

CHAPTER 4

A LEGACY: THE SONS OF STANFORD; THE MEN OF VALUE INVESTING

Regaled Stanford Business School in California long has been seen as a bastion of “efficient markets” thinking. Indeed, two finance professors, Bill Sharpe and Myron Scholes, have won Nobel prizes—a record for business schools—advocating that markets are efficient, that stock prices accurately reflect all information. But another Stanford faculty member, Professor Jack McDonald teaches that markets are not always efficient, that discrepancies can occur, allowing a serious student of fundamental investing to buy a dollar for 50 cents.

“Jack is lonely at Stanford,” both Buffett and Charles Munger have said of McDonald. He is the only professor at Stanford teaching fundamental investing, value investing, offering a bottom-up, company-oriented approach.

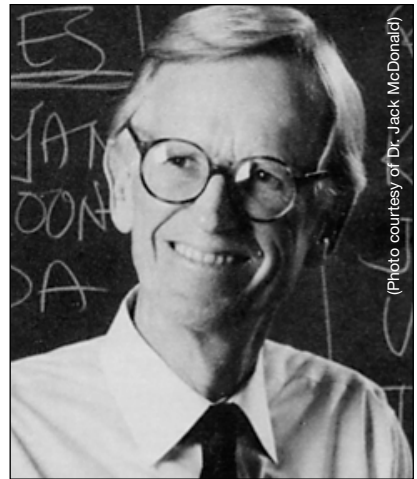
Using such texts as Benjamin Graham’s *The Intelligent Investor*, Phil Fisher’s *Common Stocks and Uncommon Profits* and Charles MacKay’s *Extraordinary Popular Delusions*, McDonald believes that gaps of value can be ferreted out. Those willing to do the homework of examining the intrinsic value, the real worth, of an enterprise and comparing it to its market price, may be able to capture the gap in value.

For the past 36 years—sort of like the Cal Ripken of baseball—McDonald has taught investment and finance classes, with a little help from his friends.

Buffett, Munger and Phil Fisher, who have all spoken to McDonald’s class over the years, say that while the market may be largely efficient, it is not always efficient. Buffett teaches one class every two years, Munger has spoken occasionally and Fisher gave his last talk to McDonald’s class in 2000.

“In the mid 1970s, I was introduced to Warren and Susie Buffett by Stanford’s Dean Arjay Miller who served on the board of *The Washington Post* with Warren. Peter Buffett was a student of music at Stanford.

“Warren Buffett has been coming to my classes since 1976 when the Berkshire stock price was \$60. A whole generation of Stanford MBAs has learned from Warren’s great wisdom in the classroom. Berkshire’s stock price has increased more



Dr. Jack McDonald

than 1,000-fold since Warren first taught with me at Stanford. Charlie is great in class and has been a terrifically wise and tough-minded lecturer in my investment classes.” Buffett has kidded McDonald that the two of them have been “teaching together for more than 10% of the history of the country.”

McDonald is a Fulbright Scholar who has been a visiting professor, teaching classes at Columbia and Harvard.

Born in Stockton, California, McDonald went to Stanford University, earning a B.S. in engineering. He began his career with Hewlett-Packard and received an MBA at Stanford in 1962. After U.S. Army duty, he returned to Stanford and completed a Ph.D. in 1967. For years he has been a successful investor himself.

McDonald caught the fundamental investing bug from Phil Fisher, who was a 1929 graduate of Stanford Business School and a classmate of McDonald’s late father Earl in the year of the Great Crash of ’29, Fisher was asked in the early 1960s to come to Stanford to teach investment management because of the success of his book, *Common Stocks and Uncommon Profits*. Fisher taught for two years, and McDonald was fortunate to be his student.

Fisher, in his 90s and ill when he last spoke to McDonald’s class in 2000, stressed, as always, the importance of looking at suppliers, customers and competitors, but “first is outstanding management,” he said. (*Outstanding Investor Digest, Volume XV Number 7, 2000*). Fisher said he didn’t want a lot of good stocks, but rather a few outstanding stocks. “I believe strongly in diversification, but I do not believe in over-diversifying...My basic theory is to know a few companies and know them well.”

Since 1968 McDonald has taught MBA courses and executive programs in three subject areas: investment management; entrepreneurial finance/private equity; and, corporate finance, all with a global perspective. (Case studies of Honda and Porsche are examples.)

As the Industrial Bank of Japan Professor of Finance, a special emphasis in his courses is on a global perspective in equity investing. Many of his students are from Japan, Korea, China and Taiwan as well as the U.S., Europe and Latin America.

In 1989 McDonald was named Vice Chairman of the Board of Governors of the NASD which owned the NASDAQ Stock Market.

“I agree with Warren Buffett: The essentials of financial analysis and the basic tools and disciplines that one must learn in becoming a fundamental investor are not really all that new. They are essentially the same as they were 30 years ago, although the setting continually changes. I am a big believer in the case method, and I love to write new cases. Our problem today as equity investors is not one of the technology or the latest quantitative method, our problem is one of learning discipline and execution as investors in real life, in a changing world. Through new cases, I am proud to teach the classes fundamentals stressed years ago by Benjamin Graham and Philip A. Fisher..

“I am personally convinced that corporate finance skills must come first—that

is, understanding how companies work as viewed from the vantage point of the chief executive officer and the chief financial officer who are trying to balance the needs for investment and financing and allocate capital so as to achieve the business objectives of the company and create value for shareholders. Those skills are primary. That was the case 30 years ago; I believe it is still the case today.”

Ironically, McDonald’s wife, Melody, went to an East Coast business school: Harvard. After earning a doctorate in musicology at Stanford on the West Coast, she switched to investing after earning a Harvard MBA in 1986, where she marched at the head of her class into graduation in Harvard’s 350th year. She was the Harvard Business School Class Marshall, the second woman ever to have that honor. She joined RCM Capital Management in 1986 and is a managing director there. In May 2002 President George W. Bush appointed her to the 7-person Advisory Board of PBGC, the government’s Pension Benefit Guaranty Corp. in Washington D.C., looking after deferred benefit pension plans. The McDonalds celebrated their 30th anniversary in 2003.

Tom Russo

Tom Russo, one of McDonald’s students in the early 1980s, and now a partner with the Gardner Russo Gardner firm in Lancaster, Pennsylvania, runs Semper Vic Partners.

Russo says, “Investment insight which helped me most to avoid such single-parameter investing during the heady days of the Internet bubble was provided by my investments professor at Stanford Business School. Professor McDonald has long distinguished himself teaching fundamental principles of investment analysis to students...a remarkable feat considering that Stanford is known as a home for Modern Portfolio Theorists, for whom fundamental analysis is largely irrelevant. (After all, since markets are efficient, then why bother analyzing individual companies...) Professor McDonald, however, provides in his Investment course a metaphor which, if applied, would have allowed investors to stay clear of most of the air pockets caused by the single-minded investment emphasis of the past several years.

“Investing, Professor McDonald maintains, is like piloting an aircraft. To arrive safely, one must scan all dashboard gauges simultaneously, never fixing on any one. Single-minded focus on the speedometer can only assure adequate speed. Failure to simultaneously observe the altimeter, however, might lead one to fly quickly into a hill. While a well-timed look at the compass will assure that you remain on course, failure to observe the fuel gauge could lead to running out of fuel. A look at the



(Photo by Michael Miles)

Tom Russo

gyroscope can help assure that you are flying on an even keel, but not that you are flying fast enough to stay aloft. An occasional simple scan away from the dashboard altogether could keep one away from obviously threatening storm clouds on the horizon, and so on....Not one of the above gauges alone is sufficient. All are collectively essential.

“Scanning has similar value to investors. Singular emphasis on growth rates of revenue or of earnings per share is no different than focusing on speed alone, as managements can show growth in both without having an eye towards long-term direction of their company. More importantly, without regard to the balance sheet to check up on cash levels, an investor might find that one’s seemingly fast-moving investment runs out of money, with consequences of crashing and burning, as has happened recently to countless formerly high-flying stocks when their underlying business ‘ran out’ of financial fuel.”

Russo, from Janesville, Wisconsin, and who graduated from Dartmouth before heading to Stanford, said one day Buffett showed up in McDonald’s classroom. “He said to think of two ships departing from England—one a row boat and the other the Queen Mary. As they headed to the U.S., the row boat grew to become a Queen Mary and the Queen Mary gradually became a row boat.” Buffett made the analogy to businesses that prosper by good management, focus and wise reinvestment. Or a business can decline without attention and execution. Boat 1, said Buffett, was Capital Cities, a business constantly growing under the management of Tom Murphy and Boat 2 was ABC, a business gradually losing market share. Five years after Buffett made these comments—and using those names specifically at that time—about Boat 1 and 2, Cap Cities bought ABC.

Another example of Buffett’s simple responses to things, recalls Russo, occurred with fellow student Terry O’Toole. Buffett had been talking about being willing to work for free but work at your passion. O’Toole, a top student, asked what Buffett would do if he wanted a job in media and Buffett said, well, the best businessman in media is Tom Murphy of Cap Cities. O’Toole did go see Murphy, but wound up having a distinguished career as a partner and principal investor at Goldman Sachs.

Buffett told the class that Wall Street rarely realizes whether a business is really growing or slowing, but he said that Bill Ruane and the folks at the Sequoia Fund (ironically where Russo worked from 1984 to 1988) understood which direction businesses were moving.

Russo, who earned a combination MBA and law degree from Stanford in 1984, says being a lawyer is an asset to being an investor. “It’s building a case for why to make an investment.” People might ask a standard set of questions, he said, about an investment, but it’s the art of listening to the answers that’s the key. “You’ve got to say wait a minute, what did you just say?” The study of law provides a way to listen for the important responses, Russo says. He’s skeptical when he’s told that he should look at losses to see how well the company is investing or promises of 50% over market returns. At that point, he knows to run for the hills.

“Jack provided cases highlighting the investment process. It might be in electronics distribution, exploring capital spending that was out of control and leading to financial distress,” Russo said.

Russo, whose Semper Vic Fund (which holds 250 Berkshire shares) has returned more than 17% annually over the years, says it is because McDonald has been an investor himself that makes him somebody who can “do” rather than “talk.” He walks the walk.

Years ago, McDonald made a successful investment in a French Champagne firm—Veuve Clicquot, recognizing that valuable acreage, reserves, and global distribution network were not shown on the balance sheet.

McDonald, who taught the Veuve Clicquot case to Russo, summarized it this way: “In the 1960s I wrote an investment case in France on Veuve Clicquot Champagne, the last of the Big Three Champagne companies to come public in an IPO in Paris (Moët and Mumm, No. 1 and 2, were already public). I bought some shares after the IPO in Paris in the 1960s; I spoke French and taught at the French Business School HEC before joining the Stanford faculty. The Veuve Clicquot case is a classic long-term valuation case, with some good comparable companies to study. Positive factors: The Champagne land, the franchise value as a luxury goods platform, sustainable growth potential, good management, and reasonable stock valuation made Veuve Clicquot a great long-term holding with a large “margin of safety”. VCC eventually became a part of LVMH-Louis Vuitton Moët Hennessey, and we made about 70x our money on VCC over more than 2 decades of investor patience, and of teaching the Veuve Clicquot (Widow Clicquot) case study.”

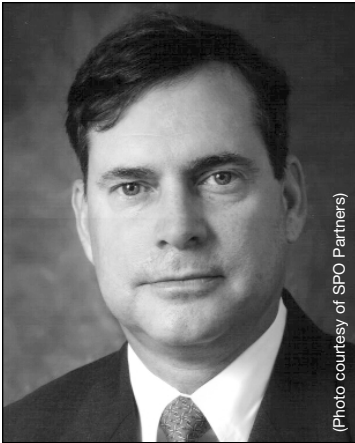
McDonald’s emphasis on foreign investments has stuck with Russo. Indeed one of Russo’s biggest and longest holdings is Weetabix, a British cereal company he feels has traded significantly below intrinsic value.

Generally Russo likes to stick to investments in the food, beverage, tobacco, and media sectors. That’s his circle of competence, a concept Buffett teaches in McDonald’s class.

Another successful investment has been *The Washington Post*. In an interview with *Barron’s* (September 16, 2002), with *The Post* trading at \$626 a share, Russo estimated the breakup value of between \$800 and \$900 a share. He advocated its shares because the company uses conservative accounting, expenses options, maintains a hugely overfunded pension fund and has an investment in Berkshire stock. Russo also said he favors family-owned companies because they generally allocate capital well and will deploy new cash for the benefit of owners rather than managers.

Russo said McDonald also stressed in class that one should not be so caught up with success and money as not to allow “following your one folly.” McDonald tells his students that his “folly” is golf.

OK, Tom, what’s your folly? “Well, I’m looking for mine. It’s my family. It’s not a folly, but it’s a pursuit.”



(Photo courtesy of SPO Partners)

Bill Oberndorf

Bill Oberndorf

Bill Oberndorf, originally of Cleveland, Ohio, graduated from Williams College in 1975 and Stanford Business School in 1978 before joining another Stanford Business School graduate, John Scully, who was running Texas Partners.

Texas Partners, founded in 1971 by former Stanford business students Sid Bass, Richard Rainwater and John Scully, morphed into Main Street Partners with Texas investor Robert Bass. Oberndorf participated in originating the investments made by the Bass Brothers in the group's public and private equity investments.

In 1991 Oberndorf became a managing director of SPO Partners, of Mill Valley, California. SPO stands for former Stanford business students, John Scully, Bill Patterson and Bill Oberndorf.

The 30-year investment record (1971-2000) for Texas Partners and Main Street Partners is 30% (before fees and expenses). SPO II Partners, formed in late 2001, has had positive returns in a sharply dropping market.

"Buffett was on the advisory council of Stanford Business School along with people such as Katharine Graham and Robert McNamara," Oberndorf said. "In the Spring of 1978 a handful of students had a sandwich lunch with Buffett and he also spoke to Jack's class at that time. He was less well-known then. He talked about how buying a dollar for 50 cents was easier than trying to make a dollar out of 10 cents." Oberndorf said he was immediately struck by Buffett's different mindset and clear focus, about how Buffett was trying to analyze something that already existed and figure out how to close a gap to the real worth. A dollar could turn into \$2, \$3 or \$4.

"The clarity of what he was saying and the combination of humility and sense of humor had a great impact on me," said Oberndorf who has followed Buffett's career as a Berkshire shareholder.

"He and I have never made an overlapping investment," said Oberndorf, but value investing is what both do.

One investment Oberndorf originated in 1982 was Pier 39, a real estate shopping endeavor on the wharf in San Francisco, a successful business today.

Oberndorf was part of a classic investment in 1991 in the form of Plum Creek Timber Company of Seattle, with large tracks of timber lands in Oregon, Washington, Idaho and Montana. "It was actually Jack's idea," said Oberndorf. The investment was made during the Spotted Owl controversy with environmentalists concerned about the bird's fate. "Government-owned timber was off the market. It was closed to timber harvesting," Oberndorf said. Private timberland became much

more valuable because 60% of the market (the government land) was closed.

SPO Partners bought 7¹/₂% of the limited partnership units of Plum Creek Timber and later approached the owners about buying the company and eventually did so, paying \$55 million for the assets to acquire the partnership interest which effectively controlled the company. The general partnership interest, in which SPO acquired 100% from Burlington Resources, had an “embedded promote” of 35%. In other words, the general partnership shared in 35% of the incremental profits generated by the partnership. Over the next decade, under excellent management and with Oberndorf, Scully, McDonald, and Patterson on the board, the value increased 10-fold. Plum Creek is now the largest independent timber owner in the U.S. with over 8 million acres.

Oberndorf said SPO Partners makes only four or five investments a year. “Our business is making capital allocation decisions and working with talented people.”

John Scully, Oberndorf’s partner, several years ago was given the Stanford Business School Ernest C. Arbuckle Award, named for a former dean. In his talk, with Oberndorf, McDonald and 200 other friends in attendance, Scully said:

I would recommend the students in attendance tonight read my partner Bill Oberndorf’s classic work published in 1978, the year I hired Bill upon his graduation from the GSB. That was, of course, the timeless piece, “The Fallacy of High Starting Salaries—You Too Can Live on Pennies.” See, I was very penurious then, a fact many of my friends here will vouch for.

Oberndorf said the reference to the salaries’ story was actually one Scully wrote. It turned out that when Oberndorf took a job with Scully, Oberndorf had an offer for twice the salary with McKinsey & Co.

“I was the lowest paid in my class,” Oberndorf laughed.

Oberndorf said he would have found a way into the business world with or without McDonald and Buffett but that they made the real difference. “Jack knew so many people and has a fabulous network and was so curious. He really cared about teaching. Value investing is what worked for me. I owe so much to Jack and it was a seminal event to meet Buffett.

“No one is smarter or has better people skills than Warren. Investors such as myself have benefited enormously by the example Warren has set of disciplined investing combined with the highest ethical standards,” Oberndorf said.

John Brennan

Out of Central Falls, Rhode Island, John Brennan graduated *summa cum laude* in 1981 from the University of Rhode Island College of Engineering, worked in General Electric management programs for several years and then went to Stanford Business School.

“Buffett came to Jack’s class of 60 people and spoke about long-term investing.

He told us about the performance of his partnership relative to the performance of some mutual funds, one of which was Mass Investment Trust which I later went to work for.

“He told us how important it is to have little turnover, saying that compounding works much better without transaction fees and taxes. Even making an extra percentage point over time can amount to big money years later.

“He went through his evolution of buying hard assets like Ben Graham and his evolution of recognizing that buying good businesses at reasonable prices can be even more valuable,” Brennan said. Buffett, with Munger encouraging him, Brennan added, came to see that the durability of the company and its opportunities to reinvest cash flow profitably mattered. Finding a business that would have good cash flow 5 and 10 years later could make for an investment with a big payoff.

“He used the example of GEICO which was undervalued in the early ’70s. I viewed him as someone who had a successful way of looking at things. He made a lot of sense.”

Buffett also talked to the class about risk saying that theoretical factors about how stocks trade, their volatility and beta and all meant little compared to a real understanding of a long-term investment. Brennan said McDonald was good at teaching conceptual material, but really kept the focus on real-world investing.

Brennan read the Berkshire and Wesco Annual Reports over the years, but never had any of the same investments as Buffett. Still it turned out that both men were buying heavily into the junk bond market in 2002.

Brennan recalled that at one point McDonald brought in 3 guest speakers, each one an expert in his area: one in speculation, one in gambling and one in investment. “Each one was successful in his area. He wanted us to see why they did what they did, what made them successful, and what were the elements of mastery that differentiated them from the average.”

During most of the ’90s Brennan was an MFS equity research analyst and pulled the MSF Capital Opportunities Fund in Boston from a 2-star to 5-star ranking, as rated by Morningstar.

In 1999 Brennan co-founded Sirius Capital Management, also in Boston. It is named after Sirius, Latin for the brightest star, or the Dog Star that stands out during the dog days of August. The hedge fund came to life after quickly raising \$500 million.

Brennan has been an eclectic investor, buying a wide variety of securities from distressed securities to U.S. government bonds to cellular issues. A huge win for the Sirius fund came as a result of shorting both Global Crossing and WorldCom at the height of the telecom craze.

Known for digging through 10-K and 10-Q company documents, Brennan shorted WorldCom stock after he saw the fundamentals faltering. “First the business was under pressure from competitors. Price erosion was going on with AT&T,

Sprint, Williams and Global Crossing in the market. Capital was flowing freely. There was massive fiber capacity,” he said. Things were masked when the Internet was exploding, but when the Internet craze slowed so did the telecoms.

Also, he said, WorldCom’s consumer accounts were leaving for wireless and other competitors. And as for the balance sheet, there was too much capital spending and too much debt. “The capital expenditures didn’t make sense for the life cycle of the company. There was \$12 to \$14 billion in spending and \$30 billion in debt.” He saw from the 10-Ks and 10-Qs that the interest expense was only 3 percent, meaning a large amount of the debt was short-term that might later have to be financed at higher rates. And “they were capitalizing instead of expensing costs.”

The company, he said, couldn’t give him good answers to his questions. So Brennan shorted the stock in the mid-teens and rode it all the way to zero for a huge payoff. Further, he shorted the bonds and hedged the position by buying Treasuries long. While Wall Street saw WorldCom bonds as pretty solid, Brennan saw them as junk bonds whose prices went from 90 to 11.

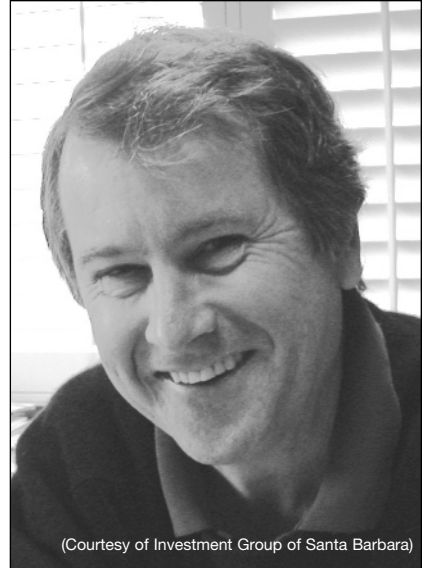
At a low point for the bonds, Brennan thought increasing risk was there by continuing the short position and so reversed his position, making money both ways on the WorldCom bonds. During this process, McDonald and Brennan discussed Global Crossing and WorldCom in a case discussion on shorting stocks in the Investment class at Stanford.

Tim Bliss

Tim Bliss, by way of Carpinteria, California, Cate School, Harvard College and Stanford Graduate School of Business, turned his net worth of negative \$30,000 (because of student loans) when he walked out of Stanford into a net worth of several hundred million today that he and several others share at IGSB (Investors Group of Santa Barbara).

“Jack McDonald consistently taught the disciplines and skill-sets of fundamental analysis and investing {unlike those advocating efficient markets}. Jack would point to Warren Buffett’s record which showed he was outperforming the market over time by a very substantial margin.”

“One day in 1978 Buffett came to our class. There were about 25 students, and Jack introduced his friend Warren as the country’s greatest investor. He made a huge impact on me. Everything he said passed the test of rationality. He talked about volatility being your friend.”



(Courtesy of Investment Group of Santa Barbara)

Tim Bliss

Under McDonald’s supervision, Bliss and classmate Bill Oberndorf did a study of the great investors, interviewing people like Phil Fisher, but, the “biggest part of it was a study of Buffett and his evolution.”

At the time Berkshire had a stock portfolio of only \$170 million and \$130 million was in eight companies.

Bliss was such an avid student of Professor McDonald’s that he even did a study to compare the various editions of *The Intelligent Investor*. Discovering the evolution of Ben Graham’s thinking was a great learning experience for Bliss.

An earlier Stanford student, Reece Duca, whose father had died when Duca was only 11 leaving Duca the sole male figure in an Italian family, had studied fundamental analysis and visited companies. He started playing the hot IPO market of the time and when Duca left Stanford had cleared \$50,000.

“That was the original seed money,” Bliss said. Bliss and several others transformed that money into several hundred million dollars over the 1970s-80s-90s.

Duca hired Bliss for \$2,000 a month with the agreement he would make 10% of what money he managed. Bliss ran headlong into failure. Markets went against him. The \$500,000 he was running turned into \$400,000 and his salary was slashed to \$1,600 a month.

Then Duca gave Bliss a break and said: “I could use the writeoff. Start over.” Bliss said Duca gave him a large chunk of money to run and “it was off to the races.”

Bliss, borrowing money and picking stocks such as Toys-R-Us out of bankruptcy, racked up the following returns:

1979	9.8%	1983	96.5%
1980	85.1%	1984	6.5%
1981	23.7%	1985	31.5%
1982	95.5%		

During this time Bliss owned Best Products (a catalog and showroom merchandiser), Federal Express, Mercury General, Everest and Jenning (dominant manufacturer of wheelchairs), Commodore Computers, A. Schulman (specialty plastics fabricator), New Hampshire Ball Bearings, ISC Systems (enterprise software for the S&L industry, Hazelton Labs, Autodesk, Williams-Sonoma, Greentree Financial, and CPI (photo studios in Sears stores).

As time went on IGSB (whose partners are Duca, Bliss, Bill Rauth, Luise Phelps and Michael Cooney) moved more into private companies which later went public such as Advent Software and The Learning Company.

Although Duca and Bliss do not have clients or shareholders or limited partners, they did have debt in the early days when they got loans from Crocker Bank. So their good results were magnified early on by borrowed money. Years ago they stopped borrowing and have operated debt-free for more than 15 years.

So no debt, no clients, no limited partners, no stakeholders of any kind: Bliss and Duca are truly “principal investors.”

“I call Tim Bliss: The ultimate principal investor,” McDonald says.

Bliss says of McDonald, “Jack is someone who can crank through the numbers, but also can find the elements of value outside the numbers.”

“He taught us that excellent managers get excellent results and mediocre managers get mediocre results.” He said stick with excellent managers. “He loves the investing process.”

Bliss recounts a funny tale about McDonald, busy and absorbed with second year students. Bliss, as a first year student, wanted to meet McDonald and went to his secretary and was told he could see him on May 7 for 10 minutes as McDonald walked to the parking lot. Bliss waited and met with McDonald, and they talked about Tandem Computers. The company made fault tolerance computers—a new concept at the time and was going public. “We were both familiar with the company and had a great discussion which....was the start of a long friendship...Jack could tell I was passionate about investing and we became lifelong friends.”

“Jack is positive and upbeat and values everyone’s opinion. He can bring someone who may be off-base into a useful discussion,” Bliss said.

“I think one of the missing things {in business education} is biography with Andrew Carnegie or Thomas Watson, Sr., of IBM, for example, things didn’t go straight up. When I had no paycheck, it was a stretch. It’s how you react {in tough times}. Jack taught us about how careers develop.” Bliss said what’s important about Buffett and Munger and Fisher is the value they bring about being a better person. “When I read something written by Buffett, I feel I’m becoming a better person.”

Bliss said there’s no question Buffett is smart, but beyond that it’s been his patience, his discipline, his ability to distill the complex to the simple. “He’s really looking at the 3 or 4 most important variables. What are the underlying drivers {to an investment or life situation}?” Bliss said Buffett takes a dispassionate look at things and arrives at the facts about what is of value.

Lastly, as to McDonald, Bliss says, “At a very impressionable time in our lives, Jack taught us ‘McDonald Capitalism.’ He taught us an investor’s version of practical, entrepreneurial capitalism.”

