

EUBEL BRADY & SUTTMAN ASSET MANAGEMENT

PRESENTATION FOR:
University of Florida



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Today's Discussion

I. **EBS Investment Philosophy**

- Firm Background
- Why Value Investing?
- Evolution of EBS Investment Framework

II. **Investment Process**

- Idea Generation: Where do we look?
- Investment Criteria: What do we look for?
- Portfolio Construction: How do we make decisions?

III. **Value Investing** - “A long-term approach in a short-term world”

- John Maynard Keynes Insights
- Opportunities/Challenges

EBS ASSET MANAGEMENT

■ Organization

- Firm established by Ron Eubel, Mark Brady, and Rob Suttman in 1993
- 100% employee owned
- Three founding partners have been colleagues and friends for over 20 years
- Firm manages assets across Small-cap, Mid-cap, All-cap, and Balanced disciplines
- Majority of partners' capital invested in EBS strategies

■ Investment Team

- Investment Committee consists of seven members
- Research team consists of five members
- Ron Eubel (Co-CIO, Director of Research), Mark Brady (Co-CIO, Director of Portfolio Management), Bernie Holtgreive (Senior Analyst), Aaron Hillman (Securities Analyst) and Wayne Bopp (Securities Analyst)
- Seasoned, stable team (Ron, Mark, & Bernie) working together since 1987, Aaron (2004), Wayne (2006).

WHY VALUE INVESTING

Academic Research – large body of research that demonstrates a correlation between various characteristics and excess returns.

Low Price-to-Book

- *“Further Evidence on Investor Overreaction and Stock Market Seasonality”*
 - Werner DeBondt and Richard Thaler, 1987

- *“The Cross-Section of Expected Stock Returns”*
 - Eugene Fama and Kenneth French, 1992

- *“Contrarian Investment, Extrapolation and Risk”*
 - Joseph Lakonishok, Robert Vishny and Andrei Shleifer, 1993

- *“Do Contrarian Strategies Work within Industries?”*
 - David Dreman and Eric Lufkin, 1997

WHY VALUE INVESTING

Academic Research.

- “Earnings Quality and Stock Returns: The evidence from accruals”
– Chan, Chan, Jegadeesh and Lakonsishok, 2001 (Earnings Quality)
- “Founder-CEOs and Stock Market Performance”
– Rudiger Fahlenbrach, 2004 (Family Ownership)
- “Corporate Financial Activities and Contrarian Investment, 2006”
– Bali, Demirtas, Hovakimian (Net Equity Issuance)

Successful Practitioners

- Small group of consistently successful investors who follow a similar philosophy and approach
– Ben Graham, Warren Buffett, Bill Ruane, Walter Schloss, Charles Brandes, Tweedy Browne, Longleaf, etc.

EBS INVESTMENT EVOLUTION

- **1980's** screening for low price-to value opportunities using S&P Compustat database. The focus was predominately on absolute valuation levels of price-to-cash flow, price-to-earnings, etc and relative to the company's historical range of valuation metrics.
- **1990's** continued with low price-to-value screens and we began to overlay an assessment of the quality of the business as reflected by return on capital, economic model, quality of management, sustainability of competitive advantage, etc.
- **2000's** added an emphasis on the quality of earnings and the integrity of the financial statements.

INVESTMENT FRAMEWORK

Fish in the right pond

- Low price-to-value (cash flow, eps, book value)
- Net equity issuance
- Insider & founding family ownership

Refine search by focusing on good businesses

- Sound business economics and strong ROIC
- Competitive advantage
- Superior management quality
- High earnings and accounting quality

Determine range of intrinsic value for the business

- Discounted cash flow
- Private valuation

4. Wait for opportunity to buy at a discount

IDEA GENERATION

- Database screening – S&P Research Insight
- Value Line Surveys
- Monitoring other investors – Value Investor Insight, OI, Gurufocus.com
- Insider Trading Activity
- Daily and Weekly new lows
- Newspapers & Magazines– Barron's, WSJ, NY Times, Forbes, Fortune, etc.
- Areas of Duress, Headline concerns

“if it's in the papers, it's in the price. The market does reflect the available information, as the professors tell us. But just as the funhouse mirrors don't always accurately reflect your weight, the markets don't always accurately reflect that information. Usually they are too pessimistic when it is bad, and too optimistic when it is good.”

— Bill Miller

INVESTMENT CRITERIA

- Bottom-up Approach: no consideration to macro trends and market predictions
- Sustainable cash flow (owner earnings) - DCF
- Return on Invested Capital, ROE, ROA
- Healthy Balance Sheet
- Shareholder Friendly Management
- Competitive Advantage/Position
- Growth Prospects

- Core vs. Non-Core Investment

SECURITY SELECTION



PORTFOLIO CONSTRUCTION

- Sector and Industry exposure independent of benchmarks
- Portfolio Averages 25-35 stocks
- Traditional turnover: 20-25%
- Typical company exposure: 5% at cost
- Typical industry exposure: 10% at cost
- Sector Constraints/Guidelines

- Investment Policy Committee
- Research Analysts = Portfolio Manager

John Maynard Keynes

General Theory of Employment, Interest and Money – 1936

Chapter 12: The State of Long Term Expectation

“But there is one feature in particular which deserves our attention. It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself. **It happens, however, that the energies and skill of the professional investor and speculator are mainly occupied otherwise. For most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it “for keeps”, but with what the market will value it at, under the influence of mass psychology, three months or a year hence.**”

“If the reader interjects that there must surely be large profits to be gained from the other players in the long run by a skilled individual who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame, he must be answered, first of all, that there are, indeed, such serious-minded individuals and that it make a vast difference to an investment market whether or not they predominate in their influence over the game-players. But we must also add that there are several factors which jeopardize the predominance of such individuals in modern investment markets. **Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes.**”

“Moreover, life is not long enough; - **human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct;** whilst he who has it must pay to this propensity the appropriate toll. Furthermore, an investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money – a further reason for the higher return from the pastime to a given stock of intelligence and resources.

Finally it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to success unconventionally.”

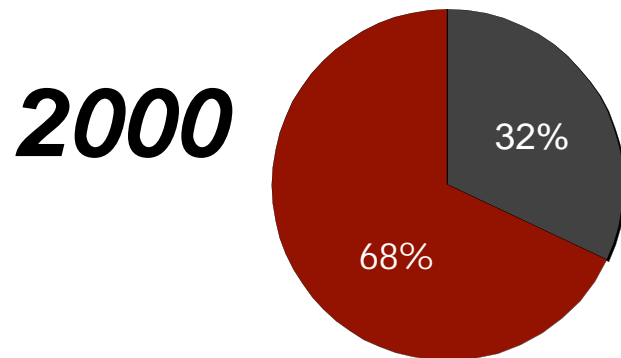
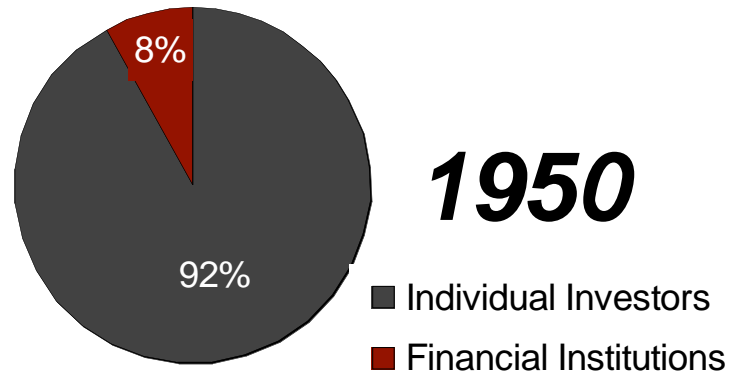
CHALLENGES & OPPORTUNITIES

Value Investing Challenges – Opportunities in Disguise

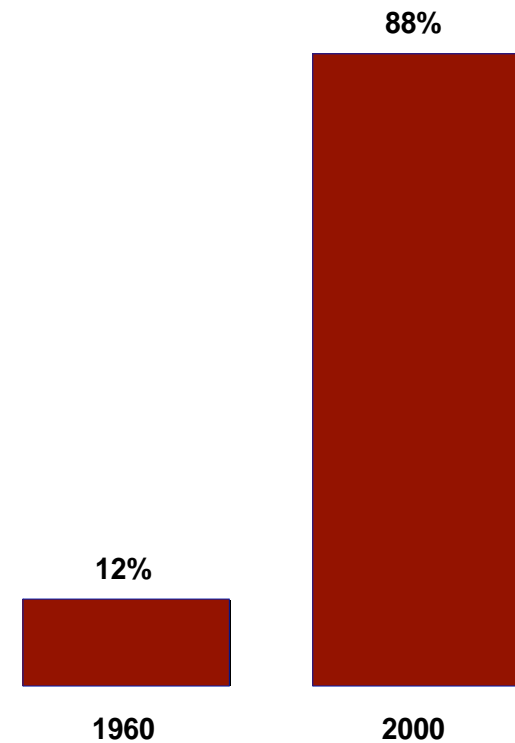
- Behavioral Biases
 - Educated vs. Experienced
- Information
 - Access vs. Assessment
 - Noise vs. Insight
- Periods of under performance
 - Patience and Discipline

EVOLVING TIME HORIZON

Direct Stock Holdings



NYSE Annual Turnover







CHARLIE MUNGER INSIGHTS




- Safest way to get what you want is to try and deserve what you want
- The acquisition of wisdom is a moral duty – resolve yourself to a lifetime of learning, go to bed each night a little wiser, develop a mental lattice work of multi-disciplines.
- Inversion will help you solve problems – turn the question or problem inside out, don't just look for positive affirmation, search for negative argument.
- Don't adopt an ideological idea until you can better state the case against than those advocating a case for.
- Self serving conduct is a basic human condition – avoid the sub conscious tendency to self serve in yourself and allow for it in dealing with others – Ben Franklin stated “If you would persuade, you must appeal to interest rather than intellect (reason)”
- Avoid perverse incentives
- Avoid perverse associations: align yourself with people you admire and respect.
- Maintain objectivity – develop routines and mental checklists, look for disconfirming evidence (Darwin theory).

RECOMMENDED AUTHORS

- **Louis Lowenstein**

-  “Sense and Nonsense in Corporate Finance”
-  ‘What’s Wrong with Wall Street: Short-Term Gain and the Absentee Shareholder’
-  “Journey into the Whirlwind of Graham & Doddsville Revisited”
-  “Searching for Rational Investors in a Perfect Storm”

- **Alfred Rappaport**

-  “Creating Shareholder Value”
-  “Expectations Investing”
-  “The Economics of Short-Term Performance Obsession” Financial Analysts Journal, May/June 2005

- **Robert Haugen**

-  “The New Finance. The Cast Against Efficient Markets”