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Graham & Doddsville

An investment newsletter from the students of Columbia Business School

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The Heilbrunn Center
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CSIMA COLUMBIA STUDENT
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ASSOCIATION

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Winter 2019

Glenn Hubbard & Joseph Stiglitz



Glenn Hubbard was named dean of Columbia Business School on July 1, 2004 and has been a Columbia faculty member since 1988.

He received his B.A. and B.S. degrees summa cum laude from the University of Central Florida. He also holds AM and PhD degrees in economics from Harvard University.

In addition to writing more

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Polen Capital



Damon Ficklin joined Florida-based Polen Capital in 2003, where he is the Lead Portfolio Manager of the Global Growth Portfolio and Co-Portfolio Manager of the Focus Growth Portfolio. Prior to joining Polen, Mr. Ficklin was an Equity Analyst with Morningstar and a tax accountant with PwC. Mr. Ficklin earned a B.S. in Accounting from the University of South Florida, an M.S. in Accounting from Appalachian State University, and an M.B.A. with High Honors from The

Damon Ficklin & Jeff Mueller '13

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DG Capital Management



Prior to forming DG Capital in 2007, Dov Gertzulin was a Portfolio Manager at Neuberger Berman where he specialized in value-based and event-driven situations, co-managing over \$4 billion for high net worth and institutional investors. Before joining Neuberger Berman, he was a research analyst at JDS Capital Management. Mr. Gertzulin received his M.B.A. with distinction from New York University's Stern School of Business, where he specialized in finance and accounting and was named a Stern Scholar. He earned a B.B.A. from Baruch College, graduating summa

Dov Gertzulin

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Welcome to Graham & Doddsville



Meredith Trivedi, Managing Director of the Heilbrunn Center. Meredith skillfully leads the Center, cultivating strong relationships with some of the world's most experienced value investors and creating numerous learning opportunities for students interested in value investing.



Professor Tano Santos, the Faculty Director of the Heilbrunn Center. The Center sponsors the Value Investing Program, a rigorous academic curriculum for particularly committed students that is taught by some of the industry's best practitioners. The classes sponsored by the Heilbrunn Center are among the most heavily demanded and highly rated classes at Columbia Business School.



The Heilbrunn Center
for Graham & Dodd Investing



We are pleased to bring you the 35th edition of Graham & Doddsville. This student-led investment publication of Columbia Business School (CBS) is co-sponsored by the Heilbrunn Center for Graham & Dodd Investing and the Columbia Student Investment Management Association (CSIMA). Since our Fall 2018 issue, the Heilbrunn Center hosted the 28th annual Graham and Dodd Breakfast.

Our first interview is with two former Chairmen of the President's Council of Economic Advisors: our very own dean **Glenn Hubbard** and Nobel Laureate **Joseph Stiglitz**. In the interview, we discuss index funds and the future of asset management, Jerome Powell's job thus far as Fed Chairman, areas of risk and fragility in the economy, and the possibility of secular stagnation in the United States.

We also sat down with **Jeff Mueller '13** and **Damon Ficklin**, portfolio managers of Polen Capital's Global Growth Portfolio, which is a concentrated growth fund with a global investment mandate. Jeff

and Damon discuss their investment guardrails, managing risk with quality, geographic diversification, and the changing consumer landscape in China. They also discuss individual positions in Tencent (TCEHY), Alibaba (BABA), Adobe (ADBE), Starbucks (SBUX), and Align Technology (ALGN).

Lastly, we interviewed **Dov Gertzulin**, founder of DG Capital, a value-focused investment firm that specializes in middle market opportunities across the capital structure. DG Capital's focus on distressed securities, post-reorganization equities, and other special situations provided great perspective as we approach 10 years of a post-Great Financial Crisis bull market. Dov discussed his early years in the industry during the mania of the tech bubble, the importance of catalysts in an investment thesis, and investing in distressed debt during the financial crisis. He also discussed individual positions in Contura Energy (CTRA), Tropicana Entertainment (TPCA), and Twin River Worldwide

(TRVW).

We continue to bring you stock pitches from current students at CBS. In this issue, we feature a pitch from the 2018 Women In Investing Conference, where Tonya Kostrinsky '20, Stephanie Moroney '20, Vivian Wang '20, and Freda Zhuo '20 pitched Nordstrom (JWN) long. We are also happy to present the winning pitch of the 2018 CSIMA Stock Pitch Challenge, a long thesis on Lions Gate Entertainment (LGF) from Amit Bushan '20, Bruce Kim '20, and Stephanie Moroney '20.

We thank our interviewees for contributing their time and insights not only to us, but to the investment community as a whole.

- G&Dsville Editors



Snapshot of the audience at the 28th Annual Graham & Dodd Breakfast



Meredith Trivedi with Professor Tano Santos, Faculty Director of the Heilbrunn Center for Graham and Dodd Investing.

28th Annual Graham & Dodd Breakfast



Presenters John Griffin and Ian McKinnon share a laugh



Thomas Russo and Andrew Gundlach '01 catch up during a break



John Griffin and Professor Michael Mauboussin have a conversation



Professor Tano Santos listens intently to the event's proceedings

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CBS professors Daniel Krueger '02 and Yen Liow join a packed house for discussions on value investing

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The Heilbrunn Center for Graham & Dodd Investing at
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From Graham to Buffett and Beyond

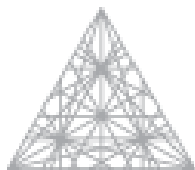
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Dean Glenn Hubbard and Nobel Laureate Joseph Stiglitz

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Glenn Hubbard

than 100 scholarly articles in economics and finance, he is the author of three popular textbooks, as well as co-author of *The Aid Trap: Hard Truths About Ending Poverty*, *Balance: The Economics of Great Powers From Ancient Rome to Modern America*, and *Healthy, Wealthy, and Wise: Five Steps to a Better Health Care System*. His commentaries appear in *Business Week*, the *Wall Street Journal*, the *New York Times*, the *Financial Times*, the *Washington Post*, *Nikkei*, and the *Daily Yomiuri*, as well as on television and radio.

In government, he served as deputy assistant secretary for tax policy at the U.S. Treasury Department from 1991 to 1993. From February 2001 until March 2003, he was chairman of the U.S. Council of Economic Advisers under President George W. Bush. In the corporate sector, he is a director of ADP, BlackRock Fixed Income Funds, and MetLife. Hubbard is co-chair of the Committee on Capital Markets Regulation; he is a past Chair of the Economic Club of New York and a past co-chair of the Study Group on Corporate Boards.

Joseph E. Stiglitz is an American economist and a professor at Columbia University. He is also the co-chair of the High-Level Expert Group on the Measurement of Economic Performance and Social Progress at the OECD, and

the Chief Economist of the Roosevelt Institute. A recipient of the Nobel Memorial Prize in Economic Sciences (2001) and the John Bates Clark Medal (1979), he is a former senior vice president and chief economist of the World Bank and a former member and chairman of the (US president's) Council of Economic Advisers. In 2000, he founded the Initiative for Policy Dialogue, a think tank on international development based at Columbia University. He has been a member of the Columbia faculty since 2001 and received that university's highest academic rank (university professor) in 2003. In 2011 Stiglitz was named by Time magazine as one of the 100 most influential people in the world. Known for his pioneering work on asymmetric information, Stiglitz's work focuses on income distribution, risk, corporate governance, public policy, macroeconomics and globalization. He is the author of numerous books, and several bestsellers. His most recent titles are *Globalization and Its Discontents Revisited*, *The Euro*, *Rewriting the Rules of the American Economy* and *The Great Divide*.

Graham & Doddsville (G&D): Bloomberg's Matt Levine sometimes writes about the idea that common ownership of firms in the same industry through passive index

funds could, in theory, be anti-competitive. He writes that "the premises of the theory – that managers are responsive to shareholders, that shareholders are increasingly diversified, and that the joint interests of companies in an industry can conflict with the interests of consumers – 'all seem, not just reasonable, but like basic textbook stuff.'" Martin Schmalz, a finance professor at Oxford and a leading proponent of the theory, asks, "Is there any plausible story for why these secular changes in the ownership structure of firms would *not* lead to a lessening of competition?" So, should index funds be illegal?

Glenn Hubbard (GH): That is absolutely silly. Full disclosure: I am a Director of the BlackRock Fixed Income Funds, and BlackRock definitely has a point of view on this subject. It is crazy to imagine that the existence of large passive investors like index funds and ETFs is facilitating anti-competitive behavior.

BlackRock or Vanguard or State Street own X% of every large-cap company. Take the example that critics of common ownership use: the airline industry. The same people who own X% of the airlines also own hotels and everything else, so trying to monopolize the airlines would hurt them elsewhere. And there is just no evidence of this actually happening.

The bigger question surrounds how you would get discipline on companies if all investment were passive. That's a more interesting question. If all investment were truly passive,

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Dean Glenn Hubbard and Nobel Laureate Joseph Stiglitz

it would be hard to have corporate control. You always need a strong, active market for corporate control. I think there will always be a need for active investors to help solve agency problems in corporate governance, whether that's a large fund, a rich person, or a private equity organization.

Joseph Stiglitz (JS): The reason index funds became so popular was that they were doing a better job managing funds for ordinary investors, net of fees and transaction costs. The one caveat I would add to what Glenn said is, as more of the stock market is owned by passive funds, assuming they're really passive and do not exercise any control, that means that you can get control of a firm with a lot less capital. If you had a company that's worth \$10 billion and is 95%-owned by index funds, then you can get control with \$500 million. So you lower the threshold for getting de facto control. It becomes an empirical question. I haven't seen that as a major problem, but I haven't really been following it.

GH: On the competition point, what are the policy implications of banning index funds? For the average person, index funds are the low-cost, efficient way to invest.

JS: What Vanguard has done has just been amazing.

GH: It's ironic for me to see these arguments and then simultaneously see Jack Bogle being rightly lionized after he passed away, because he truly made enormous contributions to the welfare of society at large.

JS: He didn't make a lot of money out of it.

GH: By my standards he did! Fortunately, Columbia Business School is blessed to have some non-ordinary investors as donors, otherwise we wouldn't be building Manhattanville. But most people aren't those star investors. Index funds are, in my opinion, the right investment vehicle for most investors. If you ban them, how are average people better

“Index funds are, in my opinion, the right investment vehicle for most investors. If you ban them, how are average people better off as a result?”

off as a result? They would be thrown back into a world where fees are relatively high and performance is relatively low. That doesn't strike me as a good idea.

JS: I think the real issue is the danger that someone could get control of a firm with relatively little money. But with regards to index funds reducing competition between firms, there has been some literature recently on cross-ownership.

GH: Yes, and I don't buy it.

JS: I've been very skeptical. I just don't see the mechanism for it.

GH: You'll be seeing some papers coming out on the

other side of that argument.

G&D: The trade war is top of mind for a lot of investors right now. What is the political rhetoric getting right and what is it getting wrong?

JS: Well, the focus is on the bilateral trade deficit – I don't think you can get any economist to say that makes sense.

GH: Except Peter Navarro.

JS: Yes, except Peter Navarro. You're not even an economist if you say that, almost by definition. Whether you believe in free trade or not, bilateral trade deficits are not what matters. Trade agreements don't determine the multi-lateral trade deficit. That's determined mostly by macro.

GH: Meaning the financial gains and the opportunity for investment and savings.

JS: Trade agreements, i.e. what you import from which country, affect standards of living but don't affect the macroeconomy. As macroeconomists, if there is an unemployment problem you use macroeconomic tools: monetary and fiscal policy. If they're not working, something's wrong.

Some discussions on China are obscured by the fact that there is a very big difference between value-added production and gross production. A lot of what we import from China is stuff that is not Chinese. Probably 90% of the iPhone is not made in China. The value added in China is 10%. But when we

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talk about imports, we treat it as a \$1,000 phone imported. In the case of China, the confusion between the gross numbers and the value-added numbers is a big deal.

That in turn relates to some of the confusion about what is at stake. The things that we export to China are by-and-large much closer to 100% value-added. When we export soybeans, 100% of the soybeans are made in America. When you account for the difference in value-added trade, it significantly changes the numbers and the trade deficit appears much smaller.

And finally, I think there is a broad issue that has come to the fore. It has always been with us, and we have never been able to face up to it. And that is managing trade with countries that have different value systems and different regulatory systems. We see it in the controversy between the U.S. and Europe on GMO. Europe says it cares about GMO, while many Americans think it is just superstition. But if Europeans really do worry about it, and it affects their utility, their view is they should have the right to regulate it.

We view GMO as a trade barrier. Even transparency is an issue. If Europe passes a law saying that you have to disclose GMO, then Europeans won't buy American wheat, and we view that as a trade barrier. That has been a source of contention between the U.S. and Europe for a long time. That's a narrow area, but you can see how two differing societies with different values come into tension over the right legal framework. We are

so deep into GMO that if they restrict GMO, we can't export many of our agricultural commodities.

Where this is coming up now is in privacy, secrecy, AI, big data – and I think I'm more on the European side of those issues. Privacy and the norms around cyber security are really important. But there are still huge benefits from trade. The question is: what are the appropriate rules for getting those gains from trade on something that might be called a roughly level playing field?

GH: I think that's one of the reasons we're struggling with the trade discussions, even though everything you learned in freshman economics is still true. Free trade is a good thing. But, the thing we always say under our breath, as economists, is that the gainers will compensate the losers. Well, we're not doing that, and it's a shame that elites around the industrial world are telling average people they should just suck it up because we're going to be better off collectively. We are better off collectively, but not every person is better off.

JS: It could even be the majority of Americans are worse off.

GH: Yes. The majority could be worse off and measured GDP could still rise. I think this problem is a big one. The other issue is China. China is a bad actor in international trade. I think the President rightly called them out. But his problem is that of the dog chasing the car. What are you going to do when you catch it? To me, if you really want to

tackle China you go after the fact that China made promises it did not keep. I was one of the people who pushed hard for China to go into the WTO, but China made promises it has not kept. Thus, I think there's a real reason to challenge China in the WTO. But if President Trump wants to do that, he shouldn't simultaneously attack the EU, Japan, and Canada.

JS: When he says that steel and autos are national security issues, he loses credibility.

GH: I'm not sure I would want to live in 1955, but even if I did, it's not on offer. We shouldn't be telling the public we can make it 1955 again, because we can't. What we need to be doing is helping people prosper in 2019, or 2055. I think that's the bigger issue surrounding trade. The ugliness on the trade issue has to do with a lot of people feeling left behind. Nobody lied to them. Trade does generate prosperity, it just doesn't generate it for everyone.

JS: Economic theory predicted there would be losers from trade.

GH: Right, but if the surplus is large enough you can compensate them so that collectively we are all better off. But that hasn't happened.

JS: Another aspect of the trade dispute is that we haven't distinguished areas with international rules from areas without international rules, and this undermines the credibility of our contentions. For instance, there is no international investment agreement. There could have

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been one, but I think the U.S. overreached. China's view on joint ventures is that everyone who came into China knew the rules of the game. You might say the rules aren't fair, but there's no international agreement saying you can't do what they've done.

GH: They forced technology transfer, and that's against the WTO protocol. But they say they're not really forcing it.

JS: They're not forcing it. Companies knew the terms. China's view is that there's no investment agreement saying that you can't require joint ventures. There could have been, but it wasn't negotiated and therefore they had the right to do it.

But there was an agreement on cyber security with the Obama administration. All the evidence is classified so we can't fully know, but everyone who looks at it says they violated the Obama agreement. That is a situation where I think they should more clearly define the rules in international or bilateral agreements. But we're losing credibility by mixing "national security and steel" arguments (which are not credible) with arguments where there are genuine concerns.

GH: I've been on the U.S.-China Economic and Security Commission for the past few years. If you look at our reports, you will see that we hold hearings on all of these issues. The U.S. has blown its opportunity to lead a big WTO challenge of China because we don't have any allies. It makes it hard. I always thought you were supposed to

unite your allies and divide your enemies, but we seem to be doing the opposite.

"I was one of the people who pushed hard for China to go into the WTO, but China made promises it has not kept. Thus, I think there is a real reason to challenge China in the WTO."

JS: To increase your credibility and acquire allies, you use international laws. And there is a WTO forum for trade disputes.

GH: Which, by the way, we win much more often than we lose.

JS: Almost always. We win most of the cases.

GH: If you say, "The WTO is in our way," that is not true.

JS: If Glenn and I brought a case to the WTO and they agreed with Glenn rather than me, I'd say, "That's the law." I'm very impressed with the quality of the judges at the WTO.

G&D: How is Jerome Powell doing as Fed Chairman?

GH: He is a good pick for that job in some sense because of politics, and I mean that with a small "p". I don't mean that he is political. I mean he is very good at "small p politics."

When I saw Jay in meetings of the American Economic Association, he was very good at calming people down, and this is a time when both Democrats and Republicans have their knives out for the Fed. Someone like Jay has exactly the right integrity and personality for the job.

I think he has made some missteps in communication, and that has contributed to market volatility. One is clearly about the size of the balance sheet. If you want to reassure markets, you need a theory of how big a balance sheet you need. Sometimes *The Wall Street Journal* editorial page writes as if we are going to go back to the pre-crisis balance sheet, but that's an era when the federal funds rate was determined in the market for reserves, and reserves had a positive shadow price.

That isn't the world we live in today. We now have foreign corridor systems, large balance sheets, lots of excess reserves, and interest on excess reserves. I think it's naïve to think the balance sheet will be small. If the Fed were to say, "Okay, here's where we think the balance sheet will be, and here's our path to get there," I think that would be much more reassuring to markets than saying "We're data-dependent," whatever that means. I give them some good marks, but I think there's some work to do.

JS: Besides the messaging, I'm actually sympathetic to the Fed's open-mindedness because, just to reflect what Glenn said, we're in a new world now. There's no a priori right size for the balance sheet.

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There's no theory that dictates that...

GH: Right, so you say, "Here is how I, the leader, am thinking about it."

JS: I think I would have been inclined to say what he said, because I don't know what the right answer is either. That's not good messaging; I wouldn't be a good Fed Chairman. But what he said is an honest reflection of our current state of ignorance. But it also may be far less important than a lot of people in the market believe. My general view is that it is probably large changes that matter - and expectations of large changes - more than the level.

GH: Also, many fingers are now pointing at the Fed with how the balance sheet rolls off, but a nearly trillion dollar annual budget deficit has a much bigger effect on the supply of Treasuries. Politicians should stop and say, "Wait a minute, where did all those Treasuries come from? From us, not the Fed."

G&D: Which sector of the economy do you think will cause the next crisis?

JS: Some part of the financial sector. I think that's where the fragility is in our economy for the most part. There are many parts of the economy where there is a lot of leverage. Debt is different from equity in a fundamental way - you have promises to repay which you will or will not fulfill. With equity there's no promise, so you go up and down. It's more of a continuous variable. But with debt you lend out money with the hope of getting

repaid, and then if you make large misjudgments and people don't get repaid, that has big effects throughout the economy.

I worry there are places where lending has gotten displaced out of our banking system. We have figured out how to control the banking system a little better, but that leads to non-bank lending that may not be monitored as closely.

GH: I would agree. Financial crises require leverage. If you look at the tech bubble collapse in the early 2000s, the economy barely hiccupped because the collapse was all about a decline in just equity value - some tech investors lost a lot of money, but the economy as a whole was fine. The financial crisis involved a lot of largely implicit debt that people didn't even realize was debt but was effectively debt through securitization and tranching. And I worry about shadow banking for all the reasons Joe said. Shadow banking was a core problem of the financial crisis, and it's still here. In many cases, it is worse and harder to find now because we have doubled down so much on bank regulation.

JS: Banks have lent money to firms that are engaged in shadow banking, so we haven't done a great job at regulating what you might call "indirect lending." If payday lending increases, who finances the payday lenders? The banks might.

GH: I worry that we haven't learned the lesson from the Queen of England's question after the last financial crisis. At

the London School of Economics, she asked economists like Joe and me, "Why did nobody see it coming?" And the answer to her question was that nobody was talking to each other. So-called experts weren't talking to practitioners. That has not gotten any better. I don't think the Fed is aware of all the financial innovations actually happening in the country. And I don't know that all the finance academics are either. I remain very worried. Everyone says we're safe now. I don't think so.

And the politics of it are so wicked. I will go to my grave believing that one of the reasons we see populism today is that during the financial crisis we bailed out the banks and failed to assist homeowners who could not refinance their mortgages. That pain and that memory will last a generation. I worry that if it happens again, we'll be in trouble.

JS: I totally agree with Glenn. That was a really bad mistake on the part of Obama.

G&D: Should practitioners be paying more attention to academic research?

GH: The most successful investors I've known are actually pretty close to research, and they enjoy it because they can dig up opportunities that others might not see. Most successful investors I know listen a lot, and they don't talk much. I often get people asking me for opinions and I say, "What do you think? You're a billionaire. I'm going to learn more from you!" But they don't say anything.

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Dean Glenn Hubbard and Nobel Laureate Joseph Stiglitz



Bruce Kim '20, Amit Bushan '20, and Stephanie Moroney '20 pose after their winning CSIMA Competition pitch.

These investors go to me, to Joe, and to a hundred other economists and synthesize the information like a honey bee going to different flowers. People say investing is not academic, but it's very academic. And it's not just financial research, it's also economic research.

I think Warren Buffett spends his time productively figuring out market structure questions and what I would call industrial organization questions. I'm not sure he's as interested in finance as much as he is interested in economic intuition. The most successful investors I know talk to a lot of people in the business: not just in the company in which they're interested but to people in the industry as well.

JS: Market structure is important because in competitive markets, profits are going to be competed away quickly. That's why Warren Buffett always talks about building moats and making them wider. Lots of people would like to cross those moats. There is a tension here between what's good for the economy and what's good for the firm, but Buffett has a very intuitive sense of where there are sustained profits.

G&D: Can we get your views on the causes of recent market volatility, as well as your thoughts on Brexit?

GH: The recent market volatility is a result of both perceptions of Fed policy as well as overall policy uncertainty. Also, small movements in a few important

variables can have big effects. Whether we can grow GDP at 1.8% or 2.8% over the long run is important — changes in views on that question can move markets dramatically, and policy uncertainty amplifies that.

With regards to Brexit, there has been just an extreme lack of competence. Putting your country up on a 51/49 vote is unwise, and it has been negotiated terribly since then. Having said that, the frustration that led to Brexit is the same sort of populism we already discussed. There are people who point their fingers at the Leave voters saying, "They're stupid, they didn't understand it." I don't think so. I think they very well understood the implications.

"If the Fed were to say, 'Okay, here's where we think the balance sheet will be, and here's our path to get there,' I think that would be much more reassuring to markets than saying 'We're data-dependent,' whatever that means."

And I think they very well understood that the country might on average be worse off under Brexit, but they felt they weren't getting their fair share and they didn't like the control issues with the EU. And I think that's really the wild card of

Brexit. It's not just what happens between Britain and the EU, but what it means generally: are elites capable of selling average people on the benefits of the EU?

JS: The recent market volatility is not the result of a major change in the functioning of the financial markets. It's not like high-frequency trading was just invented. By the way, I do think high-frequency trading adds to volatility and is not necessarily a socially productive activity, but it's not the driving force behind the increase in volatility we've seen recently. I think it is exactly what Glenn said: we're entering a world in which there is more uncertainty surrounding the parameters of the economy, i.e. what is the growth rate, etc. In a more normal world, the broad consensus would be that the economy is going to grow at population plus productivity. Productivity could grow at maybe 1.4-1.6%, but volatility in productivity is very small. In a normal world there would be a more broadly accepted consensus about the underlying parameters of the economy.

Yet, recent policy uncertainty has introduced a lot of uncertainty about medium and long-term growth rates. If anybody takes seriously what Trump says, and some people do, he says we can grow at 3-4%. To me that's a fantasy, but I think some people believe it because they're not decomposing the recent growth rate into the impact of a fiscal shock and the true long-term growth rate. When you have a big increase in the deficit, that will grow the

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economy faster than the underlying fundamentals. Saying, “Oh, we just grew at 3.5%, we’re in a new world” is really stupid. But some people out there want to believe that, and so we’ve seen a lot of uncertainty in the underlying parameters of the economy that we didn’t used to see. We had similar uncertainty back in ’08-’09, but we haven’t had it for a while.

G&D: Will the uncertainty continue for as long as Trump is President?

JS: The policy uncertainty will continue. It could even get worse. Remember we’re not only talking about economic policy, we’re talking about war – a President announcing foreign policy perspectives that are counter to what the foreign policy establishment says. These are not minor issues. There are people betting that within X months we’ll have a war in the Middle East.

G&D: What are your views on secular stagnation, and what are the implications for asset managers?

GH: I don’t believe in it.

JS: I don’t either.

GH: Yet, it is definitely important for asset managers to consider this question. Permanently low levels of real interest rates would affect the rate of return on all assets. But I’m not so pessimistic about long-run productivity growth. The way I see it, artificial intelligence and machine learning have all the attributes of what economists would call a General Purpose Technology

(GPT), and if you look at previous GPTs, it takes a long time to see the full effects. I mean, Bob Solow’s famous quote “You see productivity everywhere except for in the productivity statistics” was uttered just before you could see it in the productivity statistics.

Part of the problem is not that scientific progress takes a long time, but that it takes a long time to change the way firms are organized. Whether you’re considering electrification or the internal combustion engine or mainframe computing, previous GPTs took a long time to become incorporated into the economy. I believe we

“Most successful investors I know listen a lot, and they don’t talk much. I often get people asking me for opinions and I say, ‘What do you think? You’re a billionaire. I’m going to learn more from you!’ But they don’t say anything.”

are going to see a productivity transformation. We are not going to see the same favorable tailwind from the labor market because right now our society is both aging and not favorably disposed toward immigration, and the way you bolster your hours worked is through native demographic improvements

and through immigration. So that’s less of a good news story. But if we’re talking about productivity, I’m pretty optimistic.

JS: There are two parts to secular stagnation. One is the short-run component, which you might call “macro management,” and the other is the long-run component, which depends on the rate of technological change. And we can never perfectly know about the long-run component until we experience it. I am mostly a techno-optimist with regards to productivity and artificial intelligence. I am a little more pessimistic about the way we manage our workforce, with a fraction of the American population either addicted to opioids or not well-trained, and with our average exam scores low relative to peers. There are two countervailing forces: our human capital is not doing well, but our technology is doing really well. How those will balance out, no one knows.

GH: The silver lining is that some of those things are fixable. Turning around demography is hard, but achieving an adequate healthcare system and treating the sociological pathologies that lead to alcoholism and drug abuse – these are problems we can actually address. The politics are admittedly difficult.

JS: I think there is a bit of a macro problem, and that is the increase in inequality combined with lower marginal propensities to consume at the top than at the bottom. The massive change in the distribution of income has

(Continued on page 12)

Dean Glenn Hubbard and Nobel Laureate Joseph Stiglitz

macro consequences. And we know how to deal with that. There are clear needs for new infrastructure and labor force training. I think there is wide agreement over how to technically solve these problems. We just do not have the political will to solve it.

G&D: Do you have any advice for MBA students going into investment management?

JS: Buy low, sell high. Be smarter than everybody else.

G&D: Brilliant!

JS: My serious advice would be to think about market structure – not just good ideas, but market structure. In a sense, economists would call it arbitrage. Intellectual arbitrage. Take something that has worked in one place and try it somewhere else. If you can be the first person in, you get something out of it. Many of our advances are in one way or another intellectual arbitrage.

GH: I agree. The successful evaluation of entrepreneurial opportunities is all about putting a puzzle together in a way nobody else saw. To me that is also the secret to great investing. My other admonition to you is Biblical: To whom much is given, much will be required. You all need to care about the welfare of society, and we are depending on you.

G&D: Thank you for your time.

**Tanya Kostrinsky '20**

Tanya is a 1st year student at CBS. Prior to CBS, Tanya was an equity research analyst at Fine Capital, a value-oriented long/short hedge fund.

Nordstrom, Inc. (NYSE: JWN) - Long 2018 Women In Investing (WIN) Conference

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Trading Statistics (as of 11/12/2018)

Capital Structure		Key Statistics	
Share Price			
(11/12/2018)	\$64.30	52 Week High	\$67.75
Shares (M)	168.6	52 Week Low	\$38.39
Market Cap (\$M)	\$10,860	EV/LTM EBITDA	7.8x
- Cash	\$1,343	Target EV/EBITDA	9.7x
+ Debt	\$2,734	Target Price	\$94.00
Ent. Value (\$M)	\$12,416	Return	46%

JWN stock price (5 year history)

**Stephanie Moroney '20**

Stephanie is a 1st year student at CBS. Prior to CBS, Stephanie was an equity research analyst at Anchor Capital Advisors, a value focused investment firm.

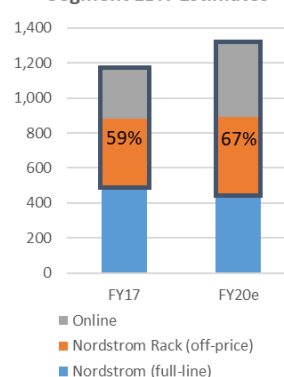
Recommendation

We are long Nordstrom (JWN) with a price target of \$94, representing 46% upside on 11/12/2018's price of \$64.30. Despite common perception, Nordstrom is not only a traditional department store, but it also generates >50% of its revenue from e-commerce and Nordstrom Rack. Continued outperformance in these favorable pockets of retail industry will support growth in cash flows and a valuation re-rating.

Business Description

Founded as a shoe retailer in 1901, Nordstrom is a leading fashion retailer in the U.S. today, offering a selection of high-quality brand-name and private label merchandise. Nordstrom provides customers with a differentiated, seamless shopping experience through multiple retail channels. 45% of sales come from Nordstrom full-line stores, 26% from Nordstrom Rack, and 25% from the full-line and off-price online businesses. Nordstrom's footprint spreads across the U.S., with a high concentration on the West Coast. The Nordstrom family owns ~30% of the company and manages the company as the CEO.

Segment EBIT Estimates

**Miaozi (Vivian) Wang '20**

Vivian is a 1st year student at CBS. Prior to CBS, Vivian was a sell-side equity research analyst at China International Capital Corporation covering the energy sector.

Investment Thesis

1) E-commerce capabilities prove Nordstrom is not a traditional retailer anymore

JWN began investing in its digital capabilities earlier than its competitors, with investment growing at a 20% CAGR 2010-2015. It now boasts the highest exposure to online growth among its department stores peers at 26% of sales today, with expectations to reach 40% of sales by 2020. In-store and online purchases have similar margin profiles, inclusive of returns. Typically in retail, 80% of off-price online orders are returned in-store and over 60% of full-price online orders are returned in-store. JWN, however, managed to mitigate the dilutive impact of reverse logistics on retailer margins.

Part of JWN's investment in e-commerce has included initiatives to improve fulfillment of online orders and to get items to the customer as quickly as possible. Online orders are shipped primarily from two owned fulfillment centers (Cedar Rapids, IA and Elizabethtown, PA) as well as from a leased fulfillment center in San Bernardino, CA. Owning two of its centers is especially advantageous as JWN has more direct control of its online fulfillment operations, which had allowed JWN to learn how to manage the fulfillment process more efficiently. JWN built these centers nearly a decade ago as their e-commerce business was picking up; replicating the same logistics network today would be significantly more expensive. In addition, the recent efforts to move from a push-inventory model to a pull-inventory model allows for leaner inventory management and frees up additional dollars in net working capital. These important improvements to supply chain operations make it possible for customers to get their purchases quickly and mitigate the risk of losing customers to competitors due to speed and cost of delivery.

Finally, JWN recently rolled out its local store strategy in LA. The local store in LA will serve omnichannel customers and will not carry inventory actively. Instead, JWN is adding several fulfillment centers near LA which will allow customers to place online orders for faster pickup at the physical store, which will offer an array of services, including alterations and stylist appointments. Given how concentrated JWN's sales are (LA and NYC make up 25% of JWN sales), JWN believes that this strategy will increase fulfillment times and marry the best of the online and in-store experiences to further engage and retain customers.

**Freda Zhuo '20**

Freda is a 1st year student at CBS. Prior to CBS, Freda was a sell-side equity research analyst at Goldman Sachs covering consumer staples companies.

****Editor's note: JWN was originally presented in November 2018 at a share price of \$64.30 with a target of \$94, representing 46% upside****

Nordstrom, Inc. (JWN) - Long (Continued from previous page)

2) Attractive retail trends and long runway underpin growth of Nordstrom Rack

Nordstrom Rack sells high end brands at 30-70% discounts. It provides a unique treasure hunt-like shopping experience, similar to TJ Maxx and Ross but with a broader assortment of high-end brands. The Rack generates \$5bn in sales annually and has been growing sales and market share by 13% and 26% respectively since 2012.

Nordstrom trades at a six-turn valuation discount to TJX and ROST, despite its better performance and growth opportunities in the off-price segment. Nordstrom Rack has grown same-store sales at a 4.4% rate over the last five years versus 3.5% at TJX and ROST. In addition, Nordstrom Rack's store productivity is better at \$500 sales per square foot versus \$400 at its off-price peers. Finally, the Rack has a long growth runway, with just 250 stores versus TJ Maxx and Ross with over 1,500 each. With sustained growth in same-store sales and new store openings, we expect Nordstrom Rack to be a driver for performance and valuation closer to Nordstrom's off-price peers.

3) Strong cash generation provides extra upside potential

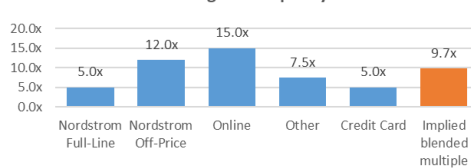
The stock is currently trading at a 9% free cash flow yield. We believe the completion of capital-intensive e-commerce investments and growth from Nordstrom Rack will support positive growth in JWN's cash flows. Moreover, Nordstrom's outstanding track record of disciplined and effective capital allocation could reinforce the company's strong commitment to shareholder returns. The seasoned management team led by the Nordstrom family has prudently spread capex over many years and capped annual capex at 5-7% topline even during the investment cycle. This stable pace of investment also supports Nordstrom's market-leading ROIC. Meanwhile, Nordstrom generates free cash flow and thus cash return for shareholders. Over the past 20 years, Nordstrom has consistently increased cash dividend, including through the 2008 recession period.

Going forward, we expect free cash flow to continue to grow, based on our assumption of \$700mn capex per annum, or 4% of topline. We also assume that the company will maintain the dividend payout ratio at ~40%. Nordstrom authorized a \$1.5bn stock repurchase plan in early 2018. While we have not factored in the impact from potential share buybacks, we would not rule them out considering Nordstrom's strong cash position and attractive current valuation.

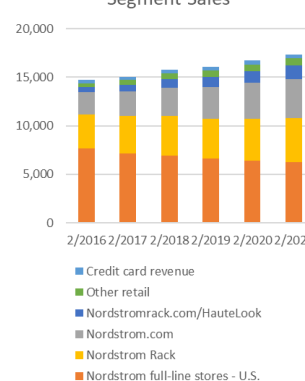
Valuation

We value JWN at \$94/share (46% upside) with a very favorable risk-reward profile as the base case return represents almost 3x the downside of our bear case scenario. We believe JWN merits a sum-of-the-parts valuation given its underappreciated and multifaceted business model, and derive our segment multiples based on an analysis of peer comps. Our target price of \$94 assumes a 9.7x blended multiple on our \$1.8bn FY20 EBITDA estimate, based on i) 5x department store multiple, ii) 12x off-price multiple, and iii) 15x e-commerce multiple. Furthermore, our above-Street EBITDA estimates are driven by higher sales growth at Rack and online, as well as a 40 basis points EBITDA margin improvement, to 10.7%. Our bull case results in a \$107 price per share (70% upside) and is based on a 10.4x blended multiple applied to a \$2.0bn EBITDA, while our downside case results in a \$54 price per share (16% downside) and is based on a 7.3x blended multiple applied to a \$1.4bn FY20E EBITDA.

Base Case Target Multiple by Business



Segment Sales



Key Risks and Mitigates

1) Growing threat from e-commerce

Although e-commerce continues to take share from retail, Nordstrom is well-positioned to benefit from these tailwinds given its digital investments and expectations that it will grow e-commerce to 40% of sales by 2022. In addition, Nordstrom has differentiated its e-commerce platform by offering a curated selection of higher-end items, being less promotional than competitors, and investing to develop best-in-class online capabilities.

2) Department store competitors are becoming increasingly promotional on price

Nordstrom has historically been successfully at running fewer promotions than its department store peers due to its differentiated high-end offering. This strategy combined with the ability to push stale inventory to Nordstrom Rack stores helps reduce the need to run promotions.

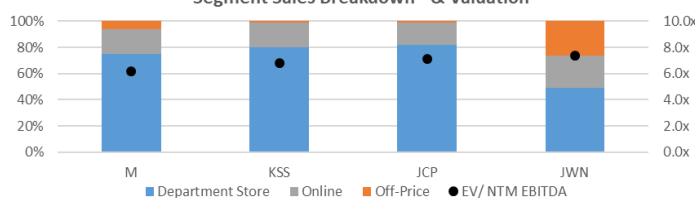
3) Nordstrom operates in a cyclical industry

Our bear case reflects a recessionary scenario, resulting in a \$54 price target. While this price target represents a 16% downside to the current stock price, we believe the risk/reward profile justifies our buy recommendation.

Conclusion

We believe that the risk-reward profile for JWN shares is positive, given market perception of Nordstrom as a traditional department store when in reality its higher-growth e-commerce and Rack drive over 50% of the business. Continued outperformance in these favorable pockets of retail will drive cash flow growth and valuation re-rating.

Segment Sales Breakdown* & Valuation



Lions Gate Entertainment (NYSE: LGF.A) - Long 2018 CSIMA Stock Pitch Challenge — 1st Place (Nov. 2018)



Amit Bushan '20

Amit is a 1st year student at CBS. Prior to CBS, Amit was at Energy Capital Partners, an energy-focused private equity firm.

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Recommendation

We are recommending a long of Lions Gate Entertainment (LGF) with a price target of \$26, representing a +44% upside.

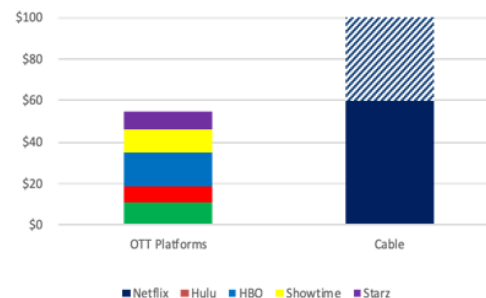
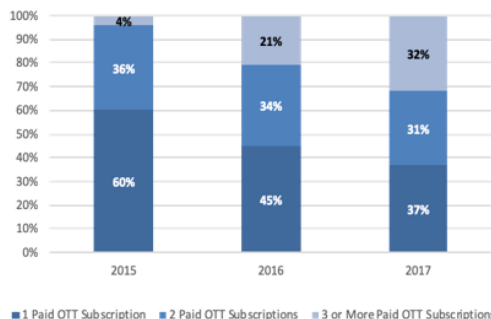
Business Description

LGF is a diversified entertainment company with 3 segments: 1) Motion Pictures; 2) TV Production; and 3) Starz, a premium cable network the Company acquired in December 2016. As of FY2018, Starz accounted for 37% of total revenue and 66% of EBITDA. Starz has 2 subscription programs: 1) linear pay TV service bundled in cable TV packages; 2) streaming-only OTT service (launched in April 2016).

Variant Views

1) The Street misunderstands the streaming service market as a winner-takes-all market

- A recent survey by Video Advertising Bureau showed that 1/3 of US households subscribe to 3+ streaming services. Even with 5-6 streaming services, the total monthly cost (~\$50-70) is below that of a traditional cable TV package (~\$100-130). Therefore, premium cable networks (e.g. HBO, Starz) can grow as complements to larger streaming services. Note that both Amazon Prime and Hulu, operating as digital distributors, offer premium networks as add-ons.



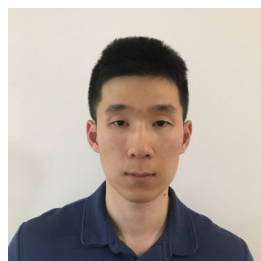
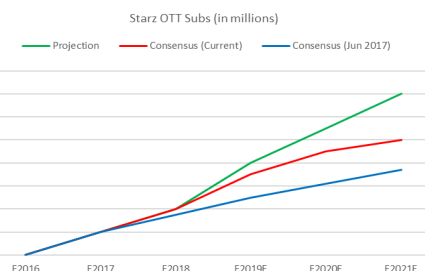
- Our conversation with an industry executive of a premium network confirmed the multi-player dynamic of the streaming market: "Consumers view Netflix and Hulu as complements. Most viewers don't consider the cost of Amazon Prime coming from the same wallet. So that leaves room for around 2-3 additional services." This is also in-line with management's view of Starz's competitive positioning ("...we want to position Starz as being an addition to Netflix, not a replacement of [it]" - Jeff Hirsch, COO of Lions Gate, 10/4/18).
- Starz is well positioned as a complement to Netflix/Hulu due to its 1) low price (\$8.99/mo vs. \$14.99/mo for HBO and \$10.99/mo for Showtime); and 2) differentiated target audience (focus on female and African-American demographics – segments missed by other networks).

2) The Street is overestimating the decline in Starz linear Pay TV subscribers

- In the last 2 years, Starz lost 4.5M linear subs, with half of the drop coming from telco. The Street continues to model a steep decline in linear subs going forward, extrapolating the recent trend. However, the drop in telco subs was impacted by a one-off factor: after DIRECTV acquisition, AT&T promoted migration from its U-verse (high penetration) to DIRECTV (low penetration), resulting in subs losses for Starz.
- With the migration complete, we are modeling a more moderate pace of linear subs decline vs. consensus. Recent results support the thesis: 2 quarters of linear Pay TV subs gains.

3) The Street is underestimating the growth of Starz OTT subscribers

- The Street is modeling a moderation in OTT subs growth going forward (~5M by 2021). Note that the Street has consistently underestimated Starz's OTT subs growth trajectory.
- We are modeling that the company will maintain the recent pace of OTT subs gains (1.5-2M/yr) for the



Bruce Kim '20

Bruce is a 1st year student at CBS. Prior to CBS, Bruce was a global macro PM at BlackRock. In summer of 2019, Bruce will be interning at Alyeska Investment Group.



Stephanie Moroney '20

Stephanie is a 1st year student at CBS. Prior to CBS, Stephanie was an equity research analyst at Anchor Capital Advisors, a value-focused investment management firm.

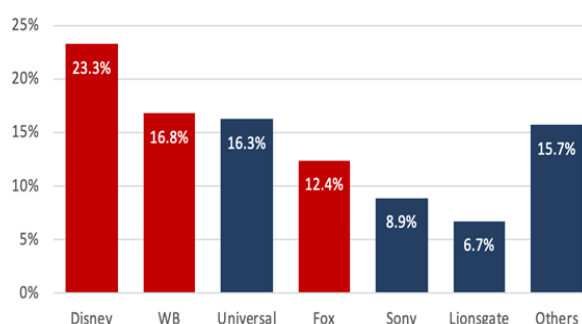
Lions Gate Entertainment (LGF) - Long (Continued from previous page)

next 3 years, reaching 7M subs by 2021, driven by: 1) digital distribution/international expansion (2018: YouTube Live, Hulu, Amazon UK/Germany; 2019: France, Italy, Spain, Canada); and 2) increased investment in original content. The company has also been integrating 3 divisions: Starz has a first-look deal on all shows developed by the TV production segment and has access to the film segment's IP (e.g., Starz is currently developing a new show tied to the *John Wick* movie franchise).

4) Lionsgate remains an attractive acquisition target

- Industry executives noted the upcoming "content scarcity" around 2020/21. With Disney/Warner launching OTT services, large portions of content libraries will be locked out of the market. Therefore, the value of LGF's film library (16,000 films) is set to appreciate. Given the company's content library, film/TV production studio, and Starz, LGF remains an attractive acquisition target for media companies trying to expand their operations as well as for new entrants to the industry (tech, telco).
- In 2017, EPIX (a smaller premium network) was acquired at 11x. Given that EPIX had no original content, no OTT capability, and a small film library, Lionsgate should trade at a premium. According to Variety, Hasbro offered around \$40/share (~15.5x EV/EBITDA) before talks broke down last year: "The toymaker wanted to offer the company more than \$40 a share, but Board Chairman and lead shareholder Mark Rachesky thought Lionsgate was worth more and killed the pact, insiders say." (Variety, Feb 27, 2018). We are modeling a 13x target multiple (mid-point of 11-15x) for the M&A scenario.

Network	Major studio deals	Expiration
Netflix	Disney	2018
HBO/Cinemax	Warner Brothers	Owner
	Fox	2022
	Universal	2022
	Summit	2022
Starz	Sony	2021
Epix	MGM	Owner
	Lionsgate	2021



*Source: Boxoffice-Mojo

Announce Date	Target	Acquirer	Implied TEV	TEV/EBITDA
12/14/17	Twenty-First Century Fox	Walt Disney	93,115	13.3x
5/11/17	EPIX Entertainment	MGM	1,275	11.0x
10/22/16	Time Warner Inc.	AT&T	109,262	13.5x
4/28/16	Dream Works Animation LLC	NBC Universal	4,239	34.3x
	LGF Target Multiple			13.0x

Valuation

- Above-consensus subs projection results in a 12% above-consensus NTM adj. EBITDA. Given the FCF stability of the subscription-based business, we are applying a premium over movie studios (~10x). Note that 12x multiple is 12% lower than Starz's recent average (13.7x).
- Catalysts:** 1) higher-than-consensus OTT subs growth in the next few quarters; 2) increased visibility on the impact of the international expansion; 3) M&A.

BASE CASE	
Target EV/EBITDA	12.0x
Adj. EBITDA NTM	663
EV	7,957
- Net debt	2,271
- Minority interest	135
Market capitalization	5,551
/Shares OS	214
Target share price	\$26.0

PROJECTION VS. CONSENSUS			
In millions	F2019E	F2020E	NTM
Revenue	\$3,930	\$4,321	\$4,127
Consensus	\$3,883	\$4,139	\$4,023
Diff (%)	1.2%	4.4%	2.6%
Adj. EBITDA	\$628	\$738	\$663
Consensus	\$580	\$657	\$591
Diff (%)	8.2%	12.4%	12.2%
Adj. EBITDA (%)	16.0%	17.1%	16.1%
Consensus	14.9%	15.9%	14.7%
Diff (%)	1.0%	1.2%	1.4%

SCENARIO SUMMARY			
	BEAR	BASE	BULL (M&A)
EV/EBITDA	9.0x	12.0x	13.0x
Adj. EBITDA NTM	560	663	663
Share price	\$12.3	\$26.0	\$29.0
% Change	-29%	44%	60%

Key Risks and Mitigants

- Volatility of the Motion Pictures segment:** LGF takes a risk-mitigated approach to its film slate. Management is scaling down the film segment vs. Starz.
- Cyclical risk:** Low monthly price mitigates the risk of a spike in churn rate during a recession.
- Talent cost inflation:** Starz has been successful at developing and maintaining new talent. Note that its two flagship shows ("Power" and "Outlander") were both developed by relatively new showrunners.

Polen Capital

(Continued from page 1)



Damon Ficklin



Jeff Mueller '13

University of Chicago Booth School of Business.

Jeff Mueller '13 joined Polen Capital in 2013 and is currently Co-Portfolio Manager of the Global Growth Portfolio. Prior to joining Polen, Mr. Mueller spent ten years in the US Marine Corps, during which he logged over 400 hours flying combat missions in F/A-18 Hornets. He ended his tour as an instructor at MAWTS-I, the Marine Corps version of Top Gun. Mr. Mueller earned a B.A. in Communications and Business Administration from Trinity University and an M.B.A. from Columbia Business School where he graduated from the Value Investing Program with Honors and Distinction. Mr. Mueller also teaches at Columbia Business School as an Adjunct Professor.

Graham & Doddsville (G&D): Can you start by discussing your background and how you got into the business?

Damon Ficklin (DF): I have both a bachelor's and a master's degree in accounting with a focus on taxation. That led me to PwC after college, where I worked in international tax for about four years. My long-term aspiration was to be in money management, but I thought that public accounting experience would be a solid building block. After my time at PwC, I earned an MBA from the University of Chicago Booth School of Business with concentrations in finance and

economics. I effectively used this as a stepping stone to transition into the money management industry. I worked for Morningstar as an equity analyst after graduation, joined Polen Capital about a year later, and have been at Polen ever since. Despite going to the University of Chicago – the birthplace of the efficient market hypothesis – I've always been a Warren Buffett and Benjamin Graham junkie. I'm happy to have found an opportunity at a firm that adheres to many of Buffett's and Graham's tenets.

Jeff Mueller (JM): In 2001, I was living in Texas and training to see if I could become a professional tennis player. My plans completely changed on September 11th, 2001. After the second plane hit the North tower, I decided to join the US Marine Corps where I spent 9 ½ years on active duty flying in F/A-18s. While I was deployed to Iraq flying combat missions, someone sent my squadron-mate an investing book that introduced me to Ben Graham and opened my eyes to a world I had previously not known. That book inspired me to read *The Intelligent Investor*, which I quickly devoured, and any other Graham works I could get my hands on. It sounds surreal, but I can still picture myself sitting in an airbase in the middle of the desert reading Graham between missions. His words really connected with me: I quickly realized that investing is the last Renaissance occupation and that I wanted to make a career out of it when I left the Marines.

My chance encounter with Graham pushed me to set the

ambitious goal of attending Columbia Business School – the institution where Graham taught and Warren Buffett trained. I was fortunate to be accepted into CBS and, subsequently, the Value Investing Program. It may be considered blasphemous to say this in Graham and Doddsville, but at CBS, I came to realize that the best way to compound wealth over time is to invest in high quality businesses, not in cigar butts. This led to a desire to work for a firm that invests in high quality businesses in a concentrated manner with a long-term orientation and that also has a terrific culture. Coming from a Marine fighter squadron, which has a culture of purpose, teamwork and service, it was important for me to find the same culture at my first post-Marine Corps job. I found all of that at Polen Capital, which I joined immediately after graduation. I have now been at Polen for about 5 ½ years and have been managing the Global Growth portfolio with my partner, Damon for the last 1 ½ years.

DF: Polen has a long history of successfully managing concentrated growth portfolios with a business-owner mindset. The large company growth team, which Jeff and I are a part of, is one fully-integrated global investment team executing a proven investment discipline across three different portfolios. Our flagship Focus Growth portfolio, which started in 1989, is invested in the best growth companies in the U.S. Our Global Growth portfolio, which launched at the beginning of 2015, invests in our best ideas anywhere in

(Continued on page 18)

Polen Capital

the world. International Growth, which launched at the beginning of 2017, invests in the best growth companies outside the U.S.

G&D: Was there any strategic reason why Polen chose to be based in Boca Raton, Florida?

DF: David Polen, the firm's namesake and founder, began as a broker in New York before moving to Tampa, Florida to bootstrap the business in an area with a more affordable cost of living. By 2002, when the investment track record was well-established and he wanted to attract talent to build the business, he decided to move the firm to Boca Raton, Florida, where we are based today. Boca Raton is far from New York, but we believe being disconnected is a good thing. We have a unique investment philosophy and process, which is built upon independent fundamental research. We are not concerned with what anyone else thinks of the companies we own. In that way, we think it is actually an advantage to be on an island of sorts.

G&D: Can you elaborate on your investment process and how it's unique?

JM: I think what is probably most unique is that we have consistently executed a process that hasn't changed in any significant way for more than 30 years. We owe a large part of our success to our discipline in sticking with our process. We begin with a very large universe of about 3,000 companies globally, but we quickly whittle that down by applying five investment

guardrails which have been in place since the inception of the firm. We are looking for companies with (1) a return on equity above 20%, (2) an exceptionally strong balance sheet, (3) stable to improving margins, (4) abundant free cash flow, and (5) real, organic revenue growth.

"The [pre-mortem] is to reverse-engineer explanations for how a company can hypothetically become the worst investment Polen has ever made. It's an interesting exercise because it can show how strong – or weak – our investment thesis is; the harder it is to come up with plausible pre-mortem reasons, the more likely a company is special."

While each of these guardrails sets a high bar individually, looking for companies that meet *all five* becomes an exceptionally high hurdle. For example, while an ROE of 20% or greater is roughly double the corporate average and signals a strong competitive advantage, it is possible for a business to increase its ROE

simply by adding leverage. This is why we also demand low levels of debt in our companies.

Once we apply our five guardrails, our investible universe of companies drops to roughly 350 companies. From there, we study these companies extensively, aiming to remove businesses that are overly cyclical or driven by an unsustainable fad. We have traditionally avoided materials, utilities (not enough growth), telecom (too capital-intensive and cyclical), energy, banks (overly leveraged with opaque balance sheets), and real estate. Our overarching goal is to construct a portfolio of roughly 25 high-quality, competitively advantaged businesses that generate consistent mid-teens earnings growth, with the belief that stock appreciation will follow the earnings growth over the long term.

After filtering out cyclical businesses and businesses with more temporal growth prospects, we are left with about 100-150 companies, which we call our coverage universe. These are the businesses that we spend most of our time on. One of the advantages of holding positions for an average of five years is that there's no rush to get the next idea in the portfolio; the goal is to truly understand the competitive advantages that protect the business and the sustainability of those competitive advantages going forward. I believe Charlie Munger said that the first rule of fishing is to fish where the fish are. We believe we are fishing in a stocked pond.

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One of the last things we do is a pre-mortem on the companies. This is taken from the discipline of social psychology. The exercise is to reverse-engineer explanations for how a company can hypothetically become the worst investment Polen has ever made. It's an interesting exercise because it can show how strong – or weak – our investment thesis is; the harder it is to come up with plausible pre-mortem reasons, the more likely a company is special. From there, Damon and I apply critical thinking and judgment and choose the best ~25 businesses.

G&D: Can you touch on how you put the portfolio together?

DF: We like to say that we are investing across the growth spectrum. On the left side of the spectrum you have steady businesses that grow at a higher-than-average, but more moderate and dependable rate. On the right side of the spectrum you find quality companies growing at much higher rates, perhaps 20-25% per year and above. Of course, these businesses often have higher multiples as well. We are happy to own higher growth companies such as Adobe or Tencent that have a higher valuation, as long as the business fundamentals support it. What looks expensive in terms of the next-twelve-month P/E becomes more reasonable if the business is growing earnings at a 20-25% rate and the stock isn't following along.

G&D: Aside from your unique investment process, what else separates Polen from other investment firms?

DF: We would put concentration at the top of that list. We have about 25 positions in the Global Growth portfolio, which we think is a big advantage from two perspectives. From a performance perspective, by concentrating in the best growth businesses, we can construct a portfolio that grows underlying earnings faster than the market. This is what we believe drives excess returns over time. From a risk perspective – which is arguably even more important – portfolio concentration in only the highest quality businesses reduces risk.

“What looks expensive in terms of the next-twelve-month P/E becomes more reasonable if the business is growing earnings at a 20-25% rate and the stock isn't following along.”

We've had among the best downside capture across the industry in our flagship fund over the past 30 years, and our Global Growth fund is following in the same footsteps. In the four years since its inception, the Global Growth portfolio has compounded at about 11% compared to just over 4% for the MSCI ACWI (all country world index) and ranks in the top decile for downside capture. We have been able to

deliver significant excess returns while also capturing less of the downside than 90% of our peers.

The second advantage that we would highlight is our long-term holding period. We're not trying to generate returns by buying and selling stocks; in fact, half of the Global Growth holdings have been in the portfolio since inception (over four years ago). And to use our Focus Growth portfolio as another reference point, we've only owned about 120 companies in that portfolio over the past 30 years.

We also believe we have an advantage in the way we put it all together to manage risk. As Jeff described earlier, we only consider high-quality business, which removes a lot of risk at the front-end of the process. We are also quick to adjust to any new risks that emerge in a business. We don't want to take any undue risks with a concentrated portfolio, and our track record shows that we don't need to. We have produced strong returns not because we have taken big risks and have been right, but because we have avoided taking unnecessary risks.

G&D: To what degree does engaging with management factor into your process?

DF: We engage with management, but it's not the most important thing that we do. We meet with management maybe once a year. We really try to put the picture together with publicly available information before we talk to management. Management conversations tend to confirm what we have

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The judges' panel for the 4th Annual CSIMA Stock Pitch Competition

already learned. If the situation is so complicated that we can't understand it without having a conversation with management, that would be a red flag.

JM: We don't meet with management to ask about quarterly inflections or catalysts. We understand the business model, so when we meet we talk through their strategy over the next three to five years or beyond.

G&D: Polen is currently roughly half US and half international. Do you set a geographic target when building the portfolio?

JM: We do not target a certain geographic mix. We tend to think more in terms of where the underlying revenue is being earned as opposed to where the company is domiciled. You can have a US business that does 80% of its business outside the US, and vice versa. We are mindful of what the mix is, but we are really just looking for the best businesses while staying balanced over time.

G&D: Let's talk about specific investments. You own Tencent and Alibaba. How do you think about investing in China and state-controlled enterprises?

DF: We're very thoughtful about how we invest in China. Most businesses in China are not investible for us today. Even Tencent and Alibaba have Variable Interest Entity structures, which is not direct equity ownership. While that set-up is a risk factor and something we keep in mind – a reason we have limited our aggregate exposure to those

two enterprises to about 10% of the portfolio – we think it is highly unlikely that the Chinese government would do anything to usurp these assets. These companies are highly visible businesses that have significant foreign institutional ownership. Any meaningful effort to assert direct control over these businesses would likely result in foreign capital flooding out of China, which would be against China's broader interest in becoming a global hegemon.

"We appreciate companies with high returns on invested capital and that operate in both underpenetrated and expanding addressable markets."

We also feel confident that both businesses are well-aligned with China's strategic direction, particularly Alibaba. China is trying to move towards a more consumer-driven economy, and Alibaba is essentially the backbone of commerce across China. These businesses are Chinese champions, helping propel the economy in a way that the government really supports. We are mindful of having the wind at your back when investing in China, as opposed to running into the wind, which can be fraught with challenges.

G&D: JD is one of Alibaba's direct competitors. Did JD

miss one of your guardrails?

JM: This goes back to our approach on strategically thinking through what is happening today and what could happen over the next five-plus years. Alibaba is not only more dominant today, but it's also more profitable and has higher returns on capital. JD's business is still heavily weighted towards their low margin, capital-intensive IP business which largely consists of selling consumer electronics. Alibaba is completely dominant, and they're reinvesting heavily to ensure they maintain their strategic position.

We appreciate companies with high returns on invested capital and that operate in both underpenetrated and expanding addressable markets. Both of these qualifications apply to Alibaba, particularly as China's middle class grows from 300 to 500 million within the next few years. The company has a long runway to deploy free cash flow at higher returns. Alibaba has also reinvested heavily into payments, as Alipay has become China's leading payment platform. Their dominance is so impressive that we think it will continue to do very well against JD.

JD has had one main advantage over Alibaba: a built-up system of in-house logistics and last-mile delivery. However, Alibaba has arguably caught up by leveraging their massive amounts of data and scale. Its logistics network, Cainiao, now handles over 60% of Chinese packages, or 25 billion packages a year. With access to the over 600 million users

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on Alibaba's retail platform and their 50 billion annual transactions, Cainiao is using advanced machine learning to "guess" where a purchase is most likely to happen and plan the logistics accordingly. A more efficient logistics network will likely further widen the gap between Alibaba and its competitors.

Alibaba's current take rate is only about 3.5%, which pales in comparison to Amazon's 13%. We think that rate should go up over time. We are watching these Chinese companies execute similar strategies that our team studied in the past with eBay and Amazon. For example, third-party sales became a big part of Amazon's business model between 2000 and 2002. The introduction of 3P increased profitability and was also strategically effective: 3P is a high-margin business given that Amazon merely takes a cut of transactions, it allows for a greater selection on the platform without added inventory risk, and it strengthens the Amazon network effect by attracting more buyers (and by extension, more sellers).

However, Amazon struggled with scale problems during this period of rapid retail business growth, forcing the company to build many of its own systems to deal with application, computing, and storage needs. That led to the birth of Amazon Web Services, currently Amazon's most profitable division. We saw Alibaba benefit from a similar rise in 3P growth and we're also seeing the same pattern play out with Alibaba Cloud, which now controls almost half of China's cloud-computing

market.

G&D: Alibaba sounds like a compelling investment. Are there other names that you're excited about that hit all five guardrails?

DF: Adobe is a great example of a company that we're really excited about – there's a reason why it's our top holding in the portfolio. We think it has a huge competitive advantage and a very strong opportunity to continue to reinvest back into the business at high incremental returns.

Adobe basically has two businesses. One is Digital Media which is the creative side and about 70% of the business. That's content creation, software like Photoshop that allows users to edit photos and create videos.

Digital Experience is the other 30%. Firms are transitioning their marketing away from traditional channels like newspapers, television, and magazines and toward digital channels. With Digital Experience, Adobe will conduct entire digital marketing campaigns for companies and run very fine-tuned analytics. Adobe can tell you how long someone hovered their cursor over a link, what they clicked on, how long they watched a video, etc., while also creating a unified customer profile in the background. This is basically a code that informs companies, with a fair degree of accuracy, who you are and what you're most likely to buy online.

JM: We found Adobe in 2013 when we were doing a big exercise on Oracle (which

we've owned since 2005) to see what the transition to cloud would be like and how significant the headwind would be to revenue. As we were doing the research, we started thinking, "Alright, the cloud's obviously a good thing for a lot of companies even though they're going through some short-term headwinds. Who else is really benefiting from this cloud transition?" Adobe was one of those companies.

In December 2011, Adobe decided to stop selling packaged software for its creative content and transitioned to a subscription model. That strategic shift was attractive to us because the company went from a boom-or-bust revenue cycle, where every two years customers may or may not upgrade to the newest version of the software, to a more predictable and sustainable revenue cycle where Adobe could easily raise prices. Adobe effectively holds a monopoly in this space; there's really nowhere else to go if you're a professional and you want to create digital content.

We spent roughly 15 months researching Adobe, trying to answer questions like, "What is the growth rate of Digital Experience? What is the value proposition? Are there synergies between Digital Media and Digital Experience that create an even greater competitive advantage than what you might see on the surface?" It turns out there are deeper synergies. Since Adobe is a monopoly on the creative side, any company that signs up with Adobe to run a digital marketing campaign will also end up using Adobe's creative

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content for their digital media. All the code is the same, so nothing gets lost in the transition between the creators and the marketing people. It all works seamlessly. That functionality informs the decision of a lot of large companies as they choose Adobe over a competitor.

We later realized that there's this secular tailwind where digital marketing is becoming increasingly important for companies not only to survive but to thrive. That has created even more demand for digital content creation. Not only are the two businesses helping sell each other, but they're both growing due to the same secular tailwinds.

We think management has done a good job of broadening their Digital Experience business and expanding their product offerings. Previously, if a company used Adobe's digital marketing, they'd have to use a third-party company to enable their clients to check out. That gap no longer exists following Adobe's acquisition of Magento, an open source e-commerce platform. Adobe's ensuing purchase of Marketo, a B2B digital marketing services provider, further bolsters its product lineup.

Tapping into Polen's experience, we found that for enterprise software, the full-suite offering usually wins out over best-of-breed point solutions. It's logical – if you're the deciding person for enterprise software purchasing, you don't want 100 different point solutions, because not only is there a chance that they won't integrate well, but you have to

call 100 different people if or when things start going wrong. The full-suite offering ensures that everything is integrated and you have just one point of contact.

What makes this even more potent for Adobe is that their full-suite offering also includes best-of-breed point solutions. This makes it very difficult for other software vendors to compete. We think Adobe is well-positioned to continue to compound earnings in excess of 20%. We feel margins can still expand over time, with the high quality of the business acting as the investment's margin of safety.

G&D: We noticed you also own Starbucks. Building on our earlier discussion of China transitioning to a consumer-driven economy, do you view Starbucks as a stock where most, if not all, of the growth in the future is going to come from China?

DF: We expect continued growth from both the US and from China. The US is currently 70% of Starbucks' business. Though the region is certainly more mature than China, it is still a meaningful contributor to overall growth. Starbucks is growing store count at about 4% annually in the US, a rate which has been pretty consistent over the past several years. Same-store sales have moderated from high single-digits a few years ago to what we think will be a sustainable 3-5%. Aggregate growth in the US, though more modest than it historically has been, is still quite healthy.

China is certainly a bigger growth opportunity and will

become a more significant part of the business over time. Starbucks is growing store count in China in the high-teens. That has had some impact on same-store sales which are now relatively flattish after being as high as 8%+ a few years ago. Moderating comps, plus an intensifying competitive environment with the entry of local players like Luckin Coffee, are undoubtedly short-term headwinds.

Nevertheless, Starbucks has a very strong established position in China, which is a bit of a land-grab market. They have thousands of stores. They have a real brand experience which is not really being challenged. I think they have the right strategy there, which is not to optimize for same-store sales but rather to open more stores. They're playing the long-term game instead of taking easy short-term wins.

Additionally, the store-level economics in China are as good as they are anywhere in the world. Usually, US-based companies that try to expand abroad aggressively chase after growth markets at the expense of profitability. They try to build a beachhead and grow into new areas with the hopes of making money in the future. But for Starbucks in China, the overall economics and cash-returns of stores are actually quite good. So, not only is it the right strategy to accelerate store growth, it's a good return strategy as well.

G&D: Is there any worry the trade war might shift Chinese preferences away from American companies to domestic brands like Luckin?

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DF: I think there's enough opportunity in this market for more than one player to have some growth, but you need to grow in the right way. It's funny because you have companies like Luckin that are taking this technology business model approach like, "We'll just grow. We're not going to worry about profit. We'll make money tomorrow." That might make sense in certain technology businesses where there's a network effect, but we don't see that here. Luckin is just building stores. The consumer could wake up in two years and say, "If you're not giving me a discounted cup of coffee then I'll go to Starbucks." You don't have that lock-in effect like you do in other businesses where you see that type of approach. It's a competitive environment, but I think brand definitely matters.

Moreover, there's probably a multi-tiered marketing opportunity in China. There are some consumers that are going to be price-sensitive and won't go to Starbucks to buy a \$4 latte. But there are other consumers that do want the brand, that will pay a premium to carry around the mermaid on the cup. I don't think anyone is challenging Starbucks on all dimensions, and it's a big enough market for more than one player. Starbucks is going to do just fine as time passes.

G&D: Can you give your take on Align Technology? They had a rough 2018 with the stock dropping about 50%. Do you still feel that clear aligners will eventually replace braces?

DF: We still own Align, although we trimmed the

position a couple of times throughout last year because the valuation had become a little more demanding. It turned out to be fortuitous timing, since they had a bit of a hiccup last quarter which brought the stock down quickly.

Two things happened last quarter that repriced the stock. First, promotions for Invisalign aligners didn't turn out as well as expected, putting downward pressure on average selling prices. Second, new competitors entered the market. Combine those developments with a rich valuation, plus the negative market environment last quarter, and investors got scared.

"We have a view that vanity is increasing across humanity."

We looked at all of those factors and determined that they were short-term challenges and that the business is still in a very good position for the long-term. The valuation is reasonable again, so we brought the position back up to a 2.5% weight in the portfolio. While it wasn't an outstanding year in terms of share price for Align, the stock was still a strong contributor in our portfolio because of solid position management.

JM: We still love the business, and it is worth noting the importance of historic perspective and how it benefitted our understanding of Align. Damon knows Allergan exceptionally well

after owning it in our Focus portfolio for a long time. We believe Invisalign is similar to Allergan and its Botox product. Botox has been off-patent for decades, yet it's still a very powerful brand and the go-to for people that want to get rid of wrinkles and look younger. Most people can't name Botox's competitor (it's a brand called Dysport). We've found that the Invisalign brand, even though it's still patented, has all the hallmarks of the brand equity that Botox has.

We also have a view that vanity is increasing across humanity. First, you have the creation of the internet, and the advent of smartphones and social media shortly after. Now, sadly for our children, humans are taking more pictures of themselves than ever before, which means that people are more into their faces and, by extension, their smiles. We think that fits right into what Align is bringing to market with Invisalign.

We first saw this market shift with adults. Many adults that got Invisalign wouldn't feel comfortable going into a professional workspace with braces on, making braces a non-starter. We're now seeing that trickling down to teens and children.

Clear aligners are more aesthetically-pleasing than wires and brackets. They're also healthier. You can't floss while you wear wires and brackets, which can lead to gum irritation, at a minimum, and potentially even gum disease. It's an easier and more time-efficient process, as technology with clear aligners has advanced to the point

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where clear aligners are generally quicker than wires and brackets.

We think the sub-10% market share that Align holds today in teeth correction procedures is only going to grow from here. Honestly, if wires and brackets are still around in 20 years, then clear aligners have really done something wrong.

G&D: That's a very strong case for the industry. Why do you think Align is better positioned than its competitors in the space?

DF: While putting this little piece of plastic in your mouth to shift teeth seems simple, optimizing the biomechanics and algorithms behind the technology and then mass-producing these aligners at scale is incredibly complex. No set of teeth is the same. Align is essentially mass-producing snowflakes on demand and then shipping them to a widely distributed set of dentists and orthodontists all over the world.

On top of all that, Align also has the patents underlying the technology in addition to its strong brand equity. If a dentist or an orthodontist brands their practice – and here's the parallel between Align and Botox – with the Invisalign product, there's going to be little incentive to move away from that. Once you build that brand into your practice and become comfortable with it, you're not going to switch unless there's something much better or much cheaper – and even then you need to think twice because you don't want to diminish the patient experience.

G&D: Can you talk about the purchase decision and how it's made? Does the orthodontist make the decision about what brand customers use and is there any real threat from direct-to-consumer brands in the space?

DF: The dentist or orthodontist can make a recommendation and steer you towards different types of products and alternatives. But most of the alternatives are only for very moderate cases. Only Align has the capability to treat extreme cases such as extractions that require teeth removal and palate restructuring.

As for threats from direct-to-consumer businesses, Align explored that model but ultimately decided to go in a different direction. It would be very easy for them to target lower-end treatments. But Align has always kept the dentist and the orthodontist at the center of the experience. They're doing other things to pull more people into the market but they're always trying to direct them to the dentist or orthodontist, not work around them. That's their channel – Align believes that you want a quality healthcare professional managing this outcome. They're creating all the tools to make it incredibly simple to get great outcomes, but they still want to prioritize protecting the relationship with the professional.

You could think about this as market segmentation, just as we were discussing with Starbucks and Luckin Coffee. There's a certain population

out there that might need a few aligners. They might want to straighten one tooth out but they're not going to pay much for it and they're willing to take on a lower-end direct-to-consumer product. That's a customer that Align is probably not going to win. There's room for different players in different segments of the market, so we don't think it's a long-term problem for Align.

G&D: Thanks for that insight. Do you have any advice for MBA students looking to get into investment management?

JM: I'll give three pieces of advice: two on perspective, and one on how to improve perspective. First, investing can be a long career. Even if it takes you five years to break into the right place with the right people who compound capital in the right way, five years represents only 10-12% of your total career, which isn't much.

Second, the investing industry should be approached with the goal of lifelong learning and an understanding that you're compounding your knowledge over time. It's important to keep in mind that the industry lives on an exponential curve. This means you will experience long plateaus without noticeable improvement, with the key word being "noticeable." There will be inflection points; you just won't know when. Grow to embrace, or even love, the plateaus.

Finally, consciously develop your values and moral compass. One way to do this comes from Charlie Munger, who said, "Read history, read

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history, read history.” Don’t do it to memorize facts to impress people, but do it with the understanding that decisions made in the past were made by people with the same cognitive makeup that you and I have. When reading about frauds, catastrophic decisions, and decisions based on weak values, try to understand what led to those decisions, and think about how to improve your own judgment to prevent yourself from making similar mistakes. Reaching the point where your values and your moral compass are impenetrable will make your life better because you will have earned the trust of people you work with, and there is a good chance your example will influence others along the way.

DF: Don’t compromise your vision for yourself. As you complete your studies and begin your career in investment management, make sure you set sail in a direction that you believe in. Prioritize principles over money and join people that you respect and can learn from. I understand the desire to repay the student loans and to monetize all the learning that you’ve already paid for, but there’s much more to learn. You’ll be better off if in the long run if you decide to double down and invest in yourself again. If you guide yourself with the right principles and align yourself with the right people, then you’ll learn how to create real value for the people that ultimately entrust their money to your care. If you do that well, the money will come, and you’ll be able to feel good about not just what you’ve accomplished, but what you’re

contributing to others.

G&D: Thank you so much for your time.

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Dov Gertzulin

cum laude. Mr. Gertzulin is the Co-Chairman of the Investment Committee of the Baruch College Fund with responsibility for overseeing the endowment. He is an avid hiker as well as a Trail Maintainer of the Long Path.

Graham and Doddsville (G&D): Dov, thank you for chatting with us today. Can you introduce yourself and discuss how you became interested in investing?

Dov Gertzulin (DG): I grew up in Brooklyn and, from a young age, was interested in investing. I heard about Warren Buffett and got my hands on *The Intelligent Investor*. After that, I started learning as much as I could about Ben Graham. I was a bit of a value investing nerd – I went to Berkshire Hathaway's annual investor day many times and even read *Security Analysis*.

G&D: You actually read *Security Analysis*?

DG: I did.

G&D: Wow, that is somewhat unusual to have read it cover-to-cover.

DG: I actually have a first edition *Security Analysis*, third printing. Anyhow, I went to Baruch College to study finance and investing. When I was there, I got a summer internship at Neuberger Berman. I was lucky to get the job, but they put me in the IT department. I didn't know the first thing about IT. I would sneak out and go to all the investment and research meetings that I could. We even

met with the CEO of General Motors, which was pretty exciting for someone who was still in college.

Everyone else went back to school when the summer ended, but since I was going to school in the city, they asked me, "Would you want to work here part-time during the school year?" I said yes. That was an incredible opportunity. I then started working in research at Neuberger. I was 20 years old, and they would send me to these IPO lunches for companies like Blackberry and Palm. Those companies were going public then, and a lot of these companies don't exist anymore. It was an absolutely crazy period when all ideas about value were completely thrown out the window and companies routinely traded at 50x, 100x earnings, sometimes even infinite amounts of earnings.

In 2000, I joined a hedge fund named JDS Capital. This was at the peak of the market. The world seemed completely irrational, and then we had a significant correction. Subsequently, you had the ability to buy quality companies cheaply; I remember REITs trading at double-digit yields because no one wanted them since they were not involved with the internet or some sort of exciting technology. In a sense, investing was very simple because you had quality companies trading at single-digit or low double-digit multiples of earnings and free cash flow.

I realized I wanted to go back to a value-based investment process. I returned to Neuberger in 2002, where I

spent the next five years as an analyst and as a co-portfolio manager. During that time, I really dug deep into value investing: how to value companies and how to find undervalued companies. That was a very productive period for me.

During that period, I also received my MBA at NYU and studied distressed investments and bankruptcy law. I realized over time that, while buying something very cheaply was good, what's even better is marrying that with a catalyst or a specific event to unlock value, or looking in the parts of the market where there is less competition. Doing this, you could find more compelling opportunities than in just trying to find cheap stocks.

G&D: What convinced you of that?

DG: One major influence was Columbia Business School professor Joel Greenblatt. At that time, you could watch his classes on the internet, and I also read his book *You Can Be A Stock Market Genius*. Another influence was Seth Klarman at Baupost.

That led to the basis for DG Capital. I wanted to create a firm where we could be passionate about uncovering deep value, and at the same time able to invest across the capital structure – everything from first lien debt to post-reorganization equity. Additionally, a focus of ours would be clear catalysts to unlock that value, whether in the form of debt payment, a high rate of interest, a special dividend, a listing of shares, or a company putting itself up for

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sale.

Distressed investments naturally display this framework, with situations in which a company goes through a distressed event and the banks or the lenders then take over. In many cases, the lenders are not set up or are not able or willing to own the equity or junior parts of the capital structure. As a result, you can buy into the company at a significant discount to peers.

If you take a step back, I think the reason why investing today is so difficult is because we have so much more capital available. You may have seen the recent National Bureau of Economic Research's study that shows there were 4,943 listed US companies in 1976, a total which grew to about 8,000 at the peak of the market in 1996. By 2016, that number had dropped to only 3,671 listed companies. Today, you have less than half the number of publicly traded companies than you had 20 years ago, and fewer companies than 40 years ago. Yet our economy is so much larger, the pool of capital is so much bigger, and the number of people working in investing and graduating from business schools is so much greater. I think this makes it so difficult to outperform and add value.

The question is, where can you add value as an investment firm? I think you have to start by looking in a place where the vast majority of people aren't going to be searching for an investment, or where there are structural advantages. The number of funds that can buy first lien distressed debt is just

so much smaller than the number of funds that can buy stock in IBM or Microsoft. When a company comes out of bankruptcy, its shares are not listed on an exchange. You need to call a trading desk and bid on those shares, which is a back and forth verbal negotiation. The number of investors who can do that is relatively small. Furthermore, in this space there are actors selling for institutional reasons and not necessarily fundamental reasons.

“[1999-2000] was an absolutely crazy period when all ideas about value were completely thrown out the window and companies routinely traded at 50x, 100x earnings, sometimes even infinite amounts of earnings.”

We also invest in more classic areas where people add value, such as transactions in which big companies spin off a small business unit, or turnaround situations in which companies looking for financing may have to issue convertible debt or other debt instruments that have equity upside. We prefer to focus on middle-market companies rather than large, multi-billion-dollar ones.

G&D: Can you talk about the timing of when you opened DG?

DG: We started the fund in mid-2007, which looking back seems like the worst possible time to start. Very few funds that started at that time exist today. We didn't get fully invested until just about when the financial crisis was getting going. It was also a good lesson for us because late in 2008, when the world was in a very difficult place, you had the opportunity to buy debt in companies that, in some cases, had more cash than debt, and were either profitable or not losing any significant amount of money.

I remember investing in the debt of JDS Uniphase when they had an approximately \$500 million debt issue that was trading at 50 cents on the dollar, as well as about \$800 million in cash. While that scenario was certainly unusual, it showed that there are ways to make money even in difficult periods. That was another really important lesson for us: always keep a portion of the portfolio in the senior part of the capital structure. From there it's been a good journey.

G&D: Why do you think more capital hasn't found its way into this space?

DG: I'll give you an example that should help answer your question. Take AMF, the largest bowling alley chain in the US. They were over-levered and went bankrupt. In the bankruptcy, the lenders merged the company with Bowlmor, which had two locations in New York and was expanding across the US. It is a very profitable business. AMF was a mismanaged company, but at Bowlmor, management came in and transformed the

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business from the league bowling business, which has no growth, to the party event, corporate event type of business. Have you been to a Bowlmor?

G&D: Not recently.

DG: They have bars and good food – it's a high-quality experience. When the company exited out of bankruptcy in 2013, I called the CFO. We had a nice conversation, and I reviewed the projections that were available in the bankruptcy documents. I asked him, "Has anyone else called you?" He said no.

I thought that was really strange. The stock was trading at \$5 and there was a plan to significantly grow earnings, but at \$5 a share, the company was valued at less than 5x EBITDA. There were comparable businesses, such as Dave and Buster's, Chuck E. Cheese, movie theater chains, other forms of entertainment, that were trading high single-digit, low double-digit multiples of EBITDA.

There was also a second lien piece of debt that was yielding approximately 15%, for a leverage of 4x EBITDA. Additionally, you had the exit first lien debt on which you could make around 13%. We were also part of the financing that allowed the company to exit bankruptcy. The shares were not listed, but through investment banks you could source the first lien, the second lien or the common shares.

Over time, Bowlmor's superior management team

significantly grew earnings. They bought Brunswick's bowling business. Bowlmor's shares, which weren't listed but did trade, went from \$5 to \$77 by 2017 after being purchased by Atairos, a private equity firm backed by Comcast. They grew EBITDA from about \$50 million to approximately \$160 million through acquisitions, cost-cutting, rebranding, and rebuilding the business.

"If you are able to buy significant companies on a fractional basis, you can buy assets at very deep discounts. In many cases, these companies are set up to win because you have a management team whose incentives are aligned with the interests of the investors who put them in place."

Why was that opportunity available? Why was it trading at such a massive discount? Even though bowling is not a sexy business, the company still had strong cash flows. What's the incremental cost of bowling? It's almost like software. What's the cost of electricity for running the pins? It's about an 80-90% gross margin business.

G&D: That seems like an idea which should have attracted a lot of attention.

DG: The fact is most investors lack a flexible mandate and need to buy something that has a ticker. If you are able to buy significant companies on a fractional basis, you can buy assets at very deep discounts. In many cases, these companies are set up to win because you have a management team whose incentives are aligned with the interests of the investors who put them in place. The valuation may also be extremely compelling because you have a good business that just holds too much leverage, with leverage then significantly reduced in the restructuring process. It really can be an attractive opportunity. Will more people try to exploit that over time? Probably. But we see opportunity for the enterprising investor who is willing to work really hard to uncover these ideas.

G&D: Can you walk us through your process and how you work to uncover these ideas?

DG: Our research team sources ideas broadly. It starts with a focus on off-the-run middle-market companies, with an enterprise value generally below \$1 billion. We follow companies that are going through restructuring or into bankruptcy, as well as post-reorganization companies and companies whose debt is trading at a big discount from face value, or even companies that have had changes in management, among other special situations. We also work closely with a

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proprietary network of attorneys, restructuring advisors, middle-market lenders, sell-side trading desks, and other industry experts to source our ideas.

G&D: Do you have a sector focus?

DG: We tend to invest in gaming and lodging, medical technology, business services, certain parts of the energy business, and natural resources. But our mandate is broad. Our research process revolves around building our own proprietary model. What's nice about many of these companies is that you can't just pull them up on Bloomberg, and there is often little to no research coverage.

Private financials also offer us an opportunity. It's a risk, since other people may have been involved for a long time and could be more knowledgeable than us, but the reward is high because the market is less efficient in those cases. We then ask ourselves, "Is management aligned with us? What are their incentives?" That's a key question. What's their history? What's their background? Do they have a track record of success? As I have done this for longer and longer, I have realized that quality of management is a key factor. It's too easy to lose money with poor management teams, and in many cases, when we've done extremely well, it's with people who have shown a track record of success.

Then we look at the situation. We ask, "Is it undervalued? Is it undervalued on an absolute basis? Is it undervalued relative

to peers?" If we find the valuation compelling, we then ask, "What's the clear catalyst to unlock the value?" We don't want to come back here a year from now and say, "We own all these cheap securities and they're still cheap." We want to be in positions where there are clear catalysts that will drive the return.

G&D: How else do these opportunities present themselves?

DG: Often, when companies come out of bankruptcy, these exit term loans offer rates of interest far in excess of where comparable companies would have to offer their debt. This debt is usually refinanced within a year or two. They may issue it at 98 cents on the dollar, but if they refinance it within two years, they have to pay 102 cents on the dollar. You just made four points right there, and if you can make a high single-digit rate of return on the interest rate, something like LIBOR plus 700, you can earn a double-digit, equity-like return with a debt-oriented investment.

In terms of equity, we look at the elements we already mentioned. For example, a typical situation we like is the one where a company generates high free cash flow and tenders for shares. Another one would be a situation where the company lists its shares on a major exchange. To identify catalysts, we ask ourselves questions like "Will the company be put up for sale, or will a large special dividend be paid?" That's really our research process, after which we ask ourselves "Do we understand the industry

risks? Is there some way we could hedge our position?"

We own a position in Contura Energy, the largest metallurgical coal company in the US. Metallurgical coal is used to make steel. The company was formed during the bankruptcy of Alpha Natural Resources. After bankruptcy, Contura and post-reorganization Alpha Natural Resources merged. There is always cyclical risk with a resource company like that, but the shares trade at about 2.5x our estimated EBITDA, and maybe 3.5-4x free cash flow. We think that this is very, very attractive. As it trades at a big discount to peers, we may look to hedge our position against more highly valued peers.

G&D: For your event-based theses, do you actively engage management?

DG: Yes. We definitely make our viewpoint known to management. We're not loud activists, but we do engage with management, especially in the distressed process. We'll typically work with other creditors and engage with the board and management to talk about strategy, change, and how they can drive value.

G&D: Does part of your analysis focus on who else may be investing along with you?

DG: Absolutely. There's no question that you need to be very aware of which firm owns which part of the capital structure, or if a firm is a sponsor of the company, how they typically conduct themselves in a distressed situation.

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DG Capital Management

Furthermore, you also have to be aware of where you are in the capital structure, asking yourself questions like “Is there a lot of first lien debt ahead of you that exposes you to significant risk?” If there is first lien debt ahead of you, perhaps that debt will get reinstated or refinanced, making it much easier for the junior creditors to be the fulcrum and take over and/or get a stake in the company. Those are all things that need to be considered.

G&D: How do you think about how long to hold a position and when to exit?

DG: I have a big sign in my office that says, “When the thesis changes, sell.” It’s very difficult to follow that advice, but I suspect that if we only followed that advice, over time, we would have avoided some mistakes. We continually ask ourselves, “Is the thesis still intact?” If the thesis has changed but it’s too cheap to sell, that’s a very difficult place to be. I think a lot of money has been lost by the investment community in those types of situations.

We think our approach to time horizon is a competitive advantage, especially in the current environment. We don’t ask, “What will the company be worth in a month or a quarter or six months?” The minimum amount of time that we’re looking to hold is one year. We’re asking, “It’s trading here today, but what could it be worth in one year or two years, sometimes even three years?” We don’t go past three years for a number of reasons. For one thing, we

think it is very hard to predict beyond 24 months from now. We need to have a clear thesis like, “We’re trading at X today, which represents some discount to what we think it’s worth. Then, in a year from now, when the company sells itself, pays a special dividend, lists the shares, or refinances its debt, it could be worth Y.”

“I have a big sign in my office that says, “When the thesis changes, sell.” It’s very difficult to follow that advice, but I suspect that if we only followed that advice, over time, we would have avoided some mistakes.”

Many investors can’t do that today. They don’t have that time horizon. They’re focused on their monthly and quarterly P&L, and while we like to make money every month and every quarter, we don’t think it is helpful to focus on that.

G&D: What do you think is driving this opportunity set?

DG: The big driver is private equity. Private equity was a zero business in 1976 and is now a multi-trillion-dollar industry. Thousands of companies that would have been public are now owned by private institutions, and they use significant leverage. Many

of these companies are not built to be on that level of leverage. What we’ve seen in these companies is that small problems cause distress. For most of these companies, this wouldn’t happen if they were heavily equity-financed.

G&D: We’re in what seems to be the late innings of a 10-year bull market. How do you approach investing in distressed assets over such a cycle?

DG: Our flexible mandate allows us to invest in different parts of the distressed cycle, which entails everything from when companies are going into distress and their debt is trading at a significant discount to par, to when they’re in bankruptcy, and also includes when they come out of bankruptcy and you can invest in post-reorganization equity or in the exit debt. If you are able to invest across that entire distress cycle, you can always find opportunities.

Over the last few years, we have found some attractive opportunities in companies that were bankrupt years ago and which are now earning record results, yet whose shares are still not listed on an exchange. Sometimes, they are just now listing for the first time, paying special dividends, or selling themselves. For our organization, it’s actually a very exciting time to be harvesting a lot of those gains and, for example, selling these companies to other publicly traded companies trading at much higher multiples. It’s a win-win. There are also private equity firms that can buy these businesses and pay a much higher price thanks to debt

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financing.

G&D: That's an interesting approach to cycles. Do you want to discuss any specific holdings?

DG: Sure. In 2018, our largest holding was the post-reorg equity in Tropicana Entertainment. The stock was listed on the OTC market. We started buying in late 2016. Tropicana was trading at 4x EBITDA and generating great cash flow with almost no net debt, at a time when nearly all gaming and lodging companies were trading at 8-12x EBITDA. Additionally, the regional gaming industry was beginning to experience consolidation.

Why was it trading at such a significant discount to intrinsic value and peers? Well, it was closely held, and it was listed on the OTC market. That, in our view, created a tremendous opportunity to buy this asset, which had been distressed many years ago but was now run by highly qualified management.

That is the type of research that we do. We married that fundamental research with a deeply discounted valuation and a trend towards consolidation in the regional gaming space. That led us to believe that this would be a prime asset to be sold. Finally, you had multiple property upgrades which were starting to flow through in the numbers. It was an extremely attractive investment, and the company ended up being bought by El Dorado Resorts last spring for about 10x EBITDA.

G&D: Was Carl Icahn in the

name when you looked at it?

DG: Yes, he was the largest shareholder and, along with the company, did a joint tender for the shares. Once we saw that happening, it became pretty clear to us that they thought there would be a significant appreciation of the business and of the shares over time. That was a clear signal to us.

"Everyone is looking for someone who can contribute to performance. That is the ultimate equalizer. In the investment management business, if you can add value, it almost doesn't matter where you came from or where you've been. If you can add value, there will be a place for you."

This goes back to one of our fundamental tenets: the actions of management, the board, and the people who control a company. If those individuals are buying as many shares as they can, that is something to really take note of. Historically, we have found that for investors who are not on the board or inside the company, it is very valuable to follow what insiders with a history of success – like Carl Icahn – are

doing. In addition to your own due diligence, it is a clear signal that there is real value that can be created here.

G&D: It seems like a lot of value investors are orienting themselves around the gaming industry and, potentially, trapped value.

DG: Yes, definitely. We own Twin Rivers, which is another casino that came out of bankruptcy. It just filed its registration statements and is merging with Dover Downs, ticker DDE. You can see the historical financial performance at Twin Rivers, it has been incredible. They operate one of the leading casinos in the U.S., up in Rhode Island, and also own one in Biloxi, Mississippi, and just acquired a few more in Denver.

Twin Rivers was trading at 3x free cash flow after coming out of bankruptcy and following the legalization of table games in Rhode Island. We thought that, even though the shares weren't listed and you didn't know exactly when you would be paid, you should still put yourself in the position of acquiring as much as you could of a great business run by quality people, and trading at 3x free cash flow.

Over time, management has done a great job of growing earnings and increasing the value of the business. Now, they're finally listing their shares on the New York Stock Exchange. I think that is a good case study of what is possible through the whole distressed cycle.

G&D: You don't have much

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exposure to retail, which produces a lot of distressed names. Is that by design?

DG: What you'll notice in nearly every investment we spoke about is the importance of free cash flow, asset value, and earnings generation. We typically stay away from liquidations or declining businesses, where we say "Well, it's cheap, and maybe one day it'll be worth more than what we paid for it, but still, it's not growing in value." We like buying operating businesses that generate free cash flow and where we can look out in a couple of years and say, "This is an attractive business."

A declining retail business where we might say "Well, it could be liquidated, it's worth more dead than alive," is not attractive or exciting for us. That's outside of the area we typically focus on. In our view, companies that generate free cash flow and have long-term value are the companies that over time make for the most rewarding investments.

G&D: Perhaps we could close with advice for MBAs?

DG: I still believe in the investment management business. People want to compensate people who have great ideas. Read, do research, and you'll be shocked at what you uncover. Always have two or three ideas at your fingertips when you meet with a prospective investment manager for a position. What's your best idea? What's your second-best idea? What's your third-best idea? That adds value.

Columbia Business School is a very prestigious school, but the truth is, it almost doesn't matter where you come from. If you have great ideas, people in this business will value that highly. That's what this business is all about: having the tools to find great opportunities, and then doing the work and the research to uncover them.

Everyone is looking for someone who can contribute to performance. That is the ultimate equalizer. In the investment management business, if you can add value, it almost doesn't matter where you came from or where you've been. If you can add value, there will be a place for you.

I would add the importance of making time for things that you are passionate about. For me, enjoying the outdoors and being physical helps clear the mind.

G&D: Thank you very much for your time.

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