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John Phelan is Co-Founder & Chief Investment Officer at MSD Capital. John spoke with the editors of the Ben Graham Centre's Newsletter about his experience being a value investor.

Could you share your journey to becoming an investor and how you initially developed an interest in history?

When I was ten, my parents gave me a stock certificate. After, I started looking at stock tables, intrigued by the numbers and probabilities; I always liked math as a subject. I worked for my parent's broker as a summer job in high school. My father, like most doctors, was a pretty lousy investor, so I learned a lot based on what he did and how he did it. I always traded stocks on my own, but when I graduated college, I wasn't sure what I wanted to do, so I worked at Goldman Sachs. I had bought some apartments, renovated them and made a decent amount of dough, but I went to a more formal structure at Goldman.

During the summer between my first and second year of business school, I did merger arbitrage with Eddie Lampert and I fell in love with it. Unfortunately, I graduated from business school in 1990, which was not ideal because the market was down huge and many funds were going out of business.

Candidly, I needed a job, so I went back to real estate and it was a great experience because I ended up going to work for Sam Zell. He was one of the few guys in the real estate industry who had capital, so it was fascinating. But I did go back to the markets to found MSD Capital.

What did you take away from your time at goldman sachs and does that still play a role today?

It was the first big company I've worked at; I've always had smaller entrepreneurial pursuits. When I was at the firm, it was a private partnership. There were around 45 analysts in my class; today, there are 45 analysts just in M&A. Goldman Sachs had a robust and focused culture. So, I learned a lot about treating clients, rigorous analytical skills, and how to deal with complexity. The biggest thing that was helpful to me was that it led me to want to be a principal much more than an agent. So, even though I loved it, you are just giving advice and then you move on. I wanted to see how the transaction worked out.

At the time, Goldman was not doing principal work. When I left, they looked at the space and began to figure it out. In the first year at business school, I think that's when they started to be much more activated. I have also become good friends with my fellow analysts and hired several professionals who were a few years after me.

You came from real estate, but you talk about having an inkling of wanting to look at special situations; could you describe your time at esl partners? What made you so successful there? What lessons did you

learn that were vital to msd capital?

As generalists at ESL Partners, we had a pretty vast universe of opportunities. So, I always thought being a generalist had an advantage, as we were very opportunistic-driven. I started out doing mergers arbitrage and distressed investments. I worked on corporate real-estate credits, for example, Rite Aid, Carson, and Dillard's. After doing that work, I saw a massive opportunity as there was a bunch of debt on these companies.

Interestingly, I went to Sam Zell and pitched him to start a junk bond operation. I'll never forget; he stood up from his desk and shook my hand, saying, "great idea, but I'm not interested in only company pieces; I want to own companies." I didn't quite know how to interpret that. I asked him, "did I just get fired?" and he said, "no, but you're going to leave because it's a good idea and you should pursue it".

I got into the area on the tail end of the distress cycle, so, at least in the U.S., there were still a lot of opportunities to pursue in a smaller market back then. People were still figuring out how to trade bank debt. I got to work on the 1994 emerging market debt crisis, which was enormous fun.

I've watched hedge funds and all these people move to specialization. I understand that, given the velocity of information today, you probably need to do it when you're benchmarked each month, but that's different than investing and I view that more like trading. My view is being trained as a generalist is better. I can get to 85% of what a specialist can by myself, but I can buy the other 15% of knowledge from a consultant. Our success stemmed from our discipline, understanding of risk-reward, a firm conviction in ideas, and knowing our edge.

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What is the story behind founding MSD capital?

I first met Michael in 1994 when I was still working with Eddie Lampert. We pitched him on investing in our fund and he gave us some money. We had an excellent year in 1994, so he gave us a little more money. So, I decided to raise my fund. I had a fair amount, a decent amount of capital committed and was about ~6-8 months away from opening when Richard Rainwater called me and said, "Hey, I want you to meet this guy," who ended up being Michael Dell.

Because of some personal reasons, I decided to take a short break. After, I decided to figure out what success is in investment organizations. I went to about ~8-10 successful people, from hedge funds to private equity to family offices. After taking copious notes, I distilled them into the three C's for success – capital, connections, and culture – which I put into a business plan. I met with Michael to give him the business plan, thinking I would start the firm myself. However, he asked me to explain how I would be better off by myself rather than with him. He offered his capital and connections; I would build the culture in an office located anywhere in the United States. That offer was tough to refuse. You fast forward 25 years and it has been a fun, successful partnership.

Investing is often called an apprenticeship business. Throughout your career, are there any individuals that served as a mentor?

All my experiences have been mentoring. In different ways, my mother and father were mentors. At Goldman Sachs, I worked for several incredibly successful people in their own right: Hank Paulson, and Byron Trott, among others. Richard Rainwater, Eddie Lampert, and Sam Zell have all been great mentors. I've learned a lot from each of these people and taken their approaches which are all different. It has helped shape my perspective and influenced me as an investor.

How do you think about investing at msd capital with such a large universe of opportunities? Is narrowing down the

opportunity set a thematic process, or is it more organic?

I think the two most important questions that you have to answer when you are asset allocating are:

1. What is your time horizon?
2. What's your risk tolerance?

One of the biggest challenges in asset allocation is that today's opportunity set is not the complete opportunity set. If you think about it from any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. We try to understand what is priced in markets and where we have an edge across asset classes. We also constantly try to compare things. If we are looking at a real estate deal, I force the real estate team to ask if an investment can be replicated for cheaper or with more liquidity in the REIT market. There's constant competition for dollars amongst the groups, which leads to excellent allocation outcomes.

Now, the other thing is how you construct your portfolio. As Richard Rainwater used to say, you've got to decide if you are in the stay rich business and get rich business. What he was alluding to was risk. We've tried to be flexible and opportunistic, waiting to see what the market gives us and try to allocate opportunistically. The last 6-9 years have been a super liquid market, but there has been chaos underneath the surface. It's not clear how deep the market is in liquidity, and we're starting to see that right now.

If you go back and study history – the Morgans, the Rothschilds, and even think about Buffett – how have they made great returns? By being liquidity providers when there's no liquidity. It is hard in the public market investing today to do that. Now, that's partly a function the market shifting. We have all this passive investing today, which has enormous implications across the markets and for investments. You can get sucked into different scary things. For example, today's private market technology is not recalibrated. If you look at financial history, when the current macroeconomic environment occurs, that's usually not a good thing for multiples. When you're buying growth companies, you are betting on multiples and profitability down the future.

We constantly try to understand the narratives, understand the false assumptions that underpin those narratives and try to take advantage of those narratives as much as we can. I never feel forced to have to do something, and that's a great place to be. I think being able to invest in multiple asset classes, up and down the cap structure, that's important. If you think about investing, most successful investments are made by positioning your capital where your view is subsequently adopted and acted upon by others. You're trying to be in front of the market; you're trying to be different. That's an essential aspect of investing. Buffett talks a lot about the Bayes' theorem and how he uses that to limit the number of decisions he makes. I could not agree more; I'm a huge proponent of the same theorem.

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One of the critical aspects of being a good investor is thinking probabilistically. Just like when you cross the street, what is the probability you get hit by a car? Having the patience to wait for the appropriate risk-return profile and not worried about cash burning a hole in your pocket is essential.

At MSD capital, how do you assess the quantitative and qualitative factors in the risk-reward profile?

Risk is a function of how you define it. I like to say just because something's familiar doesn't mean you understand it. That's a common fallacy that adults all make, but a child never does. The risk is not a number; it's a concept or a notion if you think about it. It's not a simple one. The amount of risk we take is not a physically given constant we choose; we decide how much we will take. Investors should focus on process, not outcomes; There's a big difference between wrong and bad decisions. A wrong decision is picking door number one when the prize is behind door number two; the fault lies with the method. Launching the Space Shuttle Challenger was a bad decision when the engineers predicted a nearly 100% chance of catastrophe. That distinction is important because it separates outcomes, which you can't control, from processes, which you can.

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At MSD, the word "risk" cannot be used without putting an adjective in front of it. There is no general risk. There is market risk, investment risk, and currency risk, among others. We, just like Buffett, try to avoid investment risk, which is the permanent loss or impairment of capital.

The essence of investment management, as Ben Graham said, is the management of risk, not the management of returns. If you manage the downside, the upside will take care of itself. Avoiding significant losses is the key.

I don't think volatility is a risk. Interestingly, it underpins a significant amount of asset allocation. Charlie Munger has talked a lot about why Beta is an imperfect measure. We try to look at the loss of a company's earnings and pricing power. With inflation today, you have many problems if you own a company that does not have pricing power. We look at valuation, quality, defensibility, and pricing power, among other attributes. We also try to look at what are the adjacencies. In a disruptive market, what is the competitive set? Are their competitors over or under levered? Do they have the opportunity to take market share? Are there adjacent areas that they can attack?

Value investors often preach about the circle of competence. Having invested across a large spectrum of special situations, asset classes and industries, what are your thoughts on the concept?

I wouldn't buy biotech because I don't understand science. But going across asset classes and up and down capital structures, you benefit from pattern recognition. You'll find that companies that you own will offer tremendous opportunities often. For instance, if a company misses earnings by a penny, the stock market might go down 20%. That's insane. It doesn't make sense to me. You get opportunities to take advantage of people who either don't understand what they own or were in it for the wrong reason. That's one of the reasons I like the public markets: you have less efficient holders who are doing things for various reasons.

When you've looked at different things and studied them, you can get up to speed while being a generalist. For instance, I knew nothing about emerging markets in 1994. When the Mexican peso crisis hit, I spent time in Mexico City, Buenos Aires, and Argentina. I had never looked at Brady bonds before, but we were buying the asset. When you can buy assets that have double-digit return outcomes, and in the worst case, you could still earn a single-digit rate of return, I'll do those all day long. For instance, IndyMac was impossible for us to lose money unless the United States government went broke.

You can apply what you're learning from different things from the generalist perspective. There have been instances where we looked at an asset differently than someone who owned it for 15 years. One of the things I always say to young people if you want to do this, the more businesses you can look at, the more companies you can study, the more situations you can look at, and the more you build up that library of knowledge. You build up that library of success; you'll be able to apply learnings to other businesses. Back in 1995, we started looking at specialty chemical companies which were down because of oil. The specialty chemical companies traded at a substantial multiple to commodity chemical companies. What's fascinating is that the volatility is very similar if you look at both earnings. But one had almost twice the multiple, just because it was called specialty.

I think what Buffett is good at understanding is the quality of that business. How big is the moat? Is the moat extendable? We were always trying for a long time to try to buy $1.00 for $0.80. You have to evolve and see what markets will give you.

Does your ability to focus on longer-term investments provide an edge in the market? Is there any specific asset class where you have an edge?

I debate this a lot in my head. I think it is advantageous to have a long-term perspective and thought process, but it would help if you also had pressure as, in a way, it enables you to funnel better. You asked me earlier about how I narrow down the universe. I think 80% of the game is figuring out what to work on. The stock market's a bloodbath. Is Facebook cheap at 8x EBITDA? I don't know if the metaverse is a great bet. I don't know if someone will make or lose a lot of money on that bet.

I think investors have unrealistic expectations, marking you to market each month or quarter. However, the pressure helps you figure out what you want to work on and it enables you to manage risk better as it keeps you away from doing stupid, more speculative things. I think in that sense, it's very beneficial. Do I think it's an advantage? The answer is I do; when everybody else is worried about each quarter, I have the luxury of not worrying about that. We benchmark people over three years and five years, not year to year. I think we've done well because, back to my earlier point, we've always been able to be a liquidity provider. And what we've done is, when a portfolio is down, we get on the phone, go through it, understand it. If we like it, I'm buying it so that we will give them more money. As an investor, it's much easier knowing when to buy than when to sell. Selling is hard.

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How do you think about balancing high inflation, rising interest rates, and companies with valuations that are dependent on growth in this environment?

As I am getting ready to move on to a new role as chairman and prepare to manage my own money, that is the responsibility of Gregg Lemkau. Though some of these companies have substantial network opportunities, they can attack adjacent areas beyond their core business. It's one of the things I've learned from looking at technology. I've learned a lot from some of these young tech entrepreneurs looking to disrupt companies and break them up regarding how they look at businesses differently. One of the significant areas where that's also going to take place is biotechnology. As most people have seen, I'm incredibly bullish on that area; it has gotten destroyed. But when you think about biotech today, I don't mean to digress, but it feels like the early stage of the internet. If you think about it, we decoded the genome, now we can look at massive amounts of data. We're collecting data every day; I wear a ring that is collecting all my sleep data. You can download that information and give that to your physician or an AI machine to look for trends. You think about what's going on in medicine; it's incredible. I think it will be that convergence of bioinformatics, data analytics, the decoding of the genome and precision medicine.

So, I'd suggest all you get your biology major and think about getting into that field. The one space you want to be in with the macro environment you spoke about is probably software because it allows you to deal with inflation. With the possibility of a deflationary environment, you will have to be very comfortable that they have the balance sheet to survive. If you're a company with only a year's liquidity, I would be very concerned.

What is your outlook on special purpose acquisition vehicles (SPACs)?

When we started SPACs, we were trying to get outstanding investors and were very selective. You will notice a lot of big institutional investors, not a lot of hedge fund investors. I like to say we're kissing many frogs, and hopefully, we'll find an excellent investment for it. When we were out raising the SPAC, one of the things we talked about was some form of disruption in the market, which might lead us to be able to invest at a more appropriate valuation. I think that might play itself out. We may get lucky and be able to do that, as plenty of companies are pretty good and probably don't have as much balance sheet as they'd like. We are an excellent solution for that. There is still an enormous amount of competition from the private markets, so it is trying to find the needle in the haystack.

How have you worked to maintain an attractive culture at MSD Capital since founding the firm?

For us, it's been a consistent process of demanding certain expectations from people. I always like to say that at MSD Capital, we are an outstanding college football team, but we are trying to be a professional team. If you think about a good college football team, their offensive defence is designed around maybe four or five players: whether it's a wide receiver, tight end offensive line. But, on the professional teams, all 11 players on the field are exceptional, and they all have a job to do. If one guy is out of position, it doesn't matter how good your defensive end is; you will probably get burnt.

In many ways, I learn a lot from watching successful coaches. Constantly setting challenging goals is essential. We are a tough place to work, as it is an intense place that demands performance. I work just as hard as most young people, ensuring we don't do dumb things. I'm not better than anybody else; I'm not more superior than anybody else. I'm a big believer in lifelong learning and being able to admit when you're wrong or knowing what you don't know. These are all critical things. Many people get hung up and debating and arguing, trying to win an argument instead of getting to the correct answer. In investing, your goal is to get to the correct answer; it's not to win an idea.

Having worked with many young people and has mentored many of them, I think that passes on culture as they know the expectations. If you come in with a poorly written memo or are not prepared for an investment discussion, that's probably not a fun day. Candidly, I don't think it should be fun: if you're not going to take the time to make it good, why should I take the time to read it? Among others, these attributes are indicative of our culture at MSD Capital. I tried to take the best aspects of those cultures in most workplaces and use them at the firm.

For investors early in their careers, do you have any advice?

I spoke at Harvard Business School recently and, in the process, came up with a slide trying to define the ideal individual capability profile for an investor. In the end, there were 16 of them:

1. Self-awareness
2. Independent thinking
3. Having an interest in learning
4. Self-discipline
5. Personal integrity
6. Curiosity
7. Intelligence
8. Low ego
9. Writing skills
10. Open-minded but stubborn
11. Confident but nervous
12. Gone through a period of adversity
13. Effective in dealing with people
14. Strong, sophisticated entrepreneurial sales skills
15. People who are real people
16. Perfectly comfortable saying they don't know the answer

You can be outstanding in this business if you have these attributes.