

April 2010 CGI Value Voices: Interview with Matthew Richey

Dear Member:

Our third installment of the Value Voices Interview Series features Matthew Richey. We hope you'll enjoy Matthew's reflections.

Thanks for being a Value Focus Member.

Best wishes,
Ragu and Jeff

Background

Jeff Anello: To start, tell me a little bit about your background. What were you doing before you got into investing?

Matthew Richey: I caught the investing bug during my first year in college at the University of Tennessee. I quickly came to the conclusion that I wanted to be a securities analyst, but I had trouble finding available opportunities straight out of school. My plan was to get the best job I could, work for a few years, and then apply to a top-notch MBA program, which I assumed would open the necessary doors on Wall Street. It was a well-laid plan, but it was not to be.

Upon graduation from Tennessee in May '98, I went to work for Accenture -- which was Andersen Consulting at the time. I liked the idea of helping client companies improve their businesses, but the job wasn't what I had it cracked up to be. Less than a year into my consulting tenure, I jumped ship to join The Motley Fool (TMF) as an investment analyst. That was February 1999, which was when my investing education really took off.

JA: How did you become interested in investing?

MR: My dad was a stock junkie of sorts. I remember him watching the *Nightly Business Report* and taking copious notes. He bought some stocks I could relate to as a kid -- names such as Nike and McDonald's -- and he would regularly tell me about their progress. It was common at our dinner table for my dad to discuss the power of compound interest and use his financial calculator to tell us how much even a small amount of savings can grow into, provided steady returns and a handful of decades.

Later, when I was a teen, my dad would tell me about his exploits in the option market, mostly writing calls and puts. He also subscribed to a number of investment newsletters, and I would read them occasionally in high school. All of these experiences helped plant the seeds of interest for me. But what really captured my imagination was my first investment book, Peter Lynch's *Beating the Street*, which I read in 1995. After that, I was hooked, and aimed my career sights on following in the footsteps of Lynch as an equity analyst.

JA: That's a great story about your dad. In a way it reminds me of my own in that we got similar sit-downs about saving and investing. I grew up very conscious of money, as it sounds you did.

MR: Exactly. I'd say I had an above-average consciousness of money while growing up. My dad worked hard to get ahead, and he tried to teach me the same lessons that he was seeking to apply.

JA: How did you go about learning the craft of investing? What books, resources, or people were your earliest influences?

MR: I was fortunate that my first few books on investing were great ones. After *Beating the Street*, my next read was *The Motley Fool Investment Guide*, and then Robert G. Hagstrom's *The Warren Buffett Way*.

Those three books, along with the naïve invincibility of youth, provided the confidence for me to begin managing my own online brokerage account at age 19. I jumped in with both feet, and did a few things right, but also learned by making a TON of mistakes. Experience is a great teacher, and there's nothing like losing money to reinforce a lesson learned.

I was a daily reader of almost everything published by The Motley Fool, and especially enjoyed the articles written by Tom Gardner, Jeff Fischer, and Randy Befumo. Those three writers did a fantastic job of teaching fundamental analysis and how to gauge the quality of a business.

Along the way, I discovered that I really needed to gain a more sophisticated grasp of how to value companies. The various shortcuts related to P/E ratios were a critical source of mistakes early on to me as I struggled to decipher whether a stock was cheap or expensive.

Going back to my childhood, I'd long wondered what caused a stock to trade at its given price. I remember asking my dad that question and his answer was "supply and demand." That didn't exactly answer it for me!

Around 1997, Randy Befumo wrote some Fool.com articles on discounted cash flow analysis, which fascinated me. I wanted to really understand that concept, so I purchased *Damodoran on Valuation*, by NYU professor Aswath Damodoran. The process of digesting that book -- it's not a book one merely reads -- and then building my own discounted cash flow (DCF) valuation spreadsheets was a pivotal experience for me. I came to deeply appreciate the mathematics of how business value is created and transferred to shareholders.

So many of my most fundamental investing questions were answered by gaining a firm grasp of the truism that *a business is worth the present value of all its future free cash flow, discounted at an appropriate rate*. I now look at every business through the prism of how, when, and for how long this business will generate free cash. It's amazing how much clarity one gains from that approach.

JA: What role do these DCF models play in your investing process today? Do you actually go through the entire exercise any more, or do you know a business' rough value when you see it?

MR: DCF models are still a regular part of my process, although not for every single idea. Early on, they were tremendously helpful to me in understanding how much business growth was required to justify a given P/E or P/FCF multiple.

But, as you suggested, long experience with DCF models has gradually allowed me to recognize value on a more intuitive basis. Today, I use them

primarily as a way to document my growth assumptions for a given investment thesis.

This might not be necessary if I had Warren Buffett's mind and memory. I think Buffett once said something like, "I don't need a computer – my mind is a computer." Well, I need a computer!

For me, keeping a DCF spreadsheet and/or a written summation of my investment thesis is vital to my process. As companies report their quarterly results, or as other material developments occur, I revisit my DCF growth assumptions and my written notes, and I'm able to quickly digest new information and respond accordingly.

JA: Tell me about an early investment you made. How did it go?

MR: **America Online (AOL)** was one of my early stock picks, which was a direct influence of The Motley Fool's enthusiasm for that name. In 1996, the investment community was deeply skeptical about AOL due to the way it capitalized some of its marketing expense -- clearly an aggressive accounting practice -- and also because it was thought that AOL's proprietary online service would soon be marginalized by the Internet.

Ironically, both of those concerns were 100% correct, but it didn't matter, because AOL would succeed in massively growing its revenue and free cash flow (FCF) for the next several years, thereby propelling the stock to huge gains. I made good money on AOL but I regretfully didn't keep records back then. I do recall selling the stock at various inopportune times, but doing well on the whole. That was in 1996-1997, and my investment decisions at that point were mostly by the seat of my pants, not grounded in any particular rigor.

That, and my inexperience with business analysis, led to some really terrible stock picks – names like Jayhawk Acceptance Corp and Micrion (both now defunct, as far as I can tell). I didn't ride them to zero, but they were definitely big losers for me. I wrote about the Micrion experience for a [Fool column in 1999](#).

JA: How have you improved as an investor over time?

MR: Beyond gaining a solid grasp of fundamental analysis and valuation, the other critical factor in my growth curve was simply looking at one idea after the next, and so on. Every company I look at adds something to my repertoire. The great thing about working at TMF was that my job was to constantly analyze new companies and share my insights through writing articles. I can't imagine a better discipline for learning about investing.

JA: How did you get into writing online?

MR: It was actually a bit of an accident. My official role when I joined TMF was as an editor and manager of the online content for The Cash King Portfolio, which was later renamed the Rule Maker Portfolio. I had very little writing experience at the time.

But within a few months on the job, I was asked to begin writing a weekly column. I remember laboring horribly over those early columns. Each article for me was something like giving birth. But I can't imagine a better training ground for learning and absorbing the lessons of investing. There's no better way to learn a subject than to be forced to teach it.

JA: Do you like to read books? What are your favorites?

MR: I love to read, although I don't get around to reading books as much as I'd like to. Some of my all-time business favorites besides the ones I

already mentioned are: *Economics in One Lesson*, by Henry Hazlitt; *Common Stocks & Uncommon Profits*, by Philip Fisher; *Titan: The Life of John D. Rockefeller, Sr.*, by Ron Chernow; and, *Built to Last*, by James C. Collins and Jerry I. Porras.

JA: What's one book about investing or business that we don't hear much about that you would recommend to our readers?

MR: I'll go out on a limb and recommend *The Creature from Jekyll Island* by G. Edward Griffin. I stumbled upon this book at a used book store around 2005. The "creature" is the Federal Reserve, and the book reads like a fast-paced novel in describing the historical account that led to the Fed's creation in 1913. I'll warn you, there's a conspiracy theorist side of the book that I don't necessarily agree with, but I still found the book fascinating and highly informative. The author, G. Edward Griffin, does a great job explaining how our fractional reserve banking system works.

JA: What are your professional goals?

MR: I feel incredibly privileged to have had the opportunity to begin managing money professionally at the relatively early age of 26. I realized during my time at TMF that my real passion wasn't writing about investing, but doing analysis and making the judgment calls that go into constructing an investment portfolio. I still feel that way today – I really can't imagine doing anything else.

My goal at this point is to take my experience at Centaur Capital and build on it as I lay the groundwork for starting my own firm. To answer your question more generally, my goal as an investor and money manager is to protect capital and grow it prudently. For me, it comes down to a daily goal of making one good investment decision at a time. I'd like to look back in 20 years -- and hopefully in 40 years, as well -- and see a long history of successful and consistent compounding.

Philosophy & Process

JA: Let's talk about your investment philosophy as it stands today. What are your main tenets? What do you look for in any investment?

MR: My investment philosophy is based on valuing businesses, assessing risk, and seizing opportunities that offer an asymmetric risk/reward profile. On the long side, I aim to find ideas that offer at least 20% upside, and usually 30% plus, based on my estimate of intrinsic value, and a minimum 4:1 ratio of reward versus risk.

I seek to minimize risk by sticking with businesses I readily understand, that have a wide moat and/or hard asset value, and that have little, if any, debt. I've never really been attracted to

turnaround situations. My bias is towards quality companies where the fundamentals are good and improving, but where, for whatever reason, the value isn't being fully recognized by the market.

On the short side, I basically look for the polar opposite of a compelling long idea. My ideal short candidate sells a generic product/service, has no significant moat or unique assets, has significant debt, and is either experiencing slowing fundamentals or is imminently vulnerable to fundamental weakness. I aim for short ideas that are overvalued by at least 20% and that offer a minimum 2:1 ratio of reward versus risk.

My lower required standard of risk/reward for short candidates is a concession to the greater difficulty of quantifying risk on the short side, where obviously there's inherently more theoretical risk than reward. Lastly, I tend to favor short ideas that have enjoyed a recent run-up in the stock price and where I perceive investor sentiment is unreasonably optimistic.

JA: Do you look for “terminal shorts” as opposed to shorts based on over-valuation? In this category, I'd put fraud, aggressive accounting, management impropriety, etc.

MR: I do look for terminal shorts, although through experience, I've come to appreciate the challenges associated with this category of short. Terminal shorts are clearly the best shorts, theoretically, but with the following caveat: beware a high short interest, a promotional management team, and a story that captures the current investment zeitgeist. It's awfully hard to find terminal shorts that don't have those characteristics.

I've lived through more short squeezes than I care to remember, and I've trained myself to be cautious of the factors that can lead to a squeeze. But when I do find a terminal short that I think is truly between a rock and a hard place, I get very excited – and greedy.

JA: Of the prominent investors we all follow, whose investment style is yours most closely aligned with?

MR: David Einhorn is probably the closest parallel. From what I can tell, he gravitates to quality businesses that are out-of-favor – Microsoft and EMC being a couple of examples from the past few years. Einhorn is equally adept at the long and short side, which I admire.

His portfolio is probably a bit more concentrated at the top end – I recall a 20% position at one time – than what I will allow, but I'd say he and I are in the same ballpark philosophically on concentration, with our top 10 ideas typically accounting for upwards of 70% of the portfolio.

I also agree with Einhorn's view on gold, namely that: “Gold does well when monetary and fiscal policies are poor and does poorly when they appear sensible.” (New York Value Investor's Conference, 10/19/09)

JA: How do you think about portfolio management? Do you consider yourself a concentrated or more diversified investor?

MR: I want my best ideas to drive my performance, so I'm fairly concentrated. But at the same time, I know my own fallibility, so I maintain both position size limits and loss limits. I cap my largest positions to 12.5% at cost, for instance, and most of my larger positions are 5 to 8% in size.

As for loss limits, I automatically bail on any long idea when it hits a portfolio loss of 200 basis points. On the short side, my limits for both position sizes and loss limits are roughly half that of the long side -- a maximum position size of 6% and a loss limit of 100 basis points.

My assumption is that I never can know everything about a given investment, and so I don't want my portfolio results to ride entirely on any one idea or industry. This fits with the ancient wisdom found in Ecclesiastes:

“Cast your bread upon the waters, for after many days you will find it again. Give portions to seven, yes to eight, for you do not know what disaster

may come upon the land. ... Sow your seed in the morning, and at evening let not your hands be idle, for you do not know which will succeed, whether this or that, or whether both will do equally well.” (Eccl. 11:1-2,6)

JA: To go with that, how well do you think you’ve done — over time — at properly sizing positions in the portfolio? Is this a mistake you often make -- positions too small or too large)?

MR: Overall, I think I do a decent job of sizing my ideas. In general, I’ve had positive experiences with my larger positions.

That said, in a probabilistic endeavor such as investing, I accept that there will be exceptions. For instance, Neteller was a big position and a big loser. On the opposite end of the spectrum, I recall that Centaur’s top portfolio contributor in 2007 was a smallish long position, **Ag Growth Income Fund** (TSX: AFN). Such exceptions to the rule, for me, only serve to prove the value of maintaining reasonable diversification.

JA: Besides long equities, what else do you put in your portfolio? Do you ever short stocks or buy bonds, mutual funds, or derivative instruments like options?

MR: Short selling and options are both regular fixtures in my portfolio. I’m open to bonds, but I rarely find one that’s adequately compelling relative to other available investments.

JA: How do you find investment ideas?

MR: My ideas arise from any number of sources: industry studies, screens, value investing forums, and general business reading. On the long side, industry studies are particularly valuable to me. On the short side, screens are helpful in finding stocks that aren’t already heavily shorted.

JA: Okay, so you’ve found an idea. Bring us through your process of investigating the opportunity and deciding “Yes, I’ll buy it,” or “No, this is not a good investment.”

MR: In general, I’m looking to get a handle on value and risk. I often start by utilizing a financial software package called Stock Investor Pro that allows me to see a company’s seven-year financial history, along with a host of financial metrics including my own custom metrics. This software package also makes it easy for me to look at a company’s fundamental metrics versus that of its peer group.

From there, I’ll then typically dig into earnings releases, SEC filings, annual reports, and conference call transcripts. I also frequently create spreadsheets to map out a company’s financial history and valuation.

Finally, I write down my notes and seek to summarize it in a succinct thesis. If the idea is compelling and meets my criteria for risk versus reward, then it goes in the portfolio. If it’s not compelling at the current price, but would be at a lower price, I’ll create an alert in my trading system to remind me to revisit the idea.

On almost all occasions, I pre-plan at what price levels I would add to a given position, and pre-decide the appropriate sizing at a given price.

JA: How far back do you read the financial statements of companies that interest you?

MR: It really depends. I can think of ideas in the past twelve months where I went as far back as 10 years, but others where I’ve focused on the more recent past. I know this is vague, but I mine the historical data as deeply as I need to grasp the business. Gun to the head, I generally look at the past five years.

JA: What sources do you spend the most time reading? Where do you focus your time?

MR: I split my time about 50-50 between general investment reading and company-specific research and analysis. For macro perspective, I subscribe to *The Gartman Letter*, which offers a wide-ranging commentary on the investment world. I also enjoy John Mauldin's weekly commentary that provides a macro perspective.

As for company-specific research, I read a lot of conference call transcripts because they give me insight into how management thinks and how they're addressing current opportunities and challenges. Finally, I regularly devote time to updating my spreadsheets for the various companies I follow.

JA: What role does "scuttlebutt" play in your investment process?

MR: Virtually none. Scuttlebutt is great when it's available, but I simply don't find it a good use of my time to seek out scuttlebutt instead of

reading and analyzing the readily available public information.

JA: That's interesting. Not many investors I talk to rule out scuttlebutt as part of their process. Are there certain situations where it's valuable?

MR: On consumer names, I'll sometimes seek out the opinions of my wife, mom, and sister – but other than that, I generally don't bother with scuttlebutt. That's despite my affinity for Philip Fisher's *Common Stocks & Uncommon Profits!*

JA: Where do you need to improve as an investor?

MR: Even after more than 12 years as a full-time investment professional, I still stand in awe of all the available public companies and my need to know more of them in-depth. I think the limiting factor on my results is probably my bandwidth for keeping close tabs on various companies. I need to continuously search out the companies that are worthy of my attention. I also want to read more financial history, which I find fascinating, but which typically takes a backseat to the time I devote to current events.

Investments and Businesses

JA: What would you consider to be your most successful investment to date, and why?

MR: **Quality Systems (QSII)**, a maker of medical records software, was an idea I sourced from my own screen work in 2003 when it was around \$5 per share (\$20 pre-split). Today, the stock is north of \$60, although I captured nowhere close to that full return.

Nevertheless, I think it was one of my better ideas in terms of originality and recognizing the company's growth potential when it was totally

off Wall Street's radar. The stock was priced cheaply because, from the outside, it appeared to be growing slowly; but inside, it was actually two business units – a small, fast-growing medical records business and a larger, but slow-growing dental records division.

With each passing quarter, the high-growth medical side of the business became an ever-larger portion of the business, thereby driving overall company growth at an accelerating pace. The hard part was knowing how long the growth

might last. On that front I was far too conservative and sold the stock *years* too soon.

JA: Would you be inclined to be more patient after this experience?

MR: That's a great question. Yes and no. Yes, in the sense that I absolutely want to become more skilled in recognizing when a company's growth story is strong and enduring. I clearly underappreciated QSII's growth potential, and therefore underestimated the company's intrinsic value. But no, in the sense that I've made peace with capturing what at Centaur we called "the low-risk end of the return arc."

The idea here is that undervalued businesses offer a return profile that becomes progressively higher risk as the stock becomes more expensive. I view my job as concentrating on the lower-risk returns available when a stock is deeply undervalued. I regularly reduce my long positions as they approach my estimate of intrinsic value, and I don't view it as a "mistake" if the stock continues to advance.

The philosophy of value investing is built upon minimizing risk, and that's best done by investing heavily in situations where risk is low and potential return is high, and then reducing positions when the opposite condition exists. For me to have held QSII these past seven years, I would've had to hold the stock even when growth expectations were high, thereby enduring higher risk.

I've accepted that philosophically; it's not realistic that I will hold a high-growth business indefinitely through its maturation. I'm content to capture the low-risk return, and then move on to other opportunities.

JA: What would you consider your least successful investment? Why?

MR: Neteller was one of my worst picks ever. In 2005, it was on a trajectory to become the PayPal of the online gaming world. It had all the appearances of a fantastic business in the making: high margins; a competitive moat based on the network effect of being the most widely available payment tool in the online gaming world; and, both revenue and FCF were growing at more than 50% annually. The stock appeared cheap at a mid-teens multiple to its fast-growing FCF.

By late 2005, though, the insiders had sold almost all their shares – a glaring red flag that, sadly, I chose to rationalize and ignore. By mid-2006, Internet gambling in the U.S. was outlawed by Congress, thereby eliminating overnight the majority of Neteller's revenue. I think we got out after about a 75% loss. It later would've become a 90% loss if we'd held.

JA: Where do you typically make your mistakes?

MR: One type of mistake that really bothers me is when I allow cognitive dissonance to blind me from news that goes against my thesis. Neteller's insider selling is a perfect example – when insiders sell the majority of their shares, I now sell first and ask questions later.

Also, in an effort to avoid mistakes of cognitive dissonance, I now keep a daily investing journal -- a spreadsheet, actually -- with several questions that I ask myself. One of those is: What names in the portfolio are causing me worry right now? My hope is that by writing down these worries, I'll not so easily dismiss them.

JA: Can you tell us more about your journal? What sort of information do you record? How long have you been keeping it? Has it helped your process?

MR: The journal is an idea I had a few years ago, and I finally made good on it as of the beginning of 2010. My daily categories are: (1) What progress was made today on investment research?

(2) How abundant are compelling long ideas – on a scale of 1-10, where 1 is net short and 10 is 'trembling with greed?'

(3) Emerging risks, opportunities, or lessons learned?

(4) Current port names causing worry?

(5) Thoughts on the Journey?

It's probably too early to declare whether it's helped my process, but the journal helps me summarize my work and insights each day. That much alone is valuable.

JA: Assuming you were offered a fair price, if you had to choose one stock to buy for the next 30 years, which business would it be, and why?

MR: In thinking about a 30-year commitment, I'd focus my decision on three factors: (1) an unassailable moat; (2) long-term societal relevance; and (3) a culture of great leadership spanning multiple CEOs.

My thought here is that the business must be permanently great, meeting an unchanging human need. The company should have a proven ability to hand off the leadership baton from one CEO to the next while continuing to achieve excellent results.

The main company that comes to mind for me is **ExxonMobil** (XOM), a perennial overachiever with a fantastic long-term track record of focusing on creating shareholder value. Their product – energy -- is quite obviously essential. Their annual report includes an outlook for energy demand over the next 20 years -- it's expected to increase by 35% as the population grows to 8 billion people worldwide.

Management is clearly already thinking about how to excel for the next several decades. Best of all, I believe XOM is available right now at well below a fair price.

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If you have any questions, join us on the [Member Forum](#) and thank you so much for being a *Value Focus* member.

Best wishes,
Jeff

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