GuruFocus Value Insights: Jeff Auxier on Market Manias, Patience and High-Grade Ethics

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Jeff Auxier (Trades, Portfolio), the president and chief investment officer of Auxier Asset Management, recently honored GuruFocus users with the opportunity to ask him questions about his strategy, outlook and stocks he sees value in currently, among other topics. We are pleased to share his responses.

Auxier has previously been a guest on our Value Investing Live stream series and has been a speaker at the GuruFocus Value Conference in Omaha, Nebraska.

Combining fundamental value investing with a top-down macro approach, his Oregon-based firm seeks to invest in "compelling, undervalued" companies that have, among other attributes, strong or improving fundamentals, consistent operating results, a significant competitive advantage, understandable products and a demonstrated ability to earn a high return on capital.

He has been a GuruFocus member since 2007.

GuruFocus: How has the current environment of high inflation and elevated interest rates affected, if at all, your investment approach?

Auxier: Inflation is a critical component to the overall valuation of stocks. Historically, 20 less inflation gives you the market multiple. So back in 1979 when inflation was around 12%, we had a multiple on the market of 8 times earnings.

We see opportunity in higher rates and higher inflation because it leads to greater volatility in the market. It benefits long-term investors who utilize price and value with a margin of safety in allocating capital. The nature of the business is more important when inflation is persistent. We favor businesses with strong franchises that earn high returns on equity, have high inventory turns, freedom to price and have low mandatory capital requirements. This gives them the financial flexibility to survive all kinds of economic challenges that result from elevated inflation. Necessities tend to do better as consumers are forced to "eat or heat."

GuruFocus: Regardless of market conditions, what specific metrics or factors do you pay the most attention to when analyzing a stock? Why are they important?

Auxier: The most important thing we focus on is the ability of a company to generate growing revenues and earnings over extended periods of time. Our main daily focus is in identifying companies and managements that are continually building their franchise and building value and earnings over the very long term. We try to buy stocks when they are out of favor and mispriced in the market.

GuruFocus: In the "Farming on Wall Street" video on your website, you explain how investing is like farming. You say, "You plant and you wait. Most days you are not harvesting." What do you find is the hardest part of putting this into practice?

Auxier: The hardest part of putting this into practice is the short-term nature of most investors.

We are trying to make 10 to 20 times our money over decades. We focus on identifying those businesses that can compound at high rates over long periods of time. The current short-term speculative nature of markets makes it difficult if you have shareholders who are seeking instant gratification.

GuruFocus: As you know, Charlie Munger (Trades, Portfolio) recently passed away. In your opinion, what was his most significant contribution to the investment community?

Auxier: In my opinion, Charlie Munger (Trades, Portfolio)'s biggest contributions to the investment community were his high-grade ethics, rational approach and the value of consistent and voracious research. You cannot endure without high-grade ethics.

GuruFocus: How do you decide when to sell an investment that you bought based on value but has since become overbought in the current market?

Auxier: We look at all aspects of a company and if we really like the management and business, that often will outweigh temporary overvaluation. Some of our biggest winners have been seemingly overvalued in the market, but often great management, through execution, can grow earnings enough to overcome the higher valuation. We think it is hard to find outstanding management and businesses. If we buy at the right price, we are reluctant to sell. Generally, we will sell if management starts to misallocate capital or competition comes into the industry. We also will tend to trim positions when stocks are excessively overpriced while still holding the core.

GuruFocus: In your third-quarter letter, you cautioned investors against “buying into the hype.” With a number of tech companies seeing elevated valuations due to the rise of artificial intelligence, do you think they are also at risk of falling victim to this phenomenon? Why or why not?

Auxier: Over my investing career, we have witnessed several manias. In 1983, there was the PC bubble where 90% of companies failed. Then the dot-com bubble in 2000, where internet hosting and fiber optics were the rage and ultimately suffered 70% declines. More recently, crypto, SPACs, autonomous driving, electric vehicles and office sharing are examples of great stories and hype with no cash flow. If a company does not have sustainable cash flows, in time, their valuations should compress. That leads to the portfolio torpedoes. A torpedo stock is one that has built-in lofty expectations and a high valuation which disappoints. This hurts the portfolio and interrupts the compounding process. If a stock goes up 50% in year one, up 50% in year two then drops 50% in year three, it loses out to the 8% compounder over three years. We are not against innovation, but as investors we have seen a number of heart-wrenching declines over time. In the 1920s for instance, RCA was the most widely held tech stock and plummeted from over $100 to $2 in 1932. History is littered with exciting manias that became detached from underlying cash flow and led to extreme disappointment.

GuruFocus: According to GuruFocus data, health care stocks currently have the largest weight in your equity portfolio. While the overall sector has not done well this year, what is your outlook for the space?

Auxier: There are a number of different companies within the health care space. Our biggest holdings have been in companies like UnitedHealth (UNH, Financial) and Elevance (ELV, Financial), which this past year have fallen out of favor due to fears of rising medical cost ratios with higher medical utilization rates. Also, concerns over greater regulation out of Washington. We originally bought UnitedHealth in the $40s and now it's trading over $530. The news has generally always been bad since we've owned it. However, earnings have driven those stock returns. We like health care today as many companies are trading at the cheapest valuations versus the market in over two decades. There has been a big sell-off in medical device companies such as Medtronic (MDT, Financial) and Zimmer (ZBH, Financial). With the introduction of obesity drugs, there is a

perception that there will be less need for medical devices. We haven't seen proof of that yet. These companies enjoy enormous free cash flow. As 10,000 baby boomers are turning 65 every day, the fundamental demand for medical technology products still looks promising while valuations are attractive with high free cash flow.

GuruFocus: You also discuss in your letter the increasing popularity of Novo Nordisk (NVO, Financial) and Eli Lilly's (LLY, Financial) weight loss drugs, along with the pros and cons of them taking off. With the long-term side effects of these treatments still largely unknown, what risks are investors taking if they invest in these companies based on the supposed potential for these drugs?

Auxier: We are looking very hard at weight loss drugs. Some of the side effects we are studying are concerning to us and many are still unknown. The basic fundamentals of weight loss have more to do with increasing exercise and reducing calorie intake. We have seen a lot of heartache over the years with drugs that garner tremendous enthusiasm and lead to spikes in company valuations, which often disappoint. As an example, Pfizer (PFE, Financial) in the 1990s developed Viagra, which led to a jump in the company's stock price. It took 20 years to return to that euphoric level.

GuruFocus: Tell us a bit about your new position in Kenvue (KVUE, Financial). Was it acquired as part of the recent exchange offer? How do you feel about its prospects now that it has been separated from Johnson & Johnson (JNJ, Financial)?

Auxier: Kenvue came about as a spinoff from Johnson & Johnson. We have not been aggressive buyers yet. We do like the nature of the franchise and the enduring quality of their products. It's going to be much slower growth, more along the lines of Unilever (UL, Financial). Consumer packaged goods companies have pushed pricing aggressively, which is a negative going forward.

GuruFocus: Your portfolio appears to be fairly diversified across a wide number of sectors, but are there any areas you tend to stay away from? Why?

Auxier: We typically don't like companies that have high required mandatory capital spending and those that are subject to obsolescence, companies that are difficult to understand or are magnets for competition. When you get into inflationary periods, companies with high mandatory capital expenditures, like utilities, can erode free cash flow and can lead to a dependence on expensive financing, putting the balance sheet in peril. We saw that in the 1980s when utilities spent heavily on nuclear power plants. The rate commissions would not cover their cost overruns. It was a disaster for the shareholders.

GuruFocus: Heading into 2024, where do you believe we currently are in the market cycle? What is the biggest risk investors face?

Auxier: The pandemic kind of distorted the market cycle as interest rates declined to four or five thousand-year lows (source: "A History of Interest Rates"), which impacted price discovery. It is difficult as we are not in a normal economic period. We put greater emphasis on individual businesses and management. Tremendous fiscal stimulus in the areas of semiconductors, reshoring manufacturing, rural broadband, etc. has provided a positive boost to the economy today. Interest rates over 5% on short-term Treasuries have finally rewarded savers and conservative companies. We see the return to a normal free functioning bond market as a huge positive. Historically, the bond market has been more volatile than the stock market. This backdrop is much better for the fundamental investor because it requires a much greater research effort to mitigate risk. One can't depend on the Fed to bail out bad choices. In short, we are somewhat economically agnostic and keep our focus on buying exceptional management and businesses that can navigate through difficult conditions. We are not going to trade our way through.

GuruFocus: Are there any international opportunities you find appealing currently?

Auxier: Historically, some of our biggest winners have been in the international space. FirstService (FSV, Financial), which does property maintenance, is up over 7,500% since our original investment in 2005. Colliers (CIGI, Financial) is up over 3,000% over a similar period. Recently we added Arcos Dorados (ARCO, Financial) out of Brazil. It is the number one McDonald's (MCD, Financial) franchisee. So far, it is up over 150% since our purchase.

We see with reshoring and nearshoring trends that Mexico looks really strong. Argentina is looking more interesting with recent leadership changes and a move to the right of the political spectrum. The valuations are more compelling in emerging markets. Back in 1994, when the Fed raised rates aggressively, we were a buyer of Mexico's Cifra, which is now Walmart de Mexico. It has gone from 24 cents to $4.20. We like exceptional business models regardless of location. We are more inclined to buy beverage stocks or low-ticket necessities.

GuruFocus: What is the most important lesson you have learned over the course of your career?

Auxier: The number one thing is that you want to study the best in your field who have the highest ethics. My first phone call when I got into the business was to Warren Buffett (Trades, Portfolio). He took several calls very graciously. I flew around the country and met investors he liked. Warren Buffett (Trades, Portfolio) has said, "choose your heroes carefully."

Another lesson learned is to plan on working seven days a week for the rest of your life. There are no shortcuts, and the big thing is a relentless research effort daily. You can't research enough. I was always taught that they can take away your money, but not your knowledge. To survive it is important to have that humility, hard work and research effort together with a strong balance sheet and an aversion to a lot of debt.

Another thing I've learned is to never underestimate the value of a good enduring business and the goal is to keep these businesses going for the long term. The power of compounding through a good business is unbelievable.

GuruFocus: What is your key advice for individual investors?

Auxier: You need to have humility with the markets. There are a lot of smart people out there. The tendency is to overconcentrate without doing the necessary research. Competition is fierce. A rational temperament is critical. You want to take advantage of fear, greed and folly; you want to be the vulture, not the roadkill. The markets will punish bad behavior and shortcuts in risk management; look at Silicon Valley Bank this past year. Over 40 years of work wiped out in less than 40 hours.

GuruFocus: Could you recommend three books and three movies, whether they are investing related or not, for our readers to check out? Please also share why you like them.

Auxier: Books:

"Titan: The Life of John D. Rockefeller, Sr." by Ron Chernow shows how John was always rational and in control of his emotions at all times. He had a consistent focus on the ledger. He was successful in teaching his values and the importance of focusing on the ledger to the younger generations.

"Cattle Kingdom: The Hidden History of the Cowboy West" by Christopher Knowlton is a really interesting book on one of the first investment bubbles in the country. Any investment can turn into a bubble. In the Cattle Kingdom, after the Civil War cattle were running wild and basically free for the taking in Texas. Enterprising investors drove those cattle from Texas to Kansas and had phenomenal returns because of very low costs. They used teenagers, got cattle for free, and

marketed results to Europe. This led to a euphoria and in turn, attracted massive amounts of capital into the cattle industry. Then in the 1880s it crashed, leading to massive losses for investors who arrived late to the party.

In "Buffett: The Making of an American Capitalist"by Roger Lowenstein, Roger does an exceptional job capturing the essence of what makes a great investor.

Three recommended movies are "Lonesome Dove," "Miracle on Ice" and "Dances with Wolves." All three of these are about enduring values.