A Strategy with a 25-year Record of 25% Returns

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Indiana-based SBAuer Funds *launched its inaugural mutual fund in December of 2007, after having established a successful track record with a separately managed account business. The Auer Growth Fund (AUERX) is managed by father-and-son team Robert and Bryan Auer. The Auers have employed the same stock selection system used by the fund for the last 25 years.*

I spoke with Bob Auer on November 2 at the Schwab IMPACT conference.

What is the history of your fund? I understand it grew out of a separately managed account business and then you created a mutual fund.

I was a registered investment adviser with Morgan Stanley. I started there in 1987, and I had a small retail practice for 21 years, from until 2007. I totally understand where advisors are coming from, because my business was advising clients. I had no institutional accounts.

In 1987, as a new young broker not knowing anything and trying to drum up business, I hit up my family, of course. My parents were not very wealthy, but my Dad had always dabbled in the stock market and he had a small IRA account from rolling over a pension from another company. He had $100,000 and he said I could have his account, but we had to take that $100,000 and buy 100 stocks, or up to $1,000 in each holding.

I thought that was a little overkill. We should have been able to at least take a $10,000 position, and we could have built a nice portfolio with 10 different stocks. He said, “No, I want to spread it in 100 companies, and give me a big discount on the commission so we don't get eaten up.” So that's what we did.

He had formulated – I give him all the credit – an investment thesis of simply doing three things: buying only companies that had 25% increase in earnings for the quarter versus last year's quarter (not for the year); sales or revenues up 20% year-over-year; and P/E ratios no more than 12. He gave us permission to buy the first 100 stocks we found that meet those criteria.

He added another caveat. “If you send me any research from your firm – at the time it was Dean Witter – I will close my account, because I don't want to be biased by that,” he said. “I just want it to meet these simple criteria.”

That was in 1987, before the crash on October 19. Just before the crash, the $100,000 was worth $120,000, so we had made 20%.

On the day of the crash we went down to $60,000. It dropped 50% in one day because the portfolio held micro-cap and small unheard-of stocks. But by the end of the year it was at $105,000 and we had a gain of 5%, which only equaled the S&P 500 for that year. We had worked our tails off – we had probably touched 120 stocks over the year – and we had only made $5,000.

He made five $2,000 contributions over the course of the next five years. So there was $110,000 invested, $100,000 initially and another $10,000 in small contributions. By the end of 2007, without adding any additional money, its value was $34 million. We kept to the same methodical investing system.

Nobody knew about it except me, my family, and the branch manager.

We started looking at it, humbly, and nothing beat it. Out of 10,000 mutual funds, nothing beat it. Warren Buffett didn't beat it.

Has anyone reviewed your performance record?

We brought in one of the top auditing firms in the US. I personally picked up one of their partners from the airport. He went through 21 years of statements. When I drove him back, I asked, “Have you ever seen anything like this?” He said no, he hadn’t.

Our returns were achieved without ever shorting stocks and with no market timing whatsoever. We were always fully invested, through thick and thin. We had no leverage, because in an IRA there is no margin. We were basically in 100 names the whole time.

When we show people our track record, they say, “Oh you must have owned Cisco, Microsoft, Starbucks and Wal-Mart 20 years ago, because those were what were hot. They were the Apple Computers of those 20 years. But we never owned any of those stocks, because they always had too high a P/E ratio even though they often had the growth metrics we required.

What is your sell discipline?

Once we buy something, it doesn't have to keep meeting our P/E criterion, because we hope its price starts going up. So we don't judge it on PE anymore after it is in the portfolio. But it has to keep achieving the 25% earnings. Every quarter it has to keep doing that or it is sold. Also, if the stock doubles it is sold.

We now have 25 years of history and the combined pre-fund and fund returns have averaged over 25% a year for 25 years. But it is very volatile – like I said, it was down 50% in one day. We had a terrible 2008, when we were down 53%. These numbers represent the pre-fund and the three years of the public fund. We are the largest shareholder in the fund. We have about $19 million in it, which all came from that first $100,000.

Is it still 100 stocks, equal weighted?

Right now, it is 103 stocks, and there are seven weightings. We don't know if our weightings help our hurt our performance. We don't really care. But for example, let’s say we had two stocks. Say we had two steel companies and one grew at 80% and was at an 8% P/E, and the other grew at 40%, but just barely made our 12% PE. We would weight the one with a higher growth and the better P/E a little higher.

Our annual turnover is about 200%. Our expense ratio is about 1.75%. That's management fee and all expenses. We just have a no-load share class.

When I was at Morgan Stanley, they were very big on rolling out new tools to help the advisor. For a while the efficient frontier was very popular. This was pre-crash, because when the market crashed nothing worked. Asset allocation got thrown out the window.

Basically what the efficient frontier says is that if you had been 8.8% in emerging international, and 12.2% in high-yield bonds, and 3.2% in Latin America, 32% in S&P 500, and so on, you could have had 90% of the return on the S&P 500 with 50% of the standard deviation risk. Investors love it, because they get 90% of the pizzazz but only half of the headache.

The problem is that nobody ever got wealthy with that strategy. You don't have to buy our fund. But one thing I see – and I heard Liz Ann Sonders [chief investment strategist for Charles Schwab] say it here – is how clients don't care about the return *on* their capital, they care about the return *of* their capital. That’s the exact wrong thing to be preaching.

You should be putting more risk in your portfolio. It seems counterintuitive, but it is the history of investing that right when you should be taking on more risk, you take on less risk. Right when you shouldn't have been taking on any risk, you took on more risk. Advisors are not exempt from this. They have a higher sophistication level and more common sense than their clients, but they get pulled by their clients. A perfect example was in the dot com era. I lost a lot of accounts because I am geared to a deep-value, low P/E approach.

But it's also a high-growth approach.

Yes, we actually mix both. But I wasn't able to buy doggie.com or even Amazon. For every Amazon there were 100 things that hit the wall. And I lost accounts because there was pushback from clients who said we were not with it. It's a new paradigm shift. This was like investing in railroads in the 1900 and we are going to miss out. For most of 1996 to 1999, they were right. But in 2000, 2001, and 2002 I was right, and I am still right. It doesn't make sense to buy things without sales and no profits. But you get pushback from clients, so you tend to do what you think that the client wants versus what's really best for the client.

Does Morningstar classify you as a growth or value fund?

They categorize us as a small-blend. We are really a multi-cap growth fund, but they don't have that category. Lipper has a multi-cap area.

Do you rebalance monthly?

It's actually a daily process. Today we have a stock that I'm selling right now. It was a Greek Baltic shipper that came in with four cents of earnings, so we're going to sell that.

The day a company announces earnings the stock is sold if it no longer meets our criteria. We don't sit around. Even if the market is up strongly and a stock is down 6%, we just hit the bid. We are out and we move on. So it's a daily rebalancing. We reset every new stock that we buy and so it is the correct weighting, and keep everything smoothed out.

What tends to be the average market cap?

It goes all over the place. We own Exxon Mobil down to a little $22 million micro-cap and everything in between. According to Morningstar it averages $2.2 billion. Over our whole 25 years, we are typically about 50% small, 25% medium, and 25% large. Right now we own Caterpillar, John Deere and Cummins. Those companies are booming.

Are you using as-reported P/Es or Shiller-normalized P/Es?

We calculate P/E three ways. The first is trailing 12 months, just like what you would see in Yahoo. The second way is if there is more than one analyst that follows it. Then we look at forward P/E. We'll use the consensus as the forward, because one of our companies might have been earning $.10, $.10 and $.10. Then they make $.25, and let's say they are not seasonal, and it's because the new widget is on the market. If the Street has them earning $1.10 for next year, we'll consider that. The third way, if we can't determine the trailing P/E and have no analysts' estimates, is taking the current quarter (times four). We will extrapolate the quarter if they are not seasonal. Basically we are assuming they just can earn what they just earned (without allowing for some growth). A quick way for us to calculate this is the quarter's EPS x 48. That would be the maximum we would pay to justify a 12 P/E or less.

For example if a company earns $1 per share for the quarter, we would buy stock at $48 or less, because we assume no growth and just $1 x four quarters x 12 P/E ratio.

Let's talk about some of the holdings in the fund. You've owned some technology names – Micron, Intel, Texas Instruments. How do they meet your criteria?

Those companies have all been in the portfolio in the past 10 months, but they are not in there now. They don't qualify. We do own some technology stocks. For example, we are in Intel right now. The stock is only 10-times earnings, is having great results, has a squeaky-clean balance sheet and a dividend to boot. But it's not getting any respect because everyone is too focused on tablets. The truth is people still buy a record number of PCs.

You have also owned had a bunch of for-profit universities.

We haven't owned those this year. They were not kind to us. We got absolutely slaughtered, but they all met the criteria. They were very deep discounts.

This may be a weakness in our simplistic way of being so quantitative and disciplined. They were under huge attack by the shorts, which we ignore, usually to our peril, because there was a short case. They were also under huge attack by the government at the very time unemployment was rising, and we thought the government would turn the other cheek and say it would rather get a guy sitting in a diesel mechanic's classroom and off the street even if he is flunking out. At least it would be putting money into education. But we had never seen such a pushback at the very time people needed to be retrained.

What I found most interesting about the whole thing was how those schools were demonized and attacked because the percent of the graduates that paid back their loans was so much lower than standard universities.

To me, that goes without saying. The average person enrolling in one of these schools is married, maybe with a family, has been laid off for six months, and doesn't have his mother and father paying his tuition to go to Indiana University or Notre Dame or whatever. Of course, a 19-year-old that has the family backing to go to a typical university is in better financial means than someone who is down on their luck and trying to retrain themselves and already an adult.

But wasn't part of the criticism because those schools were very aggressive in their approach towards candidates and encouraging them to take on debt?

Absolutely. They were there when the Marines got off the ship. "Hey, you want to sign up?" Some of that should have been cleaned up, but they still perform a good service. For the most part the public ones operate actually at a pretty high standard. But was it perfect? Is it perfect at Indiana University? Are there games that go on? You can scrutinize just about anything.

Are there any common threads among the companies meeting your criteria now?

It is really surprising. We are heavy in basic materials, despite the economy bumping along. For a while it looked like we were double dipping, but we own steel and iron ore stocks. We have some precious metals, miners, gold and silver that met our criteria. Typically we are not able to buy any gold stocks. They usually have a very high P/Es. But what is interesting right now is gold year-to-date is up 20%, but most of these gold stocks are actually down. Some of them have a lifting cost of $400 an ounce. So when gold is at $1,700 an ounce, there is a wonderful business, yet the P/Es are 10 to 11, whereas typically they are 20.5.

Do you ever run into situations where you just don't have enough stocks that meet your criteria?

It's never happened, because we look at about 8,000 stocks. We look at every stock that has a ticker symbol the day after they report earnings. What is interesting in the 2008 crash, we had a lot of energy stocks that then got pruned out of the portfolio. We started buying pawn shops. Some are publicly traded – there's always somebody doing well even when things are doing poorly generally.

We don't hold it at 100 stocks. We went up to as many as 150. The least we had was 82.

Over 25 years, buying every single stock that qualifies, the fewest we ever owned was 82. That's 99 out of 100 didn't meet our criteria. Even when things are roaring, 98 out of 100 don't meet our screens. But we always get about 1% of the stocks in the market.

We made a lot of money on pawn shops. There's one called First Cash, which is traded on the New York Stock Exchange. These are like McDonald's – small operations with approximately 500 stores. When you go into a First Cash, it looks the same anywhere in the country. The guitars are over here and the diamond rings are over there, and it's clean. You can go in and use the restroom like a McDonald's. The guys are honest and you are not going to get shot in there.

Those stocks boomed during the crash. If you are a pawn shop, you need people who are still getting married, so business still goes on. They are not going to Zales; they are coming in. You've got more customers, but you've got more merchandise being hocked. You have it coming both ways in a bad economy.

Do you still take a research-agnostic approach? Do you go out and visit any of these companies? Do you talk to their management?

No. We don't want to fall in love with anything. Let's say we took a plant tour and a company's sales came in up 19%. Is that close enough to the 20? And oh, that was an awfully nice plant. We heard what management was saying about the future. We don't want to be biased by that. The numbers are the numbers.

This is the most interesting aspect about our process after 25 years. When we talk to money managers, brokers or advisors, we see that the average guy is trying to look at Apple and how it is doing. I think Apple will continue growing at 20%. So they are trying to buy something that is already fairly valued that is going to continue to grow so they can make another 20%.

We are looking to buy an Apple or Google at half of what it should be trading at, because it is growing at 25%, but we only want to pay 12 times earnings. We are buying companies like Apple, but paying half. When it doubles in price to its fair value we sell it. We are selling everything at "Apple valuations" of fair value, and we are letting the other guy take it. Most of the stocks we sell continue going up quite a bit.

I don't know another money manager who is looking to buy everything at half of what it should already be trading at. So if you interviewed another manager and asked, “What is your very best stock? Do you have a gem that was growing at say 40% at an 8 P/E?” That would be their gem. That's my whole portfolio.

What advice would you offer to our readers?

Our opinion is they are not taking enough risk and they are letting their customers dictate. Customers are scared, and I totally understand that. But 10 years from now they're going to look back and they are going to say they missed the best buying opportunity in their career. When you see that the 90 day T-bill is at one basis point and a 10-year bond is flopping around at 2% to 2.25% and the 30-year is 3.35%, this is absolutely insane. It is not a logical business case; it is a fear case.

