

At Pzena, when we think about value investing, what we're really focused on is buying companies that are cheap relative to the normalized earnings power of those businesses. So what's normalized earnings power? You can think of that as a sort of mid-cycle view—what a business should earn in a relatively benign environment. When a company's cheap relative to that metric, it means something bad has happened. The earnings have collapsed, the stock price has collapsed, and the market is behaving as though this business is permanently impaired. So then it's the job of the research team to come in and say, "Is this business permanently impaired—in which case we shouldn't own it—or is it a temporary problem, in which case the earnings will recover, and so will the stock price?" That's where the research team spends all of our time, really hunting down these opportunities one by one.

In so doing, there are two important things to keep in mind. The first is we're looking to buy good businesses. I think sometimes when people hear "value investing," they think you're buying a bunch of optically cheap junk. That's not what we're doing here. We have concentrated portfolios, and we really look at each opportunity as though we're buying the whole business, so we're looking to buy businesses that would generally return or exceed their cost of capital through the business cycle, and businesses operating in industries with decent structure and decent positions within those industries. Kind of the way to think about it is it's like a car driving down the road and it's hit a pothole. Is it going to straighten out, or is it going to careen off into the median? That's a way to think about it.

The last point that I really can't emphasize enough is that we obsess about what will happen if things go wrong—what if the path to normalization is rockier than we would have thought, what if the business deteriorates before it gets better, what kind of protection do we have? It may mean a strong balance sheet with flexibility in lending lines, or even a net cash position. It may mean that there are ancillary or subsidiary businesses that could be sold off to raise cash if need be. Basically, the most painful thing that can happen is you can be right about the normalization of the business in the years to come but have lost your equity stake in the meantime or been massively diluted because the business deteriorated in that interim period. We already know that we're hunting for ideas in the cheapest part of our investment universes, so we have that massive upside potential. Then, if we can limit the downside, you have a really attractive risk-reward skew, and that's what we're really focused on here at Pzena.

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