U.S. VALUE EQUITY

Investment Management
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Seeking Value

Value investing, says our U.S. value equity team, is like seeking a four-leaf clover in a field of three-leaf clovers. And to do that, they take a particularly collaborative approach. To get a better sense of how the team works, Greg Czarnecki, our U.S. value equity team's portfolio specialist, sat down with Matt Fleming, CFA, co-portfolio manager on our Mid Cap Value and Small-Mid-Cap (SMID) Value strategies, to discuss the team's investment philosophy and approach.

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Portfolio Specialist
Greg Czarnecki

Co-Portfolio Manager
Matthew Fleming, CFA

Greg Czarnecki: To kick off, let's talk about the team. We've been managing small-cap assets for more than three decades, and more recently mid-cap assets. That is a considerable tenure for this asset class. How is the team structured and how do the members interact?

Matt Fleming: We employ the same exact team for our small-, small-mid- (SMID), and mid-cap strategies, which we believe lends to the repeatability of our process. We segment our investment team by industry vertical. So, for example, I cover industrials, energy, and utilities. A colleague covers financials, another covers consumer discretionary, and so on. So, we have very specific and deep domain expertise in our respective sectors.

We're also very experienced investors. Our analysts have been doing this for a very long time, over many different market cycles. I've been covering the transportation and industrials sector since I started my career 25 years ago.

In addition, many of our analysts also have tangible industry experience, having directly worked in their sector prior to transitioning to the investment buy-side. Jamie Shurtleff, who covers healthcare for us, has a graduate degree in healthcare policy. He's worked in the healthcare industry for years, as a senior healthcare consultant. Similarly, Josh Overholt, who covers technology, started his career as an advanced business services analyst.

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Left to right: Greg Czarnecki, Portfolio Specialist; Bill Heaphy, CFA, Portfolio Manager; Gary Merwitz, Director of Research and Research Analyst.

But the real secret sauce is the collaboration among team members. We think the best view is brought to bear by rigorous debate among a really talented group of investors. We have a flat organization where analysts are not only encouraged, but in some cases required, to participate in meetings and challenge each other. So not only are you getting valuable insights about an industry, but you're also getting the collective wisdom of the group.

I think a very important part of our investment process is that we're all pulling the oar in the same direction. When we enter an investment meeting, we immediately are thinking about the same things. There's a very consistent approach to our analysis. We're all defining things like quality and valuation, on the same page. And so, we're not spending time really having to discuss what makes the investment attractive. We're able to get very quickly into the meat of it and really discuss things like valuation points and certain specifics of the investment. It's a very unified approach.

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Greg: The word "collaboration" is used a lot. What does it mean to you?

Matt: Well, as one example, one of our newer colleagues was surprised that he could just walk into the office of Gary Merwitz, our director of research. So, we have a real open-door policy. We are constantly walking into each other's offices, chatting in the copy room, connecting in the hallways on the way to lunch. It's very, very interactive.

Left to right: Bill Heaphy, CFA, Portfolio Manager; Matt Fleming, CFA, Portfolio Manager.

Greg: You talked about how the team interacts as a whole, but how do analysts work with portfolio managers like you? It doesn't sound like the process is overly formal, and I assume that aids in the efficiency you spoke of earlier?

Matt: One of the hallmarks of our process is that it's bottom-up, meaning it's led by investment analysts. Analysts walk into portfolio managers' offices and talk about ideas they have. Portfolio managers certainly make suggestions to analysts, but by no means are analysts required to take those suggestions; they are fully free to push back.

And analysts are encouraged to challenge portfolio managers and each other. Everything's up for debate. There are no sacred cows; anything that's in the portfolio, however long we've owned it, is open for discussion. We really pride ourselves on being willing to discuss anything and everything as a team.

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Greg: Moving on, could you briefly describe our investment philosophy and the types of companies we're seeking to purchase?

Matt: Sure. Very succinctly, I would describe our process as the combination of value and quality. So, we're looking for very high-quality companies that are trading at what we believe is a discount to their intrinsic value. This could be caused by a number of different situations—overlooked companies; misunderstood companies that are going through a transformation the market is not appreciating; or any area of potential or unrecognized value that we think is being mispriced by the market. We think of this as finding the four-leaf clover in a field of three-leaf clovers.

Greg: I assume these inefficiencies you mention are not only applicable for small-cap companies but for all market capitalizations in which we invest?

Matt: Absolutely. Whether it's small-cap, midcap, or SMID, there's a common philosophy in terms of where we're seeking value. Again, we think you can have high-quality companies trading at a discount to their unrecognized value—very high-quality companies trading in line with much less profitable or much less well-run companies. We think that holds true for all three market-cap ranges in which our products are offered.

Greg: And you leverage the same process across market capitalizations?

Matt: Yes, as part of our fundamental research process, we look at competitors, customers, and suppliers. What I think is interesting is that the work we do for the different market capitalizations is interchangeable.

When we're looking at a small-cap company, for example, we're also looking at SMID-cap and midcap companies, and in some cases large-cap companies, in the same sector. An analogy that I like to use is that if you're looking at a small-cap auto parts company, you really have to understand what General Motors is doing. Similarly, if you're looking at a small- or midcap aerospace manufacturing company, you really have to have a view as to what Boeing and Airbus are doing.

And when you have analysts who follows their sector for decades, like our team does, it allows us to take our analysis deeper, regardless of size, given our intimate familiarity with our investable universes.

Greg: So quality and valuation are critical components. Maybe we can walk through those one at a time. First, how do you determine the quality of a business?

Matt: We're looking for companies that are businesses with differentiated products or services, very strong margins and return profiles, and very importantly, high free-cash-flow generation and low balance-sheet leverage.

We're looking for empirical evidence that a company is a market leader, because if it has the ability to price, we should see that in margins or returns.

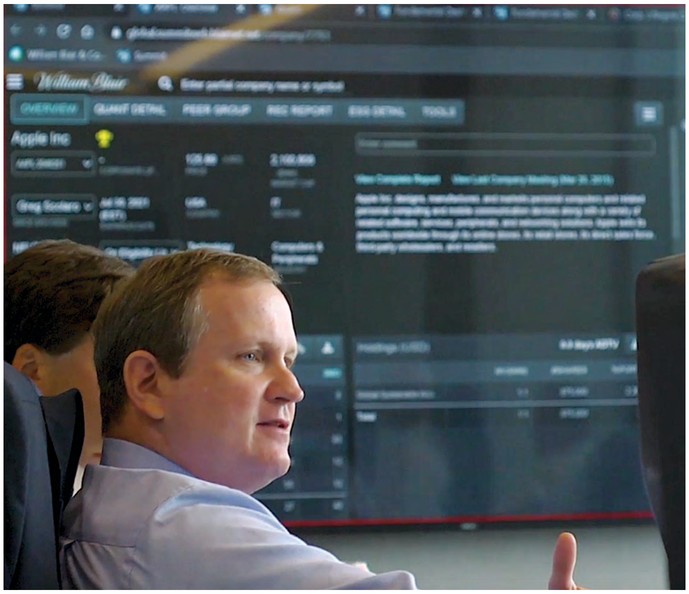
We're looking for companies that are run by management teams that are aligned with shareholders. We look for evidence of that within the proxy statement and how management is compensated.

And then we look for evidence of superior capital allocation, both within the business, which is evidenced by return on capital and return on equity, and in shareholder capital—things like buy-backs and dividends.

It's a very qualitative assessment of the business supported by quantitative evidence.

Greg: Turning to valuation, I've heard you say that we're looking for companies that trade at discounts to their peers and other comps (certainly private market values). But I've also heard a lot of talk about an emphasis on historical metrics as it relates to a company's own trading range. Can you go a bit deeper into how you think about that valuation assessment?

Matt: Sure. We're looking for superior companies that are trading in line with less superior companies. To find them, we look at all metrics, as you mentioned—peer group, private market value, free-cash-flow generation. But we place the most emphasis on historical trading ranges, for two reasons.



Bill Heaphy, CFA, Portfolio Manager.

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First, comps are terrific, but they don't tell you where the industry group is relative to its value. For example, you could find a company that's the cheapest in a group, but that doesn't tell you if the group is too expensive. Said another way, we don't want to buy the cheapest house in an expensive neighborhood just because we have to. And when you look at historical valuation, we believe that really helps mitigate that risk. You're able to look at a company not only relative to its peers, but also relative to its own industry and its own history.

Second, we believe some companies just have their own historical trading patterns. They might always be expensive relative to the group, or they might always be expensive relative to other metrics, but relative to themselves, there might be really good opportunity that we're overlooking if we don't use that analysis.

Greg: And we're not required to own certain industries, correct?

Matt: Correct. We're not relative value investors, so we're not required to own any holdings within an industry. Sector weights, to us, are a function of where we are finding value in the market. Of course, we always challenge the active and passive bets we are taking versus the index.

Greg: That's really helpful. And how do you think about risk and reward when you construct these portfolios stock by stock?

Matt: We always start with risk; it's the most important thing to us. We not only look at what the risks are to an investment, but we also try to quantify that and put it into our investment process.

So, as part of our fundamental analysis, we're always going through the usual analysis of the risks with the industry. What are competitive risks? What are customer risks? We're really trying to figure out what challenges the company may have.

We also spend a lot of time thinking about what I call the "why." So, "why" is a company temporarily mispriced? Do we understand that scenario? Can we effectively quantify and understand it? A lot of thought goes into that initial assessment.

But again, at the end of the day we really want to buy correctly and seek to limit the downside—so we always start with the downside.

Greg: Interesting, could you walk me through that discipline in more detail, in terms of how you quantify that strict downside assessment and attempt to build in that margin of safety?

Matt: We look at the low end of historical trading ranges, and apply that multiple to what we think are conservative estimates of a company's earnings power going forward.

Those are proprietary estimates that we come up with, so we're not just taking a sell-side analyst's or company's guidance as valid. We're really going through it ourselves to make sure it's valid. We then come up with what we think is a very conservative downside. When we buy the stock, we want to buy it within about 10% of the downside.

We do that for a couple reasons. First, we want to protect shareholder capital. Second, we're trying to find companies that are going through an improvement in quality. They might be selling a business; they might be improving a business. But we want to give that company time to achieve its potential; time to work on itself for, say, 12 or 18 months. And we think limited downside and a good balance sheet creates a situation in which the company has time to do that.

Greg: How about the upside?

Matt: We believe that if we do our analysis and find high-quality companies, the upside takes care of itself.

Greg: Before we close, let's spend a few moments talking about portfolio construction between the three strategies we manage. I assume a large portion of it is driven by market capitalization, but if you could provide any color that would be great—from a sector weight perspective, names across the investable universe, etc.?

Matt: Again, the opportunity set and process are the same across strategies. However, as we sought to optimize risk-adjusted returns and ensure style consistency, there are some minor nuances to the different strategies in terms of portfolio construction.

That is driven largely by market cap and the number of names in the index. So, if you look across our small-, SMID-, and midcap strategies, target market caps go up in size. Roughly speaking, for small cap, the investable universe is companies with market caps of around $1 billion to $5 billion at the time of purchase. For SMID-cap it's approximately $5 billion to $25 billion, and for midcap it's approximately $10 billion to $50 billion.

In the small-cap portfolio, there are approximately 100 positions; in SMID-cap there are approximately 80 positions; and in midcap there are approximately 60 positions. The number of positions in each strategy is a function of our desire to construct diversified portfolios that deliver excess returns through security selection across different market environments. We seek to deliver investors low-tracking-error portfolios with high active share that consistently add value over time. As you go up in market capitalization the indices become more concentrated, in that there are more small companies than larger as a whole. But if you divide the number of holdings by the relative benchmarks, on average, we own about 7.5% of the index in each of the portfolios.

So, over time, we seek to achieve similar risk-adjusted return profiles for each of our strategies. Like our consistent philosophy, we attempt to employ consistent portfolio construction, which we believe contributes to consistent long-term results.

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