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THE MIKE ALKIN SHOW

TALKING STOCKS OVER A BEER

Ep. 6: Why "Boots-on-the-Ground" Research Matters

with guest Greg Rice

Speaker 1: Free and clear of the chatter from Wall Street, you're listening to Talking Stocks Over a Beer, hosted by hedge fund veteran and newsletter writer Mike Alkin, who helps ordinary investors level the playing field against the pros by bringing you market insights and interviews with corporate executives and institutional investors. Mike sifts through all the noise of mainstream financial media and Wall Street to help you focus on what really matters in the markets. Now, here's your host, Mike Alkin.

Mike Alkin: Welcome to the podcast. It's Monday, March 19th, 2018. This is my sixth podcast. In the opening, I like to review the prior week, and I'm sensing a rhythm to the markets over these past six weeks. One step forward and two steps back. Investors seem to be trying to find some sort of footing since that nasty sell-off we had in early February. Last week, equities gave up ground. They gave up about a third of the prior week's rally, and since that dropped the S&P 500 has had 3 up weeks and 2 down weeks, and it's reclaimed about 60% of the 300-point plunged that it had.

For the week the S&P 500 lost 1.2%, and the NASDAQ and the Dow fell 1 and 1-1/2%. Last week's lingering concerns in the market seemed to be focused on trade wars. President Trump said he's seeking to hit China with these tariffs and the investment restrictions as early as this coming week and the chatter was there would be about $60 billion in the initial round that's going to be targeted and specifically going to be targeting information technology, telecom, and the consumer electronic products.

That's kind of punishment for the "alleged" intellectual property theft that the Americans believe the Chinese conduct but that's just the beginning. It could certainly expand to a broader range of products. Now, coming out of the White House they look at it a little bit differently. Pete Navarro, who's the Director of the White House National Trade Council, he tried to ease the market's concerns. He did an interview on CNBC on Thursday, and he assured investors that the US can implement these tariffs in a very peaceful way and approve and strengthen the trading system.

I spent time, I'm not going to go into it again. You could listen to the prior podcast but I am very skeptical that this can be a smooth landing but time will tell. As usual with the Trump administration it's never a boring week on the political front and the game of musical senior administration members continues as CIA Director Mike Pompeo is replacing Rex Tillerson over at state as the new Secretary of State and from what I understand Secretary Tillerson learned about that from a tweet from President Trump, which is always nice. Nice to get, to learn you've been fired from a tweet.

Gary Cohn the White House Economic Adviser, Trump's top economic advisor who resigned a couple of weeks ago. He's being replaced by CNBC personality Larry Kudlow, respectable guy so we'll see where that goes but he's also missed a few things in his career, some major things so I'm not sure we're going to come out on that, and some more news that might have scared the markets a little bit is that the Times reported on Thursday that Special Counsel Mueller has subpoenaed the Trump Organization for documents relating to their ties to Russia so that saga continues.

For the Week 9 of the 11 S&P sectors were negative. The material sector was the hardest hit down 3.2% but the consumer staples continued their decline down 2.1%. That's interesting because normally staples are viewed as safe-haven but they've had such a massive run over the last several years and they are besieged with a tough environment to grow revenues right now. It's very tough for them to get any sort of pricing power. It's hard to raise prices. Volumes are tough to come by, it's so competitive.

They've had a massive move up over the years in margins that they've already cut as many costs as they possibly can and they produced their earnings through financial engineering by levering up what were very under-levered balance sheets. What I mean by levering up is just borrowing at very low-interest rates, putting debt on their balance sheets, and with that cash going out and buying stocks so that they can reduce the share count and when you reduce your share count, it helps you grow your earnings.

Interesting to see that in market uncertainty that sector, which normally catches a bid and what I mean by that is people normally will rotate into a consumer staples sector as they perceive it to be safe but that's not happening. The industrials and the financials were also down handily for the week, down to a 2-1/4% or so.

I've been traveling a lot lately. God, over my career, over that 20-year span in the hedge fund industry, I traveled to more countries than I could count and I was the ultimate road warrior going out looking for good investment ideas, and meeting with industry experts, and company management teams, and after a while, one city one country all seems to run together. My wife would always say to me when I'd come home I'd be exhausted it might be the weekend and she said, "What are you talking about? You're in Paris. You're in Milan. You were here, you were there."

I was but I didn't even see those cities. You land, you go to sleep at nighttime, you then get up, you're on a five-hour difference and from the moment you wake to the moment you're put your head on the pillow, you're in meetings in office buildings. You're not out enjoying the city, you're not doing the tourist thing, and after a while, it does, the cities and countries all start to run together and since I haven't been running a fund or being a partner as an analyst in the hedge fund business, the last couple of years I haven't traveled as much but that's picking up again a lot lately.

I went back to my old stomping grounds, which I've been to probably I've probably spent two to three months a year for many, many years in London. I went back there a couple of weeks ago to visit a few people and more than a few people that I had a bunch of meetings with folks. I was also down in Florida this past week, and one of the things my wife will tell you if you asked her, one of her complaints about me and the list could, after 24 years start to accumulate but I think she would probably tell you that I am sometimes not present.

She jokes that I'm a little bit like the Nutty Professor that I could be somewhere but my mind can be a million miles away thinking about work, and after 24 years of marriage I do subscribe to happy wife happy life view of the world so I agree with her own on that. On this particular point, she's right though. I'm especially like that though when I'm doing these mundane things like traveling for work. You just do so much of it, it just becomes rote and routine. I could ... From the time I leave the house to the time I get to where I'm going, going through airports, going through security, sitting at gates on the flights.

I rarely pay attention. I'm focused on whatever I'm reading or whatever emails I'm answering, normally work-related. I'm pretty much on autopilot until the last few weeks. It was a bit odd, the flight to London, which is one I've taken like I said countless times over the years. I noticed in the gate area, I thought I might have been at the wrong gate. I've done that before more times than I care to count. I've sat at the gate, they've called my flight, I've been so focused on whatever I'm doing, the flight's taken off and I look up and I wonder why no one's there.

This particular time, I was sitting at the gate, and I didn't understand why it was so empty, and I figured it was just a late arriving crowd but I was wrong. The flight was half full, I landed at Heathrow, I went through customs in record time. I jumped on the Heathrow Express to Paddington Station, which I do. I'd rather pay 37 pounds for a roundtrip 15-minute train ride into the heart of London than sit in a taxicab and pay 80 pounds or over $100 for 50 minutes of traffic, but Paddington was quiet, and I then took the cab to my hotel and the hotel was interesting because I like to stay in the Kensington section in the UK and I have a favorite hotel that I stay at, and while I love the hotel, one of the things that annoys me about London, while I love the city. I have many good friends there.

The prices never go down. It's so expensive. The city is, whether it's a taxi ride or a restaurant or a cup of coffee, but especially the hotels, over the years they just go up and up and up, not this time. I was able to stay at my favorite hotel in Kensington, and they were offering deals, which I could not get my head around and meaningful deals, so who am I to complain. I took the deal.

Then, my first day of meetings I was on the 24th floor of an office building. It had a great eye of the London Eye and you can see the Thames and you could also get, it was a great panoramic view the way that the office, it was a corner office, and one of the things I like to do when I am in any city, like I said getting to the city I'm not paying attention, but once I'm there I am.

I like to look at the number of cranes that I see, and I don't mean birds. I mean construction cranes. What I tend to find is that there's an inverse relationship between construction activity and the future of the economy. At peaks, we tend to see massive expansion as the developers feel flush and they could get access to money and they build like there's no tomorrow, and then, the cycle turns.

What I saw in London was unlike anything I'd seen before when I was there. As far as my eye could see and in every direction were construction cranes. It reminded me of what I've seen recently in Toronto, which I joked recently to a friend of mine who lives up there that the Ontario province state bird is the construction crane. Now, I don't know what it means. I don't know why the flight was half full. I don't know why I soared through customs. I don't know why my hotel room was discounted. I don't know why the construction cranes were booming, but I do know over the years what has served me really well as an investor is anecdotal evidence.

You can build all the spreadsheets you want, you can read all the annual reports, all necessary, all important, but being out in the field, looking at anecdote evidence has been the catalyst for some of my best investments over my career, whether it was calling a top in oil in 2014 by visiting the Bakken or calling a top in steel in 2008, by getting out into Cleveland and talking to people in the industry. You can really put a mosaic of information together and I don't know what I'm seeing now, but I know my antenna is up. I think you know if you've been listening to the podcast that I am more, much more bearish than not.

I think the market is much closer to a peak and I think the risk/reward is not attractive from the bullish side, and I start to think about what's going on the people who are analyzing these businesses and investors who are sitting behind a desk, maybe there's stuff going on underneath the surface that is hiding in plain sight, you just have to pay attention to it. We're told the economy, the global economy is humming, everything's doing great here. As I travel around the country here, I see other signs of anecdotal evidence that things may not be so great.

I've talked before about me visiting random shopping malls, seeing hundreds and hundreds of cars that are backed up, to new cars sent out from the dealers sitting in shopping lot, excess overflow lots, sitting in hotel overflow lots, hundreds of cars, sometimes thousands of cars that I see. I've seen them not just in my area and in the hundred-mile radius where I might drive around and look, but on a recent trip down to Maryland and Virginia, I saw the same thing.

What I want to do, I'm going to bring in a guest today on the podcast what I have done is tried to bring ... I do this podcast for ordinary investors, if professional investors are listening, great, but I don't care. It's not important to me. What I want to do is help ordinary investors by leveling the playing field with Wall Street, and in doing so I want to expose you, the listener, to all different corners of the investment world.

I brought on a healthcare services specialist, a gold fund manager. Last week we had Danielle DiMartino Booth, an economic maven and an expert on the Fed. I've had a uranium company CEO, a few weeks ago I brought on a 4-Star Morningstar Mutual Fund Manager who runs a balanced portfolio. Today's guest is a good friend of mine and he and I were only a handful of partners at a hedge fund called Knott Partners, which was a multi-billion dollar hedge fund that we worked at.

He's going to give you a bird's-eye view of a few different sides of Wall Street. He was the head of equity capital markets at a storied investment bank called Lazard and he was there about 20 years or so, and then, he transitioned to the investment side as a hedge fund analyst and partner where I just mentioned at Knott and now he does something totally different but equally as fascinating, which we're going to talk about. But one of the things he did when he was over at the hedge fund was get out in the field a lot and he and I would travel and I share with him how a short seller does their primary research and how you can gather a lot of insights from all of this anecdotal research.

We're going to talk about, not my trip to London, but how you can start to put this mosaic of just observations together to form an investment view that may have a variant perception to what the current prevailing narrative is, so without further ado, I would like to bring on a very good friend of mine, Greg Rice. Welcome to the podcast.

Greg Rice: Mike, it's my pleasure and congratulations on your success in your new media ventures.

Interviewer: Thanks, Greg. I appreciate it. The media empire that we're attempting to build. Greg, you have a wealth of experience both as a sell-side person and a buy-side person. You started out at Vanderbilt and you went to work for Lazard. For those who don't know Lazard, it's one of the old line investment banks in the industry. It's French-based and it's been around for a very long time. Let's take you all the way back. Let's tell our listeners what it was like coming out of school, why you chose Lazard? What opportunities there were for you then? We're going to walk through life as a sell-side person.

Greg Rice: Well, I had a great experience starting out at Lazard and spent the first half of my career there. I came out of school, I knew I wanted to get into Investment Banking, but I wasn't going to be able to get into the banking training programs, which are a traditional entry point for undergrads coming out of school, becoming a financial analyst, and working two years for an investment bank, and going on to business school.

I had some interviews set up with some sell-side firms and I walked into Lazard on a Wednesday and had a job offer on a Friday night and I was there for about 18 years.

Mike Alkin: You started out in what, institutional sales?

Greg Rice: Actually, I was hired as an analyst and turns out I enjoyed picking up the phones more than I did doing spreadsheets, and when I started, I didn't even have a desk. I had one of those pull out things between the desks that people wrote on for my own, and then, I hoped that someone would be out of town, and then, I could sit in their seat for the day. I didn't even have a desk for the first several months of my career but Lazard was a boutique capital markets operation attached to a tier one investment bank. It was a very horizontal place and you had the opportunity to wear multiple hats.

You could be in sales, you could come up with ideas, you could do lots of different things that might not have been possible at a bigger firm.

Mike Alkin: The reason I do this podcast is to help non-professional investors. That's my goal. If professional investors are listening, so be it, that's fine. If they're not, that's great. But my goal is to level the playing field for people who are home trying to invest on their own. I think it's important to understand what the stocks, right? What move stocks is whether or not they outperform or underperform consensus expectations. Consensus expectations are formed by the sell-side.

Now, there are buy-side expectations but the analysts who cover these companies and industries they publish estimates of revenues and margins and earnings and typically the companies live or die by how they do versus those expectations. In an attempt to level the playing field, help the regular investor understand the machine that is the sell-side of Wall Street. Can you walk them through the process?

Let's take a company, a company who's going public, they're now public and what does an analysts do, an institutional salesperson? How does that research get consumed by a buy-side firm? A buy-side firm could be a mutual fund or a hedge fund, and while individual investors are going to be buying and selling stocks, the marginal buyer that typically takes up the price were down, the price of the stock is the capital with the hundreds and billion, hundreds of millions and billions of dollars. Let's give a little behind-the-scenes look at life at an investment bank in a research house and how that works.

Greg Rice: Sure. Let's take a step back and think about what investment bankers do and the classic function of the investment bank is to help clients access the capital markets or provide advice.

Mike Alkin: Clients being corporate clients?

Greg Rice: Well, they can be both. You have corporate clients and you'll have institutional or individual clients. An investment bank will help a corporate client access the capital markets. In this example, they would help the company figure out how much money they need and what the best source of capital is. It might be raising debt, it might be raising equity, and so, if it's to raise equity then the investment banker will try and figure out on an initial public offering what the company's worth and do a lot of due diligence to make sure that the company is for real and that its prospects are reasonable.

You document a lot of this in the SEC filings, the prospectus, an S1, S3 filings and the company goes public in a process known as an Initial Public Offering where institutions and individuals are gathered together, they are shown the company through a marketing process, the company spends two weeks on the road visiting institutions all across America and parts of Europe, and at the end of that process ...

Mike Alkin: That's the key, they're visiting institutions, not individual investors.

Greg Rice: That's correct, and while they have public events that are available, they're controlled by the investment bank, and so, most of the marketing process as you correctly point out is directed at the institutional investor, the professional investor. The company calls on large money managers around the world, and at the end of the process, the lead investment banks gather the orders and gather the feedback from the professional investors and based on the order book that is built, the company assesses whether it can go public and at what price and the company starts trading on the exchanges.

At that point, the only people that know anything about the company are those who have seen them on the roadshow or read the prospectus, which is publicly available. But over time, the underwriter is certainly and others will publish research on the company and the underwriters will publish research because the corporate clients insist upon they're writing research and other broker-dealers may write research based on whether it fits into their coverage, existing coverage or not. Those reports are often a ...

Mike Alkin: Come on, say it, Greg.

Greg Rice: Well, they often are, initially, at least, a regurgitation of what's in the prospectus because you're publishing pretty shortly after the company comes public. But over time, hopefully, you have some independent analysts who pick it up and the ...

Mike Alkin: I'm going to add that Greg's quite the statesman so ...

Greg Rice: Look, I think one thing that it's helpful to point out to your listeners is there's an inherent tension in the IPO process, an inherent conflict.

Mike Alkin: Even once they're public?

Greg Rice: Yes.

Mike Alkin: Whether IPO or not, once the company's trading ...

Greg Rice: But even at the moment of pricing, for whom are you pricing the deal? Are you pricing it to benefit the corporate client or are you pricing it to benefit the institutional client? There's a pricing tension and often getting the highest possible price for the corporate client is sometimes but not always the right thing to do because you want to make sure that the stock performs reasonably well in the aftermath of the IPO so that should the company need to come back to the capital markets in the future, people will remember their initial public offering fondly and be willing to come back and perhaps by more on a follow-on offering.

There are times when you have to tell a corporate client that the price that they had hoped for is not achievable and that the better course of action is to sell stock at a lower price. They may choose to sell less stock at a lower price, they may choose to sell the same amount but there is a natural tension between buyer and seller.

Mike Alkin: Now, a company is public, gets trading, and it's covered by a research analyst at the firm who typically covers a specific sector, whatever it may be. It could be food, it could be semiconductor chips. He's writing research or she's writing research on as-needed basis when they have something to say or they may have a thought that they want to pass along at a morning meeting. Let's help listeners understand how the sausage is made. In a day in the life of, now, I should say Greg was a partner at Lazard and he ran the equity capital markets, which is a big job and he had a lot of salesmen, institutional salespeople working for him.

The analysts have comments they come out with a new recommendation, they downgrade or upgrade a stock from that point walk us through how the machine works.

Greg Rice: Sure. Once the stock is trading and the markets are assessing its value the issue begins to mature and season, and as research notes come out and they are generally broadly in line with what was presented during the roadshow, at times they're at odds with what was presented, and the investor group both individual and institutional get more information from more sources. The stock starts to trade in accordance with the estimates that have been established.

The assumption generally is that early on company projections are pretty dependable, and therefore, when a company that has been recently taken public as earnings expectations on the first or second quarter out of the gate the stock often gets hammered and rightly so because investors assume that they had those numbers dialed in, and in fact, they didn't and it's an indication that either they don't really know what's around the corner, one or two quarters from now or they do and they're not telling you the truth.

Companies' stocks get very heavily penalized when they are, when they disappoint early on, but research analysts are an important part of the process because they help distill what drives the company and what drives the stock. They help put the stock into context relative to its peer group and relative to the market so that investors have an idea of what drives the business, what kind of valuation the company ought to get, and thus begins the normal process by which companies either meet, beat or disappoint Wall Street estimate.

Mike Alkin: It takes a life of its own from there. What happens? An analyst comes out and he upgrades or downgrades a stock or he has a thought on the company. What does your sales force do when you were there?

Greg Rice: Well, our job is to provide a mouthpiece for the analyst to make sure that the insights that the analyst has, the salient points of his or her work get communicated to the client base.

Mike Alkin: Client base being in the case of an investment bank like that.

Greg Rice: It's going to be both institutions and individuals. In a large integrated investment bank, they will have an institutional securities business and they'll have a wealth management business that used to be referred to as retail, and their research is distributed to both channels. At that point, let's say that morning an analyst will come out with an initiation report or with an update. The sales force gathers in a morning meeting that starts at 7:00 AM or 7:30 and the research updates are provided in that meeting to all the sales force and the sales traders.

The research salesmen cover portfolio managers and analysts on the buy-side and they keep them up to speed with the brokerage firms thinking and sales traders keep the trading desks. The people who on the buy-side execute the orders for the [inaudible 00:32:14] managers.

Mike Alkin: Is there a counterpart on the other side?

Greg Rice: Yes. They keep them informed and the analyst reviews, the company reviews what's important about their note, reviews why it might be different than consensus, what else is already out there.

Mike Alkin: That's rare.

Greg Rice: Can be and the sales force does its best job to communicate that to clients.

Mike Alkin: One of the things, Greg. Now, Greg and I have to give you a little story before we go further. Greg and I met at a firm called from Knott Partners and I was a partner there and I had been in the hedge fund business, I don't know, 13, 14 years by that time, and to give you a little insight into it, it was I think we were $3-1/2, 4 billion at the time that Greg joined, and at a hedge fund these aren't, some of them are. Some of the biggest ones you go to work in a suit and tie if you want to, many guys just go dress casually but many times you just go in and you go in your shorts, you go in a jeans. Your focus is to generate as much profits for your investors that you can.

It's not a beauty contest. It really is ... The walls are silent, anything you see on TV, if you're watching Billions on Showtime that's rare. These are just very quiet offices with a lot of spreadsheets on Microsoft Excel up on guy's desks, and a handful of meetings once in a while. They're very casual and you talk about your stock ideas. Greg joined us because he was friendly with David Knott and Greg was switching from the sell-side to the buy-side and he was coming in as our chief operating officer and he was also going to learn the buy-side investment process and coming in as a partner and on the sell-side you're ... A lot of it is content that you have to deliver but it's, a lot of it is image and how you present yourself.

These guys go to work very well-dressed. They're really well polished. They're entertaining clients and they really are, they're very, very, for the most part, sophisticated folks. Greg comes into the office, he takes his drive out to Long Island where our office was and the fund had been in existence for well over 20 years at the time. I had been there for a few years and we overlooked a storage unit. We didn't really particularly care.

It was a nice office, but it was in the burbs and Greg had come from midtown Manhattan and spacious office and running a big team and here he came to a firm with maybe 20 people, maybe, and he showed up and I may have been wearing sweatpants that day or not, I'm not sure. My other partners may have been wearing shorts and Greg used to like to come in, as part of his job on the sell-side was

Greg would have his sales force and he would question the analysts in those morning meetings and really grilled them because he had to really understand the message he was going to be delivering out to his clients and his sales team did the same.

Well, here came this new guy in a probably, I don't know, a $2000 suit, which was more than my entire wardrobe I would expect at the time, and here came Greg into the firm and he would sit down, in the first few weeks he would come into my office and very affable, very nice and, but he'd ask me a lot of questions. I was a partner there and just kind of did my own thing and I was quiet. I'm a short seller and short sellers can be a little ornery, a little cranky, and don't like to be questioned a lot once the person questioning them doesn't really have the depth on that particular company, but Greg was extremely skilled because he had to know 50 different industries that his analysts were covering.

Greg would come into my office and he'd say, "What are you working on? I'm just trying to learn." I'd give him two minutes of my time, and then, he'd keep drilling down on questions and I gave him two minutes of my time and I didn't want to give him more than five minutes of my time, but he would keep going and keep going, and so, finally, was starting to wear me out and, now, to see Greg, and you'll see a picture of him where we put up on a website, a he's a dapper guy. He looks like Steve Martin.

He's very dapper. He's tall. He's 6'3, very well-dressed and he reminded me of Louis Winthorpe from Trading Places, and so, after one night we were sitting around late at the office, he had probably been there for a month or so and he was, just kept asking me all these questions and I finally said, "Would you please shut up? You're driving me crazy. You come from the sell-side, you think you know what you're talking about." I went off on him.

From that day forged what is a really great friendship for many, many years. I call him Winthorpe. I call him Thorpe because to know us, it's kind of like the odd couple. He's very erudite. He's very sophisticated. He's dressed very well and I'm dressed like a shrub. That's just my thing. I wear jeans. My wife's not happy with it but you know what it is, it's just not important to me. I wear an $18 watch, it might be 20 bucks now if you bought it new.

Anyway, so to go back so Greg, now you're taking this information, you're going out to the buy-side with it and the analysts, one of the things I see a lot, I'm on Twitter a lot, I get asked a lot of questions from people. I get emails. I get phone calls. The analyst at such-and-such firm just raised his rating, he just lowered his rating, he just raised his price target. To me, that doesn't mean really that much because I'm a big power of incentives guy and I always want to understand what the incentives of people are and so over the years, and it's changed.

I'm going to have Greg talk about the changes that have occurred but over the years I viewed the sell-side as a source to get up to speed quickly on an industry because they only cover one industry at a time, and if you're a generalist you want to get up to speed but I didn't put much stock and weight into their price targets or how they arrived at them because their job is different than the buy-side to some regard in terms of both the ability to go out and do different types of research and incentives.

Greg, what would an analyst who's upgrading or downgrading his stock, if he's really negative on a stock, and I see he goes to neutral, why did he do that? Talk about what the old system used to be like and what the new system is like when it comes to how analysts are compensated and how that works and Thorpe -

Greg Rice: What Michael really said was once I submitted to him then we got along famously.

Mike Alkin: Exactly.

Greg Rice: It's hard to look at a hockey player and not feel a little scared and when you get under his skin, it's a problem. I learned my lesson and no more questions.

Mike Alkin: You can ask questions but at the right time.

Greg Rice: At the right time. If you look back over the years, Wall Street research really was focused on publishing reports that were generally positive, constructive towards the investment banking corporate clients about which they were written, but there were investment boutiques like the LJ, which didn't do a lot of financing in the early days. They were publishing independent research and were known to cater to institutional and individual clients and put their interests first. But the moderate investment bank that's dealing with large corporations that are financing their businesses in the equity markets are relatively mercenary, were about how they devote resources to, in research to their clients.

In the old days, equity research was largely provided as a service to the corporate client and a helpful service to the institutional client. Eliot Spitzer changed all that and essentially he was the Attorney General and governor of New York. He focused on the notion that, in fact, a lot of the ratings and published research was at odds with what the analysts actually thought and that was a problem. It was well-known institutionally. I think most buy-side institutions understood that the analysts brought certain biases in favor of the investment banking clients and they were able to work around it.

There's lots of great information in Wall Street research, but you knew as a buy-side investor how to read that report. You could read through what was being said, but retail investors wouldn't know that, right?

Mike Alkin: That's right.

Greg Rice: I think Spitzer was correct in the notion that individual investors were not aware of the extent to which equity research had been biased towards the corporate client.

Mike Alkin: That's an example a difference between Greg and me. He says the right word and I just used the more street word.

Greg Rice: But I think, again, it's not to say that there's not a lot of talent on the sell-side. There was and there is and a lot of great people, but when it came down to which companies you published on, you typically put out buy reports. At the worst, you were a hold and there weren't a lot, there wasn't a lot of appetite within the investment banking community to have sell reports because that upsets a potential client or an existing client.

Mike Alkin: Client being a corporate client.

Greg Rice: Corporate client. In fact, oddly enough, the buy-side didn't really embrace a lot of sell reports and for all their high-minded talk about the purity of the research process, I can remember calling portfolio managers running multi-billion dollar funds of household names and telling them that I had found a negative piece of information and that we were concerned about this or that fundamental development, and I'd get yelled at ...

Mike Alkin: Because they owned a lot of stock and they couldn't get out of it.

Greg Rice: They owned a lot of stock. They would hang up on me and they'd call the company, the company would say everything's fine, and then, 12 months later the management gets indicted and people [inaudible] the government. There is, it's a strange contradiction in that many buy-side portfolio managers don't really want bad news about names they already own.

Mike Alkin: Can you draw a distinction between the buy-side mutual fund manager and buy-side hedge fund manager with respect to that?

Greg Rice: I think that, first of all, by definition, the mutual fund manager is a long-only investor who is typically fully invested or largely fully invested running a cash balance of 5% to handle redemptions. A hedge fund manager has an infinite number of exposure options, right? They can be flat the market, they can be along the market, they can be long on leverage, they can be short the market and they're driving a Ferrari and those with the skills to drive a Ferrari do incredibly well.

A mutual fund manager, and there are many, many talented mutual fund managers, they, at least, do not have the burden of having to decide what their exposure to the market is. They are 95 to 100% invested at all times.

Mike Alkin: Typically, in a certain market cap or a certain style, a mandate, right? That they [inaudible 00:45:02]

Greg Rice: That's right, and that even got narrower ... I remember in the 90s, there were mutual fund managers with holdings that bear no resemblance to the investment style of the fund or the supposed title of the fund, and there were equity income funds that owned stocks that didn't pay any dividends. They were value old funds that owned a bunch of tech stocks in the late 90s so that got tightened up over time and the investment styles driven in no small measure by the consultants became narrower so that they could put every mutual fund in a box.

When I started in the business, you just had generalists managing money, and if you'd asked them what they did for a living they would say, "Well, I'm just trying to buy low and sell high." They might have had a style, they might have been value, they might have been growth, but they weren't narrowly constrained, and as consultants started to create a grid for the type of styles that were employed on the buy-side, people had to decide what box to be put in because they would market themselves, not just as a good portfolio manager, they started to say in the 90s, "I'm a large-cap growth manager. I'm a small-cap value manager. I'm a mid-cap value. I'm large cap GARP." Growth at a reasonable price.

All these boxes were created and the managers who didn't pick a box often got left behind because they found it harder to raise assets as the allocators, the pension funds, and endowments, and others who were putting money into, or with money managers, the consultants would tell them you need exposure to small-cap growth and midcap value and large-cap value and that recipe required finding a firm, and a fund, and a manager somewhere in those boxes. What was a field of generalists became a field of specialists and much narrower styles.

Mike Alkin: By the way, I'm sorry. I didn't mean to offend you earlier. I mentioned your $2000 suit. I meant that was just one side of your suit. I didn't mean ... You're right sleeve, you're left sleeve but I'm sorry. I hope you're okay with that.

Greg Rice: Do I have any choice whether I'm okay or not?

Mike Alkin: We could edit that. Okay?

Greg Rice: It's much safer if I just nod and say it's all good.

Mike Alkin: All right. Now, here, okay. We understand the motivations of the sell-side and like, I agree with you. They're very, very smart people. For me, personally, price targets are something that are just out there and they're based off a lot of times discounted cash flow analysis, that don't apply in the real world, but they have to come up with a rationale for a price target or they, an earnings multiple. You want to say something?

Greg Rice: Well, I just think that the if ... Even if you don't put much weight on an analyst’s recommended rating or whether it's a buy or a hold or something like that, even if you don't weight that, what analysts can do is point out changes at the margin that might be worth looking into.

Mike Alkin: Changes at the margins are what drive stock prices.

Greg Rice: Precisely. In other words, if the market ...

Mike Alkin: If you're going to take one thing away from this podcast this is it.

Greg Rice: Yeah. I think that what the market ... The market's constantly evaluating information and it's a mechanism that is constantly refreshing on every trade.

Mike Alkin: [inaudible 00:49:04] this thing.

Greg Rice: Whatever is known, broadly known about a stock price is often reflected in that stock price, and so, what all investors are doing is trying to find or develop a variant perception. What is it in their view or investment thesis that is different or at odds with the prevailing investment view? That's why when you see companies that report a quarter that might show 50% year-over-year growth and the stock goes down 10% the next day, it's not because they didn't put up a good quarter, it's because the quarter did not exceed the already baked in expectations of the shareholders.

What the sell-side can do is point out changes at the margin, which could make people rethink how they look at the stock. As an investor, and a consumer of this research, we, Mike and I always looked at the sell-side as competition because by the time they find out about something they're telling all their customers and we want to try and develop our views and act on them before those views are broadly known, and so, that we can take advantage of the disparity between either our estimates of growth or our estimates of the persistence of growth versus the sell-side.

Mike Alkin: What I'm going to bring up now I think in addition to Greg pointing out variant perception and changes at the margin, the next thing I think is one of the most important things for investors to understand is how those estimates are derived, so way more often than not, the sell-side analysts is forming his estimates based on guidance given from the company, and that guidance is given during conference calls, at conference presentations, earnings reporting calls, and they take the revenue growth estimate, the margin estimate, the taxes, how much interest expense and they put it into a spreadsheet and they come out and management guides towards that.

If you have a management team that is not all over their business and is not aware of what's going on day to day, and it happens all the time, that's where you can really see company slip up and conversely, you have to know the management team, maybe keeping things in their back pocket and they want to surprise people to the upside so it works both ways. But that's how a sell-side analyst forms his estimates and oftentimes, it doesn't behoove a sell-side analyst to be out there on an island by himself, to come way against consensus. There's comfort in crowds because if you're wrong it could cost you your job.

We're going to transition now because I want Greg to walk you through his transition from the sell-side to the buy-side and how a buy-side analyst derives with their estimates. I think ... Greg, we should talk about our trip to Cleveland in 2008 because I think that's a great way to talk about how we were able to get a variant perception.

Greg Rice: To your point about the sell-side and the process of coming up with estimates, in the old days, a sell-side analyst would develop a model and it was an iterative process with the management. The analyst would send the model to the CFO and the CFO would point out which numbers were too high and which numbers were too low. In the end, it was driven largely by what the company wanted to put out there in terms of its own expectations plus some of the analysts work independent of that, but it's remarkable how closely packed all the estimates were in the old days within pennies a share on very complicated companies. That's because the information really was coming from mostly one source.

Mike Alkin: The analyst’s job is so packed during the day with talking to institutional clients, to talking to corporate clients, the companies you're covering that they don't really have the time to go out into the field and dig up their own information, right? It's building models. It's talking eight hours a day to institutional portfolio managers and company so what time is left to go do your own work.

Greg Rice: Yeah. I think for a large integrated investment bank the analyst does spend a lot of time marketing and the analyst is used to help attract, certainly, in the past was used to help attract investment banking business through their knowledge of the industry and their institutional contacts and following. But you're right, they've got a lot on their plate, and so, they can't spend all of their time focusing on doing research.

Now, they have teams of people that help write their reports. They have teams of people that help model, junior analysts ...

Mike Alkin: Often junior who might miss the nuances.

Greg Rice: Absolutely, but they often have very good teams. Now, there are more independent firms that do less financing, less investment banking where they might hire senior people out of industry like a Sanford Bernstein, AllianceBernstein now, which has a very well-respected research product, and largely independent of the banking process, and there are any number of boutiques that ...

Mike Alkin: [inaudible 00:55:18] right research.

Greg Rice: ... that have just the right research and they focus on coming up with their own numbers, but I will tell you that in the old days it was all coming from the CFO, and the analyst would add a touch here and there and to Mike's point part of the reason was there's very little incentive to drive a wedge between the analyst and the corporate client by having vastly different numbers. If your numbers are too high and they're not met, it makes the company look bad because they missed your number. If your numbers are too low then it makes people doubt the company's ability to execute.

The analyst has a tough job dealing with the corporate clients and the natural tension, likewise buy-side investors also in the old days wanted access to managements. Companies would come around and visit with all the big mutual funds on non-deal roadshows, where they would just call on institutional managers and give him an update on the company in a 45-minute meeting.

In that scenario, challenging a company or pushing back against the company's thesis was also difficult for the buy-side firm because to push back against management risks your relationship with management and it put at risk the information flow between the company and the money manager, so nobody really had an incentive to push back on management in the old days. Now, there was a regulatory change in the 90s called regulation fair disclosure, Reg FD for short.

What that said is that any time a company has something material to say it has to make it available to everybody at the same time. In the old days, they would give those changes at the margin about business conditions. They would give those to their favored analysts, favored brokers, larger stock shareholders, and that became quite a game because you would see a stock go down 3, 4% one day there's no news, and then, two days later you find out that the company's lowering their earnings estimate, somebody had that.

In the old days a lot of times they came from the company. It just didn't, wasn't broadly distributed and what reg FD did in the 90s was force companies to level the playing field so that everybody's getting the same information at the same time in theory. That had two effects. One is it made it very difficult to learn anything incremental about a company when you're meeting with them as either a buy-side or sell-side firm because the management's pretty quickly learned that they had to have a very polished, very consistent investment outlook or business outlook that they shared with anybody who asked and that anything material they had to put either in a SEC filed disclosure or a press release.

You found that for the big issues regarding business conditions, everybody was pretty much on the same page, and it was harder to differentiate your work from someone else's, and so, that had some profound effects for the industry. Those buy-side firms that invested heavily in their own internal research capabilities were able, at least, to have a better shot at coming up with a variant perception and, again, I think that's really what drives the investment process is after you do your work and you talk to companies, you talk to their suppliers, you talk to their customers, you talk to their competitors, and you come up with your own view about what the company can earn and how persistent that growth can be. If it's at odds with the existing consensus then you've got something.

Mike Alkin: One of the things that I have learned over the years is, it is a very tough business. Trying to be on the right side of an investment is hard. You hope to be right 7 out of 10 times. You're definitely going to be wrong and sometimes you're going to be wrong a lot, and I've been wrong a ton in my career, and I learned, hopefully, you learn from those mistakes that you make, but it's a very humbling business. What you tend to do when you're taking the responsibility of managing other people's money, OPM, you go to sleep every night just hoping you're right because it's a huge responsibility, and if you're in good conscience, which I am and Greg is and most people are in the business, you're trying to find that variant perception that could generate above-average returns for them.

One of the things that I often look at is when there's so much emotion or conviction one way or the other in a sector industry or company, when the scales of conviction are tilted so strongly either bullish or bearish that the narrative becomes somewhat rote, and it's there where I often find that complacency can set in and I go back to comfort in crowds. Greg and I have been to many, many investor dinners where 8 or 10 hedge fund guys will get together just to catch up and you talk about interesting ideas that you like.

I call it the head bob, when you're, somebody's pitching an investment idea and everyone at the table saying, "Yeah. Yeah. Absolutely." Makes me wonder because I think a lot of that's priced into the stock. Greg and I in 2008 were looking for ideas long and short, and one of the areas we saw that made us scratch our heads and I have a lot more hair than Greg does, one of the things that made a scratch our head was in the steel industry because one of the things I've learned over the years is industries, unless there's some real disruption, technological revolution going on in an industry especially a cyclical industry, its supply and demand, right?

Things don't really, if things get too far going in one direction or another, and you really can't get your head around it there may just be some unusual dynamic that's occurring. Well, we saw the steel industry doing things that we had never seen before, and we went back and looked through history, and that got us curious. Greg, why don't you take it from there and share with investors or our listeners what happened there?

Greg Rice: Sure. The steel industry was going through some very interesting pricing dynamics in 2008. A ton of cold-rolled steel used to trade at $300 a ton, and then, by the beginning of '08, it was at $600 a ton and by the summer of '08, it was $1260 a ton if I recall correctly, and so, this was an unusual move and we wanted to understand whether it was fundamentally supported by supply and demand or whether it was going to prove to be temporary.

Mike Alkin: At the time, the sell-side, the analysts were very bullish.

Greg Rice: Very bullish and indeed the companies were putting up very good numbers, business conditions were excellent, pricing was, as I say through the roof, and in steel, it's largely for an integrated mill that's using iron ore and the raw components of coke that go into steel, they had access in most cases to their own iron ore supply, and so, when prices jump like that they were making a ton of money.

The marginal pricer in the business is the mini mill, and the reason that the mini mill sets the marginal price is that their input goes up and down with the cycle.

Mike Alkin: Explain a mini mill.

Greg Rice: A mini-mill is instead of an integrated mill melts iron ore and coke and other components into steel and pours it into various shapes. A mini-mill uses and basically an electric arc and melts scrap and it takes scrap from scrap dealers. It melts it and by sticking these giant electrodes into a pot and create an arc, electrical arc between them and eventually the steel melts and it's reused. It's the ultimate recycling of steel, and whether it's a washer dryer or a school bus or an old car that steel gets recycled and ultimately sold to a mini mill, which is called that uses an electric arc furnace.

The price of scrap had surged, and so, the mini-mills, in order to make money had to raise their prices and the integrated mills followed right along. Prices were elevated and we decamped to Cleveland to figure out whether that was sustainable or not. Well, I mentioned reg FD. Reg FD binds public companies to the standard of releasing information at the same time to all of its stakeholders publicly. But when you speak to a private company in a business they're not bound by Reg FD.

We set off for Cleveland to speak to a series of private companies who were distributors, traders, fabricators, some mills, and scrap dealers in order to get some unadulterated views about where we were in the cycle. Were we in the third inning or were we in the top of the ninth.

Mike Alkin: Greg was like a kid in a candy store. I think after all those years on the sell-side this was his first big field trip, right? He was very excited to be doing this as a buy-side analysts.

Greg Rice: The great thing about managing money is your grades are on a piece of paper every day. It's not about your haircut or your suits, it's about getting the right answer. Off we went to Cleveland, and we had a dozen meetings over two days, in three days with private companies who could tell us anything they wanted to tell us. That was critical because you weren't going to get anything incremental or particularly interesting out of the public companies. They were all bullish. They all thought that the business had changed on a secular basis and it was going to be good times for a while.

When we got to Cleveland, we were able to sit down with people who had been trading steel for 30, 40 years. They had seen cycle after cycle. They understood what inning we were in, and at the end of the trip, we learned several things. A lot of the old-timers were much more concerned about price levels not being sustainable. One notable steel trader showed us a fax in his office and it had a list of all of the extra steel that was for sale on that day and normally, it was a one or two-page fax and I think this fax was 30 pages. You knew that inventory was starting to build up and the mills were looking, had overproduced a little bit and looking to get rid of it.

Mike Alkin: This is the same guy who told us on our way out to the airport to drive by somewhere. He said, "What are you being told?" We told him what Wall Street said, and he said, "How you get into the airport?" We told him, he said, "Go a different way." We went by a field, and in that field was more steel than the eye could see, but if you listened to Wall Street and the companies they would tell you they were inventory shortages.

Greg Rice: That's exactly right. We drove by the back lot in one of the mills and there was cold rolled steel piled up left and right, and so, clearly, something was going on, but when we got back to New York and we met with scrap dealers as well and they gave us their insights. When we got back to New York we didn't do anything right away because we thought that; A, the street was very bullish and likely to defend the group for a little bit; B, the companies were going to be reporting very good earnings near-term, and whatever conditions that we witnessed or thought were around the corner, we're not going to hit the earnings reports until a quarter or two later.

We sat on it for a couple of weeks, but we kept up our conversations with our contacts and we were on a phone call with scrap dealer contact of ours. Now, this guy was 30 something-year-old scrap dealer in Cleveland, he looked like [inaudible 01:09:31] from the Food Channel, and he had the crazy shirts and didn't look like a Wall Street guy for sure.

Mike Alkin: Thank God.

Greg Rice: Yeah. But he was incredibly insightful and I remember thinking, "These guys don't look polished but they really understand their business. They really have a good pulse on what drives scrap prices." We knew we wanted to keep in touch with them.

Mike Alkin: You could say they look like me.

Greg Rice: I don't know if they played hockey but they were remarkable in their depth of knowledge about the scrap business. We knew we wanted to keep in touch with them, and so, we had a series of phone calls back and forth. "What's the latest? How are business conditions developing?" One day were on the phone with these scrap guys, and I remember asking them, "Why did you go into scrap? What was so interesting about the scrap business?"

They gave a great answer. They said, "Well, we saw all of our really smart friends going to work on Wall Street and we thought, 'Why would we want to compete against them?'" They went into a business where they didn't think the competition was going to be as sharp as they knew they were and they were right. In the course of these conversations, they said something really odd. They said, "Did you hear about the Gerdau shipment?"

Gerdau is a South American steel company. We said, "No. What do you mean?" Well, the United States has a deep reservoir of scrap. There's lots of scrap. There's washer and dryers, there's used cars, there are school buses in the woods, there are all sorts of things that end up in a scrapyard and we have more scrap than we need. The emerging world interestingly does not have a deep reservoir of scrap because they're relatively young economies, and so, in order for them to make steel locally, they either have to build an integrated mill where they build an electric arc furnace or a mini mill.

It's far more cost-effective to build a mini-mill, but you need scrap to be able to feed the mini mill, melt it down and create new steel. They buy that scrap from the United States. China buy scrap, the Middle East buy scrap, and at the time, the Turkish mini mills were buying a ton of scrap from the US East Coast, and so, scrap dealers would fill these boats full of scrap that's been shredded in their machines, they would send it across the Atlantic Ocean to Turkey, and the Turkish mini mills would melt it down, turn it into new steel, and sell it to the Middle Eastern construction market, which was dominated by the growth in commercial building in Dubai as an example, also Abu Dhabi.

He said, "Did you hear about the shipments of Gerdau?" We said, "No." He said, "Well, the Turkish buyers, the mills had a deal to buy a boatload of scrap from the US East Coast, the ship was halfway across the Atlantic and the Turks canceled the order." The owner of the scrap had to find a new home for it, and while the ship was in the middle of the Atlantic, desperately called around to find another buyer for the scrap shipment. The only buyer at the time was Gerdau and Gerdau is South America.

They rerouted the ship to South America and sold their scrap to Gerdau for $100 a ton, lower than the market price, which then at the time I think was $500 a ton, something like that ballpark. We knew right then what was happening. The Turks refusal to buy the scrap meant that the Middle Eastern construction market was slowing or stopping and if that's the case the incremental buyer of scrap, the incremental producer of steel, and the incremental demand for steel was going to change significantly.

We came in the office the next day and we [inaudible 01:13:59] a whole basket of steel stocks in both short sales and options.

Mike Alkin: Options.

Greg Rice: In the next three or four weeks we made a ton of money because the market came to realize that things were slowing dramatically.

Mike Alkin: Had we not been on that field trip to Cleveland spending those days talking to people in the private industry and walking away knowing or thinking we had lightning in a bottle, but had a way to find a catalyst. That phone call, I mean, even if we hadn't read about the Gerdau, it might not have made sense to us.

Greg Rice: That's right. That's what we mean by variant perception. We came to believe that the demand for steel as evidenced by the demand, the declining demand for scrap, the demand for steel was going to shift downward, and that was going to be a surprise, and the people who were bullish on the steel cycle didn't know this. We were able to profit because we had a variant perception on the steel market.

Mike Alkin: That's why I love investing in deeply cyclical industries because you have these great fluctuations of supply and demand and when you go out there and talk in the field, it's stunning. We were, and I forget if you were with me on this trip in Iowa. I was with Ashley. We were out in Iowa with one of the analysts who worked for [Ray 01:15:32] and Brent, and it's a couple of analysts who worked for me, we were out meeting farmers in Iowa. We were doing work on the agricultural industry, which we'll talk about in a moment.

But we were doing work on the AG industry, and at the time the options exchange was showing, the commodity exchange was showing corn prices looking out into the future as being very depressed. We were in Iowa, we were in Nebraska, we were in Minnesota, we were driving everywhere over the course of several weeks, we would come home on a Friday, and then, go back on a Monday and meeting with farmers at their homes, big farmers, 10,000 acre farms, and we were having dinner in Iowa one night and the farmer said, "What are you seeing?"

We said, "We're seeing a lot of corn." He said, "What do you think of that corn?" We said, "Well, looks like they're right in Chicago." He said, "No. You're wrong." We said, "Why is that?" He said, "You see the brown on the top of that corn?" We said, "Yeah. We do notice some of that." He said, "It's no good." He said, "Price is going to go way up because estimate on a number of bushels this year's going to be way off come harvest season." We said, "Wow." Sure enough, it was, and we had taken advantage of that.

When you're out there these deeply cyclical industries when there's so much conviction one way or another there's, that's consensus, and you can develop a variant perception by getting out there. Greg, I just mentioned farmland. After many, many years of a fabulous run at our old firm, it is now a family office, and you and I have moved on to different things, and I think what you're doing now is fascinating. I mean, you are in the agricultural industry, but in a different way. You were a partner at a storied Wall Street firm on the sell-side Lazard, you were a partner at a storied hedge fund and now, you're a partner at a fund that invests in the agricultural industry.

Tell people what you're doing because I think it's really interesting because I learned a lot talking to Greg about what farmland is all about and there are some things, and I'm not ready to talk about it yet. I will in the coming weeks about a view on farming, about one area of the agricultural space that I think is interesting. But Greg, why don't you share what you're doing now?

Greg Rice: Sure. I have a couple of partners who are developing a product in this area. I won't get into the details of the product but we think agriculture is an interesting area to invest and many people just don't know much about it as an investment asset class. When we started to look at farmland, we noticed a couple of things. One is that there's still inefficiencies in farmland.

In the securities markets there are a lot of smart people doing a lot of smart work, and it gets harder and harder to develop that variant perception because you may think you have a variant perception but others stumble upon it very quickly and all of a sudden it's armed out of the stock and already discounted in the price. In farmland there are some inefficiencies that we think can be exploited and make for attractive returns. Just generally speaking farmland has generated very good investment returns over a long period of time on relatively modest volatility. It has limited or no correlation with other major asset classes, and it's both defensive in nature, and it also has some gearing with inflation.

Mike Alkin: It blew me away by the way because when I thought of farmland, you think of Sissy Spacek in the old movie when people were losing their farms and farm, obviously, it's recovered but I didn't realize how well it has performed.

Greg Rice: It's done very well but it's not just this cycle. It's done well over a long period of time. If you look at farmland over a 20, 30, 40-year period, quality farmland has outperformed the S&P 500 by 200 basis points a year, 2% and over a 30-year period that really adds up and yet what's interesting is you have this terrific investment performance, you have modest volatility, and you have a very limited correlation with other asset classes. Meaning, it doesn't really move with bonds or equities or commercial real estate or other major asset classes that people invest in or institutions invest in. It does its own thing, and yet when you looked at how many institutions were invested in farmland there really, it's a pretty small group.

Mike Alkin: Why is that?

Greg Rice: I think in part because it's almost self-fulfilling. If there are a lot of people invested in it, a lot of investors don't want to do it, and they're scared or they're not familiar enough with the asset class, and so, we thought that was appealing because here's a high-quality asset that was being overlooked. As an example, if you look at the farmland funds that are out there. There's probably $30, $35 billion of farmland owned by investment funds and thereby people, that's nothing.

It's not a lot, but it's a big number and you look at it and it's, and you've got the Prue and John Hancock, and CREF, TIAA-CREF and MassMutual and all sorts of insurance companies have farmland products. In those products are invested wealthy individuals and institutions and institutions like Texas Teachers or New York State Common they participate in some of these farmland funds, but it still only adds up to Mike's point about 35 billion.

It's $35 billion against an asset class that is $2.5 trillion in value so the institutional penetration of farmland funds is about 1%.

Mike Alkin: Which is interesting though because when you think about the college endowments and insurance companies and pension plans those with really long-term time horizons, it's very common for them to own Timberland, very long-lived assets so what's the difference?

Greg Rice: Well, timber is basically a cost of money asset, whereby you plant and you know the maturity curve of the trees that you're growing and depending on the pricing of lumber, you can choose to harvest today or harvest tomorrow, but it's very hard to switch. It takes a long time for the crop of trees to grow, but it's a fairly visible return. Farmland depending on the type of farmland there are permanent crops and there are row crops.

In the row crop world, you're replanting every year, and great farmland can grow almost anything so you can rotate from depending on the economics, from corn to soybeans depending on how the end markets are doing. I think that when you look at the ownership of farmland, it's overwhelmingly individuals, and related family institutions. What drives farmland as an asset, population growth, per capita consumption of grain goes up over time particularly in emerging market economies, the amount of arable land per capita declines fairly steadily predictably over time and there is increasing pressure in terms of water sourcing.

There's a pretty good supply and demand outlook for farmland itself and the grain that you grow on it is driven by food consumption and one interesting dynamic is that grain is an ingredient of feedstock for livestock, and so, when you are raising beef cattle, you put in between four and seven pounds of corn for every one pound of beef that you generate. Chicken is two to one, pork is three to one so you have as demand for protein grows in the emerging world, you have an accelerator or a booster of grain demand as it's converted into animal protein.

It's underpenetrated, it's historically proven to be a good asset to own, it generates income, the current yield on high-quality farmland is somewhere around 3 or 3-1/2%, and which is at a premium to the US 10-year and we know two things. They're going to be making a lot more 10-years and they're not going to make any more farmland.

Mike Alkin: By 10-years, you're talking about the 10 -year Treasury?

Greg Rice: Sorry. Yes. The US 10-year Treasury. Look, it's an underappreciated asset class that I think may create opportunities for investors and it has gone through cyclical ups and downs. What's interesting today is that commodity prices are relative depressed. If you look at a chart of the S&P versus the commodity research bureau's commodity index, we're at an all-time or cyclical low. If inflation comes back, what happens?

Well, if commodity prices go up then growing the commodity becomes more profitable. If that's more profitable you can charge higher rent as the landowner, and that makes the land more valuable if you can charge more rent. If you get a resurgence in commodity inflation, it should benefit farmland over time. You have some protection in being able to renegotiate your tenant leases every year, you have the ability to renegotiate those up should you see better rents ahead.

Mike Alkin: I'm going to play rapid-fire here for a second. I'm going to put you on the spot. Favorite professional investor.

Greg Rice: Mike Alkin.

Mike Alkin: Doesn't count.

Greg Rice: I'd have to ... It's an obvious answer to me but I'd have to say Stan Druckenmiller.

Mike Alkin: Tell listeners who that is.

Greg Rice: He's one of the greatest hedge fund managers of all time. He put up 30% a year returns for 30 years and didn't have a single down year. He's brilliant.

Mike Alkin: The thing you think is most important for an individual investor to focus on when they are picking a stock or a sector.

Greg Rice: Don't be afraid to buy something when everyone else is panicking. When I look at some of the better investments that I've had over a long period of time, it's when the market was in an emotional state and I was a little less emotional. An example, in 2008, the world was falling apart and the group that was most under pressure was the financial sector. It was under pressure for a lot of reasons, it was highly leveraged, the assets were, some of them were of questionable value.

Mike Alkin: Toxic.

Greg Rice: Toxic. There was a tremendous amount of leverage within the investment banking industry and you had a liquidity crisis, which forced these investment banks to really ponder what they could, what those assets were worth. The underpinnings of the financial system as everyone knows were at risk. Well, most commercial banks take commercial lending risk. Everybody from JP Morgan to Wells Fargo to Comerica to pick your bank, they're extending loans to companies and to individuals, and whether those were mortgages or those are corporate loans there's exposure. They may be able to sell them, but they have a balance sheet and they're exposed.

A company like State Street Bank, STT, was not exposed. They don't do any corporate lending. They have a trust business whereby they keep and hold securities on behalf of mutual funds and other money managers. They don't take a lot of risk, and so, even State Street Bank was getting hit in the fall of 2008, and perhaps deservedly so, but then there was this rumor that they had an off-balance sheet entity that was in trouble and they did an off-balance sheet thing where they were on the hook for the entity, but it wasn't on their balance sheet, and at the time, investors were very suspicious of this because in the wrong hands it could be abused and exposed the bank or financial institutions to all kinds of trouble out of the blue, and something that the investors because it's not on the balance sheet, the investors would have no way of knowing what the true exposure was.

When people learned that investment banks had these off-balance sheet entities, it was another reason to sell the stocks. State Street Bank was trading down 40, 30, 20, and the rumor started to come out and started trade with the mid-teens, and I just said to myself this is a great company. They don't take a lot of risk. I don't see how the financial crisis puts them out of business. The business of collecting modest fees for holding securities will be there tomorrow. In fact, arguably, it's even more important in a way and they're not, they don't have the same risk profile of a large commercial bank.

I started buying the stock for myself at 20, and then, 19, and I think I bought my last bit of stock at 15-ish and when the storm passed and people had a chance to reassess State Street and whether it should trade at a premium or discount to other commercial banks, the Fed saved the day as we all know, and the banking industry lifted, and over time as the as their customers, the mutual funds recovered, State Street stock recovered and it's trading above 100 today. I think it's having the courage to buy good companies when they're not wanted.

Mike Alkin: Don't panic would be one so two more questions. The trait you most admire in investors. Now having spent 20 years at the sell-side, you've called on some just world-class investors across the board so we know who your favorite investor is, but the trait you most admire and the trait you least amongst investors.

Greg Rice: I think the trait that is most useful is being unemotional. It's being able to assess information and remember that the stock doesn't know you owned it, the stock doesn't care whether you own it, and if you find something out that changes your investment thesis, and you don't really understand it, sell it. No nobody gets angry, the company doesn't get upset, you sell the stock and move on.

I think it's a good discipline for individual investors. If you own a stock and you have three reasons why you own the stock, whatever your investment thesis is and the stock starts going down against you. You've got to make a decision, has your investment thesis changed or is it the same? If it's the same and that stock price decline might be an opportunity, but if the fundamentals have changed, having the ability, the unemotional ability to just change your mind, sell the stock, take a small loss before it turns into a large loss that you have a hard time recovering from is a great attribute of great investors.

Mike Alkin: The flexibility. When I work for Joe DiMenna, one of the great hedge fund managers. Joe could be long a stock today and short tomorrow. It was price and value, and it was an incredible thing to learn.

Greg Rice: I'd say that the second valuable skill that comes to mind is and it's something that Michael pointed out to me because he's a big hockey fan is that when asked why he's such an exceptional hockey player Wayne Gretzky's remark was, "Most players skate to where the puck is, I skate to where the puck is going." When you own a stock, think of a couple things. One is every time you buy a stock somebody sold it to you, every single time you bought a stock, and you were excited and you think you're getting the deal of a lifetime, somebody said, "You know what? That stock is junk. I want out of it."

It's very humbling and consider that when you buy a stock, "Why am I buying it and what do I understand about the stock that the market does not?" But I think that trying to figure out what is going to make that stock go up because that's ultimately what matters and most of the time it's because business conditions 18 months from now are going to be different than today's business conditions. Investing is about trying to figure out what business conditions are going to look like, how the company is going to be doing in 6, 12, 18 months and if your view about where it's going to be is a lot different than the markets and different than today, then that's the basis for I think a good investment.

Certainly, you want to understand the company and the industry dynamics but you really need to figure out where things are going to look 18 months from now and hopefully, the company will move towards what you predict and that's how you earn good returns.

Mike Alkin: Last question. Mistakes you've seen people made that jump out at you.

Greg Rice: So many and I've made them all. I'd say it's the analog of what I was saying, which is you become emotional about a stock, you dig your heels in, and you can't see, you can't be objective about a change in the investment thesis, a deterioration in the fundamentals, and you buy it for reasons one, two, three. Reasons one and two go away and you invent reasons four and five. Now, you own it for three, four, five, not one, two three. Not having the ability to sell unemotionally and walk away is a terrible trait.

Mike Alkin: Mr. Rice, I can't thank you enough. It's been a lot of fun. The name of the podcast is Talking Stocks Over a Beer. When somebody's in studio I like to have a beer with them. You don't drink beer, more of a wine guy. I don't know how [crosstalk 01:36:45] ... But thanks for coming and I really appreciate it. It was great.

Greg Rice: Thanks, Mike. I enjoyed it.

Mike Alkin: Well, I hope you enjoyed listening to Greg. That was the education segment. You got exposure to somebody who has been at a very high level on both the sell-side and the buy-side and brings a wealth of knowledge, experience, and insights from what it's like on all sides of the investment world. I'm looking forward to next week. I also have another exciting guest for you. You can follow me on @footnotesfirst on Twitter or you can email me at mike@curzioresearch.com. If you have any comments, I always look forward to listening, and have a good week. Happy investing.

Speaker 1: The information presented on Talking Stocks Over a Beer is the opinion of its host and guest. You should not base your investment decisions solely on this broadcast. Remember it's your money and your responsibility.