CONSUELO MACK | WEALTHTRACK

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On this week's show: In a rare interview, great value investor Tom Russo explains why the ability to say no and the capacity to suffer are key to investment success.

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CONSUELO MACK: This week on WEALTHTRACK, a rare interview with noted value investor Tom Russo on why the ability to say no and the capacity to suffer are key to investment success. Next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Do brands still matter? In the U.S. the great disruptor known as Amazon with its cheaper prices and fast delivery is wreaking havoc across a wide swath of consumer brands, products and retailers. Amazon is touching everything from books to food, to household goods to entertainment, to wine and, with its offer for upscale grocer Whole Foods is going retro into traditional bricks and mortar.

Now one of the world's most valuable companies, it is hard to believe it only went public two decades ago. Amazon is the biggest online retailer in America with a lot of room to run. Its e-commerce site accounts for about 5% of U.S. retail spending, still half of Wal-Mart's but catching up fast, and it is capturing over half of all new spending. 17% of all retail sales are now done online, more than triple what they were a decade ago.

This week's guest's investment specialty is global, consumer brand name companies. He faces two headwinds right now. One is that he is an active manager at a time when investors are overwhelmingly choosing passive and the other is his focus on well established brand name companies that are under competitive assault from Amazon and others.

He is noted value investor Thomas Russo, who is making a rare television appearance on WEALTHTRACK. He is Managing Member of the investment advisory firm Gardner Russo & Gardner which he joined as a partner in 1989. He oversees more than $11 billion dollars of separately managed accounts and Semper Vic Partners, a limited partnership. The global value, long-term oriented portfolio has beaten the S&P 500 handily over the last quarter century.

I started our conversation asking him about an issue he recently raised with his investors. That *"The broad switch to U.S. equity market indexation, which has grown at a torrid pace over the past four years has driven capital away from the internationally based businesses that form the core of our portfolio."*

What's his strategy to deal with it?

THOMAS RUSSO: Well, the strategy that you use to deal with capital flows is you just have to endure them. Over time our portfolio companies should deliver results. They're building the intrinsic value that they have on a per share basis through reinvesting internationally and doing so with a long-term mindedness. And over time the market's a weighing machine and not a voting machine. The investment benefits of what takes place will be expressed in higher prices.

CONSUELO MACK: But even though a voting machine, it can still be a voting machine for several years.

THOMAS RUSSO: Absolutely.

CONSUELO MACK: You have a fabulous long-term track record.

THOMAS RUSSO: Yes. Thank you.

CONSUELO MACK: Which we mentioned in the introduction to you, but the last few years you're making money for your clients, but you're not beating the market. So how long can this voting machine last before it turns into the weighing machine where you think the intrinsic value of your companies are going to be recognized by the market?

THOMAS RUSSO: As you may have seen, at yearend I sent a letter out and it referred to the same reality which is three mid single-digit years of performance in a row which is perfectly reasonable against the backdrop of one percent Treasury rates and whatever else you see and up against many other investors. It's not keeping up with at this moment the S&P let's say, but massively outperformed international indices, and 70 percent of our assets are non U.S., and so you would have to think against what benchmark, first of all. But the more important question is that we can deliver I believe over time good results… but not on time.
There's absolutely no way to sort of clock the performance. It just happens as the market capital flows move, but the actual performance is going to be based on the ability of our business to reinvest and to create more future wealth, more jam tomorrow for example. That's what we focus on.

CONSUELO MACK: What about this indexation trend? I feel like it's a craze quite honestly, and you're seeing money flows as you told your shareholders. You're seeing money flows come from overseas into U.S. indexes as well.

THOMAS RUSSO: Sellers of Unilever shares because they want to own the domestic market. It heated up particularly at the end last year as sort of a cathartic move as people wanted to catch the Trump Bump, and so with the transfer of assets from euro land to the U.S., the dollar strengthens because the euros to buy into the S&P, they're dollars first and, hence, there's a movement upward in the dollar which rewards global investors for a while.
It all works for a while, but it's a consensus move, and I can only think back to 1989, and in 1989 you would have had a period of time when the Nikkei Dow went up with the smoothest position of any recorded market in history, and it went up every quarter smoothly. It was never volatile, and it at the top hit 32,500; subsequently, collapsed 75 percent.
Now all along the way it was beating all of the active managers. So, there's no reason to think that indexation just because to date it has generated outstanding returns without stumbling ... it would be as if you were saying in 1992 after the three years after 1989 and the Nikkei Dow continued to advance. You could have said there, "Look. It's been now 40 months worth of steady advance. It's outperformed anything else, but it was getting ever more expensive."

CONSUELO MACK: That's what's happening.

THOMAS RUSSO: In our time today, the expense aspect is so driven and complicated by the low interest rate environment that's held by the federal reserves around the world to try to stimulate economies that can no longer govern themselves in a way that can drive Keynesian-type investments to better the nation. Instead we simply rely on the Fed with low interest rates to try to trigger job growth, and that blunt instrument has all sorts of secondary effects that show up in the investment business. One is that equities just have gone upwards in valuation.

CONSUELO MACK: Let's talk about Amazon and the disruption effect. You can call it creative destruction or creative disruption which is probably a better term. You specialize in global brand name companies, and Amazon is attacking brand name companies in this country, and it has repercussions all over the world.

THOMAS RUSSO: It really does.

CONSUELO MACK: How are you dealing with that? How do brand name companies look given this disruptive force?

THOMAS RUSSO: Let's step back for a second and revisit Berkshire's annual meeting this year. If there was one sentiment that I took away from this year's annual meeting for Berkshire, it had to do with a sense of remorse on the part of Warren and Charlie Munger over this notion of Amazon, because for all the years up until now, the given word was, look. Amazon's rather technical. We don't do technology. Therefore, we don't do Amazon. Therefore, let's continue doing exactly what we do. At the annual meeting this year I had the distinctive feeling of a game that I used to play years ago called Hearts. It's a card game, and at some point in the game people are moving cards around, and somebody will have created a sequence in their hand that well before the hand's actually played out secures them the certain victory at which point their colleagues look at them and say, "You're going to shoot the moon." Amazon in some sense has shot the moon from the standpoint of why now Berkshire spends so much time talking about it. It's because it has nothing to do with technology. In fact, going back over time as I've done since the meeting and listened to all of Jeff Bezos' various speeches, he's all about the number one thing that Buffett would care the most about, which is customer service.

CONSUELO MACK: Explain that because Bezos had a line that you quoted and that Warren Buffett quoted. Right?

THOMAS RUSSO: Oh, absolutely, but if you ever listen to any of the lectures or talks of Jeff Bezos, it's clear the only thing he's preoccupied by 24 hours a day is the consumer experience, and then he said his job is simply to reason backwards from what steps it'll take to

improve the consumer experience, and that directs his investment spending. That's purely the Charlie Munger story. He has said at the annual meeting for decades that the way to live your life is through the power of inversion. Think of what it is that you want to create, and then reason backwards to come up with the most efficient way to get there. That's Charlie Munger in spades, and that's exactly what Bezos is talking about. Now how does it express itself competitively? So, they now have 440 fulfillment centers within arms reach of consumers. So, forget about the notion of the expensive FedEx package that has to fly all over the world to get to you to deliver you below-cost products. It's no longer third-party source.
It's increasingly near a town, Amazon truck delivered with massive distribution and logistics efficiencies that have only now started to take effect because of this network effect. They have such a broad network. It becomes impregnable, and it becomes a competitive advantage.

CONSUELO MACK: So talk about a brand name, Tom. I mean should you be owning Amazon?

THOMAS RUSSO: Well, it's a very good question because the valuation feels high. I would say that what I talk about as investors, I want to find a business that has the capacity to reinvest. Amazon has 60 percent of e-commerce in North America, and e-commerce in North America may be 12 percent of total. So, I mean they have call it five or six percent of commerce now. It's still early days for them to enjoy the benefit of the investment spending that they've been making for all of these years. So it's possible.

CONSUELO MACK: But it's not a global brand yet. Right? Is that ... ?

THOMAS RUSSO: It's been busy in the U.S. let's just say. One saving grace for our portfolio is that most of the businesses we own have alternate routes. In the case of someone like Nestlé, for example, someone like Budweiser, someone like Heineken, someone like Nespresso. Nespresso has its own dedicated cafés through which you experience a product and through which you reorder the product. They have a digital reorder. They have a telephone reorder for their products. So, they have purposely put together businesses that are outside the reach of traditional retail because the threat that Amazon offers retailers today is really an elaboration of the threat that Wal-Mart posed already for the past 25 years which is the growing pressure for private label in forums that Wal-Mart controls. So, if you go into a Wal-Mart, you will see a vast expanse of private label, knock-offs of Nestlé's finest products.

CONSUELO MACK: That's a threat.

THOMAS RUSSO: At a discount price, but it's a threat that we live with. Now it'll be a bigger threat when Amazon gets around to it, because his model is more efficient than Wal-Mart's because Wal-Mart, they have one and a half million square foot distribution centers in the middle of nowhere that used to have trucks that bring everything to the superstores that were in your neighborhood. Well, those superstores have become effectively un-shoppable because if you want to go in there and buy milk and groceries, you have to go through the snow shovel department. You have to go through all this other stuff. So, Amazon is a much more efficient deliverer.

CONSUELO MACK: One of your major holdings is Nestlé, and Nestlé has just hired a new CEO, Mark Schneider, who has no background whatsoever in food and beverage. He's from a healthcare company or something. Right?

THOMAS RUSSO: Yes, Fresenius.

CONSUELO MACK: Nestlé was targeted by Dan Loeb, an activist investor. I mean Nestlé is shaking things up, is being shaken up. What's your view of Nestlé?

THOMAS RUSSO: It's a fabulous enterprise. It has global reach. It's 150 years old. It has 125 markets. You think about markets, whether it's Nigeria, whether it's Kenya or India. Their products are literally the staples of life, and companies as strong and as deep in domain expertise in food and beverage that exists in Nestlé are going to be required for us to feed the world. So, no question they have an important role to play in the future. The question is how much they can afford to invest today at the expense of current results for future returns, and they're willing.

CONSUELO MACK: They're feeling the heat.

THOMAS RUSSO: They feel the heat today because someone's come along and said, "Enough today. We need more today."

CONSUELO MACK: Dan Loeb.

THOMAS RUSSO: Less jam tomorrow. It's about jam today or jam tomorrow, and there's an IRR that's built into the mix, and Nestlé has always favored gold-plated spending for the future returns. If you look back since we owned it in 1987, it's probably compounded at 14 percent a year total return, and it's done so because they've been willing to take those big bets and they've won the results that have come from it.

CONSUELO MACK: Now what?

THOMAS RUSSO: Today there's pressure on the demands for returns upfront. That's the world that investors face. Ideally Nestlé would have had what Heineken enjoyed 18 months ago, when a company came knocking and said they wanted to take over Heineken, and the family simply said, "No thanks." They had 50.1 percent of the vote and that was the end of the conversation. Nestlé doesn't have that blocking vote. It has loyal shareholders. It's a Swiss-based company. It has Swiss heritage and all the rest, but they don't have the vote, and so they have to pay attention, and pay attention I think they have. They're already announced a $20 billion share repurchase program that they actually commenced before the publication by

Third Point of their stake.

CONSUELO MACK: You told me before this interview how unusual that is, and actually Switzerland looks down upon that they had to petition for a special permission to do a stock buyback. I mean it's completely against their business culture.

THOMAS RUSSO: Yes. They're such capital-oriented folks in Switzerland that the notion of destroying equity capital by giving cash out to retire it requires a vote by the Securities Exchange Commission equivalent because they so lament the thought of getting rid of hard-earned equity. Nonetheless, the math is very compelling. They have a very low leverage ratio at the moment. Borrowing costs, I think for them will be 25 basis points over MS for long-dated paper, and so today is a fine time to borrow, and the shares I believe will represent fine value over time if they apply some of the borrowings and buy back shares.

CONSUELO MACK: Capacity to reinvest is one of the hallmarks that you said that you look for in a company. We just talked about that at Nestlé, and also the other one is the capacity to suffer which means that you reinvest and you suffer short term. Your results aren't as great because you're putting the cash basically back into the company or in businesses. So, one of the examples of the capacity to suffer is Philip Morris, and that's one of the ones in the capacity to reinvest. Can you tell us what the story is with Philip Morris and why that is a core part of your portfolio?

THOMAS RUSSO: Yes. I'd be glad to. What's really interesting about the capacity for management to suffer as it relates to the reinvestment, first the most important thing. You have to have the capacity to reinvest. We owned in the 2008 era four or five companies that were fabulous. There was International Speedway and NASCAR in the U.S. or H&R Block. They were great franchises. They had no reinvestment. They had maxed out the U.S. market. The beauty about the business is that we try to find/have open-ended reinvestment opportunities geographically with population, and 96 percent of the world lives away from the U.S. You'd like to increase your odds of success by finding markets beyond our shores. That's really the driver. Philip Morris is the largest premium cigarette manufacturer in the world, so they have plenty of space in which to invest worldwide. However, the product on which they have relied has harmful side effects. They want to stay in business, and they resolved four years ago, that they would invest a substantial amount of their then abundant profits to help them transition from a business that was going to over time, die, into one that they could transition to. So, they committed to spend half a billion dollars a year to come up with products that were non-combusted.

CONSUELO MACK: They're called RRPs, reduced risk products.

THOMAS RUSSO: The beauty of what they embarked upon is that others didn't follow. I mean they basically spent the money. You understand what it means is that their reported profit would show $500 million less than it could have, had they not been investing purely on the science. Now what did they come up with? They came up with 1.8 million pages of clinical data that they presented to the FDA to get approval by the FDA ideally that would recognize that this product has the substantial equivalency of smoking cigarettes without the harmful effects because it's not burning.

CONSUELO MACK: It's iQOS, i-Q-O-S.

THOMAS RUSSO: iQOS.

CONSUELO MACK: It's not a vapor cigarette. It's not ...

THOMAS RUSSO: No, no, and that's one of the side issues with the capacity to suffer. It applies to the burden of doing something, but it equally applies to management's willingness not to do something, and that's where it gets really interesting because Wall Street clamored for Philip Morris to get on the e-cigarette train, and they refused to commit the kind of capital because they felt it was bad technology, and the reason is that if you're a smoker, when you initiate smoking you end up at something like 19 milligrams of nicotine within the first minute of your smoking. E-cigarettes by contrast would deliver two.

CONSUELO MACK: You don't get the hit.

THOMAS RUSSO: So, if you think about what a consumer wants and what they can deliver, and they can't deliver more because of battery technology and the way the aerosol goblets are created and go through the throat and all the rest, the reasons why it's capacity constrained, and for that reason Philip Morris had the capacity to step away and say, "No. It won't be our capital commitment to try to improve that un-improvable basis." But they did go off into a different venture, and that's turned out to have some extraordinary receptivity. In the markets in which they first launched this product called iQOS in Japan, they have as much as 30 percent market share of what was formerly the cigarette market converted to the iQOS, and this is extraordinary.

CONSUELO MACK: Therefore, the outlook for Philip Morris, they have reinvented the cigarette essentially into a product that delivers the nicotine but without the harmful effects.

THOMAS RUSSO: Exactly. Ninety-nine percent reduction in the burning-related carcinogens with 98 percent of the same satisfaction of nicotine absorption. So, it's the equivalent of smoking with the equivalent of quitting, and the equivalent of quitting is substantiated by 1.8 million pages of clinical data that the company has submitted, Philip Morris has submitted to the FDA. So, we'll see how that avenue of third-party accreditation evolves.

CONSUELO MACK: One investment for a long-term diversified portfolio. What would you have all of us own some of?

THOMAS RUSSO: Well, it's an interesting question because as a value investor price matters a lot. As an investor who cares about the very longest term because most of my investors are taxable individuals, we want to buy businesses that have the ability to reinvest for a long haul so that we don't need to sell the positions and trigger gains. I look for more than just low price, and so one of our higher priced portfolio holdings is MasterCard, and yet that's probably the one I would suggest. I would suggest it because it's global at its very core. It's far more internationally leveraged than would be its much larger counterpart, Visa. It's run by one of, I think, the country's leading CEOs names Ajay Banga who sort of started at Nestlé in India. Then he was an extremely senior successful executive at Citibank and came across maybe seven years ago, when I first invested in MasterCard.

CONSUELO MACK: MasterCard.

THOMAS RUSSO: It was because of his arrival, and he has been exactly what we had hoped which is absolutely prepared to invest way beyond the average dosage to keep MasterCard at the leading, bleeding edge of technology in Fintech, and so every year since we've invested the gross dollar volumes of the business have grown low double digits, and the operating margin is relatively static which means all the leverage that comes from the increased volume has been redeployed back into investment spending that will hopefully come up with products. Now the products they've come up with, they've helped countries digitally deliver social benefits to the deserving mother without having to send a check which gets massively discounted when she has to go cash the check. It's secure. It's a secure channel for countries to distribute benefits. MasterCard's participating in helping that. It's a secure way for governments in emerging markets to begin for the first time to collect taxes because any government that doesn't have sort of the benefit of a country with saintly souls realizes that nothing is reported. So, they get no revenue, and so the migration for payment systems at the behest of governments has the ability for them to start for the first time to collect tax receipts.

CONSUELO MACK: All right. We're going to have to leave it there. Tom Russo, thank you so much for joining us on WEALTHTRACK.

THOMAS RUSSO: Thank you.

At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: Read *The Everything Store: Jeff Bezos and the Age of Amazon* by Brad Stone. If you are as fascinated by amazon and its founder Jeff Bezos as I am this is a biography worth reading. Bezos wouldn't be interviewed himself but gave Stone permission to talk to family, friends and business associates which he did. It's a fascinating insight into a brilliant visionary and entrepreneur who named his company after the river that "Blows all other rivers away" and has what stone describes as "A limitless spring of new ideas," evidence of which we see every day.

Next week we are going to focus on the supposed return to normalcy by central banks and what it means for interest rates and bonds with two outstanding fixed income managers: Western Asset Management's John Bellows and Brandywine Global's Steve Smith.

In the meantime, check out our EXTRA interview with Tom Russo about why he makes a donation to a different charity every year, on behalf of his firm.

Also thank you so much for the feedback on Facebook and Twitter that you are giving us. Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.