SEARCHING THE WORLD FOR VALUE

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Leah Joy Zell, CFA, and Morgan Housel discuss Zell's value-oriented, small cap, concentrated approach to portfolio management. This approach focuses on the fundamentals and taking advantage of time arbitrage while mitigating risks in international equity investing.

Morgan Housel: Our next speaker today is Leah Joy Zell. She's a CEO and portfolio manager of Lizard Investments, which focuses on small- and mid-cap international equities. Previously, she was co-founding partner and portfolio manager at Wanger Asset Management, which she is also the head of the international equities team. She's a member of the New York Council on Foreign Relations, the Global Advisory Council at Harvard University, and the Harris Council here at the University of Chicago.

And we're going to talk today about searching the world for value. Leah, thanks very much for being here.

Leah Joy Zell, CFA: Thank you very much for inviting me.

Morgan Housel: I'm always curious how people got started in investing. Now, you have a PhD in European social and economic history. How did that influence how you got started in investing, and how you have progressed during your career as an investor?

Leah Joy Zell, CFA: So, I started life out as an academic. I thought I was going to teach history at a university. And as I made my way through my PhD, I became more and more interested in business. And by the time I finished my degree, I had one adviser at business school, and one adviser in the economics department, and nobody in the history department willing to claim me.

And I came from a very business-oriented family. And the pipeline in the academic world, there was a long queue. It was stuffed. And Wall Street had just come through a terrible bear market and recession. And they were desperate for anybody with a brain. And I said to myself, "OK, I'll join the family business for a bit and eventually, I'll go back to teaching." And that was the end; I never turned around.

I would say that the great thing about the training that I had, after an initial difficult adjustment period, is that I do think somewhat differently than someone who has had an MBA. And once you get over being threatened by that, it means that thinking long term is easier.

Morgan Housel: You and I were talking earlier about the structure of the investing team at Lizard Investments. What can you tell me about how it's structured compared to how a typical investment firm?

Leah Joy Zell, CFA: So, at Wanger Asset Management, I founded a 40 Act fund, which at the time was called Acorn International, and still exists now, branded Columbia Acorn International. And we were a traditional, long-only, international small-cap fund. And today, they manage within that group $10 to $12 billion — $10 billion, call it. I think when I was there, we peaked at $5 or $6 billion. But in order to run that kind of, that amount of money in small-cap equities, being international or domestic, you need to organize your team by sector and/or geography. And money management process is done in silos. That is, the guy who does Southeast Asia really doesn't talk to the guy who does European consumer, because they don't have a lot to say to each other. And they're competing for capital in a portfolio.

I always thought it was more interesting to run money along what I call the dinner table metaphor. The dinner table metaphor is how many people can you get around a table and have a single discussion. And once you get beyond about six people, the conversation breaks down.

And so we run money along what I call the dinner table metaphor. And that is that everybody on the team is a generalist. Each of us has strengths and weaknesses, but we have a single conversation. And we scour the globe for compelling opportunities, regardless of geography or sector. And we only own about 30 equities, so we have relatively concentrated positions. And that way, there's no competition for capital and everybody talks to one another. And hopefully, we put our money in our best ideas.

Morgan Housel: Is there a downside to being generalists? In that there's not in-depth specialization that might be necessary, especially when we're talking about global equities, where culture and regulations and accounting might be so different than what we're used to in America?

Leah Joy Zell, CFA: Our due diligence process can run between two weeks to two months. We often track equities for years before we buy them. So, our turnover ratio is about 40% per year. And if you translate that, it's about one idea a month. So, that gives us a lot of time to dig. And again, in today's world, between what one can garner on the Internet and between expert networks, that kind of depth can be purchased. What can't be arbitraged away is having an investment process that perforce dilutes your best ideas and causes you to hold too many names that you own not well enough, because of the weight of money as the enemy of performance.

Morgan Housel: I would imagine that when you started international small-cap investing, there was little, if any competition, but there's significantly more today. Is that fair?

Leah Joy Zell, CFA: There is, and there isn't. The asset management industry is, of course, much more mature today. You know, I had the good fortune of entering the profession when it was transitioning from being a small obscure business operated predominantly in bank trust departments, to a large entrepreneurial business, that then has now been sold back to banks and insurance companies.

But now, the small-cap space is increasingly orphaned as the size of funds grows. So, if you are managing $10 billion, you're not going to look at anything with the market capitalization of a billion dollars, particularly outside the United States, when the investable portion of that billion dollars is a fraction thereof because of large stakes held by dominant shareholders or historical families, or whatever. And so we are seeing fewer and fewer people looking at the names that we own.

And in fact, we did a little study of the top 10 names that have contributed to performance since the inception of our fund, and we found that over an eight-year period, only two of them appeared on the Goldman Sachs favored hedge fund list.

Morgan Housel: So, would you say there's more opportunity in international small caps today than there was 20 to 25 years ago?

Leah Joy Zell, CFA: I remember going to visit SAP in Germany in the early '90s. And there was a little plaque at the door when I walked in that said, "Welcome Leah Zell". And I would go in, and I was the only American who had been there that month, so it was a big thing. Somebody comes from across the ocean to go see them. So, I would say that when I started the industry, I was comforted by the fact that I saw nobody else. And that also meant that nobody allocated money to the asset class, because it was considered to be beyond niche. It was very much frontier.

That's no longer the case today. We have, I developed emerging frontier, all kinds of specialties and niches. But what I do believe is that there is not the kind of work done on international small caps as there is done on US small caps, and there is not the same kind of work done on small caps as there is done on more easily investable portions of the marketplace.

And as a consequence, I would argue that this is one of the last vestiges where active management not only gives you an opportunity to outperform, but is absolutely mandatory.

Morgan Housel: So, let's talk about your research and due diligence process. How do you screen for ideas? And then once you have ideas, what is the due diligence process like?

Leah Joy Zell, CFA: So, we get ideas from essentially two places. We have a watch list and we see probably, talk to or meet in person with, maybe 1,000 companies a year. That doesn't mean that it's a new 1,000 companies a year; we may talk to the same company once or twice a year for a long period of time. So, in the small-cap space, I've often said that I don't want to be closing valuation gaps. Because given the liquidity, if I buy it at 15 and I think it's worth 22, by the time I have my position, I've paid 17 and 1/2. And by the time I get out, I've gotten out of 20. And for all the amount of work we do, it isn't compensatory.

So, I like finding what I call horses with legs — namely, companies that can create value. So, we want high-quality companies. We don't [want] turnarounds; we don't want companies with a lot of debt. If you're going to buy small companies, you want to buy them because you think they're going to get bigger. You don't want to buy them because you think you're buying $1 at $0.70. And that means we want companies that are not necessarily dependent on GDP plus; that means we want companies that have sustainable advantages — comparative, competitive advantages. We often ask ourselves, is there a reason for this company to exist? Do you expect it to be around in 10 years?

And then the final piece is always valuation. If I buy it at this price today, what kind of a return do I expect I can earn? And we never look at any investment short of a three-year time frame. So, this is a long way of saying that this is not a trading strategy. And in fact, in the eight years that this fund has existed, we have never had a year where we have had a net short-term capital gain. So, the process is very long-term oriented.

But anyway, just getting back to your question. We have this watch list that's got 300 to 400 companies that satisfy all of our criteria, but maybe for valuation. And so we're always looking for situations where these companies stumble, there's a temporary issue, and then we really get into the due diligence to see whether it's temporary, whether something has changed. On the other side, we're constantly monitoring. So, our universe is a very dynamic universe where there are lots of new companies that come in, lots of companies that get taken out. And the churning of the pool of potential investments provides the opportunity to find companies that do not have sponsorship.

So, broken IPOs. Everybody gets excited when the company goes public, and then they stumble for whatever reason. And then everybody who bought it flees, and you have no one who is in the company with conviction, because no one spent the time to get to know that. That's been a great source for us. Spin-offs, a Japanese company that's listed Hong Kong with management that can talk English — perfect.

Morgan Housel: I have plenty more questions, but do we have any questions so far?

Speaker 1: So, where are you finding value currently?

Leah Joy Zell, CFA: We're really bottoms up, so sometimes, the macro factors overwhelm. So, for example, we were heavily in Brazil in 2009, 2010, but we were out of Brazil then for three years. And we made the mistake of going back on one investment too early. So, sometimes, particularly in the less developed markets, the general macroeconomic environment will prevail. With Brexit, we just went in and bought three new names that all had UK exposure. So, that was a short-term macro opportunity, where we knew the names, we followed them and particularly, with FTSE 250. I think we bought two of the names at average; they had fallen between 25% and 35%.

We also had three shorts in the UK which we covered, or partially covered. So, those are kind of temporary things. But broadly speaking, the short-term value opportunities aren't long enough for our investment horizon. So, our largest position in the portfolio today — you'll all think this is really idiosyncratic, which it is — is a company called Moleskine. And I think some of you, if you are in school or if you go and you take notes and you don't want to have a computer sitting in front of you, which impedes your ability to have a discussion with somebody, you have a little Moleskine notebook.

And this was an IPO that came public in the summer of 2013. It was a defunct brand that some Italian luxury goods, private equity people resurrected. And they used to be just little black notebooks that you had to go to a specialty store to buy. Well, you can now buy it at every airport in the United States. And I've seen the Moleskine display in the major bookstore and in Melbourne, Australia, and in Singapore. And go to the Time Warner Center in New York if you want to see the Moleskine store. And so they took the money from the IPO, and they restructured their distribution globally. It was a relatively small company, €120 million in revenues when we bought it, with global distribution and a well-recognized brand name and zero debt.

And now, you have a euro that's weakening. So, you go back to, where do you find value? Well, I wouldn't have looked to Italy per se to find the value, but everybody had thrown this baby out with the bathwater.

Morgan Housel: There's one other.

Speaker 2: I'm just curious, based on the processes, it certainly sounds, and you sort of alluded to a longer hold. But 40% turnover in sort of a two-and-a-half-year average hold, has that just been a product of the recent market environment — where you've been right, the valuations got a little frothy — or is that your target, two-and-a-half-, three-year holding period?

Leah Joy Zell, CFA: I didn't hear what you said about the current environment.

Speaker 2: I was wondering if, is the two-and-a-half-year average hold implied by the turnover, a function of sort of markets recently, where you've just been seeing valuations get out of hand, or is that sort of the target holding period?

Leah Joy Zell, CFA: I would tell you that our biggest mistakes have not been the things we bought that haven't worked out, but the things we've sold that we shouldn't have. And we're getting much better at that. The guys who started with me came more from a large-cap, or a market capitalization–agnostic background. And I think if you are investing in larger caps, you probably have to turn your portfolio over a little bit faster, because you don't have the runway for a company to develop and grow.

So, I would say that two-and-a-half-year time, what I'd ideally like is to continually to push the edge of the envelope to hold things longer and longer. But to be much more selective or increasingly selective on what we own. Because you're always shaken out of things, if you allow a temporary thing to upset you. You have to be able to distinguish between what's temporary, cyclical, versus what's structural.

Morgan Housel: Speaking of holding period, can you talk about the concept of time arbitrage?

Leah Joy Zell, CFA: Yeah, I'm going to talk about two kinds of arbitrage. One is time arbitrage, and that's what I've been alluding to, which is that there'll be something going on, either in the company or in the marketplace, that depresses margins that should not continue. However, if a company issues a profit warning, almost guaranteed, the stock will plummet. So, we follow those. We love when a company on our watch list issues a profit warning. That's perfect.

And so Moleskine, when it became public and then didn't meet the projections that the analysts had for it on the road show, stock went from €2.4 a share, bottom, to 18 months later, €1 a share. But the long-term value of the company didn't change. So, that's time arbitrage. You look over the valley and you say, this company and its intrinsic value should be this; the depression in the stock price should not be sustained.

There's the other thing, which I used to call "been to the movie." It's geographic arbitrage, and that has to do with the fact that certain industries will move from one geography to the other. And they will be at different levels of development or sophistication. One forgets this, but Europe was dominant very early on in cell phone technology. And the United States was way behind. And the leading companies in the world were Scandinavian, and they were Nokia and Ericsson. And the standards in Europe were — of course, they've lost that. And the iPhone has eaten their lunch. But that's an example of an industry that develops in one place.

So, one of our best stocks in the last year and a half, two years — and you're going to laugh at me, because I actually use this stock. I spoke at the Ira Sohn conference in London and I used it as my example. And everybody thought that this is about as uninteresting, as unsexy as it comes. And it turned out to be the best-performing stock that was presented at the conference that year. And it is, believe it or not, a Polish-based debt collector. Why in the world would you do that? And the answer, if you know the debt collection business in the United States, and there's a company in Baltimore called PRAA, which is one of the dominant, you know what these businesses look like. You know how good they are. And we came across this little Polish debt collection company based in Roslov, Poland, which is the old Breslau.

And the entrepreneur who started it had been a bankruptcy lawyer. And coming out of the Communist era, he developed a whole friendly system of collecting debts that he advertises on TV. And he says, "Come call us. Come talk to us; we'll help you work it out. We'll give you a schedule," et cetera, et cetera. The metrics have been absolutely stellar. He's done a fantastic job. I think it was named the number one young growing entrepreneurial company in Poland.

When we bought it, there was not a single major investment bank that had written a research report on it. The only people who owned it were Polish pension funds. How did we find it? The guys came to Chicago, because Chicago is a big place for international small-cap investing. And John Moog, who I worked very closely with and who did this gig before me for CFA Institute, happened to know a whole lot about non-bank financials and particularly about debt collection companies.

Well, now you have now a big problem with the banks in Europe. And you have the regulators pushing on all of them to clean up their balance sheets. And this whole industry of buying NPLs is just emerging in Europe. It has no history, but it's growing. United States, it's been around forever. So, that's geographic arbitrage. So, this particular company, guess what? Had just opened a subsidiary in Italy. That's geographic arbitrage.

Morgan Housel: The social norms and cultures are so different throughout the world. How do you assess corporate culture and management style in different places around the world, when it's so different from what we might be used to in the United States and what other of your portfolio companies?

Leah Joy Zell, CFA: I think you have to start by understanding that the way equity markets operate is that you get paid for taking, I call them calibrated risks, as opposed to calculated risks. So, you do not have the corporate governance standards that you are used to in the United States, broadly outside the United States. There are some jurisdictions we don't invest in, mainly because they don't satisfy our needs from a corporate governance perspective, the most notable one being Russia. We've looked at lots of Russian equities over time, and we've never been able to get comfortable with the corporate governance standards.

Asia is more problematic than Europe. One of the interesting things about Brexit is this: The UK is the deepest and most trustworthy equity market outside the United States, which is why I'm actually doing some work on it right now. I'm going to give a talk in a couple weeks to some foreign policy people. And I'm saying that I don't think the Europeans are going to be able to kill the equity market or the role of London as a financial center for Europe, because of the element of trust. And the infrastructure, and the fact that it's human capital. But that's notwithstanding; that's an off point.

There are two answers. The first answer is that where there are issues or cultural issues, they tend to be culturally common. So, when you go to Japan, you know your biggest problem is capital allocation. So, you look for the couple of managements who have demonstrated that they understand the cost of capital and pay attention to how they allocate capital, as opposed to focusing on revenue growth. So, there are certain kind of generalities that will apply to different jurisdictions.

And then the other thing that I think you do in operating around the world is, we call ourselves concentrated. We have peers, other investment organizations. When they are concentrated, they'll put 10% to 15% of their portfolio in a name. But that's when they can do kind of due diligence that is simply not available to us, no matter how smart, or maybe it's laziness. So, generally speaking, we are concentrated for what we do, but we limit the amount of capital we'll put into any individual name to 5%. We may let it grow beyond that, but we generally try not to put more than 5% of initial investment in any one name. And that's because there are limits to our ability to really do the kind of due diligence that warrants greater concentration.

Morgan Housel: What regions out there do you think are small enough to, where there's not a lot of competition from other investors? But at the same time, developed enough that the corporate governance and the reporting standards are strong enough that you feel confident to go in there as an investor?

Leah Joy Zell, CFA: You know, we're bottoms up. So, it doesn't end up being by region. I'll give you an example. We had a position we purchased in 2009 in a Chinese company called Hsu Fu Chi. And it's classic Lizard: listed in Singapore; Taiwanese management; Chinese operations; and finally, controlled by a family which own 55% of it. And so of the remaining 45%, there was a fund in Hong Kong that owned 10%, we owned a piece, and a couple of other people owned pieces.

But this is quasi-, almost private equity. So, you look at it and you say, "OK, why would you do this?" Well, one of the guys who works for me, a guy named David Lee, is native Chinese. He grew up, came to the United States for high school from Shanghai. He's fluent in Mandarin. And this company makes candy. And he remembered the candies from growing up. And they were the dominant candies in China during Chinese New Year. They had candies for all year round, but they were particularly well known. And he went and he talked to the management. He looked at it.

And the family, which is Taiwanese, had an absolutely squeaky clean reputation. And we can go back and take a look at how they had invested money, what they had done with the money, what plants they had built, and it all checked. The boxes all checked. And you are listed on Singapore, so you had world-class reporting standards. And here's how the whole story played out. It's kind of fun, I think. What we hadn't realized is that Nestle had wanted to buy this business forever. But Nestle doesn't buy businesses unless they control it. And the family did not want to give up control. And then finally, the eldest brother got sick, purportedly.

And what they ended up doing was, Nestle bought the company. The family agreed to sell down to 40%. So, they kept the 40% stake. Everybody else got cashed out. And we probably made three to four times our money on it. So, at the end, we did very well, certainly, on an IRR basis. But arguably, this would've been a company you would have wanted to own for the duration. There's no reason you would have sold this company that was extraordinarily well managed, growing nicely.

And a friend of mine who also owned the stock called me up and said, "We should protest. We should refuse to tender our shares. Why don't you call that, the fund in Hong Kong, and let's all get together." And the fund in Hong Kong gave us — I knew what they were going to say. But the truth of the matter is, you're operating in Asia. This fund in Hong Kong specializes in consumer goods companies. If they mounted a fight with this company and they own 10% of it, which other Asian consumer company would ever allow them to acquire 10% of the shares?

So, from their perspective, they make good money, good relations with management, and their reputation as an investor in Asia far outweighed what they could get by squeezing this company, or squeezing Nestle for a couple more pennies. And I don't even know whether the elder brother was ever sick.

Morgan Housel: Any more questions?

Speaker 3: You mentioned that there were managers looking into this space because the fund sizes are getting bigger. Does that make the space more dangerous as a result?

Leah Joy Zell, CFA: Does that make the space —

Speaker 3: More dangerous.

Leah Joy Zell, CFA: I think that's not dangerous; I think that's opportunity.

Speaker 3: And what role does dominant ownership play in your stock selection?

Leah Joy Zell, CFA: So, outside the United States, it is much more common for there to be dominant shareholders, because the concept of equity ownership — I used to say that if you're going to do international small cap, you don't want to be investing with someone who is predominantly a US manager, who looks for a product extension and says, "Well, I can take what I do and move it overseas." I see a lot of people who are, quote unquote, "global managers," and that means they have 70% of their assets the United States, 25% of their assets in Canada and Europe and other places which feel like the United States. You want to start. You want international investing to be that company's culture and strong suit. So, you live in that particular space.

And the second part of your question was?

Speaker 3: What role does dominant ownership play in your stock selection?

Leah Joy Zell, CFA: Look, in the case of the Hsu Fu Chi, that story I just told you, it was a strong positive. Because it was the management which owned the stock who made sure they didn't get ripped off by their Chinese clients. There are owners who look upon minority shareholders as targets, and there are owners who think about the company as if it were a private company that they're going to own forever. And if they think about it as a private company that they're going to own forever, they may not do the sorts of things that US managers do to return value to shareholders. But strategically, they often make what we consider to be the right decisions. So, it's part of your assessment. And it's a qualitative assessment, but it's a qualitative assessment that's based on quantitative behavior.

Morgan Housel: Are there regions of the world right now where you see a surprising amount of either optimism or pessimism? Not among investors, but among CEOs and business managers?

Leah Joy Zell, CFA: I don't do emerging market debt, but my friends who do emerging market debt are getting very positive. I'll give you a 30-second on what I think. This is just my hypothesis as to what's happening in the world, because we're still playing out the aftereffects of the financial crisis and probably will be doing that for the rest of my tenure as a fund manager.

To me, the Brexit vote is symbolic of the end of austerity. I think that all of the politicians around the world who have been talking about tightening your belt and reducing money for public services, and we can't afford this and we can't afford that, are finding that the people who voted for them are abandoning them and supporting protest candidates globally. Whether it's Malcolm Turnbull, who was unable to get a clear majority in the elections in Australia; whether it's the Brexit vote; and we all know about what's going on in the United States.

On the other side, you have Shinzo Abe in Japan who is coming out and saying, "We're going to spend. I don't care if we could afford it. We're going to do everything we can. We have to stimulate. We have to get inflation up." And he just won a supermajority last weekend in the elections in Japan. Theresa May, who just took over as prime minister in the UK, has thrown out Osborne's austerity budget. And both of the candidates running in the United States are going to be launching infrastructure projects. And you couldn't have asked me how this is all going to be financed, and I have an answer for that, too, or hypothesis for that, too. But I think that if, that being the case, the alternative to that, I don't want to think about.

Morgan Housel: So, how is it going to be financed?

Leah Joy Zell, CFA: Governments are going to extinguish debt. Let's take a look at Japan. At this point, Kuroda has probably bought two-thirds of the public debt in Japan. And you have to remember — the Germans don't understand this, because the Germans think that the way you manage countries is the way the little housewife manages the household, and then you need to balance the budget every year. Well, all the debt at this point has been moved up to the sovereign level. Well, guess what? What the sovereigns can do that households can't do is print money. And "print money" has a dirty name, but if the money multiplier has fallen as low as it's fallen, and if the risk globally is deficient demand and deflation, that is exactly what you ought to be doing. You ought to be printing money.

So, my bet is that the Japanese are going to be the leaders. And at some point, Kuroda is going to say, "OK, guess what? A lot of this debt we owe to each other, because it's interagency governmental debt in Japan. I am going to issue a zero-coupon perpetual bond. So, it'll still be out there, except nobody's going to pay me and I've just created all this money. But I'm not going to tell anybody that it's called helicopter."

Morgan Housel: Related to that point, as a US-based investor investing in international equities, how does the relative strength of the dollar play a role? I know you're bottoms up, but especially in recent years, that's certainly made a difference.

Leah Joy Zell, CFA: Look, nobody who does what I do, or what you guys do, should do it unless you like playing with money. It's fun, right? So, I look at the currencies obsessively. I try to do less than I think about it. So, I have what I call a neutral setting for my portfolio, which is hedging 50% of my foreign currency exposure. And I may play around country by country as well, when I hedge more. So, I raised my hedge, for example, on the British pound a couple of weeks before Brexit, because everybody thought that the referendum wouldn't pass. I had no strong view on how the referendum was passed; I just thought I had asymmetric exposure. Because if it passed, there would be a limit to how much the pound would appreciate. But if it didn't pass, I had much greater downside. So, that's an example of where I tinkered on the margin.

In 2009, 2010, I didn't hedge the portfolio at all because the dollar was extremely strong. By 2013, I had brought my hedge ratio — in 2013, 2014, I was probably 75% hedge. Now, I'm about 55% hedge. So, that tells you where my head is. It doesn't mean I'm going to be right, but that's what I'm thinking. In general, the short answer is that you'd think a strong currency would correlate with strong equities. But it's actually, generally speaking, the opposite. So, Japan is the classic case where every time the yen strengthens, the equity markets go down. Every time the yen weakens, the equity markets go up. But that's because the Japanese are, like, obsessed about what the yen does.

Occasionally, in an emerging market like in Brazil in 2009, 2010, everybody got interested in the market. Everybody started investing. The currency went up and the equities go up, but the short answer is that for domestically oriented companies, you probably want to hedge the currency, because they don't get any benefit when the currency weakens or strengthens. And exporters, it's the opposite. So, ultimately, you have to look through your portfolio at what your exposures are.

But yes, since we invest bottoms up, it gets factored into our bottom-up analysis. And the nice thing about currencies in today's world is you can actually make a differentiated choice. You can say, "I like this equity, but I don't like this currency. So, I'll buy the company and I'll hedge out the currency risk."

Morgan Housel: Questions?

Speaker 4: You mentioned that other qualities that were concentrated more heavily on the name were able to do another level of due diligence to get that confidence. What benefit is that extra level of due diligence?

Leah Joy Zell, CFA: If I'm investing in a US company, the rooting around for information is an accepted part of the game. So, you'll talk to customers, you'll talk to suppliers. You'll ask the company to take you through plants. You might, if you want to buy 10% or 15%, you might actually go there and ask to see multiple levels of management. And you'll go once a quarter. And you take an awful lot of time. You try to go to Korea and ask a company to let you talk to their second or third level of managers. And they'll look at you and they'll say, "Who do you think you are?"

And in Japan, you're going to have a hard time talking to the CEO, because he doesn't meet with investors. Anecdotally — so, once in a former life, I actually used to be involved in Chinese art. And you would go to Hong Kong and you go see a dealer. In the US, the dealer will immediately bring out his very best piece, fancy price. Totally different. You'll go, sit and talk to the dealer, and you'll have tea. And you'll do it one day, and then you'll come back two months later and do another day. And then after maybe six months, he'll take you into the back room and he'll show you his third level of best stuff.

And then after two years, maybe, once you've established your credibility, you start seeing the real stuff that he has. This is like in a kind of capitalist Western notion, my god, you put your best out first. So, I think how much of your coat you open and show differs in different places around the world. And I just think we just understand that there are limits to what we can do.

Speaker 4: So, have you stock positions? I would be interested in hearing about those.

Leah Joy Zell, CFA: So, we're more thematic on the short side than we are on the long side. We have done a lot of work on — believe it or not — groceries, food retailing. And we think it's going through a structural change globally. And it's a subset of what I see in consumer goods in general, which is a bifurcation between cheapest price and premium, and that everyone in the middle is getting wiped out.

So, a good example of that would be in the UK, where Sainsbury and Tesco are losing market share to two German challengers that are not public, Aldi and Lidl. And we didn't short Sainsbury and Tesco. We did short a company in the UK called Ocado, which does online grocery delivery. We're not sure of the position right now, but we did it on the theory that online growth — who knows? Maybe Amazon will make this work. But if I order a book on Amazon, it can sit on my doorstep or in my mailbox for three days. If I don't pick it up, I don't pick it up. If I order a pint of ice cream, that doesn't work.

So, if you think about online grocery delivery, you have to disaggregate what you're going to deliver into dry goods, refrigerated, and frozen. You have to re-aggregate it at the point of delivery, and you have to make that delivery within a one-hour window, because it can't be left on your doorstep. That makes it a logistics business, not an online business. If it gets valued as an online business, then somebody's misunderstanding what in fact the core of the business is. So, that's an example. And anyway, what happens with industries is they work for a long time, and then they don't work. Something technological has changed, something about buying habits has changed, something about supply chains has changed. And it takes time for the world to figure out that it hasn't worked.

And so grocery retailing used to be a really stable business with really predictable margins over long periods of time. And that means that the company's all levered up because the theory was that they could handle the debt. Well now, suddenly there are all these cheap upstarts that are challenging them. And the debt is a constraint on their ability to bring margins down. So, that's an example structurally of an area we've done a lot of work on, where we've found some good shorts.

The shorts on UK retail real estate kind of flows from that, because we think that retailing is changing. And so anybody know what food retail chain in the US is owned by Aldi?

Speaker 5: Trader Joe's.

Leah Joy Zell, CFA: Got it. So, that's one of the reasons Aldi's been a little slower coming into the US, because they're using Trader Joe's instead of coming in head-on.

Morgan Housel: Questions? Are other areas of the world that for whatever reason, you won't touch?

Leah Joy Zell, CFA: Look, I have a lot of friends who do frontier markets. And they buy things in Bangladesh, and they're into Pakistan, and they're into Solan, and they do Nigeria. We did a mobile phone company out of South Africa who had a big Nigerian exposure. We looked at Greek bottler which had a lot of emerging market, a lot of African exposure. We have enough problems with doing due diligence; that's something I'm not sure we have the bandwidth to handle. And again, if in my old life, where we owned 200 names, so you put 30 names into something where you can't actually touch it. You buy half a percent of something, fine.

But if we're going to buy starting positions of 3% of the fund in a business, then we have a basic rule. And again, it's not so much an area of the world, but I sort of alluded to it. It's got to be a sustainable business with a good balance sheet, with management that understands how to allocate capital, with corporate governance standards, and evaluation that we can model a double, ideally 20% compound return. Those are the five. That's like our holy grail, our five issues.

If we can't get an answer to all four of the first questions, we pass. And so a better way of answering your question is that sometimes, it's a country. So, as I said, Russia is an example where we haven't really gotten comfortable. We got ripped off on corporate governance on a Korean investment recently, even though Korea has been a country we've had good success with. More typically, it's an industry that we don't get involved with, because we can't get comfort on answering the first four questions. And the two industries that are mainstream investment industries that we don't get involved in: We don't buy banks because we can't analyze them, because they're black boxes. And we have not invested, for the most part, in commodity companies, because we can't predict where the prices are going to go.

Morgan Housel: How important is it to meet with management and see the operations with your own eyes? With the exception of a Polish CEO who's flying through Chicago, might be prohibitive to a lot of money managers.

Leah Joy Zell, CFA: I don't know that seeing operations tells you very much. I think sitting down with management is mandatory, particularly, for the kinds of companies. We get more valuable information from expert calls. And one of the things we do cultivate is a broad network, now simply through professional expert calls, but we just know people who are in businesses all over the place. And we exploit our friendships shamelessly.

Morgan Housel: I think we have time for one more question.

Speaker 6: How sensitive are you to FX hidden costs?

Leah Joy Zell, CFA: FX doesn't cost us anything to hedge. Or let me rephrase it. So, I hedge in the cash futures market, which simply means that I agree to set the price of the yen in my portfolio wherever it is three months out, or whatever time frame. And the cost will be the interest rate differential. And since most developed countries outside the United States have interest rates lower than the ones we have here, I actually get paid points. Where it does become important is in a country like Brazil. And so if the SELIC rate is 14%, the underlying equity investment has to be screamingly compelling for me to want to pay the interest rate differential to hedge out the currency.

I don't know whether the currency has bottomed, but it's closer to bottom, or certainly was 6 to 9 months ago than it was 24, 48 months ago. So, sometimes, that's when I think it's one of the factors that you take into consideration. So, I actually have taken a look at what we've made or lost on currencies. And over the years that we run the portfolio, I would say the main impact has been that it's dampened volatility. But now, but that means that here and there, I make a lot of money. And every once in a while, I lose a lot of money.

Morgan Housel: We're going to have to end it there. Leah, thank you very much.

