CNNMoney

Are these the new Warren Buffetts?

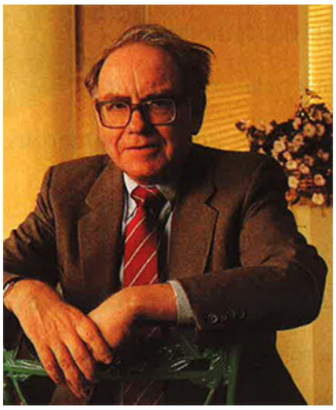
November 21, 2012: 11:37 AM ET

The dozen young investment managers you'll meet here are brainy, ethical, and good at making money grow consistently.

By Brett Duval Fromson

This story is from the October 30, 1989 issue of Fortune*. It is the full text of an article excerpted in* Tap Dancing to Work: Warren Buffett on Practically Everything, 1966-2012*, a* Fortune *Magazine book, collected and expanded by Carol Loomis.*

FORTUNE -- Wouldn't you like to become partners with someone who would double your money every three to four years *ad infinitum*? To put it another way, wouldn't you like to invest with the next Warren Buffett?


Warren Buffett

Riches come to investors who, early in their lives, find great money managers. Buffett is certifiably one of the greatest. His early clients are now worth tens of millions of dollars (See "And Now A Look at the Old One" in *Tap Dancing to Work*). He achieved that by compounding money consistently and reliably at about 25% per annum. The young investors you will meet here show signs of comparable talent. But even if they can return only 20% a year -- most have done at least that well so far -- $10,000 invested with them today would be worth $5.9 million in the year 2025.

What reveals their potential? Strong investment performance, of course. But that is not conclusive, especially among young managers who generally lack a ten-year record. More important are certain character traits. Buffett himself starts with "high-grade ethics. The investment manager must put the client first in everything he does." At the very least, the manager should have his net worth invested alongside that of his clients to avoid potential conflicts of interest. Those profiled here have put the bulk of their assets with their customers'. Buffett says he would invest only with someone who handled his *mother's* money too (as he did).

Brains help, but above a certain level they are not the salient distinction among investment managers. Says Buffett: "You don't need a rocket scientist. Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ." The size of the investor's brain is less important than his ability to detach the brain from the emotions. "Rationality is essential when others are making decisions based on short-term greed or fear," says Buffett. "That is when the money is made."

More often than not, the best money managers, like Buffett, are "value investors," intellectual descendants of the late Benjamin Graham. He emphasized buying securities of companies selling for less than their true worth. The dozen young managers presented here are Graham's grandchildren, in a sense, but they are not necessarily dogmatic Grahamites. A few dredge for average companies at rock-bottom prices -- Graham's specialty. Others follow Buffett's approach and buy great companies at reasonable prices to hold for a long time. Two practice arbitrage, buying stock in companies about to be taken over or restructured in publicly announced deals. One prospers by selling overvalued companies short. Most do some of each, especially in a market where value is increasingly hard to find.

Surveying these relative rookies, a reasonable man should ask, "How will they do in a bear market?" Probably better than other money managers because they comprehend the basic rules of investing: No. 1, Don't lose money. No. 2, Don't forget the first rule. Each searches intently for discrepancies between a security's price and its worth, whether measured by asset value, earnings, cash flow, or dividend yield. If they are wrong about a security -- and everyone is sometimes -- the difference between price and value provides a margin of safety.

The best way to spot a potentially outstanding investment manager is to ask another one. Each of the 12 presented below was named by his or her peers as someone they would entrust money to. They tend to handle money for the rich and the famous; each has at least one investor whom any reader of *Fortune* would recognize -- if the clients allowed their names in print. With the exception of the two who manage mutual funds, the required minimum ranges from $250,000 to $5 million.

Most of these promising players will succeed. Some will fail. But the odds are that at least a few will go on to investing fame and their clients to fortunes. In order of how long they've been managing money on their own:

The bargain hunter

It hardly seems possible that Michael Price is only 38. He has been picking stocks at Mutual Shares, the estimable no-load mutual fund based in Short Hills, New Jersey, for 15 years. He came to investing immediately after graduating from the University of Oklahoma. "I was a mediocre student," he says. Perhaps, but Price gets nothing but A's for his work on Wall


Michael Price, Mutual Shares

Street. If you had invested $10,000 with Mutual Shares ten years ago, you'd have $62,289 today. Before taxes but after all fees and expenses, that works out to a 20% average annual compound rate of growth.

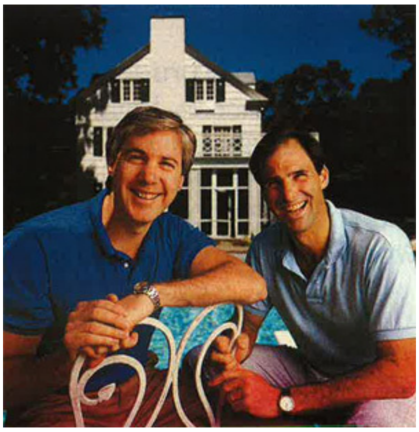
"I like cheap stocks," says Price. "I'm basically a guy who looks at a company's balance sheet and asks, 'What is the company worth? Give me a number.' If the answer is, 'Substantially more than the price,' then I get interested."

Price usually holds about 350 securities in his $5.7 billion portfolio. He spreads his holdings because many of his picks are small-capitalization issues whose prices would surge or collapse if Price bought or sold heavily. His largest holding, however, is Time Warner (**TWX**), parent of *Fortune*, which he bought at an average of $60 a share starting in November 1986. Time was languishing because the government had nailed Ivan Boesky and scared away many a speculator investing on takeover rumors. Price saw a good media business at a cheap price and accumulated 1.9 million shares. Time Warner traded recently at around $135.

A Freudian Grahamite

Randy Updyke remains virtually unknown, even to his peers. Perhaps that's because he is a solitary soul who rarely talks to other money managers. "Investing is about survival," he says. "I stay away from the herd." And how. When the bright lights of Philadelphia get too distracting to him, the 46-year-old Updyke removes to his ranch in Idaho or his plantation in South Carolina. Solitude seems to serve him well. If $100,000 had been invested in his partnership ten years ago, it would be worth about $850,000 today. That works out to a 24% average annual compound rate of return.

Updyke is a decidedly unconventional investor: He combines the teachings of Benjamin Graham with those of Sigmund Freud. "I like to buy things for a lot less than I think they are worth," he says. "But to me the psychology and mood of the market are more important than anything." Updyke uses a variety of gauges to measure its state of mind -- for instance, whether corporate insiders are buying or selling. If he thinks the market or a sector of the market is headed south, he unloads stocks en masse (some 60% of his portfolio was in cash before the October 1987 crash). "I don't care how good the fundamentals are. Very few people make money in down markets," Updyke says. What does he think of the market's prospects? Recently, 32% of the $225 million currently under his management was in cash.


John Shapiro and Glenn Greenberg, Chieftain Capital Management

The passionate and the skeptical

Warren Buffett would be proud of the two young men who run Chieftain Capital Management. They scout for a few excellent companies selling for reasonable prices and loose their arrows only at robust businesses with top-notch management. This style has served them and their small tribe of investors well over the past 5 1/2 years. If you had invested $100,000 with them early in 1984, it would be worth $409,000 today. That's a 28% average annual compound rate of growth.

Glenn Greenberg, 42, and John Shapiro, 36, work as a team, much as Buffett does with his partner, Charles Munger. Greenberg, son of Hall of Fame slugger Hank, is usually passionate one way or the other about a stock. Shapiro is more the detached skeptic. Their stock selections are joint decisions. Says Greenberg: "That way we avoid blaming each other for our losers. We try to be competitive with the rest of the world, not with each other."

This duo likes to be wedded to their stocks for years. That is why they check them out thoroughly before investing and then put as much as 20% of their money into a single investment. Their biggest position is in Burlington Resources, an oil and gas producer spun off by the Burlington Northern railroad in late 1988. They bought in at an average price of $27. It traded recently at $47.

Seeking subtle signs of value

At 32, Seth Klarman is already a legend among colleagues and competitors. "Seth is as good as they come," says his former boss, Mike Price of Mutual Shares. Certainly no one in his generation has a better investment record. From his offices at the Baupost Group just off Harvard Square, he invests for a small group of affluent families who snagged him to run their money soon after he graduated from Harvard business school in 1982. A $100,000 stake entrusted to Klarman at the birth of Baupost today is worth on average $500,000 -- a 28% average annual compound rate of growth.

Klarman's exceptionally quick and subtle mind allows him to see value in many different guises. With stocks high, he looks for "market-insensitive opportunities." By that he means companies whose financial performance depends on bankruptcies, announced mergers, liquidations, restructurings, or spinoffs -- corporate events largely independent of the vagaries of the financial markets. For example, he bought the senior bonds of the ailing discount chain Pay'n Save for 62 cents on the dollar. They yield 23% to maturity in 1996 and are backed by assets far in excess of bondholders' claims. Klarman also has clear ideas about what isn't value. A vocal critic of junk-bond financing, he says he would never buy a new issue of a highly leveraged company.


Seth Klarman, Baupost Group

Klarman's insistence on protection from market fluctuations served his clients well in the October 1987 crash. For the fourth quarter of 1987 his portfolios broke even, and for the year as a whole they earned an average of 20%. Says Klarman: "I focus on what could go wrong. Before buying, we always ask ourselves, 'What would we pay to own this company forever?' "

A scientist on Wall Street


Thomas Sweeney, Fidelity Investments

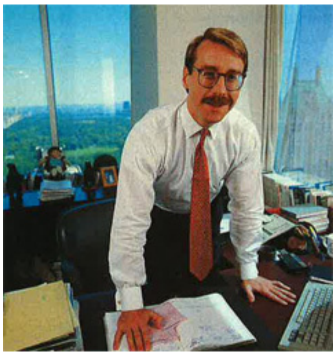
At Fidelity Investments, where he runs the Capital Appreciation Fund, they hail Thomas Sweeney, 33, as the second coming of Peter Lynch, legendary manager of Fidelity's Magellan Fund. This shy workaholic lives across the street from his downtown Boston office to put in 80 hours a week more conveniently. In almost three years of steering Capital Appreciation, Sweeney has sailed right by Lynch's more celebrated ship. That is no mean feat, even if Sweeney's $2.4 billion fund is about one-fifth the size of Magellan. Anyone who invested with him 2 1/2 years ago has seen the stake double. Average annual compound rate of return: 28%.

Sweeney picks stocks like a scientist. Says he: "Where I came from -- Wappingers Falls, New York -- business was looked down on. Smart people were supposed to go into the sciences." He almost became a geneticist, and calls his approach "pattern recognition," after a discipline geneticists use to predict behavior under specific conditions.

His favorite pattern? "People always panic," he says. "If you study this phenomenon over time, you see that eight times out of ten you make money by buying into a panic." Sweeney was eyeing Monsanto (**MON**) in early 1988, but the price, about $86, was too high for him. In September a federal court ordered the company to pay $8.75 million to a woman hurt by a Copper-7 intrauterine contraceptive device manufactured by a subsidiary. The news prompted a wave of selling by those who failed to recognize that the company was fully insured. Sweeney bought 940,000 shares at an average cost of $77. He sold in 1989 at $110 a share for a 65% annual rate of return. He has recently loaded up on electric utilities, especially those with extra generating capacity and high-powered cash flow that are near regions lacking adequate sources of energy. One of his favorites is DQE Inc., formerly Duquesne Light Co.

Turning value upside down

You have to marvel at shortseller Jim Chanos. After all, he makes money on a stock only when it goes down -- and the Dow has gone up 250% since the bull market began in August 1982. Even more amazing, the Milwaukee-born Yale graduate has kept his sense of humor. "I'm a great market timer," says Chanos, 31. "I wrote my first short recommendation on August 17, 1982." Pointing to a combat helmet on a shelf in his Manhattan office, he adds, "On really bad days, I put it on and hide under my desk."


James Chanos, Kynikos Associates

He is too modest. If you had invested $100,000 with Kynikos (cynic in Greek) Associates back in October 1985 when it began, you'd have $173,119, an annual compound rate of return of 15.7%. That may not sound so hot until you understand that people who invest with Chanos think of his services as insurance against a bear market. Says Chanos: "The difference between my policy and Aetna's is that their clients pay for the insurance and my clients get money from their insurance." As long as he earns more than the riskless rate of return on T-bills, his clients are satisfied.

Chanos is in truth a perverse kind of value investor. Using the same techniques as the others, he looks for overvalued stocks. He stays mainly in large-capitalization issues. That way there is more liquidity and thus less chance of a short squeeze, which would force him to liquidate his position because he could no longer borrow shares from brokers. Last winter Chanos made a big bet against Harcourt Brace Jovanovich, the troubled publishing company that was trying to sell its Sea World amusement parks to avoid drowning in debt. Chanos figured HBJ wouldn't get as much as management hoped to. Lo and behold, when it finally sold the parks to Anheuser-Busch in September, the price was some $400 million less than most analysts anticipated, and HBJ shares tumbled. Chanos sees no reason to take his profit yet. Says he: "We think the common is worth zero."

Mr. and Mrs. Aggressive

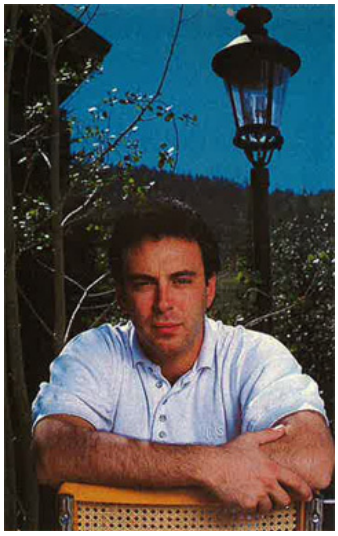

James and Karen Cramer, Cramer & Co.

In a windowless lower Manhattan office, a young married couple with matching desks furiously buy and sell stocks. "Sell at three-quarters," she says to a broker at the other end of her line. "Terrific. I want to participate," he says to *his* broker. Karen and Jim Cramer, 31 and 34, are the quintessential Eighties couple, equal partners in work and at home.

So far, the Mr. and Mrs. have succeeded in both venues. They recently celebrated 12 months of excellent financial performance -- and their first wedding anniversary. Their investors are toasting both. Someone who placed $100,000 with them in April 1987 would now have $165,000 -- an annual compound rate of return of 23%. The Cramers divide the labor. He generates most of the investment ideas; she handles the trades, using techniques she learned at the feet of master trader Michael Steinhardt, head of Steinhardt Partners. Their strategy is nothing if not aggressive. They place about 50% of their $19 million portfolio in stocks chosen with an eye to long-term value. A current favorite is **Williams Cos**. (**WMB**), a natural-gas pipeline and telecommunications company. The Cramers bought 65,000 shares at an average price of $39. It traded recently for $42 a share.

They commit the other half to intraday trading. "Our goal is to make money every day. That is why we trade," says he. "I never want to write a letter to our investors saying that we didn't participate this quarter because we think the market's too high. That's none of our business."

Pairing value with arbitrage


Edward Lampert, ESL Partners

Two years ago, at 25, Edward Lampert left the safety of Goldman Sachs (**GS**) to go out on his own. He had a bright future in arbitrage there, but after meeting dealmaker Richard Rainwater, a Goldman alum, on Nantucket, he decided he wanted more than becoming a Goldman arb. Says he: "I wanted to set up my own business to invest in undervalued securities as well as arbitrage situations." Rainwater, maybe seeing a bit of himself in the young man, helped him get started in April 1988. ESL Partners of Dallas started with $29 million under management.

Lampert's strategy gives him enormous flexibility. Says he: "Arbitrage helps our value investing. If we can earn 20% to 25% annualized returns in arbitrage, then for the long term we can buy only stocks that we think will earn comparable rates of return. Conversely, if deal stocks get overpriced, we will begin investing in companies with good long-term prospects at low prices." Like Buffett, he doesn't talk about his current holdings in case he decides to buy more. His results, however, are eloquent. Had $100,000 been placed with Lampert a year ago April, it would be worth $165,000 today. That's a plump 44% average annual rate of return.


John Constable, Constable Partners

Mr. Preservation of Capital

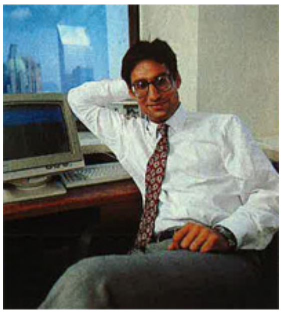
This teddy bear of an investor is living his boyhood dream. As a boy in Glencoe, Illinois, John Constable, 33, took Warren Buffett as his hero. "It amazed me that by simply thinking and being careful you could make money in stocks," he says. Constable followed his dream to Harvard, where he took night-school extension courses and worked all-day as a block trader for the university's endowment fund to pay tuition. He went on to apprentice at some of the most successful value-oriented investment shops, including three years at Ruane Cunniff & Co., managers of the redoubtable Sequoia Fund.

Constable went out on his own in August 1988. He has $28 million under management. As befits a value player in a pricey market, Constable is cautious. He owns a few stocks involved in publicly announced deals where he can make, say, 10% in 90 days if the deal goes through. But he prefers to buy "wonderful companies" like Nestlé for the longer haul. He owns 160,000 shares, bought at an average cost of $24. Why? "It was one of the world's superb food companies selling at 9.5 times earnings," he says. Nestle traded recently at $25 a share.

In large part because Constable has kept 30% of the money entrusted to him in T-bills, his limited partners are only 16% richer than a year ago. That's not quite up to his 20%-a-year target, but he's prepared to wait patiently for the day when prices come down and he can accumulate an entire portfolio of Nestles. His clients aren't restless. "First and foremost, my investors want preservation of their capital," he says.

A formula for deals

Like his friend Eddie Lampert, Richard Perry, 34, is a veteran of Goldman Sachs's arbitrage unit. He too chose to leave Goldman because of its size; there are 132 partners. "I wanted something smaller, where a few partners could work closely


Richard Perry, Perry Partners

together," he says. After asking the advice of his uncle, James Cayne, president of Bear Stearns, he established Perry Partners in September 1988 with $50 million to invest in publicly announced risk arbitrage deals, including mergers, tender offers, and bankruptcies.

His investment approach? E(V) = {P(UPx) + [(1-P) (DPx)]} ÷ (1 + COF). That simply means he values a deal by calculating the odds that it will go through, how long it will take, and what the investment is worth with and without the deal. Why all the effort to quantify? Says Perry: "There are no lay-ups in the arbitrage business. This helps us maintain clear, high standards for buying a deal." It seems subjective, but so far it seems to work: $100,000 invested with Perry ten months ago is worth $120,000 today, an annual compound return of 24%.

Like his confreres, Perry is having a devil of a time finding great value in the stock market. One of the few good deals he found recently was NWA, the parent of Northwest Airlines, which became the object of a takeover attack this past spring. In June he bought 82,000 shares at $115 a share. Using his special equation, he estimated an expected annualized return of 27%. When he sold in July at $121, his return was 50%. Today, however, deals are pricier, and he does not anticipate such quick profits. He is buying one deal for every five he looks at. Says Perry: "To be consistent over a long time, you have to know when to say no."

Mr. Buffett would approve.

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