Columbia Business School
AT THE VERY CENTER OF BUSINESS™

Graham & Doddsville

An investment newsletter from the students of Columbia Business School

Issue XL

Fall 2020

Inside this issue:

Bill Nygren, Harris Associates

Bill Nygren, CFA

Bill Nygren has been a manager of the Oakmark Select Fund (OAKLX) since 1996, Oakmark Fund (OAKMX) since 2000 and the Oakmark Global Select Fund (OAKWX) since 2006. He is also the Chief Investment Officer for U.S. Equities at Harris Associates, which he joined in 1983; he served as the firm's Director of Research from 1990 to 1998.

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Ray Kennedy, Hotchkis & Wiley

Ray Kennedy, CFA

Ray Kennedy serves as a portfolio manager on the High Yield bond portfolios at Hotchkis & Wiley. Prior to joining the firm, Mr. Kennedy was a Managing Director, portfolio manager and senior member of PIMCO's investment strategy group. At PIMCO, he headed the global high yield business along with managing and overseeing High Yield funds, bank loan trading and collateralized debt

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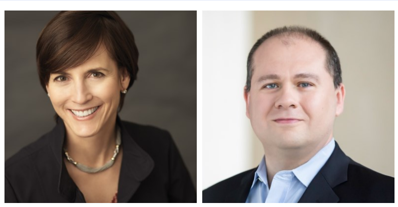
Causeway Capital



Sarah Ketterer and Alessandro Valentini '06, CFA

Causeway Capital manages equities globally with a fusion of fundamental and quantitative analysis. The firm was founded in 2001 and has $39B in assets under management as of September 30th, 2020.

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Lyrical Asset Management

John Mullins and Dan Kaskawits '11, CFA

As Co-Portfolio Managers of the International Value portfolio, Dan Kaskawits '11 and John Mullins lead the international investing effort at Lyrical Asset Management. Dan and John are also Portfolio Managers of the Lyrical Global and Global Impact portfolios, as well as Associate PM's for the U.S. strategy. Lyrical manages concentrated long-only portfolios, reflecting both deep value and quality/growth. The firm has a long-term orientation with just 15% annualized turnover since inception.

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The Heilbrunn Center for Graham & Dodd Investing

CSIMA Columbia Student Investment Management Association

Welcome to *Graham & Doddsville*

Meredith Trivedi, Managing Director of the Heilbrunn Center. Meredith 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.

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CSIMA Columbia Student Investment Management Association

We are pleased to bring you the 40th 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).

We first interviewed **Bill Nygren**, portfolio manager of the Oakmark Funds at Harris Associates. Mr. Nygren discussed Oakmark's approach to value investing, which looks past traditional GAAP accounting to find businesses whose potential may be understated today. Bill shared with us a few sectors Oakmark finds attractive, as well as his general views on today's markets and how they compare to prior periods in his career.

We also chatted with **Ray Kennedy** of Hotchkis & Wiley. Ray has had an extensive career in the high yield bond markets. He shared with us his framework for credit investing in today's uncertain times, and how his thoughts on the macro environment impact his approach.

Next, we interviewed **Sarah Ketterer and Alessandro Valentini '06** from Causeway Capital. Sarah and Alessandro described Causeway's unique lens on value investing, which combines rigorous fundamental business analysis with a quantitative overlay that helps structure their portfolios. Sarah and Alessandro shared their views on some of the hardest-hit areas of the market during Covid-19 that may represent attractive opportunities moving forward.

Finally, we got the chance to speak with **John Mullins and Dan Kaskawits '11.** Dan and John are co-portfolio managers of the International Value fund at Lyrical Asset Management. They explained their concentrated approach to value investing, which focuses on finding high-quality businesses whose secular growth characteristics are underappreciated by the market, resulting in cheap valuations.

We continue to bring you stock pitches from current CBS students. In this issue, we feature two pitches from the 2020 Women in Investing Conference: April Yin '22, Maria Van Heeckeren '22, Joyce Zhang '22 and Sherry Zhang '22 share their long idea on Hanesbrand (NYSE: HBI), and then Cathy Yao '22, Flora Chai '22, Joanna Zhou '22 and Wenbo Zhao '22 share their long idea on The TJX Companies (NYSE: TJX). We also feature a pitch from Dickson Pau '22, presenting his long idea on Farfetch (NYSE: FTCH).

Lastly, you can find more interviews on the *Value Investing with Legends* podcast, hosted by Professor Tano Santos. Professor Santos has recently conducted interviews with guests including Henry Ellenbogen & Anouk Dey, Rishi Renjen, Richard Lawrence, Tom Russo and Kim Shannon.

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

G&Dsville Editors

Bill Nygren, Harris Associates

Bill Nygren, CFA
Harris Associates

Mr. Nygren has received many accolades during his investment career, including being named Morningstar's Domestic Stock Manager of the Year for 2001.

He holds an M.S. in Finance from the University of Wisconsin's Applied Security Analysis Program (1981) and a B.S. in Accounting from the University of Minnesota (1980).

Editor's Note: This interview took place on September 30th, 2020.

Graham & Doddsville (G&D): Can you walk us through your background and what brought you into the world of investing?

Bill Nygren (BN): I grew up in a middle-class family in St. Paul, Minnesota. In school, I always did better with numbers than words and baseball was one of my passions outside of school. One of the things that attracted me to baseball was how easily available all the statistics were. I played Strat-O-Matic Baseball as a kid and was always looking in our local newspaper at the full page of baseball box scores that they had. Coincidentally in the *St. Paul Pioneer Press*, the business section was right next to the baseball box scores and that section had all the stock quotes on it. I was intrigued by this page of numbers that I didn't know. When I asked my dad and he told me that they were stocks and that the numbers represented dollars, it suddenly became very interesting to me. So that interest in stocks and numbers was there from a young age.

"We would alter our purchasing habits based on prices that were charged. That was how I learned to behave as a consumer—always trying to expand what my dollars could buy by being very careful about the price that I paid. "

I also grew up in a very traditional household. My dad worked outside the home and my mom raised the kids. My mom was always on a very tight budget for grocery spending. Therefore, she would always shop specials. When I was a little kid getting dragged to the grocery store with my mom, a weekly shopping trip would usually involve three different locations so we'd buy the stuff that was on sale at each store. If grapes were on sale one week and cherries weren't, we had a lot of grapes in the house. We would alter our purchasing habits based on prices that were charged. That was how I learned to behave as a consumer—always trying to expand what my dollars could buy by being very careful about the price that I paid.

Additionally, there was a family trip out to visit an older cousin of mine who was serving in the Air Force. This would have been, I guess, the tail end of the Vietnam War. The trip took us through Las Vegas and my dad took my older brother and me into, I think what was the Kroger grocery store across the street from the Motel 6 that we were staying in. My dad pulled out five nickels and he said, "I'm going to show you two boys why you should never gamble." He put the first nickel into a slot machine and seven nickels came out. Then he put the next one in and a few more nickels came out. I could see my dad getting frustrated because his object lesson was going awry.

But I was standing there saying, "Dad, stop. You're way ahead, stop, stop." And he just got angrier and angrier and threw these nickels in until they were all gone and then said, "See boys, you should never gamble." By then my eyes were huge and I thought, "This is fascinating. I just watched my dad make

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Bill Nygren, Harris Associates

multiples of his money. If only he hadn't been so foolish to throw it all away."

That created a fascination with understanding gambling versus investing. My dad worked in the accounting department at 3M Company. He had a business background, so I knew he understood probabilities and dollars and what made sense for investing. And here he was telling me gambling was foolish. So, I started studying all forms of gambling. I learned that lotteries gave you an expected value of about 50 cents on the dollar and horse racing was maybe 83 cents. If you played craps really well, you could get that up to 99. And if you counted cards in blackjack, you had a chance to get better than 100 cents.

All these things we called gambling had expected values less than 100 cents on the dollar, but the things we called investing gave you more; if you bought bonds, you would usually come out just barely ahead of inflation while stocks gave you a much more significant expected return. I became fascinated with stocks throughout high school. During college, almost all of my free time was spent reading investment books from our local library and over the course of a few years, I read most of the books they had about investing. That's not as heroic as it sounds today because I'm sure the local library would have hundreds of books on investing. Back then they had maybe 10 to 20 books because it hadn't really become the national pastime to figure out how to day trade and invest.

"It was important to have an investment approach that was consistent with the way I thought about money and all other aspects—trying to get the most value for my dollar and applying that same process to investing. I wasn't fighting any cognitive battles inside my own head. "

In my reading, I was always attracted to the people who approached investing the way my mom approached shopping. When Benjamin Graham said, "You buy stocks when they're on sale," that completely squared with the way I behaved as a consumer. I started to believe that my style of investing would be value investing. That's not to say that I believe that's the only thing that can work. But for me, it was important to have an investment approach that was consistent with the way I thought about money and all other aspects—trying to get the most value for my dollar and applying that same process to investing. I wasn't fighting any cognitive battles inside my own head.

Once I had the feeling that an investing career is what I wanted to pursue, I thought it made sense to spend a lot of time learning the language of investing, which is accounting. I majored in accounting at the University of Minnesota and I had an internship at Peat Marwick and Mitchell, which was one of the Big 8 eight accounting firms back then. But one of the things that bothered me about an accounting career was that it looked like if you were 10 or 20% better than the person you were sitting next to, you could maybe get paid 10 or 20% more than that person could. There wasn't leverage. In the investment business, the average investor doesn't add any value to an index fund, but someone who can outperform the market can deliver tremendous leverage on the value of their time and that had great appeal to me.

And then one last story. My dad was a credit manager at 3M. I enjoyed the outward focus of his job. It was an interesting contrast between my dad and one of my uncles who also worked

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at 3M. My uncle managed the forms department and knew more about the company than almost any other human did because he helped write the forms that drove the operations for every department. My dad, on the other hand, knew a little bit about a lot of companies because he had to be responsible for credit decisions to 3M customers. Anything that was in the business news usually overlapped with what my dad was doing. When Chrysler was going through its bankruptcy, my dad was involved in decisions about whether or not 3M should continue to sell them product. I loved the external focus of having very broad, but more shallow knowledge as opposed to knowing all the details about one company. That cemented that I wanted to study investments when I went to business school.

G&D: How did you decide where to attend business school and where to launch your investing career?

BN: I was at an internship at General Mills the summer before I started business school. The last couple of weeks there, they had executives from different departments taking us to lunch to try and convince us to work for them. I found myself saying, "What I'd really like to do is work in the pension department and work on investing the pension money." And one of the guys said to me, "If you're really interested in investing, General Mills probably isn't the place for you. A very close friend of mine, Steve Hawk, is running this interesting program at the University of Wisconsin called the Applied Securities Analysis Program. I'd suggest you go down there and interview with Steve because I think that program would be really interesting for you."

"I loved the external focus of having very broad, but more shallow knowledge as opposed to knowing all the details about one company. "

So I went and interviewed with Steve. Madison, Wisconsin wasn't really on my radar, but when I found out I could get my master's degree there in 12 months, I could start right after undergrad as opposed to waiting multiple years and I could spend most of my time in a program where the students got to invest real money, it was a no-brainer for me to go to the University of Wisconsin. Looking back, this was one of the best decisions in my career.

After Wisconsin, I took a job at Northwestern Mutual Life in Wisconsin and learned two key things during the two short years I spent there. First, it was important to me to work at a company where investment results drove the success or failure of the firm. Northwestern Mutual was driven primarily by its ability to sell insurance and the brand that it had with customers. It was important that they didn't screw up on the investment side but getting unusually good returns was not as important to them as the ability to sell insurance was. Secondly, I worked in a small department there with portfolio managers whose investment process was kind of a mix of momentum investing and trying to use Wall Street buy recommendations to drive what was in the investment portfolio. As an analyst there, my managers and I were like two ships passing in the night. I would look at something that was on the new low list.

I remember looking at a company called Allied Stores, which owned Brooks Brothers among other things, and getting excited because I thought the real estate value of its properties was worth more than the stock price. Nobody on Wall Street was recommending it. I presented my report and they said, "There just

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Bill Nygren, Harris Associates

doesn't seem to be enough interest in this stock for us right now, so let's keep an eye on it." The stock did well and Wall Street started recommending it. They came back to me saying, "Hey, you like this Allied Stores, let's look at buying it." I responded, "Yeah, but I liked it when the stock was at $15 and I thought it was worth $30 and it's selling at $27 now. I think there are better things we could do."

I learned that being good at executing one's personal investment philosophy didn't really matter if the people that you worked with were using a different philosophy. Not that theirs was right or wrong; the important thing was that it was different, so we had a mismatch. I decided that I needed to change firms and was looking for a company committed to value investing, where investment results drove its success or failure. I called Steve Hawk and told him that I was going to be looking for another position and asked that he please let me know if he were to come across anything.

A couple of weeks later, my phone rang and it was Steve. He said, "Bill, an alumnus you don't know named Clyde McGregor from a firm you've never heard of, Harris Associates, is going to be calling you in a minute about a junior analyst job. You should take the job. I told him to call you so I have to hang up now."

"I learned that being good at executing one's personal investment philosophy didn't really matter if the people that you worked with were using a different philosophy. "

A minute later Clyde called and invited me to come down to Chicago to go out to dinner with several Harris partners. They were asking about stocks I was interested in and were genuinely interested in all of the companies where I was hitting a brick wall at my current firm. There was an intellectual meeting of the minds that I'd never experienced before. I ended up joining Harris in 1983. My thought at the time was, "I can learn a lot here and I know the next three to five years will be good. I don't know beyond that." At that point, I wasn't worried about beyond three to five years. And here we are today, 37 years later, and I'm still in the same spot.

G&D: It sounds like you had the Ben Graham value mentality early on and you were drawn to the statistical and the numerical side of things. But obviously Oakmark is known for not only being a value investor, but also looking for high quality businesses that are well positioned. Could you talk a little bit about kind of how that transition emerged for you and maybe delve into the strategy at Oakmark?

BN: I think part of it is just how business has evolved more than how we have evolved. If you look back to Graham's time, businesses were hard asset-based. Fixed assets on the balance sheet were depreciated and there was a reasonably good correlation between stock prices and book value because competitive advantages that didn't get represented on the balance sheet tended to be relatively temporary. A textile company that was first to invest in the newer, faster looms for a few years would have a competitive cost advantage. They would do really well, then their competitors would make the same investment and they were back to the same lousy commodity-based business that they had always been in.

But looking for discounts to book value tended to identify average businesses that were out of favor. If you did that and were patient and waited for a reversion to the mean, you could be successful. In the

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early 1980s, Warren Buffett was instrumental in expanding the universe of what we called value. He invested in a consumer business that left a lot of his followers scratching their heads because it sold at a multiple of book value. Buffett's comment was, "If you look at the assets on the balance sheet, you won't even find brand value, and that's more important than any of the assets that are listed on the balance sheet." That started a move in the value community to look for important assets that weren't part of book value.

It could be real estate that was at a historical cost and today was worth way more than it was when it went on the balance sheet. It could be brand value that was created through advertising, which was expensed and not capitalized. The same applies to customer acquisition costs and R&D expenditures, which not only didn't increase book value, but also depressed earnings. At Oakmark, we were always open to the idea that GAAP accounting was not a perfect measure for how business value was growing.

One example from the early days of Oakmark in the early 1990s is the cable TV industry. We were seeing a lot of private market transactions taking place at enterprise values of $1,000 a subscriber or 11x EBITDA. These were companies that didn't look cheap on net income or book value, but there was clearly business value there. We went through and reconstructed income statements and balance sheets acknowledging that customer acquisition costs had very long-term benefits and that depreciation of cable in the ground was occurring at a much more rapid rate on the accounting statements than it was in real life. If you made the accounting match real life, these companies had real book value and real earnings.

"At Oakmark, we were always open to the idea that GAAP accounting was not a perfect measure for how business value was growing."

We also felt that way about a company like Amgen where very heavy R&D spending was depressing earnings and making it look very expensive relative to the pharma industry. But if you looked at enterprise value to EBITDA plus R&D, Amgen looked much cheaper than the pharmas and it also had much longer patent protection and much better growth ahead of it. That ability to make exceptions to GAAP metrics when we don't think GAAP reflects the real world carries through to today to positions that are important to us, like Alphabet, where its spending on "Other Bets" goes through the income statement, depresses earnings by something like $6 a share and is not reflected on the balance sheet.

If Alphabet were investing with Kleiner Perkins instead, it wouldn't be called an expense and there'd be an asset on the balance sheet called venture capital investments. But they do it themselves, which we think is even better because it helps them hire higher quality engineers. But as a result, it depresses the earnings and inflates the stated P/E multiple. Once you adjust for that and the cash on the balance sheet, which earns almost nothing today, you see that you're really not paying much more than a market multiple for the Search business.

Another example is Netflix, which very strongly rhymes with the way we thought about cable TV companies. It isn't reporting much in the way of income and its book value is relatively meaningless. A similar company like HBO got

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purchased by AT&T as part of Time Warner for a value of a little more than $1,000 per subscriber. On that basis, Netflix stock looked very cheap and based on the subscribers they were adding every year, it was selling at a single-digit multiple of the value it was adding. We don't think of value and growth as opposites. Growth is a positive characteristic in a company and as long as you don't overpay for it, it's a nice thing to have.

We also owned Apple for a long time, although we finally sold it last quarter. Almost the entire time we owned the company, it was selling at less than a market P/E multiple, yet it was always the first question we got asked by clients or consultants. "How can a value manager own a growth company like this?"

If we can get growth and not overpay for it, that's a huge positive. I think there are mischaracterizations of how value managers should think—that we should be confined into this universe of subpar businesses that are destined to fail in the long term. That's not how we at Oakmark think of value at all. We believe there's a way to value a business fundamentally and if we can buy a stock at a big discount to that value, whether it's a low P/E or a high P/E, it's a value stock.

G&D: It seems like there are situations in your portfolio where you don't necessarily think that analysts' forecasts for the next few years are necessarily off base, but you think often the multiple that's being ascribed to those businesses is too low or people are not recognizing the quality. Could you expand on that?

"If we can get growth and not overpay for it, that's a huge positive. I think there are mischaracterizations of how value managers should think—that we should be confined into this universe of subpar businesses that are destined to fail in the long term."

BN: I think a lot of Wall Street analysis tends to be relatively simplistic, where someone will say, "Over the past 30 years, this industry has averaged X% of a market multiple, and based on that, the stock doesn't look cheap today." We've been attracted to industries like auto parts where the analysts who've covered auto parts for a generation are basically stuck on the idea that those companies ought to sell at 5-6x earnings. But we think the industry has changed a lot for the better over the past 30 years. A generation ago, GM would design a part themselves and would put it out to bid to a handful of auto parts companies and say, "Here are the specs of what we want, give us a bid."

Today, they will say, "We need you to design a thing. The thing can't weigh more than this and has to accomplish all these functions." The important change is now the intellectual property is sitting at the auto part company. It's not just a race to the bottom of who can be the lowest price supplier of a commodity product; these companies are actually designing solutions for the auto OEMs. It's important to the auto companies that their suppliers be successful because they've realized that it doesn't make sense to have one company supplying the United States and a separate company supplying China and yet another company supplying them in Europe. They want their parts companies to be successful global businesses that can follow them around the world. I think the market has been very slow to accept the idea that the relationship between OEM and parts supplier is no longer focused on the OEM just extracting a few pennies less in costs. It is actually a

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true partnership today and we believe that should express itself in a higher P/E multiple.

Banks are another example. We believe the banks that have much higher capital relative to their assets today than they had a generation ago are substantially less risky businesses. And because of that, their cash flows should be discounted at a lower rate and that should result in a higher P/E multiple. Most of Wall Street research still simplistically says the industry has typically sold at about 10-11x earnings, so that is still appropriate.

"We want to invest in companies that will utilize their free cash flow to eventually force a convergence of business value and stock price."

There's no acknowledgement that the businesses are better today and more competitively advantaged with larger scale that helps on mobilization, fraud protection and regulatory compliance. It's why the large banks are gaining more share today without having to buy the mid-sized banks.

G&D: If you're right, what causes stock prices to eventually reflect that reality?

BN: Either the market changes its opinion and willingly elevates these companies to higher P/Es or you get in a position like the banks and the auto parts companies are in today where there's almost no use for capital that can add as much to per share value as purchasing their own stock. Pre-pandemic, we had a number of the large banks that were not only paying a dividend yield that exceeded what you could get on a 30-year bond, but they were also repurchasing enough of their share base that they had double-digit EPS growth, even though top line was only growing a couple percent per year.

We want to invest in companies that will utilize their free cash flow to eventually force a convergence of business value and stock price.

G&D: With those two particular sectors, it seems like the market is very focused on cyclicality and risk of disruption. Do you think those concerns are overblown by the market?

BN: I think cyclicality fits well into discounted cash flow analysis and estimates of valuation. You just need to be careful that you are not projecting either peak or trough returns for a company into perpetuity. The way we will look at a cyclical company is to try to make as accurate a guess as we can of the next couple of years of earnings. But as we think out longer than that, we will look toward a reversion to the mean of what the company has typically earned on its equity or profit margin to try to get to metrics that make sure we're capitalizing normalized earnings.

As far as disruption risk, some of the auto parts companies that we own, like TE Connectivity and Aptiv, are leaders in electrification. Their content is significantly higher on EVs than it is on traditional vehicles. I think they benefit from disruption. Lear is a company we own that's dominant in seating. I think the concern there relates more to whether we will end up with a giant, shared car fleet in the United States of autonomous, utilitarian vehicles where nobody's really concerned about comfort of seating.

I think what people are missing is that as we move toward a more autonomous vehicle, you start thinking of the inside of your car becoming more like your living room or your den, where comfort becomes more important to you because you aren't constrained by needing to

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drive the entire time. We can see a future where the average price of a seat in luxury vehicles is multiples of what it is today because it becomes an entertainment center.

So, I think if we were invested only in auto part companies that relied on fossil fuels and combustion engines, there'd have to be some concern about disruption. But given where we are invested, I don't think our companies face that concern.

Shifting to banks, the most basic function of a bank is to collect deposits and loan them out at a spread. I think the fact that the most competitively advantaged banks in the world today are selling at less than a market multiple does a lot to discourage anybody from trying to compete with them. If a company like Ally Financial, which has the best auto lending business in the United States, sells at two thirds of tangible equity, who in their right mind would say, "I'm going to try and replicate that?" I don't think a company like Square is really trying to disintermediate the retail deposit to a retail lending business that companies, like Bank of America, Wells Fargo, Capital One and Ally, make the overwhelming majority of their profits from.

G&D: How do you evaluate management teams and capital allocation, and do you think about capital allocation differently for some of the higher growth businesses that you own like Alphabet and Netflix versus some of these auto parts suppliers and banks?

"A company like Netflix could report a much higher profit today if it chose to by curtailing spending on acquiring new customers, raising prices significantly and then generating significant cash flow to repurchase shares."

BN: Our view on capital allocation is that it's management's duty to deploy capital to the highest long-term return potential. A company like Netflix could report a much higher profit today if it chose to by curtailing spending on acquiring new customers, raising prices significantly and then generating significant cash flow to repurchase shares. When we look at the return that it is getting by giving us bargain rates on Netflix so that it grows its subscriber count as rapidly as it can and by spending to try to grow that internationally, it's much more attractive. Netflix is adding something like 25 million subscribers a year, even in non-Covid times. If you believe, as we do, that those subs are worth $1,000, that's $25 billion of value that they're adding. Netflix's market cap is around $200 billion today, so the annual return on spending for customer growth is 12.5%. That organic return is better than what it could likely achieve by just buying back shares.

For companies like banks, in a low loan growth environment, using capital to buy back their own business at a discount to stated book value is a very attractive use of capital, especially because we believe that the financials are worth a significant premium to book. We think they deserve to sell closer to 1.5-2x book rather than the three quarters of book that they sell for today. So the money that they're investing in their own stock is returning twice what they're paying for it. It's very hard to find that kind of organic growth opportunity or acquisition opportunity. We don't have a magic answer of what we want to hear a company doing with its capital, but we want to hear a thought process that's consistent with maximizing long-term per share returns.

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G&D: What is your approach to selling?

BN: I've always thought that the reason people have so much trouble with the sell decision is because they didn't have a well-defined buy decision. If you really know why you decide to buy a stock and why you own it, then the absence of those reasons becomes the reason to sell. At Oakmark, we're looking for three things when we buy a company.

First, we want a significant discount to current business value. Second, we want that business value to grow over time at a similar rate as the S&P 500, so growth in per share value plus dividend income must at least match what we expect from the market. And finally, we want a management team that's aligned with us wanting to maximize long-term per share business value.

If we feel we've lost any one of those three items, we'll sell the stock. In an ideal world, we buy something at 60% of value and it goes up to 95% of value. If we don't think our value estimate has changed, it's no longer cheap, so we sell it and we move on to another cheap stock. But you also have mistakes where you thought a business was going to be able to grow and as you're tracking the results after you purchase it, you decided you were wrong with your original thesis. That's a reason to sell the stock. You originally thought management was acting in the shareholder interest trying to maximize long-term per share returns. Then you see them issue an undervalued stock for a full price acquisition. You ask about it and they can't explain it in terms that make sense to you. If you've lost confidence that management is trying to maximize long-term value, that's a reason to sell the stock.

"If you really know why you decide to buy a stock and why you own it, then the absence of those reasons becomes the reason to sell."

The danger is when people will buy a stock without having a really disciplined investment philosophy. Then they're at sea when the stock goes up or down. If you buy something at $50 and three months later it's $30, that's not what you signed up for so you sell it. Or if you buy it at $50 and it goes up to $70, then you're excited because it's going higher, and why would you sell something that is going up? It becomes a very difficult and very emotional decision if you don't have a solid reason for owning that stock.

G&D: We discussed earlier how businesses that have become higher quality should merit a higher multiple than they did in the past. How do you pick a new absolute multiple that a business should trade in order to drive your value estimation and your buy / sell decision?

BN: We use a lot of different methods and try to get to a reasonable average. In the auto parts sector we discussed, one thing we look at when comparable companies get acquired for cash is if somebody is willing to pay more than the 5-6x earnings at which analysts are valuing them. We keep close track of acquisition multiples in each industry because we think a buyer who's paying cash for an entire business is likely a more informed buyer than somebody who bought 1,000 shares of the stock.

We'll also look at what comparable public companies are trading for. We might argue an auto parts company today is becoming more like a high-quality cyclical industrial business, which is trading at 12x earnings in the marketplace, instead of 6x.

We'll do a discounted cash

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flow analysis. As a value manager, we think our crystal ball gets hazy faster than growth managers tend to think, so we'll build a detailed two-year forecast and then use a five-year growth rate after that. After those seven years, we model a regression to the mean because we think it's hard to project for any business that the advantages or disadvantages we see today persist beyond seven years. We'll set a discount rate based on risk levels, informed by where their bonds trade and where comparable companies trade, and then we'll do a discounted cash flow.

If we compare those three different methods and they're wildly different, we want to understand the differences. Once we understand, we can thoughtfully say something like, "Maybe the acquisition price is out of line with the others because there's always a big synergy opportunity," as opposed to computing a naive average of the different approaches.

I always find it funny when somebody says, "My fair value estimate for this business is $74.70." We're just trying to get into the right ballpark and that's one of the reasons we look for big discounts. If a stock is selling at $50 and we can't get pretty confident that there's a way of looking at it that says it's worth more than $70, we'll move on to something else. The precision isn't nearly as important. It's the idea that there is a compelling body of evidence that gets to a substantially higher number than where the market is offering it to us today.

G&D: What are your thoughts on the current environment, and how does it compare to prior market environments during your career?

BN: When people ask about the current environment, especially a few months ago when prices were more depressed than they are today, they would always want to make a comparison to 2008. I have a very hard time saying that this market bears any resemblance at all to 2008. In 2008, if you took a normalized earnings number for the S&P, the market was selling at 7-8x that number. The most important message back then was simply to get your money invested in the market. Today, I don't feel that way at all.

The multiple on the S&P is somewhat higher than the long-term average. I think you can argue that that's deserved given the lower interest rate environment, but I wouldn't argue that the current market level is so undervalued that you should be shifting your asset allocation much more to equities.

"The most important message back in 2008 was simply to get your money invested in the market. Today, I don't feel that way at all."

This reminds me much more of the market I went through earlier in my career in the late '90s, where the S&P looked a little high, not crazy high, but you had this massive divergence between where traditional businesses were selling and where dot-com stocks or large-cap, rapid growers were selling.

Banks were selling at 5x earnings and food stocks at 7x earnings, but GE was at 50x and Home Depot was at 70x. For the fastest growers, you couldn't even compute the multiple because they were losing money. Back then people would say, "Well, this massive gap is deserved because these traditional businesses are dying, everything's moving online." Having been through that before, it makes me less willing to believe it today.

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Source: Empirical Research Partners Analysis.
¹ Equally-weighted data; excludes negative earnings during the New Economy era.

The chart above compares multiples on the fastest growers to the lowest P/E stocks. If you look at that over the past 70 years, it looks like a sine wave going between 2-3x. So if the cheapest stocks were at 7x earnings, the most expensive growers were usually 14x to 21x. The line goes crazy around 1998 to 2000, getting up to about 10x. In the couple of years after that, it came crashing back down and started sine-waving between 2-3x again.

People talk about value underperforming for a decade, which is true, but for the first six years of that decade, there was a pretty tight correlation between the Russell Value and the Russell Growth. It's really the last four years where the divergence has become extreme. Today, that chart of relative multiples has again gone from 2-3x up to 10x.

One common argument supporting today's extreme price for growth is that the shortcomings of GAAP accounting are even greater today than they were two decades ago. As we discussed earlier, I believe that as well but not to the magnitude that would justify these stocks selling at 10x greater multiples than low P/E stocks. Another common argument is that the value of the future becomes infinite as interest rates go to zero. That's mathematically true, but we don't believe it makes sense to project interest rates staying at zero forever.

Eventually you have to return to a world where investing is getting a return for being willing to defer the utility of present consumption. To lend money long term, people will have to get back more than they expect inflation to be. We are not willing to do a DCF at 3% for a rapid growth company today.

In a normalized environment in which inflation is going to be around 2%, like the Fed is targeting, long government bonds would be 1% more than that, corporates a bit more than long bonds and then equities a couple of hundred basis points above corporates. I think as interest rates recover to sustainable levels, it makes sense that this P/E gap

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comes back to normal.

"We think this environment is very similar to that late 1990s, early 2000 environment."

The next question everybody always asks today and asked me back in 2000 is, "What do you think is going to cause a reversion?" Even having lived through it, it is difficult to pinpoint what caused the collapse of the dot-com and large-growth bubble of 2000. I think the rubber band expanded too far and finally snapped. Low-price companies were able to increase their value more through share repurchase while high-price companies started to make acquisitions of more traditional businesses–like the AOL/ Time Warner merger. In the midst of it, nobody knew why it was happening, but that 10x multiple premium that investors were willing to pay for growth relative to cheap started to collapse all of a sudden.

We think this environment is very similar to that late 1990s, early 2000 environment.

I'm writing my quarterly letter right now and going back to comments I made 20 years ago about how small companies with large valuations were taking over the large-cap universe. I wrote back then that investors who thought they were getting a low risk portfolio because it was large cap were actually deluding themselves because they were taking on a magnified risk with smaller businesses that had bigger ranges of fundamental outcomes on top of the risk of very high valuations.

This analogy is important today as we see big businesses that were previously large cap, like Schlumberger, Phillips 66 or Dollar Tree, falling out of the large-cap universe and being replaced by smaller companies with very high valuations. I think that creates a dangerous situation for the large-cap investor who thinks they have a relatively low risk portfolio.

G&D: Do you think this is a dangerous environment for the S&P index as a whole?

BN: I want to be careful there because we part ways with a lot of our value peers who believe the FANG stocks are grossly overvalued. As I mentioned earlier, we own Alphabet and Netflix, which we think are value stocks. Same with Facebook, which no longer looks that expensive based on its projected P/E because it's grown so much from the time people started complaining about how high the multiple was. Those three stocks alone are a pretty big part of the S&P.

We owned Amazon at one point. For a brief second, people thought we were brilliant as value investors buying Amazon in the $200s. We thought that on a percentage of sales, it was cheaper than the brick-and-mortar stores it was putting out of business and it was making an investment decision to depress earnings and grow the scale of the company. The stock hit $600 within a year as people started getting really excited about AWS. At the time, we were not equipped to make a reasonable business value case for AWS. Our thesis for owning it as a retailer was running out. We sold the stock too quickly. Instead of being the geniuses who bought it in the $200s, we became the idiots who sold it in the $600s. But where Amazon stock is today, I think it's tough to make a value case.

I mentioned Apple earlier, which we used to own. In the past quarter, you've seen almost no change in earnings estimates for Apple, yet its price has gone up nearly 50%. It's all multiple expansion. That's a tough one for us to

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understand at this price. But the craziness to us is not in the FANG names. It's in the companies that might have $1-2 billion of sales that are now large-cap stocks because they have capitalizations over $35 billion. And we think they have the fundamental risk of unexpected outcomes that you would expect from companies that are that small. Most of them have competitors that are very well funded. You don't know what the market share structure of their industry will look like a decade from now, much less knowing what the demand for the product will be.

Those names have very high fundamental risk coupled with very high valuations. That is the area we think could be very risky for investors.

One risk I do think is there for the S&P investor is concentration risk. We tend to run concentrated portfolios at Oakmark. Our typical peers own something like 150 stocks in their diversified funds, while we own about 50. We also run concentrated portfolios that have 20 stocks. I can't tell you how much time and energy we've had to spend explaining to people why we thought it was prudent to have positions that we really liked in a concentrated portfolio represent over 5% of the assets. The index investor today who owns the NASDAQ, or even the S&P, is starting to get a lot of wealth concentrated in just a handful of very large companies.

I don't think that's necessarily a valuation risk, but it is a concentration risk that any problem at one of those companies can have a bigger impact on the portfolio than you would expect for an indexed portfolio.

"The index investor today who owns the NASDAQ, or even the S&P, is starting to get a lot of wealth concentrated in just a handful of very large companies."

G&D: How do you think the world of travel will evolve in post Covid-19? And also, how do you maintain a sense of optimism in the markets when something like Covid-19 hits in March?

BN: Part of what makes that easier is the history and temperament of people who are attracted to long-term value investing. In trying to estimate the value of a business and having that drive all of your decisions, the focus is much more on what you think the world will look like 5 to 10 years from now than what the first quarter of next year will look like.

When we went into lockdown in March, we immediately had our analysts change their estimates for companies to be based on the Fed's severe adverse scenario just because we thought that was a reasonably good indicator of what we could expect in this super sharp self-imposed decline we had in the economy. We modeled a slow recovery with 2022 being the first year that was above 2019 and then normal growth after that.

What it highlighted was how advantaged the asset-light businesses were that were in the eye of the storm, like the travel and leisure areas. We owned American Airlines at the time and it looked tough for them. The stock had been selling at 4-5x earnings, but the business has a lot of financial and operating leverage and was entering an environment they'd never seen before where global travel basically went to nothing. We didn't have confidence that airlines would survive, but an asset-light, franchise business model like Hilton wasn't even going to lose significant money. For Hilton, we just

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had to bake in a couple years of lost income. Same for a company like Booking Holdings. We thought Booking would actually emerge stronger because its traditional competitors were not as well financed and had asset-heavier models.

The fact that our valuation would have to drop by a couple of years of lost earnings doesn't really change the multiple that we believe these businesses are worth down the road. We've now had two quarterly earnings reports since we went into our adverse scenario and on average, the analyst revisions to those estimates have been slightly positive compared to what we estimated back in March.

"We are invested in companies we think can survive even if this environment lasts for several years."

That's not what we're used to. Usually, value investors assume earnings are going to be a lot better for their companies than the market thinks, and over time, those estimates fall somewhat. In this situation, our earnings estimates have increased from the bottom.

In February and March, when everything fell by about 50%, our immediate move was to analyze our companies on an unlevered basis and see if we had an opportunity to trade up to higher quality balance sheets now because they've actually become cheaper than the companies that were highly levered. We also looked where the market was giving us an opportunity to move out of the eye of the storm to businesses that might actually benefit from the lockdown, without having to pay much of a premium. At the end of the first quarter, we bought companies like Match.com and Pinterest, while we sold a company like American Airlines.

Pinterest fell from low $30s to $14. It had $3 in net cash on the balance sheet, so the enterprise value fell more dramatically. With people spending more money on their homes, engagement was increasing on Pinterest. We thought Covid might have increased the business value and instead it fell more than the average stock. That's the kind of thinking that went into rearranging our portfolio. My only regret is that we were moving as fast as we could and I wish we could have gone faster.

G&D: Do you worry about the risks if the recovery from COVID takes longer than anticipated?

BN: I'll start by saying that the forecast we have of a gradual recovery from the trough isn't a non-consensus forecast. There are some people who are even higher than we are on 2021 earnings. We think 2021 starts to make significant progress back toward 2019, but is unlikely to exceed 2019. When you get into distinctions like, "Could S&P earnings be 20% worse than we had thought," the question I come back to is, how important is that 20% to the long-term discounted cash flow value of business? For an index that sells at 20x earnings today, 100% of one year's cash flow would represent only 5% of the current value.

So I don't think an extra year or even two years of getting past Covid concerns would change long-term discounted cash flow values by that much. The uncertainty of when Covid will end, whether it's at the end of this year, middle of next year, middle of 2022, is why we're focused more on the quality of the balance sheet. We are invested in companies we think can survive even if this environment lasts for several years.

That ties back to why we eliminated airline stocks early on. We think travel will come back because we're all getting sick of virtual meetings and we're

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anxious to sit down and meet in a room together. We want to do our management meetings in their offices across the table from them. It might be a couple of years until we can do that again. And if it's a couple of years, most of the airlines need help to get through that period. When you're relying on strangers to help you, that's usually not good for equity shareholders.

G&D: Are there any particular ideas you want to discuss in more detail?

BN: One holding we're excited about is Ally Financial. Ally's basic business is providing used and new car loans both to dealers and ultimate consumers. Traditionally, Ally had been funded by short-term debt, so there was a risk that when markets seized up, it would be unable to roll over all its short-term financing. When that happened in 2008, it led the company to shift to a business model that was funded with customer deposits.

In banking, you've got two basic business models today. You've got the companies that are spending about 100 basis points per dollar of deposits on a nice brick-and-mortar network with tellers where you can go into the bank and conduct your business. That's a model that we see Bank of America, Wells Fargo and JPMorgan using.

Then you've got the companies, like Ally and Capital One, which are more internet-based businesses. They don't have the fixed costs, so they can take the 100 basis points that the largest banks are spending on brick and mortar and return it to the customer as interest income. A consumer will typically earn 1% better by putting money in Ally or Capital One than Bank of America in exchange for giving up the branch structure convenience. Ally has moved now to where it is almost entirely funded by retail deposits. The asset side of its balance sheet is almost entirely car loans. I think what investors seem to question is how a company like Ally can make money in such a low interest rate environment.

"Before Covid, Ally earned about $3.70 per share, which represents about 7x P/E at the current stock price. We expect post-Covid, it will very quickly get back to that number. "

There is not a rush of new money trying to figure out how to create auto loans. Because of that, spreads on both new and used auto loans are higher than they have been traditionally and are more reflective of the rates that Ally is paying to its retail depositors. Ally is still earning a very good spread income. Additionally, even though Treasury rates are down to about zero, it can still pay 1% because it doesn't have the branch network. Ally is still collecting deposits and lending them out as car loans.

Ally's valuation is compelling. Book value is supposed to be about $31 at the end of this year and it sells at $25 now, so 80% of book, and that's after taking the hit from all of the charge offs that they expect Covid to ultimately cost them.

Before Covid, Ally earned about $3.70 per share, which represents about 7x P/E at the current stock price. We expect post-Covid, it will very quickly get back to that number. Ally was using most of its cash flow to repurchase shares because that swamps the return it could get on anything else. Because of Ally's leadership position in auto loans, we think it ought to be earning a low-teens return on equity. It should still be selling at a discount to the S&P, but if the S&P is going to be at a high-teens multiple, Ally

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could sell at a low-teens multiple. That would equate to 1.5-2x book value, which is 2-2.5x the current stock price.

If we're wrong on P/E multiple expansion, the company should be able to buy back more than 10% of its stock each year, pay us a dividend that's more than we could earn on a long-term Treasury and have the dividend grow by the same rate that its earnings per share are growing. We don't need to be right on everything for this to be a very good stock from current price levels.

"When we look through a pile of hundreds of resumes of students who are interested in one opening, somebody with a strong accounting background really sticks out."

G&D: How do you get comfortable with the default risk in their auto loan portfolio with unemployment so high and all the COVID disruption?

BN: Part of it is the accounting rules, which mandate that Ally has to estimate what it is going to lose throughout the life of a loan and record that as a charge against income. This impacted Ally heavily over the past two quarters. Second, we get to see how its charge offs are comparing to other public companies that have similar quality loan books. We're comfortable that Ally has been in line with those charges.

Additionally, we listen to what management says when they speak publicly. They have spoken about how delinquencies have not been as high as they thought they would have been. The individuals who took advantage of forbearance have come back current on their loans at a faster rate than Ally had projected. You can never be rock-solid certain, but we're hearing a consistent message from all of the consumer banks that credit losses do not look as bad as they had originally estimated they would be.

If the consumer doesn't pay, the ultimate protection is for Ally to go back and repossess the car. Back in March, we were all assuming that used car prices would fall dramatically because people wouldn't have as much money. Instead they've risen dramatically because people want more private transportation than they wanted pre-Covid. So the worst case outcome is if the customer stops paying, they now have to repossess the car and the salvage value is going to be higher than they had previously estimated.

G&D: What's your view on the risk of autonomous driving, which we discussed earlier, disintermediating Ally's business?

BN: It depends on what assumptions we need to get our money back. With Ally selling at 80% of book, if there's a disruption risk and we all quit buying personal autos so that Ally doesn't have a way to grow anymore, simply winding down the business and decapitalizing both debt and equity would get us more than our money back, so we don't worry too much about that as a downside case. We'd worry about it more if Ally was selling at 1.5x book and our target was 1.75x book.

G&D: What advice would you give to MBA students who are interested in pursuing a career in investment management?

BN: One thing I'm really surprised by is how little interest there is in accounting at most schools. When we look through a pile of hundreds of resumes of students who are interested in one opening, which we are in the fortunate position of being in today, somebody with a strong accounting background really sticks out.

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I also think it's so important for people who are going to be successful in this business to be passionate about it. If you're passionate about investing, you can't turn it off. I can't go into a store without seeing how shelf space has changed between different companies. My reading list is almost always about things that I think will make me a better investor.

I get puzzled when I'm interviewing a candidate who claims to have that level of passion about investing and you ask them what they're reading and they say, "Oh, my reading time is pretty much consumed by school. I don't get much free time to read." When I was in school, I was trying to get my hands on every Wall Street research report I could. I was reading investment books that were not part of any course I was taking. That passion comes through in an interview and I think it's really important to be able to demonstrate it. It's not something to fake because you're going to be miserable in this career if it's not an honest passion you're presenting.

G&D: How do you spend your time outside of work?

BN: I love wine. When I was younger, I had no interest in wine and couldn't understand people who did. Over a generation, it has become a passion. I joke that my hobbies basically involve either food or wine and one of the reasons I want to keep working is because I don't want to have more free time to spend on my hobbies—it wouldn't be healthy! I also love sports. Baseball is a passion, and despite the stock market being super exciting today, this afternoon, I'm going to be at a rooftop to watch the Cubs first playoff game.

I am also involved in charitable activities. Rather than mention any individual names, I'll just say that my passion is trying to give disadvantaged kids the same educational opportunities that I had. Most of my focus is on inner city education.

G&D: Thank you very much for speaking with us.

Hanesbrand (NYSE: HBI) - Long
2020 Women in Investing Stock Pitch Competition

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Capitalization	US$MM
Share Price ($ / Share, 10/9/2020)	17.21
FDSO (MM shares)	348
Market Cap	**5,992**
Net Debt	3,451
EV	**9,443**
Target Price ($ / Share)	**25.70**
Multiples (Consensus)	**(x)**
EV/'20E EBITDA	9.2
P/E'20E P/E	11.7
ROIC'19A	11.7%

Financials (US$'M except per share	CY16	CY17	CY18	CY19
Revenue	**6,028**	**6,471**	**6,804**	**6,967**
Gross Profit	2,315	2,544	2,692	2,778
Gross Margin	*38.4%*	*39.3%*	*39.6%*	*39.9%*
EBITDA	**1,005**	**1,030**	**1,056**	**1,065**
EBITDA Margin	*16.7%*	*15.9%*	*15.5%*	*15.3%*
EBIT	902	908	924	934
EBIT Margin	*15.0%*	*14.0%*	*13.6%*	*13.4%*
Net Income	**528**	**82**	**546**	**609**
FDSO (M)	385	369	365	366
EPS	1.37	0.22	1.50	1.67

Recommendation: We recommend a long position in Hanesbrands, Inc. ("HBI" or "the Company"). HBI is a market leader in apparel, sportswear and underwear, and we believe HBI's current valuation does not recognize: 1) the growth potential of its business in eCommerce, athleisure, and international markets; 2) the value creation from vertical integration within the supply chain; and 3) the expertise and experience of the new CEO. We believe HBI should yield a ~14% three-year IRR based on a $25.50 target price (based on SOTP valuation).

Business Description: Hanesbrands is a leading global apparel company based in the US. Founded in 1901 and employing ~68,000 employees in 43 countries, HBI designs, manufactures, and sells basic / intimate / athleisure apparel in the US and 30+ international markets. Unlike other apparel brands, HBI owns the majority of its worldwide manufacturing facilities which produce 70% of the apparel units it sells. HBI has two key brands: 1) Hanes – #1 selling apparel brand in the US found in 9 of 10 US households; 2) Champion – #4 recognized athleisure brand among Gen-Z/Millennials. HBI's other brands include DIM, Maidenform, BALI, Playtex, Just My Size, Bonds, Abanderado, Bras N Things, etc. HBI sells through two channels: 1) brick-and-mortar stores of 3rd party wholesale customers (76% of net sales in 2019); 2) direct-to-consumer, incl. its own offline stores and own & 3rd party e-commerce (24%). Its largest customers include Walmart (14% of net sales in 2019) and Target (11%).

Investment Thesis:

1. The Street is underestimating Hanes's growth potential from its eCommerce channel, Champion brand, and presence in international markets. We believe there is unrecognized growth potential in three key areas. First, we believe Hanesbrands will benefit from the shift in its sales distribution from brick-and-mortar to online retail. With a recent Amazon distribution partnership, as well as a revamp of Champion.com, Hanesbrands witnessed 12% growth in its direct-to-consumer channel prior to COVID-19 (2018-2019) and 200% growth in sales volumes on Champion.com after the revamp in Q2 2020. Online sales now represent 30% of sales (as of Q2 2020), and HBI products are most frequently represented among "Bestsellers" on Amazon. As a majority of Gen-Z/Millennial shoppers prefer to purchase products online, we believe online retail will grow to be an increasingly large portion of the Company's overall revenue, thereby increasing growth of the overall business. However, we believe the Street still views Hanesbrands as a traditional brick-and-mortar supplier, and as a result does not attribute credit to its eCommerce growth potential. Second, we believe the Champion brand is an undervalued asset with high growth potential within the overall Hanesbrands business. When surveyed, Gen-Z and Millennials indicated high awareness of the Champion brand, and retailers have been increasing store shelf space to cater to the increased popularity of the Champion brand. For example, in May 2020 during Walmart's reset of the branded underwear aisle, Hanesbrands' share of shelf space grew double digits and took share from Fruit of the Loom. Historically, Champion has grown its global sales at a 3-year CAGR of ~30% from 2016-2019 – a trend we expect to continue going forward. Third, we believe the street is undervaluing the growth potential from Hanesbrands' international markets. Although the international segment's revenue has grown at a 5-year CAGR of 26%, consensus is only forecasting 4% growth for the segment from 2020-2022. However, Hanesbrands has strong brands across continents, with 19.5% market share as the #1 player in the Australian underwear market. Many of its markets are fragmented with high potential for market share expansion, and others, such as Mexico, are markets where a growing middle class is delivering high single-digit market growth.

2. HBI's large scale global operations and vertically integrated supply chain drive competitive advantage. HBI is differentiated from most other apparel companies as it owns its supply chain, which includes 40 manufacturing facilities and 47 distribution sites worldwide. Its manufacturing facilities are strategically located in low-cost and tax-advantaged regions in Southeast Asia, Central America, and the Caribbean Basin and produce 70% of HBI products. Owning the supply chain results in 15-20% cost savings relative to relying

April Yin '22

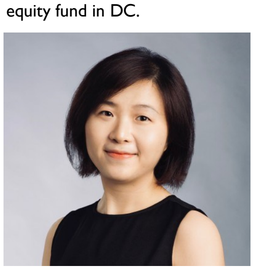
April is a 1st year MBA student at CBS. Prior to CBS, she worked at the IFC AMC in DC and Singapore, investing across the capital structure in emerging markets. April began her career in investment banking at Scotiabank and Goldman Sachs.

Maria Van Heeckeren '22

Maria is a 1st year MBA student at CBS. Prior to CBS, Maria worked as an analyst in the leveraged loan group at Eaton Vance, focused on portfolio management, the healthcare sector, and investing in CLO mezzanine tranches.

Joyce Zhang '22

Joyce is a 1st year MBA student at CBS. She began her career with Bank of America Merrill Lynch in their investment banking team covering healthcare in New York. She then worked at Martis Capital, a healthcare-exclusive private equity fund in DC.



Sherry Zhang '22

Sherry is a 1st year MBA student at CBS. Prior to CBS, she worked at Citi HK as a Research Senior Associate covering China financials companies and at LyGH Capital, a SG-based L/S equity hedge fund, as a Research Analyst.

Hanesbrand (NYSE: HBI) - Long | 2020 WIN Stock Pitch Competition

on 3rd party manufacturers and allows HBI to capture downstream profits. Its vertical integration also drives its ability to innovate new fabrics (X-Temp temperature control), styles (Tagless shirts), and techniques (reverse weave fleece). HBI's large scale as the #9 apparel producer in the world gives the Company significant negotiating power with suppliers, as demonstrated by HBI's ability to set the cost of cotton, its primary input. Cotton represented only 4% of the Company's COGS in 2019. Owning the supply chain allows HBI to be opportunistic and flexible. During COVID-19, the Company was able to quickly pivot to produce masks and other PPE, generating $750mm+ revenue in 2Q20. The Company's size and portfolio of valuable brands allow HBI to better negotiate with retailers such as Amazon, Wal-Mart, and Target. Recently, HBI ramped up its eCommerce presence through its own branded websites (Hanes.com, Champion.com) in response to consumer demand, capturing upstream profits. The DTC channel allows HBI to observe consumer demand and segment pricing, thereby offering more premium products on their own sites.

3. <u>The new CEO has the necessary expertise and proper incentives to drive growth.</u> Stephen Bratspies became CEO in August 2020, replacing Gerald Evans who became CEO in 2006 after serving as COO and starting with the Company in 1983. Bratspies was most recently Chief Merchandising Officer of Walmart, where he managed $330bn in sales, drove major merchandising transformation initiatives, and accelerated same-stores sales and market share gains. There, he oversaw the basics apparel strategy and overhauled grocery aisles to focus on improving the fresh offering and expanding private brand and global sourcing capabilities. We see this track record as a positive sign that Bratspies is able to proactively drive growth at HBI. We believe the market is underestimating the significance of Bratspies joining HBI for 3 reasons. First, his annual $9.5mm compensation ($2.75mm cash with $1.1mm base, $6.75mm equity) is higher than what Evans received ($9.0mm total - $2.75mm cash with $1.1mm base, $6.25mm equity), indicating the Board's confidence in his abilities. His compensation structure incentivizes long-term sustainable growth as of the $9.5mm, $5.0mm is performance-based and $3.4mm is time-based vesting over 3 years. Second, we believe Bratspies has the skills needed to drive value-added initiatives, including optimizing SKUs, clarifying a good/better/best product architecture, and increasing sales to Walmart through a partnership to tackle the trend towards more premium underwear at a better price point. Third, given Bratspies' information advantage from his time at Walmart, we believe it is unlikely he would have transitioned to Hanesbrands had he believed HBI was not well-positioned to grow going forward.

Valuation: We derived a three-year $25.50 price target using SOTP valuation, implying a 14.2x NTM P/E and representing a 14% IRR.

SOTP Valuation	2023E	EV/EBITDA	Mkt Value
Global Champion	467	15x	**6,999**
US non-Champion	416	5x	**2,080**
Intl non-Champion	251	5x	**1,256**
Total Enterprise Value			**10,335**
Net Debt			1,404
Equity Value			**8,930**
Upside			
Target Price			**25.65**
Current Price			17.21
3-year Total Return			***49%***
IRR			***14%***

Key Risks and Mitigants:

1. <u>Significant slowdown in revenue growth of Champion brand.</u> The possibility that athleisure is a short-term trend and increased competition from private labels (ex: Amazon Basics) and online-only brands (ex: Rhone) pose risks to HBI's business. However, we see the rise in athleisure as a structural shift as evidenced by the 30x increase in Google Search interest between 2010-20. We also note the slowdown in private label apparel sales growth between 2015-19, noting segment market share dropped from 5.1% (in North America) in 2015 to 4.9% in 2019. Brand continues to be a key factor in consumer purchasing behavior, as a former buyer for Ross acknowledged they did not pursue private label innerwear or activewear given consumer demand for a recognizable brand. Additionally, the broader macro shift to eCommerce is likely to be a tailwind to HBI and headwind to private labels, as a former Walmart Category Management Lead in eCommerce admitted "private label brands are a little funny – they perform very well in store, but hit or miss online." Also, HBI's collaborations with brands such as Supreme and Off-White produced valuable brand equity that is difficult for newer private label or online-only brands to duplicate.

2. <u>Accelerated closure of brick-and-mortar stores</u> could reduce HBI's revenues given 76% of its net sales are generated by 3rd party wholesale brick-and-mortar stores. However, we see HBI's major wholesales customers, such as Walmart and Target (14% and 11% of 2019 revenue, respectively), as recession-resilient. Additionally, consumers have strong brand loyalty to Champion and will "actively seek out the brand" regardless of venue as demonstrated during 2Q20.

3. <u>Surge in cotton prices</u> may increase costs paid to yarn suppliers and decrease margins given HBI is unlikely to pass on cost increase to customers. However, cotton only accounted of 4% of HBI's COGS in 2019. The Company also has the ability to periodically fix the price of cotton to reduce the impact from interim price fluctuations.

The TJX Companies, Inc. (NYSE: TJX) - Long
2020 Women in Investing Pitch

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Cathy Yao '22

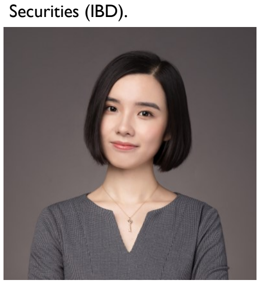
Cathy is a 1st year MBA student at CBS. Prior to CBS, she worked as an M&A banker at UBS Securities, and later as a strategic investor at KE Holdings, Inc. (NYSE: BEKE)

Flora Chai '22

Flora is a 1st year MBA student at CBS. She started her career with Goldman Sachs IBD in Financial Institutions Group, and later joined Merrill Lynch Equity Research covering Greater China Bank and Fintech sectors.

Joanna Zhou '22

Joanna is a 1st year MBA student at CBS. Prior to CBS, she worked at Fosun Pharma focusing on healthcare investment in private market. She also worked at Deep Snow Capital (financial advisory) and Zhong Shan Securities (IBD).



Wenbo Zhao '22

Wenbo is a 1st year MBA student at CBS. Prior to CBS, she worked at China International Capital Corporation (CICC) in Beijing, providing investment banking services for financial sponsors.

Recommendation

TJX is a leading off-price retailer in US and international markets. We would like to recommend a LONG with a 3-year target price at $93.98, representing an IRR of 16%.

Business Description

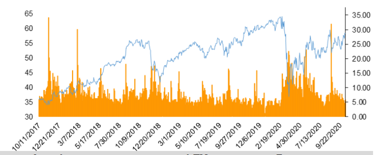
TJX is the biggest off-price apparel and home fashions retailer in the States with over 4,500 retail locations across 9 countries on 3 continents. TJX generates nearly $42 billion in revenues and $4.1 billion of cash from operations in 2019. TJX ranks No.85 in the 2019 Fortune 500 listings.

As of 2020/10/12

In millions expect for share prices

Current Market	
Last Price	58
52wk High	65
52wk Low	33
Dilluted Shares Out	1,216
Market Cap	**70,463**
Plus: Total Debt	15,661
Plus: Prefered Equity	-
Plus: Minority Interest	-
Less: Cash	6,620
Enterprise Value	**79,504**

3-Year Historical Price Chart



	Actual					LTM	Forecast		
Income Statement Summary	**FY2016**	**FY2017**	**FY2018**	**FY2019**	**FY2020**		**FY2021E**	**FY2022E**	**FY2023E**
Revenue - Base Case	30,945	33,184	35,865	38,973	41,717	33,734	31,549	45,638	49,852
Revenue growth		*7.2%*	*8.1%*	*8.7%*	*7.0%*		*-24.4%*	*44.7%*	*9.2%*
Revenue - Consensus							*32,262*	*41,400*	*44,268*
Variance to Consensus							*-2.2%*	*10.2%*	*12.6%*
EBITDA - Base Case	4,321	4,508	4,713	5,038	5,284	1,980	1,307	6,062	6,775
EBITDA Margin	*14.0%*	*13.6%*	*13.1%*	*12.9%*	*12.7%*	*5.9%*	*4.1%*	*13.3%*	*13.6%*
EBITDA - Consensus							1,337	5,169	5,696
Variance to Consensus							*-2.3%*	*17.3%*	*18.9%*
EBIT - Base Case	3,705	3,850	3,987	4,218	4,416	1,101	396	5,064	5,660
EBIT Margin	*12.0%*	*11.6%*	*11.1%*	*10.8%*	*10.6%*	*3.3%*	*1.3%*	*11.1%*	*11.4%*
EBIT - Consensus							420	4,165	4,676
Variance to Consensus							*-5.5%*	*21.6%*	*21.0%*
Normalized Dilluted EPS - Base Case	1.7	1.8	1.9	2.1	2.2	0.5	0.1	3.0	3.5
EPS Growth		*7.0%*	*6.9%*	*9.2%*	*7.5%*		*-94.9%*	*2536.8%*	*16.5%*
EPS - Consensus							0.1	2.5	2.9
Variance to Consensus							*-18.1%*	*21.3%*	*21.9%*
ROIC	29.0%	25.5%	25.4%	28.3%	17.6%				
ROE	53.1%	52.1%	54.0%	60.0%	59.5%				

Trading Multiples	**LTM**	**FY2021E**	**FY2022E**	**FY2023E**
EV/Sales	2.3x	2.5x	1.7x	1.6x
EV/EBITDA	15.7x	60.9x	13.1x	11.7x
P/E	99.2x	502.2x	19.x	16.3x

Investment Thesis

1. Resilient and flexible business model with precise value proposition, world-class buying organization, efficient supply chain and distribution network

1.1 Precise Value Proposition

- Despite prices generally 20-60% below dept stores, TJX offers value instead of simply cheapness to its customers. It targets 25~54 year old, middle to upper-middle income female who are fashion and value conscious. Around 28% of TJX's customers belong to a household income group of above $100,000.
- Treasure hunting shopping experience greatly increases turnover and the frequency of customer visits.
- TJX is also popular among younger generations as evidenced by rising percentage of Millennials and Z-Generation among customers.

1.2 World-class buying organization

- Actively opportunistic buying: over 1,100 buyers actively buying from 21,000+ suppliers across 100 countries; TJX has buying offices in 12 countries and 4 continents.
- TJX University: Advanced learning opportunities for merchandising Associates through specialized training, a year-long one-on-one coaching program, and store exercises; Both TJX's former CEO and current CEO were once buyers at the company.
- Direct purchase from manufacturers, supplemented by distributors and private label.
- Buyout purchasing and no request of subsidy from suppliers nurtures good long-term relationships with suppliers.

1.3 Efficient Supply Chain and Distribution network

- Digital inventory management system: Inventory management system dynamically manages the process of product purchase-store distribution-price adjustment-sales.
- Well-established warehousing and logistics infrastructure lay the foundation for quick turnover:28 self-owned and leased distribution centers, covering an area of more than 1.6 million square meters; Total investment of US $234.22 billion in warehousing and logistics from 2015 to 2018.
- TJX transfers goods from store to store much more frequently than traditional department stores: its "Single-piece purchase" inventory strategy promotes the mentality of FOMO in costumers and push them to make the purchase.

2. Best positioned to capture counter-cyclical opportunities for long-term growth

- Off-price tailwind has been accelerated by retail apocalypse during Covid-19. More than 15,000 stores in US are projected to shut down in 2020, with 8,000+ closures announced by far and department stores suffer from sales plunge (19% Y/Y in the first 8 months of 2020). We believe TJX will be one of the few winners during the pandemic with favorable changes on both supply and demand sides. We expect TJX to gain share from closing stores. Compared to its peers, TJX's customers skew towards higher income demographics who shop from department & specialty stores to mass merchants, and their pent-up demand can partially pivot to TJX, especially in the case of a prolonged recession after pandemic.
- Our analysis on TJX's historical performance also shows that, a high and sometimes lagged growth in

The TJX Companies, Inc. (TSX: TJX) - Long (continued from previous page)

- We believe TJX has more penetration opportunities in the US especially in states like California, Texas and Florida, where the off-price store coverage is less saturated, and TJX has less store presence compared to its strong Northeastern position. TJX has a solid store pipeline at hand of ~120 signed leases this year, and they are delayed to open next year. We believe when consumption recovers, we will see more store expansion. Moreover, TJX can seize better locations from exiting retailers, i.e. opening a HomeGoods in 2021 at a former Bed Bath and Beyond at Stafford Marketplace.
- Other short-term opportunities that help start the engine for TJX's long-term expansion include (i) faster-than-peer recovery with a widely distributed network and thus less exposure to heavily affected states; (ii) negotiation for rent adjustment and payment deferrals with increasing bargaining power, with estimated 400 stores require rent renewal in 2020/2021; (iii) strong cash position and cash generation capability (~$4B annual FCF in FY22/FY23 by our model).

3. Opportunities to gain share in merchandise supply and build vendor relationship due to regular-price weakness

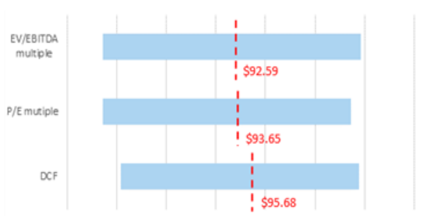
- TJX has the largest buyer network and vendor relationship in the industry and manages inventory with the highest efficiency.
  - TJX: 1,100 buyers with 21,000 vendors; ROST: 900 buyers with 7,500 vendors
- Short-term: TJX is able to grab the excess inventory caused by COVID-19 shut-down in the marketplace, purchasing higher quality brands and merchandise at a lower cost, some of which can even be sold next year at a significantly higher mark-up as packaways. Given its leading position with 4,529 stores worldwide, TJX is the go-to off-pricer for closing stores like Macys', JCPenny, Pier 1 and Ascena Group.
- Long-term: Due to ongoing uncertainty, more and more brands consider off-price as a great channel to quickly get rid of inventory, which is an opportunity for TJX to bring in new brands and build on-going partnership. Meanwhile, apart from specialty and department brands, TJX also sources manufacturers to produce private label products to fill in a great portion of its assortment. Hit by pandemic, manufactories have production down nearly 50% (apparel) and are desperate for new orders. As the savior to keep the factories running, TJX is able to negotiate better terms and explore new ways of cooperation.
  - Some brands (e.g. Calvin Klein) will license out the brand to retailors, including off-price. There is some differentiation in the product in texture, craft, etc. They are flexible to work with the off-price to produce at the price point needed.

4. Underpenetrated international market remains a strong growth engine

- As the only major brick-and-mortar off-price retailer in Canada, Europe and Australia with no other scaled competitors, TJX takes the leading position to establish the unique off-price model. TJX has an unparalleled market share of 86.3%, 84.5% and 90.5% in Eastern Europe, Western Europe and Canada respectively.
- International markets have significant lower off-price penetration rate compared to US, while customers respond to off-price experiences "not dissimilar from US". The brand-dominated retail industry in Europe does require TJX to be intelligent on its opportunistic buying strategy, but COVID-related disruption gives TJX a great breakthrough opportunity.

Valuation Analysis

With 6%-7% revenue growth and slight margin expansion, we derived a 3-yr $93.98 price target using DCF, P/E multiple and EV/EBIT multiple (implies 21x NTM P/E or 13x NTM EV/EBITDA). We differ from the market on: 1) TJX will soon recover the speed of opening new stores in 2021-2023 to quickly obtain market share from regular retailers. 2) TJX will lock-in long-term lease by leveraging low rent during COVID-19, which will enhance margin by 50-70bp. 3) TJX has raised abundant low-cost debt during COVID-19 to fuel its growth.



		WACC				
		6.6%	7.1%	7.6%	8.1%	8.6%
PGR	1.5%	+22%	+18%	+15%	+12%	+9%
	2.0%	+25%	+21%	+17%	+14%	+11%
	2.5%	+28%	+24%	+20%	+16%	+13%

	Bear	Basic	Bull
Avg. # of store 20-25E CAGR	3.4%	3.7%	4.0%
Comp sales 20-25E CAGR	3.2%	4.3%	4.5%
Gross margin 25E	28.3%	29.4%	30.1%
Net income 20-25E CAGR	4.7%	8.2%	11.0%
2025E EPS	$3.73	$4.46	$4.43
NTM P/E	15x	21x	27x
Stock price	$68.38	$93.98	$118.50
3-yr IRR	**+5%**	**+16%**	**+25%**

Risks and Mitigants

- **Store opening slower than expected:** TJX management has a solid plan for store opening and abundant liquidity on hand.
- **Store traffic decrease as customers don't feel comfortable to visit stores and do more online shopping:** TJX stores are usually in stripe centers instead of a large shopping mall, which make people feel safer to go. The offline treasure hunting experience cannot be fully replicated online. E-commerce severs more like a supplement to connect customers to physical stores.
- **Trade dispute and rising tariff:** TJX has a balanced mix of close-out purchases which are already in the market and private label production. Its global buyer and vendor network also make it resilient to potential trade disputes between US and other countries.
- **Lack of inventory depth as COVID created some supply chain/logistics challenges, coupled with retailers over-correcting to get inventory clean as stores re-opened:** This can be a relatively near-term challenge as buyers has begun to buy more aggressively and DCs get up to speed. In the longer-term post pandemic, retailer demand and supply will revert to pre-pandemic levels. As TJX's newly invested DCs come into operation, TJX will have more flexibility in inventory management.

Dickson Pau '22

Dickson is a 1st year MBA student at CBS. He started his career with Deutsche Bank in their Asset and Wealth Management department as a graduate analyst in Hong Kong. He then worked at Ascender Capital, a long-biased investment firm. As a generalist, Dickson covered Asian small and mid caps.

Farfetch (NYSE: FTCH) - LONG

Dickson Pau — CPau22@gsb.columbia.edu

Key Metrics				2015 – LTM Operational Metrics	
Share Price (Oct 16, 2020)	$27	**EV/Sales**	6.8x	**Revenue CAGR**	64.4%
52 Week Range	$5.99 – 31.88	**EV/Gross Profits**	15.1x	**Gross Profit CAGR**	60.1%
Shares outstanding (M)	339.6	**P/BV**	12.6x	**Average Gross Margin**	48.7%
Market Cap (M)	$9,169	**Avg. 3M Dly Vlm (M)**	4.9	**SG&A Expense CAGR**	51.3%
Net Cash (M)	192.4	**Float %**	72.7%	**R&D Expense CAGR**	82.3%
Enterprise Value (M)	$9,133	**Short % of float**	14.4%	**No. of Active Customers CAGR**	49.4%

Executive Summary: Farfetch is by far the largest luxury goods online marketplace worldwide. It aggregates demand and offers a centralized high-end shopping experience to customers. I believe Farfetch is undervalued as the market (1) **underappreciates its economic moats**, (2) **overreacted to Amazon's recent entry to the luxury goods market**, and (3) **underestimates Farfetch's growth potential.** Through my research, I arrived at a 3-year target of $40, representing 48% upside and an IRR of 14%.

Company Overview: Founded in 2008, Farfetch carries products from more than 3,500 brands on its platform. The number of SKUs on Farfetch is seven times greater than the closest competitor's. The inventories are sourced from more than 1,300 luxury sellers, including 900 luxury boutiques and 400 direct brand partnerships. At any time, customers can access more than $5 billion worth of sellers' stocks on Farfetch. This large inventory base currently attracts 2.5 million active customers. The customer base is diverse, with the gender split well-balanced at 60% female and 40% male. More than 50% of them are Millennials, and on average, they spend $1,000 on Farfetch annually. As a platform, Farfetch charges an average take rate of 30%.

Investment Thesis:

#1 – Farfetch Already Has Highly Defensible Moats

Even though the business is subscale in terms of profitability, Farfetch is already leaps and bounds above most other competitors (other than NYAP, which Farfetch is catching up to). As explained in the first point below, the structure and characteristics of the luxury goods industry is not conducive for new entrants . As the industry moves online, I believe the advantages of the biggest players will further improve. As the emerging aggregator of demand for personal luxury goods, Farfetch is showing its strength during COVID-19 since it is on track to grow its digital platform GMV by more than 20% while the industry is projected to decline by 25-45%. The appeal of the platform is clearly reflected by the 500,000 new customers acquired in Q2 2020 alone.

I. It is difficult for a new entrant to replicate the marketplace model of Farfetch, especially not on the same global scale. Building a marketplace entails solving the classic chicken and egg problem. But unlike car sharing or other "commodity-like" marketplaces, you cannot simply throw money at this problem. The luxury brands are highly focused on brand perception on a relevant platform and cautious with distributor selection. It takes time to build trusting relationships with them to access inventories, and it is not possible to subsidize the customers as brands retain pricing control and are strongly against unnecessary discounts. The relationships are also sticky on the boutique side, as 80% of the boutiques sign exclusive contracts with Farfetch. Even though these are one-year contracts, the renewal rate is very high given that there is no better alternative platform that offers the same scale of client outreach globally. The more realistic means to compete in this industry is to become a direct seller. But this either requires too much time to build relationships with brands or takes too much capital to have a competitive offering. It is thus very challenging for direct sellers to compete with Farfetch on product breadth and depth.

II. Competition from existing players, for instance department stores which are now pivoting toward online more aggressively, is the bigger threat. Yet, they are also not in a good position to compete against Farfetch. The supply chain of running an e-commerce site is very different from that of the physical retail business. Furthermore, not only is the core business of luxury department stores on the decline, they also tend to be heavily indebted (some, such as Lord & Taylor and Neiman Marcus, even went bankrupt recently), both of which reduce the flexibility they have for investments into online capabilities. Those that are surviving, for instance Harrods, chose to work with Farfetch instead. Harrods is now a main client of Farfetch Black and White, utilizing the technology infrastructure that powers the Farfetch Marketplace to revamp its own ecommerce site.

III. More brands could go direct. The biggest luxury conglomerates are investing in their own online capabilities, but other than Richemont, which owns YNAP, key players like LVMH and Kering have yet to achieve a scaled-up e-commerce offering. LVMH launched its multi-brand e-commerce site 24S in 2017 and has yet to achieve any meaningful scale. But for most brands without resources, even for Chanel, it is simply easier and cheaper to use Farfetch's Black and White solutions to operate their own online channel.

Farfetch (NYSE: FTCH) - LONG

#2 – The Market Overreacted to the Entry of Amazon in the Luxury Goods Industry

In late August 2020, it was leaked that, after several failed attempts, Amazon was again expanding into luxury goods retail. As a result, the share price of Farfetch once declined by nearly 25%. On Sep 15, Amazon officially launched its Luxury Store platform. But to create the feeling of exclusivity, it is now only open to invited customers. In the previous few attempts, Amazon was either more focused on flash sales or gave no control to the sellers on how their digital store fronts are designed. This time, Amazon is taking the Farfetch approach, acting only as a marketplace and allowing brands to design their own digital store fronts. The market clearly is worried that Amazon will finally be able to enter the luxury goods market successfully.

I believe the market is overreacting for the following reasons: (1) Despite the dire state of physical retail and a delayed of launch, only 12 brands have agreed to be on the platform and only one at the start, implying most brands remain cautious about selling on Amazon. (2) My conversation with a small luxury brand suggests it remains worried about the clientele on the Amazon platform and the risk of Amazon copying its designs. If a small brand, which has limited visibility, is not willing to take the risk, it is difficult to believe the big brands would consider doing so any time soon. (3) Furthermore, the market is growing rapidly, there is enough room for multiple players. Amazon's penetration in this market may help grow the pie faster. And (4), more importantly, if Amazon succeeds, I do not believe it will be terminal for Farfetch. The impact will be felt on lowering take rates.

#3 – Long-term Growth Potential Exceeds Market Expectation

The long-term potential of market share is higher than analysts are currently expecting. For instance, GS is projecting an GMV target of $24 billion by 2030, for a CAGR of 25% in the next 10 years. This projection may seem aggressive. But they then put on a perpetual growth rate of 4.5% p.a. afterwards, which effectively assumes minimal market share gains by Farfetch. I think this misses the possibility that Farfetch can potentially grow to become more dominant than any department store chain ever did.

Macy's, the biggest US luxury department store, earned $28 billion in revenue in 2015, the highest in its history. In that same year, global luxury goods market was $289 billion. Assuming 70% of Macy's revenues come from apparel and accessories, Macy's had around 7% of the global market, even though it only sells in the US. Farfetch, in contrast, is a global business, with global reach and an unlimited store front. There is no reason why Farfetch cannot grow to become bigger than Macy's ever was. The digital savvy customers Millennials and Generation Z is expected to become 60% of the luxury goods customer base by 2025, up from the current 39%. In ten years, the global personal luxury goods market is expected to grow to around $450 billion. A 7% market share will result in a GMV of $31.5 billion, which is 31% higher than Goldman's estimation. The global market share of Farfetch is now around 1%. It is more conservative to assume that it will take more than 10 years to reach a global market share of 7%. If we take the analysts' estimation from above, then by 2030, the global market share of Farfetch will only be 5.3%. As Farfetch continues to grow faster than the industry, there should be another leg of growth before the perpetual growth rate kicks in.

Key Risks and Assessments:

#1 Sustainability of Take Rate

Farfetch's take rate is a major concern to short sellers, as 30% is a much higher take rate than what most other platforms charge (usually 5-20%). I believe the take rate is reasonable and sustainable for the following reasons: 1) Luxury fashion is a high margin, slow moving product category. Comparing take rates across product categories is not the correct analysis. Despite a 30% cut, retailers and brands can still make 10% to 20%+ margin. The ability to increase product turnover at lower marketing costs makes it worth selling on Farfetch; 2) The wholesale channel takes a 50-65% cut of the final retail price. Shifting products from wholesale to Farfetch allows most brands to capture a lot more profits. To be conservative, in my base case, I assumed the take rate to decline to 27%.

#2 China Risk

Chinese consumers make up 35% of the global luxury goods market and contributed to over 90% of the growth in 2019. A major slowdown in the Chinese economy will meaningfully drag down the industry growth. However, a recession in China should reduce outbound travel, which in turn should provide customers additional incentives to purchase luxury goods online. Just as Farfetch has been a significant beneficiary of COVID, Farfetch should then again offer a cost-effective alternative to Chinese customers for buying authentic luxury goods.

Valuation:

I derive my base case valuation by looking ten years out. I am expecting the active customer base to reach 14.3 million by 2030, for a CAGR of 20%. With minimal expansion in average order value and a decline of take rate to 27%, I expect Farfetch can generate close to $10 billion in reported revenue, including fulfillment. With an estimated operating margin of 11%, the company would be generating $1 billion in EBIT by 2030. Farfetch has no direct comparable. Historically, it has traded from 3-8x EV/Revenue. With growth slowing down, a conservative and reasonable multiple would be around 2.5x, resulting in an EV of $25 billion by 2030. Assuming 2.5% annual share dilution and a discount rate of 9%, I estimated my 3-year target price at $40, representing a 48% upside and a 3-year IRR of 14%.

Model Case Summary			
In millions	**Base**	**Bear**	**Bull**
2030 Revenue	$9,755	$7,035	$12,630
'20-30 CAGR	22.6%	18.6%	24.0%
2030 EBIT	$1,021	$370	$1,337
% Margin	10.5%	5.3%	12.3%
2023 Price Target	$40.0	$18.9	$48.5
Implied 2023 EV/Revenue	5.0x	2.5x	6.0x

Ray Kennedy, CFA
Hotchkis & Wiley

Ray Kennedy, Hotchkis & Wiley

obligations. Mr. Kennedy was formerly associated with the Prudential Insurance Company of America as a private placement asset manager where he was responsible for investing and managing a portfolio of investment grade and high yield privately placed fixed income securities. Prior to that, he was a consultant for Andersen Consulting (now Accenture) in Los Angeles and London. Mr. Kennedy, a CFA charterholder, received his BS from Stanford University and MBA from the Anderson School of Management at the University of California, Los Angeles.

Editor's Note: This interview took place on September 23rd, 2020.

Graham & Doddsville (G&D): Hi Ray, thank you for taking the time to chat with us today. Can you start by telling us about your background and how you got into investing?

Ray Kennedy (RK): I came from a pretty different direction than most people. I graduated from Stanford with a degree in industrial engineering in '83 and spent three years doing operations and actuarial programming for Andersen Consulting (now Accenture). My second assignment was in London working for the London Stock Exchange on a project called Big Bang, which was to design and automate the exchange's equity trading system. At that time, in 1986, there was only one automated trading system and that was the early stages of the Nasdaq, so this was kind of a big event. Naturally, I became heavily involved in how trading works, how you build a position and clear a position by the end of the day, and that was kind of my first insight about the financial markets.

I enjoyed that project and understanding how markets work, so I said, "This is really fun. Let's go and get an MBA." So, I went to UCLA and got my MBA. During this time the LBO market was very hot, and the money was with the insurance companies – the first investor of KKR was actually Prudential, where I worked for a summer. At Prudential, we were among the first to buy the entire tranche of an LBO, the debt, equity and even bank debt, so I was interacting with Drexel and KKR on a daily basis and investing heavily in very leveraged situations.

After UCLA I returned to Prudential full time in 1988 doing private placements in the mezzanine space. Then the LBO market blew up in the late 1980s; Drexel went under, and the insurance market for investing in the space changed materially. I spent the next four to five years doing debt and equity investing, but more on a private basis.

We did a private placement for a small firm in Newport Beach called PIMCO in 1994, when the firm was still very much under the radar and had around $40 billion in assets and $500 million in high yield. I joined PIMCO's high yield group in 1995 and took over the global high yield business in 2001. By the time I left in 2007, PIMCO was $800 billion in size, $60 billion of which was in high yield.

It was a rush being at the firm during that 12-year period because we were making markets and making new products left and right. We were one of the first to do CLOs and CDSs. We were doing synthetic products because we always had an incredible need to invest the dollars. I always described it to people as drinking out of fire hoses every morning: you'd sit at your desk until 4:00 or 5:00 and you'd realize you just had more hours to work, so most of us came in on weekends. But the firm was growing so that was the focus. By now there aren't many of my generation left at PIMCO. Most retired, some started their own businesses, and I retired for a few years before joining Hotchkis. The CEO of Hotchkis and I were freshman roommates, and a lot of my college friends from Stanford are at the firm. It's slower paced here,

(Continued on page 27)

Ray Kennedy, Hotchkis & Wiley

but we decide what level of growth, what businesses, and what product lines we want.

G&D: You spent a big part of your career at PIMCO, which is a trading-oriented, top-down focused firm, and now you are with Hotchkis, which is a traditional bottom-up type of fund. How does trading and macro fit into your investment philosophy today?

RK: In high yield, we view macro as the guardrails for investing. We wouldn't necessarily avoid situations because we had a negative macro view on a sector, we would just need to be more secured or more senior on the capital structure.

When I was at PIMCO, high yield was largely founded by value equity managers. The guy I worked with, Ben Trosky, was a value equity manager from Merrill, so the roots of the High Yield group was driven by fundamentals. It evolved over time as the asset class became more commoditized, which is why trading has become such an important part of high yield and bonds, but we did marry the two a bit at PIMCO. We were always given the leeway to focus on research first, but as a firm, Bill's strategy was to trade around the curve and interest rates.

"In high yield, we view macro as the guardrails for investing."

One of the strategies the firm employed was to buy off-the-run securities and price them to be on the run to get instant alpha, because that's how inefficient the market was at that time. The other part was also born out of necessity in dealing with the sheer volume of cash movement throughout the day. You never trade in high yield to pick up a few basis points. A bid-offer spread is anywhere from 15 to 50 basis points. On a good day, you may get an eighth. On a really good day, you may get a sixteenth. Contrast that with treasuries, where your trading positions are 1/64th bid-offer spread, and it's sometimes even 1/28th.

At Hotchkis, however, we view trading as a cost. Low interest rate environments often lead to portfolios being called as companies refinance at aggressive rates. This year alone we probably lost, on average, a third of our names this way. We then have to play the new issue market as our source of ideas. So, coming back to Hotchkis has brought me back to my roots of fundamental research.

G&D: You mentioned that PIMCO thought about macro as the guardrails of investing. Is that a framework that you still use in your day-to-day at Hotchkis?

RK: In high yield we say that you can always buy a good bond in a bad company or a bad management team, or you can buy a bad bond in a good company. Getting the credit right is your number one source of return, industry sector is the second, and duration the third. You can get burned on duration, though, as we have in the last 18 months because we were positioned more for a standard economic growth cycle that sees upward pressure and rates.

"You can always buy a good bond in a bad company or a bad management team, or you can buy a bad bond in a good company."

So that's our framework: get the credit right, get the sector partially right, at least be aware of what you're buying into, and the last thing is duration. Embedded in all that is making sure your structure is correct.

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But like I said, you can buy a good idea in a bad sector and still make money.

G&D: Could you elaborate on the process of getting the credit right? What's your framework around that?

RK: I'll share a few different approaches for perspective. At Prudential, we took a structured approach, and that's where my grounding was. We had a statistical framework similar to Moody's, where we bias credit ratios based on size because there are axioms like, "Smaller companies have a higher probability of default and lower recover rates because they have less financial flexibility." Smaller companies can't grab capital the way large companies can, and they have less ability to dispose of something. That's why it's hard to kill GE. If GE were a small company, it'd probably be dead by now. But GE, as a large company, can pull different levers to keep bailing themselves out and buying time.

We also had a matrix we used to determine the implied risk of a specific rating and whether you're being priced rich or cheap relative to that. So, the statistical approach is one way to do it. It works up to a point and works better for investment grade issues.

At Hotchkis we take the approach of looking at the business, because history has taught me that a bad business model will likely be your killer. The first thing I do when evaluating an issue is to look at the balance sheet. If I can understand how things move around the balance sheet, I understand the income and I understand the cash flows. If I see receivables go up but no earnings, I know this is not a cash business.

"At Hotchkis we take the approach of looking at the business, because history has taught me that a bad business model will likely be your killer."

The best example is film accounting. If you look at the numbers, you would invest in film and TV syndication all day long because they generate enormous earnings, but in reality they are just building huge assets on the balance sheet and spending a ton of cash. For example, Netflix is a horrible credit idea. It's not going to default, but it generates basically no cash because it's constantly building a stream of shows and movies that are earned over time.

Then the second thing is what we call a business test, which is "do they have a reason to exist"? Generally speaking, high yield companies are likely to run into problems. You're dealing in a space where on average 30% of the companies are in secular decline. They wouldn't be junk if they weren't. We used to come across paper companies all the time in high yield. Most of them have filed bankruptcy by now because there's just no reason for small paper plants to exist. Eventually the business hits the wall and your recovery is literally zero. So you don't get A+ businesses, and you don't get A+ management teams, but you do try to find little gems and little ideas out there.

The third thing is looking at the history of management and the incentives of management, because nine times out of ten, most of the problems we run into in credit are bad management decisions or bad management teams. In high yield, there's a cohort of management teams that just moves around because, again, you're not getting class A management teams in this space. So, we really do focus on incentives of management, their knowledge base and their tenacity to work through problems, because you're

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dealing with leveraged situations.

If you've noticed, I haven't mentioned anything about credit stats. I haven't mentioned anything about pricing, because I'll overpay for a good credit all day long, and there are yields at which I just won't buy a bad credit. In credit, there isn't always a price at which you can buy something because buying Chesapeake bonds at 30 cents on the dollar seemed great; well, now they're worth 5 cents. The fact of the matter is you have to think about the asymmetric return profile of bonds and credit in general, which is if things go well, maybe on a good day, you'll get a 120 or 130. If things go bad, you're at zero, and statistically, your historical recovery rate in credit is about 30, 35 cents on the dollar.

So, buying bonds at 60 cents on the dollar on average is a great trade because you're starting from a fairer position at 30 points down, maybe 60 points up. At the end of the day, one of the things we do when we're looking at this is a Porter analysis: Where are they on the cost curve? Do they have some sort of technology that makes them unique? Do they have customers that make them unique? Because these are the things that will keep the company going. And again, we're buying credit, so swinging for the fence at 50 cents on the dollar means my potential return is 2x, whereas buying an equity at $3, your upside is infinite. It's a very different return profile. So, trying to find those companies that have survivability is probably one of the most important things you can do.

"One of the great things about today's environment, which is unfortunately tied to a pandemic, is that it flushes out the weak companies. Clearly, we've had a lot of the apparel companies going or gone under, but one thing that still has value is brand."

G&D: Are there any specific sectors or industries you view as difficult businesses to be in over the next five to ten years?

RK: Yeah, so we can talk about current ones and then emerging ones. The current ones are things telecom related, wireline. Just about all of them have filed bankruptcy now; Frontier Communications, Windstream Communications, Consolidated Communications – they've all restructured their balance sheet. There are also parts of the paper industry that still exist. For example, a printing company, LSC Communications, filed for bankruptcy. People don't buy books as much anymore, and textbooks especially.

Obviously, you know the story on retail. Big mall retail has been in decline for a while due to different shopping behaviors. You can blame some on Amazon, but at the end of the day, they just don't have a reason to exist anymore, and COVID has pushed them to the edge. One of the great things about today's environment, which is unfortunately tied to a pandemic, is that it flushes out the weak companies. Clearly, we've had a lot of the apparel companies going or gone under, but one thing that still has value is brand. Take Boardriders, which is the parent company of Quiksilver, they make t-shirts that are screen printed and charge $30 for something they make for $3. So, that's the value of the brand.

An emerging one we all talk about is autos. If you compare the auto world today against 20 years from now, it's going to be fundamentally different.

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California announced today that no combustion engine cars can be sold in California in 15 years. Sounds great on paper, but it's going to be very difficult to implement. So, you have to ask yourself who is able to adapt to that.

The last one I would add is energy. The high yield market overinvested in the energy sector and effectively sparked the Shale Revolution. When you look around at the energy sector today, the amount of carnage is stunning. Chesapeake was a junk issuer, and so is Aubrey McClendon, the pioneer in horizontal wells and fracking, who literally founded the modern-day shale revolution. 20 companies filed bankruptcy recently, and we're working on three of them.

Between climate change and the shift to renewables, we've seen a significant shift in gas demand around the US that indicates we may have too many pipelines. California is now up to 35% renewables in the form of solar, wind, and geothermal. As a result, all the gas pipelines that were pointed toward California are seeing excess capacity. So, long-winded answer, but those are the ones that I'd put out there.

G&D: For the industries you mentioned, would you stay away from them completely, or could there be potential opportunities? Or do you think that with the secularly challenged industries, it's better to just stay away completely?

RK: It depends. For example, when you look at telecom, wireline is easy to say no to. I'm sure none of you have a wireline. The only people I know with wirelines are my parents. So that's easy to stay away from. That being said, we do have one investment in a company called Unity, which owns fiber to the home that they lease to Windstream.

In the energy space, we own a company called Nine Energy, which specializes in making disposable plugs that are used in horizontal drilling, though that one scares us a bit because if Biden wins, you have to assume that fracking on federal lands will be challenging.

There are certain apparels that we think are valuable as well, like Quiksilver, which we talked about before. With autos, we own Allison Transmission that specializes in making not only the standard transmissions used in combustion engines, but also the electronics.

So the answer is, again, it depends. You try to find the ones that can survive because otherwise I'm walking away from 30% of the market, and that's just not feasible when you're trying to run a high yield portfolio.

G&D: How do you think about these more recent bankruptcies in retail? Is there anything there that you believe is still worth looking into?

RK: It has evolved a lot because COVID has changed the parameters. First of all, established brands do seem to have more value. For example, Forever 21 is a retailer that has some of its own brands, but those are fickle brands. Limited Brands, on the other hand, has Bath & Body Works. That part of the business is in good shape. The Victoria's Secret brand also still has value, but they missed the changing tastes in some of their key product lines. You'd have to think that if they repositioned with the right products, they probably could revise that brand, because it's a good brand name that people like.

But let's talk about retail more broadly. We bought the first lien bonds for J. C. Penney. You're probably thinking, "Are you kidding? Who goes to a J. C. Penney?" Well, if you go out in the Midwest, people shop at J. C. Penney. With Sears

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and Kmart out of business, they were the last survivor, and the company seemed to have had a chance of making it. In addition, they owned a lot of their properties and just the dirt alone would be incredibly valuable.

It all seemed good on paper and seemed like the investment was working. The bonds were in the 80s, and we were almost rooting for them to go bankrupt because we could just take the leases and the underlying land, and flip it to another person. COVID changed the situation dramatically because now there is no one to replicate the space. Those first lien bonds are now in the 30s, maybe moving toward the teens. It now looks like the company might be split into two: the operations will be acquired by mall operators who want to resuscitate the corpse for rent, and the properties will be turned into dark store liquidation.

So, a creative solution to dealing with a dead retailer. On the other hand, we have Neiman Marcus, which has a good brand and good clientele, but the company was starved of capital because it was too over-levered. But if you go into their stores, especially in a world where there's a lot of global travel, they're packed, and people will pay an enormous amount for their products. As a result, they seem to have a reason to come back, and they probably will with a less levered balance sheet, especially if they can pull off the online.

"Right now, the going consensus is to take the business, split it into two, keep the operations alive when they have a reason to continue to exist, and sell off the dead stuff."

The sad one to watch is Nordstrom. Nordstrom has done a great job of executing both its physical and online presence in an Amazon world, but COVID changed the dynamics for them and they're now a junk issuer. I think they can avoid a restructuring, but they need the market to come back to make it happen. The landscape has evolved in terms of how we look at retail due to COVID. Right now, the going consensus is to take the business, split it into two, keep the operations alive when they have a reason to continue to exist, and sell off the dead stuff.

G&D: You have said before that the path it takes to get to a destination matters. Could you elaborate on that in terms of why it is important and how you incorporate that into fundamental investing?

RK: The tension between credit and equity is about path. Equity investors often make assumptions like, "Oh, they can get liquidity. Oh, the banks will roll. Oh, there's no shift in quarterly cash flows that will potentially starve a company." In credit we think about whether they will trip a covenant or be up against their bank capacity, which means the trade could pull their lines.

So, the path for credit investors can be incredibly important. Take energy for example – we can make very probably correct assumptions about the value of the resource, but if you can't get there, it doesn't matter what the value is. We had a company that was involved in building a plant, but they just kept running out of cash. With unlimited cash access, they obviously would have finished the plant and never would have had to file bankruptcy, but they ran out of cash, and that is what brings companies to bankruptcy at the end of the day.

But again, remember that in credit, at best I can get 2x my investment, maybe 3x. But in equity, you can get unlimited. So, equity investors are more likely to make a bunch of these bets, a few of them flop, but the third can be a home run.

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Credit, you can't do that. If you have three bad trades, you're pretty much done.

G&D: With path being something that matters, how do you navigate the market in the next 6 to 12 months?

RK:
It's a great question because we're thinking that ourselves. Base case is that things start going back to normal in first half of 2021. But the base case was also that we'd be back to normal by mid-July of this year. The way we've decided to think about this is to still stay somewhat conservative and senior in capital structures. If you think COVID is going away in the next three months, you should buy unsecured airline paper, Carnival Cruise unsecured bonds, and the worst part of the capital structure in the travel and leisure space. I'm not ready to do that. We'd rather buy a piece of paper secured by airplanes, by routes, by cruise ships, because there're just too many things that can come along and make things difficult.

The one thing that's made it extremely difficult is the Fed. If the Fed hadn't stepped in the way they did, neither the high yield nor equity market would not be at the levels we're at today. A company's ability to get cash determines its ability to survive, which means their equity would survive. Let's face it, if Carnival Cruise couldn't have gotten the billions that they did, the equity would be in Chapter 11. Take that across the entire travel and leisure sector and the equity market would be at a much lower level than it is today.

"But again, remember that in credit, at best I can get 2x my investment, maybe 3x. But in equity, you can get unlimited. So, equity investors are more likely to make a bunch of these bets, a few of them flop, but the third can be a home run. Credit, you can't do that. If you have three bad trades, you're pretty much done."

A lot of companies have not recovered to pre-COVID levels, but the Fed has put a floor on credit. They did it both directly through buying bonds that were downgraded after March and indirectly through purchases of ETFs. So, I guess we have to take our hands off the wheel a bit and just ride along, and that's frustrating because you want to do things fundamentally based, but you can't because you have this third party that can fundamentally change things. Let's say you want to short high yield at current levels. That's a dangerous trade when you've got someone with a big balance sheet and the willingness to buy through the end of the year.

So, in essence, you can't short the market, given that dynamic, and the Fed knows that. But you don't necessarily want to be aggressive either because it's a buyer that you don't know much about and acts a bit irrationally. No one in this current environment is comfortable investing, especially on the credit side. We hate it, but we have to play along.

There were two axioms that we stood by at PIMCO. One, don't fight the Fed. Paul McCulley used to say, "If that's where the Fed's going, you've got to be there." The second one is that technicals become fundamentals. This ability to raise cash in a very difficult environment is fundamentally saving these companies. Using Carnival Cruise as an example again, I had no idea how expensive it is to dock a cruise ship. You don't just tie it up, turn off the engine and say, "I'm coming back in six months." You have to constantly flush

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it. You have to have crew of 50, 60 people go out at the port every day, turn around, come back in, or else one side can basically get ballast issues. But a technical bid by the Fed caused the new issuing market to be supportive, which caused the companies to get cash, which caused them to fundamentally survive.

G&D: With the Fed stepping up in the risk spectrum and doing things they have never done before, what does that mean for the market and what are the longer-term implications?

RK: Well, once you do it, people will always know there's a chance you will do it again in the future. So, every bond that I think is going to get downgraded, even though I might not fundamentally like it, I will look at buying and potentially even buy some because I know this player is out there. So, it's fundamentally changed the risk of the asset class. And as a result, the asset class will probably never get to the cheapness that it should again.

For example, I think we had a thousand basis point spread over treasuries, and historically, hitting 1,600 or 1,800 was a very possible scenario. Our base case before the Fed stepped in was that that should happen and provide a great buying opportunity for high yield. Once the Fed came around, however, those spreads collapsed and now we're at 500 off. As investors now, every time you see a sell-off that's event-driven, whether it's the 2008 banking crisis or this pandemic, you're going to buy the asset class even though fundamentally the spread should widen.

"The Fed's ETF program also doesn't seem well-thought-out to me. Instead of buying a slice of everything to show no favoritism, they are buying winners and losers, which is something that disturbs a lot of us."

The Fed's ETF program also doesn't seem well-thought-out to me. Instead of buying a slice of everything to show no favoritism, they are buying winners and losers, which is something that disturbs a lot of us. Second, ETFs only represent portions of the market. In the case of high yield, you have a whole cohort of issuers less than $600 million in size, but the ETFs only buy $600 million in size and larger, so the bonds of those smaller companies were not supported because they weren't ETF eligible. This caused some strange behavior and I'm sure the Fed will just say, "That's just collateral damage in the process. We will be out of the market soon and you guys can act like a normal rationing risk market then", but it will never be the same.

G&D: Does that mean that the Fed can push up security prices forever, and prices will just never go down? What are the implications from a moral hazards standpoint?

RK: That's the implication. Thank God they didn't buy equities, but we think that's probably next. That's been the game plan in Europe, and Japan bought equities to manage through their difficult period. I think you have to assume that's coming for the US. It'll be a safer market for investors, but if you have a Treasury crisis, it's going to be a disaster for the markets, but no one sees that happening under the new, modern monetary theory.

I had a call with some UCLA professors about the moral hazards subject, and I think this is in the hands of the academics to make the case to the Fed that this isn't good. Companies that maybe shouldn't be getting money are getting money. Investors that shouldn't be

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in risk asset classes are in risk asset classes because they think you will always be there to bail them out. From my vantage point, yes, we saw bid-offer spreads widen out from a normal 25, 50 basis points to 50 to 100 basis points, we saw volumes being challenged at times, but what's interesting is that when lockdown happened in March, there was a rally that was beginning to occur at the end of March, before the Fed announced their program in early April. So, the market was already starting a correcting path. One of the things I like to say is that we never have a liquidity problem in high yield, what we have is a pricing problem: at the right price, there's always a buyer. We are an established asset class that's been through a number of cycles now, and the market would have corrected on its own. Maybe Carnival would have had to pay more for the pricing on their bonds or given up more equity, but instead they, in a way, got a free gift indirectly from the Fed. So, I do think the Fed made a mistake, but I'm not sure how we will realize that mistake occurred because we could be in this place for the next five years.

G&D: What was your day-to-day like in early March and what was your strategy in navigating this very unprecedented situation?

RK: The situation never seems to change whenever you have weak markets. The first thing, you never have enough cash. Your clients always take cash out, so your job is to manage through the cash flows. We run a product that can't take cash positioning and redeploy, nor do we have the ability to call on cash and say, "Hey, market's cheap, come in." So really, you're just in triage mode.

"Maybe Carnival would have had to pay more for the pricing on their bonds or given up more equity, but instead they, in a way, got a free gift indirectly from the Fed."

Once we got control of that, the second thing we did was a liquidity analysis on the entire portfolio. So, we just broke it into a risk category and said, "Okay, based on history, who's likely to get hurt the most in this world, and who's likely to get hurt the least?"

We took every company and evaluated their credit lines, how much they're likely to bleed per quarter, who's going to run out of cash first. Anything that looked mispriced, you'd try to sell it. For example, we had some aircraft leasing company bonds, and for some reason, at the very beginning they were still bidding like they were investment grade. No one's flying, which means there's going to be a ton of bankrupt airlines, which means aircraft lessors are going to be challenged. So we let those go.

Then there were buys that were strange. Charter bonds were off 15, 20 points when people were at home watching cable. If anything, there's going to be more demand due to stay home orders. We went on the offense there.

There were things that completely caught us off guard too. We were overweight in building materials and home builders, and I was scared for them at first because we thought no one would buy homes virtually. I was obviously wrong. People buy homes virtually all the time now, and with the additional time on their hands, they're preparing and upgrading their homes. So that one caught me off guard.

The cruise lines were probably the most interesting because they clearly have to dock the ships for 6 to 12 months,

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and some think that people are never going on cruise ships again. But we've been through this before with 9/11, when everyone swore they'd never go to hotels in Las Vegas or go on airplanes again. As we know, they all did again eventually, and that same thing is going to happen for cruise ships. So, you can buy cruise ships. Am I going to go buy unsecured? No, but I could go buy secured, and so that's kind of what we did and saw the bid-offer spread widen out and narrow back in.

So, we started with cash management, then got our arms around the portfolio, because none of us anticipated a scenario like this during the initial investment decisions. Then the next thing is look for defensive play. You go on defense for some and offense for others. We went defensive on the aircraft lessors and offensive on charters. We were also trying to pitch and bring in new money in the midst of all this. And then, of course, you're trying to do all this remotely.

G&D: What do you think COVID's impact on both the economy and on the world will be?

RK: I'm still trying to figure that out myself. I am actually in Utah right now, and I flew commercial for the first time since it all started. The plane was clean and there were a lot of people there. The fundamental questions we're asking ourselves is, "Will we ever get back to normal travel mode?" I'm in the camp that says we will get back to normalcy, that people will look back and say we overreacted. We will be smarter about it – like how we adopted TSA after 9/11, we'll adopt a different travel pattern post-pandemic. But I'm not sure salespeople will ever be traveling at the pace they used to. So, that's a wild card.

"I think that, with the exception of travel, we will probably get back to a normal world. Interest rates are going to be low for a very long time. The Fed has said that. People are starting to really embrace the modern monetary theory, and it's scary that you can flood our world with money and there's no consequences for it."

I also think people will get back in the offices. JPMorgan's already said this doesn't work for them. I'm on the board for a privately held REIT, and they said their productivity simply stopped. I feel the same. We need to get our people back into the office to interact and make decisions together, and I'm tired of talking to people on the phone when they're walking their dogs.

So, I think that, with the exception of travel, we will probably get back to a normal world. Interest rates are going to be low for a very long time. The Fed has said that. People are starting to really embrace the modern monetary theory, and it's scary to old people like myself that you can flood our world with money and there's no consequences for it. But for the foreseeable future, I just don't see that changing. Credit still has a role in a portfolio, even more so for older and high net worth people because they need income. The losers in these type of worlds are always the people on pensions, because they need high deposit rates and high interest rates to survive.

G&D: Shifting gears a bit, do you have any specific investment ideas that you are excited about today?

RK: Well, given that I see travel returning to normalcy eventually, the travel space is still the opportunity, whether it's a Carnival

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Cruise or Delta secured bonds. I think the other one that's interesting is the idea that this is the end of energy, so maybe we're supposed to be looking for exits. That's one I struggle with because we're long energy, and it's a fundamental shift in our thinking. But we're all starting to really question whether energy is going to fundamentally change.

One bond that we like a lot is PG&E bonds, post-bankruptcy. We think their bonds are really cheap given that PG&E, as a utility, is a buyer of power generation, so the business is more about the distribution of the lines. Their current situation is due to a specific risk situation, rather than being tied to macro risks.

"The losers in this COVID world are not the high yield companies but the middle market companies who are struggling to get capital from regional banks, who don't have the risk tolerance to provide capital. As a result, specialty credit will continue to grow.

Regional gamers are still interesting. I would probably stay away from the Las Vegas, because that's going to be a much slower recovery as Vegas is predicated on jamming everybody in a building and feeding you drinks, which is something that will take some time to get back to in a post-pandemic world, if ever. Regional gamers tend to be a bit smaller and more niche, and people gamble in good times and bad times, so that business will continue to exist. Those are the ones that stand out. As I mentioned, high yield tends to have a lot of secular challenges, so sometimes it's a game of avoiding the losers.

G&D: You mentioned you think travel will return to normal levels of activity, specifically for cruises. How do you contrast this thinking that people will return to traveling the way that they did before versus people would be a little more cautious about going into a casino?

RK: That's a good point. My gaming comment is a relative one versus an absolute one. If you're going to own a gaming company, many of which are in the 80 cents on the dollar range, you probably should own a regional versus a Las Vegas. The travel comment is that people just like to get out. Following 9/11, people learned that there are safe ways to travel and not be concerned about a catastrophic event occurring.

G&D: Got it. Finally, Ray, you come from a business background as well. Are there any tips and advice that you have for current students that are trying to go into investing, and specifically high yield investing?

RK: The need for credit will increase in this world because the banks have pulled back and will continue to pull back. The losers in this COVID world are not the high yield companies but the middle market companies who are struggling to get capital from regional banks, who don't have the risk tolerance to provide capital. As a result, specialty credit will continue to grow. Also, as equity markets get increasingly rich and concentrated in terms of performance, people will look at ways to invest, and one of the ways to do that is through high yield and specialty credit funds. When we interview people for equity, we always ask, "Which equities do you buy? Which portfolios do you buy?" That's an unfair question to ask a high yield candidate because you can't really buy high yield bonds as a private investor. It's extremely difficult, especially in your 20s,

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unless you have a million dollars or more in assets, so you need to get under the wings of somebody else. Internships are key, even if it's through the platform of an insurance company.

"Summer's often a strange time for credit. It tends to be slower, so it's actually one of the worst times to learn the credit markets. You want to catch it in the fall because that tends to be where the volatility really picks up."

The other path that people should think about more is the world of distressed, which has gotten bigger and more involved. We work with a lot of folks from Evercore, Greenhill, Houlihan, AlixPartners, and I think those are great training grounds because you have to do a lot of models, you have to understand balance sheets, you see a lot of problems really fast. Once you do that, you can carry that over into investing. I think a lot of distressed funds tend to hire from those firms because they come with some incredible expertise. It's a grind, but that's probably one of the best ways to get expertise if you can't get your foot in the door on the investment management side. It's hard for us to train because we don't have the depth nor the time, and summer's often a strange time for credit. It tends to be slower, so it's actually one of the worst times to learn the credit markets. You want to catch it in the fall because that tends to be where the volatility really picks up.

G&D: That's great. One final question, and this is one we like to ask to just see a different side of investors. What are some things you like to do outside of investing?

RK: I have ownership in a real estate brokerage business that's actually the fifth largest Berkshire franchise. It's fun and different because you're working in a world that is more crude and making real-time decisions that impact businesses. I'm also on a board for a private family REIT. They have about a billion in assets, but they do industrial properties and they're one of California's land grant families.

I was on the governing body for USA Water Polo for a number of years, and I do a little bit with the UCLA business school. I've done career days with them, and I'm part of a credit pitch contest that they do every year. Then it comes down to interest of sports. My kids are now out of sports, but I had some very accomplished college athletes, so it was fun to travel all over the nation and internationally with them. Other than that, I work out a lot, and I have a house in Utah where I do a lot of outside activities, hiking, skiing, things like that. And I'm an intermediate piano player and I've been taking lessons for about seven years.

G&D: Thank you Ray, we really appreciate you taking the time to speak with us today.

RK: Thank you all and good luck.

Causeway Capital

Sarah Ketterer and Alessandro Valentini '06, CFA

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Ms. Ketterer is the chief executive officer at Causeway, fundamental portfolio manager, and is responsible for investment research across all sectors. Ms. Ketterer co-founded the firm in June 2001 and is a member of the operating committee.

From 1996 to 2001, Ms. Ketterer worked for the Hotchkis & Wiley division of Merrill Lynch Investment Managers (HW-MLIM). At HW-MLIM, she was a managing director and co-head of the firm's HW-MLIM International and Global Value team. From 1990 to 1996, Ms. Ketterer was a portfolio manager at Hotchkis & Wiley, where she founded the International Equity product.

Ms. Ketterer earned a BA in economics and political science from Stanford University and an MBA from the Tuck School, Dartmouth College. She is currently a member of the Stanford University Board of Trustees, co-chair of the Los Angeles World Affairs Council and Town Hall, a director of the Los Angeles Philharmonic, the Music Center Foundation (as chair of the investment committee), and serves on the Girls Who Invest President's Council.

Mr. Valentini is a director and fundamental portfolio manager at Causeway and is responsible for investment research in the global healthcare, financials, and materials sectors. He joined the firm in July 2006 and has been a portfolio manager since April 2013.

During the summer of 2005, Mr. Valentini worked as a research analyst at Thornburg Investment Management, where he conducted fundamental research for the International Value Fund and the Value Fund, focusing on the European telecommunication and Canadian oil sectors. From 2000 to 2004, Mr. Valentini worked as a financial analyst at Goldman Sachs in the European equities research-sales division in New York. Mr. Valentini earned an MBA from Columbia Business School, with honors, an MA in economics from Georgetown University and a BS, magna cum laude, from Georgetown University. Mr. Valentini was inducted into the Beta Gamma Sigma honors society, is a Phi Beta Kappa member, and is a CFA charterholder.

Graham & Doddsville (G&D): Can you start by telling us about your backgrounds and how you got into investing?

Sarah Ketterer (SK): I started out in investment banking, which, as you know, is trial by fire—and there is a lot of fire; I learned so much. I then started a database business which turned out to be cash flow negative, but I sold the data to an asset manager and joined them on the investing side. *[editor's note: Sarah joined Hotchkis and Wiley]*. I built the international equity business there using a value investing approach. This was in the early 90s, where the technological tools we have today did not exist.

Alessandro Valentini (AV): I did both my undergrad and master's in economics and was planning to pursue a PhD in economics, until I decided, "You know what? Let's do something that is not necessarily sitting in an office writing academic papers or looking purely at theory." So, I joined Goldman Sachs's equity sales and trading desk to experience a more hands-on approach. I ended up covering a lot of clients that were value investors, which to me yielded the most interesting conversations.

I had some clients who based decisions on momentum—I would provide to them daily EPS changes that Goldman made, and they would base their investment process on that. That was not interesting to me. But I spoke to really, really smart guys that were value investors. And it is from those conversation that my interest in value investing developed.

That led me to apply to Columbia Business School, the only business school I applied to. The intention was to join the Value Investing Program. After graduating from CBS, I joined Causeway in 2006. I am from Italy,

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so the international focus of Causeway made sense; that along with Causeway's value investing approach and location in Los Angeles checked all the boxes for me.

G&D: Were there any well-known investors or any specific mentors that really influenced how you view the investment world today?

AV: When I think of the Graham and Dodd approach, it's not just about value investing. To me it is the basis of fundamental investing. It is the discipline of looking at the assets of a company, looking at earnings capacity, and looking at equity valuation in terms that are understandable and driven by fundamentals. When I was just starting, this was especially important to me as I had less of a background in accounting, coming from a more theoretical economics background.

At Columbia, I was lucky to take classes with Professor Bruce Greenwald and Professor Greenblatt - those classes and investors really helped me understand what to look for when analyzing companies. One interesting piece of practical advice I received is that, when looking through a 10-K, you should start from the notes section and work your way backwards because most people do not look at the footnotes. These footnotes contain crucial details that help you understand what you own as an investor.

"...when looking through a 10-K, you should start from the notes section and work your way backwards because most people do not look at the footnotes. These footnotes contain crucial details that help you understand what you own as an investor."

SK: When I was starting in the industry in the 90s, value investing was the dominant and most popular investing style. This was true right up to the Global Financial Crisis, which did, in fact, change everything. Now we are the few left; it's very strange.

But we've gone through a period of massive monetary creation since 2009, and the pandemic today has only accelerated that—imagine having $5 trillion more of balance sheet assets for the Fed, ECB, Bank of Japan and Bank of China—that's just shocking.

The ramifications of that are going to affect *your* careers. It's hard for us to imagine that undervaluation is meaningless, that there's no cost to capital—that just doesn't make sense to me. But then again, I like having criteria that are timeless. If it turns out that investors don't think there's any cost of money, we have a real problem in value investing.

G&D: What are the principles behind the origin of Causeway, and what kind of value investing approach do you take?

SK: Harry Hartford and I founded Causeway in 2001. Our idea was to start with international value equity and create a firm that integrated both fundamental research and quantitative research. In 2001, nobody was doing this, and 20 years later, it's still very rare to see investors meld the two together. When we began in 2001, we'd see some supposed stock selection gurus put together a portfolio, but where was the risk management? Where was the multi-layered understanding of what sort of risks were in that portfolio?

That's why when we formed our firm, we started with three quantitative analysts on staff, which has since grown to eleven. What they did was to build a proprietary multi-factor risk model. That allowed us to understand, at a very granular level, where we're taking systematic risks. And then, as Alessandro noted, it's up to us as analysts to understand the idiosyncratic risks of companies and know those companies as well as

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any outsider can know them.

AV: The quant risk assessment is incredibly important. Most managers build a portfolio and then look at the risk. That's like finishing a dish and then checking if you've used the right amount of spices. You can add some at the end, but it's not going to be as good as if you tasted it while cooking it.

"The quant risk assessment is incredibly important. Most managers build a portfolio and then look at the risk. That's like finishing a dish and then checking if you've used the right amount of spices. You can add some at the end, but it's not going to be as good as if you tasted it while cooking it."

Thanks to our integrated quant side, risk is an integral part of our portfolio construction. It's done at inception and then reviewed on a continuous basis; we have regular meetings where we examine the risk characteristics of our portfolio and make sure we know where the risk is coming from.

We make our stock selections not just based on returns but based on risk-adjusted returns. As an example, in 2008 and 2009, during the crisis, some of the biggest absolute returns were in banks, but some of the biggest risk-adjusted returns were in high quality industrial companies.

You can add risk to a portfolio, in the form of volatility, if you get paid for it. And that's really the philosophy of how we build our portfolios and how we think about investments.

G&D: How do you define risk?

AV: The ultimate metric of risk is permanent loss of capital, which is not measurable. Volatility, while not ideal, is the best proxy.

When you look at individual securities over an extended period, there is a high correlation between volatility and possible permanent loss of capital. Until someone finds the perfect metric to quantify the risk of permanent loss of capital for any stock, volatility is the best proxy for risk. We will take on volatility if we get paid for it.

G&D: How do you approach portfolio construction? Given Causeway's value focus with a quant overlay, at what point does the quantitative approach come in during the idea generation process?

AV: The quantitative approach starts at the very beginning of the idea generation whereby the quant team runs screens. When we start with screens, we are not looking to disqualify companies (i.e. companies don't need to pass our screens to go on to the next stage). We look at screens because we know that metrics such as earnings yield, price-to-book, dividend yield have been helpful in terms of identifying ideas in the past. We have general screens for all industries. And then each industry group within Causeway does its own screens. For example, in our financial institutions group, we screen for implied cost of equity. We look at what the return on equity is, we make assumptions on growth and we calculate the implied cost of equity.

I'd estimate 40% or 50% of our ideas are generated through screens. The rest might be from reading news, talking to experts and managements. There have been numerous times when I've spoken to the management of a target company and ended up deciding to do work on their competitors as well.

After the quant team runs screens, the analysts do the fundamental work. We talk

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with the company, with third party research, and with the sell-side as well. We do in-depth diligence to form a differentiated opinion, which is the basis of a successful investment.

In parallel, the quant side starts scoring each company on how much risk that company has vis-a-vis the rest of the portfolio. The team also uses external data to validate our investment thesis (e.g. using credit card data to derive insights).

The quant team helps us with views on emerging markets. They've developed strong models to assess macro risk, which we use if we're looking at a company that is either in an emerging market or does business in an emerging market. For instance, if we look at BBVA, a bank headquartered in Spain, which does business in Mexico and Turkey, we use quant models to understand what the macro factors look like in those countries.

Next, we present the company to the entire team. We have heated discussions about the investment thesis and the assumptions that go into the price target. Usually we don't reach a conclusion during these initial meetings. We often need to do more work after the first presentation.

Our goal is to reach a price target that has been vetted by the entire team and ensure that everybody is comfortable with it. After that, we take that name and we put it into a ranked list of ~200 companies that we use as the menu to then form the portfolio.

At that point, the quantitative risk assessment and the fundamental work are examined together. We determine how many units of return per unit of risk we are getting from a company, vis-a-vis the rest of the portfolio and form a ranking which we then use to build a portfolio.

We believe this helps us with our sell-discipline too. The biggest problem for fundamental investors is when is it time to part with a stock that has worked well? You can always find a reason to hold on to a winner. For us, if it ranks well, we will put more capital to work. On the other hand, if something ranks less attractively, we take capital away and redeploy it elsewhere.

And this is a natural process—everybody buys into the process and everybody agrees. There is a natural replacement of less attractive ideas with more attractive ideas.

SK: The fundamental quant integration is really our secret sauce. You can't just take thousands of stocks, screen them and then know what to do. Let's just say in healthcare there might be 40 interesting stocks. Where do you start the research? How do you put them in order of priority?

"The quant side gives us an indication of incremental or marginal prospective volatility. The stock should add to the portfolio's risk adjusted return. "

That's where quant kicks in right away. The quant side gives us an indication of incremental or marginal prospective volatility. The stock should add to the portfolio's risk adjusted return. Granted, the quant view is theoretical and based on an eight-year estimation window where you must believe the past is a good indication of the future—but that's often the case, particularly with cyclical stocks where history has repeated itself.

Quant helps us just to get fundamentals oriented to the most efficacious stocks right away and they also help us understand the environmental, social and governance aspects of the companies we cover.

Fundamental investing cannot be effective without quant to supplement it. And as far as I'm concerned, quant without fundamental is just massive numbers and statistics without in-depth fundamental knowledge.

G&D: How do you think about ESG investing?

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SK: I don't believe ESG is a fad. I think it's here to stay. It may get renamed or reconstituted, but for as long as I've been managing money, governance has been critical. You can't believe in a company where management is going to implement a poison pill or some sort of awful dilutive effect—what's even worse is complacent management that are protected by layers of governance protection.

Governance is critically important and always has been. Quantitatively, we've been able to measure and score environmental and social impact. We have specific questions that we ask companies to score them and we are improving our ability to interpret the output scores to generate alpha.

At some point, every company will be reporting ESG metrics, and there will be a standard measurement for their carbon output. We'll know, and we'll be able to compare it. And efforts are moving very quickly along this. Companies feel a tremendous amount of pressure. They've never been more transparent on ESG.

Companies will be able to know the ESG metrics of their suppliers and their customers and we will have a much better sense of how these companies rank. We don't think of this as a screening tool; it's not an exclusionary tool. But rather, it's a way for us to say, "Here's another risk factor. Do we have enough return to compensate our clients for it? And/or is there something we can engage with the company on to make it even better?"

Volkswagen is a great example. At the end of 2015, they had the biggest scandal in the whole automotive industry and were poisoning the planet with diesel emissions that they fraudulently withheld. So why would anybody want to be anywhere near a company like that?

"We view ESG as another risk factor. Do we have enough return to compensate our clients for it? And/or is there something we can engage with the company on to make it even better?"

They're based in Europe which is at the forefront of green policies. We think the company is going to be the world's leader in electric vehicles and they'll have the cleanest fleet in the next decade. And that's in part since they're bending to a huge amount of pressure that came from shareholder engagement. And we were right there at the forefront.

There's so much that institutional investors can do to bring about the outcome we want in ESG and make it coincide with alpha. That's critical. It's not just a moral principle. It's returns in excess of benchmark that matter.

G&D: In situations where a fundamental analyst strongly believes a stock still has further upside, but the quant risk assessment says otherwise, how do you reconcile that kind of dynamic?

AV: That's the art of portfolio management. It's not necessarily the case that if something ranks as number 24 that it needs to be the 24th largest position in the portfolio. We have meetings three times a week now assessing whether a company belongs in the portfolio, or whether there are more attractive ideas to redeploy capital to.

When we have discussions to exit a position, sometimes the decision is not to do it immediately. We look at issues such as: what does momentum of analyst revisions look like? It's probably less attractive to sell a company that is not ranking well where you're seeing earnings estimates or expectations move up versus a company that is not ranking well and you're seeing expectations move down.

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We are very strict in terms of adhering to a discipline. And discipline only works if you apply it consistently.

G&D: How does the quant overlay play into industry selection? Value tends to be more concentrated in more cyclical industries that may be correlated when there's a downturn. How do you think about that?

AV: We are really industry agnostic in that sense. We don't build a portfolio saying, "Industrials look cheap. Let's find some ideas in industrials and allocate capital to that area. "

Our process is bottom-up driven and that's why the quant team is so important. We think about the marginal risk. We ask questions such as: "If I take the n+1 bank that I want to put into the portfolio, what does that do to the risk on a marginal basis? How much does that increase the risk?" Adding another security to an industry might increase concentration. In order to justify that increase, we require a higher expected return.

And that's really what the quant team and that marginal contribution to the risk approach really helps us with. If you have too much concentration in a sector that is cheap, is that still the best opportunity on a bottom-up basis?

You are right that the quant overlay helps us with industry selection. But it does not tell us we should have higher exposure to a particular industry. It helps us establish whether the returns justify the additional level of risk.

"The quant overlay helps us with industry selection. But it does not tell us we should have higher exposure to a particular industry. It helps us establish whether the returns justify the additional level of risk."

G&D: When you do concentrate in certain sectors like European banks, there's obviously a big macro component there as well. Does that go with more of the fundamental analysis? How big a role does that play?

AV: The macro is the micro for banks. You're asking about interest rates. It could be a macro decision, but it's a micro input in terms of our financial modelling. For some of these industries, the top down macro view blends with the bottom-up approach. But that's why our internal meetings discussing investment ideas are so crucial, because we don't have an in-house economist.

We go to these meetings and we lay out the assumptions and we are conservative. In our banks models, we don't have rates going up. It would be very easy to make a buy case for a bank stock saying rates normalize in two years, but we don't need that in order to own what we own. If I go into a meeting pitching a bank arguing that interest rates will increase next year, I'm going to get a lot of pushback.

So that's why it's so important to have those meetings because you bring in everybody's opinion. You can really vet your assumptions. You need to vet what your assumptions are and justify them. If people disagree, you need to defend the assumptions. If your argument is not strong enough, you need to change your assumptions. And that is the kind of back and forth discussion which determines the right price target for a security.

G&D: We'd love to hear your general thoughts on the market, on value investing and any parallels you see between today's market environment vs. other points in your career.

AV: This is not about value versus growth anymore. It has become about whether fundamental investing works

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anymore. Value, by definition, is fundamental investing. You look at a security, you look at a company, you do the work, you draw your best conclusion on what you think the fair value is and you determine your margin of safety. In our case, you also look what's your margin of risk, and then you make the decision whether to invest or not.

In the current environment, you cannot just focus on arithmetically cheap companies. Just because a company trades at four times earnings, it does not imply it is necessarily undervalued.

You need to go beyond that. And that's the greatest evolution in terms of value investing. And that's why real value investors focus on the differentiation in the investment thesis. What am I seeing that other people are not seeing? How can I confirm that?

Some people think that value investing is just screening for everything that trades at a low P/E and then building an investment thesis around that valuation. Value investing is not just about low P/E; it's looking at the margin of safety.

Personally, the way I think about value, it's two buckets. You have cyclical value and you have restructuring value.

Cyclical value is a company that is well managed, well positioned in its industry, and is a good capital allocator but is cyclical. It's going through an environment where earnings are coming down, whether it's because everybody's staying at home, because nobody takes a flight anymore, or because nobody orders food from the cafeteria for a meeting. Whatever it is, earnings are under pressure. They have the right business model, they have the right balance sheet, and eventually earnings should go up, and the multiple should go up. 2008 and 2009 was a great period to find companies like that.

In the other bucket you have restructuring value, which is companies that are almost in the opposite position. A lot of the banks after the crisis were in that position. They weren't doing the right thing. They were focusing on the wrong returns. They needed to change themselves fundamentally. You most often need a change in management in order to have a change in strategy—and that's where we get really interested. I've seen countless companies that come through the screens that look cheap, but where nothing changes week after week for two years. Those companies qualify as value traps. But when real change does happen, they can become strong investments.

An example of this is UniCredit in Italy. A few years ago, a new management came on board who identified that non-performing loans on the balance sheet were weighing down the performance of the bank. They made the decision to raise capital and sell those loans after writing them down. They restructured the capitalization—the risk was lowered, cost of equity came down, ROE went up, and so the multiple came up. We find restructuring value in every sector, including healthcare, telecom, and technology.

"In the current environment, you cannot just focus on arithmetically cheap companies. Just because a company trades at four times earnings, it does not imply it is necessarily undervalued."

In 2008 and 2009, the cyclical bucket was full. As we went through the cycle, more and more of those cyclical stocks rerated and came out of the bucket. So that bucket grew lighter. The restructuring bucket, on the other end, grew fuller. Fast forward to this year and the pandemic, now

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both buckets are full. That's so exciting for value investors.

One of the biggest challenges we are facing is to find the capital to allocate to all the ideas that we have.

G&D: On your website earlier this year Causeway published an article about buying high-quality cyclicals during a downturn. How do you make sure that you're buying a business that will emerge stronger with more market share and better positioning?

AV: If you want to put it down to metrics, that entails a strong balance sheet and high ROIC in terms of the capital allocation. By "quality," we mean companies that are good allocators of capital, have strong balance sheets, can weather the pandemic and a market downturn and survive.

You can have the best business, but if you're overleveraged, then you are not in a good position when you get into an environment like this. Companies need to have a strong balance sheet which is often the consequence of good capital allocation. When we talk about governance with companies, we talk about capital allocation very often.

In addition, you need companies that have good management. That goes back to capital allocation, because in the current environment, if you have a great balance sheet, you need to be able to capitalize on opportunities such as M&A.

SK: You know high quality when you see it, because getting to know management is important. That's one of the reasons why it takes years, we believe, for someone to move from being an analyst to becoming a portfolio manager. You just can't get to know that many management teams that quickly, and AI cannot help you.

When it comes to the rapport we have with management and understanding whatever sort of verbal and nonverbal cues they're giving us, there's no substitute for just the time and meeting after meeting, after meeting.

We are running natural language processing to analyze transcripts to look for changes in sentiment, but that's all at the margin. What really matters, for example, is how Alessandro has gotten to know the management team of one of Japan's largest pharmaceutical companies.

What really matters is meeting after meeting trying to push management to prove the trajectory of profitability and cashflow. And I don't know how that will ever change.

G&D: Do you think that there is a confusion in the market about what's cyclical versus what's secular?

AV: Absolutely, those are great opportunities for us when the market thinks something is secular and it becomes cyclical. But the greatest danger lies in the opposite situation, when something that we think is cyclical instead turns out to be secular.

It's all about examining competitive advantages. High returns, high sustainable margins, high barriers to entry. If you see more competitors entering the market, see if the company can hold its competitive advantage: see whether the company is forced to change the way they do business and see if returns come down, or if margins come down.

For financial institutions, it's very important and it's something you need to analyze case by case. Fintech is an enormous disruptor. And we need to, both on the insurance and on the bank side, be very attentive in terms of figuring out what the opportunity is and what the risk is.

You think about banks and disintermediation. What has happened so far in fintech is mostly around payments. Nobody wants to get a big balance sheet that is going to be regulated — you want

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to be capital light.

So yes—you have a lot of competition there. But the regulation to some degree is on your side and disruption is also what creates the best opportunity. Also, sometimes what you think is a disruptor is just part of the cycle and you need to take advantage of that to reap returns for your clients.

"What really matters is meeting after meeting trying to push management to prove the trajectory of profitability and cashflow. And I don't know how that will ever change."

G&D: On the Causeway website recently, you posted an article on aerospace. Are there particular pieces of the aerospace value chain that you think are especially interesting?

AV: We talk about this pandemic as the GFC for airlines. But it's not just airlines. It's clearly been an extremely difficult time for any company involved in travel.

The biggest problem right now is the uncertainty. When are things going to normalize? This holds true for the entire industry including airlines, manufacturers as well as tech companies (e.g. Amadeus, Sabre).

We don't know when things are going to normalize. What we do know is that some things haven't changed despite the pandemic. People still want to travel and go on vacation. We've seen it in the airline data in Europe, in China, and even in the US as things have improved. We find the most compelling opportunities in leisure travel.

So how do you make sure that when things return to normalization you can take advantage of that, but if things take longer, are your stocks going to be able to survive? You look at the balance sheet, which goes back to the point about quality we touched on before.

And that's why the work that we do in terms of those opportunities, whether it's in the aerospace manufacturing side (e.g. Airbus, Rolls Royce), or the airlines side (e.g. Alaska, Air Canada) we want to make sure that they have a balance sheet that is strong enough that they can survive. That doesn't necessarily mean they won't need to raise equity, but we want to ensure that if everything is delayed for longer, they can survive off their balance sheet and take advantage of that.

G&D: During a period where value as a style is kind of struggling, how do you manage that process emotionally and psychologically? And how do you continue to have conviction when stuff goes against you?

AV: Personally, I get very excited in periods like this. You need to be a contrarian. The most dangerous time in your career is when everything feels good, when your ideas all seem to be performing.

With our process of ranking risk-adjusted returns, if something is not ranking attractively, you need to take it off. That helps with our process psychologically because it really gives you objective parameters. If you do the right fundamental work and the ranking is attractive, it gives you a lot of support in terms of deploying more capital.

G&D: What are a couple of investment ideas that you're excited about?

AV: I'm going to go into my wheelhouse and talk about financials, the much-maligned European banks. Some investors believe the business model is broken. We disagree - look at now versus the GFC. Back then, banks had high expected returns, but they were very

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high-risk opportunities.

Now you have high potential returns, but significantly lower risk. And why is that? Look at the capital levels. The common theme is capital levels are multiples of what they were during the GFC.

In addition to that, you have significantly less risky balance sheets. Balance sheets haven't grown dramatically, and regulatory changes have forced them to focus on lower risk businesses.

That's why UniCredit is such an interesting opportunity right now. A bloated balance sheet, full of mispriced assets, led to lower returns and higher cost of equity for the bank. Now they have gone through a painful restructuring, raising capital and writing down assets. Management also focused on improving the corporate governance and resizing the cost base. And importantly they bought shares in the company, aligning their interests with those of shareholders.

What you have now is a bank operating in a tough market, but with more attractive returns and lower cost of equity. They have a less risky balance sheet, three times the capital that they had before, and a better mix of business between fees and interest income.

And on a price to book basis, it trades lower than it did during the GFC.

Then on the insurance side, where we're seeing opportunity is in stocks like AXA in France. They went through the XL Group acquisition, where they clearly overpaid. Now for the first time in 15 years we are seeing a property and casualty market where prices are increasing.

Prices are increasing in the 20% range in the US and in the mid-teens elsewhere. This more than makes up for any COVID related and catastrophe losses.

One more idea I'd call out is Rolls Royce, which has been an underperformer this year. They are leaders in what is a duopoly in engine manufacturing. The business model is simple: as a new airplane hits the market, the company designs and manufactures the engines which is a big drag on cash. Then they sell and install the engine while charging maintenance fees, and cash comes pouring through the door.

Going into the pandemic, there were a few issues with the Trent 1000 engine they were installing, which delayed their cash flow. That made this a very attractive opportunity for us. And with the pandemic, orders for plane parts just dried up - the business has slowed down significantly.

As demand for airplane engines returns, cash flow should return for Rolls Royce—and that's what's so attractive about that business. Right now, you're seeing a market valuation implying the end markets will not recover - that really doesn't make sense for us.

G&D: For Rolls Royce, do you think the rights issue removes some of the left tail risk of bankruptcy? What do you think of a business like that if they were performing well post-COVID?

AV: Earnings are almost irrelevant for Rolls Royce—cash has really been the focus historically.
For the rights issue, you can never say anything puts all concerns to bed, but, if successful, that could reduce the risk in terms of this interim period until flights start to come back. Management could've managed the balance sheet better. But clearly, they recognize the shortcomings, and they need to act on it.

G&D: What's the reason that you prefer the European banks over US based ones? Is it more valuation based?

AV: We own both European and US banks in our portfolios. The US provides a blueprint on what we believe is going to happen longer term to the European banks. They spent sever-

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al years raising capital or accumulating capital for regulatory purposes. We're getting towards the end of that.

In Europe, regulators right now are saying that capital levels are sufficient. What's going to happen to all that capital that is being generated now? We've seen what's happened in the US—it's been returned to shareholders. And there's massive amounts of excess capital as we come out of this crisis.

During the pandemic, regulators in Europe have requested the banks to conserve capital by not paying dividends because of the uncertainty. When the situation improves, the situation should reverse.

We still think some US banks are attractive opportunities, especially the money center banks and some of the larger regional banks. It's a very similar theme: better banks with more capital and a lower cost of equity than two of the previous cycles.

G&D: Are there any examples of situations where a company was in trouble and new management came in and turned it around? And then on the contrary, any situations where new management came you thought, and it turned out badly?

AV: Sarah mentioned Volkswagen. After the Dieselgate scandal, all the old management was gone. And it was necessary for them to move on from that crisis. And new management set up very clear expectations, improved the top line, improved the margins, and repositioned the company as a leader in the EV space.

"Passion for investing is extremely important...If you have passion, you will see those down days as opportunities. If you don't have passion, the best understanding of accounting and being the greatest financial modeler will not help you."

Peugeot is another example of a restructuring that worked very well under a new management. New management drove aggressive cost controls. They delivered on the targets and the company became stronger.

AstraZeneca within pharmaceuticals also comes to mind. This was a company that had almost no pipeline. New management came on board and revitalized the R&D effort. The company went from being one of the cheapest less loved companies in the industry to what is now recognized as an innovator.

Usually, when it doesn't work is when new management doesn't understand the business, or when they cannot communicate the path correctly. It can be a matter of not understanding how deep the issues are. But sometimes new management comes in, and the issues are just too deep. That's why it's so important for us to talk to management. The managements that really know the business are the ones who are successful. If we have these conversations and management seems to be out of touch, or if they're still learning after a very long period, we see that as a red flag.

G&D: What would be the advice you have for students at Columbia who are interested in pursuing a career in investing?

AV: Passion for investing is extremely important. You're going to have days when you look at the screens and the market is telling you the opposite of everything you think is true about the companies you own. And it's very easy to get down on those days.

If you have passion, you will see those down days as opportunities. If you don't have passion, the best un-

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Causeway Capital

derstanding of accounting and being the greatest financial modeler will not help you.

G&D: How you spend your time kind of outside work?

AV: I have two wonderful kids. My son is three and my daughter is seven. She's passionate about soccer. I'm very active in the local American Youth Soccer Organization (AYSO) as one of the volunteer coaches. I've been doing this for three years. Even in a year like this, during the pandemic, we've managed to put together a season in a very safe socially distanced way. We're starting this week and I'm very excited.

So, a lot of my time is just spent training and coaching her team. I have been a long-time fan of soccer, but a very marginal player in the past—hopefully, a better coach. But coaching kids, seeing them develop and get passionate, is an enormous reward.

G&D: That's awesome. Were you on the Columbia soccer team when you were in business school at all?

AV: Like I mentioned, I was and still am marginal as a player. I think I'm a better coach than I'm a player. Hopefully, that's what my daughter would say too.

G&D: How about as a fan, who was your team?

AV: I'm a Juventus fan. It's been crushing to never make it very far in the Champions League lately. But they have done well in the Serie A, especially with Ronaldo joining the team recently.

G&D: Thank you for taking the time to speak with us.

Lyrical Asset Management

John Mullins & Dan Kaskawits '11

Prior to joining Lyrical, John worked at Elm Ridge Management, Orbis Investment Management, and Clearfield Capital. John graduated from Yale University, cum laude with distinction, and received his MBA from Stanford Business School.

Prior to joining Lyrical, Dan worked at Elm Ridge Management. Dan graduated from Tulane University and received his MBA from Columbia Business School. While at Columbia, he was an editor of Graham & Doddsville.

Editor's Note: This interview took place on September 16th, 2020.

Graham & Doddsville (G&D): How did you get started in investing?

Dan Kaskawits (DK): I went to Tulane University, where I took an equity research class taught by Peter Ricchiuti. I really enjoyed the experience but I didn't have any relevant internships or connections to the industry, so I ended up working with a couple of financial advisors at Citigroup making cold calls. It definitely wasn't the ideal job but as my friend's father said, "It's a lot easier to get the job you want if you have the job you don't want." He was right - after five months I was able to transfer to Citigroup's equity research department, where I worked with Tobias Levkovich, the chief U.S. equity strategist for about five years. That was an incredible seat because most of our clients were portfolio managers or chief investment officers, so I got a lot of exposure to leading thinkers in the industry at a young age. After that I went to Columbia Business School for the Value Investing Program, where I was an editor of this newsletter!

G&D: What about you, John?

John Mullins (JM): I graduated from Yale and went to work for Steve Shenfeld and Phil Sivin at MD Sass in New York, seeding funds. It was a great intro to investing; we looked at everything from your classic long/short hedge fund to clean energy VC funds to a fund for investing in wine futures. After MD Sass, I went to Stanford Business School, then joined Adam Karr at Orbis Investment Management, a concentrated, long-only firm. Adam is one of the great contrarian investors, and Orbis has a performance-driven culture; on day one as an analyst, you're given a paper portfolio, so if you have a view on a stock and the PM doesn't agree with you, you can still go and put that to work and have that be meaningful. Early on I was able to get a feedback loop to see where my alpha came from, and I learned a lot about the power of investing in good businesses when they're out of favor.

G&D: Where did you two first work together?

DK: John and I met at Elm Ridge Management, a hedge fund run by Ron Gutfleish, who worked with Rich Pzena at Sanford Bernstein in the 1980's. The CIO of Lyrical, Andrew Wellington, was Rich's first analyst when Rich started his own firm, Pzena Investment Management, so John and I actually come from a very similar background as Andrew. Ron's good at boiling problems down very quickly and figuring out what drives a business. It was the perfect place to get in lots of reps as I dug in on hundreds of businesses.

G&D: So, how did you end up at Lyrical?

JM: When we were at Elm Ridge, we both read an interview of Andrew Wellington in Graham and Doddsville. For me, it was a light bulb going off. Andrew had come out of this same kind of a background in structured deep-value investing based on five-year forward earnings. But what Andrew realized over time is that he could improve his returns and improve his hit rate if he avoided investing in lower quality businesses and more complex situations. I was coming to the same conclusion in my philosophy. I reached out to Andrew on LinkedIn and said, "You don't know

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me, but I'm pretty sure we think about the world in the same way, and we should meet." When Andrew and I first sat down and chatted, it was an amazing experience because we were speaking the same language. We didn't have the same view on every stock, but we had the same view on how to evaluate every stock. It was extraordinary to find the perfect home after honing my investment philosophy all those years. I joined Lyrical and I was there for about a year before I reached out to Dan to bring him onboard.

DK: I learned a lot about Lyrical through John's interview process because I served as a reference for him. I had also read that same interview John mentioned, and I was really impressed with Lyrical's approach. One of the things I learned as an analyst is that, with lower quality businesses you're more likely to get the forecast wrong. It's just harder to get right. And by adding that quality bar, it made a lot of sense, and it was a place that I was also coming to individually in terms of my own philosophy.

G&D: Let's talk about the investment process at Lyrical.

JM: At Lyrical we run a structured deep value investing process. We start with the cheapest stocks in the market, but then we filter for quality and what we call analyzability, which we think dramatically improves our hit rate, returns, and our ability to sleep soundly at night. Lyrical has been running the exact same process since its founding in 2008, and it's the same process Dan and I implement in international markets.

"We are typically looking to buy stocks in the cheapest 20% of our universe based on five-year forward earnings. The cheapest quintile is the best pond to fish in … buried in the junk are some very good companies, the gems."

G&D: G&D: Could you talk more about those three investing criteria – value, quality, and analyzability?

JM: Sure. It all starts with value, which is the fuel for our returns. We want to own companies with the biggest discounts to our estimate of intrinsic value, because the deeper the discount, the greater the return. We are typically looking to buy stocks in the cheapest 20% of our universe based on five-year forward earnings. The cheapest quintile is the best pond to fish in, because that segment of the market has significantly outperformed historically. However, many companies in this group are junk - low quality businesses that likely deserve their low multiples. But buried in the junk are some very good companies, the gems. So when we go through our screen, looking at the cheapest stocks, we are seeking the gems hiding within the junk.

G&D: How do you define a gem?

JM: A gem to us, simply, is a good business. While no single measure is perfect, we use return on invested capital as our primary measure of business quality. We don't want to touch any business that cannot sustain at least a 10% ROIC, and we prefer to see at least a 15% ROIC. It is more about avoiding the bad, than seeking the great. To earn a good ROIC, these businesses must have a durable competitive moat. And having a durable moat means that a business is more resilient in the face of economic and competitive threats, can grow more quickly, and is a lot more predictable. Because of our focus on quality, there are some classic value industries we avoid like

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airlines, deep cyclicals, or pure commodities. As I mentioned, good businesses are more predictable, and that gets to our final requirement, which we call analyzability. This is about keeping it simple. We believe the value of anything is the present value of its future cash flows. If we can't reasonably estimate the future cash flows of a business, we can't reasonably estimate what it is worth, or whether it's cheap or expensive. Now, valuation does give us a margin of safety to be wrong to some degree, but we still must be in the right ballpark for the investment to be a success.

As with quality, our focus on analyzability removes many industries from consideration: no banks, no pharma or biotech, no disrupted businesses like traditional brick-and-mortar retailor legacy media. Anything that is being disrupted is just not analyzable. We can put numbers in a spreadsheet and build a model and calculate an EPS, but in the end, we know the chance is slim of that model being right.

G&D: Could you dive a little deeper on the analyzability criteria? For example, on banks, is that rule ever breakable? And how do you think about portfolio construction when you are limiting yourselves to certain sectors?

JM: Think about a financial model. We're valuing everything that we own on its five-year earnings power. We need to have a reasonable estimate of revenues, margins, and capital allocation for the next five years. Many businesses have visibility allowing a model like that, many don't. With a bank, we could build a model, but the one thing I'd know about it is that it would be wrong. The interest rate matters as much to earnings as any bottom-up work, and credit risk is a huge variable that is very difficult to get right.

"We went through the cheapest 300 names or so independently and came up with a list of about 75 stocks each ... We had overlap of about 80% of the names on our respective lists. And the reason for that is that we have such a strict definition of what we're looking for in value, quality and analyzability."

DK: We're not trying to find every great investment. There are 1,500 companies in our universe. We're trying to fill a portfolio of 25 to 40 names that are going to give us a high chance of success. And there's still a significant number of industries and stocks to choose from within our framework and achieve that objective.

When John and I started the international equity business we did an interesting exercise. We went through the cheapest 300 names or so independently and came up with a list of about 75 stocks each that we thought were reasonable candidates to do a real deeper dive on. We had overlap of about 80% of the names on our respective lists. And the reason for that is that we have such a strict definition of what we're looking for in value, quality and analyzability. With that short list, we started the much deeper fundamental work.

G&D: Can you talk about an investment that made it through your screen, but didn't work out, and whether that led you to refine your process?

JM: Late last year, we sold Pirelli, the Italian tire maker. Pirelli had great returns on capital and strong growth over a very long period. They dominate a niche of premium and super-premium tires where brand is important and where operating margins

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are very good at 20%+. 75% of demand is for replacement tires, making the business a lot less cyclical than many believe.

G&D: We've heard people pitch the bear case – that lower quality tire makers were going to move up the value chain.

JM: Agreed. That was something that we were tracking closely. At first, Pirelli seemed unaffected by the trend and continued to show its strength at the high-end, even as over time Korean players like Hankook and Kumho won some pretty good OEM placements. But then we saw the increased competition begin to impact their business.

DK: On their 3Q2019 earnings call, Pirelli highlighted pricin g pressure in their premium value-add tires, which had previously been immune. We saw this as evidence that their competitive moat was diminishing. With the new information, we acted very quickly and sold the stock.

G&D: On the flip side, can you give an example of a successful investment?

JM: We bought Itochu in June of 2019 with the launch of the fund, paying just below 6x earnings. Today the shares trade at 9x earnings, so still quite cheap despite a good return for us. Our Itochu investment is a good indication of the value you can find as an outsider looking into a market like Japan.

Itochu is one of the major trading companies in Japan, which originally served to import raw materials into Japan when its economy opened up in the 1800's. Over time, these trading companies typically went more vertical within the products they imported. Companies like Mitsubishi and Mitsui imported metals, so they decided to move upstream into mining – which tend to be low-quality businesses. That's why a typical local investor in Japan sees the trading companies as volatile and driven by raw material prices. Itochu gets lumped in with this group, but it's fundamentally different.

When you look at it from a bottom-up perspective, you see a company growing its earnings at 10% annually for 15 years while generating low-teens returns on equity. The question for us is always: why? Well, the history of Itochu is that they were originally importing food and textiles. So, when they went more vertical they got into branded food and bought the Dole brand. When they went downstream in food, they got into convenience retailing and operate FamilyMart, which is the number two C-store operator in Japan behind 7-11 and is a fantastic capital-light franchise business. Because of their textile history, they moved into brand ownership and now receive high-margin license streams for brands like Converse in Japan.

This is a collection of great assets, and they've got great cash-focused capital allocation at the helm. In fact, in many ways their capital allocation reminds us of Warren Buffett, who announced purchasing shares in Itochu in August of this year.

G&D: Sony has been a big winner for you as well. What was the thesis there?

JM: If I may, let me insert a quick legal disclaimer here: all of our recommendations – the winners and the losers - are available upon request to ir@lyricalpartners.com, and there's no assurance we'll continue to hold positions mentioned in this interview.

For us, Sony was an opportunity to buy one of the greatest entertainment businesses in the world at around 10x earnings, ex-cash. They are #1 in video games globally, #2 in music rights, and #3 in TV and film production. The low valuation came from several misunderstandi ngs. One was the miscon-

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ception that their gaming business is still a cyclical, hardware-driven console business. We think it's now a recurring, software-driven platform business with strong network effects. Sony has by far the largest network of monthly gamers and the best exclusive gaming content, with about 15-20% of PS4 game sales coming from Sony studios. People want to play on the network with the most available players and the best content. People are worried Google Stadia will win away players from Sony, but we don't think that's the case. Even if Google can let you stream games with the right latency, they can't give you the best games or the most players. Beyond gaming, of course, you have the music label business with Columbia Records, which is an exceptional business.

"Our view is that, if a business is compounding its earnings at a healthy rate, the multiple is going to converge to what is justified by the fundamentals."

G&D: It sounds like there there's a collection of different businesses in there that you thought were potentially hidden assets or undervalued. Do you invest with a catalyst in mind for the value realization in that business or do you just assume that over time as the music business or the gaming business performs then people will recognize the value?

JM: We don't invest with catalysts in mind, and I think our greatest competitive advantage is that we invest with a truly long-term time horizon. In our U.S. portfolios, we've held stocks on average for seven years. We have no problem buying great businesses at cheap prices and holding them for as long as it takes. Our best investments have been ones where there's not some extreme controversy, it's just that there might be no catalyst. One reason Sony was so cheap was that it's a conglomerate and people didn't see a path to value realization.

Our view is that, if a business is compounding its earnings at a healthy rate, the multiple is going to converge to what is justified by the fundamentals. But if not, what's important is that we buy compounders. Let's say that Sony traded at 10x P/E forever. As long as they're growing their earnings at a double-digit rate, they're going to generate an attractive double-digit return. We don't buy value stocks where the earnings are flat, and we're hoping for a re-rating - that's when you really need a catalyst.

DK: Japan's been a fruitful area for us. As value investors, we all read about Warren Buffet and Ben Graham back in the day being able to find those stocks that are trading for less than either the cash or the realizable value on the balance sheet. You rarely, if ever, find those today in the U.S. market. But in Japan it's been exciting because we have found a handful of these. And we haven't just found these cigar butts that are terrible businesses where you might squeak out a 10 or 20% return. As John mentioned, we've found these Japanese businesses that have these amazing balance sheets with net cash positions but they're also high-quality businesses.

G&D: Let's talk about one.

DK: In the cheapest quintile in Japan, you find a lot of engineering and construction stocks, but many of these are not the type of businesses that we want to own. They're very cyclical, with large projects that often come with a lot of losses. The industry is ripe for adverse selection – the way you win contracts is through an auction by offering the lowest bid. And the lowest bid might just mean that you estimated the costs wrong.

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Nippo is an asphalt and road manufacturing business but, according to standard industry classification, it shows up in the engineering and construction industry. But Nippo is not your typical E&C business – it's a small project business that generates consistently strong returns on capital. It's a good industry because it's a local business, and the market is consolidated. You can't ship asphalt very far because it's heavy and you must keep it hot. What that means is there's not a lot of competition. And the largest three companies in Japan control over 50% of the market, with Nippo being the largest player.

Nippo has generated 13% annualized earnings growth over the past 15 years, but what's really exciting is the valuation. Nippo trades for 11.5x forward earnings today but adjusting for the net cash and investments on the balance sheet, it's under 5x earnings. And on top of that they have valuable real estate in Tokyo that's worth about 30% of the market cap. So we're getting a business that should compound its earnings for effectively less than 2x earnings.

JM: Nippo is a great example of analyzability. When you think about modeling Nippo, it's very simple. Their margins are consistent because of these dominant local positions. On the topline, it's stable growth. Road paving is non-discretionary; you can't leave big potholes on the road, at least not in Japan. There are three entities that build roads in Japan. There's the federal government, local governments, and then five private toll roads companies. They all put out five-year budgets. You build an industry model and see that the revenues in this business are going to grow at a mid-single digit rate for the next five years. It's not hard to imagine what the revenue and margin for this business will be in five years.

DK: We went through each of the cheap E&C stocks one-by-one, but when we dug into Nippo we were quickly able to see the attractive characteristics of the business. And this ties back to what I mentioned earlier about repetitions and developing mental models. That local market density is a mental model that you pick up on quickly when you see it.

G&D: Are there certain sectors or industries that tend to be more concentrated in your hunting ground?

DK: Yes, the cheapest part of the market internationally is full of banks and cyclical industrial businesses, and we don't own any of them. The cheapest quintile and the EAFE value index have a 34% and 29% exposure to Financials, respectively. We have a more modest 24% exposure to Financials, but we don't own a single bank.

Instead we own companies that provide services that are financial. For example, we own a Canadian company called Element Fleet Management. This is the largest commercial fleet management business in North America, providing the mission-critical service of leasing, managing, and maintaining customer fleets for a blue-chip customer base (including Amazon and their rapidly growing fleet of vans). As more and more customers outsource this service, Element should steadily grow at a mid-single-digit topline rate, while taking very limited risk as the company holds no residual value risk in its vehicles. In the Financial Crisis, credit losses were 10bps of receivables. The ROE is 13%, and we bought the stock at 8x 2021 EPS. This is a secular grower with extremely low credit risk and clear competitive advantages from scale.

A key part of our process is sifting through these industries until we come across a name, like Element, for example, that is a high-quality name trading at levels near many other lower-quality financial stocks. It takes a lot of work to find the easy

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investments.

G&D: Can you talk about your experience transitioning to investing in international markets? Do macro factors in the various countries you are investing in play into your analysis?

"When you think about why these businesses perform so well, I think it's been driven by having a long-term focus and the right incentives … These owner-operators are focused on generating wealth for themselves for the long term. Aligning ourselves with these types of CEO's fits well into our long-term approach."

DK: We weren't international investors prior to running this fund, but we were international business analysts. The revenue of our U.S. stocks that are sourced from outside the U.S. is 40%. So we have a lot of experience studying businesses overseas. Because of our analyzability focus, we strictly avoid businesses that are too reliant on local market dynamics or local market politics. What we end up owning are businesses that tend to be more global in nature. For example, we do own one Italian business, Exor, that generates less than five percent of its profits from Italy. Is it really an Italian business? Or CK Hutchison, a Hong Kong business that generates more than 98% of its profits outside its home country.

G&D: Did anything strike you as different in terms of the opportunity set in international markets?

JM: As we transitioned to international markets, one interesting thing we found was a lot of cheap owner-operator businesses. They exist in the U.S. but they're not typically cheap. As we were combing through our universe and saw these companies, we wondered if they were a fertile hunting ground for us: are we fishing in the right pond? So we looked at busi nesses where the chairman or CEO owns at least five percent of the company or a family owns at least 20%. If you go back and look over 20 years, those businesses have outperformed the MSCI World Index by more than 1,000 basis points annually. When you think about why these businesses perform so well, I think it's been driven by having a long-term focus and the right incentives. These companies are not focused on quarterly results, they are not even focused on annual results. These owner-operators are focused on generating wealth for themselves for the long term. Aligning ourselves with these types of CEO's fits well into our long-term approach.

A good example of that is a company that trades in France called Bollore, which is a holding company controlled by Vincent Bollore and his family. The stock trades for 6x our estimate of 2021 earnings, despite being a collection of two very good businesses. Half the earnings come from Bollore's 27% stake in Vivendi, which controls Universal Music Group, the number one music label in the world. UMG owns the rights to 8 of the top 10 artists of all time. Every time you listen to a Jay-Z song on Spotify, UMG earns a high-margin royalty stream. They're in the business of monetizing iconic content, and other people like Spotify do the work for them. Ten years ago, people didn't think this was such a high-quality business because we weren't paying for music, but Spotify and streamers have changed that and over the last five years we've seen the operating profit in that business more than double and

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there's a long runway to go. The third player in the space, Warner Music, trades for 50x earnings.

The other half of Bollore's earnings come from its African logistics and transport business, which by its nature is volatile but a fast grower that has compounded EBITDA at a high-single digit rate historically. Bollore was early to West Africa (where people predominantly speak French) and has been investing $250 million a year in building out African ports, logistics and infrastructure over many decades which gives them a wide moat. It can be hard to get a package from point A to point B into and across the continent, which generates a wide competitive moat and solid mid-teens returns on capital for an expert like Bollore.

When you put it together, you get two great growth businesses here for a cheap price.

DK: There's also this unique corporate structure, known as "Breton Pulleys", which allows the Bollore family to maintain voting control despite owning a minority of the shares. We'll spare you all the details, but effectively the Bollore parent company owns shares of holding companies that in turn own shares of Bollore. This means that the reported share count is different than the "economic" share count which nets out the crossholdings. We see the stock trading at around 3x our estimate of its five-year forward EPS, and we think it's worth about 150% more than where it trades today.

"We're patient and truly long-term investors... But, we can move quickly when a stock meets our criteria for value, quality, and analyzability."

G&D: Given that the music label business appears a couple of times in their portfolio, how do you think about the industry profit pool evolving over time, especially as potentially Spotify continues aggregating demand and growing in relevance?

JM: Spotify is a 20% customer of the major music labels, and the music labels provide about 75% of Spotify listening time. For now, we think the balance of power remains squarely with the labels, but the more important point is that the rise of streaming and the resulting near 100% incremental margin profit it brings to UMG or Columbia Records is going to overwhelm any potential deterioration in economics for the labels.

G&D: How did you navigate the market turbulence resulting from the pandemic?

DK: We know we own good companies, have a margin of safety with low valuation, and on average our portfolio earnings are less economically sensitive than the EAFE index. That said, COVID was something no one had ever seen before. Our priority was to stress-test every business and balance sheet and speak to every company to confirm our understanding of how COVID should impact their business. Through this process we sold four stocks. We also went hunting for new opportunities resulting from the turbulence. From mid-March to mid-April, over the course of five weeks, we added five stocks to the portfolio. One investment was NXPI Semiconductors.

NXPI was on our radar since last summer, but it was never cheap enough. We had done work on it, we had engaged with the company and its competitors, and we had a strong understanding of the business. We're patient and truly long-term investors – on average, in our U.S. fund, we've

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only made four new investments per year.
But, we can move quickly w hen a stock meets our criteria for value, quality, and analyzability.

JM: April was a great time to buy compounders on sale. NXPI is a global leader in sensors and technology that are part of a secular trend towards safer driving with auto-braking and driver assist leading eventually to autonomous driving. Because 50% of their business sells into autos, NXPI sold off with all the other auto cyclicals. We bought it at around an 11x P/E. I think there's a misunderstanding today that if you're a value manager, you own sleepy, old-world companies that are getting disrupted and that's just absolutely not the case. With discipline and patience, you can buy businesses with strong secular growth. It takes a lot of work to find them, but they are out there and you just don't have to overpay for them.

G&D: What's another example of a secular grower in the portfolio?

DK: Another good example is Ashtead. Ashtead is a tool rental equipment company that operates under the Sunbelt brand in the U.S. The industry will benefit from secular growth and Ashtead is one of two national organizations that is in the best position to continue taking market share. In the U.S., only about half of equipment is rented, compared to the UK and Japan at 80-85%. That doesn't make a lot of sense. Most companies should not own equipment like scissor lifts or industrial power generators. By renting, customers get 24/7 service and support, avoid maintenance, and free up their balance sheets. Over time, the rental penetration rate in the U.S. should continue to increase.

G&D: What's Ashtead's market share?

DK: Ashtead has 10% market share and the top two companies control about one quarter of the market. The rest of the industry is smaller regional players and mom-and-pops. This is a tremendous opportunity for Ashtead that also should fuel its future profit growth. Ashtead has significant advantages over its smaller competitors. As a national player, they can offer their larger customers a single point-of-contact for tool rentals across the entire country. And, by following a "cluster" strategy where they enter a market and build out store density, they can lower their cost base and optimize their inventory.

Ashtead also is applying technology to an old-world industry. If you want to rent a forklift, you can use the app and schedule to receive the forklift at the exact time you need it. The smaller players can't offer that. And Ashtead has sensors installed on its equipment so that if it is about to fail, the customer is alerted. This reduces downtime and improves safety.

G&D: It makes sense that customers would want to rent rather than own, but how do you think about the capital intensity of Ashtead, especially in the context of its cyclicality?

DK: The beauty of Ashtead's business is that they can cut all orders for new equipment with just 45-60 days' notice to any of their suppliers. That's critical. In a period like the current environment, Ashtead can slash their capex. In fact, this year, capex is expected to decline by 75%. And that leads to countercyclical cash flows. EBITDA is expected to fall 12% this year, but free cash flow is expected to increase by 63%, resulting in a 10% free cash flow yield for the stock. This stabilizing feature of the business model is under-appreciated by many.

Ashtead also offers specialty rental equipment like climate control and power/ HVAC, which is a lot more stable. Even from February through April of this year, specialty rental revenue

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grew 10% year-over-year.

JM: We also own their competitor, United Rentals in our U.S. portfolio. So it's a business model that we're familiar with, and we think that these two companies are going to be the long-term winners with a lot of open space to go.

G&D: Fast forwarding to today, what do you think about this current market environment? Obviously, the market has been very bifurcated for a while between growth and value, so curious what your view is on the overall market environment, how it compares to prior periods in both of your experience.

JM: We haven't seen an opportunity in value like this in 20 years. You have to go back to the tech bubble to find value stocks trading at such a wide discount versus the broader market, and historically each time the value factor has gotten so dislocated, it has been an incredible time to buy. We don't think the value factor itself is broken, but it's also important to note that we don't own those typical value stocks. While we buy stocks from the cheapest part of the market, our companies have compounded their earnings at a 5.5% rate from 2007 through 2021 estimates, or about six percentage points above the EAFE's annual EPS growth over that time. And yet we trade for 12x P/E, well below the EAFE's 16x. And this is what you get when you add quality and analyzability to the value factor; you get an uncommon combination of value and growth.

"We haven't seen an opportunity in value like this in 20 years."

G&D: How do you get comfortable investing in light of the uncertainty around how the pandemic will unfold over the next 12-18 moths?

JM: Buying businesses for the long-term requires you to buy resilient business structures that can adapt and manage through very challenging periods. This means good balance sheets, flexible cost structures, low capital intensity. As COVID hit, we exited from four companies we thought could be materially impacted by the pandemic, and we believe the rest will manage well through the crisis.

DK: And it goes back to our competitive edge and being long term in nature and the way that we define risk. We don't define risk as volatility; we think risk is simply the permanent loss of capital. We're not path dependent. What we're focused on is five years out. And we say, if we're going to get the earnings right, we're going to eventually get the investment right. And if it's a volatile path on the way to having a good five or ten-year investment return, we'll always take that over a potentially more stable but lower return. Being able to invest with a long-time horizon requires being at the right organization. We're fortunate that Lyrical's founders – Andrew and Jeff Keswin – have built a firm that allows us to invest with this mindset.

G&D: Dan, can you talk about memorable classes or experiences at CBS that have impacted your investing career?

DK: There were two classes that were the most influential. They were both during my second year.

The first was Applied Value Investing taught by Artie Williams and T. Charlie Quinn. The real value from that class was in how to form a thesis and how to really develop a persuasive pitch and analysis. It's awesome if you find a great investment, but most of us are going to be working for other people and with other people. It's not valuable to find a great investment if you can't con-

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vince someone else to buy into it.

The second was Advanced Investment Research taught by David Greenspan who, at the time, was working at Blue Ridge. And the reward there was a little bit different. We spent the entire semester working on just one stock. The real value was in the primary research and differentiated quantitative analysis and how to go deep, and how to think differently, while focused on only the two or three key investment questions that truly matter. And you come up with your own financial forecast based on the independent work that you're doing. That objectivity has really provided me with the foundation for the work that I've done over the last 10 years.

G&D: What advice do you have for business school students who want to pursue a career in investing?

JM: I think one of the most important things that you need to figure out as an investor is where your alpha comes from. There're lots of different ways to invest. The question is what are you really good at and how can you apply that to picking stocks and doing it in a successful and repeatable way? One of the best ways to figure that out is go and buy some stocks and have some winners and losers and really reflect on why. It's a tough industry but full of motivated, passionate, brilliant people. Try to find the right people and the right strategy for you.

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

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***Graham & Doddsville* Editors 2020-2021**

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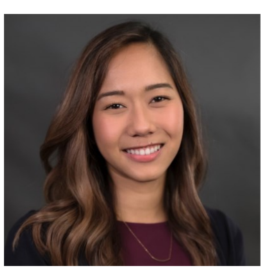

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