Value investing requires creativity, focus, and fortitude. Value investors concentrate on the long term and look for companies with a passionate commitment and a well-articulated plan to win. Quantitative financial analysis is essential, but investors should beware of measurements that add no real value to the investment process.

Think of the following as a fireside chat in which Fred Speece encourages John Rogers, a veteran value investor and disciple of Warren Buffett, to share his insights into financial markets. Fred asks John a series of questions to learn about his philosophy, the culture of his company, and his investment strategy. Toward the end of the session, Fred will ask questions contributed from the audience. This question and answer format offers an opportunity to explore the thinking of one of the investment industry’s finest value investors.

**Speece:** Do you agree with the academic opinion that the markets are efficient and active stock pickers are a thing of the past?

**Rogers:** Active stock pickers are not a thing of the past, but the markets are extraordinarily efficient. Those investors who hope to outperform must show creativity, focus, and fortitude.

Growing up in Hyde Park (in Chicago) and becoming familiar with the University of Chicago’s perspective on investing, I have long assumed that the markets are extraordinarily efficient and that it is no easy feat to outperform. Today, 27 years after starting my business, I am even more convinced that only a rare handful of people have the ability to outperform over several market cycles. Outperforming takes creativity, focus, and fortitude.

I played basketball at Princeton (University) for Pete Carril, an outstanding basketball coach who taught me many things. He said that certain players can envision moves before they happen and can then position themselves appropriately for the future event. That type of creative thinking, he said, was something he could not teach. Something similar applies to the investment management business. The ability to outperform in the financial market requires creativity, vision, and the ability to see things that others cannot see.

Staying focused is an idea I borrowed from Warren Buffett. To outperform, you have to stay within your circle of competence and invest in things you know because when the tough times come—and they will come—if you are not totally convinced that you understand the unfolding story better than everyone else, you will freeze at crunch time. Therefore, staying within your circle of competence is absolutely critical.

Outperformers must have the fortitude to stand alone and be independent thinkers. Many people say they are value investors and that they buy when everyone else is selling. But in 2008–2009, we all had a prime opportunity to prove our fortitude as value investors, and a lot of people found one excuse or another to sit on their hands and wait for the dust to settle.

**Speece:** Suppose you make bets against the crowd that do not pay off right away. How do you keep your clients and your assets from going out the door? How do you teach patience and persistence?

**Rogers:** It is not easy. People in our (United States) society are more short-term oriented than ever before. With investment personalities pontificating on television and creating a lot of fear, it is difficult to convince not only our clients but also our
own team that value exists in doing things contrary to herd behavior. February and early March of 2009 were especially taxing. Clients would call me in a panic and tell me what everyone else was doing. I would try to reassure them. I would say, “I have received six calls like this one in the last week, but if everyone is doing the same exact thing at the same time, it cannot be right.”

To keep my team and shareholders on the road of patience and persistence, I spend a lot of time familiarizing them with great value managers that I respect. During difficult periods in particular, I bring them into contact with such people as Bill Miller of Legg Mason (Capital Management) and Warren Buffett. I send them to Berkshire Hathaway’s annual meeting and annual meetings of other peers. Such exposure reminds them of the value of our convictions and helps them stay the course.

I also circulate my Forbes column as well as my quarterly report to our shareholders. We take that responsibility very seriously. We hope to be right about these things, and we remind our shareholders of what happens when they think short term and follow the crowd. In this way, we hope to keep our clients on board, but it is a difficult task that was made even more difficult by the events of 2008–2009.

**Speece:** Then you believe that good managers are disciplined take a business risk in doing what they think is right?

**Rogers:** Yes. My 27 years in the business have been focused on small- and mid-cap value investing. I explain to our clients that all those years of focus and experience have allowed us to get better and better at what we do. Yet I still have people tell me that I should minimize my business risk by offering a wider variety of products. But in March 2009, I saw many business peers capitulate to client pressure, and their portfolios began resembling the indices at exactly the wrong time, which cost their clients a lot.

**Speece:** How do you define value?

**Rogers:** Mathematically. Ariel Investments’ analysts do all the modeling that one would expect and use a variety of tools to determine the true value of a business. We do a discounted cash flow analysis to compare with other companies in the industry. We enjoy finding companies that are priced low relative to future earnings and have a discipline of entering positions at a 40 percent or better discount. In his book *Contrarian Investment Strategies*, David Dreman (1998) emphasizes the importance of buying stocks with low price-to-earnings ratios and at a significant discount. We think both are critical to the value equation.

**Speece:** What do you look for in a company and its management on the qualitative side?

**Rogers:** First and foremost, we try to determine the depth of a company’s moat—that is, how stable is the company? How stable is the industry? If the market were to close for 10 years, would the business still thrive? Would it still generate a lot of cash? Is its market position such that new competitors would not be able to wreak havoc on it or its industry?

We also spend as much time as possible talking with the company’s customers, competitors, and suppliers, as well as former employees, board members, and management. When talking with management teams in particular, we want to determine whether they are being truthful with us. That in itself is an art and a skill, and it is something that cannot be delegated. For example, we own J.M. Smucker Company’s stock. We have been to Orrville, Ohio, and met with Tim and Richard Smucker. We have also met with them in Chicago several times. I have no doubt that they love what they do and that they intend to provide a quality product that is going to make a difference for their customers. They will not mislead you, and they will not overpromise. That is how they come across to us, and that is the culture of their company. Far too many businesses overpromise and underdeliver. The Smucker brothers do just the opposite.

Finally, we want to know that a company has what I call “a plan to win.” Does management have a well-articulated vision to show why its business will improve during the next three to five years, not just the next three to five months? That way, when we check in with the management team each quarter, we can determine whether it is making progress toward its plan to win or whether it has become distracted and lost sight of its goal. We step away from management teams that do not remain focused on their vision.

**Speece:** Some people in our business will not let their analysts visit with management. They would rather their analysts sleep with the Form 10-K than have lunch with management. How do you respond to that strategy?

**Rogers:** Certain people have a real talent for pouring through the balance sheet and finding magic that others cannot see. But I believe our business is one of vision and anticipating the future, and as valuable as the numbers are, they tend to look

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backward at what has already occurred. In his biography of Lyndon B. Johnson, Robert Caro (2002) quotes LBJ as saying that the most important thing a man has to tell you is what he least wants to talk about. Part of our expertise is getting managers to tell us the things they really do not want to talk about. If we can get them to talk about the future, about what will make their company great or keep it from being great, then we have accomplished something of value. That is why it is important not to sleep with the 10-K. Getting to know the management team is the key to understanding a company and its product. It offers a powerful vision of the future. For those who expect to outperform, there is no substitute for a vision of the future.

**Speece:** Did Regulation Fair Disclosure (FD) hamper you in the process?

**Rogers:** Regulation FD has certainly made the job harder, but being a long-term investor alleviates the challenges. Turnover is low at Ariel, and our patience and long-term thinking help us build deep relationships with management teams. Therefore, when we ask for information, management is likely to call us back a little quicker, open the door a little faster, because we are the kind of shareholder management likes and wants to keep. In that sense, therefore, Regulation FD puts more of a premium on taking the time to build relationships of trust. Further, firms such as ours that are asking questions about three to five years down the road often get a more pleasant and disarmed response from management. The intense focus of Wall Street analysts on the short term is actually reducing the amount of valuable information that companies are willing to share and similarly reducing the insights provided by Wall Street research. One of my top analysts recently pointed out that company managers visibly relax and become more forthcoming when they realize that we are not fixated on the current quarter. Certainly, we want a sense of how things are going currently, but such information is meant to be part of the long-term perspective.

**Speece:** Do you prefer cash dividends or stock repurchases?

**Rogers:** Our team has a preference for stock buybacks. That is most often the best use of cash, but we are willing to work with managers, understand the conditions they are facing, and come up with a suitable balance.

**Speece:** For 80 years, about 40 percent of the return on stocks has come from dividends. Would you discount that and say that share repurchases would be more attractive?

**Rogers:** Certainly. Some of our best performers have been companies in which the management was buying stock and shrinking capitalization. But we love dividends, too.

**Speece:** How about acquisitions?

**Rogers:** We are very conservative about acquisitions. We do not want to invest in a company with a management team that is hell-bent on growing through acquisitions. We warn teams like these up front that too much time spent on acquisitions will not make us happy shareholders. In many acquisitions, a company’s management is mainly trying to please Wall Street by getting to some growth number, and it is getting there through acquisition rather than through organic growth. When management teams lean in that direction, we remind them that most acquisitions will take them outside their circle of competence and will usually lead to disaster, both economically and culturally.

**Speece:** As value managers are trying to avoid the pitfalls of their clients’ limited patience, how do they also avoid the value trap that their own convictions can lead them into?

**Rogers:** All of us have been in the value trap at one time or another. To avoid it in the future, we have been turning more toward behavioral finance research. Although it was not called behavioral finance at the time, I believe that David Dreman’s work provided some of the earliest insights into behavioral finance. More recently, though, we have studied the work of Richard Thaler at the University of Chicago, Michael Mauboussin at Legg Mason, and Tobias Moskowitz, who is also at the University of Chicago.

Moskowitz’s work in particular helps us see how value managers can use momentum to avoid value traps. His research shows that new information takes a while to be filtered into the price of a company. In the past, perhaps 10–15 years ago, contrarians like me would hear bad news about a stock and immediately start buying, only to find that the stock would be cheaper a month later. Moskowitz’s work has helped us to be more patient and take our time building a new position. It goes against some of our contrarian instincts, but it is an important discipline and has helped us on the margin. We have acquired a new tool that benefits our work.

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Speece: How do you balance the poor short-term performance of a holding versus what you believe to be its good long-term potential?

Rogers: Among Ariel’s 10 senior members, we do have a healthy debate about this subject. Some do begin to worry after three problematic quarters. As for me, I seem to be naturally wired to let the past be the past. I am not blind to the fact that past behavior contains information for the future, but I do not want to penalize a company if I can understand the reasons for past disappointments, especially if the evidence persuades me that those past disappointments will not carry forward into the future. In fact, I will not only continue to hold the stock, but I will also buy more of it if I still believe in the company’s viability.

We realize that clients sometimes put our firm on their watch list because we have underperformed in the short term. But if we stay true to our discipline, our portfolio will be more competitively priced and we will be better positioned to outperform coming out of the cycle. Nevertheless, our clients’ investment committees and the consultants often come to the opposite conclusion. It does not make sense to me.

Speece: When do you sell?

Rogers: We watch three things. First, we track the private market value of a stock every week and rigorously update it. When a stock moves toward its private market value, when all the research reports are positive and people believe in the story, and when the stock is no longer selling at a discount, we sell. Second, if a management team is no longer executing according to its plan to win, if it seems to have lost its way and seems unlikely to return to its core beliefs, we sell. Third, we study the balance sheet. If management does not allocate capital effectively, if it makes poor strategic decisions or does not seem to act in the best interests of the shareholders, we sell.

Speece: You mention your “scuttlebutt” network on your website. How does it help your process?

Rogers: Everyone has a scuttlebutt network. Every contact and every relationship can be used to improve our knowledge and thereby our prospects. At Ariel, we work especially hard at developing a scuttlebutt network. For example, I serve as a volunteer on several nonprofit boards and their investment committees. I hope that I am benefiting those organizations through my advice and expertise, but I also use my participation on those boards to improve my own understanding. Boards and investment committees often invite speakers to share their ideas. I have heard dozens of excellent presentations, and I have gone out of my way to visit these speakers and build a relationship with them. If they are smart and can teach me something that will make me a better investor, then I will add them to my scuttlebutt network.

When I first started my newsletter, The Patient Investor, I was 24 years old. I often wrote stories about the great investors in Chicago. I would call each of these investors, such as Ralph Wanger of the Acorn Fund, and ask for an interview. I would visit and try to learn everything I could about how, for instance, Wanger had built his company, how he thought about the market, what his favorite stocks were, and how he was continuing to build his business. It was a conscious effort to build a scuttlebutt network.

We encourage all of our younger employees to use every opportunity to network and build relationships in order to build our firm’s and their own scuttlebutt networks.

Speece: Financial analysis is full of new tools—information ratios, tracking errors, benchmark risk, peer risk, job risk, capital risk, and so on. Do you find these tools helpful?

Rogers: Go to Berkshire Hathaway’s annual meeting, and listen to Charlie Munger and Warren Buffett. They will tell you that information ratios and tracking errors have nothing to do with how they invest. When the greatest investors of all time tell you such tools are irrelevant, you should not disregard their advice. Today, the most fundamentally perfect investor of all time is moving in one direction and the rest of the investment world is moving in the other. I cannot make sense of that.

Speece: Benchmarks and other new tools are an integral part of today’s investment culture. Yet, many thoughtful people believe they have not been helpful and that they even restrict a manager’s ability to add value. How do we unravel the very things we have been teaching our investment committees for the last 20 years?

Rogers: Do what we are doing right now: Talk about it. All of us, all of the time, have to be on guard against groupthink.

When I am on an investment committee and the staff recommends that a certain manager be changed because the manager’s three-year ranking is low, I stop them and ask them to tell me something qualitative about the manager. Is he a hard worker? Is she creative? Is he thoughtful? What is
her long-term track record? I want the staff members to ask themselves the same questions they would ask when hiring or firing an investment banker or a lawyer or an accountant.

On the one hand, consultants often claim to be making certain decisions because their clients are short-term oriented and want to reduce volatility. The clients, on the other hand, will say their decisions are based on their consultant’s advice. It is an unhealthy feedback loop.

**Speece:** What are your thoughts about the impact of hedge funds on the achievement of client goals?

**Rogers:** Every committee thinks it is above average. But they are all using the same model—funds of hedge funds. If the markets are as efficient as we assume them to be, how can every investment committee use the same model and still outperform? And add to that the burden of fees. If an endowment is paying 2 and 20 plus another set of fees on top of that and then paying a consultant to boot, how well can its portfolio really do?

**Speece:** Where are you finding value today for your portfolio?

**Rogers:** Several areas that we think are attractive and cheap have helped us tremendously during this great recovery since March 2009. The two biggest are media and financial services. Media stocks were very painful for us in 2008, but they are making a comeback. Gannett (Co.) is one of our largest positions. It owns USA Today, small-town newspapers, local television broadcasting networks, and CareerBuilder.com. It is seeing advertising increase across the board. Even after moving from a low of $1.70 to around $14.00 today, Gannett and other media stocks are still cheap.

We also like financial services because of its recurring revenue. We particularly like two sectors within financials—mutual fund companies and real estate services stocks. The mutual fund companies of T. Rowe Price, Franklin Resources, and Janus (International Holding) continue to be very cheap. As the economy and the stock market recover, all three are positioned to do really well.

Real estate services companies were not easy to own at the bottom of the crash, but we could see that people were still going to lease properties, buy and sell properties, and outsource real estate services and that endowments and pension funds would still hire real estate services managers for their portfolios. Jones Lang Lasalle in Chicago and CB Richard Ellis are my two favorites. They have recovered strongly from the bottom, and their earnings have been better than expected.

**Speece:** Do you pay much attention to who is nominated to a company’s board? What makes a good corporate board member?

**Rogers:** We pay close attention to the talent and integrity on a board of directors. We also look for diversity on a board, which indicates that the company recognizes the diversity of its customers and the value that diversity brings to idea generation and decision making.

A gifted director understands the core issues and the factors that drive financial returns, reputational risk, and regulatory risk. Gifted directors stay focused and keep management focused on the things that drive ultimate results—reputation, profitability, and balance sheet. The best directors have the courage to do the right thing. They are also unafraid to surround themselves with strong managers and other strong directors. Directors who surround themselves with tough, strong people will lead their companies to success.

**Speece:** What do you think the money management business will look like over the next 10 years?

**Rogers:** I have this dream that 10 years from now, the old-fashioned stock picker is going to have by far the best performance coming out of the cycle. I think the performance difference is going to be so large that investors are going to wake up to the idea that, in the end, it is best to have a solid stock-picking firm with talented, trained people who are passionate about the business. My dream is that value investors will so far outperform the benchmark-hugging, risk-averse types of managers that the industry will be transformed. We will start to read more about those heroes of the past that we used to see on Wall Street Week. I loved reading John Train’s *The Money Masters* (1994) and learning about great investors, such as John Neff, (Sir) John Templeton, and Peter Lynch. John Templeton said that to get above-average return, you have to do what the average person is not doing. I think those beliefs will come back and be popular again.

**Speece:** Now, I will begin with questions from the audience. The first one is, Why do you think the media sector is going to come back?

**Rogers:** I do not believe the media’s basic business model is as broken as many people think. Most small-town newspapers are still throwing off a lot of

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cash. They still have high margins because local content still matters and local communities cannot get that information from CNN or HuffingtonPost.com.

Most of the damage inflicted on the media was not caused by the decline of circulation and traditional advertising but by the loss of revenue from classified advertising, which is the most profitable part of a newspaper. CareerBuilder.com and craigslist devastated the classifieds. The other blow came when many newspaper companies made ill-timed acquisitions—bad capital allocation decisions—just a year or two before the economy imploded. The Tribune Company bought the Times Mirror Company, and that leveraged buyout has not worked out, to say the least. Lee Enterprises bought Pulitzer (Inc.) and McClatchy Company bought Knight Ridder, both at the peak of the market. Businesses took on huge amounts of debt to make these acquisitions and were unprepared for such a sharp downturn in the economy.

Looking ahead, the introduction of (Apple’s) iPad has caused media companies’ management teams’ spirits to soar in the last six months. They are optimistic about being paid for content, about making advertisements fun and visually entertaining, and about getting better pricing than analysts have anticipated. Plus, the cost of delivering a paper will diminish greatly as customers begin to get it digitally.

These companies are cheap enough and generating enough cash that investors should be able to get great returns over the next three to five years.

Rogers: What is the minimum number of stocks you are willing to hold?

Rogers: For me to sleep well at night, the number cannot be fewer than 30. Anything over 40, however, also does not work for us. It is difficult to generate the necessary passion or conduct in-depth interviews when we hold too many stocks. In fact, too much diversification is merely an excuse for not doing your homework. Therefore, 30 to 40 stocks with generally no more than 10 percent of our holdings in any specific industry is the right fit for us.

Rogers: We all worry about clients leaving us, but do you ever fire a client?

Rogers: No, we have not fired any clients yet, although if we are uncomfortable with a potential investor, we may try to dissuade that investor from investing. We had a tough 2008, with clients making the decision to leave the market at the wrong time, so we are not in a position at this moment to be too selective. But as the recovery continues, we will have more opportunity to identify which clients match our long-term thinking and which do not.

Speece: How do you educate investment committees and stop them from making short-term decisions?

Rogers: The best education is to read as much as possible about the great investors. I encourage them not only to read but also to attend the annual meeting of Berkshire Hathaway, where they can listen to Charlie Munger and Warren Buffett, or I invite Joe Mansueto or Don Phillips from Morningstar to talk with them. I have taken some of the key players of investment committees to meet with people like Lou Simpson of GEICO. I want them to see that these extraordinarily successful people are giants at what they do. Expose committee members to the best of the best and hope that they will absorb some of that better thinking and learn to make better decisions.

Speece: What are your thoughts about indexing in an efficient market?

Rogers: I have no problem with indexing. Burton Malkiel, a great thinker about the markets, says in A Random Walk Down Wall Street (2007) that indexing the majority of a portfolio makes sense for investment committees, except for that uncommon committee or staff that has a unique gift for finding value. If you cannot look inside yourself and know that you have a special gift, indexing the majority of your assets makes the most sense.

Speece: What do you think about quantitative approaches?

Rogers: I believe people tend to measure what they can see. Quantitative measurements are often misused. It is somewhat like going to a doctor because you have a terrible headache, but the doctor only has equipment to examine your feet. So, the doctor examines your feet thoroughly and gives you a diagnosis but still has not addressed the cause of your headache. Investment analysts use their quantitative tools in a similar way. Far too often, the results have nothing to do with the success of your portfolio.

And I disagree with such terms as tracking error, which imply that you are in error if your portfolio or a subset of your portfolio has underperformed for some short period of time. No academic research shows that that is a logical way to invest. Why should endowments or pensions pay active fees to have their manager replicate an index? It is not in the best interests of the pensioners or of the endowment.

Speece: How do you react when management teams are not entirely honest with you?

Rogers: When management teams are not honest with me, I sell.

Speece: Can value strategies be applied to international emerging markets?

Rogers: Yes. John Templeton did it really well. He built the Templeton funds by understanding what parts of the world were cheap relative to other parts of the world. As investment firms become more sophisticated, this lesson can be applied throughout the emerging markets.

Speece: Did you learn any lessons during the market crash of 2008–2009?

Rogers: Yes. I learned that we need to stress test for a much more difficult economic environment than we have had to in the past and that we need better tools to determine how the bond markets view our credits, especially incorporating the timing of cash flows. At the height of the crash, we were spending a lot of time with management teams trying to figure out whether they had the balance sheet strength to survive. Since then, we have added several more layers of balance sheet analysis.

I also learned that I need to be in the room with the management teams myself and not delegate such meetings to a younger analyst. When I am engaged in such conversations, I can calibrate whether people are gaining or losing enthusiasm in their plan to win and whether they are changing the story from the last time I talked with them. It is important that I keep participating in the scuttlebutt network. This business is a creative business, and I cannot delegate such work. I have to be involved in the process.

Speece: Thank you, John, for sharing your wisdom and your passions. I hope that 2010 marks a rebirth for fundamental investing.

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