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THE WALL STREET TRANSCRIPT

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## The Money Manager

**CLAUDE R. CARMICHAEL  
CARMICHAEL CAPITAL INC.**



(ZM501/02e) CLAUDE CARMICHAEL is President of Carmichael Capital, Inc. He holds a B.A. from Duke University and was previously affiliated with WR Lazard & Co., Oppenheimer & Co., and Merrill Lynch. He is a Chartered Financial Analyst and a NYSE Supervisory Analyst. He is a member of the New York Society of Security Analysts. Mr. Carmichael is married, has one child, and in his free time enjoys piano, guitar, composing and sports.

(ZM501/01)(5422) TWST: Okay, tell us about the focus at Carmichael Capital.

**Mr. Carmichael:** The focus here is on value investing. My training has been in value analysis, starting at Oppenheimer & Co. over 15 years ago. The last time you and I spoke, I was part of The Value Group at W.R. Lazard & Co. which was dedicated to coming up with value-oriented investment ideas. About a year and a half ago I set up my own company to continue doing the kind of value analysis and investment that we'd always done, but with a little more freedom with my own company.

**TWST:** First of all, value means so many different things to different people.

**Mr. Carmichael:** Using the phrase "value investing" doesn't tell you a lot until you define it. In general terms it simply means that you believe in buying stock in companies at prices which are less than the current value of the business. This is fundamentally different from growth stock investing in which you buy stocks on the assumption that future growth will justify a higher stock price. It's interesting the way value analysis has developed. The classic case was developed by Graham & Dodd, the fathers of value investing. If you could shut down the business, sell all the physical assets and end up with more money than the stock price, then you had a good value investment. Warren Buffett extended the idea of value beyond that of physical assets to include things like franchise value. That is, you wouldn't shut down Coca-Cola (KO) and sell off all the syrup and the bottling equipment and make money, but you could certainly continue to run Coca-Cola with their brand recognition and make a lot of money. There's a lot of value in that name! So what we look for starts out with numerical analysis and then gets into estimating the value of other assets, like franchises and brand names. It all comes down to the cash flow that can be generated from the company either through asset sales or continuing to run the business. Beyond that, everybody has their own style even within the value school.

**"Fruit of the Loom: They have a couple of things I like, which is name recognition, high operating margins, low cost production and terrific growth opportunities in extending their brand name."**

--Claude R. Carmichael

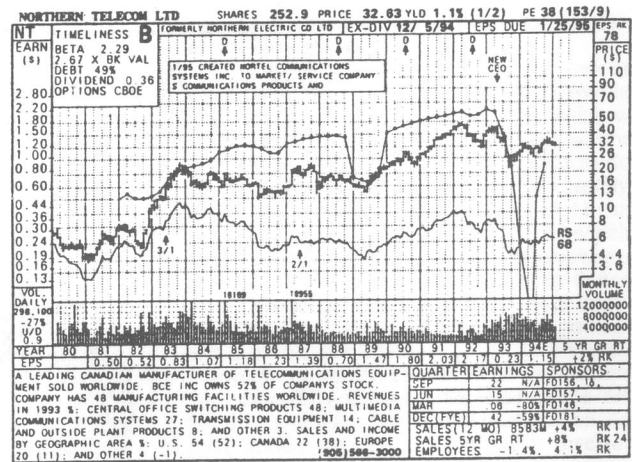
I find that our greatest success is in two areas: unpopular large cap stocks and underfollowed small cap stocks. In following the value approach, you often end up being somewhat contrarian by reason of necessity. The word "value" means that it's a good value, and that means the stocks are cheap. Well, if the stocks are cheap, they're cheap for a reason. The companies we buy represent value because they are either unpopular, misperceived, or underfollowed. You don't find the companies that I buy being touted on the front page of all the investment journals as the new wonder companies. In fact, I get very nervous if they start to become popular because that is often when the disparity between value and price disappears.

We've had quite a bit of success in buying big-name companies that are coming out of a phase of being unpopular and are basically turnaround plays. The bigger names in the past have been companies like Sears (S, 45) back in '90 when it was trading around \$20 and before it started cleaning itself up. Everything from AT&T (T, 49½) to Eastman Kodak (EK, 48½) to, more recently, companies like IBM (IBM, 72½), Digital Equipment (DEC, 32), Northern Telecom (NT, 34½), and American Express (AXP, 29¾) are companies that have undergone pretty terrific restructurings. There was a lot of value in these companies but it needed to be realized by a management team that was willing and able to take the difficult steps needed. I've always held the philosophy that there's very little analytical expertise that I can bring to the highly scrutinized large cap stocks that is greater than what has already been applied. In other words, I don't profess to be such a genius that I can figure out the fundamental story better than those 100 analysts who are

following IBM, for example. The advantage I do have is that I can be nimble. I can take advantage of the big boys' problems and I can exercise more patience. That makes me willing to buy stocks when they are down and unpopular. IBM is a good example right now. We bought that a little early, in the high \$50s to mid \$60s, just before they cut the dividend and announced record losses. Then we watched it go to \$45 -- we were sweating bullets for a while. But the value, as it turns out, seems still to be there and the stock's back in the \$70s. So it looks like we're being vindicated on that one. It's not that I'm any smarter than the other analysts looking at IBM. It's just that our value criteria didn't let us buy it at \$180!

The small cap stocks we buy tend to be underfollowed; few people pay much attention to them. So our small stock picks can be both misperceived and underfollowed, but they normally aren't particularly unpopular because they aren't very well known in the first place! The big cap names are the ones that tend to be very unpopular. By the time everybody has gotten thoroughly disgusted with them, that's about the time we're willing to buy -- if we see value there.

## NORTHERN TELECOM



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**TWST:** You were talking about sweating bullets, that's a typical side effect of your large cap strategy. Do you have to have a catalyst in the small cap area?

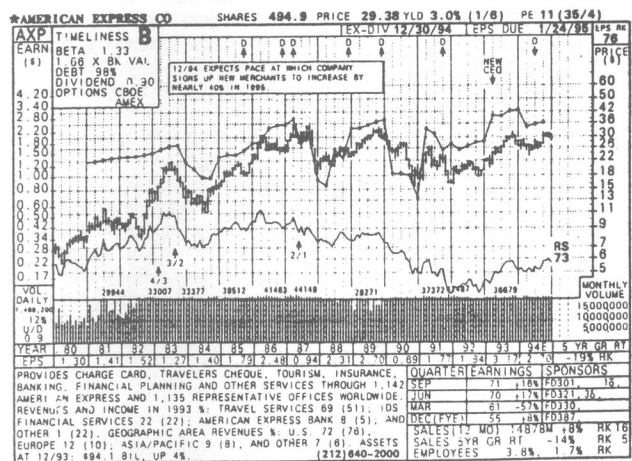
**Mr. Carmichael:** Well, you look for a catalyst in any of them. Sometimes it's more exciting in the small cap stocks because they are more easily taken over. We were very fortunate just recently when a major position of ours, Pet, Inc. (PT, 25¾), got a tender offer for \$26 a little over a year after we'd bought it at \$16. But I always like the idea of having more than one reason to be right. Some of the catalysts we look for are earnings turnarounds, restructurings, asset sales, spin-offs, and stock buybacks. They can all help. We find some of the smaller caps give us the bigger percentage returns, but the larger cap stocks give us what I call the core holdings. These are the companies we can buy and put away for a good long time, where the value is better established and we don't have to worry as much about getting killed in them. When the market pummels smaller over-the-counter stocks, ours may get hurt, but the balance of large caps keeps us from getting hurt as much. So we have a somewhat defensive position in the core holdings of the big caps. In the small caps, if we're right we can make a higher-percentage return. The combination of the two makes for a pretty good overall return.

**TWST:** Do you ever find that you're investing with themes in mind? It doesn't sound likely; it sounds like your approach is purely bottom-up. But I wonder if you find whole areas that are overlooked or undervalued.

**Mr. Carmichael:** We occasionally find whole industries which are very unpopular where we see a lot of opportunity. One

of the themes in the past year or two has been the drug companies, which were wildly popular several years ago. Growth rates were very high, but things began to change. The stocks dropped and the excuse was that the health care reform was going to crush the drug companies. Well, what most people didn't realize was that the growth rates of the drug companies were slowing anyway because it was impossible to sustain without severe strain on major portions of the economy. So I think what was happening in the drugs was a slowdown in the growth rates at the same time that you had a terrific scare thrown into the equation by the uncertainties created by the Clinton health care proposals. Drug company stocks got slaughtered. Well, we started picking up a number of them. In fact, we ended up owning four or five major drug companies in which we're beginning to make a little money. We're not knocking the lights out yet, but we own companies like **Warner-Lambert** (WLA, 74), **Bristol-Myers** (BMY, 59¾), **Upjohn** (UPJ, 32½), and **Merck** (MRK, 38½). **Merck** is beginning to work nicely after their takeover of Medco. These stocks have been through the mill. After all that pain, a lot of people hated them. They then fit the criteria we were looking for, companies that had fallen from favor, and had become what I thought was overly depressed.

### AMERICAN EXPRESS



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The end of that story hasn't been told yet. The drug stocks seem to have bottomed and are slowly working their way back up. But we're patient, so we don't expect them to double or triple in the near term. Value investing often doesn't give you those quick kinds of gains that growth stock investing sometimes does. But in the meantime, you tend to have some comfort in what I call the trampoline effect. If you buy good value, you may certainly see the price go down, but there is a trampoline effect that generally pulls you back up from below certain levels. The trick is to figure out how low the trampoline is, where you stop freefalling and start being bounced back up by the discrepancy between the depressed price and the higher value of the company. So the drug stocks became a whole industry where we found a lot of value. We also ended up buying a bit of technology in that both **IBM** and **DEC** were similarly slaughtered. Title insurance companies are also beginning to look attractive again as the prices have come down.

**TWST: How long do you typically hold a stock? Do you have what would be called "a core position," or is a core position sort of a "failure?"**

**Mr. Carmichael:** A failure? No. We try not to make the classic mistake of cutting our profits short and letting our losses run. If you do that, your core positions can certainly end up being all your failures. Luckily we've done a pretty good job of avoiding that. What I call "core positions" are really companies where I just see such good long-term value in the company that

I'm reluctant to sell it for short-term profits. Some of these companies may be theme stocks, like those in the telecommunications businesses. A little over a year ago, telecommunications companies were wildly popular, and we lightened up about half our position in them. I get very nervous when companies I own are on the front pages of financial publications, and that began to happen with these stocks. Remember, that was when the information highway became the Infobahn, and then the Road to Investment Heaven. However, I didn't sell the entire position, the reason being that the long-term trends are so powerful in that business that I'd rather be there, at least to some extent, than not at all. Luckily, we did sell part of it before they fell back. We hung on to some, because of the fact that this is an industry that is probably going to continue to grow for the foreseeable future. If you're an investor, if you have good companies in that business, you probably want to stay there for the ride and not try to get too smart. One of the problems in investing is that you can easily outsmart yourself by selling good companies at reasonable profits and then see them continue to grow year after year while you are left behind with a small profit. So I try to avoid that on what I consider to be good, long-term plays.

**"The value of those stocks held by FTX looks to me like it's over \$20, while FTX is trading at about \$17. It is a good way to buy a good commodity-inflation-hedge stock at a discount."**

**--Claude R. Carmichael**

**TWST: Now, let's find some recent favorites in, first, the large and then the small cap area.**

**Mr. Carmichael:** Okay, a recent favorite in large cap. We don't make interest-rate prognostications. However, I'm always on the lookout for interesting contrary indicators. Last October, bonds had been going down for about a year and long-term rates had been going up with short rates up pretty dramatically. I was watching a football game and Jim Palmer came on in an advertisement for "The Money Store." In his admonition to refinancing now, he was telling people not to wait because, "...most experts agree, interest rates are going up." A little alarm bell went off in my head saying, "If Jim Palmer is in a commercial on TV telling everybody and his brother that interest rates are going up, it's probably over already." Markets have a habit of behaving in such a way as to frustrate the expectations of the majority.

Consequently, I started buying some securities with good yields because of the fact that the yields had become so attractive and also because the bearishness was so intense. So one of the big cap names we bought was not **DEC** common (which would have been a very good investment at \$19 or so), but the **Digital Equipment** preferred A (**DEC prA**, 23). We locked in about a 10 percent yield with the potential for another 10 percent or so capital gain over the next few years. It probably will be called in several years if rates are anywhere near here and the company's results get stronger. I didn't quite have the courage to buy **DEC** common, which, in retrospect, would have been a good buy. I figured the preferred was a good, conservative way to play the restructuring at **DEC**. It also fit in with our big cap value orientation since the company had been very unpopular and, I perceived, was doing some of the right things that would turn it around. The common stock has borne that out recently, going from \$19 to over \$30. The preferred has moved up a fraction, but I still think it's a good investment.

Another theme which has led us to some large cap value stocks is, as one of my friends calls it, "Buying the arms manufacturers in the communications war." We have a pretty large position in **Northern Telecom** (**NT**, 33%). **Northern Telecom** is the largest Canadian company in the telecommunications manufacturing business. There are basically three big companies providing the digital switches that are needed worldwide, and these are the arms manufacturers in the

communications war: **Northern Telecom**, **Ericsson Telephone** (ERICY, 55) and **DSC Communications** (DIGI, 33). The last time we spoke we talked a lot about **Ericsson**, which was a classic turnaround in a big cap name. For various reasons, one of which was that it is a European company, it had not been fully appreciated by American investors. It did go up fairly dramatically soon thereafter and we sold it. It is still somewhat above our price target now, as is **DSC Communications**. **Northern Telecom** is only a few points above our buy price, but we've been a recent buyer when it slips to the high 20s. **Northern Telecom** has undergone a restructuring and the beginnings of a return to popularity similar to the way **AT&T** did several years ago after the Baby Bell break-up. **NT** fits the classic "turnaround and return-to-popularity" big cap play we've been talking about. It also fits our theme of participating in the continuing growth of the telecommunications business worldwide since they're one of the major suppliers.

**"Fidelity National Financial has been pretty aggressive in their takeover practices, and they've almost always done a good job of increasing efficiency at the companies that they take over."**

**--Claude R. Carmichael**

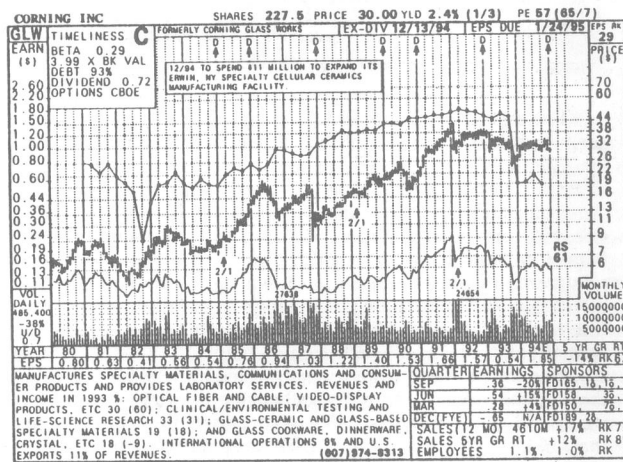
**American Express** (AXP, 29¼) in the high \$20s is another example of what we are buying now. It's a wonderful company that fell on hard times, another typical big cap, unpopular company which is now doing the right thing. They're now beginning to bring the earnings to the bottom line, a goal which had frustrated them for so long. They'll probably earn \$3 this year and \$3.45 next year, a \$29 stock -- and they have a very valuable franchise, which I think they began taking the right steps soon enough to salvage. There was a danger at one point that **American Express** was going to blow it, and I think, to a certain extent they had. They had alienated a lot of consumers and retailers, but I think they turned that around and realized once again that they're a service company. I had a bad experience with them myself several years ago when I asked them to do something, they didn't do it, and they gave me a hard time about it. I wrote a letter to clarify the problem and they responded in a fairly high-handed way. They explained to me that I was in danger of losing my "privileges in the club." They put it in terms like that. I wrote them a letter back saying, "You know, I also have Visa and MasterCard, and **American Express** is not a club to which I feel I absolutely must belong." They sent me back a very apologetic letter and took care of what I'd asked them to do. But it was typical of the attitude they had towards their customers at the time. The idea was that we were supposed to feel lucky that they would let us do business with them. A number of retailers I spoke to thought the same thing. I think they've actually gotten their philosophy straightened out so that they realize once again that any company, to be successful in this decade, is going to have to realize that service to the consumer is of utmost importance, not secondary importance. That change in philosophy, along with the financial restructuring that they've undergone, has put **American Express** back on track. And it's on its way to becoming popular again. They also have very interesting plans for creating value from one of their greatest assets, a centralized database of the buying habits of a large portion of the American public. The value of that information is not often recognized by investors. It will be very interesting to see the creative ways they come up with to capitalize on that useful little asset.

**Corning** (GLW, 31½) is a major company in four areas including telecommunications. It overlaps the telecommunications "arms providers" in that they are, with **AT&T**, the largest manufacturers of fiber optics. Obviously, the pall that was cast over **Corning** was largely due to the problems involving the liability for materials used in breast implants. That, I think, has been sufficiently discounted in the stock, and they have put enough money in the liability accounts of the subsidiary involved

to substantially cover the claims. That subsidiary is a joint venture with **Dow** (DOW). Here is another turnaround situation where a company fell on hard times in a number of areas, became very unpopular because of one major event, and the stock went way down because few people want to own it anymore. The rest of the company's businesses are still extremely valuable, so that if you start breaking them down and looking at the values of them separately, you come up with a number quite a bit higher than the current stock price. Whether or not the joint venture has completely funded the liability for breast implants, I believe that **Corning** is on its way back to being a highly profitable, premier American company again, after going through a pretty tough time.

Another one of these turnarounds with a well-known name is **Fruit of the Loom** (FTL, 24¼). This company has somewhat of a franchise value, good name-recognition at least, and is fairly unpopular again after having gone through several cycles of being wildly popular and wildly unpopular. The thing I like about **Fruit of the Loom** is that they have the opportunity to take an underutilized brand name and get more value out of it. **Fruit of the Loom** is one of the brands with the highest name recognition in the country and probably in the world. It's fallen on hard times recently and the stock dropped from \$49 to about \$25. They've done a number of the right things. They are now a low-cost producer after quite a bit of investment. They are providing products to the mass distribution retailers (**Wal-Marts** and the like), taking advantage of a major trend that is taking place in retailing. They have very high consumer recognition and they are beginning to extend their product line beyond what they call "basic apparel items." I love the term "basic apparel items," by which they mean underwear, T-shirts and all those things we have to wear to get out the door in the morning. So they have a couple of things I like, which is name recognition, high operating margins, low cost production and terrific growth opportunities in extending their brand name. The stock is fairly unpopular at the moment. Bill Farley is no longer adored by the public as he once was, and although he still owns 9.3 percent of the company, he no longer has voting control. So he has an incentive to get his stock up but he can't control the board of directors. So I think **Fruit of the Loom** is an undervalued megabrand that is in the process of turning itself around.

## CORNING



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### TWST: Do you invest with target prices in mind?

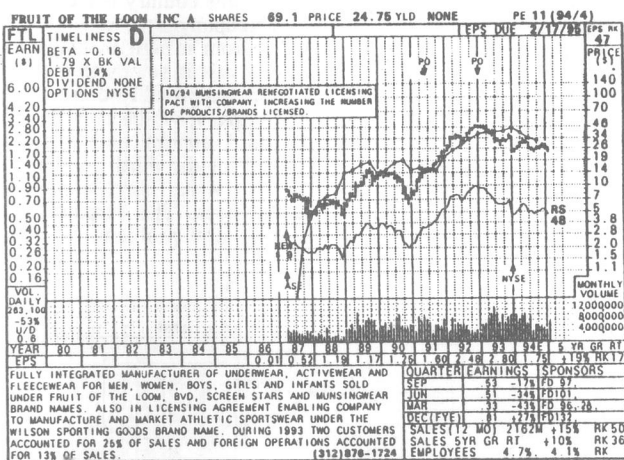
**Mr. Carmichael:** Usually not. What I try to do is buy companies that I perceive to be undervalued, and when they become relatively fairly valued we try to sell them. Another problem is what is "fairly valued." A company can be "fairly valued" relative to the industry, relative to the market, or relative to what you consider to be the long-term business prospects of the company. We use the latter. So if we determine that the

long-term prospects of the company are "fairly valued" in the stock price, then we sell it. Therefore, we may hang on to a stock if the general market is depressed. For example, if the market's trading at 8 times earnings and our stock is trading at 8 times, then, even though it's a fair value relative to the rest of the market, we may hold on to it because we think the long-time prospects are better than 8 times earnings would warrant. So we don't use a market-relative benchmark, but one we consider to be tied to the long-term prospects.

**TWST: It's the same analysis on the way in as out basically?**

**Mr. Carmichael:** Right, very much so. Consequently, when markets are down, we find more to buy than when markets are up. We don't keep a set percentage in stocks and disregard how expensive stocks are in general. We set buy-price targets for virtually everything we buy, and if the company is not in that range, we will not buy it. The good part is, you end up imposing some discipline on your investing. The downside is that you occasionally miss companies like **Microsoft** (MSFT, 60), **Home Depot** (HD, 47½), or even **Wal-Mart** (WMT, 22) in its highest growth phase. They never got cheap enough for us. We've basically made a decision to give up the potential of some of those high-flyers in order to avoid the terrific losses that can come with chasing growth. Recently, the market has pummelled stocks that have disappointed growth investors. We have taken a philosophical position that it's better to take a more conservative position and hit a lot of singles and doubles than to try to hit too many home runs and strike out a lot.

**FRUIT OF THE LOOM**



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**TWST: How has value investing changed in the years in which you've been involved in it? Can one do well investing by the old rules?**

**Mr. Carmichael:** Wall Street is as much subject to fad, if not more so, than any other sector of American society. One of the advantages of dealing with somebody who is experienced on Wall Street is that they have seen the fads come and go. I tell my clients that one of the things that they really employ me for is to keep them out of what I call the dangerous parts of "the exploitation cycle." The exploitation cycle is a term I use to encapsulate what we just talked about. Companies, industries and markets in general go from being wildly unpopular to wildly popular and back again. So what I try to do is spot the fads and, using a discipline we call value investing, buy the things which are out of favor and sell those as they become fads. So we try to avoid the downside of the cycle.

Like everything else, value investing itself has gone through several cycles of being in and out of favor. It was very much in favor in the '80s. When the market was very low, starting off the bottom in '82, there were many stocks that showed up on the value screens from a purely statistical analysis. Quite a few of

those stocks did very well because you literally could have shut those companies down, sold off their assets and made more money than the stock price. You could use the classic Graham & Dodd criteria at that time and find a lot of stocks that met them.

By virtue of the fact that we had a good long bull market, a value investor couldn't find many of the classic value plays anymore. (It helps to remember that Graham & Dodd developed their specific criteria at a time when the stock market was pretty depressed.) Not finding as much to buy, a lot of value investors started loosening their definition of value, or trying to find value which didn't show up numerically. About this time Warren Buffett became known for expanding the definition of value beyond simple statistical measures to include the very valid concept of "franchise value." It was interesting then to see other value investors take the idea of franchise value and extend it far beyond that to what turned out to be fad value. Certain companies had very little franchise value, they just happened to have a hot product and a hot market for a short time. These were not true value investors, but they adopted the name and stretched the definition to suit themselves.

As markets go higher, value investors find fewer and fewer stocks to buy. That becomes a problem, especially for brokerage firms because they are in the business of getting customers to buy stocks, whether or not stocks are high or low. So you find a lot of the recommendations coming out as value stocks which really are not. Growth stock investing can provide spectacular returns when markets are hot, and value investing sometimes gets left in the dust. So generally, value investors only get the cheers when the growth cycle has slowed down as it recently has. Suddenly growth investors are seeing their stocks go down 60, 70 percent and the value investors are holding their own. People start saying that they'll try value investing again and the cycle starts over.

**"Repap has gone through a gut wrenching period. The stock went from \$12 to just below \$2. More recently, the company has turned itself around at the same time that there's been a cyclical low and a subsequent rise in the price of coated paper."**

--Claude R. Carmichael

**TWST: Let's look at some of the smaller ideas, if we may. I assume that I've never heard of some of them.**

**Mr. Carmichael:** I hope not. One of the smaller companies that I think is extremely interesting falls under the heading of unpopular and underfollowed, if that's possible. Very few analysts on Wall Street seem to pay much attention to the stock, and those that do don't show much affection. The company is **Repap Enterprises** (RPAPF, 5). Have you ever heard of it?

**TWST: No.**

**Mr. Carmichael:** Good. That reinforces my case! **Repap Enterprises** is a Canadian company based in Vancouver. It is one of the largest paper companies in North America. The largest portion of their revenues come from coated paper. Coated paper is the kind used for magazines and catalogues, with shiny, glossy, colorful pictures that we all like to see and have to pay more for if we want them to look that good. The big players in coated paper are **Champion International** (CHA, 40¼), **Consolidated Paper** (CDP, 47¼), **Scott Paper** (SPP, 70¾), **Repap** is fourth, then **Mead** (MEA, 50¾) and **International Paper** (IP, 73¾). You've heard of all these other companies and nobody seems to have heard of **Repap**. **Repap** has gone through a gut wrenching period. The company took on too much debt several years ago. They spent a lot of money adding to and improving their machines and mills. At the same time the prices for coated paper were dropping to new lows. For the past several years, that leverage was definitely working against them and the company had huge losses. They ended up having to restructure their debt and the stock went from \$12 to just below \$2. More recently, the company has turned itself around at the same time

that there's been a cyclical low and a subsequent rise in the price of coated paper. Here a company with about \$1.4 billion in long-term debt and a market value of about \$600 million in the common stock began to see the leverage work to their advantage for the first time in several years. The cash flow and the earnings are beginning to pick up, so it's a classic turnaround. Once the earnings begin to flow through to the bottom line from the price increases that have recently taken effect, the company's profitability is magnified because they are now a state-of-the-art low cost producer. They also have a \$350 million tax loss carried forward, which means that they won't have to pay taxes for the next several years. They can earn up to \$1.65 per share and \$2.40 of cash flow within the next three years and the stock is only \$5. So in the past it's been unpopular and it's definitely underfollowed. I only know of one analyst in the country who writes about the stock. I think this is the kind of turnaround low-cost producer in an improving industry that could be a big winner.

**TWST: Where is it traded?**

**Mr. Carmichael:** It's traded on the OTC market in this country.

**TWST: And in Canada where is it traded?**

**Mr. Carmichael:** Toronto.

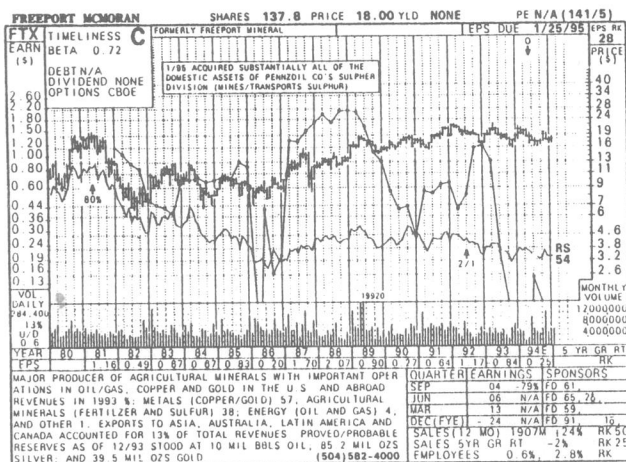
**TWST: I was wondering if you ever go into the less mainstream exchanges to find stocks?**

**Mr. Carmichael:** Very seldom.

**TWST: So you wouldn't necessarily fish for a stock on the Vancouver exchange?**

**Mr. Carmichael:** No. I try to avoid the places where I perceive the speculative excesses to exist. I'll buy an occasional ADR (American Depository Receipt). I'll buy an occasional over-the-counter stock in a foreign company. But I really try to stay away from investing in secondary exchanges where I might more easily get blindsided by what I don't know.

### FREEMPORT MCMORAN



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**TWST: Do you want to talk about another overlooked stock?**

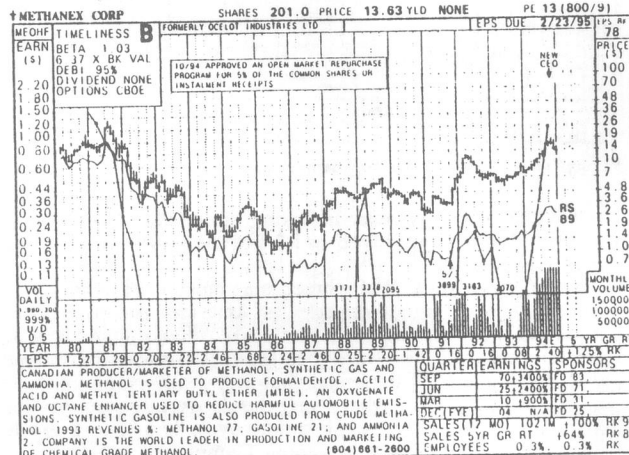
**Mr. Carmichael:** Yes. There's another little company that has a similar story to the one I outlined for **Fruit of the Loom**, a case where management is increasing the value of some well-known product names. I believe very few analysts cover this company too. **Sport Supply Group** (GYM, 11) is a sporting goods company based in Dallas, Texas. They are a direct mail marketer of sporting goods equipment to institutions and organizations all over the country. It actually caught my eye about two or three years ago when it came across the tape that **Sport Supply Group** had bought the rights to the name **McGregor** for sports equipment. When I was a kid I had a **McGregor** baseball glove which I loved. Occasionally I would be given a **McGregor** baseball, too. It's not one of the bigger names

in sporting equipment, but I wondered what had happened to **McGregor**. So I started looking into **Sport Supply Group** and I found a very interesting little company, it caught my eye because it looks like a little growth company in a non-growth business. Revenues will probably be over \$90 million this year and they've been growing fairly quickly. Their revenues have been growing in the mid 30 percent range and they will probably be able to sustain something like 25 percent revenue growth in the near future. The stock's trading at about 12 to 13 times this year's earnings. Management owns about 15 percent of the company. The institutions they sell to include public and private schools, corporate organizations, leagues, coaches organizations, civic organizations and the government. Their business with the federal government represents only about 6 percent of their revenues, supplying sporting goods equipment for armed services personnel.

I noticed that revenues continued to grow pretty fast and they bought or licensed more and more of what I consider to be well-recognized brand names. At the moment they include **McGregor**, **AMF**, **Voit**, **Gold Eagle**, and they license **Arnold Palmer** golf accessory products. The company is run by a couple of guys who own a fair amount of stock and who seem to have a talent for increasing the sales of these brand names and smaller sporting goods operations. For example, they took **Gold Eagle** golf accessories from something like \$1 million in sales to \$15 million within a few months time by plugging these new products into their distribution channels. There is also a pretty strong demographic trend here in that they are selling brand name sporting equipment directly to schools and leagues at a time when the baby boomers' children are getting into sports in a big way. The popularity of sports in this country is increasing. So it looks like a very interesting company.

Then the stock got hit recently from a high of about \$17 down to about \$10-11. So at these levels it begins to get very interesting to me. Last fall they were supposed to close on the purchase of a hockey equipment company, which they thought might close by the end of the third quarter and it didn't. Consequently the costs were booked for the third quarter, but none of the hockey company's revenues were. Some people were disappointed with that and sold the stock. The earnings were affected, but I don't think it's a long-term problem.

### METHANEX



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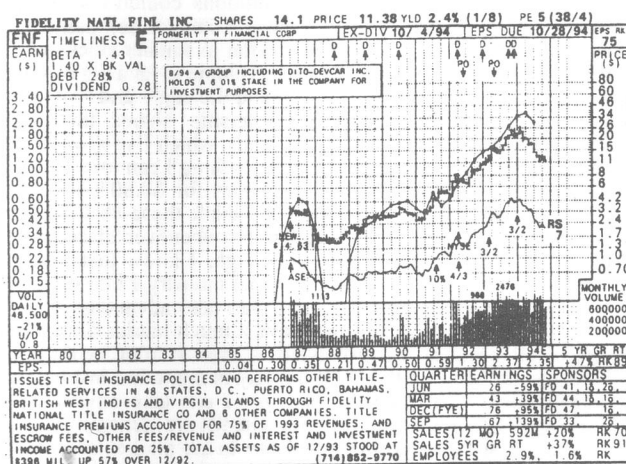
They've also gotten into a very interesting business with what is euphemistically called "experienced" golf balls. People like me buy these things because the balls have more experience than we do. Also, my experience with each ball tends to be somewhat short-lived, and these are a lot cheaper. **Sport Supply Group** has bought a lot of little mom and pop operations that recycle and resell golf balls. And they've been able to increase the profitability of these and other acquisitions of small

companies. The factor that's kept this company out of most people's screens, I think, is that they only had 3.7 million shares a little over a year ago, and they issued 3 million shares over the course of the last year. So although their earnings growth and revenue growth was dramatic, the earnings per share growth was not, because of the almost doubling of the number of shares outstanding. They seem to have taken care of their financing needs for the foreseeable future, so the company's earnings growth should start showing up in the per-share numbers now. Once the earnings per share start increasing, I think more people will be interested in the company. If they can sustain their growth rate of 25 percent over the next few years, the value of this company could go a lot higher.

**TWST: Is there anything that can happen that will cause you to sell a stock? Dilution, for instance?**

**Mr. Carmichael:** Oh yes, that has happened on a number of occasions. If I get the sense that management has either changed their strategy or I no longer have the faith that management is acting in the best interest of shareholders, then I definitely will sell the stocks. Most of the time management sticks to the game plan and, if nothing has changed in the basic reasons for buying the company, I continue to hold the stock. Obviously, the problem does not occur with stocks that go up. The problem occurs with the stocks that go down, when you're questioning if you should remain. Stocks go down because of some disappointment, and the problem is deciding whether the disappointment is short term or long term. That's really where the hard part of investing comes in.

### FIDELITY NATIONAL FINANCIAL



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**TWST: Where do you find the greatest challenge in your work? Is there anything that is puzzling you now that is constantly part of the process? Where's the challenge?**

**Mr. Carmichael:** The challenge is to maintain your discipline both when the markets are going up as well as when they are going against you. There are two questions which are tough to answer. First, if the market in general is getting clobbered, "Am I smart or stupid to buy now?" Second, if the market is running up, "Am I smart or stupid to keep my price targets and not to buy at these levels?" I must admit, I wrestle with one of these questions almost every day. It's a fundamental problem of investing and I haven't figured any way out of it other than to impose the discipline. That's why I think the investors who have done well are the disciplined investors because the emotions of investing can get pretty high, especially in those two situations. In the first case, you own stocks that are going down, and in the second, you don't own enough stocks and they are going up. Those are the high pressure situations in this business. Of course, what the average investor does is become depressed about his losers when the market goes down, then sell his winners because he's afraid they too will fall. He

then hangs on to the losers and hopes that the market will make him whole. When the market is running up, the average investor waits until he can no longer stand the feeling of missing out on all those nice profits everybody is talking about. He then buys in near the top. The professional's job is to do just the opposite.

Overcoming the influence of crowd behavior is still one of the hardest parts of investing to me. In Wall Street there are really two crowds. One is the general retail investor crowd and the other is the professional manager crowd. Both tend to be followers, which is a necessary ingredient for crowd behavior. You can lose just as much money following institutional fads as you can following retail fads. I find myself not being drawn into the retail fads very much because I'm professional. But I still have to fight being sucked into the institutional majority. The fact that the professionals are more sophisticated doesn't mean that they're more often correct. It just means that their more sophisticated analysis is harder to pass off as being naive.

I have developed some informal barometers for judging when certain trends are near their end. They can be excellent contrary indicators. For example, one of my clients called me in the fall of 1993 and said that we had to get out of the money market fund and invest in almost anything else. I knew when cash became trash in this average investor's mind that something was about to happen. Lo and behold, the asset class that did the best over the next year was the money market fund that this client wanted to get out of. Institutional fads are harder to spot because the analysis is more sophisticated, but you still have to be on the lookout for both.

**"Overcoming the influence of crowd behavior is still one of the hardest parts of investing to me. In Wall Street there are really two crowds. One is the general retail investor crowd and the other is the professional manager crowd. Both tend to be followers, which is a necessary ingredient for crowd behavior."**

--Claude R. Carmichael

**TWST: What is your cash level like now?**

**Mr. Carmichael:** Our cash level is fairly high. Actually it's been fairly high for some time. I'm reducing it slightly now because, as stocks have come down, a number of these companies have gotten cheap enough to entice me to nibble at them. Two more that I've recently bought and haven't yet mentioned are **Methanex** (MEOHF, 13), which is the world's largest producer of methanol, and **Freeport-McMoRan** (FTX, 17½). **Freeport** is in the process of liquidating and spinning off to shareholders its ownership in **Freeport Copper & Gold** (FCX, 20½) and in their chemical company, **Freeport-McMoRan Resources Limited Partnership** (FRP, 16½). The value of those stocks held by FTX looks to me like it's over \$20, while FTX is trading at about \$17. It is a good way to buy a good commodity-inflation-hedge stock at a discount.

**Methanex** is the largest and one of the lowest cost producers of methanol. Methanol has had a terrific price rise, partially due to its being used in reformulated gasoline in urban areas to reduce automobile emissions in accordance with the Clear Air Act. The supply of methanol is fairly tight worldwide and the company is beginning to report sharply higher earnings. New capacity is a couple of years from being built, so they may have dramatic earnings growth for a while. In the third quarter they turned a corner with earnings of \$0.70 versus \$0.01 for the prior year. The fourth quarter could be \$1.40 versus \$0.04 with earnings of close to \$5.00 for 1995. At this level, the stock is less than 3 times potential '95 earnings and it will start jumping out at people as an extremely low p/e stock pretty soon. One of the most profitable ways to invest is to spot the value in these turnarounds so that you buy before the temporarily depressed earnings come roaring back. Then as the earnings go from negative or miniscule to reasonably positive numbers, the impact on the stock is dramatic.

We spoke about themes a little while ago. There is another

entire industry that is beginning to look cheap again. Several years ago I gave you the complete rundown on title insurance companies. Remember then we talked about how they were misperceived as being regular insurance companies, subject to the vagaries of chance, disasters, and "acts of God." The reality is that they never insure against fire, destruction, loss, or acts of God. They only insure that the title on the piece of property you bought is free and clear. In that kind of business, the better the research you do, the fewer claims you will have to pay. So these companies research the title on your property, then charge you to insure that they have done a good job. It's a very unusual insurance business where the company can reduce their exposure to claims by doing good work. To me, that is fundamentally different from praying that a hurricane or earthquake doesn't hit. Several years ago we were buying **First American (FAF, 16%)**, **Alleghany Corp. (Y, 150%)**, and **Stewart Information Services (STC, 15¼)** and did extremely well on those as interest rates dropped and refinancings took off. We've been out of them for a while now. Recently the pendulum has swung again with rates going up. Refinancings have slowed down quite a bit and these stocks have been pummeled. Quite a few of them are down 50 to 60 percent from their highs and trading at fractions of book value, in some cases only 30 to 40 percent of book. This is classic Graham and Dodd value criterion. So title insurance is an unusual business that's usually tarred with the same brush as other riskier insurance businesses. It's also sensitive to levels of real estate activity. With rates up, real estate activity down, and insurance companies in general being unpopular, title insurance doesn't have many friends in the investment community. That, as we have said, can mean opportunity.

One of the details that has not been noticed is that, over time, these companies build up large databases of their own which become valuable for future title searches. That also means that their future searches should be cheaper and more reliable as time goes on. That means that costs as well as claims should go down. They have also built up fairly large cash reserves because each year they put away a good percentage of revenues for the times when they blow it and insure a title that isn't free and clear. But the fact is that those reserves have traditionally been more than they need to pay claims. Those reserves are cash which they invest and they have grown steadily over time. The income from those reserves helps support the bottom line in downturns.

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**"Methanex is the largest and one of the lowest cost producers of menthol. Menthol has had a terrific price rise, partially due to its being used in reformulated gasoline in urban areas to reduce automobile emissions in accordance with the Clear Air Act."**

**--Claude R. Carmichael**

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There are two companies that are getting close to our buy prices right now. One is **Lawyers Title (LTCO, 11½)** which was spun out of **Universal Corp. (UVV, 19¼)** several years ago. The other is **Fidelity National Financial (FNF, 10¾)** down from \$27 to about \$11. These companies are expanding fairly rapidly right now, buying a lot of mom and pop operations around the country at a time when the values of these businesses are down because of the cyclical slowdown in real estate closings. These companies can be very valuable, partly because their large reserves don't show up as part of book value but they really represent an off-balance-sheet asset. Most people don't realize that. So title insurance companies have gotten so unpopular that they are getting interesting again.

**TWST: Also, as time goes by, these become increasingly efficient, don't they?**

**Mr. Carmichael:** Absolutely. One of the reasons that the takeovers work is they are able to get economies of scale and increased efficiency from the operations they takeover. Their databases grow and their regional coverage increases. **Fidelity National Financial** has been pretty aggressive in their takeover

practices, and they've almost always done a good job of increasing efficiency at the companies that they take over. **Lawyers Title** is also growing by acquisition. Their revenues declined this past year because of the slowdown in refinancings. But the value of these companies, especially in their reserves and databases, is still there and growing. At the time we did our analysis several years ago **First American Financial** had had over 100 years of never having drawn down their reserves below the previous year's value. That means their reserves had grown without interruption for 100 years. That's very unusual in the insurance business, but maybe not so unusual for the title insurance business.

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**"At the time we did our analysis several years ago First American Financial had over 100 years of never having drawn down their reserves below the previous years' value. That means their reserves had grown without interruption for 100 years."**

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**TWST: What would you like to add or to underline that hasn't come out in the interview?**

**Mr. Carmichael:** Only that with a company the size of mine, I'm able to do some things that I enjoy. One is to provide a little more personalized service to my clients. I get to know them pretty well and most of my clients have been with me for a long time, so I enjoy that. The other is that I'm able to do things for them that the larger institutions couldn't do simply because of their size. Because I have a smaller company I can take what is for us a significant position in smaller stocks which might not have great enough trading volume to let a big manager get in and out. I'm able to work around the edges and buy things like exchange-traded limited partnership shares that some institutions can't buy. Closed-end funds, which I've always kept an eye on, are another example of something I can use. The idea of buying a dollar's worth of securities for \$0.80 has always been attractive to me, especially if I think those securities are actually worth more than a dollar. So whenever discounts on closed-end funds have gotten very high, I know that investor sentiment is low. If the funds are in an industry I like or in one I think has been overly sold off, I can take advantage of that. Some of the larger institutions have a much harder time doing that either because it's prohibited in their charter or they just have the attitude that they will not buy into another institution's management. I just like the fact that I can take advantage of those types of opportunities. My clients are generally not as sensitive to the quarterly comparisons to the market because we are trying to generate good absolute returns over a longer time frame. I know the institutional game and I don't particularly like playing it. I know a lot about the way Wall Street works by having been in it for so long. By having my own company I'm able to do what I think is best without worrying so much about the political or short-term aberrations. That makes my life more enjoyable and I think it gives me a slight advantage in trying to do a good job for my clients.

**TWST: Thank you.**

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