Focus on the Manager

Jim McCluskey and Jeff Simon: Large Cap Value Team

Back in 1997 when Jim McCluskey was interviewing potential partners to help him grow Bear Stearns Asset Management's (BSAM's) value investing team, he was looking for someone who was level headed, who wasn't easily ruffled by stock market gyrations, and who shared his deep convictions regarding the significance of value investing.

Jim McCluskey and Jeff Simon

Jim's search took him 18 months, but he found the perfect counterpart in Jeff Simon. Like Jim, Jeff had since early in his career been a disciple of Ben Graham, considered by most to be the father of value investing, and also of Warren Buffett, arguably one of the most successful investors of all times. Both Jim and Jeff had devoted their careers to value investing, believing—like Graham and Buffett—that the key to consistent market-beating performance is to look for stocks that are trading at less than their intrinsic value.

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"By the time we met, we both had about two decades of experience working for some of the industry's top value shops," says Jim. "We had a chance to see the plusses and minuses of value investing at other organizations, and to apply the industry's best practices to our own efforts here at Bear Stearns."

As co-heads of BSAM's value team, Jim and Jeff believe the central tendency of every stock is to migrate toward its intrinsic value over time. "Throughout history, investors have had a psychological tendency to sell when they see share prices fall—but that's exactly when they should be looking for buying opportunities," explains Jeff. The team devotes itself to finding mispriced securities, that is, stocks trading at a discount to their intrinsic values. In addition to its two co-heads, BSAM's value team includes four research analysts, a client portfolio manager and two portfolio administrators.

It sounds simple, but how does one determine a company's intrinsic value? "One way is to estimate how much cash the company can generate, and how that cash can be allocated back to shareholders," explains Jeff. "Another is to look at a company as the sum of its parts. If each part were sold, how much would it all add up to?" If a company's stock is selling at less than the sum of its parts or the present value of its future cash flows, it might be a good candidate for investment.

So what gives the BSAM value team its advantage? "Our approach is different in that we look at a company like a CFO," says Jeff. "We put an extensive amount of effort into getting at a company's real economics, which may or may not be reflected in its financial statements," he says. To explain, Jeff cites examples of companies that report earnings that aren't generated by their core business, and/or choose not to list employee stock options as a cash expense.

Though legal, accounting practices like this can skew a company's true condition by overstating earnings and understating expenses. "Our goal is always to distinguish a company's true earning power from its stated accounting results," says Jim. He elaborates, "Sometimes a company's financial statements do a good job portraying the true economics of its business—and sometimes they don't. It takes a tremendous amount of effort to figure this out. We're constantly asking ourselves, if it's not on the balance sheet or

income statement, how do we as investors account for it?"

"As investors, our first rule is to remember we're investing for the long term," says Jeff. "It's an 'own versus lease' mentality. We view time as our ally, not our enemy. If we know a company's business model is a successful one, we can be patient in waiting to buy its shares at a discount." He adds, "If you can buy companies consistently over time for less than their intrinsic values, you will outperform the overall market."

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Jim and Jeff's like-mindedness is not limited to their investment philosophies. They are both avid runners, and see a number of parallels between performance at the road race and in the equity markets. "One of the most critical components of success in running a race is to decide ahead of time how you're going to run it," explains Jeff. "It's the classic tortoise and the hare. Some people start the race too fast and furious: they don't pace themselves, and they don't think strategically," he says. "Instead, they go for the excess return, but half way through the race, they're walking." Jeff adds, "All I have to do is be consistent on every mile mark in my race and I can count on finishing near the head of the pack. If I can do that in every race over time, I know I'll be a quality runner." "That's how we look at investing," says Jim. "If we're consistent along each mile marker, at the end, we can expect to finish in the top quartile."

When it comes to finding the most promising opportunities from a pool of undervalued stocks, Jim and Jeff draw on their proprietary research and extensive experience to make the final call. "We don't profess to know how to run a company, but we're very good at identifying the threads of success," says Jeff. There are three "threads of success" the team looks for in every stock:

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First, they look for companies that are creating value, not depleting it. "Just as our jobs are to be excellent stewards of capital for our investors, we want the managements we invest in to share that same philosophy," says Jeff. To determine this, the team focuses on a company's return on invested capital. "If every dollar invested into the business earns less than the cost of running the business, it's like a depleting oil well," explains Jeff. Instead, they look for companies where every dollar invested generates a higher return than the cost of doing business.

Second, "We look for management teams that run the company for the shareholders, not for themselves," says Jim. To determine this, the team tries to discern if the company's managers view themselves as owners. "You didn't find that kind of concern for shareholders at headline-grabbing companies like Enron," Jim notes. "It's very hard to teach that kind of concern,"adds Jeff.

Finally, the team likes companies that have a focus on research and development, since history has shown R&D to be predictive of a company's growth potential and its ability to create value. "Managements who are willing to sacrifice some earnings today in order to keep the company growing strong in the future tend to be better stewards of capital," states Jim. "Their focus is on reinvesting in their business for the long term as opposed to milking it for short-term gains. That's good management."

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By Bobbie Turner, a financial writer based in New York City. 4/04

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