Virtues of Vice

Value investors often seek opportunity in the positive economic fundamentals of perfectly legal but less-than-virtuous businesses. Charles Norton has made finding such opportunities a full-time pursuit.

INVESTOR INSIGHT

Charles Norton
GNI Capital

On strategy: "It's pretty simple: Focus on areas with a lot of positive attributes and understand them better than anyone else for the benefit of our shareholders."

Editors' Note: *Charles Norton is quick to point out that he doesn't at all look at the $180 million (assets) Vice Fund he manages as the antithesis of socially responsible investing. "We take no part in the characterization that we're a 'sin-stock' fund," he says. "All we're trying to do is capitalize on attractive businesses that have demand characteristics not predicated on overall economic health." Investing in only four sectors – alcoholic beverages, gaming, tobacco and aerospace/defense – the Vice Fund has earned an annualized 20.2% over the past five years, vs. 11.3% for the S&P 500. With economic concerns at the forefront of investors' minds, we spoke recently with Norton about where he's finding opportunity in what he considers "economically independent" industries.*

Describe the philosophical underpinning of the Vice Fund?

Charles Norton: We're focused on four sectors that have exhibited unvarying demand regardless of economic activity and that have key fundamental strengths that help explain why they've been around for hundreds of years. The inherent demand of people to smoke, drink and gamble and of nations to arm themselves is clearly strong and long-lasting. These industries are generally characterized by high barriers to entry, resulting from strict government regulation, scale economies, limited access to distribution channels and strong consumer brand loyalty. In tobacco, for example, the inability of new entrants to advertise in the U.S. and elsewhere creates a significant competitive advantage for established brands.

The businesses are typically quite profitable, combining low production costs with tremendous pricing power, especially in tobacco and alcohol. A single serving of liquor costs about 3 cents to produce, including packaging. A pack of cigarettes costs maybe 25 cents to make.

It's also important that governments tend to be large beneficiaries of these businesses, through the collection of billions of dollars in tax revenue. That essentially makes the government a partner, with the financial incentive not only to see that the business stays around, but that it also does well.

Our basic strategy is pretty simple: Focus on these areas which have a lot of positive attributes and understand them better than anyone else for the benefit of our shareholders.

Describe your idea-generation process.

CN: We start with a macro, 30,000-foot view of the major underlying trends within each sector. If there's a very strong industry current, most of the companies in it are going to be impacted by it. We then go through the bottom-up process of identifying how well-positioned the specific companies are relative to the trends we've identified. The companies with the best growth prospects and lowest relative valuations get our full attention.

Unlike some individual-sector funds, we feel no compulsion to be permanently bullish about any individual industry. As it happens, we're finding plenty of opportunity in each sector today, but we'll exit a sector if we see something we don't like.

We'll also short stocks within our core sectors, which serves two purposes. The first is to generate alpha by betting against fundamentally weak and poorly positioned companies that we expect to go much lower. To decrease beta, we'll short what we consider to be relative underperformers versus the longs we have in a given area, which allows us to reduce industry-specific risk.

I don't want to mention individual names, but we've disclosed that we've been active on the short side in pure-play regional casino operators, which have had a tough time because they're more tied to lower-end consumers whose discretionary spending dries up when gas and food prices are high. We've also had a core short position in a major smokeless tobacco company, which we believe is facing challenges related to the pricing dynamics of the smokeless-tobacco market.

What's your portfolio mix, by sector?

CN: As of March 31, the portfolio was relatively evenly distributed, with just under 29% in tobacco, 26% in aerospace/defense, 23% in alcoholic beverages and 21% in gaming.

Walk us through the major trends you're seeing in each industry, starting with tobacco.

CN: There are two completely different stories in tobacco: the U.S. and the rest of the world. Volumes in the U.S. are decreasing 2-4% per year – recently closer to 4% – so it's all about pricing power from strong brands, cutting costs and using your balance sheet to buy back stock. The threat of increasing federal

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excise taxes – which would accelerate the decline in volume – is on our radar and probably an intermediate-term issue.

But there is growth outside the U.S., primarily in emerging markets in Eastern Europe, Latin America and Asia. Growth is coming both from new users and from significant trading up to more premium brands. This will disproportionately benefit the global brands and those with established and growing distribution clout.

Is the outlook for defense contractors tied to the election result in the U.S.?

CN: The conventional view, that Republicans are better for defense stocks than Democrats, is just not supported by the data. Defense-stock performance is tied to budgetary cycles: as long as budget authority for procurement and RDT&E [Research, Development, Testing and Evaluation] is increasing, defense stocks tend to outperform. We think that will remain the case for another year or two. There's a very high threat level right now and defense spending historically remains strong when that has been the case. All major defense contractors stand to benefit from that to varying degrees.

On the aerospace side, we're in a unique period. Every aerospace cycle since the 1960s has been mostly driven by North American and European demand. Since those economies are so tightly linked, demand ebbed and flowed at the same time and created a very cyclical environment. Today, however, we have Asia and the Middle East driving significant demand, and we think that geographic diversity of demand will prolong the current up cycle and make the eventual down cycle less severe. When Asia and the Middle East slow down, we expect a fresh wave of orders from the U.S. as fleets are re-tooled to take advantage of new planes that are 20% more fuel-efficient. Overall, we believe we're in the middle of the current cycle and that it will last at least until 2011.

Where do you see opportunity in alcoholic beverages?

CN: For brewers, the primary driver is emerging-market exposure, where the dynamics are similar to what we're seeing in tobacco. Companies with brands and distribution in emerging markets are poised to grow, while those most levered to the U.S. and other mature markets, where there's no growth, are simply not attractive. In the U.S., consumers are gravitating to wine and spirits away from beer, and if they are drinking beer, they're more likely to choose a craft beer or an import. That makes U.S. domestic beer, in our opinion, a bad place to be.

On the spirits side, global distribution and brands are everything as well, but North America is actually showing strong growth prospects. In our view there are only a couple of dominant global spirits players that are well-positioned – the rest are also-rans.

What are the most important themes in gaming?

CN: The first is that the slot-machine equipment makers are at the beginning of what we believe will be a monster replacement cycle, driven by new technology called server-based gaming. In simple terms, all the slot machines on a casino floor will be centrally networked, making them more efficient for the casino operators. That will allow them to do things like change the games being offered on the fly, track players and offer more targeted comps, conduct tournaments among players at different machines and

Investing in Vice
Business and Pleasure

Seeking relatively economy-independent returns and to capitalize on favorable industry fundamentals, Charles Norton of the Vice Fund invests only in tobacco, gaming, alcoholic beverage and aerospace/defense stocks. Below are the Vice Fund's largest holdings as of March 31.

Company	Ticker	Industry	Price@ 4/29/08	52-Week		% of Portfolio
				Low	High	
Altria	MO	Tobacco	20.24	19.48	24.17	9.1%
Carolina Group	CG	Tobacco	66.19	63.66	92.79	6.9%
International Game Technology	IGT	Gaming Equipment	34.24	33.27	49.41	5.5%
Diageo	DEO	Alcoholic Beverages	79.86	73.39	93.12	5.5%
British American Tobacco	BTI	Tobacco	76.40	61.56	81.04	5.2%
MGM Mirage	MGM	Gaming Resorts	50.76	48.52	100.50	4.8%
Boeing	BA	Aerospace/Defense	85.53	71.59	107.83	4.7%
InBev	INB:BB	Alcoholic Beverages	52.72	46.03	68.97	4.6%
Raytheon	RTN	Aerospace/Defense	64.42	52.28	67.49	4.1%
Lockheed Martin	LMT	Aerospace/Defense	105.89	88.86	113.74	3.9%

Sources: Vice Fund holdings as of March 31, 2008; publicly available information; InBev share prices in Euros even advertise restaurants or shows on their property. All of this should improve the economics of each machine. We think the technology change is like going from black-and-white TV to color and every casino, new or old, is going to want it.

The second big theme, on the operator side, is Asia. It's no exaggeration to call the development of Macau one of the great business growth stories of our time. The first casino opened there in 2004 and within two years it had passed the Las Vegas Strip in gaming revenue.

While demand in Macau is off the charts, the supply side there has entered a quiet period, which may last into next year. We think the even larger story is that various other Asian countries are in different stages of developing their own gaming industries. We can imagine multiple Macau-like successes throughout the region, which would make the shares of any Asia-oriented casino operator attractive.

Tell us about one of your favorite current ideas, Philip Morris International [PM].

CN: This is the international tobacco business of Altria, which was recently spun off when the company split its U.S. and non-U.S. operations. The way the numbers worked out, for every $100 in stock held by an Altria shareholder, post-spinoff he had about $70 in PMI and $30 in Altria, which now consists of the domestic tobacco business plus a large stake in SABMiller.

The story here is global demand growth benefiting the largest and best-positioned global player. PMI operates in 160 countries and is the #1 or #2 player in most of them, with Marlboro obviously its primary global brand. A big benefit of such a geographically diversified base is that there's very little regulatory or legislative risk tied to any single market.

There are a few key components to the investment case here. On top of overall growth in cigarette demand outside the U.S., we see significant opportunity for the company to expand its market penetration. Excluding China, which we'll get to in a second, PMI has a roughly 25% market share outside the U.S. It's unrealistic to expect them to reach the more than 50% share enjoyed by Philip Morris USA in the domestic market, but there's plenty of room for them to increase beyond 25% and each added share point on a global basis will have a big impact on the company's results.

We consider the newly unencumbered management team – led by the former CEO of Altria – to be like a turbo-charged sports car that has been driving in a school zone and can now hit the open road. The result should be a renewed focus on improving operating performance, more aggressive marketing efforts and a rush of new-product innovation. They've also announced they're taking $1 billion out of the company's cost structure between now and 2010 and plan to buy back $13 billion in stock over that time. We think they'll end up being more aggressive on both those fronts.

What's the opportunity in China?

CN: To give you a sense of the scale, there are more smokers in China – 350 million – than there are people in the U.S. Of the 5.5 trillion cigarettes consumed annually around the world, 2 trillion of those are in China. So while the opportunity is immense, that fact has never been investable because the state-owned China National Tobacco Corp. owns a virtual monopoly on the market.

In December 2005, Philip Morris International signed a deal with China National Tobacco to make and distribute Marlboros nationwide. While it was still part of Altria, there was little progress, but we expect that to change and for China to be a major growth driver for PMI over the next decade. It's hard to predict how exactly it will play out and when, but fulfilling the deal's promise would dramatically change the growth profile of PMI, which we think the market isn't recognizing.

With the shares trading at $52, how are you looking at valuation?

CN: The forward P/E multiple on the shares is around 14.2x, less than the closest competitors such as British American Tobacco and Imperial Tobacco. Given its growth profile, management team and plans to significantly reduce share count, I'd be happy to buy today at a premium to its competition.

We don't set target prices, but we see at least 20% upside for the shares over the next 12 months or so. But this is not just an idea for the next 12 months – I could own this for the next 12 years. VII