



# The Science & Art of Managing a Concentrated Portfolio

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## **Portfolio Manager**

**Mr. Macauley serves as co-portfolio manager of the Focus Fund. Mr. Macauley joined FBR Fund Advisers in August 2009. Prior to joining FBR Fund Advisers, Mr. Macauley served as a Research Analyst at Akre Capital Management, which he joined in January 2003.**

**Prior to joining Akre Capital Management, Mr. Macauley held investment analyst positions with Credit Suisse First Boston and with Wachovia Securities.**

**Mr. Macauley holds a BS in Commerce from the University of Virginia.**

# The Science & Art of Managing a Concentrated Portfolio

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Part 1: The Science

Part 2: The Art

Part 3: Q&A

Part 1: *The Science*  
of Managing a Concentrated Portfolio

## Conventional Wisdom: *Jensen Study*

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### ▶ *Jensen (1969):*

- *Question... does active management add value?*
- *Answer... rarely<sup>1</sup>*
- Numerous later studies reinforce that active funds, net of expenses, tend to underperform relevant benchmark indices

### ▶ **Conclusions:**

- **Lower expenses and diversify, diversify, diversify!**
- **Picking stocks is futile**
- **Index**

1: *Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios*, Michael Jensen, 1969

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## Cremers & Petajisto (2009)

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- ▶ “Active management” ill defined by Jensen
- ▶ Redefine “active management” as portfolios that differ significantly from their benchmark
- ▶ Find active management outperformed by 1.5 to 2.4 percentage points each year over a 25 year period (1979 to 2004)<sup>1</sup>
- ▶ **Conclusion:**
  - **Active management adds value**

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1 : Martjun Cremers and Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, Yale School of Management, March 31, 2009

## Best Ideas Study (2010)

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- ▶ Isolate managers' "best ideas" in actively managed funds
  - Defined as largest deviations from index allocation
- ▶ Group "best ideas" and evaluate performance over time
- ▶ "Best ideas" outperformed by 4 to 10 percentage points each year over a 23 year period (1984 to 2007)<sup>1</sup>
- ▶ **Conclusion:**
  - **Managers best ideas significantly outperform the rest of their portfolio, and the market overall**

Source: Cohen, Polk, and Silli, *Best Ideas*, MIT, LSE Goldman Sachs, April 20, 2010

## Big Bets Study (2007)

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- ▶ Study of concentrated vs. non-concentrated mutual funds
- ▶ *“...domestic stock portfolios with strong weightings in a relatively small number of holdings deliver higher returns... than portfolios which held more uniformly weighted positions... approximately 30 basis points of additional performance each month, or roughly 4 percentage points of additional return each year.”*
- ▶ **Conclusion #1:**
  - **Concentrated portfolios significantly outperform non-concentrated portfolios**



Source: Klass Baks, Jeffrey Busse, and Clifton Green, *Fund Managers Who Take Big Bets: Skilled or Overconfident*, American Finance Association  
2007 Meetings Paper

## Big Bets Study: Risk

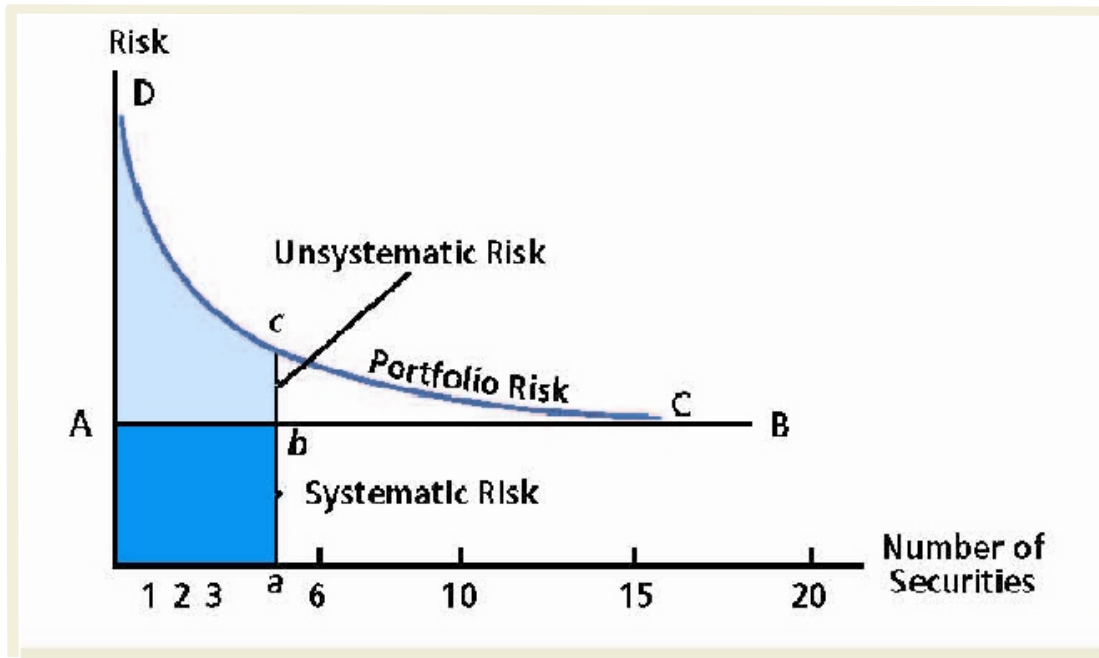
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- ▶ *“...portfolios that included only managers’ best ideas generally delivered strong returns without added risk”*
- ▶ **Conclusion #2:**
  - Superior return are delivered with similar volatility

Source: Klass Baks, Jeffrey Busse, and Clifton Green, *Fund Managers Who Take Big Bets: Skilled or Overconfident*, American Finance Association 2007 Meetings Paper

# Risk: Diversifications Diminishing Returns

Holding 20-50 stocks can reduce unsystematic risk by 90 to 95%



1: John Campbell, Martin Lettau, Burton Malkiel, and Yexiao Hu, *Have Individual Stocks Become More Volatile*, The Journal of Finance, Vol. LVI, No. 1, February 2001

## Risk: Morningstar Study (2009)

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**Finding:** *Morningstar research demonstrated that mutual fund portfolios with 40 or fewer holdings “aren’t more volatile than more diversified funds, on average, and some are surprisingly steady despite their small number of holdings”*

Source: Morningstar analysis reported by Larry Light, *OK, Now Concentrate*, The Wall St. Journal, October, 2009

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## Review of Recent Research

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- 1) Active management adds value
- 2) Managers' highest conviction ideas significantly outperform
- 3) Concentrated portfolios significantly outperform
- 4) No significant increase in risk / volatility

## Why Does Concentration Work?

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*“We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.”*

- Warren Buffet

Berkshire Hathaway, *Annual Report*, 1993

# Why Isn't Concentration More Widely Adopted?

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- ▶ Flawed financial incentives<sup>1</sup>
- ▶ Effects of 'prudent man rule'
- ▶ Portfolio manager career risk<sup>2</sup>

*“Worldly wisdom teaches that it is better to fail conventionally than to succeed unconventionally”*

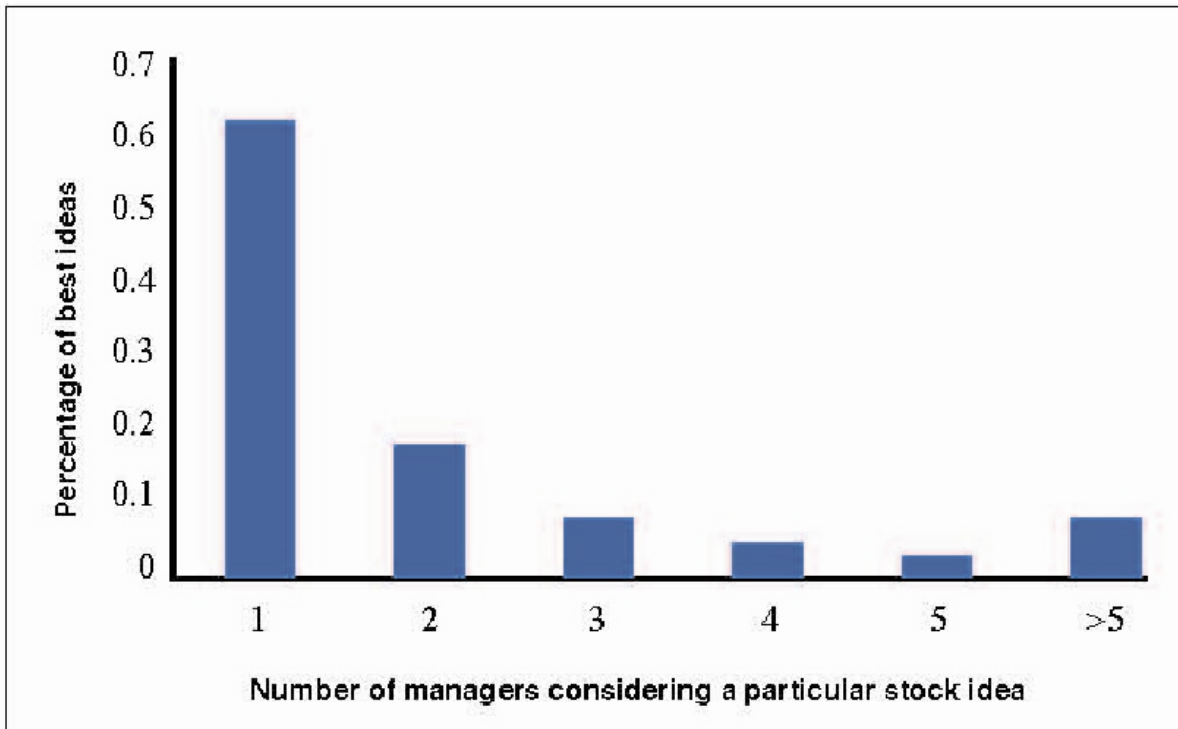
- John Maynard Keynes

<sup>1</sup>Source: Study by Sirri and Tufano, *Costly Search and Mutual Fund Flows*, Journal of Finance, Vol. 53, Issue 5, 1998

<sup>2</sup>Source: Study by Chavalier and Ellison, *Career Concerns of Mutual Fund Managers*, NBER Working Paper Series, August, 1998

# Best Ideas: Little Overlap

About 62% of best ideas were unique to one manager, while just 7% were shared by five or more managers.



Source: Cohen, Polk, and Silli, *Best Ideas*, MIT, LSE Goldman Sachs, April 20, 2010

Part 2: *The Art*  
of Managing a Concentrated Portfolio

# Is the conventional mutual fund model broken?

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## **9 of 10 actively managed mutual funds underperform their benchmark over the long-term\***

	<b><u>Mid Cap Growth Avg</u></b>	<b><u>FBR Focus</u></b>
<b># of Positions</b>	<b>101</b>	<b>18</b>
<b>Trailing Twelve Month Turnover</b>	<b>139%</b>	<b>5%</b>
<b>Since Inception Turnover</b>		<b>17%</b>

\*Source: Vanguard comparing actively managed open-end mutual funds, after fees vs. performance benchmark

Source: SimFund

Is the conventional mutual fund model broken?

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**One-fifth as many stocks, held for 6x as long...**

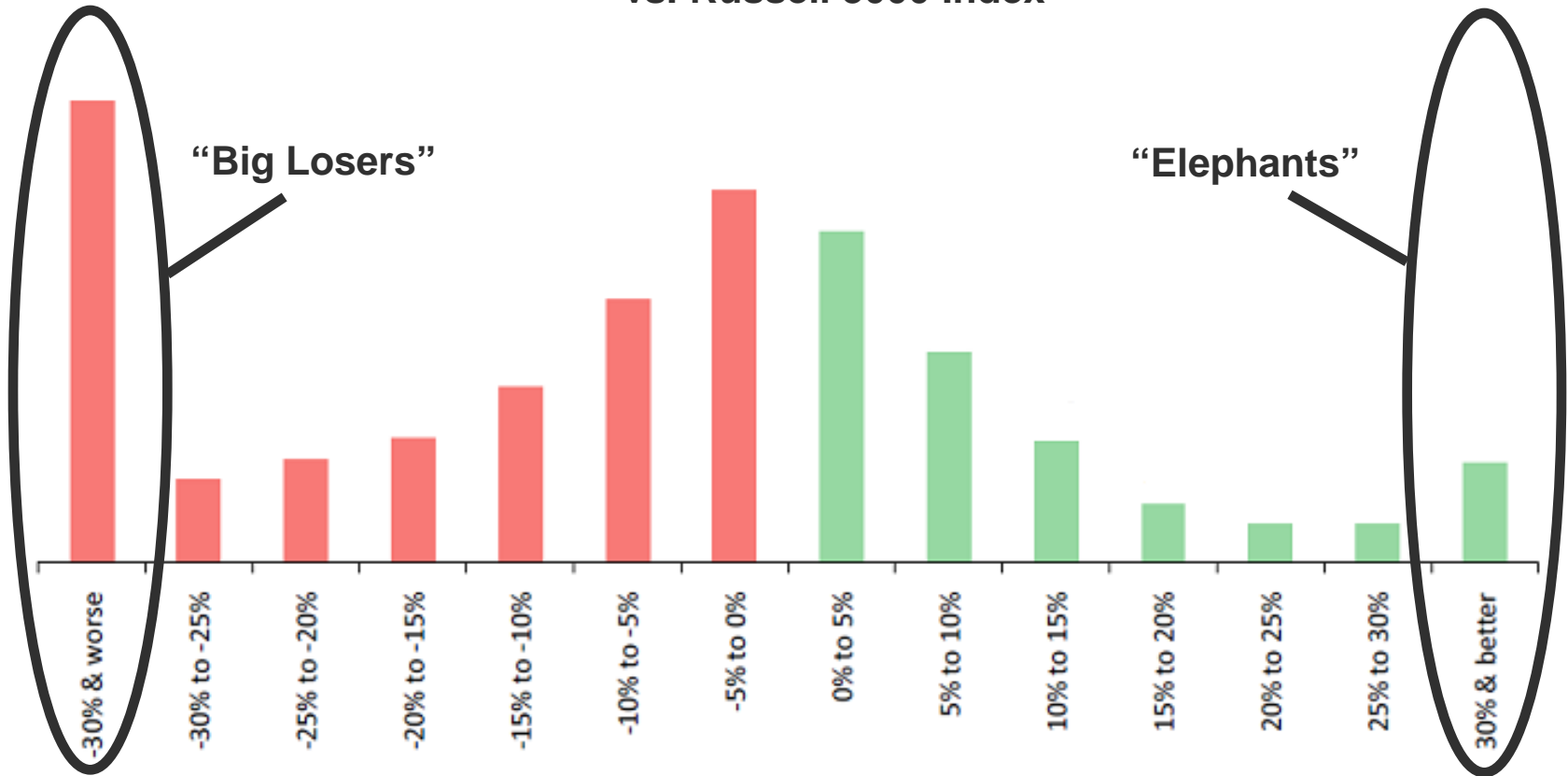
**30x the resources per investment**

**Creates an informational advantage in an  
information business**

\*See previous page

Play 1: Avoid Big Losses;  
 Play 2: Hunt for Elephants, Not Rabbits

Distribution of Annual Returns for Individual Stocks  
 vs. Russell 3000 Index\*



Source: *The Capitalism Distribution*, The Blackstar Funds

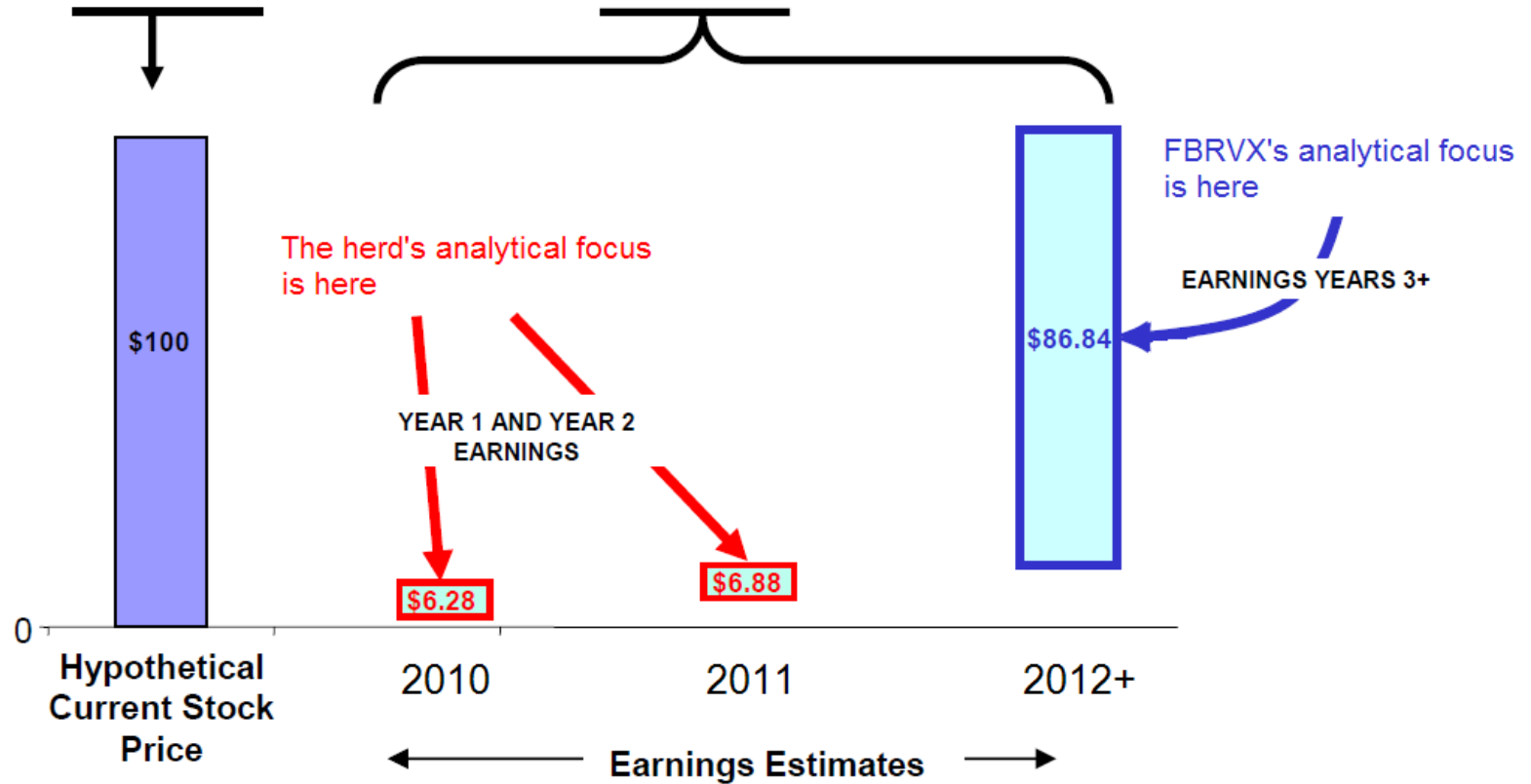
\* For 24 discrete annual measurement periods: 1984-2007

Play 1: Avoid Big Losses;  
 Play 2: Hunt for Elephants, Not Rabbits

<b><u>Big Losers</u></b>	<b><u>Elephants</u></b>
▶ Excessive valuation	▶ Strong competitive position
▶ Unsustainable demand	▶ Large growth opportunity
▶ Eroding competitive position	▶ Superb management
▶ Technological, fashion, fad risk	▶ Fair or cheap valuation
▶ Open-ended contingent liabilities	

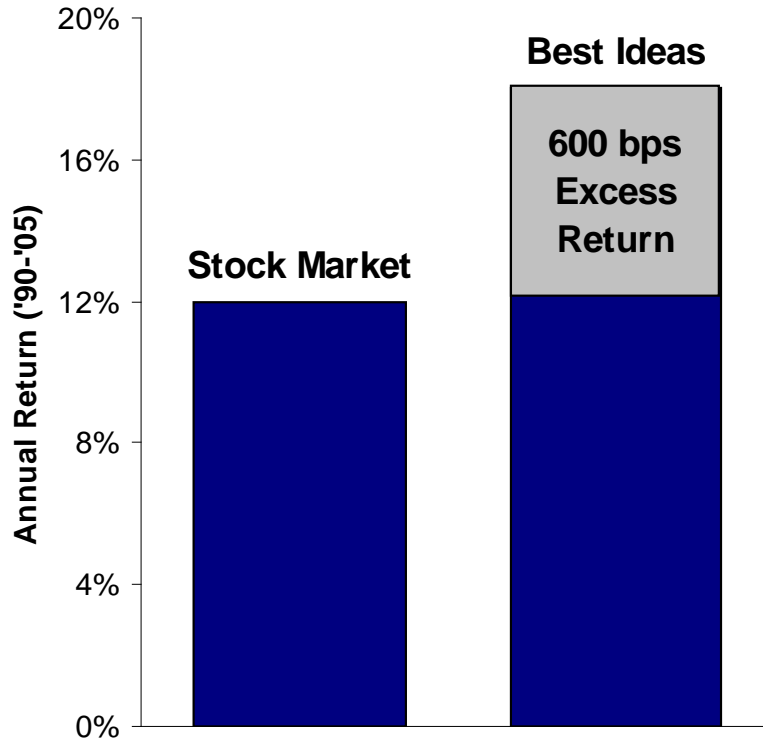
# Play 3: Focus on the Long-Term (hypothetical)

A STOCK'S VALUE.....IS DRIVEN BY ITS FUTURE EARNINGS



**Our long-term view helps us take advantage of short-term market overreactions**

# Play 4: Invest in Your Best Ideas



*"We document strong evidence that...the best ideas of active managers generate an order of magnitude more alpha than their portfolio as a whole."*

*"The poor overall performance of mutual fund managers ... is not due to a lack of stock-picking ability, but rather to institutional factors that encourage them to overdiversify."*

**We concentrate in our best ideas to maximize risk-adjusted returns**

Source: *Best Ideas*, Harvard and LSE study, Cohen, Polk, and Silli, March 18, 2009

# Investment Philosophy

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- 1 Approach buying a common stock with the same approach as evaluating the purchase of an entire company:**
  - Conduct comprehensive research focused on the key long-term business drivers
  - Anticipate a hold period of five years or longer
- 2 Invest in understandable businesses that have defensible franchises, outstanding management, and significant opportunities to grow intrinsic value**
- 3 Pay a discount price so that, at a minimum, long-term investment returns match the growth in intrinsic value of the underlying business**
- 4 In the absence of compelling opportunities, hold cash – recognize that acts of omission can be as important to long-term wealth creation as acts of commission**
- 5 Outstanding investments are rare, so focus time and capital on the very best ideas**

## Idea Generation

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- ▶ **Most new investments come from a universe of 500+ companies that have been reviewed in the past because they possess at least a few of the desired business characteristics**
- ▶ **This universe is continuously refined and expanded with ideas sourced from:**
  - Conversations with network of like minded investors
  - Businesses adjacent to existing portfolio holdings
  - Reading of financial and other press
  - Management meetings and industry contacts
  - Investment conferences
- ▶ **When thorough research determines that a company possesses all the desired business quality characteristics, it is added to a 50+ stock “watch list”**
- ▶ **This watch list of prospects is regularly compared to current portfolio holdings to determine the most compelling opportunities for the fund**
- ▶ **“Special situation” investments often emerge from companies in the 500+ stock universe that possess some, but not all of the desired business qualities**

# Idea Research

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- ▶ **Perform rigorous proprietary and non-proprietary research on potential investments**
- ▶ **Assess the business from multiple perspectives – company, competitors, suppliers, customers, industry experts – to build a more complete view of reality**
- ▶ **Emphasis is on those issues that will impact long-term value: business risks, competitive dynamics, growth opportunity, and management quality**
- ▶ **Research is continuous on existing portfolio positions to monitor the investment thesis and respond appropriately to changing circumstances**

## Non-Proprietary Research

- ▶ Review:
  - three to five years of conference call transcripts
  - five to ten years of annual reports and 10Ks
  - recent conference and analyst day presentations
  - business press articles on company and industry
  - industry trade publications
  - sell side company and industry reports
- ▶ Interview senior company management off site
- ▶ Conversations with sell side analysts
- ▶ Thoroughly review all public competitors

## Proprietary Research

- ▶ Multiple on site visits with senior management
- ▶ Manufacturing, distribution, and field/store visits
- ▶ Conversations with:
  - mid level and field employees
  - former employees
  - customers
  - suppliers
  - private competitors
  - trade groups and consultants
- ▶ Attend industry trade shows

## Sell Discipline

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- **Negative reassessment of any one of the four key quality metrics:**
  - Strong competitive position
  - Large value creation opportunity
  - Superb management
  - Favorable business risk profile
- **Relative valuation – capital is needed for a more attractive investment opportunity**
- **Absolute valuation – a less than 10% IRR is expected even under a favorable scenario**
- **Portfolio-level risk – position size, on its own, or in combination with other portfolio positions, results in undue exposure to a particular systemic risk**

# Case Study - Core Investment: O'Reilly Automotive (ORLY)

O'Reilly is the second largest specialty retailer / distributor of aftermarket auto parts in the United States, serving both the professional repair shop and the do-it-yourself customer. Founded in 1957 by the O'Reilly family, the Company operates 3,613 stores in 38 states (as of 3/31/11).

## Strong Competitive Position

- ▶ Unique dual market distribution model enables higher service levels, higher sales per trade area, and higher inventory turns
- ▶ Scale, as 2<sup>nd</sup> largest in industry, provides substantial buying power versus competitors
- ▶ Fanatical company culture a valuable service and execution advantage
- ▶ These advantages enable 12-15% returns on capital, and even higher ROEs

## Large Opportunity

- ▶ O'Reilly is an industry leader but still has just 3% share in this huge \$188B market
- ▶ Many years of organic store growth remain as O'Reilly continues to penetrate existing markets and expands geographically into the Northeast and Gulf Coast
- ▶ Sales per store at acquired CSK stores should improve from \$1.3 million to \$2.0 million as commercial sales effort is expanded with new distribution capacity
- ▶ A conservative balance sheet allows this proven consolidator to continue to make highly accretive acquisitions in a fragmented industry

## Superb Management

- ▶ Chairman, David O'Reilly, is an exceptional capital allocator and has successfully shepherded the company through five major acquisitions
- ▶ CEO, Greg Henslee, and COO, Ted Wise, have been promoted from within and are best-in-class operators with a combined 69 years at the company

## Discount Valuation

- ▶ Entry valuation was 9x EV/EBIT and 14x NTM EPS (Q1'05)
- ▶ Had / has little financial leverage and best balance sheet in industry
- ▶ Returns on capital and proven growth model promise(d) good value creation

## Proprietary Research

- ▶ 7 trips to Springfield, MO to meet with senior management
- ▶ Visits to 30+ O'Reilly stores across multiple regions
- ▶ Visits to 15+ competitor stores across multiple regions
- ▶ Visits to and surveys of 20+ professional repair shops
- ▶ Meetings w/ senior management of public competitors AutoZone, Advance Auto, CSK Auto, and Genuine Parts
- ▶ Multiple conversation with private competitors, industry trade groups, industry parts vendors
- ▶ Conversations with former senior O'Reilly employees

## Unique Insights

- ▶ A better "mousetrap" that is deceptively hard to replicate and should allow many years of growth and market share gains
- ▶ Rational industry competitive behavior and acyclical demand make this business safe and future cash flow predictable
- ▶ A fanatical culture, insider ownership, and long term thinking make this the management team to bet on
- ▶ Company has a long history of adding value by integrating competitors acquired at attractive valuations – such as CSK

## Investment Result

- ▶ Shares were first purchased at 14x NTM EPS in Q1'05
- ▶ EPS is up 17% per annum, store count is up to 3,613 from 1,249, and sales are up to \$5.8B from \$1.7B
- ▶ Now an 11.9% position trading at 4.5x+ our cost basis
- ▶ Shares trading at 15x our NTM EPS estimate
- ▶ O'Reilly led to successful investment in CSK Auto

# Case Study - Core Investment: American Tower (AMT)

American Tower is the largest cellular tower owner in the U.S. with additional assets in rapidly growing markets in Latin America, India & Africa. AMT owns or manages over 38,000 structures, is a significant beneficiary of high speed wireless network development, has a visible revenue model and an investment grade rating.

## Strong Competitive Position

- ▶ Unique operating model discourages contiguous competitors and NIMBY issues encourage co-location solutions for mobile carriers
- ▶ Scale in U.S. ensures marginal revenues create marginal EBITDA contributions in the high 80% range and much lower time to market for carriers
- ▶ Many sites in U.S. are not replicable and command unique economics
- ▶ These advantages create initial high single digit ROIC for new towers which increases to a high twenties ROIC with two additional tenants

## Large Opportunity

- ▶ Controls over 20% of co-locatable structures in the U.S. with room to expand while Latin America, Indian and African markets are in early stages of maturity cycle
- ▶ Many years of organic growth remain as company supports current 2G/3G wireless growth in the US/LA/India/Africa, new entrants in these markets (Leap, MetroPCS), and future 4G growth (LTE and WiMax)
- ▶ Expect to see the company enter another 2-3 new markets over the next five years
- ▶ A conservative balance sheet allows this proven consolidator to continue to make highly accretive acquisitions in new territories

## Superb Management

- ▶ Chairman and CEO Jim Taiclet is a very patient capital allocator having steered the company through seven smaller and three larger acquisitions

## Discount Valuation

- ▶ Entry valuation was 12x EV/EBITDA and 14x FCF/share in 1998
- ▶ Has the lowest financial leverage in the group (3.0x) and first investment grade rating
- ▶ ROIC is increasing and promises solid FCF generation for the next decade

## Proprietary Research

- ▶ 25+ meetings with senior management over the last 12 years
- ▶ Multiple site visits and facility field trips
- ▶ Regularly attend CTIA and numerous trade shows
- ▶ Regular contact with industry consultants and zoning experts
- ▶ Meetings w/ senior management of public competitors (Crown Castle, SBA Communications)
- ▶ Conversations with industry technical engineers
- ▶ Conversations with small and large private competitors

## Unique Insights

- ▶ There is a significant and often overlooked favorable difference between cash earnings and GAAP earnings
- ▶ The business model in the U.S. can be replicated overseas with the right wireless growth curve, new spectrum auctions and solid property ownership rights
- ▶ Rational industry competition and non-cyclical demand make this business's future cash flow predictable
- ▶ Company has a long history of adding value by integrating competitors acquired at attractive valuations

## Investment Result

- ▶ Shares were first purchased at 14x FCF in 1998
- ▶ EBITDA is up 39% per annum, tower count is up over 38,000 from 3,235, and sales are up to \$2.4B from \$103M
- ▶ Now a 10.4% position trading at 14x our cost basis
- ▶ Shares trading at 17x our NTM FCF estimate
- ▶ Investment in AMT led to successful holding in Spectrasite & Google

# Case Study - Special Situation: 99 Cents Only Stores (NDN)

**99 Cents Only Stores is a value oriented retailer of food, beverage, and household products at price points under \$1.00. One-half of product is sourced from close-out purchases and one-half is re-orderable. Company has approx. 285 stores in four states with a significant presence in So. California (as of 4/2/11).**

## REASONABLE Competitive Position

- ▶ Scale and reputation with vendors enable significant sourcing from exclusive close out deals that drive margin and customer excitement
- ▶ Brand awareness and store density in So. California drive high volume and efficiency
- ▶ Earned 30% ROIC and 13% pretax margins prior to expansion into Texas in 2004

## Large Opportunity

- ▶ Margin recovery from near 0% to ½ of prior rate of 13% can create significant value
- ▶ Redeployment of excess cash on balance sheet could supercharge returns
- ▶ Store base could grow 50%-plus in just the existing four state market
- ▶ Expansion beyond four state market presents further upside optionality

## FLAWED but EVOLVING Management

- ▶ Founding family runs the business, owns 33% of shares outstanding, pays itself just \$100K comp per family exec, and takes no options
- ▶ Business outgrew unsophisticated family leadership
- ▶ Shareholder pressure, internal family management reorganization, and significant hiring of outside talent (CFO, VP Distribution, VP Real Estate, VP Store Operations, VP HR, Controller, Treasurer), have upgraded capabilities

## DEEP Discount Valuation

- ▶ Cost basis at 25% discount to adjusted book value
- ▶ Significant excess cash and owned real estate on balance sheet
- ▶ Only a modest recovery of historical margins needed for investment success
- ▶ Organic growth potential and capital redeployment provides upside optionality

## Proprietary Research

- ▶ 6 trips to Los Angeles to meet with senior management
- ▶ Visits to 60+ 99 Cents stores across all four states
- ▶ Visits to 30+ competitor stores across multiple regions
- ▶ Conversations with 40+ store managers, 10+ regional managers, and various mid level employees
- ▶ Conversations with product vendors, dollar store consultants, private equity operators, and private competitors
- ▶ Conversations with commercial real estate professionals, company landlords, and former head of company real estate

## Unique Insights

- ▶ Real estate holdings significantly undervalued on balance sheet – stock traded well below book and liquidation value
- ▶ Company so inefficiently run that application of industry standard best practices was/is a large opportunity
- ▶ Customers continue(d) to visit stores despite operating difficulties, so retail concept highly relevant
- ▶ Favorable leadership changes afoot with “old guard” yielding internal power to next generation management

## Investment Result

- ▶ Initial purchase in Q4'04 at adjusted book value and 10x recovered earnings estimate
- ▶ Significant additional purchases in '07 and '08 as price-to-value ratio became increasingly favorable
- ▶ Founding family in partnership with private equity has offered to take the company private at \$19.09 per share
- ▶ Now a top 5 position trading at approximately 2x our cost basis

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