Columbia Business School

Graham & Doddsville

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Issue XV Excerpt—*Investor Profile*

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Tom Russo
"Capacity to Suffer" is Critical

Thomas A. Russo has been a partner at Gardner Russo & Gardner since 1989. The firm has over $5 billion under management, and he oversees $4 billion as general partner of Semper Vic Partners limited partnerships, as well as in individually managed accounts. Prior to joining Gardner Russo & Gardner, Mr. Russo was at the Sequoia Fund. Mr. Russo is a graduate of Dartmouth and has an MBA and JD from Stanford. Mr. Russo serves on the Executive Advisory Board of the Heilbrunn Center for Graham & Dodd Investing.

GD: You are well known for investing in high quality, high cash flow generative companies with a long-term focus. Yet some of these companies, like Nestle and Heineken, have become giants in their respective industries. Does it ever concern you that maybe in a few years they won't be able to grow at a rate that could provide satisfactory investment returns?

TR: My feeling is that there is still so much white space that is addressable for these companies. In the newer markets that these companies do not yet dominate, there is a lot of capacity to grow. If you scale Nestle from 1991 to today, the Company's returns have compounded at approximately 14%. In 1991 they could not sell in China and had a pretty small business there. Russia had just opened up, India was not yet engaged, there was no presence in Vietnam, and they hardly had a pulse in Brazil. Africa was also not developed. These are now the areas where they can commit the most capital in search of new business.

Additionally, in terms of the traditional markets that Nestle already dominates, it is still the case that Nestle's returns extracted from these businesses can grow as they become more efficient. It's amazing to see the kinds of costs that can be removed from a business (e.g. energy, water, packaging) even while addressing corporate social responsibility. There is an interesting transition that is taking place where a company like Nestle, Heineken or Unilever can take hundreds of millions of dollars out of the business because they have chosen to operate in a socially responsible way – i.e. waste less water, use less energy, less plastic, etc.

Then the question becomes that of the reinvestment possibilities and corporate culture. The corporate culture is key to making sure Nestle stays on track. Management must continue to think of the owners when they reinvest and not reinvest in a way that ensures that management can own bigger cars or afford other luxuries.

GD: There was an article in The Wall Street Journal around a few months back ago about how Nestle is making investments in Africa that will provide no near term return but should provide significant return over the longer term. What is your take on the subject?

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TR: Africa represents a great opportunity for patient firms like Nestle. The quality that I look for in managements is the "capacity to suffer." They have "capacity to reinvest" because they have brands whose awareness has already affected much of the world. Some of these brands have widespread awareness because they were originally colonial brands, such as Unilever or Cadbury. Some of these businesses have even

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predated Communism. For example, Nestle has had a presence in the Czech Republic for decades. British-American Tobacco had the tobacco monopoly in China before Communism. Similarly, Chesterfield was the brand of choice in an Eastern European country (I believe Romania) before Communism. It is amazing that now when people in these countries have the opportunity to purchase whichever products they choose, they go back to the brands that have been historically in the region, even though those brands haven't been advertising for 70 years.

The three prongs that I look for when investing in a business are: the fifty cent dollar bill, the capacity to reinvest in great brands and the "capacity to suffer." The "capacity to suffer" is key because often the initial spending to build on these great brands in new markets has no initial return. Many companies will try to invest smoothly over time with no burden on currently reported net income, but the problem is that when you are trying to invest in a new market, smooth investment spending really doesn't give you enough power to make an impression. You end up letting in a lot of competition that will drive down future margins. If you're smart, like Starbucks was in China for instance, then you invest a lot of money upfront to build your store presence, distribution, advertising, etc. Then you become a first mover and your brands become identified with a particular product category.

GD: Do you like investing in small foreign subsidiaries of large multinational companies that trade separately from the parent?

TR: I used to years ago. In many situations they end up being acquired by the parent company. Additionally, you used to be able to acquire those subsidiaries at a lower price. But I found that if the parent did not buy the company and the market matured, the lack of reinvestment opportunities became a problem. For example, at some point Unilever Indonesia will no longer be able to reinvest in Indonesia at attractive returns, and then you are capital trapped.

GD: Would the parent then come in and try to essentially "steal" the subsidiary at an unfair price?

TR: There have certainly been a lot of lawsuits associated with that question. For example, Sears Holdings attempted to buy its Canadian subsidiary. There were a lot of lawsuits back and forth and it was never consummated. At that point, you are at risk, because you don't have control over how the parent company treats the subsidiary and the subsidiary may no longer possess attractive reinvestment opportunities.

GD: Given your focus on global multinational companies, do you also try and look for smaller companies that might be acquired by one of these multinationals?

TR: I have owned such businesses that have been acquired. For example, I owned Cadbury. The very domestic nature of Kraft ultimately compelled the purchase of Cadbury. At the end of the day, Kraft realized it needed more international exposure which it thought it could obtain on the back of the infrastructure that Cadbury had. It is a tough way to grow though.

GD: What was your view on the Cadbury acquisition?

TR: While sorry to lose the future returns Cadbury promised, I was pleased by the deal's timing. The acquisition gave cash at a time when two companies that were new to the portfolio were struggling because of temporary setbacks in North America. One of those companies was MasterCard and the other was Anheuser-Busch. MasterCard and Visa together suffered because of the Durbin Amendment that was intended to regulate interchange fees for debit cards. Ironically, the real protagonist in that story was presented as the small merchant. But the truth is, for the small merchant, the benefits of a debit transaction outweigh those of a credit card or check. Despite that, debit fees were

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"Many companies will try to invest smoothly over time with no burden on currently reported net income, but the problem is that when you are trying to invest in a new market, smooth investment spending really doesn't give you enough power to make an impression. You end up letting in a lot of competition that will drive down future margins."

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reduced by 70%. The market reacted with a sharp share price sell-off due to a fear over the loss of revenue. Visa dropped even further than MasterCard because they were the dominant player in this area. We invested in MasterCard.

I thought MasterCard was the preferred alternative at the time for a few reasons. For one, it was cheaper. That valuation was 12x forward year's earnings. For a company with a capacity to grow like MasterCard, that was simply too low a valuation. MasterCard has a tremendous amount of international exposure – relatively more than Visa. MasterCard also had a recent management change. Ajay Banga, the new CEO, has a global background and is very smart. For example, he is now negotiating with the Indian government to have a state stored value card that is biometrically identified. If the government wants to transfer money to a part of the country that is very poor, the risk of theft of cash is very high right now. With the biometrically identified card, you can secure your remittances from the government in a way that isn't currently available. I think MasterCard will benefit enormously from Ajay's global agility. You have to remember that eighty-five percent of the world's commerce outside of the United States still uses cash. Commerce outside of North America is also a fraction of what it will become.

GD: Do you feel comfortable investing in some foreign-domiciled companies given that the rule of law in certain countries is not strictly enforced?

TR: Well, I'm not as comfortable as those who have expressed their comfort through higher allocations to such countries in their portfolios. In my portfolio, 60-65% of the assets are in non-U.S. companies. But what you have not seen is many non-U.S., emerging market companies. One of the reasons is due to reinvestment risk. For example, there is a big dairy company called American Dairy in China. I could invest directly in China through shares in that business. However, I don't need to because I already "own" exposure to Chinese dairy through Nestle. Nestle is a big player in dairy. So I have a big position in dairy in China run by a group I know and like. I could supplement my position, as I often do, but I chose not to buy American Dairy because I have more confidence in the management team of Nestle. For our lifetimes, American Dairy will probably have the capacity to reinvest, but at the end of the day, it will stop having an opportunity to deploy capital in China. And then the question becomes, what will the company do with the cash? It doesn't have a brand that it can take around the world and deploy capital behind its future growth.

Cultural values are also very important. In developing markets, the people who are driving these arguably faster growing businesses are sometimes willing to cut corners. For example, speaking of the local dairy market in China, every few months you read newspaper articles about children dying from toxic chemicals in the milk. That just should not happen with Nestle. Nestle cannot afford the risk of using questionable inputs for their products because their reputation is of paramount importance. I can evaluate the ability of some global firms to reach local cultures because I can see the backgrounds of management and their capacity to reach various cultures. For local firms however, it is much harder to evaluate management culture.

GD: Can you talk about your thesis for Martin Marietta and the offer for Vulcan?

TR: Martin Marietta's business, stone quarrying, tends toward natural monopolies. It is very expensive to haul stone on a truck and stone isn't valuable enough to allow it to recoup shipping costs. Within 25 miles is about the only distance that you can draw from to get stone. In most urban areas, that 25 mile radius is an area where it is not likely

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that new quarries will be zoned. So if you own a quarry in an urban region, you have a very valuable asset. That is what interested me in the business a long time ago. Of course, like so many things in this business, this awareness wasn't a piece of independent inspiration. I was working at the Sequoia Fund in 1984, and I happened to look at a research report lying around the office from a few years earlier that dealt with a crushed stone company, Vulcan Materials. My colleagues at Sequoia said that they used to have an analyst that loved the business and who did research on every quarry that Vulcan owned. It was a family controlled business, and I liked the fact that they would be careful with the way they deployed the capital. The work the analyst did showed most of the quarries were free from competition and the company clearly made a lot of money. Once clued into the business' unusual economics, I then wondered if there were companies other than Vulcan in the business. After reading that report and doing a lot of research myself, I subsequently invested in four or five related companies in the crushed stone business. The work others had already done at the Sequoia Fund provided the base for my investment thesis in Martin Marietta, and then my contribution to my investors was to try and find other smaller companies both here and abroad, trading at even lower valuations because they were not as well known. Overtime I bought shares of Ready Mix Concrete, which was located in Ireland. I also bought shares in a French company that was in the same business.

"In my portfolio, 60-65% of the assets are in non-U.S. companies. But what you have not seen is many non-U.S., emerging market companies. One of the reasons is due to reinvestment risk."

G&D: Pricing for Martin Marietta is still likely driven by macro concerns. How do you think about such exogenous drivers for a business? Similarly, how do you think about other commodity-related companies like BHP that have significant scale in certain markets?

TR: For Martin Marietta, it has been amazing how the post-08 trauma has affected its business in a way that has never surfaced before in its history. There are three legs to this business: commercial building, residential building, and infrastructure. They kind of follow different cycles. We have been going through a terrible funk in terms of job growth, but during this downturn the government has still never released the extraordinary appropriation intended for roads, so the infrastructure industry has been starved. This would typically be the kind of business that one would expect to have "Keynesian leverage" during a national downturn. Similarly, the commercial construction industry is dead - more than dead, really - because so much of the business was dependent on people who overstated their businesses' vitality during the run-up to the collapse. They were building buildings that weren't sufficiently leased by using easy money that made these businesses appear to be much better than they actually were. Of course, the market reversed and these companies fell. Residential construction has not come back. Their stone quarrying businesses as a result operate with their high fixed costs at a fraction of their scale. Pricing has actually not gone down in the face of this due to Martin Marietta's pricing discipline and the fact that price elasticity for their stone is very low. Volumes have just come down by virtue of the fact that the three sources of demand for their product are soft at the same time.

Regarding other extractive industries, such as Newmont, BHP and Anglo-American - those are really based more on global markets for commodities. Stone provides somewhat of a natural monopoly which protects the pricing a little bit but most industrial commodities are priced on the margin. While I recognize the scarcity that can be driven by emerging market demand met by fixed scale, I have chosen not to risk an investment in these businesses, because commodity prices are notorious for being unsustainable.

G&D: What is your view

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on the offer by Martin Marietta to buy Vulcan?

TR: According to all of the merger-related documents, the thought behind the acquisition of Vulcan was Vulcan's initially. But now Vulcan finds itself flat on its back both due to the extreme leverage it took on when it acquired Florida Rock at the peak of the market, and due to its heavy exposure to the Florida and California markets which turned down particularly sharply beginning in 2008. Martin Marietta has now proposed merger with Vulcan under their terms and it has become a big fight. The difficulty with such a merger is something that Vulcan discovered following its acquisition of Florida Rock. The process of putting Vulcan and Florida Rock together generated much lower profits than initially hoped for due to the Justice Department's demands that Vulcan quickly sell certain operations to a bona fide competitor. Instead of controlling more of the market where they had picked up additional exposure through Florida Rock, Vulcan was forced to sell to somebody else who wanted to stay in or even enter the business.

When Vulcan approached Martin, they had initially thought that any divestiture could be spun-out into a new leveraged entity which would be a price-taker in those markets. In a sense, a joint venture would have allowed them to gain more scale in the combined Vulcan/Martin markets. When Vulcan first proposed merging with Martin Marietta, they hoped for a loose Justice Department, which would have allowed them to shift some operations to a third party trust that would have been accommodating from a pricing standpoint. What's clear today is that Justice Department has taken a very strong turn against approving such transactions. A joint venture now seems dead on arrival.

Vulcan is now arguing that if the acquisition of Vulcan were to move forward, Justice would require massive divestitures in arms-length transactions with a third party over a very short compliance time period. Vulcan believes this will effectively provide the business foundation for a new player in their own very consolidated markets. This could disrupt the term structure of the existing industry and create margin-destroying competition in what are already quite agreeable markets from a pricing standpoint. The markets wherein Martin and Vulcan compete today tend to be duopolies with very fine structures. This was the reason that Vulcan provided for not having approved the deal.

Several of Martin's and Vulcan's large shareholders, most notably Mason Hawkins of Longleaf Partners, have come forward to express support for Martin and its offer. It is not clear to me that this threat from market disintermediation through Justice Department sales of assets to a new competitor will not threaten to disrupt the structure of the industry. In my opinion, it's probably worthwhile for Vulcan shareholders to wait on giving approval to the deal until they see what the Justice Department will require.

G&D: What is the thesis behind your investment in Brown-Forman?

TR: Brown-Forman is a family controlled, very long term minded company which owns a portfolio of brands that enjoy increasingly global consumer loyalties. Jack Daniels is a terrific brand and the company has been run by a shareholder minded family. In 1987, I was surprised to see Brown-Forman shares plunge 40% because a brand called California Cooler that they had earlier acquired had seen at that time an unexpected decline in shipments. What the market had completely forgotten about for the moment was that the company still had very solid brands in Jack Daniels and Southern Comfort. So I saw a core business that was still very strong and a company that had dropped a lot in value. At this time, early 1997, I did a lot of research on the company and realized that

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investors were unfairly discounting Brown-Forman due to a misperception about the state of its whiskey business. For a while, a certain segment of the population (mostly around Wall Street) had moved away from bourbon and moved towards wine spritzers and those sorts of things. But the fact was that the rest of the population in the United States had not moved away from bourbon. It seemed that Wall Street analysts had extrapolated their tastes to the rest of the world. So as I mentioned, Brown-Forman's stock price collapsed following management's efforts to diversify the business by buying California Cooler. Missed in all of this was that Brown-Forman still sold around four million cases of Jack Daniels annually in the US, which alone I thought justified an intrinsic value worth twice the share price. Moreover, the company sold an additional half a million cases internationally.

As I was analyzing the company in 1987, the management described plans that would reorient the company to expand internationally, which would cost them money and negatively impact near-term reported earnings. Importantly, Brown-Forman had the "capacity to suffer" in this manner because it was family controlled via A and B shares which allowed the Brown family control. Folks at Brown-Forman realized that around 4 million cases of bourbon sold in North America was a great business, but it wasn't going to get much better. There was however a very large opportunity abroad. In 1987, Brown-Forman was in four markets and the company resolved to invest internationally to drive growth in its worldwide business. It was at this moment that I invested in Brown-Forman. Fast-forward to today -- they still sell about four and a half million cases of Jack Daniels in North America, but this business is probably more profitable today than it was because they have segmented their brand and created different price points for Jack Daniels. But the real story is that they now sell over five million cases of Jack Daniels internationally. When they started this journey, they only operated in four large international markets including England, Australia and Germany. Now they're in 18 markets wherein they sell over 100,000 cases each year. They were one of the first companies in which I invested that believed in the concept of suffering through some burdens on currently reported profits in pursuit of future success and growth for the company. Additionally, they realized that they could do this without the risk of losing the company due to the family's controlling stake.

G&D: Was the "ability to suffer" also behind your thesis in investing in E.W. Scripps?

TR: That was certainly the case with E.W. Scripps. E.W. Scripps Company developed Scripps Network Interactive, a subsidiary it spun off about four years ago. Nearly 15 years ago, Scripps' parent company considered developing a new network. The family that controlled the company bought into the vision of a network that combined home and garden channel. This was something that had not been successfully done before but they believed that it could be done and were willing to tolerate up to $150 million of cumulative reported operating losses to make it happen. So Frank Gardner and Ken Lowe, two superb executives of the company, began to pursue this vision of a new network with $150 million in operating expenses at their disposal. They spent maybe $2 million in the first year, about $15 million the next year on hiring people, etc. The third year, their operation was even more fully developed as they began the production process in earnest, so they invested even more fully in the business. In the meantime, the new network hadn't yet generated any revenues! E.W. Scripps, thanks to its separate newspaper and television businesses which had been generating about $350 million a year, was still making a profit – albeit reporting a declining one – as investment in the network grew.

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Though earnings declined in the early stages, Gardner and Lowe ultimately spent the right amount and now Scripps Network Interactive, the company they built, earns over $500 million in EBITDA and is worth over $7 billion. If a corporate raider had come along during the early stages of the build-out and sold this Home and Garden Network because it would have probably increased near term reported profits but it would have surely destroyed all of what was, at the time, a positive NPV business.

G&D: In the past, when we have heard you discuss the spirits business or other businesses, you have frequently stressed the importance and power of brands. In the case of this nascent network, however, where a brand did not yet exist, how did you gain comfort that those early investments by Gardner and Lowe would not destroy value and would in fact add value?

TR: That was the hardest part of my whole evaluation of the company. Along the way, we did start to see some early indications of this being a promising investment for E.W. Scripps, such as some buzz being generated about the new brand. Indications like these still don't mean success is a certainty. What was certain was the family's and management's collective willingness to suffer through that period of reported profit declines in pursuit of a business that they were willing to "build to last."

G&D: During your career, you have been very consistent in uncovering and investing in high quality companies. Have you ever considered launching a hedge fund through which you could short some of those companies that you have determined to be of low quality?

TR: I've been very fortunate in having been provided the capacity to wait and take my time in earning returns. The problem with short-selling is that it is terribly event-driven. To be really successful at short-selling, one typically would place a bet based on analysis of a soon-to-be relevant problem. For example, a short seller may believe a company is going to reveal a problem with their receivables accounting when they report their quarterly numbers. It creates an urgency that is different than the kind of duration I can enjoy with the businesses that we own. To get short-selling right, it is very time specific. Moreover, the structure of shorting is such that the risk of being squeezed is so intense that you can't put too much money into any given short. For a hypothetical example, if I'm thinking of using a short position to hedge Nestle, I would have to establish a very large number of positions, given our large long position in Nestle. So you have to significantly and frequently worry about timing if you want to establish a meaningful short position.

Here's another example of a similar dilemma inherent to shorting. I probably would not have gotten the timing of shorting Diamond Foods right. I met the management of Diamond Foods when they were very small. I felt that they had a good story but I just got a funny, uncomfortable feeling about the people running the company. This was when it was $17 a share. Then the stock went from $17 to $90! That would have been a painful short, even though the shares ultimately did decline precipitously.

Thinking about that uncomfortable "feeling" I got from meeting a management team reminds me of a profound point that Charlie Munger made at a Wesco annual meeting about six or seven years ago. Charlie talked about the value of beliefs versus the conviction of knowledge. Someone during that meeting asked Charlie why he had sold Freddie Mac because shares of Freddie had really rallied since Wesco's sale. Charlie looked at him for a long moment and said, "Because we felt like it."
Charlie then mentioned a friend of his who owned a large private business which had a director of marketing who had done a better job for the company than anyone ever had. The owner

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called this director one morning and told him what a great job he had been doing and how terrific an employee he was. But the owner also told the Director that there was something about him that made the owner uncomfortable to the point that he was actually losing his sleep and appetite. The owner decided to fire this Director, despite all of his successes at the company, because as the owner told him, he was "too old and too rich" to be losing sleep and appetite over anything. Charlie then explained to the person who asked the question that he was just uncomfortable with owning Freddie Mac and it wasn't worth their worry. He explained that with scale and time, the growth Freddie had demonstrated in recent history would basically no longer be available and that Freddie had begun to accumulate more mortgages on its balance sheet in lieu of securitizing them. According to Charlie, management had also inappropriately denied recent purchases of high yield junk bonds of a tobacco company. All of Freddie Mac's moves were done to meet the market's near term, management-created growth expectations for the company. Charlie explained that he just couldn't invest in a company with a management team that was corrupting an otherwise good business and was not honest and frank about its moves.

Pictured: Tom Russo and Jean-Marie Eveillard, at a CSIMA conference in February 2011.

"All of Freddie Mac's moves were done to meet the market's near term, management-created growth expectations for the company."

My sense about the people at Diamond Foods couldn't be modeled or quantified, but I stored it away without immediately acting on that hunch. Feelings like these, enhanced by years of experience and lessons learned, are to be respected rather than ignored simply because you cannot quantify them.

G&D: When you spoke to the value investing class at Columbia, you spoke about the important nuances between Kraft and Nestle. Could you describe some of the nuances for the benefit of the readers?

TR: When I discussed Kraft last year, I expressed my observation of the challenges and constraints that they face. Their three core businesses – domestic crackers, domestic cheese, and domestic meat – happen to be the grocery categories most exposed to private label competition in the US market. Cheese is cheese. The consumer belief that there is no adequate substitute for cheddar cheese isn't high enough to support pricing over the commodity costs. The same is true for the cracker and meat businesses. So Kraft tends to be more commodity-oriented. There are nevertheless still a number of other products within the company that are valuable, such as Chrystal Light. It's not that the shares won't perform relatively well, it's just that there's an omnipresent domestic pressure on the three key pillars of Kraft's business. The solution as they saw it was to expand offshore and diversify their business beyond those three major domestic pillars. They've finally done that with the massive restructuring of the business, whereby the costs they've taken out

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may point to higher returns on those commodity-oriented segments. They further believe that the businesses they have acquired in the international markets will power up reinvestment. This remains to be seen as it can be challenging to merge cultures when a company tries to buy growth.

G&D: When Kraft splits into the separate publicly traded North American-focused and globally focused companies, will you take a look at either of the shares?

TR: It's a bit of a hodge-podge, especially if I care a lot about culture. There are a series of leaps of faith that are required of one for this investment. I'll probably take a look at both of the stocks and would be delighted to be positively surprised…

Warren Buffett outlined his own frustration with the Kraft situation a couple of years back. His frustration was in part specifically related to Kraft's selling of what was believed to be one of their crown jewels, DiGiorno, to Nestle. The CEO of Kraft claimed that Kraft had received a very high exit EBITDA multiple. But this was backward looking. The selling price also didn't account for taxes Kraft owned. So the sale price received was based on historical earnings before considering the tax affects on the sales proceeds. Warren made a comment at the time that Kraft had in fact sold the business for something like 6x operating income. My investors by contrast effectively bought the DiGiorno business through our stake in Nestle. We were provided with that opportunity because somebody was desperate for a strategic reason to consummate an acquisition and sacrifice valuation for the DiGiorno brand.

G&D: What are your thoughts on Pepsi?

TR: I am intrigued by Pepsi although I don't think that the carbonated drinks industry has come to terms with its sugary past and present. There are an increasing number of places that charge soft drink taxes and try to limit consumer intake of sugary drinks. I think that there are other shoes to drop on the carbonated soft drinks category and so I have avoided owning the company, though this is from someone who owns tobacco companies and spirits companies!
However, if we were to see a spin-off of Frito-Lay from Pepsico, that could be quite interesting. I went to a Pepsi meeting a few weeks ago and I was struck by the ongoing reality that there is no peer competitor in Frito-Lay's market. It's in a league of its own. To the extent that a category competition was developing in the form of Diamond Foods, that's gone by the wayside. Aside from that, Frito-Lay's route system, its innovations and the continued consumer demand for its products are a powerful force in the US and abroad.
As an aside, if you're going to be a high conviction investor who intends to hold positions for a very long time, you should be sure to get out and see the business. By doing so, when the market panics, you can fall back on the confidence you gained from witnessing first-hand how the company is building out its business in key growth markets. Along these lines, I was in Angola to investigate the expansion of SAB-Miller's distribution there and in a modest out of the way community, a small bodega was selling Johnson & Johnson, Marlboro, Nestle and, sure enough, Frito-Lay branded products. Frito-Lay is quite a franchise.

G&D: What do you think about Pepsi's collaboration with Senomyx to focus on the discovery, development, and commercialization of sweet-enhancers and natural high-potency sweeteners with the intent to bring to the marketplace a lower-calorie drink?

TR: I am not sure the battle over CSD market share will be over by sweetener selection. Senomyx has whiz-kid scientists in flavor and technology, specifically in the area of taste receptors. They say that the mouth has 17 taste recep-

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tors for bitter and only two for sweet. This is because humans have to survive, and things that are bitter are things that kill you while things that are sweet don't or rather do so more slowly. What Senomyx tries to do is override the requirement to get sweet by deactivating taste receptors, so you can meet your desire for sweet at much lower doses. Foods can then contain fewer calories without losing any of their taste. The problem is that Senomyx gets to learn at Pepsi's expense. What Senomyx does for Pepsi in terms of compounds developed, is proprietary, but what Senomyx scientists learn is not proprietary and hence over time shared, ingredient-based competitive advantage will likely remain short-lived.

G&D: Given your interest in Cadbury, is Mars a company that you would own if it ever became public?

TR: Absolutely! Mars would be an interesting company if it were publicly traded as it fits right into my wheel-house. They have businesses in pet food, global confectionary, ice cream treats, rice, etc. The company is family-owned, however Mars has not been as well run as possible over most recent time. I celebrate the "capacity to suffer" and the ability to take the long view. However, in some cases, the fully private nature of some companies may mean that mistakes can get buried because there is no publication. Within a public company, if you go out and say you are going to come out with a brand new product and it flops, people within your company have to address it, come to terms with it, and learn from that experience. When decisions at a fully family-controlled private company are made and they fail, I don't think the institutions learn as well from those experiences. Mars is not nearly the company it could be, and arguably should be, given what they started with 40 years ago – premium pet food, premium confectionary products, ice cream novelties, etc.

G&D: What are your thoughts on Danone and the yogurt category?

TR: I love the yogurt category. However, I have found as an investor that Danone has been more expensive than Nestle for most of the time that I've been investing. Danone has done a great job with the yogurt category. I like that with CEO Frank Riboud, the company has become very entrepreneurial. However, the company has a feeling of having a more personality-dependent future vs. Nestle, where the culture of innovation is more institutionalized. Within Danone there is a huge tribute to the vision of one man. I don't think it's a given that they will be able to find a successor with similar vision or charisma to succeed that one man. Reckitt Benckiser was very well run for a decade but its charismatic, driven and talented CEO recently left and Reckitt's shares have since languished.

G&D: Have you ever been interested in owning companies in the cosmetics sector?

TR: My investors indirectly own a third of L'Oreal through Nestle. I've never owned any of these companies directly. What has kept me away from the cosmetics companies has been their route to market. Historically this has been a department store driven business, which has been an increasingly difficult place to be. Declining foot traffic into department stores reduces opportunity to market. Other store-based concepts are emerging like Sephora. The internet is now an emerging channel. For instance, Birchbox is a new startup in this category that could be disruptive – people pay a fee to sign up and get monthly deliveries of sample products delivered to their door. The problem with the old model is that people now don't go to the department store as often and I'm unsure of the rents that are going to be asked of cosmetics companies as we move forward. Do I think beauty matters? You bet. There's a lot of

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money to be made in related products. Unilever makes gobs of money through the sale of Axe, a body spray that males start using at an early age because they think it will help them do better with young ladies. As an investor, something like this is great – it is something that people will spray on every day with hope!

G&D: You have been a long time investor in Heineken. Have you ever been interested in Carlsberg?

TR: I have invested in Heineken shares since the early 1990s. I have had no investments in Carlsberg. As much as I like family ownership because it gives a management team the "capacity to suffer," Carlsberg is owned by a foundation, which is not an ownership structure I have embraced. It is a very different beast. The kinds of demands and standards that come from a foundation versus a family-owned company versus a public company are very different. The brand Carlsberg exists in many developed and emerging markets, but in no market are they the commanding story, except Russia. The company's market share in Russia is so big, that there is a lot of country-specific risk. Russia recently went nuclear with new taxes on the beer business, and Carlsberg has felt the effects of this. Carlsberg's new management has done a fine job … it's more the corporate structure that has concerned me.

"Most of the good advice I've heard over the years has emanated from Buffett. "Do what you like to do because you will be better at it" is something he says often that I've taken to heart. Another good piece of advice of his that I've followed is "pick your heroes."

Pictured: Tom Russo at CSIMA Conference in February 2011.

G&D: You are one of the most celebrated value investors, but you did not start out at Columbia Business School. How did you first get exposed to value investing?

TR: Despite the obvious shortcoming of not having the full value investing immersion offered at Columbia and spearheaded by Professor Bruce Greenwald, I was fortunate to have taken Jack McDonald's class at Stanford Business School. Professor McDonald was a lone voice at Stanford in value investing. The other "finance" classes were all concerned with greek letters and "provable certainties" that I do not believe to be reliable. A very influential event in my life was Warren Buffett's visit to Professor McDonald's class in the early 1980s. Today, I am quite fortunate and privileged to serve on the Advisory Board of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School and have been quite fortunate to have been so affiliated with the school. In addition, in recent years, I have been assisted in my efforts by excellent work from one of Professor Bruce Greenwald's program's graduates, T. Charlie Quinn.

G&D: What is the best piece of advice you have ever received?

TR: Most of the good advice I've heard over the years has emanated from Buffett. "Do what you like to do because you will be better at it" is something he says often that I've taken to heart. Another good piece of advice of his that I've followed is "pick your heroes." While Warren is my "uber hero" for investing, within my operating company teams I've picked Peter Brabeck who was CEO and is now Chairman of Nestle. Here is a guy who has reformed the culture and ex-

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pectations of an already great company into something that is better. Another good piece of advice of Buffett is to stay within your circle of competence. Lastly, he has said "you can't make a good deal with a dishonest person." I don't think that the people in corporate America are dishonest, but they are driven by incentives that make them less owner-minded. You have seen Buffett focus more on private businesses, many of these being family companies, as these people haven't yet developed bad habits. It all comes down to people. At the end of the TV show "The Apprentice," Donald Trump, when he's about to boot somebody, always says: "nothing personal, it's only business." I think many people misinterpret this to mean that business isn't personal. I think it's just the opposite. The best businesses are very personal. It's all about the culture, the people, and the leaders.

"If you're going to be a high conviction investor who intends to hold positions for a very long time, you should be sure to get out and see the business."

G&D: What are some things that you think have contributed to your amazing success?

TR: I think the fact that Warren Buffett and his partner Charlie Munger exist has been so valuable for the investors who seek to invest for the long term. Had they never existed, the concept of buying great businesses for the long term, and staying the course through thick and thin kind of investing would have been ravaged by efficient market theorists. You would not be able to find patient capital to pursue this style of investing. Due in large part to Buffett, people know it is possible because it has been done. This has allowed me and others who do what I do to have the privilege to striving to follow similar goals and objectives. My clients have been an extremely important part of my success. They have been willing to give me the "capacity to suffer," which is exactly what I ask from the managers of the companies we own.

G&D: Mason Hawkins talks about how being located outside of New York has helped him think independently of the Street. How important has being outside of New York been for you?

TR: The concept of turning down noise of Wall Street is something that I appreciate by the training I received at the Sequoia Fund. The absolute detachment from Wall Street there was amazing. Our offices were at 56th and 6th Avenue in New York, but it could have been Topeka, Kansas for how little contact we had with the Street. I never saw a salesman come through the door. If you are located in New York and you have 16 Wall Street analysts coming through your door each day, what is that going to do to your capacity to stay the course with a company? You would have an eroding stream of banter that you would have to steel yourself against. That was what Sequoia fund offered. To see patient investing actually succeed was proof that this way of doing things could work. They accomplished this in New York, not Tennessee. So future investors should realize that it is more about maintaining a detached frame of reference than it about the specific place where you choose to work.

G&D: It was a pleasure speaking with you, Mr. Russo. Thank you very much.

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