

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Investing in Growth Global Equities with a Focus on Value



CHRISTOPHER TSAI is President and Chief Investment Officer of Tsai Capital Corporation.

He founded the company in 1997 and serves as Chairperson of the firm's Advisory Committee. Mr. Tsai is the principal author of the firm's quarterly reports and he was retained by Paul Hastings LLP to provide expert assistance with the analysis of equity securities. Mr. Tsai is frequently quoted in financial trade publications including The Wall Street Journal, Barron's, Dow Jones Newswires, Reuters, Investor's Business Daily,

Financial Planning and Investment Advisor Magazine. He has been interviewed on Bloomberg Radio, Fox Business and The Street.com TV. He has also contributed to Investment & Pensions Europe about investing in art as an alternative asset class. Prior to forming Tsai Capital Corporation, Mr. Tsai was an Equity Research Analyst at Bear, Stearns & Co. Inc., John A. Levin & Co., Inc., and Gabelli Asset Management. Mr. Tsai has been a benefactor of numerous nonprofit organizations, including the Asia Society, the China Institute, the Hirshhorn Museum and Sculpture Garden, The Metropolitan Museum of Art, the Serpentine Gallery Pavilion, and the Solomon R. Guggenheim Museum. Mr. Tsai holds a Bachelor of Arts in philosophy and international politics from Middlebury College.

SECTOR — GENERAL INVESTING

TWST: Please give us a little bit of background on Tsai Capital Corporation.

Mr. Tsai: I founded Tsai Capital in 1997. We are a New York-based, registered investment adviser that manages a long/short global equity fund. Our focus is on investing in high-quality growth companies that have significant upside potential and a margin of safety at the time of purchase. So we look for growth companies that can be purchased at discounts to intrinsic value. We think globally, and we think long term.

TWST: You used the term high quality. How do you define a high-quality company?

Mr. Tsai: We're really looking for businesses that we can own for the long term, and those types of businesses — companies that can grow for a long period of time — need to have a strong competitive advantage, an economic moat, as Warren Buffett would say. Otherwise, competition will wind up impairing the profitability of the enterprise. A high-quality business has that strong competitive advantage. It also has a high return on equity and capital. It tends to be number one or number two in its industry. A high-quality business is also one where the accounting is transparent and the assumptions are conservative, for example, with regard to pension fund estimates and depreciation rates. An enterprise, therefore, must have several components for us to consider it to be of high quality.

TWST: Why do you like the long/short fund rather than the traditional long-only fund? How do you use shorts?

Mr. Tsai: We like the flexibility that comes with managing a long/short fund. Capital preservation is paramount to us, and in a long/short structure we have the tools to adapt to more difficult environments. In a long-only product, there is just a lot less flexibility to preserve capital, unless one significantly increases cash, which runs contrary to our strategy of holding companies for the long term and compounding capital in a tax-efficient manner.

We think Tsai Capital's long/short fund is unique because it's a hybrid between long-only funds and traditional long/short funds. By that I mean we take a directional approach to our short book. We believe in bull markets you should minimize your short exposure and in bear markets you should maximize it, and the evidence speaks to the soundness of this approach. Most shorts over the past few years have not worked out, even for some of the savviest short sellers. And the reason is simply because money is being printed and asset prices are consequently rising. Our view has always been you've got to position yourself with the wind at your back, and that's a lesson that I've learned from my late father, Gerald, who had a long history on Wall Street. So in bull markets minimize your short exposure, and in bear markets maximize it.

When we think the bull market is coming to an end, our intention is to increase our short exposure quite meaningfully, particularly through the use of broad-based market indexes. It just doesn't make sense to have shorts on if the chances are very high that even if you are right on the idea that you will still lose money. And most long/short funds always maintain a short book, even during a full-on bull market. Why? Because it's easier to market a long/short fund if the portfolio always contains shorts. It's what institutions expect. But Buffett never ran his early partnerships like that. He often didn't have any shorts. And we just don't manage our portfolios for cosmetics.

TWST: So you use the shorts as a tool?

Mr. Tsai: Exactly. We are using the short book as a tool to provide protection to the long book, when it makes sense. We will also take short positions, incidentally, to generate incremental alpha. It's just very hard to consistently make money with shorts in this bull market. In a bear market, however, our intention is to be quite active with individual shorts, and we have already identified several that we think are bankruptcy candidates.

TWST: One of the trends you are watching is the growth of the middle class in Asia. Can you talk a little about how it impacts your investment decisions?

Mr. Tsai: Absolutely. The middle class population in Asia is booming, and not only is the population booming, but the wealth and purchasing power of the Asian middle class is soaring as well. This is in contrast to the States, where the middle class population is stable and there has been little change in inflation-adjusted incomes for at least a generation. In 2009, the Organization for Economic Co-

operation and Development came out with an in-depth and fascinating study. From 2009 to 2030, basically two decades, the middle class population in Asia is expected to increase from 525 million people to 3.3 billion. That's a tremendous increase. And the spending power of this group is expected to go from five trillion to 33 trillion. So that's a sixfold increase over basically two decades.

We want to position our portfolio with this in mind. And businesses that we think will benefit from this consumption explosion address the consumer. Companies like **Jardine Matheson** (J36.SI), which we have owned for many years, and **Visa** (V), should thrive. These are companies that have the brand recognition, the management know-how and the distribution to benefit from the increasing purchasing power of the Asian middle class.

TWST: Can you talk about how Visa fits in with your investment philosophy?

Mr. Tsai: Absolutely. So for an investment to make it into our portfolios, it needs to have all of the quantitative and qualitative criteria that we think are important, and some of the criteria we talked about earlier in the conversation such as an economic moat and a high return on equity

and capital. And we want all of this at a discount. There aren't a lot of businesses first of all that have all of the quantitative and qualitative criteria that we look for, and there are even fewer businesses within our universe that one can buy at a discount to intrinsic value, where downside risk is consequently minimized and upside potential maximized. And that's why we really have a portfolio that is much more concentrated than a lot of other funds.

Our universe is about 25 names, and we believe in holding up to 15 investments at any given time. All of our investments are high-conviction ideas, and we gain a due diligence advantage by focusing on a limited number of companies. So back to **Visa**, it's not an obvious name, you're right, and **Visa** is actually not understood as well as one would think. **Visa** is not a credit card company in a traditional sense because it doesn't extend credit. **Visa** is really a transaction processor. It facilitates the acceptance, clearance and settlement of a transaction. The company gets paid for every swipe of a credit and debit card. About 30% of their business comes from Asia. And again, the population of the middle class in Asia is rising rapidly

Highlights

Christopher Tsai discusses his firm's long/short global equity fund. Mr. Tsai focuses on high-quality growth companies that have significant upside potential. He says his firm looks globally and thinks long term, and enjoys the flexibility that comes with a long/short fund. One trend Mr. Tsai is watching is the growth of the middle class in Asia. He discusses specific holdings and how they fit in with the firm's philosophy.

Companies discussed: [Jardine Matheson Holdings Limited \(J36.SI\)](#); [Visa \(V\)](#); [Hongkong Land Holdings Limited \(H78.SI\)](#); [Puma Biotechnology \(PBYI\)](#); [Colfax Corporation \(CFX\)](#); [Danaher Corp. \(DHR\)](#); [Starbucks Corporation \(SBUX\)](#); [Mandarin Oriental International Limited \(M04.SI\)](#); [Dairy Farm International Holdings Limited \(D01.SI\)](#); [Yum! Brands \(YUM\)](#); [Citigroup \(C\)](#); [Campbell Soup Company \(CPB\)](#) and [The Hershey Company \(HSY\)](#).

and so is the issuance of credit cards. **Visa** has one of the strongest economic moats that I know of. It is very well entrenched around the world because of its brand, scale and the millions of relationships that it's developed since its founding in 1958.

TWST: Is the trend specific to China or is it across Asian markets?

Mr. Tsai: We're seeing the same sort of trends across the region. I should point out, however, that we've been concerned about China for a number of reasons. Our exposure to Mainland China, however, is not that great. Again, our exposure is purposefully to Asia as a region and not just to China.



Chart provided by www.BigCharts.com

Hong Kong. We have owned it for a long time, and we think it's a great way to participate in the broader trends that I mentioned. That company is **Jardine Matheson**, which was founded in 1832. We like businesses with long operating histories.

TWST: What about a company like Jardine Matheson; how does the current unrest in Hong Kong impact that investment for you?

Mr. Tsai: While **Jardine** is headquartered in Hong Kong, its operations are spread across Asia, including Vietnam, Indonesia, Thailand, Cambodia and Singapore. They are much more diversified than many Asian-based companies. They do own a controlling stake in **Hongkong Land** (H78.SI), and **Hongkong Land** has significant real estate in Hong Kong as well as holdings in Mainland China. But we figure that about 20% of **Jardine Matheson's** intrinsic value is related to **Hongkong Land**, and **Hongkong Land** sells at about 60% of book value, so it's already, we think, an undervalued asset. Incidentally, we value **Jardine Matheson's** intrinsic value at about \$90 per share versus a current price of about \$60 per share. So **Jardine** sells for a 33% or so discount to our estimate of intrinsic value.

But back to your question, the changes that have happened in China — for example, the transfer in 1997 of sovereignty from the United Kingdom to China — occur gradually and with some warning. Perhaps a prodemocracy movement would affect change more quickly. Nevertheless, the nice thing about investing in high-quality, globally diversified businesses is that you are not going to wake up one morning and realize that the intrinsic value of your investment

“The nice thing about investing in high-quality, globally diversified businesses is that you are not going to wake up one morning and realize that the intrinsic value of your investment has changed dramatically overnight.”

Let's go back to **Visa** for a second. Think about Myanmar. Myanmar is the 24th most populated nation in the world with over 60 million people. Only one out of 10 people have mobile phones. The government is very much interested in expanding mobile phone usage, and that's an area where **Visa** has tremendous potential — I mean mobile phone payments. **Visa** is growing its share of the mobile payments market around the world, particularly in emerging economies like Myanmar, where the traditional bank infrastructure is less developed. A lot more transactions will take place over a cell phone in the future.

TWST: You mentioned transparency, but there have been issues with China in terms of accounting practices — which caused problems with the SEC — and shadow banking issues. Would those kinds of issues discourage your investment?

Mr. Tsai: Those kinds of issues make it all the more difficult to get exposure to emerging markets and particularly to the middle class Asian consumer. There simply aren't a lot of Asian-focused businesses that are high-quality businesses and sell at a discount. One of those businesses happens to be headquartered in

has changed dramatically overnight. You have time to react. And we're constantly looking at the underlying health of our investments. If we think that the fundamentals are deteriorating, and the deterioration is going to be permanent, then we'll sell and we'll reinvest elsewhere. We don't fall in love with any business.

TWST: As you said, if fundamentals deteriorate, you sell. What are other reasons you would sell a holding out of a portfolio?

Mr. Tsai: We believe a long-term approach is the best way to create significant wealth. A few investors have done it successfully the other way, but very few. Philip Fisher, John Templeton, Philip Carret and Larry Tisch, who was my sister's godfather, all took a long-term approach; so do successful, contemporary investors like Ron Baron and Mario Gabelli, for whom I worked. At Tsai Capital, we too prefer to take a long-term approach and compound capital for our clients in a tax-efficient manner. But as I mentioned, we don't fall in love.

We'll sell an investment under three conditions. The first is when we think the fundamentals of a business are deteriorating and that deterioration will be permanent. The second reason is if one of our investments becomes significantly overvalued. We won't sell, however,

just because a business starts to bump up against our estimate of intrinsic value, or even if it exceeds intrinsic value by a marginal amount. Great businesses tend to get expensive from time to time. They might even be overvalued for long periods of time. But if the business is growing, eventually the intrinsic value catches up to the stock price.

The third reason we would sell is if we think we made a mistake. It's important to recognize mistakes early and move on. So we will sell because of fundamental deterioration, significant overvaluation or if we think we've made a mistake.

TWST: You have said you are a little bit skeptical about biotechs. Why is that?

Mr. Tsai: We're skeptical about most companies without earnings. My late father loved companies without earnings, because he said to me that he didn't have to worry about the p/e ratio. But for us, the underlying earnings of a company are what matter and the growth and durability of those earnings. Actually, Faye Sarofim has it right in saying that the duration of earnings growth over the long term is more important than the rate of growth in any given year. In biotech, you've got a lot of issues that work against that.

We're particularly skeptical about this sector at the moment. I'm sure there are some companies that will do very well, and there have been major successes in the past, but we are skeptical about biotechs right now because of the enthusiasm that surrounds the sector. You see that in a company like **Puma Biotechnology** (PBYI), whose product is still not approved, but the stock went from less than \$60 to over \$230 in a day. So we are seeing those kinds of jumps that we haven't seen since the previous biotech bubble started to form in the 1980s, and we are probably still at the very early stages of this type of situation.

You will see the biotech bubble start to spread to other areas of the market as the bull market continues, and we think that we're nowhere near the end of the bull market. We are at the latter stages, but we've got a long way to go. The market is going to surprise on the upside. The combination of rising earnings, share buybacks and Yellen, Fisher and Dudley on the FOMC will provide the fuel for the advance.

TWST: Another one of your top holding is Colfax. Can you talk a little bit of that one?

Mr. Tsai: Mitchell and Steven Rales founded **Colfax** (CFX) back in 1995. They previously ran a company called **Danaher** (DHR). Under their leadership, **Danaher** became an amazing success story. They built **Danaher** up through both organic growth and many well-timed and well-priced acquisitions. **Colfax** is their new baby, and they brought a number of people over from the **Danaher** management team to help run **Colfax**.

Colfax is really in three areas: metal fabrication, fluid handling and gas handling. These are nonsexy business, and we tend to gravitate toward nonsexy businesses. So metal fabrication, think about pipelines that needs to be made. For example, the **Nord Stream** pipeline in the Baltic Sea. Gas handling would be the centrifugal fans, for example, that are used to ventilate mine shafts. And fluid handling, many of the pumps you would find on oil rigs, for example. So three main areas.

They've built this company up through acquisitions and organic growth, and they really have a strong management team led by CEO Steve Simms, who has already done a fantastic job of building the business, integrating acquisitions, improving the use of working capital and cutting costs. **Colfax** has exposure to emerging markets. We like that.

The company throws off a lot free cash flow. Free cash flow conversion is over 100%. And they use their free cash flow to pay down debt, which enhances the intrinsic value of the business, and then they go ahead and they buy more companies that are complementary to their existing businesses, integrate them and cut costs. It's a formula that works for them. There are not a lot of management teams that can do that effectively, particularly in a consistent manner, and the Rales Brothers certainly know how to do that.

TWST: The last specific name I want to ask you about is Starbucks. Why do you still like Starbucks?

Mr. Tsai: **Starbucks** (SBUX) is a business that has a lot of growth ahead of it, and this year, for example, which ends in September, we figure that earnings will come in at about \$2.67 a share, and that compares with earnings last fiscal year ending September of about \$2.26 a share. So that's 18.1% growth. Return on equity will be about 32% this year. And next year, for the fiscal year ending September 2015, we forecast \$3.14 a share versus \$2.67, so that's 17.6%. And sales are rising very rapidly. Sales are rising over 10% a year, and that's being driven by not only new store openings but same-store sales growth.

1-Year Daily Chart of Colfax Corporation



Chart provided by www.BigCharts.com

Same-store sales growth has been very strong, consistently above 5%, and more recently closer to 6%. Actually, **Starbucks** recently reported its 18th consecutive quarter of global comparable store sales growth of 5% or greater. So this business clearly has momentum, and it's a global business that will benefit from rising consumption, particularly in the Asian middle class. Not everybody is going to be able to afford a new car, but many people will be able to afford to eat and drink better, dine out more and travel more frequently.

So back to **Jardine Matheson**, **Jardine** controls the **Mandarin Oriental** (M04.SI) hotel group, which has 44 hotels under operation or development around the world, 20 of which are in Asia. That's the travel component. And they control a company called **Dairy Farm** (D01.SI), which owns 5,800-plus supermarkets, hypermarkets and convenience stores throughout Asia. That's the food component. And with **Starbucks**, if you have more disposable income, you certainly are going to be able afford to spend \$4, \$5 on a drink, and it's perceived as a luxury item for the many people who are entering this middle class group.

Here's something interesting. I'm half Chinese, and I can tell you since I spend time in China that young people don't like to drink tea as much as they like to drink coffee. Tea is what their parents and grandparents drink. And young people love to hang out at **Starbucks** because they get Wi-Fi access.

Starbucks is definitely in a position to continue to grow. They have far fewer outlets than **Yum! Brands** (YUM) does. They have the ability to continue to open new locations, particularly across Asia, where operating margins are already 35%, or almost double the companywide average. They have about 10,000-plus company-operated stores and about 10,000 licensed stores. 20,000 sounds like a lot, but on a global basis it's not. We think they have the potential to more than double that count, and that excludes the potential for new concepts.

TWST: Tell us about your background.

Mr. Tsai: My family has had a long history in finance. My grandmother, Ruth Tsai, was the only woman who worked on the floor of the Shanghai Stock Exchange during World War II. She traded stocks, gold and other commodities until the exchange was closed in December 1941, when Japanese troops invaded the Shanghai International Settlement. She was an amazing woman, and she influenced my father's thinking in many ways. For example, she said that when the tide goes out, a small Boston whaler and a large cruise ship both get taken out with it. In other words, when it comes to investing, you have to think about these broader forces. Again, you have to position yourself with the wind at your back.

My father had a long and storied history on Wall Street, and that history included managing money, corporate deal-making and becoming the first Chinese-American to lead a Dow Jones industrial company. That company was called American Can, which eventually merged with Sandy Weill's Commercial Credit. The combined company became the foundation for what is **Citigroup** (C) today. My father, as you can imagine, worked very hard, and he tried to instill in my sister and I that work ethic.

When I was 11 years old, I started to spend a lot of time looking at companies. I spent a lot of hours after school. I bought my first five shares of a company called NAC Re, which was a publicly traded reinsurance company. I bought five shares at \$20 a share, using money that I earned from gardening. The stock went to \$25, and I sold it for a 25% profit. I had to convince my broker to waive the commission. Commissions were much higher back then, and the fee would have wiped out my gain, if not more so. And I thought it

was the greatest thing in the world. So I was hooked from that moment. I started to read *Value Line* religiously. I haven't missed an issue since I was 11 years old.

A few years afterward I got a summer job at Waterhouse Securities, which had around that time gone public. I did back-office work, like dealing with trade confirmations. I then went to work for my father every summer afterward at his office at 200 Park Avenue at the MetLife building, which was the Pan Am building back then. And he drilled me on the basic fundamentals of a company. He had me compile earnings, dividend yields and other key ratios, and he started to explain to me what all of it meant. I also took some very interesting courses at the New York Institute of Finance, which was just amazing because these courses, for example on securities analysis, were taught by people in the industry. I don't know how it is now.

I started to manage money for some local businessmen in Greenwich, Connecticut, which is where I grew up, hedge fund capital of the world. One of those first investors was a restaurateur who owned a Chinese restaurant on Greenwich Avenue, and I used to go there all the time because he made the best orange beef. We started to talk stocks. I was 16 years old. After some convincing, he gave me \$400,000, and I multiplied that investment a few times. So he became one of my first clients, and I had some other local businessmen in Greenwich who gave me some of their money to manage.

So then going into my college years, at Middlebury College, I came across a couple of articles mentioning that both Peter Lynch and George Soros had majored in philosophy, so I thought that was pretty interesting, and I decided to give philosophy a try. I loved it. I majored in an area of philosophy called cognitive science, which consists of multiple research disciplines, including artificial intelligence, philosophy, neuroscience, linguistics and psychology. And as you know, psychology is very much relevant to the stock market. I made philosophy my major, not economics.

During my Middlebury years, I did a couple of internships, one with John Levin and one with Mario Gabelli, so I worked for two very smart value investors. And I had my father as a teacher, and he obviously had a very different approach. So it was interesting really to get perspective from two very opposite sides of the investing coin, and not a lot of people have that exposure because they either work for a value manager or they work for a growth manager.

I then took a job in equity research at Bear Stearns following graduation from Middlebury, and that was a sell-side position. So now I had buy-side exposure and sellside exposure. I worked for Terry Bivens, who was in charge of packaged foods, so we covered companies like **Campbell Soup** (CPB) and **Hershey** (HSY). I was fortunate to have a really terrific and smart boss who schooled me on how to talk with management and ask the right questions. But I decided after a short amount of time that I really wanted to go out on my own and do what I had wanted to do since I was not even a teenager, and that's to manage money.

TWST: For the average investor who is interested in global trends, what is the best advice you would give them?

Mr. Tsai: I would give them the same advice that Peter Lynch,

John Templeton and Phillip Carret gave to others. The most important advice is the need for patience. Everybody wants to get rich tomorrow, or today, but that doesn't work. Maybe you get lucky on one name, but luck is not a viable long-term strategy.

If you've got a high-quality name, a business with real growth potential and you buy at a good price and hold onto that company, you can wind up multiplying your investment many, many times, but it might not appreciate right away. It might take time and you need patience. But the compounding effect of that growth can be significant. And Peter Lynch said in, I think, *One Up On Wall Street*, that some of his best ideas don't wind up really taking off until quite a bit later, quite a bit after his initial purchase. So I would tell people, you have to have patience, and you should buy growth companies at value prices. When you have a growth company that you can hold onto for many, many years and compound wealth that way, I think that's very powerful.

Philip Fisher figured that out. He said that if the work has been properly done up front, the time to sell is almost never, and I would completely agree with that. I'm old-school in many ways.

TWST: Thank you. (LMR)

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