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Wealth

Patience can find a virtue in market inefficiency

By Whitney Tilson
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Legg Mason fund manager Bill Miller tells a wonderful story of a visit he made early in his career to an institutional money manager in Boston, to whom he was pitching the shares of R.J. Reynolds, then trading at four times earnings.

As Miller says: “When I finished, the chief investment officer said: ‘That’s a really compelling case but we can’t own that. You didn’t tell me why it’s going to outperform the market in the next nine months.’ I said I didn’t know if it was going to do that or not but that there was a very high probability it would do well over the next three to five years.

“He said: ‘How long have you been in this business? There’s a lot of performance pressure, and performing three to five years down the road doesn’t cut it. You won’t be in business then. Clients expect you to perform right now.’

“So I said: ‘Let me ask you, how’s your performance?’

“He said: ‘It’s terrible, that’s why we’re under a lot of performance pressure.’

“I said: ‘If you bought stocks like this three years ago, your performance would be good right now and you’d be buying RJR to help your performance over the next three years.’”

Whether from the pressure of demanding clients or the psychological pain of watching a stock do nothing – or worse – over extended periods, the short-term thinking of Miller’s putative client is the norm among investors. This creates opportunity, however, for those with the ability and patience to take a longer view.

As Miller explains: “In an environment with massive data overload and with everyone trying to exploit short-term anomalies in the market, the market looks extremely efficient in the short run. The inefficiencies are likely to be looking out beyond, say, 12 months.”

Some of my favourite investments have been in companies where the business has been doing okay and it has been abundantly clear that it will be doing much better one or two years into the future but where there has been no apparent short-term catalyst.

Most investors, trying to be clever and seeking to avoid “dead money”, shun such stocks until the good news is apparent. By then everyone else has piled into the stock and it is typically no longer cheap. It is a fool’s errand to try to predict when other investors will recognise an undervalued stock.

A good example of profitably implementing time arbitrage was in Wendy's late last year. For a number of months the stock hovered around $45, in spite of the fact that the company had announced plans to sell in early 2006 a minority stake to the public of its enormously valuable Tim Hortons subsidiary – a huge brand in Canada – which was easily worth $35-$40 per share of Wendy's stock.

Considering the company's cash position, one could buy Wendy's restaurant operations and franchise-fee streams for virtually nothing! Sure enough, in the subsequent five months leading up to the Tim Hortons initial public offering, the stock rose nearly 50 per cent.

So what are the time arbitrage opportunities around at the moment? Here are three ideas, all of which I own in the funds I manage: first, Wendy's – again! With the stock back around $59 and Tim Hortons accounting for $37 of this, one can buy the rest of Wendy's for $22 a share – a very cheap price by any metric – by going long Wendy's and shorting out the proportionate amount of Tim Hortons.

Many investors can't or won't short stocks, however, so this "stub" will probably remain cheap until Wendy's spins out the rest of Tim Hortons to its shareholders, which the company has promised to do by the end of the year.

My second idea is Microsoft. I recommended this at $27 seven weeks ago and today, with the stock around $22, it's even more of a no-brainer. The stock is cheap in large part because there are no obvious catalysts over the next few quarters but the company will be releasing early next year significant upgrades of its two cash cows, Windows and Office.

Historically, these events have been big and highly profitable events for Microsoft and there is no reason to believe otherwise this time, so profitability should grow significantly over the next two years.

The third idea is Tyco, which is comprised of four excellent businesses that are all doing reasonably well. The company has announced that it will split into three pieces, most likely by the end of this year, and it doesn't take very much work to conclude that the pieces are worth more than $40 per share, yet the stock today languishes in the $27 range. For investors with a little patience, I think there's an easy 50 per cent profit to be made here in less than a year.

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