How One Emerging Fund Manager Is Bringing AI To Value Investing

When Benjamin Graham developed the concept of value investing in the 1920s, artificial intelligence and related technologies were many decades away. However, today is bringing new opportunities for fund managers who combine the latest in technology with the brand of investing that made Warren Buffett one of the wealthiest people in the world.

Saguaro Capital is an emerging manager with a value focus and a continuing legacy, as five of the firm's principals came from the well-known value manager Vulcan Value Investors. Having just opened to outside investors about a year ago, Saguaro combines fundamental analysis with artificial intelligence.

In a recent interview with ValueWalk via email, Saguaro Managing Principal and Portfolio Manager Jim Falbe shared his story: how he went from being a humanitarian worker in the Middle East to overseeing an emerging fund manager that combines value investing with the latest in artificial-intelligence technology.

From The Deserts Of Jordan To Wall Street

Falbe's background is unique in the asset management industry, as he started as a humanitarian worker in the Middle East. He was based in Jordan, where he helped run an English and computer training center that had about 1,500 students per year at its peak.

Falbe started as a teacher and later ended up running the center before returning to the U.S. Interestingly, he met his wife while working at the center in Jordan even though they had both attended Baylor University — where he had earned his Bachelor of Arts and Master of Divinity — around the same time. Later, Falbe completed his MBA at Notre Dame University.

He thinks investing was always in his blood, but he needed the impetus to explore this area. In fact, getting married was what led him back to investing because he thought he needed to think more about finances with a wife and possibly children to help provide for.

Falbe's mother had passed away when he was 13, but she was a significant influence during his early years. She was treasurer for Carl Karcher Enterprises, which owns Carl's Jr. and Hardee's. Falbe's mother primarily did corporate cash management there but later moved to a small boutique firm called Winrich Capital Management, where she ran a corporate cash management fund in the early 1990s. At that time, there was money to be made in managing cash.

Venturing Into Value Investing

After reading Burton Malkiel's book *A Random Walk Down Wall Street*, Falbe became interested in index funds. However, before diving into that space, he also learned about the legendary value investor Warren Buffett.

"I googled him, was blown away by his wit and wisdom, and of course, that led me to the *Intelligent Investor*, which I took on my honeymoon, and you can guess what happened next," Falbe recalled. "I ended up making a decent amount of money for a few friends and extended family members, and they encouraged me to consider investing professionally, which for me meant getting an MBA, a CFA and a seat at the table with a world-class institution."

He earned his MBA at Notre Dame, although he was totally unaware of how well-regarded the university's investment office was. While there, Falbe connected with Scott Malpass, Rick Buhrmann and Paul Buser, all of whom are well-known at the Indiana university.

"Rick had spent part of his life traipsing across Africa doing humanitarian work, and it was an instant connection," he said. "I ended up doing some work for them on the MENA/GCC region, and they were impressed enough to connect me with Vulcan Value Partners when I finished. The rest is history."

While Falbe's mother and Warren Buffett and Charlie Munger were influential in the early years of his life and career, he also highlighted his former boss, C.T. Fitzpatrick, as a key influence on him, saying he's thankful to have learned from "one of the best."

"C.T. built Vulcan Value Partners not just to be a great investment firm but a great business with great people and great ethics," Falbe said. "Their values drive everything that they do, and it's something we hope to emulate at Saguaro. C.T. is very hands-on. He takes care of his people and refuses to even come close to anything that would be considered improper or breaking the rules. There are good people in the investment management industry, and he is one of them."

He zeroed in on value investing after reading about it because to him, nothing else made sense "from a philosophical perspective."

"I think you can have a successful career in other areas of investing, but for me, identifying high-quality businesses satisfies my curiosity, and waiting for them to become cheap satisfies my proclivity to not do a whole lot," Falbe explained. "If I can find truly great businesses, I'm happy to let them do the work."

The Turning Point In Falbe's Investing Strategy

Falbe learned humility early in his investing career. When he started at Vulcan Value Partners, the firm's largest position was Apple. Falbe said many allocators thought they were "crazy" for owning it then. It was 2013, and that year's iPhone model wasn't selling very well because it was considered inferior to Samsung's Galaxy model for that year. As a result, the sentiment around Apple was negative.

It was also right before the company initiated its share buyback program. Falbe said their analysis suggested a multiple of 10 or 11 times for Apple, which made it look cheap for that time. Twelve months later, the stock doubled, hitting Vulcan Value's estimate of fair value, so the firm sold.

“Everybody patted themselves on the back, and our allocators were happy,” Falbe said. “However, if you were to look at it on a stock-split-adjusted basis, the price was around $30. Today, 10 years later, it is at $180, so by selling when we did, we missed out on another 6x.”

He added that if they had continued to hold Apple shares, they would have skyrocketed 12 times over 10 years. Falbe's biggest lesson from this situation was humility in determining the value of businesses that are “the best of the best.”

“If you get one at a truly great price, have the humility to admit that you don’t know exactly what it is worth to the upside or downside and just let it do what it wants to do, which is to compound,” he explained. “Great businesses don’t tend to go bankrupt, so the real risk is under-performing the market, which isn’t a tragedy.”

Investing Philosophy

As a result of that experience, Falbe and his team only invest in “the best of the best,” which is their list of 100 companies. However, their investing philosophy goes further, embracing technology in the process. Falbe explained that their philosophy is to combine value investing, which he sees as “the best of classic investment discipline,” with “hypermodern technology.” Ultimately, the goal is to produce “world-class investment results” in the coming decades.

“The primary idea being that, in any occupation, it is a combination of man and machine that is going to produce the best possible results for the foreseeable future,” Falbe added. “We haven’t seen many people working on this, as it applies to long-term fundamental investing.”

His strategy for picking investments follows three steps. The first is to identify the “best businesses on Earth” and place them on the firm's list of the 100 best companies. Second, they monitor those companies closely, as if they own them, and then “patiently wait for them to become truly discounted.

According to Falbe, their experience and research suggest this happens for every company about once a decade. Finally, when they buy one of these businesses, they hold it as long as possible.

A Highly Concentrated Strategy

Saguaro Capital utilizes a very concentrated strategy with five to 20 names at any given time, although the firm usually holds seven to 14 positions. Falbe and his team focus on quality and their "desire to acknowledge what [they] don't know."

"We only consider purchasing a stock when it hits the low end of that range and don't want to trim unless something qualitatively changes, we have a much better opportunity, or something hits the high end of that range," he explained. "To this end, we use options to enter and exit positions. This helps us by fortifying that buy or sell decision when we are calm and rational. It gives us something to do in a low-turnover portfolio, and it earns us yield that we ultimately hope will be in excess of our management fee."

Falbe used Facebook parent Meta Platforms as an example of how their entire investing process works.

"Despite near universal disdain for the company last year, we kept it on our list of 100," he said. "We owned it. We were writing put options in November around $90, and then were writing calls after it crossed $200 in March. We've fully exited the position, as it exceeded our high-end estimate of value. We would've preferred to hold it for a longer period of time, but given the new economics of the business, [we] couldn't justify a higher valuation range at present."

Emerging Marketplace Themes

Falbe emphasized that they aren't macro investors because they focus on finding "businesses that can survive and hopefully thrive in any regime." However, he did say they're concerned about the dramatic increase in passive investing and its growing influence on the market's functioning. Falbe isn't sure price discovery is working as well as it did a decade ago and can't see things reversing if the current trends continue.

He's also concerned about the U.S. dollar over the very long run. Ultimately though, the theme they stay on top of is the rise of artificial intelligence and the "Industrial Revolution 2.0."

Of course, since Falbe and his team aren't macro investors, they don't make predictions about the market's direction. They focus on finding great businesses that will generate exceptional returns over the long term.

"We prefer to bet on the ships that will get us to our destination, rather than on the weather along the way," he noted.

Mixing AI With Fundamental Analysis

In many ways, Falbe's investing philosophy and strategy mirror those of Vulcan Value Partners, including the use of a master list of stocks to choose from. However, Saguaro Capital also adds the latest technology into the mix when choosing investments.

Falbe believes technology has made a significant difference in their approach and strategy. In fact, he hopes every piece of technology they use helps their human analysts to be better and faster. Falbe also expects technology to enable them to look at more names than they otherwise would and to go deeper than they could without it.

"Thus far, there hasn't been a change to our philosophy or our human method of evaluating companies," Falbe explained. "We believe technology just makes us better at it. The day may come, however, when technology gets to the point where we do have to make a change. If someone is uncomfortable with that, we may not be the right fit for them."

How Saguaro Uses AI Technology

As far as the specifics of how AI has helped them so far, Falbe said they've collected lots of data on what makes good businesses versus terrible ones. The data they've gathered is both quantitative in the form of financial data and qualitative, which is mostly textual.

Essentially, Saguaro Capital is seeking great businesses with durable competitive advantages. Falbe explained that these effects do appear in the numbers, but the cause for those effects is usually buried in the text. Thus, he and his team have created "features" around what they're looking for.

From a quantitative perspective, that means not just a particular number or data point like a company's 2022 operating margin. Instead, they look at the company's trendlines over the last 15 years. For example, the Saguaro team might look at a company's operating margin, return on investment capital, or return on total assets over the last 15 years.

Then they create "features" for companies based on the textual information they gather. For example, Falbe noted that no company states that they are a "monopoly," but some companies like Oracle have a virtual monopoly in their market niche. In fact, such companies don't even use the word "dominant," opting instead for the word "popular."

"Nevertheless, there are two-, three- or four-word-type combinations they use which betray this market structure," Falbe explained. "We are looking for these combinations which imply the existence of some concept or 'feature.'"

Tracking Company "Features"

He added that these “features” could be economies of scale, a dual-sided network effect or something else. At this point, Falbe and his team have created hundreds of these features that indicate whether a company is high-quality — according to their definition. He also explained how the technology they use differs widely from the stock screeners many investors use, both professionals and amateurs alike.

“The big differences here between this and a stock screener are obviously that most screeners today can’t handle textual information, and if you put in more than five or six variables, you tend to get no results,” Falbe said. “Machine-learning models are much more nuanced and allow for this level of subtlety, which is what a human would do.”

He added that the machine ultimately suggests companies around the world that they've never previously looked at which are most likely to qualify for their process.

“Overall, this is a big topic and frankly, the primary reason for our firm’s existence,” Falbe added.

The post "How One Emerging Fund Manager Is Bringing AI To Value Investing" appeared first on ValueWalk Premium.