Ed Wachenheim on Common Stocks and Common Sense

Shai Dardashti, managing director of The Manual of Ideas, recently had the pleasure of sitting down for an interview with Edgar Wachenheim, Chairman of Greenhaven Associates and author of the new book, Common Stocks & Common Sense.

(The following interview transcript has been edited slightly for space and clarity; still, it may contain transcription errors.)

The Manual of Ideas: Tell us about the book…

Ed Wachenheim: Conceptually, I wanted a case method book. Investing is situational, so it's very hard to get a formula. If you had a formula for investing, everybody would be rich and, therefore, nobody would be rich because everybody would be trying to buy the same stocks, and you wouldn't get the opportunities. I wanted to have a case method as HBS does of individual investments, so people could see what we actually did on a daily basis, how we generated an idea, how we researched the idea, how we did our analysis after researching it, how we reached our conclusions, including building models and then actually buying the stock. Seeing what happened after we owned the stock, our mistakes as well as the things we did right and then how we reached a decision to sell a stock, but I couldn't do that without some background as to what our approach to investing is. I put in the first chapter of the book our approach to investing. We're value investors, what we look for in a stock, how do we think in general, our broad approach.

I couldn't do that without putting in a chapter about my background because personality comes into investing. Different people have different emotions, different people have different DNA in terms of being able to be a contrarian, being a leader or being a follower… The background of a person, how he's brought up, what his education experiences were, how he first got into the business and then what he did when he was in the business, what he learned from his mentors all come in to how a portfolio manager makes a decision.

Then I have eleven chapters on individual investments, and then about a half a dozen years ago, I wrote a letter to a young man named Jack Elgart, who was just starting out in the investment business, who asked for some advice. I put it in letter form, so I include that letter at the end because it does include some dos and don'ts that were not included in the book but are important to avoid mistakes and to make money.

MOI: How does your personality shape the way you invest?

Wachenheim: Some people are born contrarians and some people are not born contrarians, they're born followers. You're either a leader or a follower and most people are followers. It's very important in the investment business to be a leader and to be a contrarian because theoretically the price of any stock at any one period of time reflects the opinion of the average investor. Stocks are appropriately priced to the average investor. To take an opinion that the stock is mispriced and its worth substantially more than the average person thinks they're worth, you're being a contrarian because you're going against the grain and taking a position that is very unusual.

Most people can't do that. I've thought hard and long about it, and it is just purely hardwired. I have a friend who I occasionally have dinner and I'll call him 'Danny Dinner Date' because I call him that in the book. Often, I will discuss a stock with him and he will say, "It's a great idea." The theory of this stock is the company has a temporary problem. It's the highest of probabilities the problem will be solved or go away by itself within a short period of time and I'm saying the stock is down because of the problem, the problem will disappear and the stock should go up substantially. Danny Dinner Date says, "Ed, that's a great idea. I'm going to do research on it." I will call him a week or two later and I'll say, "Danny, did you buy the stock?" He'll say, "I'm waiting to see the improvement come. I'm waiting to see the problem dissipate and then I'll buy the stock."

Of course, by the time he sees the problem dissipate and it makes the newspapers that the company is solving its problem, the stock is probably up substantially and he doesn't have an opportunity. This has gone on year after year after year. This is a bright man, he graduated near the top of his class at an independent school. Then went to an Ivy League college.

This is purely hardwired. The ability to become contrarian becomes critical and being hardwired goes way back. I have a thesis, which I can't prove – I don't think anybody could prove it – and that is that our DNA is essentially the same as the DNA of human beings when they were hunter gatherers. They were hunter gatherers for 200,000 years, and we've been civilized for roughly 10,000 years; our DNA has not changed. The survival technique that was important when you were a hunter gatherer is different than the survival technique that would be successful now.

When people were hunter gatherers they had to be followers because you had to band and you could only have one leader. If there were two or three leaders, there was a good chance that the leader might kill off the other leader or beat him up so badly that he would be a follower rather than a leader. There were stories of kings killing off their siblings, killing off their children in some cases, killing off their parents so that they had absolute control. They developed a society where there were one or two leaders in a band and most people were followers. The people that had the DNA to be leaders got knocked off.

Most people in the investment business are followers and they don't have the ability to really go out with confidence and say, "Yes, everybody thinks *this*, but I'm going to do *that*, and I'm going to lead everybody else to that." That's one important trait — to really be able to be a contrarian.

Another important trait is to be able to control your emotions because this a business where stocks go up and down. When stocks go down sharply, 1) you tend to become nervous, nerve-wracked. It's a nerve-wracking experience and 2) at that time, the press tends to be negative, Wall Street tends to be negative. All the media becomes negative. You're inundated with negative news and it's very easy to become emotional and upset. If you react emotionally to the market, you're not making rational decisions. Many people tend to, when the stock market is weak, sell and then after the stock market is strong, buy. Keynes once said there's a tendency of most people who trade the market based on the market to sell too late, buy too late, and to do both too often. Being able to control your emotions becomes critical.

I can give an example of somebody who was not able to control his emotions and the date was October 19, 1987 when the stock market, as measured by the S&P 500, was down 20.9% in one day. I was riding the train home to Rye, New York where I lived, and as I got off the train, I bumped into a friend who had an ashen face. My friend said to me, "Today was the worst day in the stock market since the Great Depression. Investors will lose confidence in stocks. It will be a long time before the stock market goes up. If people have lost confidence, there's probably going to be more selling before the stock market stabilizes. I sold stock today and I'm going to sell some more stock tomorrow." I said, "Fine," and said goodbye to my friend and got in the car to drive home. As I got into the car, I thought, "What did that person just say?"

Let us say theoretically he owned a stock that was priced at $10 on the morning of October 19th before the market went down. He thought that stock was worth substantially more than $10 or he wouldn't have owned it. Let's say he thought the stock was worth $14, so what happened during that day is if the stock went down as much as the market, it closed the day at $7.90. It went down 21%. He was going to sell a stock the next day at $7.90 that he thought the morning before was worth $14. That's nonsensical. It just doesn't make sense. He was not acting rationally, he's acting purely on emotion. Some people just can't help it. Seth Klarman said people don't purposely react with their emotions, they simply can't help it. It just seems to be part of the DNA because the people that do this realize that they made a mistake in the past and they can't correct that mistake. The next time the market goes down, they'll react with their emotions again. They'll react with emotions and they can't correct it. It's hardwired.

MOI: Are there habits you've built to help you be contrarian?

Wachenheim: Since we're aware of the need to be a contrarian to have outside returns and the strong desirability of controlling your emotions to have outside returns, we think about it a lot and when the market does go down, we start asking ourselves questions like why is the market down? Where is the market likely to be under more normal circumstances in a year or two? Why is the stock down? Is it a fundamental change in the company that's adverse and I should be worried about it or it's just because the market's down? We start asking these questions to try and come up with rational decisions based on fundamentals as opposed to our emotions and so we've trained ourselves to do that. If you've been in the business as long as I have and you've been through enough bad markets, it tends to come with a rhythm after a while and you don't have to think it through.

It's like a sport. Late in life, I tried to learn golf, so I have to remember how to bring the club back, how to move my body, not to swing too fast, to follow through. It's not muscle memory. I've played tennis all my life and I get on the court, I don't have to think about how I'm going to hold the racket, how I'm going to swing. It's just you do it, it becomes natural. In the investment business, I've been doing it long enough, it just becomes natural.

MOI: I'd love to explore key takeaways you've had from relevant market experiences; what you learned from the '70s, from '87, from '99, from '08. If you look back at pivotal moments in market history, what did you take away?

Wachenheim: I'm going to give you an answer that you probably don't like and the answer is that through all these periods, the market does various things, but in the end, the market ends up much higher than it started out and the numbers for the last 50 years, the total return of the stock market has been about 9.5% per year, which is terrific. The stock market has done that with really very little risk. With lots of volatility, with very little risk of permanent loss. As a matter of fact, that 9.5% includes the Enrons, it includes the Kodaks and it includes the Lehman Brothers. That is net of the permanent loss and investors have been able to retain a 9.5% average annual return and that's what counts. At any particular decade, what the market does really is not too relevant, you just live through it. You do your best, you buy stocks. They may not go up as much in a period when stocks are not so buoyant and then you may hit a period where stocks go up and your portfolio goes up 30%, 40%, 50% per year, which has happened to us. You just take it as it comes. I can't influence the different periods, so I don't worry about them.

MOI: Hearing you speak, there's a lot of resiliency and backbone in you. Where did this resiliency come from and how could people build more resiliency?

Wachenheim: We lucked out, and that answers the question as to motivation. We started out managing our own money. In 1987 when I setup Greenhaven, we were only managing our family money. In 1990, a man came to me, a friend and said, "Would you manage some of my money along with yours?" I thought it would be a more worthwhile career psychologically. More fun, more exciting to have a real job. To form a firm that really managed money for other people as well as ourselves. We limited the amount of outside funding so things didn't get out of control.

Our history there was managing our own money and when you manage your own money, you don't worry about short-term performance. You don't worry about a lot of the things that somebody who's trying to build a business is worrying about and particularly, short-term performance. By not having to worry about short-term performance, we did not have to make short-term decisions and I could take the longer term perspective. If my clients liked that, they would stay with me and if they didn't like that, they could go somewhere else, which is perfectly fine with me because I'm not looking to build a business. I'm looking to do what is intellectually correct given the nature of the business.

MOI: What advice do you give to others who are trying to become mentors and trying to teach?

Wachenheim: I've had some very good people work for us over the years both in Greenhaven associates and its predecessor company. The best way to get experience is just by doing. It's like an apprenticeship. Again, there's no formula for value investing, so I can't say to somebody who's coming into the business, "This is the way you should look at building a model. This is the way you should look at analyzing a balance sheet. This is the way you should interview management," because every management is different, every balance sheet is different and you have to be fluid and flexible. Investing is situational, so the best way to actually learn investing is to do it. To come and go with a firm that is successful and thinks correctly, that thinks long-term and really buy and sell stocks. Do the analysis and the research and the decision-making that comes along with that.

MOI: Do you mind sharing with us a few of the points that are most worth enunciating from the last chapter?

Wachenheim: The last chapter, really the first part of it repeated our basic approach to investing, which is to be a contrarian, to try and identify companies that are going to benefit by positive change and to do that in a way that you don't take a large risk of permanent loss. Nobody likes volatility. I can't sit here and say we like volatility. Actually, volatility is a friend and not an enemy because when you do get volatility and the stock market is down, there are usually some stocks that aren't as down as much and we can sell those stocks and buy stocks that are really depressed. Volatility is a friend, but I don't like volatility, it's nerve-wracking.

I start in the letter to Jack Elgart by mentioning that and then I go into a whole list of dos and don'ts. Realize that the trees don't go to the heavens, that when you get stocks that go up a lot and that are fully priced, there's a good chance that they've reached a proper valuation and you should consider selling them. Don't fall in love with stocks and don't think the trees are going to go to the heavens because they don't is one advice. Seek simplicity. Most investors get too complicated sometimes in analyzing a company. Usually, there are three, four or five determinants of some level, hopefully. I'd like one or two determinates on how a company is going to do, but it doesn't happen that way. Usually, there are two, three, four or five, maybe six determinates that are key as to what a company's going to do and, therefore, what the stock is going to do. To be able to identify those particular parameters, those variables, which are going to drive the stock. Don't get complicated in the minutiae, which we sometimes call the white noise, which can confuse you, so seek simplicity.

I mentioned here separate your analysis from your emotions. All that, I just mentioned, which is absolutely critical. Be wary of companies that have largely been put together. We see many companies that have been on the acquisition trail and recently have acquired many, many companies. Usually, those companies have a lot of goodwill, have negative, in many cases, hard book value and have a lot of debt, but more important, they've just paid a full price for the companies they've acquired. Most acquisitions are done on an auction basis. A company, as a matter of fact, usually is not allowed to sell itself unless it gets competitive its bid and goes through a whole process that the particular bid it has gotten is the best bid available. The directors in the company, by law, are required to accept only the best bid that they have, so most bids are auctions.

Warren Buffett said it better than I could, "At an auction, the right side to be is the losing side," and so you've got to assume that if a company has been put together and a lot of the subsidiaries have just been acquired that they were acquired at prices that were equal to or more than they're really worth. You can value the company. Many companies that have been put together aren't worth any more than their stated book value. If that's the case, you'd better by the stock at below their stated book value if you want to make money. Beware of projecting past or present trends into the future and we discussed that a little bit when it comes to trying to be a contrarian. Human beings naturally are lazy and it's very easy to say, "Gee, this company's doing this. It's doing that. I'll just assume it'll do the same thing." Copper prices were 20₵, 40₵, 60₵, they'll probably be 80₵.

It takes hard thinking to go through and analyze where copper prices should be, and most people would just go along and project into the future uncritically. It's important to really say, "Stop, what are the fundamentals of copper? How much is being produced? What is the demand? What mines are coming on stream and what is a normal price that if the price goes lower than that, it's not economic to produce for high cost mines, but if it goes much higher than that, there's going to be new capacity coming on stream to try and get a balance point. That's hard thinking, it takes a lot of work. Most people don't want to go through that kind of an effort. It's a proclivity of many people to try and project a present trend into the future, which is say often works, but it's very dangerous. It's like steering through the rearview mirror of a car. It works fine when you're in a straight line, but if you come to a curve, it's pretty hazardous. That was advice I gave to the young man.

Be wary of projections by managements. Managements have an ax to grind. I have an expression, "Never ask your barber if you need a haircut." We are very cautious about listening to managements and just copying down what they say and taking that for the gospel. You have to be *very* careful because managements, usually what they tell you are highly scripted and managements are trying to put their best foot forward and so the company thinks you should buy the stock. We're wary about projections made by management. Be aware of the laws of supply and demand. I just mentioned that about copper and I could really mention it about oil, which was a real situation in November 2015 where you did have excess capacity in the world building fast. Actually, we thought for a while that Saudi Arabia would hold the price because it was in their national interest to hold the price roughly at $90-100.

Then the price started coming down and we said, "What's going on here? If Saudi Arabia wanted to hold the price at $80-90, why is it going below $80? Why is it going towards $70," because the price was down substantially before the Thanksgiving Day 2014 meeting of OPEC when Saudi Arabia basically said they were not going to control production to keep price up, but the price already had slipped. We have an expression when this happens not to pay attention to the noise in the market, but to pay attention to the price of the fish and the price of the fish in this case was telling you that the price of oil was going down. You have to be aware of supply and demand. We saw there was excess supply, the cartel was going to break, so we were highly suspicious that the price of oil might go down substantially and we did have investments that were oil-related at that time, particularly oil service companies and we quickly sold them.

That's probably another lesson, which I don't know if I pointed out to Jack Elgart, but you have to in this business continually reappraise your opinions and be very quick to change because you have a batting average in this business. You're right a certain percentage of the time and you're wrong a certain percentage of the time and when you're wrong, you need to recognize you're wrong, continually analyze stocks when the fundamentals are not working out as you expected and be willing to reverse yourself and sell the stock when you were wrong, before the stock goes down more. It's very bad to let your mistakes fester. It bothers you psychologically and, of course, it hurts your performance if the stock keeps going down and then you don't know what to do with it. It's easy to sell a stock if you thought a stock was worth $80 and the stock then sells at $72 and you take a loss at eight points because you were wrong. Then you can go on and you can recoup it.

If you say, "Jeepers, it's $72. Maybe it'll come back. Then I'll sell when it goes back to $80, I made a mistake," and you don't sell it, the stock could go to $65, $50, $40 and then you've got a really tough decision to sell the stock at $40 that you bought, let's say, at $80 a share. Then you've got a major loss and it becomes harder and harder and harder. We are quick to reverse ourselves when we recognize we have a loss and that was probably one of the points I made to Jack Elgart. I forget exactly what points I put in this book at this point. I did put in the point, "To avoid permanent loss." You'll have small losses, but avoid large permanent losses. I did say here, "Be prepared and willing to change your mind if your initial decision was flawed or circumstances change." Do not attempt to time the stock market, we discussed that a little bit in terms of Cannes. Try and remain fully invested as long as you can. Find stocks that are reasonably attractive. The stock market has a tailwind. It tends to appreciate 9-10% per year. You're better off owning an average stock than you are owning cash. Unless, of course, interest rates are not at 10% for your short-term.

In most cases, you're better off owning stocks, to stay in the game because you have that tailwind of 9-10% appreciation, which is the historic appreciation of the stock market. I'm not saying the appreciation is going to be that large in the future. It'll be good in the future. It may not be quite 9-10% of our economic growth in this country. It slowed down through economic change, different era we're going into. Be relaxed and invest with a passion. Anything you do, if you're going to do it well, you're going to do it intensively with a passion and you're not going to do it intensively unless you enjoy it, so the passion is something presumably you enjoy. Investing in the stock market is competitive. There are a lot of very smart people out there that do what we do and if you do it with a passion and you do it with more intensity, there's a greater chance you're going to be successful. I'll just use the analogy of playing tennis. If I play tennis seven days a week for three or four hours a day, I'm going to be probably better than somebody who plays tennis two or three times a week for one or two hours a day. To do it intensively with a passion, you will get better results and you have to be relaxed to do that because if you're uptight, if things are going through your mind in terms of pressures for the business, then you're likely to make decisions that are not as rational as is your mind is relaxed and you can really think creatively. You think more creatively when you're relaxed.

MOI: How does creative thinking lead to better results?

Wachenheim: It's imperative to be creative because a stock currently is selling at a price that the average investor thinks is the right price, so you have to come to a decision that that price is wrong and that the price deserves to sell, the stock deserves to sell at a higher price for some reason. That reasoning is creative thinking because other people aren't thinking that way because if other people were thinking that way, the stock would be at a higher price. Every idea is a creative idea.

MOI: Are there any cases from the book that you think stand out as being most creative, most counterintuitive?

Wachenheim: It's very hard to isolate one or two. I could probably talk about a number talk about a number and the creativity is, in my opinion, the exciting part of the business. I am at an age where I don't have to work. I work because I love the business and I love the business because when you do get a creative idea, it's really exciting. The adrenaline flows. You can hardly wait to go home, let's say, at the end of the day, get a scotch, sit by your computer and work out the creative idea. I'm sorry weekends come and I have to go on the tennis court and beat my friend at tennis, which I do. It helps to be competitive in this business and I tend to be a competitive person. Definitely the adrenaline flows. I will just give you a couple of examples of when the adrenaline really made it exciting and we got a creative idea. One was IBM.

IBM was looked on with tremendous disfavor in the 1980s. It was a company that was not making any money and had lost its way, it had done almost everything wrong. It was bloated with too many employees and they had a full employment program. The company was roughly breaking even at the time. I looked at the stock many times, but at the last time I looked at the stock before we bought the stock, it was bloated with too many employees and I could figure out based on Hewlett-Packard and a number of other companies about how many employees IBM should have relative to their revenues. I adjusted a little bit based on the nature of the business, so we had X number of employees and I thought that based on other companies and some common sense, I should have Y number of employees.

As I recall, it was 85,000 employees less. I could figure out pretty much what the average employee earned. I might be off by a little bit, but in this business, you're never exact. It's more being directional. By multiplying the average wage of an employee by the number of employees I thought they didn't need, I could come out with their savings and I could tax effect that, divide by the number of shares and come out with earnings power. They were breaking even at the time and I came out they should be earning about $1.50 per share. The stock was selling at about 12 at the time. IBM was not worth a high multiple, but was certainly worth more than ten times earnings, so I put some multiple on it, 13, 14 times earnings and it was an investment, therefore, that you could make a good return on, particularly because their earnings, at that point if they got themselves straightened out, would grow.

The company was growing about 5% per year in revenues. It had been growing 20% per year in revenues. I could project ahead and say that was a pretty reasonable investment. I don't know anybody else at that period time that was saying, "IBM is fat. If they cut this number of employees times the revenues, the earnings would be this." People were saying, "IBM's a terrible company. They're poorly run because they're so fat. Microsoft and other companies, Hewlett-Packard, at the time General Equipment have knocked the socks off them by coming out with better products, better software. They've missed everything," and that was the common opinion, but that's why the stock was selling at 12. That was an idea that I thought was creative and fun and worked out.

There are many others. In 2011, the common wisdom on Wall Street was that the housing market would stay weak because there's not only a large overhang of unsolved inventory of houses at that time, but there were many houses that were underwater that likely would be foreclosed. Therefore, there was a hidden number of potential empty houses because from the foreclosures. I thought for a minute and said, "Okay, if somebody's house is foreclosed, what is he going to do?" He could move in with his parents and some would do that or his in-laws, I wouldn't want to do that or with friends, but not many friends want to take in another family for any period of time. There's a greater likelihood that they would buy a less expensive house at that point or move to an apartment, in which case they would be living in a housing unit. At that time, we found some government statistics that about two million American families have doubled up because of the recession. The two families were living in one housing unit, but they got it stabilized. In doing a little bit of research, we found out that as many people who are living with another family were now leaving and moving into an apartment or moving into a less expensive house as with leaving a house and joining another family, so they got it stabilized.

If there were more foreclosures, we thought there was a high probability that the number of unsolved houses that were empty would stabilize and not increase. We knew the number of houses that were empty, we knew that about 650,000 housing units were being built in the United States in a given year at that point and we knew that the basic demand for housing was about 1.5 billion additional units each year whether they be apartments or single family houses because people have to live somewhere and that 1.5 million could be divided into two parts, about 1.15 million based on population growth. Simply a husband and wife have a child and they want to now live in a house, family formation and about 350,000 a year get removed for one reason or another, either because of fire or flood or they're too old or the town/city wants to come in and build a highway where the house is, so the basic demand was 1.5 billion. If we kept building 650,000 a year, the number of empty houses would continue to decline until the inventory got very low.

That was our thesis and it was very much against the common thesis on Wall Street, that we are worried about the shadow inventory of houses that will be foreclosed and we didn't worry about that. These are the kinds of things that make this business fun. When you do the original research, again, you've got to be a contrarian and you've got to have the mentality to be a contrarian and then to go ahead and buy a stock against the opinion of most people, against the prevailing wisdom.

MOI: How might a good idea lead to a great idea?

Wachenheim: That's a good point. We've given a lot of thought about creativity and how do we spend our time being more creative and we have no answer. Being creative is like getting your hand around a cloud, it's just amorphous. It's hard to do, but often one idea leads to another. I mentioned houses in 2011. I will go back to housing in the late-1990s and when we by accident got involved in the housing business through a company called US Home, at that point I was just running screens. US Home was selling at about 60% of book value and about six times earnings, but anytime a company is selling at .6 times book value and six times earnings, I'm going to go to my Bloomberg and I'm going to do a little work on the company to see what's going on. The company seemed to be a real company with a reasonably good balance sheet and the history was it was going into bankruptcy.

In the mid-1990s, there was in Texas an oil crisis. US Home was a major builder in Texas. Most of the houses they built were in Texas and the Texas housing market collapsed in the mid-1990s. It collapsed also in the 1980s and so it had been bad for a long period of time. The company had never recovered from the 1980s, was not strong in the 1990s and then in the 1990s when the housing market weakened, the company declared bankruptcy to give it time to work out its heavy debt load. The company was a good company. It built good homes, it had good reputation. The problem was one of having too much debt in a bad market, so markets improved, it renegotiated its debt in the bankruptcy courts. Came out of bankruptcy and it was a perfectly fine company. We bought the stock at .6 times book value and at six times earnings. It was a frustrating holding for many years. The company actually did very well. The earnings shot up. They doubled, but the stock, which doubled, was still selling at six times earnings and .6 times book value. It did not move up with the earnings.

Eventually, the company was bought Lennar. As we owned the company, we asked a lot of questions and one of the questions we asked is how come the business is turning up, that they're doing so well? Something must be going on in the housing industry. We also looked at the results of companies like Centex and Lennar and the other publicly owned builders and they were doing very well. It was just not our US Homes whose sales were going up much more than population growth. We started thinking about it and I asked one of my friends. Actually, one of my friends said, "Ed, you're dumb because you're not aware of the thrift crisis. You've just gone through a period where the savings banks, the thrifts had gone through a tremendous crisis," and many of them had gone bankrupt. They were the primary lenders to local builders. Local builders have to go out and purchase land, which has to be financed, develop the land, which has to be financed and then build a home, which has to be financed. They were highly dependent on the local builder. If I build a house in Rye, New York where I live, I was dependent on Rye Savings & Loan.

The savings banks were impaired. Many of them had gone out of business and the ones who remained in business had such a bad experience with the housing market that they were hesitant to lend. In many cases, the builder, they'd have to personally guarantee the loan, which many businesses are hesitant to do because if something goes bad, their personal wealth's at stake. We were in a period in the very late '90s and early 2000s when many private builders were leaving the business. They were simply shrinking the business or just going out of the business and the large home builders that were public, that had access to the public markets for their debt were gaining market share. Our investment in US Home got us to realize that something else was going in the business and what that something else was. We were in a consolidating industry and whereas housing normally should grow 1% or 2% a year with population, it was growing at double-digits per year. We could benefit and buy an industry where we were going to have very strong growth for a prolonged period of time.

MOI: There's a chapter dedicated to the railroad industry, which you discovered quite early. What did you notice?

Wachenheim: That is also a case where one idea led to another idea, which often happens. I'll go back to the period of 2000 and 2003. When the stock market collapsed in 2000, the economy pulled back as Clinton left office and Bush came in. We entered a slight recession and then we had 9/11. The Federal Reserve Bank at that particular time became concerned and we did enter recession, it was a little more severe. With the Fed warning that the economy was going to be bad and with the economy actually being bad, many companies cut back their capacity and their employment levels. Union Pacific Railroad was one of those companies that cut back in 2002-2003. As we then developed late into 2003, the economy started coming back. Union Pacific, in retrospect, had cut back too much. They had too few locomotives, too few freight cars and too few people. They developed congesting on their tracks. They now deal with rush hour on a highway. When too many cars go out on a highway, the traffic tends to slow up and move slowly. The traffic was moving slowly on Union Pacific tracks.

The railroads earn money based on ton miles. You pay to move your traffic and you pay a certain number of dollars based on the number of tons and the number of miles it moves, but the cost of a railroad are tied to hourly costs because you pay your employees by the hour. As it developed, Union Pacific's hourly wages went up sharply because traffic was slowed. Furthermore, they had to pull out of storage certain old locomotives that they were put into storage because they were energy inefficient or because they needed maintenance, so their maintenance costs went up, their energy costs went up and the earnings went down sharply, but Wall Street does not like earnings surprises. The stock declined. Not a lot, but the stock market was going up in 2003. It became, I would say, absolutely attractive and relatively very attractive, so we bought shares in Union Pacific Railroad. After we owned the shares, after a period of a couple years, we noticed that they were doing better than we would have imagined and we started asking ourselves questions.

One was just the economy. The other part was that oil prices went up very sharply in 2004-2006. Trucks are much less energy efficient than railroads. The number depends on the type of commodity you're hauling, but typically trucks consume on a ton/mile basis two to four times as much gasoline or diesel oil compared to trains. When the price of fuel went up, the trucks put a surcharge on the freight they were carrying so that they got paid back the extra cost of the energy and the railroads put a surcharge, but the railroad surcharge was much less, of course, than the truck surcharge. Instantaneously, the railroads became less expensive to move many kinds of freight that previously had been moving on trucks. The railroads picked up market share from the trucking industry and that is why we notice that the railroads are doing better than they expected.

Secondarily, what happens now when you have a cost advantage over trucks and when you have a lot of business compared to your capacity, you can move prices up. the railroads are not only benefitting from 1) the extra volume, 2) efficiencies of scale because the cost of running a railroad is very little more if you're running an 80-car train compared to a 70-car train and 3) they were benefitting from increased prices. The pure prices started going up about 5% per year, which is incredible because, of course, around 2% or 3% per year, the margins are going from 15% to 16% to 19% and when you've got the extra volume, the earnings were – I'll use the word – exploded. We realized that and in addition to holding onto Union Pacific, bought shares of Burlington Northern, which is now part of Berkshire Hathaway, Norfolk Southern and CSX and we took a major position in the railroads. We saw that idea before other people because we owned Union Pacific and we saw things were going on in Union Pacific that were positive that other people were not perceiving, so we were able to jump on the railroads. When you get a concept, you've got to jump because you've got to get the idea before other people do. This, again, comes back to passion. If you have a passion, you're going to drop everything you do on the weekend and say, "What's going on with the railroads and, boy, I've got to ask fast and act with knowledge."

MOI: How were you able to be intellectually open to exploring an airline business?

Wachenheim: The door behind you is usually open, and there wasn't a knock at the door, but my associate came in, Josh. Sheepish grin on his face, looked in and thought he would maybe not come in and then maybe leave. Finally had enough nerve to walk a couple of feet in and said, "Ed, I've got an idea you're going to hate. You're going to throw me out of your office. You're going throw me out. It's an airline." We knew airlines as a terrible business. It's obvious why it's a terrible business. High fixed costs, it's a commodity. The airplane has a certain number of seats. If you don't fill the sits, you can never fill the seats again, it's gone and that leads to destructive price competition. At that point, and this is three or four years ago, airlines in their history had never made money on balance. They made money in certain years, lost money in other years, and there's a long list of airlines that went bankrupt.

We viewed it as a terrible business, but what happened was – and now we go back to after 9/11 and the recession at that period of time and then the subsequent increase in oil prices – after 9/11, the number of people flying, particularly in the U.S., declined sharply, which meant there was a lot of excess capacity, and when fuel prices went up, the airlines had to raise ticket prices to pass on because airplanes are very energy-intensive, so the airlines were not doing so well for a short period of time between about 2001 to 2005-2007 and then, of course, the recession hit in 2008. During that period of time, the airlines had little incentive to add capacity, so very few new airplanes were ordered. Then the economy picked up in 2010-2012 and we started to get interested in airlines. Ridership picked up sharply and the airlines had limited capacity because they had not ordered new airplanes during this terrible time between the recession, 9/11, the increase in fuel, and the deep recession that followed the financial crisis.

The load factor for airlines increased from the low 70s to 84%. They were running 84% full on average. If you're running at 84% full on average and my associate, Josh, realized this, that means an airplane leaving at six o'clock in the morning flying from Oshkosh to Cincinnati probably is only going to be partially full, but the airplanes that leave at a decent hour and fly from major city to major city probably are going to be full and many cases with a backlog of people that want to fly on the airplane they just didn't have room for. That's a scenario when you can increase prices because demand is outstripping supply and the airlines likely were to do that. Of course, we saw the load factor. We saw the domestic airlines in particular had very few airplanes that were going to be delivered in the next few years, we saw that the economy was improving and that the number of people flying was increasing. Prices hadn't gone up yet and the earnings of the airlines had not gone up. If we had waited for that to happen, we wouldn't have had the opportunity, but we said there was a high probability that the airlines was going to do very well.

Investing is probabilistic, so we're never certain of anything, but we placed a very high probability that the airlines finally would be able to increase their prices and if you increase your prices, earnings, of course, soar. If you increase your prices, again, the same type analogy you had with railroads, you increase your prices 5% at a period when inflation is 2%, your margins go up by 3% and if your margins start at 7% and go up by 3%, your profitability goes up by 40% leaving alone the other advantages you get in a tight market, being able to not fly the inefficient flights, getting efficiencies of scale, etc. That was our thesis and we bought Southwest Airlines. Something very important, we are very risk-adverse, so the question is, "Wachenheim, why didn't you buy the other airlines, too," because if it was applicable for Southwest Airlines, it was also applicable to American, to Delta and some of the other airlines.

The reason was that Southwest Airlines had been making money through the difficult periods, they had as much cash as debt and they were selling close to book value. American Airlines had a negative hard book and Delta had a negative hard book. Both of the airlines had lost money during the difficult time and both of them had large net debt. We're risk-adverse and if another financial crisis had come about, not that we expected one or if there'd be another terrorist incident that encouraged people not to fly, American and Delta were much, much more likely to run into some serious financial problems in which case we could have permanent loss if they entered bankruptcy again. Then Southwest, which had as much cash as debt, so we are not out to make the most amount of money. We are out to do as well as we can to earn outsized returns consistent without taking large risk of permanent loss.

As it turned out, American stock skyrocketed. It flew like an airplane. Delta flew like a rocket, and both of those stocks doubled, tripled, and quadrupled without us. We did not make nearly as much money as we would have if we had owned those airlines. Did we make the right decision? Yes. The outcome was different than we expected, so we separate decision-making with outcomes. We made the right decision not to buy American and Delta because of the risk profiles.

MOI: When you talk about decisions versus outcomes, could you walk through AIG and what you take away from that?

Wachenheim: You've just ruined my day. AIG was the worst investment I ever made in my life, but I've made enough good investments. The batting average is good enough that it won't totally destroy me to review AIG.

When we looked at AIG, it was a AA rated company, it was very close to AAA… It was considered one of the great companies in America. When you buy a stock, you do everything possible to analyze the company and you make a decision based on everything you know. Now you can always get a black swan that comes along and it happens. We take the approach that if we've done our homework and we thought rationally, that every decision we make is the right decision. The outcome may not be as we wished and the importance of always saying that we've made the right decision is because we won't lose confidence. We will know that if a stock did not turn out as we expected, if we take a loss on the stock, that it was something that came along that was not in our original analysis, but if our original analysis was good enough, we're not going to blame ourselves for that. You need to have confidence to be a contrarian and to be a good investor.

With AIG, we did all the work we could do. We did not know there was going to be a financial crisis, we did not know that Lehman was going under. AIG's problem was not one of solvency, it was one of liquidity. They had a large net worth at any particular period of their history, even when the government came in and took most of the stock of the company and really caused us to have a permanent loss. The problem was liquidity, that they did not have nearly enough funds to put up the collateral that was required during the financial crisis when they and many other companies got downgraded by the rating agencies. When those certain events happened, they had to put up collateral and they could not borrow money, any money during the financial crisis to put up the collateral and that was AIG's problem. It came out of the blue. A friend asked me soon after the AIG fiasco if I had learned any lessons and I said that it was still in the smoke of battle and until the battle clears and we can look back on history, I can't judge whether we would do it again and how we felt about it.

After the smoke cleared, I did go back and review our initial memos. I came to the conclusion if I knew then what I knew originally, I would still make the investment in AIG. It was just un-fortuitous and unfortunate – I've used the word un-fortunate because we lost a fortune – that AIG ran into this problem and it's going to happen if you invest because you don't want to be so risk-adverse in life that you just buy treasury bills. You've got to draw the line and we're pretty risk-adverse, but as long as you invest in the common stocks, some way, somewhere something is going to happen unanticipated and you're going to take a loss. It was the single really serious loss I've taken in my investment career and it'll probably happen again. I hope I live that long that it happens again. I hope it happens again.

MOI: Walk us through Interstate Bakeries and how you found opportunity in such a unique situation?

Wachenheim: I have a friend named Howard Berkowitz, who by coincidence I'm having lunch with tomorrow. Howard is a very astute, hones, sensible person, very knowledgeable with very good judgment. He ran one of the very early hedge funds, Steinhardt Fine Berkowitz. Howard's been a friend for many years, I trust his judgement. I trust everything about him. I noticed that he purchased over 10% of a company called Interstate Bakeries, also had the name Interstate Brands. Interstate Brands is a better sounding name than Interstate Bakeries. It's probably worth half a multiple more. I started doing work on the company and actually we had known the company from a previous history because somebody I know very well had been on the board of the company earlier, so I knew something about the history of the company. The baking business is a very poor business and I knew that.

I did the work. Howard Berkowitz had brought in a new management. He was an early activist. We didn't call him an activist at the time, but he bought the stock and decided that the management needed to be changed. The new management seemed to be doing everything right, it seemed to be able to make some profit by buying the stock. Not a lot, but some profit. It was marginal. My initial reaction was it's a marginal profit and not very good in history, I'm not going to buy the stock, but then I thought, and this is where intuitiveness comes in, "Look, Howard Berkowitz is a lot more knowledgeable about the company than I am. He's probably smarter than I am and he owns more than 10% and he's now chairman. I'm going to follow somebody that that's smart. He probably knows the company better than I do and may have ideas I haven't thought of." We bought over a period of several months a 7% or 8% position in the company and we then got absolutely lucky.

What happens was that the price of oil declined very sharply in the mid-1980s and the price of wheat declined in the mid-1980s. Of course, bakeries use wheat and bakeries use a lot of energy not only to bake the bread, but bread has to be transported by the bakery company in trucks that they own because bread has to be fresh and they can't rely on going to a wholesaler and the wholesaler – Sysco or somebody else – sending the trucks, so then spend a lot of money on gasoline each year and the price of oil went down sharply. Usually, when costs go down in a commodity type product, prices eventually do react and go down and the profit margins return to the mediocre level they were before, but in this case, the price decline of oil and the price of wheat was so sharp and so sudden to such a degree that the company started earning a lot of money. Howard Berkowitz very wisely decided that with his knowledge that the profits probably were temporarily inflated to sell the company and we found a buyer at a very high price.

We got lucky, but luck is part of the business. My old boss by the name of Arthur Ross, he used to tell me, "Ed, stay in the game. Stay in the game because if you're in the game, you can occasionally get lucky and there's this upward bias of stocks of 9% or 10% per year, so if you buy a stock you think is exciting and it turns out to be only average, you can still make 9% or 10% per year on average historically." That's a pretty good business. In fact, it's an excellent business.

MOI: What is some wisdom other people shared with you over the years that's really resonated at your core?

Wachenheim: I've learned by being in the hot seat myself and there aren't too many people that think and act like we do, so I don't have a whole historical perspective from speaking to a lot of people. I do not go out to lunch with other portfolio managers and a lot of other people because it's an awkward situation. They probably don't want to discuss their best ideas, the stock's they're buying or might buy more of and we don't want to discuss stocks that we are buying or might buy more of, so what do you discuss when you exchange ideas or philosophies with somebody? We don't go to lunch normally with other portfolio managers. Warren Buffett has been a major influence on my life because he's so brilliant and I've read a lot of what Buffett has said and memorized many of the things that are said. The two rules to successful investing, the first rule is avoid permanent loss and the second rule is don't forget the first rule. Adages like that stick in my mind.

MOI: I'd love to explore how you define success.

Wachenheim: It depends on age. Success when you're young is having the resources to raise a family. Success when you may get a little older is the feeling that you've had a successful career, that you've built confidence in yourself, that you're having fun at what you're doing. The money becomes less important. The financial aspect becomes less important. The psychological fulfillment of being in a business, enjoying the business, having a passion about the business, being successful in the business becomes more important. As you grow older, when you know that you've been reasonably successful and that the marginal utility of having another successful idea because you feel a little better about yourself becomes less.

Helping other people and giving back to society — that's one reason why I wrote this book. I have had a lot of experiences that are beneficial to other people and I want to get them down to paper. Before you came in, I spent an hour on the phone with a not-for-profit. Tomorrow, there's a finance committee meeting, which I chair. Any wisdom I have to help that not-for-profit be more successful, the little bit that I can contribute is a very good feeling. Many people just think financially supporting a not-for-profit by becoming a philanthropist, by giving to charity is important and makes them feel good, which is fine. I also enjoy giving financially to not-for-profits, but particularly being able to use your work and lifetime experiences to help the not-for-profit is very rewarding, so I've tried to spend a certain number of hours doing that.

MOI: At what point should someone start to give back?

Wachenheim: It's situational. It depends on the financial resources of the person and also it depends on the amount of time that the person has. I have more time now with a limited number of clients that we have. I don't have to market because I'm happy to lose a client and we're not marketing for new clients, so I don't have to spend a lot of time and the clients know me. After a period of time and with the help of the Bloomberg, my research process has taken much less time. You learn how to do things. There are companies I come across that I know the history, I don't have to spend hours and hours and hours learning about the company. The Bloomberg has changed my life and the internet has changed my life. It used to take me 30 years ago hours and hours and hours and hours to get basic information about a company.

Now I hit "bang, bang, bang, go" and the balance sheet comes up, the income statement comes up, records come up. In the homebuilding industry, I know how many lots of land that a company has owned over the last ten years. It's incredible the time savings, so I have some time to give back to charities. It's situational. Many things in life are situational as to when in life you're able to give back to charity, but it's very important. People act in their self-interest, I feel good when I do it. Would I give back to charity if I felt bad about it because it was helping other people? No. I get satisfaction out of doing it. People do act in their self-interest.

MOI: Thank you very much for sharing your wisdom with us.