Adviser Q&A

Doubling Down in Financials

Joshua Lipton 04.23.08, 1:30 PM ET

When it comes to value investing or buying out-of-favor stocks, patience is a virtue. These days few are more virtuous than Richard Pzena, Chairman of Pzena Investment Management, a $20 billion assets money management company whose New York Stock Exchange listed shares are down more than 38% in the last 12 months.

In Pictures: Richard Pzena's Top 10 Bargains

Pzena, 49, is a contrarian value investor, and, in the third quarter of 2007, he decided that beaten-up banks would provide the best bang for his investors' buck. He bet big on stocks like Citigroup, thinking that the bottom was near and they were ripe for turnarounds. Needless to say, Pzena was early.

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But Pzena's long-term record proves that his staying power pays off. According to Morningstar, Pzena's $5 billion John Hancock Classic Value Fund (PZFVX) has beaten the S&P 500 and its peer group of value funds over the last 10 years. *Forbes* magazine rates his mutual fund as “A” in down markets.

Not only is Pzena not selling his financials these days, he's buying more. Right now over 40% of his portfolio is dedicated to the financials--way more than any other sector of the market. He's continuing to maintain big stakes in hard-hit companies like Citigroup, Freddie Mac, Fannie Mae and Capital One Financial.

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Forbes.com recently visited with Pzena in his New York office to chat about this weak stock market and why he continues to buy financial, consumer and housing related stocks.

Forbes.com: Last year was a tough one for you. What happened?

Richard Pzena: A lot of it was our investment in Citigroup. Between Citigroup, Fannie Mae and Freddie Mac, that was half of our bad year in those stocks. Those three roughly fell in half from the point we bought them. We thought we were being smart. We thought we were playing our portfolio well for the end of an economic cycle. We avoided the stuff we thought was crazy, like oil and commodities, which were all inflated and tied to strong global demand. How could people feel comfortable going into a recession buying stuff that in every prior recession gets killed? So we avoided it.

We instead put our money into global franchises that aren't necessarily [influenced] by the U.S. housing market, which was clearly in excess. So we bought Microsoft, Wal-Mart, Johnson & Johnson--boring, big franchises. Mostly, they all held up.

Despite dismal results, you still think now is a good time to buy bank shares. Why?

Absolutely. This is a once in a generation opportunity to get franchises like Citigroup at five times their normal earnings power. You just don't get those opportunities. You only get them when there is panic. And the last time there was panic was 25 years ago.

But what has changed with the financials?

Not much. They obviously have losses in the current credit cycle. But that is a short-term phenomenon. But what has permanently changed about the financials? I can't find one thing. Do you think they will stop issuing credit cards? I don't think so. Do you think people will never pay their credit ever again? I don't think so. Now, I think structuring subprime mortgages won't happen again, or not for a long time. But it's a tiny fraction of Citigroup's business.

The beauty of the investment banking operation of Citigroup is that they move their people to whatever is hot. Structured finance was hot 2005, 2006, 2007, but something else will be hot in 2008, 2009--maybe workouts or distressed--and they will move people there.

Take Goldman Sachs, or any of the great ones with the best reputations, and look at what their earnings were 10 years ago versus what contributed to their earnings this year, and they're not the same businesses. They make money on whatever. Now, that may sound like a pretty loose business strategy. But the fact is that it's the franchise. You go to Goldman Sachs because you know if you need financial advice and you need a deal done, these are the guys that do it.

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But we are in a recession right now, won't these companies suffer more?

There is a difference between what gets hurt and what stock prices go down. People don't understand that concept. Typically, in a recession, when you are in the worst environments, the companies most negatively impacted are the ones that actually do the best in the stock market.

Why?

Because they do poorly before the recession. Everyone knows it will be bad for retail in a recession. So they kill retail stocks before they get into a recession. Once they're in it, people start to look out to the other side. All the speculation shifts to this question: When is the recovery? That is when you see cyclical kind of companies bottom out. That has happened in every single prior economic cycle. I think it's impossible for housing stocks to get killed any worse. Banks and finance companies have gotten killed. Credit card companies have already taken provisions so their earnings and stock prices have gotten killed. People expect the worst in the credit card business.

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Let's talk about those credit card companies. One you like is Capital One. Why?

First, I like the business. In the U.S., the credit card business has consolidated so that only a handful of players make any money. You have to be big, big scale. It's a massive processing business. It's expensive to acquire clients, and you have to be low-cost. It's only a few players that make money and they make a lot of money.

How do they do it?

It's a business where they charge a lot. Look at the fees: Between the late fees, annual fees and overdrawn fees, plus the net interest margin they collect, they are collecting close to 20% a year of the outstanding balances as fees. So there is a lot of room to lose money on people that don't pay off before the business actually loses money.

In a good environment, which we have been at in the prior couple of years, the losses are only about 3% per year. Historically, the peak losses for credit card companies have been around 7% a year. So start with 20%, lose 7%, pay administrative costs, but it's still a profitable business. It's almost hard to make that business unprofitable. You could take charges because you think it will get bad so you front load the expenses, which is what they are doing now. So you can report a loss for a quarter or two. But the actual losses where you lose the money? It doesn't happen in this business. Now it could be the biggest disaster of all times and nobody pays off their credit cards. But you have a lot of margin for safety in the credit card side.

And why Capital One?

Capital One is one of these franchises that has figured out how to do it. It is one of the few exclusive credit card companies you can buy. Now, granted, they have gotten into other stuff. But it is predominantly a credit card business. Citibank is actually 25% a credit card company. So it's more consumer sensitive than a lot of the other banks.

How do you find your stocks? What does a Pzena screen look like?

The companies at the top of the list are selling for a low price relative to what their histories suggest they should be earning in the future. Now, typically, they're not earning what their histories suggest, which is why they are at the top of the list. Something has gone wrong, and the stock price has gotten killed. So now you have basically three questions to answer: Is the business any good? Are the problems temporary or permanent? Is it rational to expect that the earnings will return back

to that historic trend? We spend all our time trying to answer those three questions. That is the hard part. It's easy to do the screen, to come up with a list of companies.

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One company you like a lot is Citigroup? What is the bullish case at this point?

OK, first, is it a good business? The history is spectacular: The company grew for the last 10 years at 12.7% a year and produced a return on equity of 27.9% a year. It doesn't get much better. But just because they did that in the past doesn't mean they can do it in the future. Maybe it was an anomaly of the go-go days of the '90s.

But are they in businesses that were in fact go-go businesses? Not really. Citigroup is in the credit card business, which had modest growth over the last 10 years. In the U.S., it has good characteristics of consolidation.

Then look at their New York City retail-banking franchise. That's pretty spectacular. There aren't that many players in this market. They have all the real estate and deposits locked up. Look at Smith Barney, as a global wealth management business, which isn't impacted by the current environment. It's a collection of pretty unbelievable businesses with really good characteristics.

What about those $20 billion of write-offs?

It's a huge number. But it's against a trillion dollars of assets. $20 billion or $30 billion out of a trillion is marginal, in the end. Does that mean that their risk metrics are completely out of whack? Because they had a two-tenths of one percent hit to their asset value? It's bad. But it's within the realm of the precision in this industry.

The reality is that if you want to be in the business of structured finance, which meant taking subprime mortgages and packing and selling them, if you want to be in that business, then you have to have some inventory on your balance sheet. That's how it works. Now you could argue that they were stupid for being in the business. The whole industry was stupid. It's what happens in every credit cycle. People get carried away and do stupid things. Is it ever permanent? No. I can tell you how many stupid things Citigroup has done over the last 25 years. This is just what banks do, unfortunately. Their credit standards loosen after you have seven or eight years of good economic conditions, and then they tighten. Now they are in one of those tightening stages.

And Fannie Mae and Freddie Mac?

We viewed them as the biggest beneficiaries of the meltdown in the mortgage markets. They weren't playing in subprime. The whole idea that the government was going to let residential mortgage finance be provided by hedge funds is insanity. But that is how they were thinking. Can you imagine what would have happened to the current market if they had pulled the plug on Fannie Mae and Freddie Mac? They are the mortgage market. They are the only stabilizing force. Their competition has dried up, so the prices they charge have dramatically increased. This is as good as it gets for Fannie Mae and Freddie Mac. This is what we thought.

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But the market thinks differently.

The market thinks the whole economy is going to hell, that Fannie and Freddie, because they lend mortgage money, are in the worst shape. We'll see if that turns out to be the case. But [Fannie and Freddie] didn't do subprime, risky loans, investor flips, or participate big time in California. What they did is the same old boring stuff with lots of money down. They will have a down credit cycle, undoubtedly. But whether that negative is worse than the positive of raising prices in this environment is yet to be seen.

Do clients ever get upset with you? They read the paper and then see that their money manager is busy buying the financials.

The single most common question I get: “Don't you read the newspaper? What is wrong with you?”

So does the Pzena client need a strong stomach?

Of course. We try and educate the clients before they open an account. We promise them that we will have these bad periods. Every single client, before they sign up, knows how badly we did in the last cycle. In the Internet bubble, the market was going up 30% a year, and we were going down. We were 60 percentage points behind the market, underperforming it for 10 consecutive quarters in '98, '99 and the first couple months of 2000. Now, that was extreme. The Internet bubble was extreme. We don't have such an extreme bubble today. But this is what we do: We buy bargains.

And you draw the same lessons today?

Right, the idea that people will never use a bank again, or that the whole financial system is now different than it was, is crazy.

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Let's talk about some of your other top picks, beyond the financials. You have a lot wrapped up in Alcatel-Lucent.

It's a great business. There are just a handful of people that have made all the technological innovations in telecommunications in the last 50 years. It's a profitable business. Once they install equipment, customers are stuck with you for years. Switching vendors is very costly, and there are only a few vendors.

Now, consolidation in this industry made sense. People spent tons of money on telecom during the Internet bubble. They spend less today. So you have all these companies and they are shrinking and that makes sense. Alcatel and Lucent both basically make the same thing, and they were calling on the same customers. If you consolidate that, it should work. But what they didn't anticipate was how strong the competitive response would be. Ericsson comes in and gives a good deal too. So a price war breaks out. But nobody in the end switched. They just got lower prices. That is temporary, for sure. It is an oligopoly, and prices are already starting to abate. We think Lucent has over $1 a share of normal earnings power once all this stuff works out. That stock got as low as $5. A 5 to 1 ratio is an unheard kind of valuation for that kind of quality franchise.

More broadly, you're overweight consumer discretionary.

We are. We have been buying. The housing-related stuff we bought into, like Whirlpool and Home Depot, are basically where we bought them for. The low-end retail we have bought has actually done well. Wal-Mart has been a win for us, as has TJX. We liked low-end retail on the theory that all these people shopping at Saks--it wasn't just rich people. It was middle-class people too. And when they got squeezed, they would head back to Wal-Mart. That was our thesis.

You're also underweight commodities.

They are ridiculously priced. It's pretty straightforward. You have to believe that these companies can sustain returns on investments that are multiples of where they used to be, throughout their histories. The definition of a commodity is a business that's crappy. It's what commodity means. You sell the same thing as your competitors. So how do you earn 35% returns selling the same thing that the next guy does? Normally, you don't unless there is a shortage. And shortages, historically, don't last very long.

What is your sell strategy? When do you know it's time to parachute out of a stock?

It is a ranking system. On the scale of the 500 stocks in our large-cap universe, we are buying when it is in the cheapest fifth quintile, and we are selling when it reaches the midpoint of the universe, ranked 250 out of 500. So we don't set a price target in advance. But we monitor where it is relative to everything else.

Can you give us an example of one you recently bailed on?

We haven't sold a lot lately, because it reached fair value. We have been trimming stuff that is relatively more expensive so that we can buy stuff that is relatively cheap. We trimmed Microsoft. We also trimmed some of the life insurance companies that held up better, like MetLife.

Thanks for your time, Rich.

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