A top athlete in the field of business

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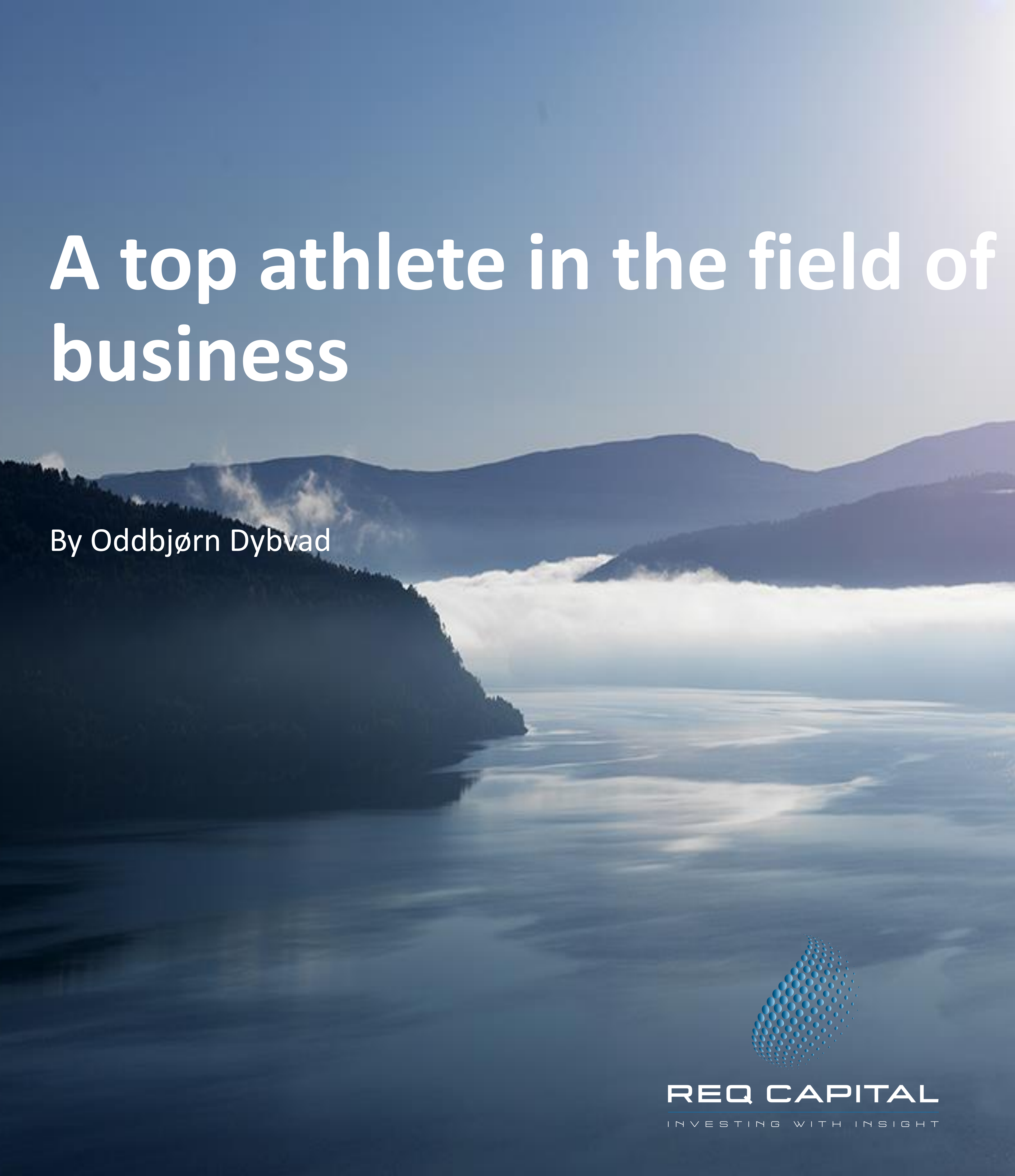

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INVESTING WITH INSIGHT

It is very interesting to study lesser known but highly successful companies whose success is based on proven principles rather than a single product, customer or market. Investing is about recognizing patterns. If we can decode certain principles and lessons behind past successes, we can apply those same insights in our search for investments.

Teledyne is one such example. An investor who invested in Teledyne in 1966 achieved an annual return of 17.9%, or 53 times invested capital, over 25 years, compared to 6.7 times for the S&P500. Henry Singleton was co-founder and CEO over that same period. Teledyne was an industrial conglomerate with exposure to areas such as specialty metals, aerospace electronics and insurance. According to Warren Buffett, Henry Singleton at Teledyne had "*the best operating and capital deployment record in American business*."

What were the key ingredients behind this success and how can we apply these lessons as investors?

Capital allocation

Henry Singleton was not only a strong business operator but also a unique allocator of capital, actively using Teledyne stock as a source of funds. In the 1960s and 1970s, he made 130 acquisitions that were financed by both equity and strong free cash flow.

In the 1970s, Teledyne used a significantly undervalued stock to buy back and retire 85% of its shares outstanding at prices far below what Singleton believed was the intrinsic value of the company. These were not regular share repurchases. On several occasions, Teledyne made tender offers to buy five percent of its stock, which instantly increased per-share value for the remaining shareholders.

In addition to acquisitions, Singleton had a firm grip on the organic engine of the business. In the 1970s, organic net income grew 19% annually, compared to 12% for the S&P500. Return on equity was over 25% during this period. The secret behind the strong organic growth was a business model based on decentralization.

Decentralization

Diversification was an insurance against catastrophe, according to Singleton. At its peak, Teledyne consisted of more than 130 individual profit centers that were managed in a highly decentralized manner. According to Teledyne:

"*We had no intention of managing these businesses from the corporate level. We did, however, establish our own unique financial and operations reporting system which enabled us to monitor their performance closely, on a monthly basis, and see any trouble spots before they became serious.*"*

*Distant Foce: A Memoir of the Teledyne Corporation and the Man Who Created It (2007)

There was no intention of micro-managing these companies remotely because the managers of these companies knew much more than head office about their products, markets, competition, and so forth. The corporate-wide financial reporting system ensured that all companies spoke the same language. The fiscal month always ended on a Friday, and by the following Tuesday morning, reports from all 130 reporting units were collected at headquarters. That was in the 1960s, and even today, that would be an accomplishment.

Because the company was always aware of each company's performance, "*we were able to establish an incentive system for honoring those companies that performed exceptionally well*.*" The company called it "The Triple Crown Awards" and honored companies that set all-time records in three categories: Sales, Net Income and Cash Flow. The group wide overview and awards were sent monthly to executives at all companies. The top-performing managers were rewarded accordingly. The policy of keeping operating units small, each responsible for its own success, was followed throughout the company.

According to Singleton, "*We depend on them. We have to trust them. Our success or failure depends on what they do*.*" People are the most important factor in a company. "*Why bother them if they are doing their job*" was Singleton's mantra.

People

Henry Singleton was the company's largest shareholder with a 7.8% stake. Promoting the right people was on the top of the agenda. The result was a high-performance culture. According to Singleton: "*we work our heads off to increase our own capability at collecting and promoting the right people. We increase our bets on the men who seem to be performers.**"

Similarly, the company tried to avoid having people compete within Teledyne but looked outward to its real competitors. "*Our objective is to increase our rate of earnings faster than they do. It is a lot of fun. As a result, we visualize it as a competitive game.**" In 1989, Henry Singleton retires after 29 years of brilliant leadership and outstanding value creation.

Summing up

Our investment philosophy is based on three fundamental principles that we believe stand the test of time: Capital allocation, decentralization, and people.

We want to invest in management teams that are excellent investors, who understand the power of decentralization and entrepreneurship, and own part of the business themselves. Teledyne is a good example of the extraordinary long-term results that come from combining these principles. We believe we have found and invested in a special group of companies that have the right ingredients to become the "Teledynes of tomorrow."

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