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Bermuda Longs

Inside the world of Orbis: How William and Allan Gray beat the markets

PAGE 36

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Unsung outperformers

With the great bull market of the 1990s on life support, sophisticated investors are now revisiting the concepts of value and absolute return. At Orbis, they never went out of style.

BY JOHN H. CHRISTY

Since FORBES GLOBAL was launched in 1998, our coverage of investment funds has had a specific purpose: to help readers identify funds that are building blocks for long-term portfolios. Not the hottest sector funds. Not the best performers over the past year. Just solid funds that hold up well in good times and bad—and don't rip off investors with exorbitant fees.

It's hard to find a fund that fits this profile better than Orbis Global Equity, a $1 billion fund run from Hamilton, Bermuda, by Allan Gray, 63, and his 34-year-old son William.

Performance? Orbis Global Equity ranks No. 1 over the past ten years of all offshore global equity funds, according to Standard & Poor's Fund Services, with a 17.3% compound annual return over the period. That's more than double the average global fund's performance.

Put another way, at 17.3% a year compounded, money doubles every 52 months. Factoring in all fees (but excluding taxes), $100,000 invested in Orbis Global Equity in 1991 would now be worth almost $500,000. The same amount invested in the FTSE World index? Just $270,000—and Orbis Global was no more volatile than the index. Orbis also trounces its peers and benchmarks over three-year and five-year periods. This year, with the FTSE World index down 7% through the end of July, Orbis is enjoying a 21% gain.

Fees? According to Fitzrovia International in London, Orbis Global Equity's total expense ratio is just 0.67% before performance-related fees. The typical offshore global equity fund monitored by Fitzrovia hits its investors with big sales loads and annual expenses of 1.93%. But more on this aspect of Orbis later.

Born and raised in East London, South Africa, Allan Gray came to the U.S. in 1963 to attend Harvard's business school. M.B.A. in hand, he went to work at Fidelity Investments in its heyday, at the same time as the gunslinger Gerry Tsai and Peter Lynch, under the watchful eye of its owner, Edward Johnson II, and his son, Ned Johnson, now chairman.

Tsai went on to make his fame and fortune in the insurance business, and Lynch became an American household name running Fidelity's huge Magellan fund. Allan Gray? He pursued his dream of starting his own firm and returned to Cape Town in 1973, where he started Allan Gray Ltd.—an institutional manager of South African stocks. Money invested by Allan Gray Ltd. has outpaced the Johannesburg All-Share index by a compound average margin of 11% a year, beating the index in 21 out of 27 years. The firm is now the largest privately owned manager of retirement assets in South Africa, with $3.4 billion under management, and advises the $60 million (assets) Orbis Africa Equity Fund.

Partly for reasons of financial infrastructure and partly for lifestyle, in 1989 Gray—joined by his son William in 1993—set up shop in Bermuda. Tucked away in a fourth-floor office suite near Front Street, Hamilton's main thoroughfare, Orbis employs 21 analysts, traders, and support staff in Bermuda. Another 23 Orbis employees are in London. Allan Gray Ltd. employs 64 people in Cape Town.

You'd think that the guys behind performance numbers like Orbis' would be pretty intense. The Grays, however, could hardly be more relaxed and easygoing. William Gray, Orbis' president and manager of the Orbis funds, dresses casually and greets FORBES GLOBAL with a simple "Hi, I'm William." The elder Gray is so soft-spoken that at times he's barely audible over the telephone. Other fund managers make a sport of working 14-hour days. The Grays work reasonable hours

Allan and William Gray: Investment products should be bought, not sold.

JOHN EMERSON FOR FORBES

and enjoy boating, tennis and golf at the Mid Ocean Club in Tucker's Town.

When it comes to managing money, however, stand back. "We are very focused and, when it comes to investment performance, almost obsessed," says Allan Gray. "It's the lifeblood of the firm."

It has to be. Most offshore funds must resort to charging their investors 3% to 5% initial sales charges to pay financial advisers to flog their funds. Those fees mean less capital at work for the investors and thus lower returns.

Orbis funds, by contrast, don't charge a load—either up front or at redemption. The firm employs no salesmen of its own and doesn't pitch its funds through the usual global-fund distribution channels. It has never had a major ad campaign; the Grays have never appeared on CNBC or other TV shows, and they are rarely quoted in the financial press.

"I'm a person who likes to let the results speak for themselves," Allan Gray says. "We believe that investment products should be bought, not sold." The funds can be purchased directly from Orbis each Thursday at net asset value—no markup. The minimum initial investment is $50,000; subsequent investments can be as little as $1,000. Geoffrey Gardner, an MIT-educated Bermudian who oversees marketing at Orbis, spends his time keeping existing clients informed, rather than on sales calls.

The Grays follow a classic Graham

and Dodd approach, but not to the exclusion of high-growth stocks. That is, they try to identify companies that are priced well below their intrinsic values—essentially, the value of their assets plus a sober assessment of their growth prospects. Like the investment icons Warren Buffett and Sir John Templeton, they know that it's hard to make up lost ground, so they put top priority on capital preservation.

Contrast this with the prevailing view at many fund companies, where the top priority is beating the benchmarks. Consider the Far East (ex-Japan) equity funds listed on page 52. Many have risen to the top of their peer group while posting *losses* over the past five years. How? By losing less than their competitors. Ditto for technology funds in the past year. Being down just 20% is a stellar performance when the Nasdaq is down 50%, so the thinking goes.

If relative performance is a religion in the fund industry, the Grays are heretics. Perhaps it's because the bulk of their personal wealth is invested in Orbis funds. Another reason may be the environment that prevailed when Allan Gray was learning the ropes in the investment business.

"When I started at Fidelity in 1965, the Dow Jones Industrial Average stood at 1,000," Gray recalls. "Seventeen years later, in 1982, it was 780." That taught him a lot about the virtues of preserving capital absolutely and to hell with relative performance.

Most participants in the fund industry these days haven't seen such a dismal stretch, Gray says. In a bull market, such as the one that developed markets have seen since 1982, the worst thing a fund manager can do is fail to keep up with the market averages. Only when things fall apart is the absolute-return manager appreciated. Hence the sudden interest in hedge funds (FORBES GLOBAL, *Aug. 6*). Of his experience in 1965–82, Gray says: "You have to learn how to pick stocks in order to make money in that kind of environment." Since the fund was launched, Orbis Global has had only two negative years: 1990, when it fell 7.8%, and 1994, when it lost 2.2%.

To keep their capital and that of their investors growing, the Grays and Orbis' team of 15 analysts sift through a database of 8,800 companies spread across more than 50 countries. Orbis then narrows the field by using return on equity, profit margins, sales and earnings growth and other classic fundamental measures.

But good numbers alone don't guarantee a place in Orbis' portfolio. Take Invensys, the U.K. engineering outfit. It sells for 10 times earnings and yields a fat 9.6%. A few months ago, Orbis looked carefully at the company because the numbers seemed attractive. "It's not a bad company," Gray says, "But their many past acquisitions make it hard for us to tell what the company is really worth." As an investment candidate, out it goes. Ditto for Marks & Spencer. The retailer's price-to-book ratio of 1.5 may be among the lowest in the sector, but Gray's not tempted. "We don't have enough conviction that they can deal with the challenges they are facing with merchandising, store formats and execution."

The several hundred companies that do pass muster receive rigorous scrutiny. The aim is to find large gaps between current prices and normalized long-term valuations.

For example, CarMax, a chain of used-car stores in the U.S. The company, started by the electronics retailer Circuit City, was floated in 1997 at a price of $20, amid plenty of optimism over the concept of used-car superstores. Three years later, however, CarMax's stock had dropped to just $2.

"There were three things hurting the stock that were beyond management's control," Gray explains. First, a feisty competitor, AutoNation. Second, falling prices for used vehicles as Detroit offered healthy rebates for new cars. Finally, the internet craze made it hard for Carmax's brand to stand out as others rushed to sell used cars online.

Gray reasoned that Carmax, with nine years of experience running its stores and a record of solid profitability, ought to be the leader in this emerging business. He also noted that it was just a matter of time before the used-car price cycle improved. He built a position at an average cost of $5 a share.

By late 1999, AutoNation had overextended itself; used-car prices had stabilized, and CarMax had integrated its website with its nationwide network of stores, setting them apart from the internet-only players. The stock rose as high as $20 in mid-July and now sells for $16.

Even now, at 20 times earnings, CarMax remains attractive, Gray says. "Return on equity of 20% is possible and sustainable, allowing earnings to grow at 20% a year for many years to come." Gray thinks that CarMax may one day fetch a much richer multiple. "Why not 30 times earnings?" he says. "They're not that different from other 'category-killers,' such as Home Depot or Wal-

Intrinsic value

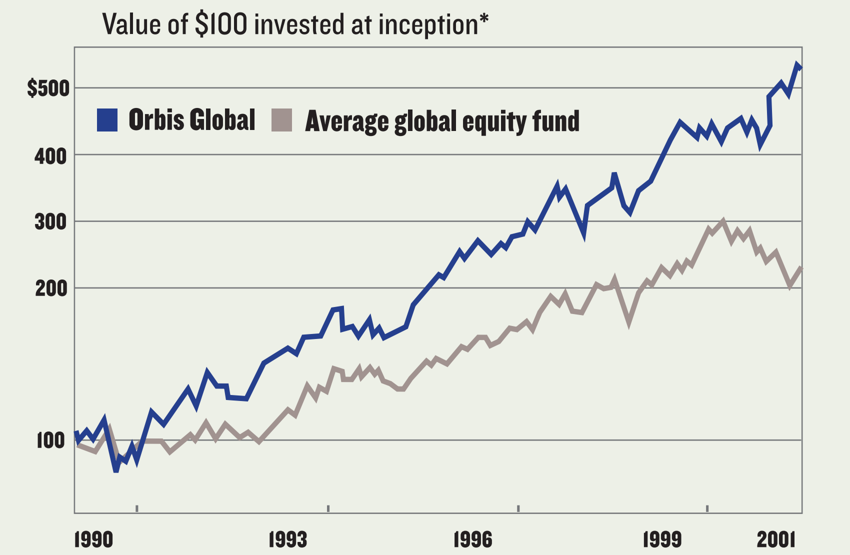
The eight stocks listed here aren't as popular as GE or Microsoft but may deliver handsome gains when their prices more closely reflect their fundamentals.

Company / country	**Recent price (US$)**	**Est 2001 P/E**	**Dividend yield**	**Price/ book**	**Market value (US$mil)**
Aioi Insurance / Japan	3.35	27.0	1.7	0.8	1,363
Associated British Foods / UK	6.70	13.2	2.4	1.3	5,301
Boots / UK	9.45	13.8	4.0	3.2	8,496
Circuit City Stores–CarMax Group / US	15.42	20.0	0.0	1.1	402
Clayton Homes / US	16.05	20.8	0.4	2.0	2,212
Corning / US	15.83	19.1	1.5	1.4	14,724
Hornbach Holding / Germany	47.26	18.6	2.1	1.5	369
Yamada Denki / Japan	79.73	23.6	0.2	2.9	1,969

Prices as of July 31. *Source: FactSet Research Systems.*

Orbis' lifeblood

Allan Gray likes to let results speak for themselves. This chart speaks volumes.



As of May 31, 2001. *With dividends reinvested *Source: Orbis Investment Management.*

Mart, that sell for premium valuations."

The Grays select stocks from the bottom up, paying scant regard to index weightings for geographic or sector distribution. Result: Orbis Global's portfolio usually looks nothing like its benchmark, the FTSE World Total Return index. "Most people start with the index," Allan Gray says. "We pick stocks and do the checks and balances later."

Don't expect any of the usual huge-cap favorites, such as Nokia, General Electric and Pfizer, to weigh heavily in Orbis' portfolio. The fund's biggest holding is the Tennessee-based Clayton Homes, a maker of mobile homes that accounts for 6% of the portfolio (once as much as 7%). The Grays liked Clayton's 15% normalized growth rate over the course of an economic cycle, its P/E multiple of just 11 on normalized earnings and its conservative management team.

Echoing Warren Buffett, Allan Gray says: "We see ourselves as business analysts more than as stock market operators. That's investing; anything else is speculation. That's why our approach works so well across borders."

William Gray notes that Clayton, having risen from $8 a year ago, is now approaching fair value at $16 a share. He's now finding similar opportunities hard to come by. "It's been very difficult to find stocks that sell at a discount to fair value," he says. "Long-term returns in the U.S. are likely to disappoint."

Gray is a lot more bullish on selected companies in Japan. "We're finding mid-size companies with 20% growth rates selling at 15 to 20 times earnings," he says.

Take Yamada Denki, a consumer electronics retailer. The company, Gray explains, runs large-format stores, such as those of Best Buy in the U.S. or Dixons in the U.K., and is taking market share away from smaller retailers.

"Even in a lousy economic environment, [Yamada Denki] is a superior offering for the customer," Gray says. Yamada Denki's return on equity of 12% is high by Japanese standards, and Gray thinks that the company can deliver earnings growth of 20% a year, even if the Japanese economy doesn't recover soon. At 20 times earnings, the stock is priced well below the Japanese market average of 35.

"The great thing about Japan now," Gray says, "is that you can find both growth stories like Yamada Denki and classic Graham and Dodd values."

An example of the latter is Aioi (formerly Dai-Tokyo Fire & Marine), a property and casualty insurance company that underwrites policies of no more than a year's term. "It's not a growth story," Gray says, "but it has a big gap between today's price and its intrinsic value." Gray reckons that Aioi is selling for half its net asset value and may become a takeover target as the Japanese insurance business is deregulated and foreign companies enter the market. Gray notes that most global insurers sell for 1.5 times asset value, implying a lot of upside for Aioi. "There's also a great margin of safety," he says. "Because they generally write short-term policies—a year or less—you know that there is no big hole lurking out there."

Orbis buys Japanese stocks for both its global fund and the $280 million Orbis Japan Equity [USD] Fund, which is hedged into dollars. The fund has gained a 19.7% compound annualized return since its inception in June 1998, compared with 6.6% for a hedged version of Japan's TOPIX index.

Other regions where the Grays are finding attractive values include the U.K. and Continental Europe. Among the stocks they like: Associated British Foods; Boots, the U.K. drugstore chain; and Germany's Hornbach Holding, which owns real estate and runs D-I-Y stores.

Given their record, the Grays could probably charge investors a lot for their talents. Instead, Orbis' management fee is based on three-year rolling performance and ranges from 2.5% if the fund beats the index by a wide margin to just 0.5% if the fund similarly underperforms its benchmark over three years. William Gray says, "We are rewarded when we do a good job and also feel the pain when we underperform."

How can two guys and a handful of analysts sitting in Bermuda hope to scour the world for the best investments? William Gray answers the question this way: "Human nature is human nature. It applies equally in the U.S., Japan, South Africa, and Europe. Our approach is to watch for and take advantage of opportunities as greed and fear cause market prices to deviate from intrinsic value." This is a simple precept, but it's a stage on which to build a great performance. FG