An Options-Enhanced Value Strategy

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by Robert Huebscher

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I spoke with Brian on May 16.

You are the son of the legendary investor Don Yacktman, with whom you've previously worked. How did you become involved in investment management and what was it like working alongside your dad?

It goes all the way back as early as I can remember. My dad would tell me why he bought Ralston Purina or Johnson & Johnson and over the years I started to get a hang of what he was talking about. He always incentivized us to invest at a young age; if we would save $100 and invest it, he would double it and put it in the stock market. When I graduated from high school and I saw the portfolio that I had accumulated, I immediately garnered the bug for investing. In hindsight, part of that was the fact that it was the bull market in the 1990s. But the desire to invest started at the dinner table.

I never thought of my dad as a legendary investor. He was just my dad. But he is a hero to me, someone that I look up to. I learned from him a lot about how to think about businesses conceptually. He's a very giving man. He's a loving man with impeccable integrity. What a lot of people probably don't know about him as a man is his character. So working alongside him was great and such a blessing because he was always open to just be there as a mentor.

What led you to split off and create your own firm?

In 2007, I mentioned to my dad that his account minimums were too high. I said there must be people who can't meet your minimums who would be very interested in a separate account. He said, "It sounds like a great idea, but just don't do it here." Basically the five largest accounts at his firm made up more than 90% of their assets and they weren't looking to have tons of smaller accounts. So he gave me his blessing and said I could even put our last name on the door, which I thought was very important to help cut through the noise, so people could find me.

I started what was then called Yacktman Capital Group. Later, Affiliated Managers Group (AMG) wanted to purchase the exclusive rights to the Yacktman name. My father asked me one week before Father's Day if I would be willing to change the name of my firm. I realized for years I had been writing in my Father's Day cards, "What could I ever do to repay you?" I realized this was it. We changed the name from Yacktman Capital Group to YCG.

How does your investment style differ from your dad's?

Being mentored by him, there's going to be similarities in the way that I pick stocks. Where there is a difference is the use of what I call "option enhancement," using options as a way to get exposure to the businesses. It's a strategic way to indirectly access a security when we believe that doing so through the option provides a better risk-adjusted return than owning the stock outright.

But as far as selecting individual securities, while there are not a lot of differences in methodology, we still have our own unique personal preferences, which lead to some overlap and also to some very different holdings.

Another obvious difference is that we're much smaller and nimbler. It's advantageous for us to only be managing $400 million as opposed to billions. It's no surprise, and empirical evidence supports the assertion, that the more assets you manage, the more difficult and cumbersome it becomes.

You have described your investment philosophy as based on price, product and people. Let's start with price. Can you elaborate on that?

No matter how wonderful a business is, if you overpay, it'll end up being a terrible investment. That is why we analyze the price. But we view valuation a little differently. We flip the equation around. Rather than trying to solve for what we believe the value of a stock should be, we ask, "If we already know what the price is, then what is the forward rate of return that can be expected if you buy the stock at this price?" Through that method, we are able to create a table of forward rates of return that are expected on different securities. I view those as probability distributions around the expected returns. We look to see if, based on the expected return and whether there is a narrow probability distribution, we want to own something that has a wider probability of distribution if it gives us a high enough spread above the narrow distribution.

Price is about developing the forward rate of return that we can expect and then figuring out the best place to allocate capital based on risk-adjusted returns.

When we analyze the cash flows of a business, we make some adjustments to reflect, for example, if a pension appears to be over or underfunded, the impact of stock options, leases or other accounting things that may come up. But generally we are looking for the true cash-generative power of the business. Another thing that is often overlooked is that sometimes acquisitions are maintenance capital expenditures in disguise.

After we make all of these adjustments, we know what percentage of the earnings that a company generates truly are free, and then we take what we call the shareholder yield and add to it the growth rate. Essentially, we want to understand if something is growing faster or slower than GDP, or faster or slower than other things in the portfolio.

Can you talk about product and people?

Product is essentially the characteristics of a business that make it attractive.

Going back to when I was 8 or 10 years old, my dad said to me, "Son, whatever you do don't buy autos and airlines." It came up because we were on the way to a Chicago Cubs Wrigley game, and we were passing an auto dealership. I had said to him, "Man, that's probably a great business – right, dad? Cars are so expensive, they must make a lot of money." He said, "Oh, son, no. Never buy autos or airlines."

He started teaching me not to buy capital-intensive businesses. The idea here is that if the business is capital intensive, by definition it has a low return on assets and thus will be leveraged because the only way you can get a high return on your equity is to borrow somebody else's money. If you borrow somebody else's money and you also combine this with cyclicality, it is a recipe for disaster. We have no problems getting into businesses that are leveraged as long as they are not cyclical. Likewise, we have no problem getting into businesses that are cyclical as long as they are not capital intensive.

But the ideal business is one that is capital-light, non-cyclical and part of that non-cyclicality comes from a short repurchase cycle. It would be a business that delivers a mission-critical product that doesn't cost a lot as a percentage of a person or a company's budget, so you can pass on price increases over time almost imperceptibly.

There are a host of characteristics that are inputs and outputs of a high-quality business. We score businesses on this list of characteristics.

The final piece you mentioned are the people. We look for businesses that know how to allocate capital wisely. That is exactly what we are doing; we are taking capital and we are allocating it. So we want to know that a business manager would allocate capital much like we would by reinvesting the cash flow that the business generates in the highest returning projects.

A business has five things that management can do with its cash flow. I call that the "GARDD approach," G-A-R-D-D. They can grow ("G") the existing business by reinvesting in itself or undergoing cost reductions or product development. They can acquire ("A") other businesses as long as they are synergistic and they don't overpay for them. They can repurchase ("R") stock as long as they are not overpaying for their own business. They can pay dividends ("D"), and they can pay down debt ("D").

The quick way that we can calculate this is to look at the earnings a business generates over time, and see how much they have paid out in dividends. The rest was retained inside the business. I call this the return on incremental invested capital. I look to see what growth in earnings the company had as a result of the earnings that have been retained inside the business.

That's our 3 Ps: Don't overpay, and get a wonderful business that is managed wisely. It's pretty easy to do the first two – identify a great business at a great price. Management is the wild card. We as humans are inherently unpredictable, so sometimes management teams do things unpredictable that can mess up our expected rate of return.

You mentioned "option enhancement" earlier. Can you describe how that works?

There have been studies that have shown that options can outperform the underlying stock. In other words, you can get a better rate of return by being a writer of an option than by owning the underlying stock.

Once we've determined the business we want to own, we will ask ourselves if it's more attractive to own the business by purchasing the equity outright or by writing an option against it. As I mentioned before, we develop a forward rate of return that we expect on the stock. We do the same thing on the option.

We will say, "Here is the premium we are going to pull in divided by the cash we are going to put on reserve." That creates a yield. We annualize that yield and then we adjust it for taxes. We ask whether this after-tax return is at the same or higher than owning the stock outright. In almost every instance, we get paid more to be a writer of an option.

In theory that means that if you are consistently writing options, say every few months, then over time you should actually generate an outsized return. I think this comes from investors having a "casino" mentality. They are willing to gamble in options and overpay for them relative to what they really should. We are like the house dealing out these options and letting people gamble with them.

This strategy does not utilize any form of leverage. This is a risk-reduction strategy, yet it has enhanced returns and we believe it will continue to do so.

When you say you are writing options, are you writing put options against the underlying stock?

Yes, we are issuing cash-secured puts on things we want to own and covered calls on things we want to sell. It is like putting in limit orders for both buys and sells.

In theory, writing puts and selling covered calls are actually the exact same strategy because that is the definition of the put-call parity. But the reason we do it is from a tax perspective. If you want to own something and you write a put against it, then if it gets put to you it becomes more tax effective. Whereas, if we do a buy-write and it is put to us, then it ends up actually becoming taxed at short-term gains. So we do puts on stocks we want to own in the hope that they actually get put to us, and calls on things we want to sell in the hopes that they get called away from us. The short-term income gets converted to long-term capital gains.

Your fund, the YCG Enhanced Fund (YCGEX), has returned 8.81% over the last three years, which is 78 basis points more than the benchmark for large-blend funds, its Morningstar category. It is also more than the 6.29% returned over that period by your dad's fund, the AMG Yacktman Fund (YACKX), which is now run by your brother Steve. Have you been satisfied with that performance?

Yes and no. We are pleased to have been able to deliver returns and to do so in what we feel was a very low-risk manner. It is good to be able to be ahead of the category.

But I say no because our goal is to not only to beat the Index but, regardless of what the Index provides, deliver at least double-digit returns, equity-like returns. In an environment where most asset classes haven't produced a lot, I'm glad we've been able to produce greater relative returns. But I am displeased with our absolute returns because I would hope that we would've had at least double-digits.

Looking at your holdings, you have approximately 45% of your positions in what Morningstar classifies as "consumer defensive." Why is that?

Consumer staples fit the mold of the type of business we seek. We view them almost as the "AAA bond" in the equity world. When we want to deviate from there, we can look for businesses that are more attractive than the safe, narrow bell curve of consumer staples.

In the consumer staples business, a higher percentage of earnings are delivered to shareholders over time than for most other businesses.

I'll give you an example. Let's say you have one business that can deliver 100% of its earnings to shareholders over time and another that can deliver only 25% of its earnings over time. With a staple-like business that does 100%, even if you pay 20-times earnings, then you are getting a 5% shareholder yield. Let's say you spend 10-times earnings on a business that delivers 25%. Then it like a 2.5% yield. It is not really 10-times earnings; it is more like 40-times earnings because you only see a quarter of it.

When you make that adjustment, combined with the consistency of these consumer-staples businesses, there is an avalanche of cash that never ends. It is what my dad always referred to as being "evergreen." That evergreen nature combined with the higher percentage of earnings means that staples rise to the top and most other businesses get downgraded on their forward rate of return.

If you look at a chart over the last several decades, both on P/E ratios and performance, you would find that staples are perpetually more expensive than the broad market, and yet they also perpetually outperform the broad market.

Most people ask, "How is that possible that you can outperform the broad market consistently when you overpay for it?" It is because you are not overpaying for it when staples are so consistent and when they produce such a high cash-conversion rate. That explains why this sector produces higher returns than most other sectors despite the higher P/E ratios.

You stack the odds in your favor by investing in this industry. But I almost view it as my cash holdings; I want to deviate from this "cash," but only when I can find better risk-adjusted returns in other industries.

Aside from consumer staples, what holdings are you finding intriguing at the moment?

One of them is Express Scripts. It is going through some turmoil because of the concern about its deal with Anthem. But I feel that it is unlikely that Anthem will go anywhere other than striking a deal with Express Scripts. It is not going to go to CVS because they are enemies. It can't go to Prime Therapeutics or take it in-house, because it would have a much smaller scale than Express Scripts. It will get a much better deal just by staying with them.

But the market has priced it as a done deal that Anthem is going to walk. We analyzed this and if Anthem were to walk, it looks like it would reduce earnings by 15% to 25%. But the stock has already been hit by 25%; it's already written it off as a done deal. We're still at a great entry point, and if Anthem doesn't walk then there is additional upside. It is a very asymmetric payoff, with a small downside but significant upside.

You've got a business here that we estimate should deliver anywhere from a 7.5% to 10% shareholder yield, plus its growth rate on top of that. If Anthem does walk, it could affect Express Scripts' bargaining power and it could cause a downward spiral in their bargaining power. But even without the Anthem scenario, if that did lead to a deterioration of the business, we have plenty of room before this isn't at least a double-digit return. The only lingering risk is if Hillary Clinton or Bernie Sanders become president and turn the U.S. into a single-payer system.

Express Scripts is a contrarian play. Our portfolio is made up of compounders, and Express Scripts, while it is a compounding business, has an element of potential disruption or disintermediation in the health-care industry.

Another holding that I would highlight is Richemont. It is an opportunity created by the turmoil in China that has this wonderful business selling at less than 15 times earnings ex-cash. It may appear not characteristic of the type of business that we typically purchase. It is a luxury jeweler and owns some well-known brands like Cartier and Van Cleef & Arpels. Over two-thirds of its business comes from jewelry. It wouldn't normally fit our mold, because we typically look for short repurchase-cycle businesses that are evergreen. Inherently, the jewelry business is a much more cyclical business because it's discretionary and has a long repurchase cycle. It has a long repurchase cycle because it's a high dollar item. Well, the buyers of fine jewelry don't want to risk spending on an upstart brand; they go to the well-known brands that have been worn by kings and celebrities for over 100 years. This leads to a virtuous and reinforcing cycle of strengthening the brand.

One of the overarching theses we have is that the global economy will continue to be innovative, continue to grow and become wealthier over time. As nations become wealthier, they have more disposable income. They have more money to put toward jewelry, which also leads to the ability to have pricing power, and we love businesses with pricing power. For the last several decades, Richemont has had consistent pricing power. Otherwise its brands would become diluted and watered-down over time.

Another thing we like in this business is its operator. Johann Rupert is a fantastic operator who knows how to balance exclusivity with growth and keep the power of the brand over time.

An interesting tidbit about Richemont is its growth area has been in China, where there is a lot of peacocking going on due to its one-child policy. There are over 30 million more men than women in China. There is a YouTube video, Bling Dynasty, which shows the role of jewelry and how important social status is to the Chinese.

You have approximately 80% of your portfolio invested in the U.S. and the remainder in developed economies in Europe. Are those European holdings currency-hedged, and what about Europe makes them attractively valued at

this time?

We do not hedge the currencies, and most of those are not necessarily European businesses. We already have somewhat of a natural hedge in those businesses because they operate in over 100 countries. For example, Nestlé is one of those businesses, and I wouldn't consider it out of Switzerland because only a few percent of the business profits come from Switzerland. It's truly a global business. It is in over 200 countries with over $90 billion of revenue. It has over 20 brands that generate over $1 billion of revenue each year. It is the largest food and beverage firm in the world. I wouldn't view it as a European holding.

Another holding is Unilever, which is very similar because it is domiciled in Europe. Its earnings stream is global, so there is a natural hedge from its geographically diversified revenues. We also own Aon, which has over half of its revenue overseas. But it's a global broker and a large chunk of its business is U.S.-based.

Some people say the market is overvalued, and some say it is undervalued. What are your thoughts on that issue? Tied into that, what is your cash position relative to its target percentage?

The way that I view expected rates of return makes it difficult to say if the market is over- or undervalued. If you were to look back, say, 50 years, you could have bought the S&P 500 and generated a 10% return. If you bought the Index in the year 2000, you would have generated a 5% return. The question I ask is this: "If I buy the index at today's price, what rate of return should I expect?" I don't view the index as over- or undervalued.

Historically investors have bought the S&P 500 at a price where they would want to generate 7% to 10% expected returns. If you are going based on that estimate, then the market is overvalued. From its price now, if you go out 10 or 20 years, you are looking at expected returns that are below 5%.

But then you have to put that in the context of the environment and ask, "Would you own the S&P 500 for 10 years and earn 5% or own a U.S. Treasury bond for 1.8%, which would you prefer?" It appears that that market is valued where it is because people are saying they would rather have a higher rate of return in the S&P 500 even if it is lower relative to historical standards.

We just look at things and say this is what the market is going to generate. We need to find businesses that are generating double-digit returns. If we cannot find double-digit returns, then we hold cash. Among consumer staples, most are priced to give us somewhere between 9% to 11% rates of return in very safe businesses. Why would anybody want to own a Treasury at less than 2% when you can own a very safe, predictable company yielding 9% to 11%?

There are other businesses in our portfolio that could compound at much higher rates, such as Charles Schwab. If interest rates start to go up, we believe its earning power could possibly triple over time.

Because we've been able to find a sufficient number of wonderful businesses priced to give double-digit returns, we are fully invested. It may appear that we are not fully invested because you will see cash inside the portfolio. But that cash is indirectly invested because it is used to secure our options positions.

By the way, since you had asked, this highlights a difference in philosophy between the Yacktman funds and us. You'll notice that they are not fully invested.

We believe that if you can find double-digit returns, you might as well be invested rather than trying to be in a position where the market may come down and you may or may not have the opportunity to invest. If the market doesn't decline, at least we are compounding at double-digits.

If the market does come down, then at least the types of businesses we own are high-quality companies that will hold up well in the downturn. Then we can take that capital and rotate into lower quality counterparts or higher quality cyclical businesses that have gotten crushed and make it back up as the market turns around.

How should advisors deal with the issue of market valuation in the context of whether or not they should use active managers?

It's interesting how we go through waves about active management. First, it's all about active management. Then it starts to change to where active managers are not worth their fee. It's all about passive. Then, after things become more about passive, you hit the market peak at the moment you wish you had an active manager who knew how to manage the storm.

We saw this going into the 2007 period where it was all about passive managers. Then – boom – the market crashed, and there were some active managers who really knew how to weather the storm. Then it became all about active management again.

Now, we are headed back to the direction where active managers are not worth their salt. Perhaps that means there is another correction on the horizon when some active managers will once again prove their worth.

