PRINCIPLES OF BUSINESS

By the mid-1970s, the firm was chugging along. My net worth was increasing, and I was doing fine. But we weren't really building a business to any great extent. A few of my longtime buddies had come on board as clients, as had a few of Eddie's. Still, we remained a relatively small enterprise.

Then in 1976 Ron said to me:

> Gerry, you're fortunate. Because of your Oppenheimer days, you have a little wealth, and here you're building your wealth through your investments' appreciation, and Eddie — because of his grandfather — has some wealth also increasing. You're paying me well, but I don't have much capital to build. You always believed in sharing all the goodies with everybody, so let's grow the firm.

There are pros and cons to building a business. I knew from my experience at Oppenheimer & Company. Beyond a certain size, it's a lot of aggravation. You work harder to move a boulder an inch. When the business is young, it happens faster. When the business is older, it takes three people to do the same thing that one person used to do. Unfortunately, that is the evolution of growth. The business becomes a bureaucracy, and as a result there are more negatives. Not to mention more politics.

At this stage in my life, I didn't particularly relish going through all that again. I had enough wealth, and I wanted to have a good time while working. Yet by nature I'm a builder. So with minimal deliberation, I told Ron, "Let's build."

The first step to build is to go out and actively look for clients. I counted on Eddie to take advantage of his social contacts to introduce me to pockets of wealth similar to my finding the Israels. He did a decent job of it, too, whereas a lot of people with backgrounds like his don't aggressively pursue prospecting for new clients. (When you were born with money, it's psychologically difficult to ask someone to give you money. You have to be a street fighter to do it — like you-know-who.)

We had to increase the staff. One of our new employees was Jay Abramson, a young man right out of school. Jay's father was my accountant, and his grandfather was a famous tax accountant. Jay graduated from the Wharton School with a degree in accounting and then went to the University of Pennsylvania Law School. His family thought he would go into the family accounting firm after graduating from law school. But Jay's father unwittingly changed that. He asked me if Jay could work at CRM during the summers and one day a week while he was in law school, coming in from Philadelphia to learn investment management.

I took Jay on, and after his graduation he surprised his family by saying that he no longer wanted to be an accountant in the family firm and that he wanted to be an investment manager at Cramer Rosenthal McGlynn. Jay is smart and has that legal-type mind that traps information. (I try to forget extraneous data, not to clutter my brain, but lawyers accumulate specific information, and they have terrific recall.) Jay worked directly under me in our pursuit of investment opportunities. He did an excellent job, and a few years later we made him a partner.

Another key hire was Kevin Chin, a 4.0 engineering graduate from Columbia University on his way to the Wharton School via working for Wang Industries and Morgan Stanley. Kevin joined to learn the investment management business. He never left. As he would say, he didn't have to get his MBA from Wharton, he got it from Cramer Rosenthal U.

We spent a lot of time with young people training them and raising them up within CRM's culture and its investment philosophy. We trained many people directly out of school, and they were indoctrinated in our investment philosophy. That philosophy I developed at Oppenheimer, and it remains the core of the investment process at Cramer Rosenthal McGlynn.

Here's how it works.

We do independent research exclusively. We don't respond to what Wall Street brokers or brokerage firm analysts try to pitch us. We do our own research — go out into the field, kick the tires, look under rocks. We study all the public information that has been published through the Securities and Exchange Commission. We scrub it, rework it, and analyze it to ascertain what may be exaggerated. Accountants and corporations have been known to cook the books, and we uncook them. That's easier said than done, but we do the best we can.

We visit all the companies before we make an investment. We go out into the field and interview senior executives. The chief executive of a company is the salesman of the company; he tells you what he knows you want to hear. In addition to the C.E.O., we question the chief financial officer, who usually throws the company's investor relations officer at us. We also talk to the general managers of individual divisions.

We go beyond the executive suite and see whether there is consistency in the corporate culture. One of my tricks is when I'm waiting to be ushered into a meeting, I'll ask the receptionist, "How do you like working here?" It's amazing how many receptionists will tell you exactly how they feel — good or bad. (A note to C.E.O.s: train your receptionist to be a spokesman for the company. When she — or he — is enthusiastic about the job, it tells you a lot about the company.)

After all this research, we create business models of what we believe is the company's base-case earning power. We use optimistic and pessimistic assumptions, evaluating each specifically trying to project the company's economics five years in the future. We compare the company to similar industry competitors. We prefer companies that are lesser known by Wall Street

There are ways of measuring a company's popularity. How many

brokerage firms follow the company today? How many followed it two years ago? The less popular, the better. Who are the owners of this stock? Insurance companies? Banks? Mutual funds? Insiders? (All of this is public information.) Generally, investment managers, mutual funds and hedge funds are smarter. The dumber investors are the insurance companies and the bank trust departments. By the time they own a stock, its prospects are universally known and predictable.

Stock ownership by large institutions like a Fidelity Fund is a yellow light. If the fund changes its mind and sells, the company's stock price could be destroyed

One of our junior analysts calls the sell-side brokerage firms that follow the company. We check with their analysts and see whether they have come to the same conclusions as we have about the company's prospects. If our views coincide, it means that there are probably no surprises on the horizon. If CRM's view indicates a brighter future than theirs, we become more interested.

We prefer research from regional brokerage firms — in San Francisco; Portland, Oregon; or Little Rock, Arkansas — instead of the big national brokerages like Merrill Lynch. They are closer to the management.

We have visited the target company, measured its popularity, and understood its accounting, its historical financial data, and its projections. Now comes the crucial question: Is there anything within the company that is changing? What is the catalyst creating this change? It could be as obvious as a new C.E.O. or a new chief financial officer. It could be the selling of a division or the spinning off of one, as an independent public company. The spinoff that might be interesting to own because, for one thing, it isn't known very well. The catalyst could be a change in government regulations, deregulation, or tax incentives. It could also be a new product, like what the iPod did for Apple Computer. (I'm curious to know if the iPod will still be around in 2050.)

You won't find the answer to these key questions by reading the *Wall Street Journal* or the *New York Times.* You find it by reading trade journals and by going out into the field and asking a lot of questions yourself. We are financial detectives or forensic accountants at Cramer Rosenthal McGlynn. We try to break information down into as many viable components as possible.

To do this successfully, a team of good analysts is essential. At CRM the work is usually done by analysts like Jay Abramson, bright young professionals with unusual educational backgrounds. Jay didn't have a master's degree in business; he had an undergraduate degree in accounting and a law degree. All of our analysts have worked in business or in an investment bank; none were just stock jockeys.

Our investment philosophy at CRM rests on three legs: understanding the company's financials and culture, measuring a stock's popularity, and the likelihood of positive change affecting the company's future prospects that will reflect in stock appreciation. It usually occurs in six to eighteen months, and then this once-unpopular stock suddenly becomes popular.

I've been reasonably successful as a futurist, thinking outside the box. Working with bright, young people sure helps. I tell them, "Don't read just the financial papers. Read other magazines. Read the *New York Review of Books*. Read *Psychology Today*. You get more original ideas by reading what most Wall Streeters are not reading. I don't care what stockbrokers' opinions are of the market that day. They all say the same thing. The more popular an idea is, the less chance it's going to be successful.

We drilled for oil and gas. Farming is usually tax deductible, so we invested in wine grapes in California. We invested in movies, particularly when they could be made outside the United States because you got tax breaks from the country where the movie was made.

There is much original academic work being done on behavioral analysis and its effect on investing. The emotional pendulum in investors' reaction to their stock ownership, going from hatred to despair to acceptance and then up to liking to loving. They go from fear to greed. That's the alpha and omega, the extremes of fear to greed. The price of a stock will overshoot its prospects. It will trade well above the trend line and then revert to the mean and then overshoots below — manic depressive. That's true not only in life but also in investing.

We retain our staff for a long time, and I'm proud of that. My assistant, Chris Stelmack, joined me in 1979, and is still working with me in 2007. An exception occurred in 2002 when we lost three important executives — two senior analysts and one head of sales, they

formed a hedge fund — but because we had a deep pool of talented younger professionals, their replacements were at least as good as they had been.

How did we manage? First of all, it comes from our respecting our coworkers as first-class professionals. Having a growing company allows staff members to grow with the company. This is important in the business world: we made sure that the rewards were shared. That doesn't mean we shared equally; after all, we are in a business, not a commune. But the rewards were shared equitably.

At CRM, employees know that they can grow intellectually and financially. They are respected, and they are able to work in a fun environment. That is the culture we have maintained from the beginning. Most of our professionals eventually become partners in our business.

The end results have been outstanding. CRM's money-management performance has showed steady growth over the years. Its performance was positive versus any benchmark, like S&P, the Dow, or a smaller stock index like Russell 2000. The only meaningful losing year was the first year, 1973. So from the early years the buzz was out there in the financial world, and CRM was being discovered by institutional investors.

Our first institutional client was the Phoenix Suns professional basketball team. At the time, the team was owned by three people, classmates in college, one of whom I knew well. From the Suns, we ended up managing the players' retirement fund and that of the National Basketball Association. For a while, we managed Columbia University's money and that of Eastern Airlines. We lost Eastern because it went bankrupt, and Columbia we screwed up in our selection of stocks. Georgia-Pacific was an early and major institution for more than fifteen years.

Institutional accounts are fickle because the institutions play the game of relative performance. If you are not doing better than your competitors on a consistent basis after three years, you will most likely lose the account. Sometimes the fellow responsible for the account moves on, retires, or is replaced. Then his replacement wants an investment manager he knows to manage the account. That's quite a contrast from high-net-worth individuals. Those clients stay because

they are pleased with the service and the personal relationships, and most important of all they trust you

Performance is important, but service is crucial. We constantly communicate with our clients. There is total transparency; there are no secrets. Clients can ask us any question, and they will receive a prompt response. We volunteer information before being asked, regarding any problems we may be having. Calling clients when we're in a slump is a smart thing to do. The stock market is mercurial. It could be up or down 2 percent or 3 percent on a short-term basis for no good reason. So you have to be able to explain yourself honestly. You have to resell yourself periodically on the firm's investment objectives.

It took close to twenty years to cross the billion-dollar mark in assets. Nonetheless, crossing the billion-dollar mark in the early 1990s was a major accomplishment. It put CRM in a different league and brought us to the attention of bigger institutions. We were hired by the States of Maine, New Mexico, and New York, Indiana University, the University of Illinois, Cincinnati University, the College of the Holy Cross. We ended up with many major institutions. We are now establishment, "venerable." We are big enough, old enough, and well known. We now have more than $12 billion under management. That sounds like a lot, but some firms have $100 billion or $300 billion under management today because of the growth of the industry.

Most of these clients came in through the consultant community. Consultants know the investment management industry and recommend a handful of prospective investment managers to their clients. The investment manager presents his firm to the university's board or to the treasurer's office. He tries to stand out above the competition. No manager wins every time, of course, but if a firm is chosen 50 percent of the time, it is doing very well. And we at CRM were doing just that.

If one had invested $100,000 when Cramer Rosenthal was formed in 1973, thirty-three years later that $100,000 would be worth over $12 million; that's up 120 times. (This is not adjusted for taxes.) The S&P average would have gone up to $3.5 million. Over time, compounding works wonders.