Tom Russo's Transcript
8th Annual Value Investor Conference

8th Annual Value Investor Conference, University of Nebraska at Omaha

This is the transcript of Tom Russo's presentation to the 8th Annual Value Investor Conference in April 2011, Omaha, right before the annual shareholder meeting of Berkshire Hathaway. The upcoming 9th Annual Value Investor Conference will be held May 3 – 4, 2012, again in Omaha.

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Tom Russo: That's a warm welcome. Thank you so much. My focus – my field of investing is global value equities and I invest in a large number of spirits companies and so very often in meetings like this the spirits companies finish their presentations and say that they're the last thing that stands between the audience and a nice drink and in this case I'm the last one between the audience and a See's chocolate break.

As a global investor I would make one observation if you would just pull up your agenda of speakers you'll look at Charles Brandes who really pioneered the field of global investing and he started in the mid 1960s and you'll see how young he looks, and so I'd say there's a lot to catching a tail wind, and his career has enjoyed the benefit of a tailwind and I came on the scene much later than he did but have also I think had a very good tail wind to my investment activity as a result of opening the investment universe which I ply to foreign stocks rather than just maintaining a purely domestic approach, as did the Sequoia Fund when I was there, and as did most of the fund managers in the early 1980s when I started after graduate school of business. I'm delighted to see this audience much expanded and I'm glad it's back in Omaha rather than L.A. It's a lot easier to get around.

I'm delighted it's bigger because Bob does a great job. Over the years I've learned a lot of lessons from this conference. He's had Kevin Clayton speak. He's had the interaction that we've enjoyed from Berkshire's subsidiary companies. So Kevin Clayton spoke one year and spoke about what it meant to be a manager within Berkshire. And he described how if there's ever a question, usually a capital allocation question, Warren would offer to fly him up and it'd be a very simple process where he'd come and state the case. "What do you want to do Kevin?" And Kevin would state the case, and Warren would ask him three questions, and the first question Kevin would answer, and the second one he would answer, and before the third question was asked typically he said he knew the answer and he went away informed as to what the right outcome was. Now that role of Warren the business counselor is one that I don't think is often enough described, and I think it keeps the capital allocation and really the focus of the company going along. Kevin gave that insight.

Bill Childs spoke some years back and he described something that's part of so many of Berkshire's businesses which is that though it's a furniture business it's really a financing business with secured lending against sofas and against the family spending power over the years. He also described something that probably cost me a lot of money. Much like Patrick

Dorsey, I had invested in newspapers and he said that the greatest thing about his business is he has enough density in every market to advertise on newspapers and it just draws traffic like mad. So that was unfortunately a confirmation that I should stay a deep and broad investor in newspapers, for which I'll take up issues with Bill if he's still around.

Flight safety, Bob mentioned I learned that a simulator is indeed a simulator because I crashed badly both on take off and landing. In life, you only crash once. It was a simulator. And so, this year, we were going to have David Sokol and that would have been a great presentation because Warren's always said according to Kevin Clayton that when people visit he sends them back with only one message. He said actually they visit the board regularly as members of the management team just to get a sense for how they're doing in the hierarchy and the only two messages they get sent back with is build your competitive moat, about which he had discussions earlier, and don't do anything to harm the reputation of Berkshire as expressed by front page news, and it seems like one of those lessons was well learned and we heard about it, but one I gather has been left unlearned.

Jack McDonald, who you mentioned, as my professor at business school said what you should do when you speak publicly is tell the audience what you're going to say, say it, and then tell them what you didn't say. So I'm going to talk about value investing and my goal is what is simply described as buying fifty-cent dollar bills. But I recognize a couple of things that Warren Buffett spoke to our business school class at Stanford Business School in 1982 that affect how I apply that that notion of the 50-cent dollar bill. And the first important point was that the government only gives you one break as an investor and that's the non-taxation of unrealized gains and so you should probably build your investment practice in a way that you capture the benefit of that, which means you want to buy and hold for a very long time. And so if you just buy a fifty cent dollar bill and it doesn't grow in value, your return is entirely dependent on when that discount closes and so if it closes quickly in the first year, you might make a 100 percent on your money, but if it takes 10 years for that discount to close it will be a 7 percent return and if it takes 20 years it will be a three and a half percent return.

Now the offset of that is if you find businesses that are undervalued but have the capacity for that dollar to grow, you're much better off. In my particular expression, the other thing that Berkshire's chairman said to us at Stanford Business School in 1982 was invest in an area that you like, where you're invested in because you'll probably work harder at it and know more about it be more intuitive about it. And for me that turned out to be food, beverage, tobacco and media. These are all businesses that have franchises in many of the same ways as Patrick described them, but those franchises are important, they give you pricing power. They tend to be global. So in my march abroad I was able to broaden my universe. If I were a beer investor, and looked beyond Coors and Budweiser and Miller at the time, to Heineken (HKHHF) and Asahi and Kiren and the whole complexion, to know the industry well you have to naturally look at the global competitor set because most of the businesses I invest in tend to be global. And so it's been an important addition. Invest to take advantage of the non-taxation of unrealized gains and then to broaden the universe of the companies that I tend to focus on to be global because that's just the natural competitor set.

Berkshire's (BRK.A)(BRK.B) chairman said you'll have a very few number of good ideas in your lifetime so pick wisely and invest for the long haul. And that's sort of the notion. It's hard to make that dollar bill grow, that's the problem. And in public companies typically it's the case that managements are not prepared to invest as fully as they could in pursuit of the growth of the dollar bill. So, buying a 50-cent dollar and then not having it grow is very costly, your capital runs out of return over time. So what I've looked for are businesses that for one reason or other are willing to invest hard behind the growth. And what that means is they have to have the capacity to suffer.

When you invest money to extend a business into new geographies or adjacent brands or into other areas, you typically don't get an early return on this. And this is a very important lesson. The concept of the capacity to suffer I borrow from a response that Jean Marie Eveillard gave at a Columbia presentation when he was asked what are the characteristics of a good analyst – what are the characteristics of a good investor in some ways, and he didn't miss a beat, he said the capacity to suffer. He said that he understood that because he grew up as a French Catholic, and the religion in France assured him that he had reasons to suffer for his life.

But the reality in the business world, it really does exist. As a money manager we have to have the ability to suffer through bad periods of performance and in my own history if you look at the year 1999 we were invested at that time in good businesses. We had Nestle (NSRGY). We had Heineken, Unilever (UL) – the whole host of companies I still own. They happened to be terribly out of favor relative to the forces that were driving the markets at the time. I was very lucky not to be forced by my investors to chase after what seemed to be generating such great returns. We were in fact in 1999 down 2 percent and the Dow was up 27, and then I think if you went into the early part of the next year, I think we may have been down 12 or 15 percent and the market may have been up again 30 percent. And you have to have the capacity to suffer when you're going through a period like that.

For me, the reason why I was afforded the luxury was that I had built some trust with investors, I had built a lot of embedded gains to that they were kind of locked in by their embedded gains and I managed a very small part of most of my investors' money. So I was able to allow them to enjoy the benefit of Cisco (CSCO) which rose to half a trillion market capitalization while we somewhat withered during that period. But we were able to stay the course. We had the ability to suffer. And we were able to then capture the benefit that arose. And in some funny way, having had such a massive underperformance in 1999 is what set up the portfolio that I manage the main partnership for the 10-year performance that you see through March of 2011. That outperformace is greater than I ever had in a prior 10-year period and I think it was in part because I was allowed to suffer through this missed performance.

Most public company managers worry about a year like 1999 and they may encounter one if they invest heavily behind a new project, they may show numbers that are unattractive and they worry about the loss of corporate control. In the 1980s, 1987, Gilette was in the midst of making a very long investment in something called the Mach 1, and at the tail end of it, Ron Pearlman came along and lobbed a takeover offer and it was in part received by the shareholders because they were exhausted by years of seemingly dull performance that were really decent performance in the core business masked by the investment spending that occurred to develop the new project. It's rare that companies are willing and able to step up and make the full investment.

I think this is a lesson not in the global sphere but in the Omaha sphere that I've learned the best from Warren Buffett. If you look at his investment behind the equity index put option business which he took on just several years ago, well he received an enormous amount of premium for ensure against the decline in global equities. But he had a very long duration and he had no collateral posting requirement and there are all sorts of interesting things he can do with $5 billion dollars given his position and the time the money came in. But the one thing he had to do was he had to be willing as a result of that investment was he had to suffer enormous hits to his reported profits. And I think one of the reasons he received as much premiums as he did in that transaction was because very few people would compete for him on that business. Because who else wants to see the reported profits collapse or who else wants to have a minus 2 percent year when the Dow says it's up 27?

It's hard to be out of step and it's a rare company that can do that. He did the same thing when he grew Geico from the point where he acquired it. And he told management at Geico just to grow the business even though every new policy holder that was put on the books cost an enormous amount of losses the first year. They had high net present values and you've seen the history I think the number insured at Geico because of Berkshire's willingness to show the losses up front have grown from just under a million policy holders to almost 10 million and his spending to drive that growth that just burdens operating income up front has grown from $30 million a year to almost $900 million. And you know that it's the case because the only advertisement on television is a Geico advertisement of one shape or another. But the fact is by spending up front, having the elasticity the willingness to burden your income statement and then getting the results in the future is a very nice trade off.

The last thing he did was he kept $50 billion in cash and he still has enormous holdings in cash and if you listen to him speak about it it basically comes to us at sort of .2 percent returns at the moment. Now that's the capacity to suffer because he could extend the terms and get sort of 4 or 5 percent some place if he chose to but clearly he would risk our wealth if he were willing to chase reported profits. Berkshire did this throughout the 1990s – excuse me the period of the mid 2000 and beyond and bore the suffering of low returns of that money and it was just the opposite of what most American companies did. I think someone asked the question about what lessons were learned as a result the crash. One of the things that almost all American companies had done by the time 2008 came around, was they had taken their entire borrowings and brought them into the short-term overnight commercial paper market. And in so doing they took high interest rate long-term money and they took it down to overnight money, just the same Warren was making on that short term paper, they were gracing their reported profits by overstating them, by shortening the borrowing period. And the whole country got caught in that trade other than Warren. A perfect example is GE (GE), who had $100 billion of overnight money had to come to Berkshire and say we'll pay you 10-plus for $5 billion, whatever the number was. Goldman Sachs had the same problem. And it was really the willingness of Berkshire to suffer through periods of understated profits that put them in such a powerful position when the crisis occurred. A crisis that came about as you seek most public companies are just the opposite. They take risks with their future, and then they overstate their short term results.

It's a very rare business that has the capacity to look beyond. One of the things Warren said to our business class in 1982 which I thought was most profound had to do with agency costs. And he said basically you can't make good deals with bad people. In terms of the investment business that means you have to be very careful of who the agents are who are investing your capital. And if I said at the very start that my client's aim is to own businesses for a long time to defer taxes, and at the same time it's to grow that dollar in value, I have to be very careful of which management teams I select to then reinvest our money to make sure they do it with Buffett-like eye toward future growth rather than the conventional focus on short-term profits.

One of the ways that I've come around that challenge is to favor family-controlled companies. And so really since the 1980s there's been a vast preponderance of family-controlled companies in my portfolios. And that actually has two benefits. One is that family-controlled companies are often undervalued. Because the image of a rapacious families that steal from shareholders is so vivid. We saw it with Delphi in the U.S. We saw it – that's probably a good example. So that ability for poorly – well Enron wasn't family controlled – but when you have a business that has the ability to self-deal because of the family-ownership structure and a controlled board, you're at a risk and so people typically paint too wide a perimeter around family-run companies and they don't pay enough for the value that comes from a company that's properly managed where the family's looking out for the long term.

So I think that that combination of looking for 50-cent dollars, looking for them where they can reinvest to grow, and then who's going to reinvest it? They better be able to suffer because proper investment requires that.

One of the examples that came to mind in the global sphere is Charles Schultz, the chairman of Starbucks (SBUX), who several years back spoke to investors, and there was one nettlesome young analyst who kept asking the head of Starbucks when they would show profits in China. And the dialogue went back and forth: When will you show profits? He said, how big do you want us to be? When will you show profits? How big do you want us to be? And it went back and forth like this. And the answer was – and I think it's the true one – if you want us to dominate China, then let us not show profits for a long time. And if you permit that, we will end up at the final analysis with a dominant position in an important market with moat-like characteristics. If you try to establish, as so many American companies did, a base in China and do it without impacting earnings, you'll do it with a very small business that won't have a competitive franchise. And that trade off is just as clear an expression of this notion of the capacity to suffer. Now Schultz isn't going to lose Starbucks because he has enough stock to keep it on the course that he chooses, but there are many companies that don't have that control, most don't, and so they favor short-term results versus the long term.

And the last thing I guess I'd say, there were several questions about what's a competitive moat and what's the method you use to decide whether something is worth a dollar in the first place? I look for 50-cent dollars, but what is a dollar? And for me, it would be a business as a franchise and a business that has the capacity to reinvest money. A perfect example of that would be Nestle, where they've been in foreign markets for over 100 years, where their products have been in the consumer's awareness, but they've been unaffordable, because that broad consumer doesn't have the consumer disposable income. But that awareness and that pent up demand is really an asset that is largely missed when looking at a company. You think about the difference between Kraft (KFT) who Patrick said has suffered badly in its domestic cheese business, and a Nestle where they have a share of the consumer's mindset in 135 markets I think around the world. Kraft struggles mightily because of the domestic nature of their business and Nestle has the capacity to reinvest money broadly around the world and in an accelerated fashion because the world is growing in its consumer disposable income. An so I would look in general to the ability in the growing foreign markets as a source of what I think has over the years been a very important contributor to the performance you see on this table. From the early 1980s we've tapped into businesses that have had the capacity to reinvest abroad. And that's been a huge part of the business success.

Remarkably in something like Nestle's case I think it's grown just below 15 percent total shareholder return for the past 18 years, and I actually think today it's more promising looking out than it was when we started 18 years ago. And that's because of the addressable market that they now tap into allowing them to direct capital at an ever greater pace to expand their franchise and to build on the latent demand for their products.

Let's take a look at the start here. This is just a quick and fun – being a long-term investor, really means that you have to stay the course very often and I use this because at one point, just before the crash of 2008, I was in Africa and we went on safari and we saw dozens of animals and every time we would see one the tour guide would say, if you ever get separated from the group and you see this animal – there was a hippo or a lion or whether it was any number of things, small animal – and it charges you, stay put, don't run, stiffen up and it will not harm you, it will run past you. And that advice again and again and again, we saw dozens and dozens of animals. We came up to this one, it was a cape buffalo, and he said, and if you're ever separated from the group and you see one of these things and it comes charging at you, run like hell.

And the good thing about that is it kind of gives you a sense of what it's like to be a portfolio manager. You know, we're supposed to hold for the long term, and then comes along 2008 and you never know from a distance until it's right on top of you whether it's a water buffalo or whether it's something else coming at you. This is what I refer to when I say it's all about the future. It's about, you know, what Warren said at the annual meeting a couple of years ago: Investing is as simple as this rule. It's as simple as this and it's as hard as this at the same time. Because you don't know how many you'll end up with in the future and you don't know when they'll come. And it's fairly simple, but it's hard getting the culture right of the companies.

And the culture of Nestle which is a firm that I have nearly 11% of our funds in, was described by the former CFO of Nestle and the head of Japan at one time, by reference to this building. He described it as a 750-year-old temple. And he said, none of the wood is 750 years old because it's been refreshed and replaced over time because it rots and it has to be fixed up and replaced and but he said the temple's 750 years old and that has to do with regenerating a culture and keeping a culture going in a way that hopefully is owner-minded and that's really the hardest thing to know, whether a culture is owner-minded, and there's just so many cases in public companies that it's just not so, that it's rare to find it.

So in the case of Nestle the appeal is this brand portfolio, and these brands are familiar, trusted and already ubiquitous globally. When I visited our South African breweries operations in the remotest part of Angola and you go to a village, which is an extremely undeveloped part of the country, you will see any number – you'll probably see Maggi will certainly be there; Carnation will be there; depending on how advanced the country is you'll have this milk product called NAN. But it's there, it's available and what Nestle is waiting for as are the other global companies that we have, is they're waiting for the company to have migration and GDP from the left to the right, so as the countries move up the scale in terms of development then they have more money to spend, so you'll draw people out from subsistence level living – where they're providing for their own needs and nothing's really processed – to processed products which Nestle can start participating in and then process branded and then process branded with a higher price and higher prestige, until the very far right upper corner where we become aspirational.

But this process is under way in parts of the world that are probably 2 and a half or 3 billion more in total numbers of people than 20 years ago. And that's really what I try to tap into through the global companies that we've invested in.

It's an interesting thing that consumer disposable income at the start grows much faster than GDP, because what you're seeing in the markets that are just developing is you're seeing people who are coming into the workplace for the first time. And so in India today there's still over 500 million people living outside of the urban area. They're still largely in the age of subsistence farming. But as GDP grows, they're pulled from that level of existence into a monetized relationship with someone. That someone today typically – from the parts of the world that we trade in – is typically Chinese in some fashion or another. So if it's in Africa today it's going to be some form of Chinese company that's developing something in their great reach for resources, and they'll build roads and they'll do any number of things, and they'll bring people into the economy, and those people with cash for the first time, start to have disposable income.

And our job in meeting with the managements of the public companies that we meet with in the foreign markets is to make sure that they're spending enough money. Are they willing to spending enough to build in advance of demand? Nestle recently announced that they're taking their spending and developing of emerging markets up from a billion dollars a year to $2.5 billion a year. And anecdotally as they describe certain markets like India, where their results recently reported results were up 26 percent for 2010. It's a big market for them and already the growth rate is accelerating in that market for them. Or a market like Nigeria where they have such a large business for this Maggi. If you'll look here, the Maggi culinary business that's the second largest market in the world for Maggi and they're basically sold in one cube at a time but they become a part of the diet. And they've tripled the amount of business over the last decade for Maggi in Nigeria and they plan to invest behind another tripling over the next decade.

And people often say about Nestle, gosh, what's the hidden value? Because as a value investor the allegation is that somehow you're seeing value that there's some trick. In Nestle's case they had $40 billion dollars in holdings in a company called Alcon which they've now monetized and that money now sits on their balance sheet waiting to make investments. They have a third of L'Oreal, the French cosmetic company. And so the question is always is the cash the hidden value? Is the holding of L'Oreal the hidden value? How is the hidden value going to surface? And really the hidden value in Nestle is the capacity to reinvest. It's the brands that they've got and it's the awareness behind the brands, and it's the willingness to invest even when it hurts.

Nespresso, which is now a $3 billion brand, if you look there it's still growing at 20 percent. That's a very serious business, and it has yet to tap into markets like North America. It's still largely France, Switzerland, Germany. But has the capacity to grow enormously.

Nestle has invested even when it hurts. During the Russian ruble crisis, for example, anybody who did business in Russia with imported products had no business at all because the currency crisis prevented dollar-based commerce. When Russia plunged, Nestle went back into the market and doubled down. They built facilities; they made acquisitions; they continued t invest in marketing. The belief was the market had the capacity to absorb the investment, and at the time, if you think about it, at a time of massive crisis you get a lot more done. It's cheaper to build because there's a lot of spare capacity. Nobody's working. You can make a lot of meaningful advance. Today they have the benefit of a $2 billion-a-year business in Russia, and many people fled Russia at that time because they wanted to protect their income statement. In fact, ironically, L'Oreal, their partner, the company in which they have a third stake, left Russia at that time because they didn't want to show their reported losses, that would have come from continuing to build their business during the downturn.

Nespresso – Inside Nestle they all described that Nespresso was almost canceled a dozen times. Because the only thing it did from the start was consume expenses. I actually went to a Nespresso tasting lab maybe eight years ago when I visited Vevey [Switzerland], and there were five scientists sitting around; they were all wired up with electrodes in their nose, to sort of sniff coffee, and I looked, and it was just extraordinarily painful watching them sit around and talk about whether they had pronated or whatever they were doing. And I told the people there that while they sat and worried about the taste of the coffee, Starbucks had opened up five stores and they were moving along. The fact is they really invested hard behind it and they got it right and now it's a $3 billion business growing at 20%. But they suffered through that. And it all has worked out well for them. They had the capacity to suffer through it.

Another company I'd look at that did much the same thing was called Pernod Ricard (PDRDF). I've invested in spirits companies since the early 1980s, and Pernod was a family-controlled company, just like Brown Foreman is family-controlled. And they have been able to take bold steps over the years to expand their portfolio. They started with a French anise-based product, which is very cash generative but it's not growing at all. And over the years they've taken bold steps. And one that really transformed the business in the year 2000, China, which by the way is a market of 500 million cases of spirits. That's the addressable market. In the year 2000 the imported market was about 1 million cases, out of 500 million. And it favored Diageo at the time. And at that time it went through an early crisis of its own, and Diageo pulled out of the country effectively in the year 2000, having had the leadership position. Because there was no prospects of making money for quite a while there. Pernod Ricard – by the way, Diageo was being a perfectly publicly controlled company where they promised shareholders quarterly results, where they worried about failing to deliver against those results, and where they mined heavily the possibility of investment spending that might cost the income statement.

So, along comes Pernod Ricard, who had family ownership. They looked at the market, thought that a half a billion cases was a pretty attractive thing to shoot for. They went into the market, and today they dominate the spirits business in China. So it was a very painful period of time, burdened with a lot of operating losses during the start up, because it was a time when China's economy was soft. But the addressable market was huge, and the result of that is they now have over 50% of the import market, which even today is only 5 million cases, still 1%.

One that awaits is further advancing of the general economy and spending power of the Chinese and there's so many evidences of where that's surfacing that I'm quite comfortable that the willingness to suffer that they evidence is going to be extremely rewarding to us.

It wasn't an easy investment. If you look at during 2009 they stepped forward again and bought Absolut, which was a business that they came to terms on the acquisition in late 2008, and in response to a question was asked earlier – what did you learn during the crisis? – I had four companies which all entered into fairly sizable transactions. Heineken bought Scottish and Newcastle beverages; Pernod Ricard acquired Absolute; Altria (MO) bought UST; and all of them, all three of those companies, left the funding of their acquisitions open. So they were exposed to the financial crisis that occurred in 2008.

In the case of Pernod Ricard you can see what happened to their default credit swaps as a result of the market's apparent glee that this deal would be unfinancable and that Pernod Ricard would suffer a financing crisis. It was about at the peak here, if you look at the top, that I started to get calls from my short-selling friends asking me whether I knew just how troubled Pernod was, and by the way, they wouldn't be able to finance the deal, and by the way, it was the number-one shorted stock of the Euro 100 and it was 6% of my portfolio. So, that was one of my *mea culpas*.

But the fact is they were able to sell a brand called Wild Turkey and raise almost $1 billion, and they did a rights offering with the family and family-related accounts where the family then put more money back into the company because they believed in it. And that financing raised another $1 billion, and within this course of just a couple of months there they were able to stave off the financing crisis. And today they have what they believed they needed in the first place which was a vodka to accompany their leading Martel cognac, their leading Chivas Scotch whiskey business. So Absolut, which everybody here would agree, is a business that has certainly lost its luster, is a business that around the world has an enormous capacity to fill into their portfolio and to receive the benefit of their distribution. So it's a business that has recovered in the equity markets and yet they're willing to take the risk and suffer for the future, and they could do it, unlike Diageo, because they didn't have the burden of fickle, public shareholders.

Last company is SABMiller (SMBRY). SABMiller has grown from the South African roots to the second largest brewery enterprise in the world. They have the largest beer brand in China, through a partnership with China resources. They dominate sub-Saharan Africa, which has been a part of the world that's been entirely neglected. Today it's a place where they're directing an enormous amount of their capital. And that has to do with the sort of growth in Africa as a region economically. But if you look here, they have spent $500 million last year on Asia and Africa; they spent $250 million in the prior three years. And what you see has happened during this period of time, is the volumes in those markets have grown, the revenue has grown, but the EBIT margin, the EBITA margin in this case, has dropped sharply. That's a measure of the capacity to suffer. I mean the reason why that's happening is because they're putting out capacity that when it launches doesn't operate with peak efficiency, and knowing that building those markets, getting the brand in front of the consumer, will have long-term returns. They're willing to invest against that, even at the expense of margins. It's the one thing that I look at in the culture of the companies that we involve ourselves with.

By again the size of the addressable market, sub-Saharan Africans drink 400 million barrels of beer-like substances, but only 90 million of that are processed beers in bottles, in bottles, the rest is sorghum-based home-made beer. It's not taxed, it's not particularly well cared-for, it doesn't taste good, and over time it will convert with the rising GDP and the disposable income of Africa. There'll be a conversion from this old-fashioned traditional mix, to a proper beer. And so what SAB's in the process of doing now is building capacity against that likely demand, and they're spending an enormous amount of money now, at the expense of reported profits. Because it's expensive to develop new capacity.

As a global investor, a couple of questions that come up and have come up since I started investing abroad in the early 1980s. The first question was, what about currency risk? At the time, having been in business and law school, I had a healthy dose of skepticism about what the rule of law means in North America. We often hold it forth as something that protects us and secures our business interest. But it's also the source of enormous entitlements, and enormous amounts of money that gets spent in nonproductive ways. That's part of our system, and my concern as an investor in North America was always to be less exposed to a currency that was once illustrious. And over the course of the decades that we've invested abroad, you can see here these marked years that currency has played an important part in our return. It's given us about half a percent per annum for 20 something years, in terms of being a tailwind. We didn't invest abroad just to assume currency gains, but over time, and I think continuing so, I think the parts of the world that are more productive, hard-working, energetic, will see rising currencies, we'll get the benefits of those as the profits from those parts of the world are translated back to ultimately back to dollars, which will give us as investors, through these companies more spending power.

The other questions I've been asked as a global investor would include things like accounting, how can you trust the accounting? Well this is more an ancient concern. But when we first bought Nestle in the late 1980s, they sent out a three- or four-page semi-annual letter to investors that basically said, "Things are fine." That's it. Didn't say a lot more. But they were. And that was sufficient for me. But today things are much more Western-like, and there's more conformity. But the greatest crises have been American accounting-based over that period of time, so, I've been perfectly comfortable with the accounting, but that was initially if you can imagine, the sort of thing that kept people from moving their capital around.

Last observation I say is capital today still remains very trapped. I think of two companies in which we have investments, one is BAT, which is British American Tobacco, and one of them is Philip Morris (PM). They both are global tobacco companies, neither of whom directly operate in North America because of fears over litigation. In the case of Philip Morris, only 6% of their shares are held outside the United States. So it gives you a sense. It's extraordinary. They have 100% of their business non-U.S., but because it's incorporated in the U.S. for tax purposes, though based in Switzerland, the foreign market just doesn't touch it. So we still have the benefit, by having a global perspective. We can buy BAT, we can buy Philip Morris, but if 94% of foreign money doesn't desire to look at Philip Morris because it has a U.S. listing and we can buy the global non-U.S. tobacco leader at a price that doesn't reflect its fair value because of silo-ed capital, we're still given a bit of an advantage for having a global perspective.

Fifty-cent dollar bills: Make sure the dollar grows. How do you guarantee it to grow? Well you probably want to tap into international because that's where the money is, that's where the population growth is. Then you probably have to make sure that the company management, who control the reinvestment to secure that growth, thinks about owners and not quarterly profits, and has the capacity to suffer to in pursuit of that long-term wealth. So, that's really what I do for a living. Any questions?

Question: Given the spaces you're interested in, have typically acquisitive management teams, how do you stomach some of that… [garble]

Russo: In the case of an Absolut, one of the things that guides me, is the family is spending their money. It's just fundamentally different. The prices are – in doing so they had to spend against public companies that have less – they're less grounded in owner mindedness because they're competing against the whole universe of possible buyers plus private equity as well. But, you know, Patrick Richard doesn't want to overpay. It's his money. He ended up ponying up more money for this transaction because the financing crisis then ensued. I use the internal discipline that comes from having a shared affinity as one of the guides. In this case, you know, they have some extraordinary number of markets where they have less than 3 or 4 percent market share. And that's because in its prior life it was managed by a consortium of companies, none of whom particularly cared about distributing Absolut. And so it was just kind of introduced into the markets around the world begrudgingly. With the strength of the Pernod Richard distribution, it should have a nonlinear jump as they get the distribution and move it through their systems, save the money that they used to pay that third-party agent, and it could look a bit like what Patrick showed for Mastercard's (MA) numbers. It looked like a full price, but if they get it into their system, and move it like I think they're capable of doing, I suspect what they claimed when they bought it – that they could take a 10 million-case business into a 20 million-case business over a decade – has a chance of occurring, and that will more than amply reward us as investors. But the heart of it is that the family-controlled businesses are spending their own money. And that's a parallel interest that I rely on. Yep, Patrick?

Question: I know it's very hard to generalize, but as someone who has spent a long time studying consumer behavior, outside the U.S., are there any generalizations you can make about the propensity to spend more on grants, spend less, brand loyalty, cross culturally in different parts of the world?

Russo: Well there are a couple of interesting observations. These are quirky. In Japan, for some reason, there's no brand loyalty. It's a lockstep market. And Kirin Ichiban will be the brand of choice for just about that long, and then Asahi will come along with something called – aren't there Japanese people here? Maybe you can help me out. What is it? Happo-shu, or something that they came out with? Which is a lower-cost new beer category. And now the entire market switched. But it's just like this: It goes 40% market share to 5, from 5 to 40. It's so unusual. That's very quirky.

Luxury goods – really, there's just a different relationship with them in Japan and China than in the U.S. For example, the head of Richemont would say the North American market remains still relatively Calvinistic. And you know, how many American men in this audience have more than two watches? And you all have Latin blood or something. Johann Rupert would tell you, that American men don't invest in their own luxuries in North America. In Europe it's very common to have six or seven watches. And in China, we hope it's the same. We know that up until now they're spending a lot on them.

And the desire to possess things of, sort of positional goods, the things that mark… but positional goods are a really high-order global story. Just how they express – I said to you afterward, to your question about the growth in private label, it's an important question for me, since most of my portfolio is branded. You know I could show you what the names are actually, and you'll get a sense. Those are the companies in which we invest. And this shows the developed market exposure, the emerging markets exposure, and how we get a composite 30% exposure to the emerging markets through this universe of seemingly developed market companies. But private label, I think you could very clearly see private label products crop up in categories, and get enormous adoption in North America as we struggle financially and certainly in Western Europe, Germany being an example in the lead there. And at the same time have those products be very aspirational in the parts of the world where the demand's going to grow. So we have two worlds in some ways, and I'm comfortable with that. I think the private label is still a threat. And yet I think there are parts of the world where people celebrate the sheer act of buying their first can of Coke. Yep?

Question: In which products is private label more of a risk?

Russo: Um, the risk – I'll answer the question what companies and then what managements will allow, in some ways, their products to go private label. Depends on innovation. Depends on marketing. And it depends on relationships with the customer. If they can keep the customer focused on their product by giving them enough product news to draw traffic to the retail. And give them some margin in it. Because they're innovating with attributes that the consumer will pay up for. The customer won't be given a reason to look elsewhere. They don't have to look elsewhere. If they can get a proper flow of innovation, branding, and then margin from the manufacturer of the brands, they don't have to go anywhere else. The consumer will pay up if they feel like they're getting value for it.

A colossal mistake I think was the set of circumstances surrounding Procter & Gamble (PG) when Bob McDonald took over. A.G. Lafley defined this virtuous cycle about innovation – consumer inside innovation, rapid speed to market, high margin to the customer, advertising to express the arrival of products that are needed. And then during the downturn, Wall Street said, you know, it's not going to work, the private label's going to kill Procter. It's going to kill it. They have to respond. And A.G. said no. And Bob McDonald said I can do that. *Swoosh*. A.G.'s out, Bob McDonald's in. and they came out with some low-brand Tide, but this is not working. It's not where Tide's supposed to go with its brand. Tide's supposed to innovate and then draw the consumer up, and then constantly close down the low end. But they took it thinking they needed to compete with private label. I think they made a strategic error there. Yes?

Question: Out of curiosity, you mentioned a couple European names, what is your view on LVMH [Moet Hennessy Louis Vuitton] (LVMUY)?

Russo: It's just a terrific collection of assets. I haven't owned it. And it's been in part – I just haven't felt as comfortable with the family that controls it, as I have with Johann Rupert and the way he's treated outside shareholders at Richemont. And then I'm not so sure that they're as long-term brand stewards as are the people who run some of the other businesses in the industry.

I'll give you an example. They had this wonderful advertising campaign for LVMH Luggage, which showed this woman sort of stitching, hand stitching, a LVMH bag, and it had all the aura of history and luxury. And their competitors called them on it. And said, you don't do that. You don't do that. You glue it on. And you don't stitch. You're misrepresenting it. So they were taken to court on deceptive marketing practices and they had to pull the ad.

[Question 2]: But would they acquire Hermes?

Russo: Oh they'd love to get Hermes. But the fact is, they don't do that. They don't invest in the time and the care to deliver the brands that they suggest they do. And that's usually a sign of something amiss. Short term versus long term. I don't think that over time if people thought they're buying stitched and it's really glued that they'll be building brand equity in the process.

Question: What advice do you have for an emerging market value investor who we don't have a decade of years of relationship building with investors before you, like in 1999 in managing new investors as they come in?

Russo: Great question. I just don't know what to say. Because if you invest in India, you would have seen the market go down 70% one year and back up 70% one year. And I think it's very, very difficult to make sure the investors don't do the wrong thing on both sides, you know, that they don't sell after being beaten down and don't buy only after the markets have come soaring back.

You could use a lock up. Or you could go with private equity. Private equity doesn't have a quote, so you're allowed to build the business under the quiet lack of transparency that comes with your own mark. And then lock up can help you as well. Over time I think it works, but you've got this enormous human element there. Yes, Paul?

Question: I'm just curious, Tom, your portfolios – do you have any investments in China or India directly as opposed to participating through other companies, and why if you do or if not?

Russo: It's a great question, and we will. We will have direct investments in China. I'm going to go in two weeks to see Diageo (DEO). And by the way I mentioned that Diageo left China, and opened up the market for Pernod Richard, and I think they'd agree with that. I still own Diageo. You know, as an investor you're not given 100% perfection when you choose between your investments. And Diageo is itself a great company. Terrific brands, they have great global reach and all the rest, they just blinked at the wrong time in China. Now maybe they'll learn the lesson and maybe they'll promise less smooth and steady results. But I'm going to go visit with them in China. While I'm there, I'm going to meet with a company called Hengdeli, which does luxury watches and jewelry in China. Whole bunch of Chinese companies will be part of the visit. And someday we'll be able to invest in one.

I met with the CEO of Nestle recently and I asked him why Bright Foods has turned out to be the bride's maid and never the bride. I should use that today because of the royal wedding. But he said just wait, because he's now seeing globally competitive companies based on technology and branding and manufacturing in China, and I should just stay tuned, and Bright Foods is a great business he said. And just last week they bought a 60% stake in one of the companies that had been making them on contract basis their Nescafe in China, and they paid up almost $1 billion. Now they have $35 billion to spend at Nestle because of the proceeds from the sale of Alcon company. So they have to do a lot of deals like that.

I met with Johann Rupert who runs Richemont (CFR) in June of 08 when I was on that safari trip – he's based in South Africa – and we were talking about Richemont, he said, the beauty of Richemont is we don't have to make investments anywhere, we can just make them where the best returns arise. And he said, for example, then he was putting absolutely no more money into Japan, which had been 15% of their profits, because it was so badly ex growth, with the declining population, no immigration, problem economy. And it's a beautiful response because he as a multinational, global franchise can put the money just where it has its highest prospective returns. He's pouring money into China now. But sometime the returns in our lifetime may even go down in China. I'm not sure it will ever happen. It's a big country and it's a growing prosperity one. But the beauty for Richemont is that they can move the money all around. If I invest in a Chinese-only company, up until the present case, I don't think they have the reach globally. You've got Lenovo. You've got Haier, and a couple of them, but they're not businesses I particularly want to go into. I'm not sure yet we're at a point where a business in the field that I'm focused on has the global reach.

And then the other thing is there's just different ethics. In my field there are probably half a dozen incidences a year where local Chinese manufacturers of baby powder tainted with melamine and kids die. And that shows that there's a pressure in the emerging markets to kind of make it fast, that's different for someone that wants to invest with a really long-term horizon. Those are segregated incidences and it's not true of the whole country, but it happens more frequently than you'd like to see. And that's just the nature of a fast-developing economy.

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