

ETHICS AND DISCIPLINE

UCLA Anderson School of Business - Distinguished Speakers Program
Speech by Robert Rodriguez

Good evening.

It is a pleasure to be here tonight and I would like to thank UCLA for this honor. My firm, First Pacific Advisors, is getting to know the Anderson School of Business better through the efforts of Professor Santa Clara and my valued board member, Al Osborne. Given my educational background, I have been much closer to the USC Marshall School of Business; however, we are looking forward to a closer relationship with the Anderson School. I know Al will be doing his best efforts to see that this occurs. Seriously, we are all quite privileged to have two exceptional institutions of higher learning in one city.

By way of background, First Pacific Advisors has been in existence for fifty years. We manage over \$5.2 billion of institutional and mutual fund assets with thirty-three employees. We are proud of the fact that during the last twenty-five years, we have not lost a senior investment professional to another competing organization. Many of our funds are counted among the top performers of their respective areas of investment.

Given the notoriety and abuses within corporate America and the mutual-fund industry, my talk tonight will briefly discuss ethics and discipline as they pertain to corporations and mutual funds. I will then cover the investment discipline that I have utilized, with some success, during my thirty-three year career. Finally, I'll provide some brief comments about today's financial markets.

We are in a period of challenge and questioning today. Many are questioning the ethics and integrity of corporate America and now, what was considered one of the cleanest segments of the business field, the mutual fund industry, is under that same microscope. It has come as a surprise to me that so many would sell their good names for so little. It seems as though we have to be reminded of this every so often to bring us back to reality.

After every major bull market in the modern era, there has followed a period of discovery of corporate malfeasance that existed during the bull phase of the market and the economy. During the past seventy-five years, there have been three of these periods with the last one occurring now. In my career, I have witnessed two of them, the first being the period between the market peak of 1968 and its trough of 1974.

What I have seen is that the excesses of the up cycle are then followed in the down cycle by psychological depression and confusion on the part of investors and the public. Betrayal is felt and revenge is sought. Many question the ethics and integrity of our business leaders. Trust is lost and the only solution is increased regulation. This has occurred after every one of these cycles and I have no doubt that it is occurring now. The first phase of this current retribution cycle resulted in a questionable piece of law called Sarbanes-Oxley and now we are on the verge of possibly getting some other dubious laws regarding the mutual fund industry. Hopefully, sanity will prevail so that the industry is improved and not harmed.

In corporate America, we have witnessed the excesses of an Enron, a Tyco or any one of a large number of corporations where their leaders pushed and then exceeded the limits of what would be considered good business and sound judgment. Why is this?

I believe that it derives from uncontrolled greed and excessive confidence. When the economic environment changes, many of these executives continue to try to maintain a business level that is unsustainable. The pressures to maintain their over-valued stock prices can lead them into bad decision-making. Even as reality sets in, these executives attempt to hold back the tide that is eventually going to overwhelm them. They lose their moral compass, assuming they had one to begin with.

I have wondered why these trends repeat themselves. Doesn't anyone learn from history? Do they not realize that the concept of "the emperor has no clothes" will eventually sink them? Obviously, many of these executives do not. They perceive themselves to be masters of their own fate.

In studying economic history, I have always been amazed at how business decision makers generally act in unison within an industry. Capital expansions generally occur at the same time. This leads to excess that then has to be cleared away in the down cycle. Aggressive business tactics are taken to excess. The unstable bases upon which some of these businesses are built encourages some leaders to abandon their business integrity and ethics. It's all about keeping the perpetual-motion machine going. Growth at any price is the driving force.

Leaders who condone this loss of integrity and ethics send a very negative message throughout the organization. Discipline is lost and the seeds of destruction are planted. Some will leave such an organization while others will stay and compromise their own standards and then justify their actions by saying that "all the others are doing it." When faced with such a situation, will you have the guts and moral conviction to stand-up to it or will you "go with the flow?" Many of you may face this type of decision in your career. It will be difficult to make the right decision. I hope you will. In the end, you have to live with yourself.

I like to look at these periods from the view of climbing a mountain. On the upside, the challenge and opportunity are invigorating. Optimism grows as the ascent continues. Greater and greater resources are brought to bear, as the summit appears to be within reach. Confidence grows in one's capabilities to deal with all challenges. Whether it is in an operating company or in the stock market, the drive and the sureness of success are very similar. As the business cycle reaches a peak, both corporations and the majority of investors are supremely confident in their abilities to forecast the future. It is on the downside of this proverbial mountain that they come to realize the shortcomings of many of their strategies. They are soon to experience the pain of excess. The magnitude of their overconfidence and pushing beyond the limits of good judgment will begin to become clear to them. When the realization sets in, it generally is too late.

In analyzing companies, we try to assess whether management has the integrity and sound judgment that we would like in a business partner. Sometimes we are good at assessing these attributes, while at other times, we are not. Generally, companies with strong market positions and controlled growth tend to avoid many of the problem areas we see today. It is when rapid growth, excessive optimism and uncontrolled greed become the dominant drivers of decisions that the environment is set for questionable decision-making. We also like to see how managements compensate themselves and their employees. Do they communicate in an honest and straightforward manner or are there an endless series of financial adjustments that add to the confusion of understanding their financial statements. Countless acquisitions that change the balance sheet each year are good indications that one should be on the lookout for aggressiveness in both the accounting and business decisions.

Aggressive capital raising and spending are other warning signs that raise questions in our minds about the operating and financial discipline within a company. If Wall Street is willing to have an open checkbook for the raising of capital, we are cautious of this type of a company or industry. If it is that popular, it can't be that good. Too much capital means too much expansion and the potential for an industry or company rationalization.

If you look at many of the companies that are facing trouble today in corporate America, you will see that they have many of these characteristics.

As for the mutual-fund industry, I have brought a handout that is titled, "Comments on Transgressions in the Mutual Fund Industry." This was placed on our website on October 31. I am told that it is one of the very first in the country to address the unfortunate events that are unfolding in the industry. This continues

a trend of candor that FPA began many years ago with its clients, shareholders and other interested parties. It also derives from my past experience of witnessing some of the problems that occurred in the mutual fund industry during the 1960s and early 1970s. Furthermore, my late associate, George Michaelis, a graduate of the UCLA School of Engineering and the Harvard Business School, set a very high standard of excellence with his shareholder letters. He had to because Charlie Munger was on his board of directors of the Source Capital Fund, a closed-end fund listed on the NYSE, for nearly seven years. Charlie Munger does not let anything go by without intense scrutiny. For those of you who have not heard of George Michaelis, you may read about him in John Train's book, *The New Money Masters*.

I am shocked at the total betrayal of trust that so many in our industry would sell their reputations for so little. It can take thirty years to build a reputation and only one day to destroy it. Because of the fiduciary nature of our business, I believe that we, as financial stewards of capital, should be held to a higher standard than even corporate management. I am always amazed that someone that I don't know will give me a portion of their life's savings on the basis of trust. It is this very thin thread that holds a good measure of our financial system together today. Without it, the system would collapse. Because of the breadth and depth of participation in mutual funds, these transgressions have the potential of being more important than that which has occurred in corporate America. The mutual fund industry was considered safe and clean when compared to corporate America. This betrayal was not expected to happen. Why would anyone do these things when this business is so profitable? When is enough, enough? I wish I had the answer but I don't. I do know that the retribution should be harsh on those who betrayed their shareholders' trust.

For nearly thirty years of my career, it has seemed as though no one cared about ethics, integrity or good corporate governance. I watched as other investment complexes took aggressive actions in the managing, marketing and selling of their mutual funds. During 1999 through 2001, it frustrated me to see that assets would be taken from us to be deployed with managers who were basically speculating. Many of these managers had what I considered to be an "OPM" attitude. You know, it's "other people's money."

I have also seen the industry talk about the economies of scale that would be achieved with asset growth and how this would result in lower operating costs for shareholders. New forms of classes of funds were allowed so that these economies could be reached. After the fact, very little in the way of scale economies has been seen even though I have watched the industry's assets grow from less than \$50 billion to over \$7 trillion.

While industry expense ratios were generally rising over the last twenty years that I have been managing mutual funds, my funds' expense ratios have declined. Over these years, my partner, Richard Atwood and his predecessor, Julio de Puzo, have been ruthless about costs. We all felt that, should we ever get into a period of low investment returns, expense ratios would take on greater importance. This discipline of managing expenses was not considered important or sexy within a large segment of the industry. We considered it important since to us it was just another aspect of treating your partners fairly and demonstrating integrity.

When I look at the companies that have run into problems, they typically have similar attributes. The problem funds have been mostly concentrated in the growth, aggressive growth and international investment sectors. They have been aggressive in the acquisition of assets as well as in the management of money. During the 90s, aggressive money-management styles were richly rewarded by huge capital inflows. The more aggressive the investment style, the more likely it would be well received in the marketplace. At one point in the late 90s, nearly two-thirds of all cash flows were going into growth and aggressive growth funds. Managers of funds that were not in these categories began to feel the pressure to compromise their investment styles so as to retain or attract money. In other words, they began to lose their investment discipline. I even met a utility fund manager who talked about AOL as a utility because customers would pay a monthly fee like a utility. In this way, he could justify owning it in his fund. Talk about compromising one's standards.

It was this overly zealous charge for assets that would eventually lead to many a manager's undoing. First the investment and business discipline was lost and then followed a loss of ethics. As many of these firms began to experience severe declines in assets, some of these managers and business executives were willing to look the other way when questionable business practices were being implemented. Many of these were condoned in the name of maintaining assets under management rather than what would be in their shareholders' best interests.

During the up cycle, many of these fund complexes increased the level of their operating expenses so as to be able to have the scale to handle a larger amount of assets under management. As the bull market bubble burst, so did their business strategies. Rather than accept a shrinking business and, therefore, scale back their level of operating expenses, they proceeded to implement strategies that would attract more assets. In each of the cases where there have been market-timing issues, attracting additional assets for fees was the overriding goal. At no time did they consider that this would be harmful to their existing investors or to their reputations.

Some executives got into the flow of this market-timing game by trading their own funds directly or they would do it indirectly through a partial ownership of a hedge fund that would trade their fund. In either case, their shareholders' best interests were the last to be considered. I can think of no other reason than this was nothing more than greed. Several of these managers or executives are worth in the \$100s of millions. In my opinion, they probably thought that what they were doing was of little importance and that no one would care anyway. Never mind that this would be a violation of ethics and integrity and a betrayal of their shareholders' trust. In the final analysis, the dollar amounts involved appear relatively insignificant, when compared to the size of their personal net worth; however, the size involved is irrelevant. It is still a betrayal of trust.

At First Pacific Advisors, we have assiduously focused on what is good for our partners. We believe that this is the best strategy for long-term business success. Each time a new product, strategy or class of fund is discussed, we think in terms of how it will affect our current and prospective partners. We are always on the lookout for potential conflicts of interest. We are proud of the fact that our code of ethics and our operating standards exceed virtually every proposal for improving governance, compliance and reducing potential conflicts of interest that have been suggested so far. Ours have been in place for years.

This dedication to fair treatment has cost us in terms of assets under management. I just read, in the November 26 issue of the *Wall Street Journal*, how Putnam Investments is dropping the practice of "directed commissions." These are commission dollars that are directed to a broker so that a broker will focus on the sale of their funds versus some other fund offering. There is nothing illegal about them but we do not condone them as a proper use of our shareholders' commission dollars. This article reported that there was an internal debate between the trustees, who argued against this practice, and the Putnam management who favored them. The trustees said that Putnam's argument was one of, "Everybody else does it. Why should we be penalized?" It is this type of thinking that continues to astound me in that it did not occur to the management that this practice, though legal, might not be in their shareholders' best interests. I believe this attitude permeates many of the executive office suites in this industry. If it is legal, then it is all right to do, rather than do what is ethical and in your shareholders' best interests. It is a concept that their primary duty is to gather assets and that they view their clients as customers. Both of these are marketing terms and each raises questions as to how these firms truly view their clients.

The industry would not be in the fix that it is in today if it truly focused on what is good for shareholders or prospective shareholders. As an example, management should have the discipline and the ethics to resist the temptation to sell what is easy as opposed to selling what is right. Many of these large organizations, as well as smaller ones who want to be large, go the easy route of offering new funds that the public is willing to buy today. When this is the case, generally, it is probably late in the day for that particular strategy and, therefore, it is likely to be a loser for these new investors. This is a successful short-term strategy, but it is a questionable one longer term.

I don't want to come across to you that everyone or every organization is guilty of these questionable practices. I know several ethical managers and organizations that attempt to treat their shareholders as partners. I truly believe a large portion of the industry does try to treat their shareholders fairly.

In summary, I want to say that discipline and ethics are related and that they can reflect the true nature of an organization.

Now I would like to now turn my focus to the discipline of investing as I practice it. For over twenty-five years I have been analyzing and managing equity and fixed-income portfolios. I would like to briefly cover how I came to my style of investing, its basic ingredients and then discuss my present portfolio positioning since I consider the current investment environment to be extremely interesting. For those of you who are interested, you may read several of the notes I have written on my firm's website, www.fpfunds.com.

To begin with, I'm an investment junky. I got hooked at an early age.

My first experience was the result of a school project that required us to write to someone who we did not know and to get something back in the mail. I was ten and I did not know what to do so I asked our librarian for help. She asked me what I was interested in and I said that it was money. She showed me a book titled, *The Federal Reserve System*. I ended up writing to Chairman William McChesney Martin since he had signed the introduction page to the book. I received a nice letter from the Chairman informing me that I was to receive the Federal Reserve Bulletin and, as such, I would become the youngest subscriber to it.

Following this experience, when I was twelve, I saw a movie about the New York Stock Exchange and it occurred to me that this looked like the greatest casino in the world. The excitement and potential for gain really caught my attention. This was something I had to learn more about.

Both of these as well as my undergraduate education guided me to the investment field that I entered in 1971. At my first company, I was impressed by how many smart people were picking stocks. The focus was on growth and aggressive-growth stock investing. There was no question in my mind that this was the way to becoming a successful investor. Let the good times roll.

It was in the collapse of the 1974 stock market that I really began to question this type of investment methodology. It really hit home when I had my largest personal investment position collapse on me. I began buying the stock at \$22 and averaged down all the way to \$8, where I ran out of money. It eventually bottomed at \$7/8. At that point I asked a very basic question, "Am I doing something wrong?" Nothing in my educational or business background had prepared me for this experience. The investment books of the time did not address what I was witnessing. Here was a stock that had \$2 per share in cash, \$3.50 per share, on a historical cost basis, of Orange County, California real estate that had been purchased nearly twenty-two years earlier. There were no current liabilities or long-term liabilities because management had paid them all off, in response to their industry's terrible business conditions. In summary, you could buy cash at less than fifty cents on the dollar and get the real estate thrown in for nothing.

In trying to figure this situation out, I went into the old portion of the main library of the University of Southern California. While looking at old business books, I "discovered" one that would change my investment world, *Security Analysis* by Benjamin Graham and David Dodd. It helped me to better understand what was going on in the stock market at that time. As a result of reading this book, I decided to write a paper for my graduate investment class. In doing my research, I found 52 other companies that had these same characteristics of the one I just described. This study raised serious questions about Modern Portfolio Theory and the Efficient Market Hypothesis that we were studying at the time. A very basic question was raised that questioned these theories. In an efficient market, how can cash sell at a discount?

My problem stock eventually turned out to be a successful investment. With the stock at \$1, the company tendered for 25% of the outstanding shares at \$5.50. Two years later, they were able to sell this same stock back to the market at approximately \$22. The company was a recreational vehicle company named Executive Industries. At the time, I did not understand the implications of the oil embargo, if you can believe that. In retrospect, I don't feel too bad or too stupid since the stock market went on to a new high after the oil embargo began.

As a result of this "new" found style of investing, I became a dedicated contrarian value investor who focuses on absolute value rather than relative value. The result of this style has led to my small/mid-cap fund, FPA Capital Fund, outperforming the Russell 2000 and S&P 500 by 722 and 463 basis points annually from July 1984 through October 2003. Their respective compound annual returns for this period are: FPA Capital Fund, 18.02% (at net asset value, excluding sales charges); the Russell 2000, 10.81% and the S&P 500, 13.40%.

It is very much an investment process where most of the time you are a loner. Virtually every time my associates and I get interested in a new idea, it usually is on the new low list or it is generally out-of-favor in Wall Street. Typically, when we are selling a position, it is usually popular and being recommended by Wall Street. As you can see, much of the time we are out of sync with the investment community.

It is a simple strategy but it is very difficult to implement. Most investors are looking for consensus or a lot of support by others who agree with their investment opinion. Being virtually alone and against the trend means you stand out from the crowd and, therefore, you have very little support of your position. A typical response is, "You are doing that. Why!" It is a very lonely feeling. Because I believe few can implement this method of investing successfully, it helps to explain why FPA Capital Fund has had long-term success. Another aspect of the strategy is to be a concentrated investor. I am willing to take on increased portfolio volatility so as to gain a competitive advantage of understanding what it is I own. Typically, my portfolio will have between 30 and 35 names with the top 10 representing between 40% and 60%. Industries will be also concentrated. I like to say to my associates and clients that I believe in the land of tall trees. Anywhere from 25% to 50% of the names will be concentrated in two or possibly three industries.

The key attributes of this investment style are the following:

1. Focus on market leadership or niche companies that are in industries that are perceived to be out of favor and unloved—a bottom-up strategy.
2. Select companies that have strong balance sheets—typically with total debt to total capital of less than 40%.
3. They must be at a significant valuation discount to the market and their historical valuation parameters.
4. Acquire them at modest premiums to book value, less than 1x revenues.
5. They should be on or close to being on the new low list.
6. Have a long-term investment time frame—typically three to five years. As a test of this, since July 1984, the average annual portfolio turnover of FPA Capital Fund has been less than 20%.

Examples of this strategy have been:

1. Our California "play" companies that were purchased during the depth of the 1990s recession. One of our long-term holdings, Ross Stores, is still in the fund today with a gain that is over twenty-fold.
2. In our March 2000 Shareholder Letter, we compared Centex's valuation to that of the Nasdaq. This comparison helped to show how there was a major disconnect in valuations and that one of these two examples was severely mispriced. We argued that it was the Nasdaq as well as the

other major stock indexes. We are now almost out of our Centex position, with it up nearly six-fold from our original purchase price while the Nasdaq is down approximately 60%.

3. A new area for us is in the energy-service industry. We are in the process of making energy a new strategic area for us. This is a major change for me since, after selling virtually all of my energy stocks between 1979 and 1981, I did not purchase another until early 1999.

Today, my largest exposure is to short-term liquidity at 23% of total assets. It is building because of what I believe to be a lack of investment candidates due to valuation considerations. We are being driven out of stocks to the point that it would not surprise me to see FPA Capital Fund's liquidity position rise to the 30% to 40% range next year. I see too much in the way of speculative investment tendencies that are reminiscent of 2000 but not to the same degree.

In managing fixed income portfolios, my philosophy is very much like what I do in equities--a contrarian out-of-favor value style of investing. It is a bottom-up as well as a top-down strategy because bonds tend to be more homogeneous than stocks and, therefore, they act more like commodities. Because of this, my style of fixed-income management is much more risk-averse than in equities. In the nearly twenty years that I have deployed this style of management, FPA New Income has outperformed the Lehman Brothers Government/Credit Index with only about one-third its volatility while never having had a down calendar year of performance. The respective compound annual returns for the period July 1984 through October 2003 are: FPA New Income, 10.29% (at net asset value, excluding sales charges); and the Lehman Index, 9.69%. This trend of never having had a calendar year loss extends to nearly 29 years, when we include the record of the previous manager.

I came to fixed-income investing in late 1979, when the bond market began to offer returns that were commensurate with the long-term returns from common stocks. It looked like the beginnings of a real investment opportunity. Bond managers were extremely bearish on the long-term outlook for fixed-income securities. For several years, bonds had provided a small yield increment over inflation but bond managers continued to buy them. The bond market began looking interesting to me because most bond manager's portfolios were being destroyed. As bond prices fell and their yields rose, these managers became more cautious and defensive. This is the typical cycle where, when yields are low, investors buy aggressively; then, when yields rise, they get cautious and defensive. At the time, I did not know that George Michaelis was also coming to a similar conclusion.

In early 1980, at a mining conference in Salt Lake City, Utah, it really began to crystallize in my mind about what was occurring with inflation. Arco had just acquired Anaconda Copper and they were explaining their reasoning at the conference. At the same time, Professor Milton Friedman was the keynote lunch speaker. At that lunch, he provided small cards with the question, "Will inflation be more than or less than 5% over the next ten years? Choose one." I picked less than but about 95% of the audience picked more than. It occurred to me that the fears of rising inflation were probably already discounted in the long-term level of yields. In retrospect, they were and it was a wonderful time to buy bonds.

Today, my fund is very defensive with a duration that is almost 50% shorter than its previous shortest duration. It currently stands at 1.3 years with 35% in liquidity. You may read more about our reasoning for this defensiveness, on our website, in a piece my associate, Tom Atteberry, and I wrote titled, "Buyer's Strike." In it we discuss why we believe there is no value in long-term high-quality bonds. We have become progressively shorter over the last two years. We do not like various trends that we see developing in the U.S. economy.

1. For the past year, we have expected substantially stronger than consensus economic growth for both '03 and '04 because of the massive fiscal, monetary and mortgage re-financing stimulus that has been provided.

2. We continue to see considerable risk to the dollar's exchange value because of our growing current account deficit and how it is being financed. Foreign central banks have purchased nearly one-third of new Treasury securities issued for the twelve months ended June while foreign bondholders purchased over three-quarters of all Treasury securities issued during this same period. Foreigners own 41% of our Treasury debt with China and Japan holding 17%. Sir John Templeton recently commented that he is very concerned about the dollar's exchange value while Warren Buffett's article in the November 10 issue of *Fortune* expressed concern about how our growing trade deficit was transferring a large portion of our economic wealth overseas. In his opinion, this is a non-sustainable trend that has negative implications for the U.S., should it continue its present course.
3. Federal government entitlement spending is likely to become a material political and financial markets issue in 2005 or 2006. During this period, politicians may be forced to face the entitlement spending issues because their terms of office will begin to overlap the initial retirements of the baby boom generation in 2010. The old adage "nothing is relevant until it occurs on your watch" is very applicable to politicians.
4. Inflation will likely become more of an issue as we go through 2004 and into 2005. In our opinion, the CPI is materially understated because of its weighting for healthcare. We estimate that healthcare spending represents approximately 15% to 16% of U.S GDP while it accounts for only 5.94% of the CPI. Healthcare inflation is currently increasing at the rate of 10% to 15% per year. Because of its low weighting in the CPI, CPI inflation could be understated by approximately 1%. This is material, given the very low level of yields we have today.

We do not know if we are right about any of the above, but we do believe that one is not being compensated sufficiently by the current level of yields for these potential risks. We just don't think there is a sufficient margin of safety, in terms of the absolute level of yields, to deploy capital into longer-term fixed-income instruments today. When most investors don't want to hold short-term liquidity because of its unattractive yield, we think that is probably where one should be, especially if one has an investment time horizon longer than one year.

With that closing comment, I would be more than happy to answer any of your questions. I hope I have stimulated some thoughts among you.

Thank you again for this opportunity. I truly appreciate it.

December 2, 2003