margin you need?

A: I get it by assuming a low-ball interest rate on your bank account. By asking what did the company do in their worst four years? Then, statistically, I lower the historical number by one standard deviation and come up with a new price-to-par ratio. So even if they have the worst four years they've ever had, you will still achieve your going-in objective as the owner and operator of that business. In other words, you'll still increase the purchasing power of your capital by the rate of inflation, plus a healthy return, over the four years. I then use this lower return, 16.6% in IBM's case, to compute a new price to book value multiplier, multiply the company's book value by that multiplier, and come up with a buy price of $145.

Q: Which is still considerably above today's price.

A: Sometimes, it is kind of embarrassing, but that's what the methodology says. It just shows how undervalued IBM is this time. And it's the nature of the market to swing between over-valuation and undervaluation.

Q: When do you decide to sell a stock?

A: This is where interest rates come into my analysis; where you have to make the secondary decision: Do I want to stay on board this business's ability to grow my capital, or do I want to be on board something else?

Q: How do you work that through?

A: IBM is still my example. If IBM earns 19.9% over the next four years, and its reinvestment rate is 50%, that means that my bank account is growing by 9.9% per year. Thus, three years from now, that bank account is going to grow to a value, under my methodology, of $261.50, from $197. I discount that back, at today's interest rate, to get my sell price, in this case, $196.50.

Q: How many stocks do you hold in a portfolio?

A: An EIC portfolio, typically, is evenly weighted across 25-30 industries. Usually, that will mean about 35-40 different stocks.

Q: And you arrive at those 35-40 picks after ranking all the listed stocks according to your methodology?

A: Right. I massage the Compustat data base and get a list of every company below my buy price, arranged by industry.

Q: How many stocks does that list usually contain?

A: The printout most often has a few hundred stocks, but a lot of them are data handling errors. Or you'll get a company that, two business cycles ago, was posting a very high return on capital but it didn't have any assets. It might have earned a 40% return on capital when their sales were $5 million, but now sales are $200 million and they're earning 13%. Those old numbers are irrelevent, but the computer doesn't know that. So a large portion of the stocks on the list, initially, are just noise.

Q: But once you filter out those, you have your buy list?

A: Not so fast. Another big part of the list are companies that aren't financially strong. That's where my quality ratings come in.

Q: What does quality mean to you?

A: I just take the companies' S&P financial strength ratings, Value Line's, Ford Investor Services' and each company's debt-to-capital ratio and put those on a one-to-nine scale. There is nothing magic about this. I am just saying, "give me a method that will keep me in high-quality stocks."

Q: For example?

A: IBM is rated double A plus by the services and its debt to capital ratio is 13%. So, assigning the points and taking the average, IBM gets 8.4 points out of nine possible. I limit myself to owning businesses that get at least five quality points, in other words, that rank in the top half, in terms of financial quality. If a stock falls below five points, it's automatically sold. The first reason I sell something is that it hits the targeted sell price, and the second reason is that its quality rating goes below five. The only other thing that will make me sell is if I see a major change in a company's business mix so that the historical data are no longer valid.

Q: It sounds like you don't do a lot of in and out trading, then.

A: That's right. I don't have much portfolio turnover. It's very low, averaging about 35%.

Q: Don't you run the risk of ending up with lots of stocks growing old in your portfolio, simply because they haven't hit your target—or, worse, because they've fallen below your buy price?

A: Obviously, there are going to be some. But that's reflected in your performance numbers. A.G. Edwards, though I'll never understand it, is one stock that I've owned for a long time, and that's now trading for less than I paid. All of my bank stocks—as an industry, they only represent 4% of the portfolio—are below where I bought them. In all, there are probably only 10 or 12 stocks out of 40 in the portfolio trading below my cost. But if you go back to the first portfolio that I set up back on 1986, probably half of those stocks, or more, are still in that portfolio, and I've returned an annualized 24.2% over that span vs. 14.6% on the S&P.

Q: You must have had a fair amount of cash going into the Crash.

A: Not enough! But yes, in the third quarter of last year, I sold some stocks and raised cash to 23% of my portfolio, because I simply couldn't find any more stocks selling at or below their buy prices. Here, I had been throwing rocks at managers who had moved into cash in 1985 and 1986, and all of the sudden, I was moving into cash. People were rolling their eyes, saying, "Oh, no, not another value manager moving into cash." That's when I first plotted my histogram.

Q: It's nice looking, but what does it do for you?

A: On that histogram, I've gone back and valued the S&P 400 as if it were a bank account that earned a 12% ROE, which is the average for corporations over time, as Buffett pointed out. I also assumed that corporate America reinvests half your earnings for you back into the business. And then I just followed my methodology. On the histogram, I plotted what the S&P was selling for, at its high each year, relative to that value.

Q: A picture is supposed to be worth 1,000 words, Jim—but what's this one saying?

A: The market, on average, has been 12% overpriced at its annual high, going back to 1928. I apologize for being so statistical, but that's the way I am. When you move out to the 36% line, that is the first standard deviation of overvaluation. In February of 1987, we crossed over that first standard deviation, and what I found was that when the market gets more than one standard deviation overpriced, as stocks hit their sell prices, there is nothing left to buy below its buy price. So cash begins to accumulate passively in the portfolio. February of '87 was the first time that we crossed over that first standard deviation marker at 36%. And at the end of that quarter, I had 7% cash. Then, in the latter part of that April and May, the market sold back down to less than 36% overpriced, and sure enough, there were some things showing up below my buy price. Once again, I got fully invested. But by the time we got to June 30, the market had gone up again, and we were sitting right on top of 1972 on the chart. At this point, my portfolios were averaging 15% cash. And by the time we got two standard deviations overpriced, at the end of the third quarter, the portfolios had 23% cash. But there were enough stocks within one lousy dollar of their sell price, that the portfolios could have been 45% cash at that point, which everyone would have liked—in retrospect—to see. So my performance last year was good, certainly relative to the other equity managers. But it is hard to puff one's chest up too big, when I know I was looking at this. It makes me feel like something of an idiot to say that I was 77% invested when the market was two standard deviations overpriced.

Q: You actually had a lot of stocks within $1 of your sell price, and held onto them?

A: That is why I feel kind of silly. At the time, the psychology against holding cash was very strong. You know, when you are being measured against a fully invested index it is folly to hold cash while the index is rising. Yet the mathematics of valuation were such that things were way overpriced. You had very little probability of getting a real return on your money. But I just continued to follow my established sell prices religiously. There is enough room for margin of error in any of these calculations, that I should have gone ahead and sold them early.

Q: Anyway, these days, it's easier to find stocks to buy, we presume.

A: Yes. And, although the market may have been just as overpriced as it is today back in January of last year, or in December '86, the difference is that, this time, the stocks that are showing up on my buy list are unusually high quality: GE, Whirlpool, Tandy—those kinds of names.

Q: You've already run through our numbers on IBM, Jim. But are there other reasons you're in the stock—at a time when lots of other managers won't touch technology—and especially not IBM?

A: Not really. I stick to my numbers. Not blindly, if there is an obvious discontinuity between the past and future, then you question your assumptions. But with IBM, at this point, you can't say that its troubles fall outside the realm of normal business problems. They are always going to have good periods and bad periods. And if you are going to be a long-term business owner, you are going to have to ride with them. It may be that the future is going to be much worse than the past. But there is not an obvious discontinuity yet.

Q: What would you call an obvious discontinuity?

A: An obvious discontinuity, for me, was when OPEC embargoed oil. That raised the return on capital for all the oil companies dramatically—and in one day.

Q: You mentioned GE. Why do you like it?

A: Well, last year they earned 17.7% on their capital. If you look back, in 1982, they earned 17.8%. In '78, they earned 18.7%.

Q: But GE has bought and sold a few businesses since then.

A: Yes. But GE has been a conglomerate for a very long long time. It may be that its recent purchases of RCA, Kidder, Peabody, etc., could lower GE's return on capital. But this is a big company. And I am not sure that these changes have been so major that it is going to have that effect. It has not shown up in the numbers yet.

Q: What is GE's "real value" according to your way of crunching the numbers?

A: My buy price is now $43. That assumes that even if they only earn 16.4% on their capital over the next four years—and there is not a single year since 1978 that they have earned that low a return on capital—and even if I paid $43—

Q: About the current price, in other words?

A: Yes. If you pay $43 and hold the stock for four years, you should earn the inflation rate, plus a healthy real return. GE has a tremendous balance sheet. So why shouldn't I own it? I do own it. My targeted sell price is $51.

Q: You mentioned owning A.G. Edwards earlier. Who's going to bid up a retail broker in this kind of market?

A: Good question. But A.G. Edwards, to me, is the cheapest stock in the universe. I just don't understand how a company that has generated a return on capital 70%-80% higher than the average American company, and done that with virtually no debt, sells at a price-to-book ratio of 1.3, when the market is selling at two times book. At the current price, you're buying it at a 35% discount to the market!

Q: Maybe the market is forecasting something here. . .

A: Perhaps, but Edwards is doing what it has done for years, in good markets and bad. It continues to be managed—in a conservative way—by the Edwards family. They stick to their knitting, so to speak. I just don't understand how a company like this can sell at this price.

Q: Spoken like a man who bought the stock at a higher price!

A: You are right. It surprises me that it sells here day after day after day. Obviously, I am not with the crowd on this one.

Q: What is your buy price on A.G. Edwards?

A: It is embarrassing, but my buy price is $32.

Q: That's almost twice the current price.

A: Yes. That shows you how ridiculous its current valuation is. That buy price is based on Edwards earning only 15.9% on their capital for the next four years. Well, you can never find an occurrence of that. You can only find two years when they earned less than 15%—in '84 and '87—even in '74, they earned 15.6%. But today's price of $17-$18 implies that, in rough numbers, Edwards is only going to generate a return on capital of 8%-9% over the next four years. That's just impossible.

Q: Nothing is impossible!

A: Okay, but it has never happened. Even the bad brokerage firms do better than that. And this is a good one. It has the most stable return on capital of any of the brokerage firms—except for Quick & Reilly, which is not quite as old. And they generate it with no debt. Yet you can buy it at this ridiculous price.

Q: What else would you buy here?

A: Block Drug is a little more difficult to value because they have so much cash. But let's just do it on a simple basis.

Q: We're all for that. Don't tell us you're a sucker for the company's products.

A: Their business is 65% dental, with Poli-Grip and Pycopay and other items—denture creams.

Q: TV wouldn't be the same without them.

A: Besides that, Block Drug has a very high and very stable return on capital—in excess of 15%, and it typically reinvests 80% of earnings. Even if it only earns 13½% on its capital, you would still achieve my going-in objective (increasing my capital by the inflation rate, plus) if you buy it where it is here now, at 31½. My sell price is $40.

Q: What else do you like?

A: Dunkin' Donuts. This is an incredible company. Franchise companies are particularly attractive once they get to a critical mass. And Dunkin' Donuts certainly got there a while back. They just generate tremendous amounts of cash, and have very low capital requirements. And with Dunkin' Donuts, if you just look at the value of their lease/sub-lease contracts (where they sub-lease the stores to the franchisees, and get a percentage of sales), on a traditional discounted cash flow type of basis—this is not normally what I do—those contracts are worth more than the price of the stock today. And that doesn't even give them any worth for the value of the Dunkin' name, or the value of their franchisees coming in; that's just the value of those lease/sub-lease arrangments.

Q: Where is the stock trading?

A: The price of the stock before the Crash was $26-$27, and it is $24 now. So it hasn't been an unmitigated disaster. The low ROE I am assuming is 16.4%. You will be hard pressed to find a year where they earned that low an ROE.

Q: Could there be something you're missing, Jim?

A: The problem with Dunkin' Donuts seems to be that they are going into these Chili's restaurants ventures. These are just the opposite of their company-owned stores, and the Dunkin' Donuts business. The Dunkin' Donuts part of their business creates lots of cash and requires no capital. The Chili's portion of their business eats cash. They have been using Dunkin' to fund the Chili's. And to me, that is an very unattractive situation. I wish they would stop.

Q: But you'd still buy the stock?

A: I can't control that situation. This Chili's business may turn out to be profitable; I don't know. But to me it is a diversion of attention from their core business. On the other hand, the big positive is the fact that you can't find a single year where the company's return was lower than 16.4%—even last year they earned 19.5%—and there is not even a hint of that trend turning down.

Q: What else pops up on your computer list as a buy?

A: The advertising stocks look awfully good—Ogilvy Group, in particular.

Q: What is your buy price there?

A: $30. You can buy it for $25 now. All the advertising companies have had lower returns on capital in the last couple of years. So it is an industry, in general, which hasn't seen the best of times recently. But even if you bought it at $30, and you owned and operated it for four years, and even if they only generated a 16.5% return on capital, vs. the 18%-plus that's more typical, you would still come out ahead in this stock over my four-year investing horizon.

Q: What's your sell target?

A: My sale price is $39.

Q: Any other names, Jim?

A: Tecumseh Products, which produces compressors and engines for lawn mowers.

Q: A classic value investor's stock, isn't it?

A: Yes, it trades around $147 a share, and they'd have about $40 a share in excess cash after repaying all debt. Historically, Tecumseh has earned about 14% on equity, reinvesting about 50%. Its debt is only 2% of capital. My targeted sell price is $222.

Q: But it trades only by appointment, doesn't it?

A: It's very illiquid.

Q: You mentioned a couple of other computer industry companies—Tandy, Shared Medical Systems?

A: Shared Medical has more uncertainty about it than, say, IBM or Tandy. But to me it's cheap.

Q: The uncertainty arises because the company draws its customers from the ranks of health-care providers, we presume.

A: It's no great shakes as a place to be. They have the double whammy of health care and computers. But if you look at Shared Medical's return on capital, it's the highest listed in Value Line. Nothing compares in terms of the height and stability. The problem is, they've had a few bad years in terms of sales. This gets extrapolated. It may or may not be true, but if it is, this is not going to be good. Last year was a really bad year, and the company returned 24.5% on capital. The stock went from 53 to 19 because their return on capital went from 29% to 25%. How many companies would die to have 24.5%? It's not as though a disaster has become evident.

Q: Shared Medical is in a service business, and isn't exactly the only firm that can provide that service.

A: Right. But they have a lot of long-term contracts, so it's not as if, when you miss the next wave of technology, you're gone. You have a long time to get your product in shape. Your customers are not going to pull the plug on their computer systems overnight. You've got to mess up for a long period of time.

Q: Tandy, you're a lot more certain of as a buy?

A: Tandy is a little bit more stable because you have a lot more mass behind you. And the software, computer service business is not as much of a money generator as the Radio Shack stores. There really is no competitor for Tandy's retail operations in terms of all the little gadgets they sell. Who knows how high a margin there is? There is no one that substitutes for them in that little niche.

Q: What do you figure Tandy is worth?

A: Just assuming that the computer portion of their business is worthless, the Radio Shack stores alone would be worth more than the price of the stock today.

Q: How much?

A: Even if they only earned 16% on capital vs. over 20%, historically, I'd still be willing to pay $44 for the stock.

Q: And your sell price is?

A: $80. That's a big number. But the surprising thing is that things hit my sell prices. The only time I've sold something that didn't fit one of my three reasons was in a takeover and then usually above my sell price.

Q: You mentioned liking Whirlpool earlier—even though the outlook for housing is less-than-robust.

A: Again, this is the case where everyone says, "Don't buy consumer-sensitive things, because the consumer isn't going to exist anymore." But he's not going away forever. Whirlpool, which I bought after the Crash, still hasn't done anything. Historically, their worst returns on equity were two years at 13.9%. Even if they only earned 12.2%, I'd be willing to pay $30. Yet it's selling at $25 now.

Q: And your sell point is?

A: $41.

Q: Thanks, Jim. ■