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Bill Nygren

The renowned value investor explains why his fund appears to drift in style and how he thinks about sustainability

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Bill Nygren can seem hard to label. He is a large-cap value manager but has at various times found his $18.1bn Oakmark fund in the Morningstar Mid Value category and it is currently in the Large Blend peer group.

But, as he explains in this interview, these changing categorizations are not the result of style drift. Rather, they reflect how the market is pricing stocks he holds in the fund.

He also discusses how current accounting rules can misrepresent asset-lite companies and what 'sustainability' means to him.

From March 2000, when he started on the Oakmark fund, to September 30, 2021, Nygren delivered a stellar 11% annualized return, smashing various large-cap indices by 3.5 percentage points or more.

Citywire: Explain how a value investor whose fund was veering toward the Mid Value part of the Morningstar style box 20 years ago comes to own Alphabet, Facebook, and Netflix today.

Bill Nygren: I see two separate questions here: Why has Oakmark migrated from mid- and large-cap stocks to large cap, and how do some of our growth-ier holdings qualify as value.

The Oakmark fund is our most diversified US equity fund. We suggest it for an investor who wants to put most of their equity investments into one fund and leave it there for decades. For that reason, we've always bought big businesses in the Oakmark fund because we believe they are generally less risky. But 20 years ago, during the technology and internet bubble, many smaller tech companies got such high valuations that they took over the large-cap universe. The big businesses in traditional industries that we'd always owned had such low valuations that they were called mid-cap stocks. Buying undervalued companies became so out of favor that our fund became a mid-cap fund, giving the appearance of 'style drift.' After the tech bubble popped and prices returned to more normal levels, the stocks we held climbed back into the large-cap universe.

Why do we own some above-average growers today? I don't know any value investor who dislikes growth, though growth is often accompanied by a high price that disqualifies it for a value portfolio. At Oakmark, we've always tried to value businesses based on true economics as opposed to shortcut methods, like a low price to either earnings or book value. Current accounting rules were designed for asset-heavy companies. They often short-change asset-lite businesses whose long-term investments get expensed rather than capitalized. In those cases, we adjust the reported accounting numbers to better reflect economic reality. As an example, Alphabet sells for an above-average P/E ratio that most value investors would deem too expensive to purchase.

But the company's reported earnings are reduced by all of its venture capital-like spending on things such as autonomous driving and artificial intelligence. We adjust its earnings per share to add back those investments and value those investments separately as if they had been made with a venture capital company. We also value cash as a separate investment because with near-zero interest rates, the P/E attributes almost no value to it. Those adjustments give us an accurate view of the real economic value of all the assets a business owns.

CW: Your 20-year record on the Oakmark fund is stellar against all large-cap indices. Over the past decade, you've beaten the value indices handily, but are about even with the S&P 500. How should investors interpret that? Is it getting harder in the large-cap space or is the S&P 500 currently a bit heavy with tech names that have run up a lot?

BN: I think the fact that the Oakmark fund has continued to perform well versus value indices shows that our consistent investment philosophy continues to work. So the question becomes, 'What has gone wrong for large value?'

If one looked at small-cap value funds, one would see similar underperformance. Therefore, clearly, it has not been a 'large' problem but rather a 'value' problem.

The underperformance of value indices relative to growth has been extreme, measured in either time (10 years) or magnitude (twice the return). It has not been caused by poor earnings performance of value names. The result is a historically high dispersion of the P/Es of rapid growers compared to P/Es of cheap stocks. Normally, the rapid growers sell at two to three times the P/E of the lowest P/E stocks. The spread today is more than twice normal. Our expectation that the P/E dispersion will revert to normal is why we've been, and continue to be, excited by the prospects for a value recovery. The fact that growth investors have earned so much more than value investors over the past decade has caused a lot of value investors to throw in the towel. We believe patience will be rewarded.

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CW: Investors are taking governance seriously these days, and you recently wrote about the topic along with the shareholder versus stakeholder debate. Give us a condensed version of your thoughts on these issues.

BN: I need to give a little background on our time horizon to put some perspective on our recent commentary. At Oakmark, we use a very long-term time horizon. We own stocks that we think are priced at a large discount to their current value, meaning that if seven years from now they earn what we think they are capable of and the market accords an appropriate P/E, we will earn a higher return than we would with an average stock.

It's important to us that we understand how sustainable current earnings are and that we understand the goals of management and the board. In our third-quarter commentary, I wrote about stakeholders not having opposing interests to shareholders. I said that treating stakeholders fairly is the only path to long-term sustainable earnings. In the prior quarterly commentary, I wrote about the importance of management and the board thinking like owners, especially when it comes to decisions about where to invest a company's excess cashflow. While we want companies to make investments when they are competitively advantaged and can expect above-average returns, we strongly discourage investment where a company lacks competitive advantage.

Many of the issues between investors and managers come down to the time period over which management will be judged. Because of our reputation as long-term investors, managements often ask for our input on their strategic decisions. We typically ask, 'Would you do anything differently if you owned the entire company and expected to eventually pass it to the next generation?' Hint – the right answer is 'no.' ■