

Investing in Crisis

S&P 500 - April 30, 2019 to April 29, 2020



As most readers of *Value Investor Insight* can probably attest, value investors are not prone to hyperbole. One could also say there's a world-weariness about them, as if they've seen it all before.

So it's instructive when talking about the recent market tumult that Mason Hawkins, who founded Southeastern Asset Management in 1975, says "We've never seen a bear market or recessionary period like this." Or when Rob Arnott, a contrarian's contrarian who founded Research Affiliates, LLC, says "Of course I'm surprised by the magnitude and speed of the swings." Variants on each sentiment have been the norm, not the rare exception.

Which is not to say value investors didn't know how to react when the tumult hit. They're obviously not immune to the hu-

man tragedy of the pandemic, but as investors, this is what they prepare for. It's why they insist on a margin of safety when deciding what to own. It's why they anchor on a stock's intrinsic value, which can separate materially from its share price in times of panic and market volatility.

"You make most of your money in a bear market, you just don't realize it at the time," said famed investor Shelby Cullom Davis. With that in mind, we've devoted this entire issue of *VI* to 12 interviews with best-in-class value investors from around the world, asking the same basic questions about the current crisis: "How were you prepared? How did you respond? Where do we go from here? Whether the worst of the crisis is behind us or not, we trust you'll agree that their answers are without question words to the wise. [See page 2](#)

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Rolling with the Punches

Warren Buffett captures an essential truth about investing when he says, “It’s only when the tide goes out that you learn who’s been swimming naked.” The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they’re navigating the roiling seas.

INVESTOR INSIGHT



Mason Hawkins, Staley Cates, Ross Glotzbach
Southeastern Asset Management

One-At-a-Time Investing

Few active value investors have a longer and more storied pedigree than Mason Hawkins of Memphis-based Southeastern Asset Management. Now working through the eighth bear market of his investment career, we caught up with Hawkins and colleagues Staley Cates and Ross Glotzbach to find out the ways in which this time around has been different, how it’s been the same, and where they’re finding opportunity as a result.

Describe generally how you were assessing the investment landscape leading up to when that landscape started to change dramatically in February.

Mason Hawkins: We’re one-at-a-time business investors, focused in each particular case on whether potential investments meet our qualifications with respect to business quality, the skill of the people running the business, and the price we have to pay against our conservative assessment of intrinsic value. At the end of 2019 we were finding little that met those qualifications, primarily due to price, so

across our portfolios we had a material amount of cash. We were not forecasting or predicting, we were pricing, as Ben Graham used to put it. We had sold or reduced a number of positions and we were waiting patiently for new opportunities that met our criteria. Cash increased as a residual of that, into the teens in the United States and somewhat less than that in international portfolios, as we’d been finding better bargains outside the U.S. than inside the U.S.

Roll forward and the world changed almost overnight. The markets went down more significantly and quicker than at any time in my life. Our views regarding the future were altered somewhat, but more significant for us was the discounted pricing now available in a number of companies we already owned or knew we wanted to own at the right price.

Ross Glotzbach: We put cash to work fairly quickly, especially as we got into the second and third weeks of March. It happened faster outside the U.S., where we already thought stocks were less richly priced. There we were soon in more-ideas-than-money mode, so we were prioritizing attractive options and using it as an opportunity to upgrade the portfolios.

We also put cash to work very quickly in U.S. small cap as there was an incredible pullback in the Russell 2000, based on the prevailing view that small companies are disadvantaged in a bad economy versus large companies. In a number of cases we thought the concern was overdone, to the extent that earlier this month we reopened our small-cap fund to new investors for the first time since 1997. In U.S. large cap, because many of the companies we already owned or wanted to own held up better in the decline, we didn’t get as much of the cash invested.

To put money to work quickly, do you have to have a basic hypothesis on how the coronavirus pandemic plays out?

MH: Again, it’s pricing for us, not timing. What we can be certain about today is that this is a very adversarial business environment. But we do believe we will return to some degree of normalcy. If a company is priced in the market at 30 cents on the dollar against our assessment of intrinsic value, for the most part all we need to assume is that normalcy will generally return in order to find that an attractive opportunity. We’ll be the first to admit that we don’t know exactly when revenues and free cash flow are going to be generated in a normal way again, but when discounts are that steep we can be patient and expect to benefit not only from intrinsic values growing again, but also from Mr. Market weighing those values much more fairly when things eventually improve.

As risk-averse capital allocators – and this comes from the largest investor in the Longleaf Partners’ funds – what we are most concerned about is not losing permanent capital. If we are very confident in our rough appraisal of value and that it will normalize in the near future, we’re willing to step up aggressively.

RG: To Mason’s point on not losing permanent capital, we are not at all blind to the short-term impacts of the current crisis. We go down the list on each of our holdings and ask the hard questions about the company’s cash flow in a severely challenged environment. How long can it withstand that? What flexibility does it have on the income statement and balance sheet to come out stronger on the other side? What I’m saying is that if we need the impact of the virus to only last five months for our investment case to work, that’s just not something we’re going to do.

Can you give an example of something on the smaller end of the market-cap spectrum in the U.S. that came into buying range last month?

RG: Empire State Realty Trust [ESRT] is a stock we've owned before, buying it in 2013 at its initial public offering, which is rare for us. Its number one asset – accounting for a significant majority of the value – is the Empire State Building, which was essentially being sold in 2013 by Leona Helmsley's dog, who was the beneficiary of the trust Leona had set up to hold it upon her death.

That first time around we really got to know Tony Malkin, the company's chairman and CEO, as a conservative, focused value creator. When he took over management of the Empire State Building earlier in the 2000s, it was certainly a famous address, but as a real estate asset it needed a lot of work. He set about improving the property, which had a very positive impact on rents and occupancy. He also saw considerable untapped potential in capitalizing on the building's history and name recognition, making the observatory at the top of the building a far more profitable tourist destination.

When the stock was at \$15 last summer, the sell side was mad at Tony because Empire State didn't have enough leverage, that it wasn't buying back enough stock, that it wasn't paying a bigger dividend, and that it wasn't pursuing M&A. Guess what? Those turned out to have been all the right moves to make, and the company is now coming from a position of relative strength.

We came into the year estimating intrinsic value at around \$20. That's come down because the observatory is closed, and while the leases generally are locked-in, there's obviously higher risk on payments than there was. But while our value estimate fell to the mid-teens, the stock fell below \$7 last month and now goes for around \$8.20 per share. The value will remain a moving target for the short term, but we have a great owner/operator at the helm seeing the numbers every day and we think he'll be making the right calls

to grow the long-term value per share. At the right price, that was an opportunity to take advantage of.

Let's talk about a non-U.S. idea, Prosus [Amsterdam: PRX], that also caught your attention in the downdraft.

Staley Cates: The origin story here is that 20 some years ago, Koos Bekker and his traditional South African media company called Naspers put \$32 million into a fledgling Chinese Internet company called Tencent [Hong Kong: 700]. They rode the

ON FORECASTING:

If we need the impact of the virus to only last five months for our case to work, that's not something we'll do.

wave all the way from then to now, and he and various entities currently own about 30% of it.

Holding a stake like that in the context of a publicly traded South African holding company created a lot of problems. For one, it dwarfed the rest of the company. There were calls for more taxation. There was an unfriendliness toward dividends. All this meant that Naspers traded at a giant discount, 30-40%, of the value of the underlying Tencent holding. Given the situation, the discount was somewhat justified so we never thought it made sense to own Naspers.

Aware of all this, the company last summer set up a holding company called Prosus in the Netherlands to hold its Tencent assets and some others. They were able to do it in shareholder-friendly ways, the most important of which is that the value of the Tencent asset could basically triple from here and if they started to sell it down there would be no tax due. In addition, if they distribute it to shareholders there are ways to pass on the basis in the holding, but it won't be taxable at the time of the event.

For a lot of reasons the market met this with a yawn. The company isn't really beating its chest about it. There's serious fatigue around SoftBank [Tokyo: 9984], another company with a powerful stake in the Chinese Internet – in Alibaba [BABA] – that is in the news nearly every day. People seem to think that the Naspers discount that never went away will never go away here either. We disagree.

Our Asian office has known and covered Tencent for a long time, and to our mind it's one of the highest-quality businesses we've ever seen. The main part of the platform, around which everything orbits, is WeChat. It's like Twitter and Facebook combined, with 1.1 billion users who spend an average of 90 minutes on it per day.

That was the first main asset and from there they've built additional businesses around it. Tencent is the world's dominant mobile-gaming company. It has all these people on its platform talking to each other and playing games, so from that it has created a giant advertising business to monetize the traffic. Like Alibaba with Alipay, they've developed a huge payments business that is still very much in growth mode. They saw what Amazon did with its AWS cloud business and have successfully done something similar with Tencent Cloud. They're also building a large music business, selling it like Apple does, and they recently took a 10% stake in Universal Music Group, the world's largest music company. These are a lot of businesses with massive moats and user bases, diversified across areas with pretty impressive long-term growth potential – which I'd add, isn't likely to be negatively impacted by the current pandemic crisis.

Is there anything else to say about the other assets Prosus owns?

SC: Over a long period of time, they've also invested in building successful online-classifieds, food-delivery and payments businesses primarily in emerging markets. They will tell you, in a funny phrase they use, that their venture capital model is not "spray and pray" – a not-so-indirect refer-

INVESTMENT SNAPSHOT

Prosus

(Amsterdam: PRX)

Business: Holding company traded in Europe whose primary asset is a long-held stake in Chinese messaging, e-commerce, mobile gaming, cloud services and music giant Tencent.

Share Information

(@4/29/20, Exchange Rate: \$1 = €0.92):

Price	€69.04
52-Week Range	€46.75 - €77.40
Dividend Yield	0.0%
Market Cap	€112.99 billion

Financials (TTM):

Revenue	€2.86 billion
Operating Profit Margin	(-19.0%)
Net Profit Margin	141.8%

Valuation Metrics

(@4/29/20):

	PRX	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	n/a	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Capital Research & Mgmt	1.0%
Norges Bank Inv Mgmt	1.0%
Vanguard Group	0.8%
Dodge & Cox	0.5%
BlackRock	0.4%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a
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PRX PRICE HISTORY



THE BOTTOM LINE

The market has more or less yawned since the holding company listed its shares in Europe in an effort to shrink the discount they had in South Africa to the underlying value in primary holding Tencent, says Staley Cates. He believes that neglect is misguided and that the discount to underlying value, which he pegs at around 40%, will eventually close.

Sources: Company reports, other publicly available information

ence to SoftBank – but focused on specific markets they know well and where their companies benefit from network effects as they grow. Some of the holdings are public and some private, but if you take out Tencent, the investment return on the other businesses has been over 20% compounded annually.

What do you think the shares, now trading at around €69, are worth?

SC: The Tencent stake at market – which we believe undervalues the company – is

worth right around €100 per share. We value Prosus’s other investments in operating businesses at another €15 per share. With €3 per share or so in net cash, our estimate of current net asset value is pushing €120. On an aggregated free-cash-flow basis, if you back out non-earning assets that are still growing rapidly but not cash-flow positive, we’re paying a multiple in the low double-digits for a company that is still growing 20% a year.

Management here is as sick of the discount as we are. It’s not a vanity thing for them, so we think if the market doesn’t

recognize the value here, they’ll distribute all or most of it out in a tax-friendly way to shareholders. Either way, we expect to come out well.

Has anything surprised you about the market in the last two months?

MH: Our experience at Southeastern goes back to the early 1970s and we’ve never seen a bear market or recessionary period like this. And I’ve been through eight of them. Businesses are coming to a complete halt. There’s plenty of speculation on when doors will open again and what happens when they do, but the divergence of opinion and uncertainty around almost everything is extremely high and a lot of the modeling and forecasting out there isn’t really worth much. That creates extreme volatility. But as difficult as that is, that level of uncertainty and volatility should be the friend of the long-term investor. It’s a necessary condition for being able to buy good businesses at 30 cents on the dollar.

SC: One thing I’d add to that: Cruising into all this there were all kinds of existential debates about value investing. Underlying the other side of the argument is very often that the quants and machines and AI bring such efficiency to markets that the value guy won’t be able to find enough inefficiency.

But what happened in this downturn to our largest international position, the Agnelli-family investment holding company Exor [Milan: EXO], is so instructive as to be hysterical. The company has a massive Italian heritage, but the actual Italian impact on its net asset value and earnings is tiny, in the low single digits. The stock, however, has continued to correlate with the Italian market, which starting last month has correlated with the public-health disaster the country has been going through.

While this is going on, the company announced two different asset dispositions, a merger of Fiat Chrysler with Peugeot and the sale of its reinsurance business PartnerRe to Covéa. The deals haven’t yet

closed, but hopefully John Elkann, Exor’s Chairman and CEO who we consider one of the smartest investors of his generation, will soon be sitting on a pile of cash at the right time. That’s something as value investors that makes us jump for joy, but the stock gets pummeled along with everything else in Italy. So really, greed and fear have been repealed, and it’s all about machines and rationality and efficiency? Greed and fear and stupid correlations have not been repealed.

INVESTOR INSIGHT



Peter Keefe
Avenir Corporation

When Philosophy is Tested

Avenir Corp.’s Peter Keefe has built a remarkable track record investing in “compounds” that are exactly the types of companies investors tend to gravitate towards when they upgrade the quality of their portfolios in a sharp market downturn. Here he describes his process and mindset through the current crisis and where he turned to upgrade his own portfolio as the market churned.

How, for want of a better word, would you say you were “prepared” for what unfolded in the equity markets last month?

Peter Keefe: Even though Warren Buffett encourages us to think about the unimaginable, we never thought about businesses being shut down for extended periods of time. What we do think about, though, is paying the right price for the value we be-

lieve we’re getting in return. That meant that cash had been organically building in our portfolio throughout 2019 and we entered the new year with a cash level in the teens. We’d sold a few things, and while there were plenty of businesses we were interested in to reinvest the proceeds, the multiples we had to pay implied modest returns even if everything went right. Cash building was not strategic or tactical, just a fallout from a simple investment process.

I bear in mind something that Brad Singer, formerly the CFO at both American Tower and Discovery Communications, once said to me. I had asked him what was the biggest single destroyer of capital that he’d seen as an investor and an operator and he answered quickly with “management boredom.” With that in mind, I’ve always tried to make sure that if I couldn’t put capital to work at what I considered to be outstanding rates of return, I would sit on my hands. That’s what we were doing.

Then the world comes unglued and our response was to keep doing what we always try to do, invest in outstanding businesses run by ethical and skilled managers and that are capitalized in a manner that will allow them to survive long periods of hardship. These are times when your philosophy gets tested. The market’s going down 5%, 6%, 7% a day and the expectations of the virus’s toll are increasingly dire. Philosophy can go out the window in an environment like that – understandably, by the way.

But as an investor, if you ignore the proximate cause of the market decline, it’s just another 35% decline and we’ve been through many of those. You have to react the same way you always do. If the businesses you want to buy have unassailable – I call them “five-year” – balance sheets, if they have durable cash flows that may be interrupted but likely to resume and compound as before, and the price gets right, you buy them. It didn’t last long – if you blinked, you missed it – but we put some capital to work at sharply lower prices. Certainly not as much as we would have liked to.

You’re a long-time owner of American Tower [AMT], and even its stock went crazy last month – from \$250 on March 4th, to less than \$175 on March 23rd, to hitting an all-time high of \$260 two weeks later. How did you respond to all that?

PK: Go figure. I should have mentioned on the subject of preparation that we have been around long enough to understand that exogenous shocks happen. As a result we try to minimize our exposure to the unknowable and concentrate on investing in businesses that aren’t yoked to an unpredictable global economy or political landscape. American Tower is a great example. As mobile bandwidth consumption grows, which is a pretty powerful tailwind, so too will AMT’s earnings. That’s unlikely to be fundamentally altered by the pandemic. Its revenues going out five or six years are largely contractual, with credit-worthy counterparties. The credit-worthiness of the counterparties has even arguably improved in the last 60 days with T-Mobile’s acquisition of Sprint.

This is the type of business we love, bond-like almost, with increasing coupons that are known and persistent. If we don’t already own it, we want to be up to speed on it and ready to buy it at the right price. In any event, when something like this goes down 30% in less than three weeks, we’re very likely to be a buyer. That was the case with American Tower.

Walk through your updated investment case for auto-auction company Copart [CPRT] in light of recent events.

PK: The company’s basic business is auctioning totaled automobiles for insurance companies. A car is in an accident, the body shop says it will cost \$15,000 to fix it, but the insurer says it’s only worth \$13,000. The insurance company declares it a total loss, pays out the \$13,000 to the policyholder and then turns to Copart to get as much for the totaled car as possible.

To give some background, the company was started in 1982 by Willis Johnson, who is still the Executive Chairman. He was a kid from rural Oklahoma who came

back from Vietnam and started a salvage business where he'd buy junked cars and people would come in and literally pull parts off the cars and pay him a couple bucks for each one they wanted. From that the business has evolved and Copart is now the #1 player in what is essentially a U.S. duopoly with IAA [IAA], which was spun off last year by KAR Auction Services. The company has 200 salvage yards located primarily in metropolitan areas across the country. Since 2003, all of the auctions have been online only.

We love the business and think it has systemic advantages that give it an in-

herent and lasting advantage over any competitor. That's primarily due to the fact that the company has spent 40 years acquiring real estate around the United States – paid for in cash often decades ago when the land was far less expensive – in metropolitan areas where there are more accidents. That makes it easier and cheaper for insurance companies to offload the wrecked cars. With a growing inventory base, the company was able to develop, again over 40 years, the biggest network of buyers, which is now international. The more buyers, the more liquidity, the better the prices at auction. That then attracts

more inventory from insurers – it's a virtuous circle.

Like eBay or Amazon, they've created a whole ecosystem that lives off their auctions. It doesn't take a lot of capital to run the business and operating margins are extraordinarily high – exceeding Microsoft's, in fact. People when they first hear about it say, "What, you're investing in a junkyard?" But this is more a technology business than anything else.

Are there any secular industry trends working in the company's favor, or against it, today?

PK: One significant positive is that automobiles are deemed totaled much more frequently than they used to. Half of the value of an automobile is now in the electronics – computers, sensors, optical cameras – much of which is located in places that often get hit. A bumper for a 2000 Ford F-150 might cost you \$300 to replace, while the one on a new F-150 might go for \$1,700. That results in newer vehicles getting totaled with much greater frequency, and also in cars being totaled that are still perfectly driveable. There are people bidding on these automobiles not just for the parts or metal value, but because they can sell them in vast quantities overseas where they're fixed up enough, if at all, to meet maybe less-strict inspection regulations. That all has created even more liquidity, making the ecosystem more valuable.

How is the business affected by today's economic challenges?

PK: We never thought about miles driven collapsing by perhaps 40%, but that's clearly an issue for them. The way we're approaching it in general is that we have to be confident the businesses we own can survive at least two years of hell. We think that's the case here and more. A lot of the costs are variable. They have about \$1 billion in total debt, having drawn down their \$800 million or so revolver they haven't had to use, so on a net basis for now there's only a couple hundred mil-

INVESTMENT SNAPSHOT

Copart

(Nasdaq: CPRT)

Business: Operator of an online auction platform that connects primarily insurance-company sellers of "totaled" automobiles with a large and liquid global network of potential buyers.

Share Information (@4/29/20):

Price	83.01
52-Week Range	55.69 – 104.88
Dividend Yield	0.0%
Market Cap	\$18.85 billion

Financials (TTM):

Revenue	\$2.23 billion
Operating Profit Margin	36.6%
Net Profit Margin	32.9%

Valuation Metrics

(@4/29/20):

	CPRT	S&P 500
P/E (TTM)	22.4	22.5
Forward P/E (Est.)	24.6	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	10.1%
BlackRock	4.9%
State Street	3.7%
Principal Global Inv	2.8%
Brown Brothers Harriman	2.8%

Short Interest (as of 4/15/20):

Shares Short/Float	2.6%
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CPRT PRICE HISTORY



THE BOTTOM LINE

The company has inherent competitive strengths that combined with a resilient income statement and balance sheet should allow it to come out of the current crisis as strong as ever, says Peter Keefe. He believes the current market cap is justified by pre-coronavirus free cash flow and that dramatic growth potential overseas is a free option on the upside.

Sources: Company reports, other publicly available information

lion in debt. Eventually we think people will start driving again and that Copart's business won't at all come out of this any weaker as a result.

The shares at a recent \$83 are about 20% off their February high. How are you looking at potential upside?

PK: Pre-coronavirus we had penciled out \$2.80 per share for free cash flow this year, and expected that to continue to grow over the next few years at a 10%-plus pace. If you take our pre-pandemic level of cash flow as something they can get back to with some delay, you could justify a 25x multiple on that, which gets you to above where the stock traded for much of March and April.

The main kicker on the upside is the potential we see from the company continuing to take its business model to other parts of the world, particularly Western Europe. They've been successful in the U.K. and are starting to really pick up the pace in Germany, where they're essentially creating a market. Western Europe's market is roughly the same size as the U.S. in terms of people and car park, and we don't think it's inconceivable that Copart's operations there one day are as big as they are now in the U.S. They're not making any money to speak of at it now, but at today's share price you're not paying anything for it either.

We have owned this since 2018 and have added modestly to the position this year. We realize we're likely facing at least a couple quarters of significantly reduced earnings, but it's a great business with great management with a lot of optionality for growth. We have to be willing to look "across the valley," but we're more than comfortable doing that here. We hope we get the opportunity to buy more at even better prices.

Are you at the point yet of worrying about lasting impacts of the monetary and fiscal responses to today's crisis?

PK: It colors the background, but not so much specific decisions to buy or sell

anything. In the financial crisis, especially with the bailouts of banks and auto companies, there was a lot of talk about the risks of moral hazard. Have you heard that at all in the past six weeks? We've become acculturated to spraying money on any financial catastrophe – that's the accepted response. I can't imagine that isn't ultimately without consequences.

If we're heading to \$25 trillion of federal debt in the U.S., that just makes me rub my eyes. You may remember in Hemingway's *The Sun Also Rises*, one character asks another how he went broke and the answer is "Two ways. Gradually, then suddenly." That's a metaphor for how these things are likely to end.

I don't know if there's a debt bubble or not, but if there is, one could imagine the ultimate outcome might be higher interest rates and higher inflation. So to us that argues to not be invested in businesses that would be significantly harmed by higher interest rates and higher inflation. More generally, we're looking for even an added layer of protection between our companies and the vagaries of the general economy. You don't want to be reliant on a robust economy to underpin your investment strategy.

How would you describe your mood through all this?

PK: Speaking just as an investor, if you understand your businesses and know what they're worth, you don't lose a lot of sleep when the market cracks. You have to have a bit of a predatory instinct, wired emotionally not to be paralyzed and think the world's ending, but instead be ready to pounce when the hunting is easier.

We have no prediction as to when the virus burns out or whether there are going to be secondary or derivative effects, which there likely will. We know it's going to be bad and our businesses better be ready for a couple of years of difficulty. But any opportunity to deploy capital at highly advantageous prices is exciting news. If you're an investor and you don't like it when stocks go down, you're not a value investor.

INVESTOR INSIGHT



Bill Nygren
Harris Associates

Know Your Strengths

The \$10 billion (assets) Oakmark Fund he's managed since 2000 has beaten the S&P 500 index by nearly 300 basis points per year, but Harris Associates' Bill Nygren has never been one to rest on his laurels. Ask him a question about any of the companies in his portfolios and you'll get an articulate, complete answer that puts many managers with far less on their plates to shame. Here he explains where he was focusing his attention as the market swooned last month, and describes a few of the somewhat surprising opportunities he found as a result.

As the healthcare and economic crisis unfolded last month in the U.S., would you say the uniqueness of the situation impacted your response?

Bill Nygren: Let's start with when the news came out that there were COVID-19 cases building in the U.S. When adverse news hits, you go back to the times most similar to what you're hearing to see how the market behaved. The baseline in a number of cases – Ebola, swine flu, MERS, SARS, the Asian flu – was a very brief panic period in the U.S., maybe enough to cause a 10% correction, maybe not. Then a couple months down the road it had all been forgotten. So we started with this thinking that by summer, COVID-19 would be a distant memory.

This is a reminder that sometimes the worst case happens. Despite the fact that it previously turned out that the market had overreacted and it was off to the races in a couple months, this time was obviously different. It shut down the economy. There were dramatic changes to 2020 and 2021 earnings estimates. That was really different and, not surprisingly, would give an investor pause. It's uncomfortable to say, "I don't know if I've ever been through this before."

Our early focus was to sort through all the companies whose share prices had fallen significantly to identify those that fell less on an enterprise-value basis and that were more in the eye of the storm. Given the unique nature of what was going on, if we weren't being well paid to take balance sheet risk, we didn't want it. If we weren't getting paid for being in the eye of the storm, we didn't want to be there.

When we think about how undervalued a stock is, we always look at enterprise value rather than just equity value. A simple example: Say two stocks fall 50%, from \$20 to \$10. Let's say one has \$3 per share in net cash, so its EV has fallen from \$17 per share to \$7, meaning the market is valuing the business at 60% less than it did when the stock was at \$20. The cash presumably was worth \$3 before and still is, so the business is worth incrementally less than the fall in the stock price. Compare that to an average company that might have \$10 per share in debt. When its share price falls from \$20 to \$10, the EV is now \$20, down from \$30 before. So the business value is down only 33% compared to 60% in the other case. When share prices are indiscriminately cut in half, the company with net cash really has been much more heavily hit.

That exercise uncovered a number of opportunities where the market didn't seem to be distinguishing between strong balance sheets and weak balance sheets. At a time when you'd expect the better balance sheet to be favored, the opposite was often the case. We tried to take advantage of that, making new purchases in companies like Pinterest [PINS] and Workday [WDAY], whose stocks fell at least in line

with similar companies that didn't have as strong balance sheets. To fund those purchases, we traded out of positions like American Airlines [AAL], which on an EV basis hadn't fallen as much and which couldn't have been more in the eye of the storm as a high-fixed-cost airline.

We are willing to take risk when we get paid enough to do so, but the way the market behaved, often the companies that were less affected and that had stronger balance sheets seemed to have the biggest

ON PANIC SELLING:

Often companies that were less affected and had stronger balance sheets had the biggest overreactions.

overreactions. Another stock we added was Constellation Brands [STZ], the large importer of popular Mexican beer labels, including Modelo, Pacifico, and to their misfortune, Corona. The big market concern seemed to be that people are not going to bars any more, which is true, but we concluded that the 15% of Constellation's sales from restaurants and bars could be largely offset by increased consumption at home. We think it's very possible earnings won't go down at all even this year, but the stock price had been cut in half. That made it interesting to us.

Everybody has to have a belief on how we come out of this, and our belief is that 2022 can be a pretty normal year. We like that if we're wrong on that, the trades we've made in the past six weeks have given us a portfolio even better able to weather a longer storm if it turns out that way.

Why did American Express [AXP] make it off your prospects' list into the Oakmark Fund portfolio last quarter?

BN: You're right that this is one of those names we stay current on and have a price in mind where it's worth adding to our

portfolio. In this case it hit that price and then went straight through.

With all of our lenders, banks and consumer-finance companies, as the crisis hit we switched our short-term estimates to match the Federal Reserve's severe adverse scenario for the economy and credit losses. We were comforted by the fact that for all of our holdings, the severe adverse scenario at most wiped out earnings for a year or so. There were no big losses. There wasn't the need for a capital raise. Dividends, at least from a financial perspective, were mostly safe.

With American Express, we believed the worst-case scenario was significantly better than all that. We think the company has done an excellent job in improving its cardholder value proposition in recent years by making significant investments in merchant acceptance, cardholder rewards and services, and small-business payment tools. Relative to entering the last financial crises, it has dramatically cut costs and strengthened its balance sheet structure. The payments-network side of the business is now more competitive with Mastercard and Visa. Given all that, in the adverse Fed scenario, we would still expect American Express to earn \$4 to \$5 per share this year. Two years from now, we think it should be earning more than twice that. With the stock where it is today [at a recent \$96], we believe that's too cheap for this caliber of business.

You mentioned Pinterest as a new purchase whose stock you thought was unduly hit in March. Describe what attracted you to it.

BN: This is an example in a growing list for us of stocks you might be surprised to find in a value portfolio. It's losing 50 cents a share, so there isn't a price cheap enough you'd pay on a P/E basis that looks compelling.

Pinterest is actually the first of the examples I gave earlier of the two \$20 stocks falling to \$10. They have \$3 per share in net cash on the balance sheet and the stock traded above \$30 post its 2019 IPO, but it was in the low-\$20s as the market

was peaking in February. It then went to \$10 at the trough, a nearly 60% decline.

Pinterest's basic business is as an online discovery tool for people looking for ideas and inspiration for any number of things, from remodeling a room, to planning a wedding, to planning a vacation. You put on your board pictures that represent what you like and are then given suggestions consistent with your posts. Unlike many consumer-Internet companies, users and advertisers are fundamentally aligned. Customers are showing intention to spend on very specific areas, and welcome information from manufacturers and service

providers who have something to sell that's consistent with what they have indicated they like. Advertising is welcomed, which is often not the case in a lot of social media.

The company isn't yet making money because it has incremental costs in preparing to be a much larger-scale enterprise than it currently is, and also because it is still in the early days of monetizing its platform. The priority to grow users – which now number more than 300 million on average each month, growing 15% a year – is higher than the priority to maximize advertising per user.

So key to our analysis is making an educated guess on where Pinterest can go in monetizing its platform, based on what we've seen in other businesses. A company like Twitter generates annual revenue per average monthly user in the low-teens, which is about half of what Facebook gets. In terms of time spent on the platform, Pinterest and Twitter are similar, but Pinterest strikes us as the more attractive environment for both the advertiser and user. Nobody's claiming the Russians used Pinterest, for example, to influence the last election. It doesn't seem heroic to assume as Pinterest's business model matures that its revenue-per-user ends up at a spot similar to where Twitter is.

How are you handicapping the impact of current crisis?

BN: There will be a short-term impact as users have less money to spend and advertisers cut back, but people are doing this out of their homes. They're planning positive things. Advertisers want to spend money reaching customers with a clear intent to buy. We really don't expect the business to be hit that hard.

How are you looking at valuation with today's share price at around \$20.80?

BN: The company has been losing \$400 million per year, but we'd argue that it is increasing its business value far in excess of that. If we assume Twitter's \$13 annual revenue per user, operating margins in the low-30% range and a mid-teens EBIT multiple, that gets us to roughly \$60 per subscriber in value for Pinterest. If they grow users by 40 million per year, that's a \$2.4 billion increase in value, for which they're incurring \$400 million in losses.

We arrive at valuing the shares in a couple ways. If in 2022 the company hits our revenue-per-user, user-growth and EBIT-margin expectations, that would translate into something between \$1.50 to \$2 in EPS. You wouldn't have to put a very aggressive multiple on that to arrive at a share price well above today's level. Alternatively, if we're roughly right on

INVESTMENT SNAPSHOT

Pinterest
(NYSE: PINS)

Business: Operator of an online "discovery" platform that helps more than 300 million average monthly users find ideas, products and services for any number of lifestyle pursuits.

Share Information (@4/29/20):

Price	20.85
52-Week Range	10.10 – 36.83
Dividend Yield	0.0%
Market Cap	\$12.09 billion

Financials (TTM):

Revenue	\$1.14 billion
Operating Profit Margin	(-121.5%)
Net Profit Margin	(-119.1%)

Valuation Metrics

(@4/29/20):

	PINS	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	n/a	21.0

Largest Institutional Owners

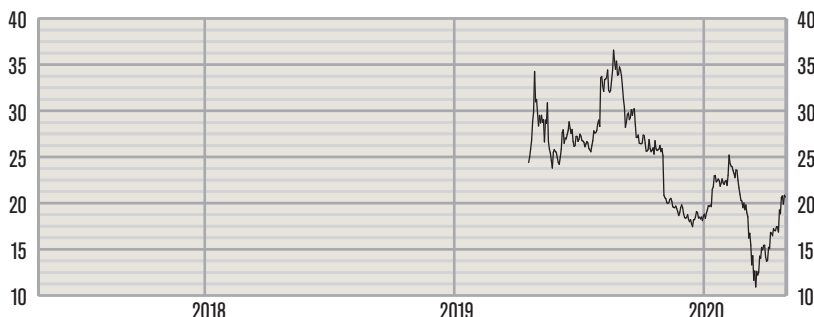
(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	6.5%
Flossbach von Storch	6.1%
Fidelity Mgmt & Research	6.0%
Wellington Mgmt	4.5%
Capital Research & Mgmt	1.7%

Short Interest (as of 4/15/20):

Shares Short/Float	5.4%
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PINS PRICE HISTORY



THE BOTTOM LINE

While the company may not be an obvious choice for a value portfolio, Bill Nygren believes its value is increasing at a much higher rate than the investment required. He thinks it by 2022 can earn \$1.50 to \$2 in EPS, at which point, he says, "You wouldn't have to put a very aggressive multiple on that to arrive at a share price well above today's level."

Sources: Company reports, other publicly available information

that \$60-per-user value, at today's number of subscribers that would translate into an \$18 billion enterprise value, almost twice the level at which the stock trades today.

We realize it's still early, but have you identified any potential lasting lessons from this latest interlude in the market?

BN: I don't know that this is a new lesson, but in situations like this you need to quickly realize where your skills might give you an advantage and where you have no business taking your own opinion seriously. We think we're pretty good at figuring out business valuations. We're pretty good at looking past current events and what companies could be worth on a long-term basis. That doesn't mean we're better than anyone else at guessing how the virus evolves or when the economy returns to normal. We need to make sure our portfolios don't depend on us being experts in areas where we are not.

he's managed, the Akre Focus Fund he's run since 2009 has earned a net annualized 15%, vs. 11.5% for the S&P 500. Joined by fellow portfolio managers John Neff and Chris Cerrone, Akre describes the "shock absorbers" built into his investment strategy and how he tries to take advantage when the market gets overly agitated about current events.

The Akre Focus Fund's outperformance relative to the market so far this year is even better than your long-term record, which is already quite impressive. To what would you attribute that?

Chuck Akre: The way we described it in our first-quarter investor letter is that we spend little time trying to anticipate shocks like global pandemics or oil-price wars, but we spend a lot of time thinking about "shock absorbers" in our investment strategy. For us, that means owning only exceptional businesses, paying reasonable valuations for them, and building cash when paying reasonable valuations proves elusive.

That's not to say we have been or will be immune to downturns, but the goal is for these shock absorbers to enable our portfolio to decline less than the broad market, recover faster, and capitalize long-term by putting substantial cash to work at advantageous valuations.

Chris Cerrone: We always have a very clear idea of the price at which we're interested in buying more shares of our companies. Last fall and into the first six weeks of 2020, most prices – for existing holdings and for stocks on our watch list – were 20-40% above where we'd be interested in buying. We were seeing pretty consistent inflows and so most of those dollars went into T-bills. As a result, cash built to around 20% of the portfolio during that time. That reflected our discipline about putting money to work only at valuations we believe are conducive to long-term returns consistent with what we've generated historically.

When the crisis started we watched as prices started moving lower, but for the

first couple weeks we were pretty disciplined and didn't do a lot of buying. If you start 30% above your buy price, the first part of the move in most cases was just excess coming off the top and not actionable. That started to change very quickly in mid-March. There were days at the worst of it where we could have made a case for buying more of almost anything in the portfolio. We didn't get fully invested, but our cash weighting by the end of March was down to 10%, primarily from adding to existing positions.

John Neff: Since neither we nor anyone else knows where or when stocks will bottom, we described our buying as spooning rather than shoveling cash into select positions. We're mindful in times like this of how much of a disconnect there can be between price and value – on March 23rd, for example, we'd argue there was a total disconnect in a number of our names – so we want to have cash available for extremes we might not have seen yet. Our mutual fund is a vehicle from which people can redeem daily, so we also think it's prudent to have some dry powder on hand to avoid ever having to sell into a rapidly declining market.

You've been a long-time holder of Mastercard [MA]. How have you handled your position in it through all this?

JN: We've always described Mastercard as a bottleneck between consumers and businesses, uniquely positioned along with Visa [V] to benefit as an increasing share of transactions globally are made through their payment networks. With the pandemic there's obviously been a material and sudden drop in spending of all kinds and Mastercard's results over the next year or two will be impacted significantly by that. If your investing approach hinges on affixing a multiple to an earnings estimate over the next 12-24 months, you're going to have a more negative view on that development than we do, which helps explain why the shares over about four weeks in February and March fell from \$345 per share to a low of \$200.

INVESTOR INSIGHT



Chuck Akre, John Neff, Chris Cerrone
Akre Capital Management

Shock Absorbing

Akre Capital's Chuck Akre is one of those investors who makes it all sound simple. Invest in high-quality companies that can compound book value at high rates over long periods, don't pay too much for them, and earn high returns as a shareholder comparable to the high returns on capital of the companies in which you've invested. Consistent with predecessor funds

We look out over a five-year time frame and contemplate prospective annual returns over that period. So we're looking right over the blast crater that is 2020 and possibly even 2021 and we see no reason to believe that life and the economy won't be back to some semblance of normal within five years. In fact, the pandemic could actually accelerate the secular shift away from cash and checks and in favor of electronic payments. Certain countries have even taken to destroying paper currency for sanitation purposes.

The accelerated shift to online, omnichannel and "contactless pickup" requires increased use of credit and debit cards and plays further into Mastercard's strength. When the stock fell as sharply as it did, we were able to add to our position for the first time in several years. The shares are still only about 40% of the way back – not as far as the market rebound overall – for what we think is an extraordinary company.

Another of your long-time favorites, American Tower [AMT], has weathered the market storm much better than most. What's your outlook for it from here?

JN: This is a rare case where the share price is positive year-to-date, for good reason. The company finished 2019 with nearly \$47 billion in non-cancelable lease revenue on its books to be recognized over the next five-plus years. Landlords owning other types of real estate may find their leases aren't as air-tight as they thought, but that isn't the case here. If a Verizon, or AT&T or T-Mobile doesn't pay their rent – which we consider highly unlikely – mobile service using those towers would be shut down. That just hasn't happened, even in the event of carrier bankruptcies in other countries. We think the visibility and stability from a revenue and margin perspective here is just extraordinary.

If American Tower's near-term position is relatively sound, its longer-term outlook as the biggest tollbooth for the growth in wireless communications is as bright as it's ever been. In addition to the continued investment needed to meet rapidly

increasing demand – wireless data consumption is growing on the order of 40% annually – we're also now on the cusp of significant new spending for the rollout of 5G technology. 5G has so far been more of a marketing phenomenon than an actual network one, but the groundwork is starting to be laid and we expect that to be a tailwind for the company over the next five to ten years. If 4G was about connecting everybody, 5G is about connecting every *thing*. And the importance of ubiquitous high-speed connectivity has only been underscored by events of the past two months.

Do you see important negative or positive impacts on the company from the recently completed T-Mobile/Sprint merger?

JN: There is likely to be some network rationalization – T-Mobile has a reputation for being good at that – but if you dig into the numbers, the actual financial impact on American Tower from any consolidation of tower capacity is likely to be very small. Churn rates could go from maybe 40-50 basis points on an annual basis to a still remarkably low 1-1.5% over a five-year period in the U.S. Weighed against the underlying secular demand growth,

INVESTMENT SNAPSHOT

American Tower
(NYSE: AMT)

Business: Global owner and operator of some 180,000 cellular towers, space on which is rented by wireless service providers to hold equipment needed to support their networks.

Share Information (@4/29/20):

Price	236.81
52-Week Range	174.32 – 260.43
Dividend Yield	1.7%
Market Cap	\$107.99 billion

Financials (TTM):

Revenue	\$7.58 billion
Operating Profit Margin	37.8%
Net Profit Margin	24.9%

Valuation Metrics

(@4/29/20):

	AMT	S&P 500
P/E (TTM)	58.6	22.5
Forward P/E (Est.)	54.6	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	13.0%
BlackRock	5.3%
State Street	4.5%
Wellington Mgmt	3.9%
Fidelity Mgmt & Research	3.9%

Short Interest (as of 4/15/20):

Shares Short/Float	0.9%
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AMT PRICE HISTORY



THE BOTTOM LINE

It's emblematic of the market's indiscriminate fall in March that the company's shares fell 30% despite not a lot of impact on its business leasing cell-tower real estate, says John Neff. Even after a rebound in the share price, he still expects to benefit as a shareholder from a low- to mid-teens annual compounding in the firm's equivalent of free cash flow.

Sources: Company reports, other publicly available information

that shouldn't be a big deal. Potentially offsetting the consolidation risk are the 5G coverage and network buildout commitments that T-Mobile made as a condition of approval for the acquisition of Sprint, particularly in suburban and rural areas where American Tower has most of its sites.

The stock, now around \$237, has pretty much round-tripped after falling 30% from its February high. How are you looking at upside from today?

JN: AMT is structured as a real estate investment trust, so we look primarily at the rate at which we believe the company can compound adjusted funds from operations [AFFO]. (AFFO dovetails well with our definition of free cash flow, except we do not exclude stock compensation expense.) The business enjoys highly recurring revenue with built-in escalators and very high incremental margins, and we believe we'll benefit from the company compounding AFFO at a low-to-mid-teens rate. The prospective return was obviously much better when the stock fell below \$200. If we get another crack at it we'd love to buy more.

Chuck, how does this market disruption so far stack up against those you've lived through before?

CA: We earlier this year looked back a bit on our experience in 1973-1974, 2000-2002 and 2007-2009. The low-30s percent decline from top to bottom we saw in this bear market has been in the range of those declines, but instead of the average 28 to 33 months those declines took before, in this case it happened in 33 days. That is a huge difference. It was also unusual how at certain points a big down day was followed by a big up day and then another down day and so on.

Our heads are not in the sand, but we try not to manage our portfolio on the basis of current events. As we've said, if the market gives us the opportunity to buy phenomenal businesses like American Tower and Mastercard at attractive valuations, that's what we're here for.

INVESTOR INSIGHT



James Montier
GMO

Living With Uncertainty

James Montier has long called on his expertise in both behavioral finance and valuation to draw investing insights, now doing so for the asset allocation team at GMO that is responsible for some \$30 billion invested in the firm's global multi-asset funds. Here he explains how both his "soft" and "hard" sides as an investor helped him try to make sense of recent market turmoil.

You've long been a student of serious market dislocations. How has this most recent one differed?

James Montier: My experience in that regard has been much more in what I would call "grey swan" events – identifying what appeared to be bubbles, not knowing how long they'd go on, but concluding there was something rotten in the state of Denmark that was unsustainable and was going to eventually be undone. These were things people didn't want to see but that were fairly obvious as long as you used a sensible lens.

This has been a genuine black swan. Very few of us have relevant experience in this kind of environment. Which raises an awful lot of questions from a behavioral and psychological point of view. How do we react? How should we make decisions?

It's been fascinating to watch the speed of the market's moves. Very little about

that surprised me on the way down – economist Rudiger Dornbusch always said these things go on for much longer than one imagines and then end faster than one imagines as well. Things usually end with a bang, not a whimper.

I actually wrote a paper last month on fear in bear markets, and a lot of what we saw in March can be explained by the evolutionary design of how the mind works. We have these two different systems co-living inside the brain, one designed for quick and dirty decisions, the other more reflective and logical. Fear resides in the quick and dirty system, which makes sense, right? If you're wandering around looking for food and see a twig that looks like a snake and jump off to the side, that's a good thing. The cost of a false negative – doing nothing and stepping on a snake – is pretty high, so we're geared to react quickly. All perfectly sensible from an evolutionary standpoint.

The problem is that human evolution takes 150,000 years and we're dealing with a world that evolves at breakneck speed. We're not fully designed for the industrial world of 200 to 300 years ago, let alone the information age we find ourselves in today. Our brains are geared to work one way that can be counter to a logical, rational approach. That could help explain why the markets moved as fast as they did. It was pure terror. It was reminiscent of 2008-2009, where for some time no scenario was too pessimistic. You'd pick up the *FT* or *The Wall Street Journal* and read about how terrible everything was and was going to continue to be, and you'd nod and say, "Yep, that's probably true," and run to sell all your stocks and order provisions for your bunker in the back. It was that kind of blatant panic that was dominating at times in March.

What's your take on the market snapping back from its lows?

JM: I've had a much harder time grappling with the speed of the rebound. It's almost as if the markets have moved ahead and said, "OK, all done, nothing to see here but a short-term hit to earnings and

then everything's back to normal. History teaches us that that is not the way markets normally behave. Markets normally double count, first knocking share prices down because profits are expected to fall, and then there's another wave of selling when profits actually do fall and people say, "Oh my god, profits are falling." That may not make sense, but it's typically the way people behave. It feels unusual for the market to so quickly factor in the proverbial V-shaped recovery. I have no idea what this recovery is going to be like and don't really think anyone can.

We've thought similarly about the confidence with which people are making judgements about how the virus and the resulting economic effects play out.

JM: I understand the temptation to go along and become an armchair virologist or epidemiologist, but I'm trying very hard to resist. Look, I don't know. I have no background in this stuff. You read the experts who actually can have an opinion on all this and they don't agree either. Now the economists are jumping in and fitting curves and doing what they do best. It does seem the market, at least, is very strong in its belief that this is going to be over pretty soon. That kind of certainty always reminds me of Voltaire's wonderful quote, which goes something like, "To live in doubt is unpleasant. To live in certainty is absurd." That strikes me as how the market is behaving right now, acting as if everything is pretty clear cut and certain. The one thing I am certain of is that I'm not certain of that.

How are you handicapping the equity opportunity set at the moment?

JM: One of my jobs at GMO is to bang the table when things get really cheap. For a week or so last month I was really banging the table, not in the U.S. because it's still the most expensive market out there, but absolutely in emerging and developed international markets. I still think the margin of safety in many of those markets is quite compelling.

If you look at the latest Shiller P/E numbers, emerging markets are trading on something less than 10x earnings. Europe and Japan are at 12-13x. The U.S. is around 24x. I've been talking about that disparity for some time now, but it's done us little good so far. Because the U.S. has recovered relatively faster, the valuation gap has only increased.

Do you think we endured the point of "maximum pessimism" in the fourth week of March?

JM: It's obviously incredibly hard to know in real time if you're at the point of maximum pessimism. That said, any time markets are falling as they were last month, you've got to think you might be given a compelling set of opportunities. For me, it's about looking at valuations and reacting to the way they're changing. Combine that with how extremely negative the broad-based sentiment was and that told me something was going on.

Sir John Templeton, who talked about wanting to buy at the point of maximum pessimism, also was a big believer in the importance of getting all your work done on quiet days when there's nothing going on. Set target prices and have predetermined buy orders at the ready, because you never know when the market is going to drop suddenly. That's important because when it does drop suddenly, you're going to find it very hard to have the courage to buy. I've always thought that notion of pre-commitment was a really useful framework, and I think it's as relevant today as it was a month ago, or the month before that.

The really good news from a value-investor perspective is that fair value or intrinsic worth is not massively influenced by the short term. With all the uncertainties out there today, we can still consider this a reasonably short-term challenge. If cash flows are hit for one or two years, it impacts intrinsic value, but on a discounted-cash-flow basis going out decades, it's by a small amount. But prices are several orders of magnitude more responsive to these events than intrinsic values, which

is in the end what creates the opportunities that all good value investors seek to exploit.

INVESTOR INSIGHT



Eric Cinnamond, Jayme Wiggins
Palm Valley Capital Management

Back to Work

It would be hard to imagine a long-only investment manager who was better prepared for the market's recent swoon than Palm Valley Capital Management. Following a strict absolute-return strategy that for years was out of sync with an ever-rising market, portfolio managers Eric Cinnamond and Jayme Wiggins had a large and well maintained "possible-buy" list and 92% of portfolio assets in cash when the market started to crack in February. Here they describe how they responded when the market action they'd been counting on for so long came to pass.

Your Palm Valley Capital Fund was up slightly in the first quarter. Explain how you pulled that off.

Eric Cinnamond: As you know from previous conversations, we use an absolute-return investment strategy focused on small-cap stocks. Coming into the year it was almost impossible for us to find any small caps trading at discounts to our estimates of intrinsic value. As a result, we held just over 92% of the portfolio in cash and equivalents at the start of the quarter. That worked out relatively well when the market fell off a cliff.

We've been waiting for so long to see some reasonable opportunities that we should at least have been ready for them when they came along. We keep a 300-name possible-buy list – heavily populated by names we've owned before – and we try to be pretty much up to speed on any names getting closer to valuations we'd find attractive.

As small caps started to roll over we didn't respond aggressively right away because they were coming from such expensive heights, but later in March the level of volatility and sloppy trading allowed us to get more active. Even high-quality names we wondered if we'd ever be able to buy again would drop 50% in a matter of weeks. We increased some existing positions and ended up purchasing 21 new names for the fund by the end of the quarter. We didn't come close to getting fully invested, but by the end of March cash was down to 52% of the portfolio.

Give an example of a high-quality name you thought might be forever off-limits but then wasn't.

EC: One would be Healthcare Services Group [HCSG], which is a leading provider of facility maintenance and food services for over 3,000 nursing homes, rehabilitation centers and hospitals in the U.S. It's the kind of perpetual-bond-type business that attracts us, with a long and profitable operating history, stable end markets, a strong balance sheet and a good dividend. It's also the kind of business in a low-interest-rate environment that has been trading at extremely low cap rates, with almost no risk premium. Well, from a 30x earnings multiple earlier this year, the share price fell to the mid-teens, against our normalized earnings estimate of about \$1.20 per share. It went from outrageously priced to very reasonable extremely quickly. That's exactly the type of thing we tried to take advantage of.

We're not surprised to see you with some energy exposure. Describe the potential you see in exploration and production company Bonanza Creek Energy [BCEI].

EC: We've actually been interested in energy for a while, but the industry's balance sheets have been so horrendous that we haven't been able to put much money to work. We try not to combine operating risk with financial risk, and clearly there is operating risk in energy. The last time we thought the sector was very attractive, in March of 2009, we held at another firm almost 20% of our portfolio in energy names. You can't do that now because of the balance sheets.

Bonanza Creek is a relatively new name to us. This may turn some people off, but it went bankrupt in 2017 for exactly the

reason you'd expect, too much debt. But the company today is not at all what it was. It still has the same high-quality and low-cost reserves – in the Wattenberg Field in Colorado – but now has what is soon to be a debt-free balance sheet and an entirely new top management team focused on keeping it that way.

Jayme tends to do all the complicated ideas, but this one is fairly simple. The decline in oil prices has caused the company to significantly curtail its development activity this year, but approximately 90% of its 2020 production – which will be roughly flat with last year – is hedged with an

INVESTMENT SNAPSHOT

Bonanza Creek Energy
(NYSE: BCEI)

Business: Acquisition, exploration, development and production of oil and liquids-rich natural gas; the significant majority of reserves are located in Colorado's Wattenberg Field.

Share Information (@4/29/20):

Price	16.29
52-Week Range	8.25 – 26.75
Dividend Yield	0.0%
Market Cap	\$309.4 million

Financials (TTM):

Revenue	\$313.2 million
Operating Profit Margin	22.4%
Net Profit Margin	21.4%

Valuation Metrics

(@4/29/20):

	BCEI	S&P 500
P/E (TTM)	4.3	22.5
Forward P/E (Est.)	3.4	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
BlackRock	13.6%
Mangrove Partners	10.0%
Dimensional Fund Adv	8.3%
Vanguard Group	6.0%
Oaktree Capital	4.9%

Short Interest (as of 4/15/20):

Shares Short/Float	12.6%
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BCEI PRICE HISTORY



THE BOTTOM LINE

Due to well-timed oil-price hedges, the company should generate enough free cash flow this year to pay off all its remaining balance sheet debt, says Eric Cinnamond, positioning it well to ride out the current energy market firestorm. Based on his estimate of the replacement value of the company's reserves, he values the stock at around \$35 per share.

Sources: Company reports, other publicly available information

average floor price of approximately \$50 per barrel. As a result, it should generate close to \$80 million in free cash flow this year, \$60 million of which will go toward paying off all of the current debt on the balance sheet. They're running the business like we try to run our portfolio. They talk about focusing on economic returns, financial strength and operational flexibility. If that means production doesn't grow, fine. They're not concerned about what other people think.

Are you making a call here on oil prices?

EC: In every commodity business we're in we try not to have an explicit opinion on the commodity price. That just gets you into trouble, often making you more likely to be bullish when the commodity price is high. To the extent we think about price, we like it when the commodity is priced at well below the cost of production, which is the case for oil today. That doesn't mean prices can't go lower, but we're in the camp that lower prices fix lower prices, and the odds are in our favor that market-price levels at least gravitate to the marginal cost of production.

How cheap do you consider Bonanza Creek's shares at today's price of \$16.30?

EC: First to give some perspective, the company made \$200 million in EBITDA last year and the total market cap today is just over \$300 million. To arrive at a fair value, we look primarily at the replacement value of the reserves. How much would it cost for us to replace these reserves if we bought the land, rented the rigs and then drilled and completed the wells? When we do that here it comes to about \$15 per barrel. Apply that to the 54 million barrels of developed reserves, subtract net debt and retirement obligations, and on the current share count we get to a value of \$35 per share.

For even more perspective, tangible book value is \$45 per share. The PV10 value, assuming \$55 oil, is around \$42 per share. So as crazy as it seems to think this is worth more than 2x the current price,

we don't think that's an outlandish valuation. Given the balance sheet, we've got time for it to play out.

Did you add to this position during the market's fall last month?

EC: We did. One of our disciplines is that we won't average down if the value of the business is in decline. As a result of the hedges, we didn't by our calculations think the value was going down. Only time will tell if that was the right call, but this is one of the few energy companies where that was the case, and it's the only small-cap exploration and production company we know that is generating free cash flow and will likely be debt free by year-end.

Are you making any macro calls with your exposure to precious-metals stocks?

EC: Valuation for us drives everything, but if we can find discounts in areas we believe can benefit in this particular environment, that's even better. We have about 10% of the portfolio in precious metals, and while we didn't say, "Hey, let's go buy some miners," it is not unimportant to our thesis that companies tied to tangible assets will likely do very well in the unprecedented environment of money printing and debt creation that we're in.

Jayme Wiggins: One micro-cap name we started buying late last year was A-Mark Precious Metals [AMRK], which is one of the most important players in the value chain if you want to acquire physical forms of gold, silver and other precious metals. They trade it. They store it. They offer loans secured by it. There hasn't been big demand for physical precious metals in the last few years, but that started to change in a big way in February. We think it's one of the few business models that should perform well in the panicked type of environment we're experiencing.

The stock has gone up a lot in the past few weeks, but the company's market value today is still just over \$100 million. That seems expensive relative to the \$3 million in pre-tax income it earned in its


last fiscal year, but much less so against the \$20 million-plus it earned pre-tax in fiscal 2009, 2011 and 2013. On an EPS basis, the stock today [at \$14.75] trades at about 12x our normalized estimate, which we calculate by excluding the big bonanza years. If we have another big bonanza year, which we think is reasonable to expect, that valuation will likely turn out to be very attractive.

It's been a while since you've been beating the market. How does it feel?

EC: It feels good to finally be able to put some money to work, but for us it's always just going to be about being patient and taking risks only when we're getting paid. Most people can't just hold cash and wait. It is refreshing to see that the absolute-return approach we believe works in the end also can work in the short term.

We consider ourselves sort of a safe haven for absolute-return investors. There aren't that many of us left, but every now and again we're reminded it's not a bad place to be.

INVESTOR INSIGHT



Rob Arnott
Research Affiliates, LLC

The Sorting-Out Process

Rob Arnott, Founder and Chairman of Research Affiliates, LLC, has established his firm as a leading innovator in portfolio construction and management – its strategies are now used to manage some \$145 billion in assets through third-party part-

ners. He also is a thoughtful and articulate student of markets, asset values and investor behavior. Here he shares how he's been processing the market environment of the past two months and how his portfolios are positioned as a result.

To start out, please tell us about Research Affiliates' strategy as a firm.

Rob Arnott: We don't manage any money ourselves, we design strategies and license the use of them to others. Our biggest affiliate relationship is with PIMCO for our global asset allocation strategies, and much of our Fundamental Index work is used by Schwab for mutual funds and Invesco for ETFs. Our business model is built solely around developing investment strategies. That allows us to stay singularly focused on product innovation, which is where we think we can have a competitive advantage and it's the part of the business we enjoy most.

Almost everything we do is quantitative at its core. "Smart beta" is a catch phrase without a particularly clear meaning, but you could characterize our equity strategies as variants on smart beta in that they are quantitative, factor-driven methods for constructing equity portfolios.

Can you generalize about where you were and weren't finding investment opportunity prior to the coronavirus pandemic?

RA: Our view was that U.S. equities were very expensive, priced to give us a likely real return no higher than inflation over the coming ten years, before fees, trading costs and taxes. That's pretty bleak. Bonds were no better than that.

Outside the U.S. we had a more constructive outlook. European markets and emerging markets were moderately cheap, priced to offer 5-6% real returns over and above inflation over the next ten years. That's pretty good.

As with the global financial crisis, the first reaction to COVID was a take-no-prisoners market crash. Pretty much everything fell in direct proportion to the risk. Small-cap stocks typically have a 20%

volatility and they were down about 30%. U.S. large caps have high-teens volatility and they were down in the high-teens. Apart from U.S. Treasury bonds, everything was brought down indiscriminately, proportional to risk. That's not atypical in the early stages of a crisis and is similar to what we saw in September/October 2008.

On the heels of a take-no-prisoners shock like that, the market goes through a sorting-out process, posing questions

ON BARGAIN HUNTING:

I currently have more than half of my liquid net worth in emerging-markets deep-value stocks.

about what has been hit too hard given fundamental realities and what is still priced kind of expensively. It's in that process that volatility can be our friend and create opportunities to take advantage of. You can earn back what you lost with room to spare if you're tactical and respond sensibly to a crash.

What are some of the distinctions you've been making in the sorting-out process?

RA: One is that we're very much favoring value over growth. I understand the narrative that FAANG-type stocks are being hurt less or even benefitting from the COVID crisis. In many respects that's absolutely correct. Amazon is shipping more products than ever. Netflix is attracting more eyeballs than ever. But the question is, how much of that is already discounted in relative valuations?

If you look at valuation ratios like price/book or price/sales for value versus growth stocks, the normal spread is four or five to one – growth is typically four to five times as expensive as value. Prior to the last quarter that spread was already 7:1, and the rubber band had gotten stretched tremendously by the end of the quarter to around 10:1. I buy into the nar-

ative that growth stocks are better companies, with better-suited products and services to the future look of the economy. My argument, though, is that that is more than discounted in the 10x relative price. The current spread is wider than it was at the peak of the tech bubble – to me that sounds like an extraordinary buying opportunity for value.

Another area of focus for us remains emerging markets. The narrative there focuses on a litany of problems. Their health-care systems are worse and the humanitarian disaster from the virus will be greater. They're resource-based, and demand for resources is way down. They're more vulnerable to supply-chain disruptions. But it's interesting to note that emerging markets are always facing some sort of crisis. From their perspective this is another instance in a long history of disruption that they learn to roll with and move on. I'd argue the developed world on a relative basis is more disrupted this time than the emerging economies are. That's not being recognized by the market yet.

The Shiller P/E [based on average inflation-adjusted earnings from the previous ten years] for emerging-market stocks was about 14x at the start of the year, while the U.S. was at twice that. Now the U.S. has gone from very expensive to somewhat less expensive, but emerging markets have gone from sensibly priced to cheap. The Shiller P/E there is now around 11x. For emerging-market value stocks, it's now under 8x. Even if earnings fall in half in the next three years before recovering, that's still cheap.

I do eat my own cooking. I currently have more than half of my liquid net worth in emerging-markets deep-value stocks, and I've been continuing to add to that position.

Where do you come down in trying to assess whether the worst is over in equity markets?

RA: This is not a high-confidence estimate, but I don't think we've seen the end of this bear market. There has never been a bear market that started and ended in just three

to four weeks. I'd put the odds at maybe 60/40 that we actually have another dive to or exceeding the March lows.

I see things unfolding in one of two basic ways. One scenario is that we've reached the inflection point from a health-care standpoint and cases and deaths plateau and start falling off. In the aftermath of that we can begin switching the economy back on, but many businesses that have been shuttered for weeks will not have an easy time re-starting and not all of them will. So we'd be looking at recovering from this mini-depression, major-recession over the course of several months, getting solidly on track by the end of the year. That's the optimistic scenario.

What I think is the slightly more-likely scenario is that it takes more time than that. The economy is being shattered by the lockdown and there are a lot of pieces to put back together. People don't necessarily return to restaurants or stores even after they've reopened for weeks or months. Hotels take months to regain occupancy. Lots of them go bust. Workers laid off find jobs doing something, so that they're no longer available to their previous employers who will need them. The result is we might start to put things back on track in maybe the summer of next year, and the economy is not back at new highs of GDP for three or four years. After the rebound in recent weeks, I don't think the market today is discounting that possibility. It's looking past this and saying this is going to pass without major repercussions.

All of which is not to say that Humpty Dumpty won't be put back together. We will have a functional, successful economy again, it just might take a few years rather than a few months. The market is currently not expecting that possibility, which makes it more likely that we'll see additional tumult in the markets for some time. If I'm right about that we'll have multiple buying opportunities.

What aspects of the response to the pandemic worry or encourage you long-term?

RA: From a pandemic-response perspective, I'm hopeful we learn somewhat

from the response in East Asia. There are aspects of it that may seem intrusive to some, but even as a staunch libertarian I'm not a believer in people's liberty to deliberately spread a lethal pathogen just to avoid inconvenience. I'm totally fine with temperature checks, follow-up testing for COVID if you have a temperature, and mandatory lockdowns for individuals who test positive. If you do that well, you identify who's got it, you isolate them, and then you wait it out.

Western democracies were unprepared and unable to take those steps and we've ended up with a mess. Our model has been to wait until the problem gets severe, then destroy the economy, then throw money at everybody because the economy is destroyed. That's not a great way to respond. This was bipartisan, by the way, and it was dumb.

Economically, we're in the U.S. kind of pursuing a Western European model, which hasn't worked so well for Western Europe in terms of magnitudes of debt and magnitudes of reliance on government as the answer to all problems. I believe long-term future investment returns will absolutely be affected. Returns are tied to economic growth, and economic growth is stifled by excessive stimulus. In Western Europe they talk about "growth-oriented" policies in referring basically to deficit spending. Well, the only thing that's growing there is government spending.

Has the speed with which everything has been happening in markets surprised you?

RA: Of course I'm surprised by the magnitude and speed of the swings. I think anyone who says they aren't surprised is being overly glib. There has never been a bear market where the market dropped 30% from an all-time high in less than a month.

But markets moving fast doesn't necessarily mean that you as an investor have to move fast. Many investors lack patience and a willingness to move in a deliberate way, which I generally think works against them. Given that we've seen a market low – but not necessarily the market low – while we would have been remiss not to

have moved somewhat risk on, I think we would have been somewhat naïve to move 100% risk on with the first leg down. I prefer in general to average in and average out.

Investors for the most part should look at tumult in the market as a gift. Tumult means the market is responding on emotion, creating some objective bargains and some objective pockets of overpricing. We're seeing that this time around and are likely to continue to see it as much as we always have.

INVESTOR INSIGHT



Brian Kersmanc
GQG Partners

Upgrade

Having started his career in the investment industry at Brown Brothers Harriman in 2008, Brian Kersmanc got an early indoctrination into dealing with market turmoil. Now a Deputy Portfolio Manager and Partner at Rajiv Jain's GQG Partners, he explains why turmoil in and of itself isn't such a bad thing: "We're truly active managers, so this is the type of environment where we have the opportunity to perform better than average, where actual stock-picking matters. We welcome that part of it."

Describe some of your initial reactions from an investment perspective as the crisis started to take hold.

Brian Kersmanc: One benefit we had from running an emerging-markets portfolio is

that we followed the coronavirus situation a bit more closely as it developed in China. Our initial assessment in late January, early February was that it looked like a fairly quick and contained SARS-like problem. That changed fairly quickly as things deteriorated in China and the virus started spreading elsewhere. We had started to add more exposure to cyclical names entering 2020 because we thought they were being relatively underappreciated by the market, but that started coming off the table, particularly in energy.

Markets really started to panic when the situation worsened in Europe, which led to the violent, equal-opportunity sell-offs in late February into March. When there's indiscriminate selling like that, frightening as it may be, as investors we have to be looking to profit from the dislocation. In our case, we try mostly in situations like this to upgrade the quality of our portfolios.

Give an example of the type of trade you were making last month.

BK: Alibaba [BABA] is a name we were conspicuously absent from through much of 2019. I use the word "conspicuous" because nearly every one of our international and emerging-market peers held it. We were concerned that regulatory pressure from Beijing on the company's core e-commerce business was mounting, and that there was also risk of the de-listing of the company's U.S. ADR if the U.S./China trade war intensified.

Despite the mounting headwinds, the P/E multiple on the stock was still in the 30's, based purely on the historical dominance of the business. It benefits on a structural longer-term basis as Internet traffic proliferates, e-commerce proliferates, data traffic proliferates, and cloud businesses proliferate. All that is more, rather than less, salient today as the virus has taken hold and you've seen an explosion in data and information being trafficked across global networks.

So, what changed? First, Chinese economic growth started to decelerate, which led the government to dial back its pres-

sure on large listed technology names. Secondly, Alibaba listed directly in Hong Kong and the U.S. ADRs became fungible with those listed shares. That means that an investor can directly convert ADR shares into Hong Kong-listed shares, essentially taking the ADR de-listing risk off the table. Finally, with COVID-19 spreading, we saw share prices of high-quality names like Alibaba pulling back pretty much in lockstep with lower-quality names, despite the fact that the company was likely to benefit in many ways as a result of stay-at-home orders. As the P/E multiple fell to the mid-20s, it gave us the

kind of quality-upgrade opportunity we typically look for.

Why did you consider Nestlé [Switzerland: SWX] a similarly attractive upgrade?

BK: Nestlé is a name we've owned with varying levels of conviction over the years. What interested us more recently is that while many consumer-staples companies have been stuck in a negative cycle of cost-cutting and leveraging the balance sheet to buy back stock, Nestlé instead was actively selling off poor-performing businesses like skin healthcare and putting

INVESTMENT SNAPSHOT

Nestlé

(Switzerland: NESN)

Business: Largest food and beverage manufacturer in the world by sales, with key product categories including coffee, nutrition, pet food, bottled water and confectionery products.

Share Information

(@4/29/20, Exchange Rate: \$1 = CHF 0.98):

Price	CHF 102.98
52-Week Range	CHF 83.37 - CHF 113.20
Dividend Yield	2.6%
Market Cap	CHF 299.81 billion

Financials (TTM):

Revenue	CHF 92.87 billion
Operating Profit Margin	17.1%
Net Profit Margin	13.6%

Valuation Metrics

(@4/29/20):

	NESN	S&P 500
P/E (TTM)	24.3	22.5
Forward P/E (Est.)	23.0	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	3.0%
Capital Research & Mgmt	2.9%
Norges Bank Inv Mgmt	2.6%
UBS Asset Mgmt	1.5%
BlackRock	1.4%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a
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NESN PRICE HISTORY



THE BOTTOM LINE

Seeing it as the type of "quality upgrade" he looks to make in times of market stress, Brian Kersmanc added to his position in the giant consumer-staples company last month. Assuming a constant valuation, he sees attractive compounding potential as the company increases EPS at a high-single-digit annual rate and pays a 2.5%-plus dividend.

Sources: Company reports, other publicly available information

capital to work to enhance its portfolio of brands in higher-growth verticals like pet food, nutrition and coffee. It was investing to expand growth potential, while many competitors were mortgaging their futures to appease short-term investors.

Another appeal to Nestlé over other staples-type names, which became more relevant as the coronavirus spread, is that it is less reliant on “on-trade” business through bars, restaurants or sporting venues. Nespresso coffee, for example, already operates with a significant online distribution model. You’ve got your machine and they ship you the coffee pods. That’s a much more resilient business model when we are all stuck at home needing our coffee fix.

One long-time appeal to Nestlé for investors has been its growth potential in emerging markets. Is that an important part of your case?

BK: The real driver is higher organic growth in the coffee, nutrition and pet-food verticals across markets, compensating for slower organic growth in other categories such as water and confectionery products. Nestlé does derive about 42% of its revenues from emerging markets, and within China specifically it has particularly strong franchises in infant formula, ice cream and ready-to-drink coffee. In general, the product portfolio continues to gain traction as more individuals move into the middle class, which is a broad theme we see across emerging markets.

Does the company’s exposure to bottled water, which seems to be meeting more consumer environmental-related resistance, concern you?

BK: This is something we monitor with Nestlé as well as some other consumer-staples names we own. The industry does seem to be working to reduce the plastic content of its bottles. At this point we don’t see this as a material headwind to the company’s long-term ability to compound earnings. But again, we’re monitoring it and if this or any other material

issue threatens that compounding ability, we will react accordingly.

The stock in March fell as low as 83 Swiss francs, but has come back nicely to a recent 103. How did you manage your position through that and how attractive do you consider the shares today?

BK: We owned Nestlé coming into 2020, but when the violent selloffs happened in March we increased our position size as its forward earnings multiple dropped several turns into the high-teens.

The stock has since retraced much of that lost ground, but we believe the long-term fundamentals support the current forward multiple of around 23x. We expect earnings per share to be roughly flat this year – which is not bad given the level of economic disruption we’re seeing globally – and that EPS can then resume compounding at a high-single-digit rate with a fairly high degree of resiliency. If we’re right about that, adding in the 2.5% dividend yield, that would give us a steady and attractive compound return. In our view, that should be valuable in a world filled with uncertainty.

Some investors are spending a lot of time and effort these days on trying to call how the pandemic plays out, both from a public-health and economic standpoint. How important would you say that’s been to your approach?

BK: What Rajiv Jain [GQG’s founder] says all the time is that we’re not here to forecast the rain. What we need to do is build the ark so that we’re prepared for when the flood does happen. That means investing in solidly growing businesses with good competitive barriers to entry and reasonable valuations. That means using conservative assumptions and maintaining highly liquid portfolios. When datapoints change, we’re continually evaluating what’s in front of us and try to have a very open mind if we need to shift direction.

Investors may agree with this in principle, but very few act quickly enough

when the data changes, due to human nature, committee-based decision making, or maybe a lack of liquidity in their portfolios. In our opinion low turnover in times like we have today is a sign of weakness, not of strength. There is a fine line between stability and stagnation. We think our mindset is right for any market environment, but it’s probably even more important in a market like today’s.



The Cure for Low Prices

Given relative valuations, many U.S.-based investors see more opportunity in the midst of the coronavirus crisis outside the U.S. than in it. On the lookout for deep-value opportunities anywhere, Álvaro Guzmán and Fernando Bernad of Azvalor Asset Management offer their perspectives on that and also describe the upside they see today in one of their favorite companies based in their home country of Spain.

Value investors aspire to have portfolios that hold up well when trouble hits. How has yours fared on that front so far?

Álvaro Guzmán: We’ve performed a bit better than our peers overall since the market meltdown started, but the differences within the portfolio have been quite dramatic. We’ve been generally negative about market valuations for the past two or three years, so had gravitated to a fair

degree into more depressed areas like cyclically sensitive names, energy and other commodities, where valuations in many cases were half the levels of eight or nine years ago. Since the pandemic crisis hit, the 30% of our portfolio in precious-metals miners and uranium has done quite well, but our oil-related stocks have been crucified.

We've been trying to do what Benjamin Graham taught us and take advantage of volatility. For us that mostly means rebalancing from things that are doing relatively well into those that aren't. If you identify sustainable businesses and partner with managers who have skin in the game and aligned incentives, low prices should eventually be the cure for low prices. Good things happen when you buy cheap.

There are certainly low prices in energy. Why do you consider Maersk-spinoff Drilling Company of 1972 [Copenhagen: DRILCO] a worthy destination for your capital?

Fernando Bernad: We call it Maersk Drilling because it was spun off in April 2019 from Maersk Group as the parent was streamlining its corporate profile to focus more on its big container-shipping business. Maersk Drilling owns and operates offshore drilling rigs – floaters for deep water, jackups for shallow water. When it came public it traded relatively expensively compared to peers, but we started buying it in the last two months as energy stocks collapsed.

There's no question this is a distressed sector and the company's stock is down 75% from the highs of last year. Almost the entire equity peer group – including Transocean, Valaris and Seadrill – is priced for bankruptcy. Our basic view is that Maersk Drilling has the balance sheet to weather the current market storm, and that the current market storm will actually reconfigure the global oil-supply balance in a way that will benefit offshore exploration and production. U.S. shale, which we consider to have been a giant misallocation of capital, will likely not come back to former levels. It won't hap-

pen overnight, but offshore oil and gas – now roughly 30% of total global supply – will have to reverse historical levels of underinvestment to meet normal global demand. That should benefit survivors in the sector like Maersk Drilling.

The company this year should still generate \$300 million or so in EBITDA, so it's not burning cash. If we normalize to what we consider reasonable day rates for its equipment – still below what you'd need to incent a new build – we think the stock today [at around 160 Danish kroner] trades at 3x cash flow. If you normalize to a level where a new build would happen

– which seems like a stretch today but we think can happen sooner than most think – the cash-flow multiple is 1.5x. That's cheap. If the stock returned to its first-day closing price from last year – when the sector was already depressed – it wouldn't be far from a four-bagger from here.

From one battered sector to another, explain why you're betting on an eventual rebound at Meliá Hotels [Madrid: MEL].

ÁG: One could say the modern resort-hotel business was invented by the Spaniards in Mallorca, and Meliá was an early

INVESTMENT SNAPSHOT

Meliá Hotels
(Madrid: MEL)

Business: Owns, operates, franchises and manages more than 350 primarily resort hotels located in 40 countries; top markets include Spain, Mexico and the Dominican Republic.

Share Information
(@4/29/20, Exchange Rate: \$1 = €0.92):

Price	€4.33
52-Week Range	€2.51 - €8.85
Dividend Yield	3.4%
Market Cap	€896.0 million

Financials (TTM):

Revenue	€1.79 billion
Operating Profit Margin	12.3%
Net Profit Margin	6.3%

Valuation Metrics

(@4/29/20):

	MEL	S&P 500
P/E (TTM)	8.1	22.5
Forward P/E (Est.)	11.9	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Norges Bank Inv Mgmt	3.1%
Global Alpha Capital	3.0%
Financiere de L'Echiquier	1.6%
Dimensional Fund Adv	1.6%
Vanguard Group	1.6%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a
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MEL PRICE HISTORY



THE BOTTOM LINE

Álvaro Guzmán believes the company has the financial wherewithal to ride out the current storm as well as the competitive strengths and culture to prosper when some normalcy returns to the travel and leisure industry. Valued both on net assets and on estimates of normalized free cash flow, he believes the stock price will return to 3-4x its current level.

Sources: Company reports, other publicly available information

pioneer. The company, founded in 1956 and now run by the second generation of the Escarrer family, owns and/or operates more than 350 mostly resort hotels in 40 different countries, prominently in Spain, Mexico and the Dominican Republic. It's been public since 1996.

There's plenty not to like about the hotel business right now. Travel and leisure is obviously at the center of the current storm and most of the company's hotels are closed. This year will be a significant loss year, and it's difficult to assess the speed and magnitude of the rebound. There also are other secular issues that were weighing on the share price even before the virus, in particular the long-term impact on hotel profitability from online travel agents [OTAs] like Booking.com and Expedia, as well as the rise of new competition from Airbnb and others like it.

The first question to answer is about staying power. We have stressed the company's balance sheet with scenarios materially worse than what we think will actually happen, and believe it has plenty of flexibility to ride out a long storm. Most of its debt maturities are later than 2025. Debt covenants don't appear to us to be an issue. Maybe most importantly, the company has considerable capacity if necessary to take out loans against a large portfolio of unencumbered owned real estate. When things return to normal – and we do believe for them that it's when, not if – Meliá will be there to take advantage.

Which gets to the company's strengths against the two big secular threats. We think it becomes less rather than more dependent on OTAs, due to its strong brand and customer base. Meliá has 11 million members in its loyalty program, which on a member-per-room basis is around 110, not far from levels at much larger chains like Starwood and Marriott. Almost one-third of the company's bookings are direct, and that percentage is increasing. We think that protects it better than people seem to think from ongoing margin pressure from the OTAs.

The threat from the Airbnbs of the world also strikes us as overdone. First of all, we think those companies are much less

competitive with resort-hotel operators, who offer much more than a clean and affordable place to stay. That advantage for resort hotels is amplified by what we consider the very customer-friendly culture of Meliá. While the company centralizes the right things to be cost efficient and take advantage of scale, it's decentralized at the hotel manager level, where the managers behave as if the hotel is their own and their first job is to serve the customer.

How are you valuing the stock, now trading at just over €4.30 per share?

ÁG: We have two valuations for this. Because they own and operate a large percentage of the hotels, one method assigns value on a gross hotel-by-hotel basis, then subtracts all debt, pension and other centralized overhead costs to arrive at a net asset value for the owned hotels. Then we look at the leased and managed hotels and apply a conservative 15x multiple to their normalized free-cash-flow stream. With this valuation method we get €14 per share in value for the owned hotels and €4 per share on the leased or managed ones, for a total of €18.

The other valuation is based purely on free cash flow. The company generated roughly €160 million in free cash flow in 2019. This year we assume they'll lose €100 million, but we expect that to start to rebound next year, back to around €80 million. For our normalized number – call it the “vaccine” number – we think by 2022 or 2023 free cash flow can get back to where it was last year, or €160 million. Applying what we consider a reasonable 17x multiple to that and then adding back the value of non-core assets, we arrive at a market value of around €3.3 billion, or €15 per share.

This is a stock that over the past 17 years has gone from as low as €3, back to €18, down to €3 again, back to €13, and now collapsing again to €4. We think this is the third great opportunity over that time to partner with a best-in-class company, with a bargain-priced stock, in an industry that will be there and grow nicely over time. We don't get these types

of opportunities that often, so we should be prepared to take advantage.

INVESTOR INSIGHT



Whitney George
Sprott Asset Management

Hard Assets

As both a portfolio manager and the president of an asset-management firm, Sprott Inc.'s Whitney George has done plenty of thinking about how well his portfolio and his firm are positioned for what he expects to be a rocky economic road ahead. Here he describes some of his key conclusions.

Like many value investors, your cash balance had grown coming into 2020 and you put it to work fairly quickly as the market collapsed. Can you generalize about your priorities in doing that?

Whitney George: I'm an active value investor trying to understand what businesses are worth and trying to buy them at reasonable prices. I always stress companies with high returns on capital, strong balance sheets and that are trading at significantly out-of-favor valuations. As you say, the pickings with that combination of attributes were getting very slim as 2019 went on and into the new year.

As we essentially got a global margin call, almost everything got hit. Correlations went to one on nearly everything. This is something investors like me and many of the people you probably regularly talk to have been thinking about for a long time. You never know what's going to

trip it – it wasn't the trade wars, it wasn't the impeachment proceedings, it ended up being a virus. But it did deflate the debt-fueled bubble that existed in many assets globally, and as a value investor that should be your time to shine.

What did we do? We put money in precious metals mining companies, which now represent more than 15% of my fund. We've been investing in high-quality energy companies, which we were doing before this crisis and before the price war between Saudi Arabia and Russia. I've also been adding to active asset managers. They are often punished the hardest in a decline because of their exposure to the markets, but asset managers have some of the strongest balance sheets and provide real leverage to a recovery.

It sounds like you might be pretty high on the shares of your own parent company, Sprott Inc. [Toronto: SII].

WG: Thank you for asking. In addition to managing money, I am also the President of Sprott Inc., where I have been for the past five years after leaving Royce & Associates. The company's stock is my most significant personal holding.

Sprott has three primary businesses, all tied to precious metals. The biggest business, with about \$7 billion in assets, is managing physical bullion trusts that trade on the New York Stock Exchange and that allow investors to buy claims on physical gold, silver, platinum and palladium. The metal is stored at the Royal Canadian Mint and the shares of these trusts are exchangeable into that metal for delivery. The second business, with about \$2 billion in assets, we purchased last year from Tocqueville Asset Management and now consists primarily of the renamed Sprott Gold Equity Fund. The portfolio is managed by John Hathaway, one of the longest-tenured and most successful active equity investors in gold and silver mining companies. We also have a well-established private-lending business that makes and facilitates high-interest collateralized loans to a range of mining-industry players in search of capital.

We expect all of these businesses to benefit considerably from the macroeconomic environment we see coming. In a world of seemingly limitless money printing, we think that it's only a matter of time before the inflation that central banks seem to seek so desperately will arrive – and that it will come on faster and increase more dramatically than people can imagine. We also believe the debt build-up we're seeing will significantly dampen economic recovery and that the debt load being taken on won't be manageable without debasing currencies. If we're right about this, hard assets will once again play an es-

sential part in wealth preservation during what looks to us like an inevitable period of stagflation required to restore balance. I admit that's not a particularly optimistic picture, but it's what we're positioning our company for.

Turning from that cheery note, describe why Pason Systems [Toronto: PSI] is one of your favorite ideas in the decimated energy sector.

WG: Energy is an area I started to find increasingly interesting over the last six to 12 months as I cycled out of names like

INVESTMENT SNAPSHOT

Pason Systems

(Toronto: PSI)

Business: Provider of technology and electronics that collect, transmit, manage and analyze oil and gas drilling data used to help optimize the performance of drilling operations.

Share Information

(@4/29/20, Exchange Rate: \$1 = C\$1.39):

Price	C\$7.71
52-Week Range	C\$5.81 – C\$21.00
Dividend Yield	9.9%
Market Cap	C\$596.6 million

Financials (TTM):

Revenue	C\$295.6 million
Operating Profit Margin	27.1%
Net Profit Margin	18.3%

Valuation Metrics

(@4/29/20):

	PSI	S&P 500
P/E (TTM)	11.0	22.5
Forward P/E (Est.)	36.4	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Mackenzie Financial	10.1%
Royce & Associates	8.2%
Fidelity Mgmt & Research	6.2%
Caisse de depot et placement du Quebec	5.2%
Neuberger Berman	4.8%

Short Interest (as of 4/15/20):

Shares Short/Float n/a

PSI PRICE HISTORY



THE BOTTOM LINE

As a service provider to the energy industry, the company's near-term outlook is predictably poor, says Whitney George, but he believes it can before too long return to earnings levels of 2018 and 2019, when its average EPS was C\$1.40. Even assuming an unambitious multiple, he says, that would translate into an excellent return on the stock.

Sources: Company reports, other publicly available information

Apple and was looking at more out-of-favor ideas. The stocks in the sector were already re-rating before both COVID-19 and the Saudis and Russians picked one of the worst possible times to start a massive price war. Part of it was due to flagging global economic growth, but at the same time all things ESG [Environmental, Social and Governance] were turning the perception of energy into the next tobacco industry. The negativity was already high, and then it got much worse.

I've owned Pason since 2004 at various times and in varying quantities. It's one of the more interesting energy-related companies I've ever seen – it's actually more of a technology company. It provides technology and electronics that collect, transmit, manage and analyze oil and gas drilling data that is used to help optimize the performance of drilling operations. For example, it has developed rig sensors that direct horizontal-well operators to the optimal site in a formation to position a drill bit, arrived at by essentially sniffing the gases the drill bit is penetrating.

The company's market shares are high – 85-90% in Canada and 65% and growing in the U.S. Like any good technology company, it spends heavily on R&D and also earns technology-like margins, frequently 50% on revenue.

The business is driven both by the rig count in North America and the number of Pason products per rig that clients use. Rig counts are obviously way down and there's not a lot of visibility on when they will recover. But I am a big believer that the best cure for low prices is low prices, and that even a slow recovery in the oil price – at least back to \$40-50 per barrel – will translate into significant upside for Pason. There's no reason in my view that its fundamentals can't come back to where they were before this crisis.

Is the balance sheet a risk?

WG: The company has C\$170 million in cash and no debt. That's C\$2 per share in net cash on a C\$7-8 stock. I don't expect net profits this year, but there's a multi-year cushion in that level of net cash. I

don't know if they'll do this or not, but with the annual dividend yield pushing 10%, they also have flexibility if necessary to save cash on that as well.

If the fundamentals do come back to where they were, what upside do you see in the stock – now trading at about C\$7.75 – from here?

WG: Pason made C\$1.50 in EPS in 2018 and just over C\$1.30 last year. Those are far from its peak earnings levels earlier in the decade, but are reasonable levels to anchor on given where oil prices were in 2018 and 2019. The company also continues to increase its offerings, so it can grow even at a lower level of rig activity by increasing penetration per rig.

What kind of a multiple could you apply here? I could make the case that a company with this margin profile and balance sheet could go for 20x earnings. But if earnings get back in the next couple of years just to where they were one or two years ago, the multiple can be much lower and this would still generate an excellent return.

You've been a long-time investor in Berkshire Hathaway [BRK-A]. What's your take on Warren Buffett's relative silence through all this?

WG: I'd argue that there's no manager or company better proven to operate extraordinarily well in crises. Berkshire Hathaway is always a go-to name for me when there's a disorderly market environment, and after averaging in during the recent turmoil it's now the second-largest position in my fund.

I don't read much into Buffett's relative silence. Running a business with 400,000 employees in an economy that is shutting down is a very challenging job. But still waters run deep and the environment over the past two months has improved for him. It's been almost trendy to ridicule Berkshire for having \$128 billion in cash on its balance sheet, but I imagine that's been a pretty valuable asset of late – and probably will be for some time to come.

INVESTOR INSIGHT



Harry Hartford
Causeway Capital Management

Flight Plan

With a keen eye on valuation, Causeway Capital over time has proven quite skilled at investing in cyclical companies whose volatility may scare other investors away. In a market where cycles and volatility have gone a bit haywire, Causeway President Harry Hartford and Portfolio Manager Jonathan Eng describe where they see opportunity in returning to some previous winners.

Causeway came out with a paper early in the recent market crisis describing opportunity you were finding in more-cyclical companies. Describe your thinking there and how you acted on that.

Harry Hartford: As the economic cycle was truncated quite dramatically, almost any company deemed even nominally cyclical went on sale at clearance prices, which meant we could be very selective in focusing on best-in-class operators in areas like transportation, tourism/hospitality, industrials and materials. By selective, that meant companies that we believe have excellent management teams, defensible franchises and the resources to weather the current environment. Also, as always, it was critical to assess if there were any structural issues – especially in light of the current crisis – that might derail the reversion to the mean we were counting on. In many cases we were buying companies

we'd owned before, had sold due to valuation, and they were now again attractive.

Jonathan Eng: To give a couple examples, we reestablished a position in Compass Group [London: CPG], which is a global food-services business serving the educational, healthcare, corporate and sports/entertainment markets. Its business has been directly hit by the economic fallout from the coronavirus, but has over the long term been a quite stable compounder of value. We also bought back into Vinci [Paris:DG], which is a French company that owns and manages tollroads and related concessions, airports and related concessions, and also has a big infrastructure construction business. A number of its businesses have also been directly impacted in the current environment, but we believe the issues are not permanent, the company is well-managed and financially sound, and that it will come through all this as strong on the other side. That longer-term view we didn't think was reflected in the share price, which was cut in half from mid-February to mid-March.

You've also highlighted finding opportunity in aviation and aerospace, another industry in distress. To flesh out an example, describe the upside you see today in Rolls-Royce [London: RR].

JE: Rolls-Royce manufactures airplane engines for wide-body aircraft such as the Airbus A330, the Airbus A350 and the Boeing 787. This market is essentially a duopoly with General Electric, and sports an attractive business model. Engines are typically sold at a loss, but then generate a cash-flow stream over some 25 years based – in Rolls-Royce's case – on the number of hours planes with its engines are in the air. It is responsible for major servicing of the engines every five to seven years, but the aftermarket annuity stream is usually 4-5x the original purchase price paid.

Even before the pandemic problem, the company was struggling with issues around its Trent 1000 engine, which is used on the 787. The blades haven't lasted nearly as long as expected, so there's been

incremental maintenance required that the company hadn't accounted for. The fixes have also taken time, so it's had to lease replacement planes for Boeing to compensate. On top of all that, when the planes can't fly they're not earning Rolls any ongoing revenue. It all snowballs in a negative way and the company has taken a hit on the Trent 1000 of some £2.4 billion in cash flow over the past three years.

HH: Our sense that the company was getting on top of this problem is what brought us back to the stock in January and February. If we were right, we thought

its monopoly position in the A330 and A350 programs were poised to generate a tremendous amount of cash that would be far more visible as the extraordinary Trent 1000 costs fell away. Then COVID-19 hit.

How are you processing the financial impact of that?

JE: We estimate Rolls could lose something on the order of £1.5 billion in revenue this year due to the crisis. Offsetting that, however, management is confident that they can cut operating and capital expenses by approximately £1 billion to help off-

INVESTMENT SNAPSHOT

Rolls-Royce
(London: RR)

Business: Designs, develops, manufactures and services wide-body commercial aircraft engines, systems for civil power generation and defense-related systems and equipment.

Share Information
(@4/29/20, Exchange Rate: \$1 = £0.80):

Price	£3.58
52-Week Range	£2.49 - £9.40
Dividend Yield	0.0%
Market Cap	£6.17 billion

Financials (TTM):

Revenue	£16.59 billion
Operating Profit Margin	(-4.8%)
Net Profit Margin	(-7.9%)

Valuation Metrics

(@4/29/20):

	RR	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	41.1	21.0

Largest Institutional Owners

(@12/31/19 or latest filing):

Company	% Owned
Capital Research & Mgmt	5.3%
Harris Associates	5.0%
Baillie Gifford	4.8%
Causeway Capital	4.8%
ValueAct Capital	4.5%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a
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RR PRICE HISTORY



THE BOTTOM LINE

The positives of the company's business model, its market position, and the long-term secular growth in its industry are being obscured by a difficult product issue and now the pandemic-induced economic crisis, says Jonathan Eng. Assuming a 10% free-cash-flow yield on his normalized estimates, the stock would trade at nearly 2.5x its current level.

Sources: Company reports, other publicly available information

set that. That means free cash flow overall could come in at up to negative £500 million this year. That's obviously not good, but against roughly £7 billion in liquidity the company has from net cash on hand and from drawing down revolving credit lines, it wouldn't be a catastrophe.

While the growth trajectory has been stretched out, we ultimately believe the medical breakthroughs needed for society to jettison "social distancing" are within a two-year investment horizon, and that secular air passenger demand will rise again. Air-travel penetration in emerging economies with rising incomes have plenty of room to grow, which should translate into good growth in global aircraft orders. You can see that in the order-backlog numbers, which are coming down but still indicate strong forward demand. Given the strength of its market position and the attractiveness of its business model, Rolls should be very well positioned to reap the benefits of that long-term demand.

With a longer-term outlook, how cheap do you consider the stock at today's £3.60 price, down 60% from a year ago?

JE: Within the next two years, with £500 million in free cash flow from the company's defense and power-systems divisions, and with revenue flying hours in the engine business back to where they were prior to the Trent 1000 issues and the pandemic, we believe the company can generate £1.5 billion in free cash flow. The market cap today is £6.2 billion. Free-cash-flow yields in the sector used to be more in the 5% range, but even at 10% the market value on our estimate of normalized free cash would be nearly 2.5x today's level.

There are two very big issues here that you have to believe are temporary in nature. It would be pretty easy to look at this and say it's just too hard. We don't think that's the right conclusion.

Has anything surprised you about the market's behavior over the past two months?

HH: One of the great things about equity markets is that they clear every single day.

What's made the recent situation more challenging for any investor whose process is primarily focused on valuation, however, is that while, yes, we've had market clearing, price discovery has often been all over the place.

I'd illustrate that with an example, also in the aerospace industry. Boeing [BA] obviously has issues, of its own making and associated now with the coronavirus. But you could have bought Boeing shares at \$95 on March 20 and sold them at \$180 on March 26. And there was a weekend in between. The notion that the single-largest U.S. export company could have its underlying equity value move 100% in four working days, that says to me that investors in many cases don't really have a clue. We've had stocks move 40% intraday. [Note: Boeing shares closed recently at just under \$139.]

There are a number of stocks we've been buying or have bought, but we haven't been able to buy enough of them because the share prices have been gyrating all over the place. But that's why you have a discipline. If stocks clear at a price where you're comfortable buying, you should be buying. If they don't, be patient.

premium on how well companies he owns are built to withstand rough times. Noting that "prior recessions perhaps haven't been a good guide" of late, he explains how he's gone about re-underwriting what he already owns during the current market turmoil.

You've written about assessing your current holdings' ability to handle a terrible environment, using sportswear company Nike [NKE] as an example. Describe your process around that.

Stephen Arnold: We generally look for companies with leadership positions in the markets in which they operate and where being the leader is a material advantage. That means we expect them to gain share at an accelerating rate, and that they can enhance their positions in times of stress. We generally avoid businesses where externalities like overall economic growth, changes in interest rates, or changes in political outcomes have a material impact on what the business is worth. Where views on those types of things matter, we'd rather not own the stock.

When panic sets in, we think it's important to review how well the companies you own – in light of the current situation – can not only withstand the challenges ahead, but also come through it all in a better position. We focus in that review on earnings resilience, capital strength, management acumen and the competitiveness of the business.

In all of those areas we conclude a company like Nike is one that we want to continue to own through a crisis like the one we're in. Across geographies and product lines it has no areas of competitive weakness – they are #1 in pretty much everything they do, everywhere they do it. As the #1 player with a strong brand and loyal customers, it has delivered consistent annual earnings-per-share growth of better than 11% over the last 10 years, gaining market share each year. In the last recession, its earnings continued to grow through 2009 and 2010.

The company has a strong culture and a deep and long-tenured management

INVESTOR INSIGHT



Stephen Arnold
Aoris Investment Management

Rating Resilience

With a concentrated international portfolio of no more than 15 stocks, Stephen Arnold of Australia's Aoris Investment Management already puts a particularly high

team, which we consider very important because they've been through this before. They did recently appoint a new CEO in John Donahoe, but he's been on the board since 2014 and two of the three other CEOs in the company's history are also still directors. Forward-looking investments made in e-commerce, the supply chain and logistics have served them quite well already in the crisis, in particular in keeping up with a surge in online ordering and demand. Online sales already account for more than 15% of total revenue, and the direct digital connection they've built with customers is a key reason we expect the company to strengthen its leadership position through the crisis.

Finally, of course, you have to look at capital strength. Poorly managed and excessive debt can throw even good businesses into peril. Given the nature of the current situation, that's going to be more true than ever. Nike has zero net debt. With resilient earnings as well, the balance sheet is highly unlikely to be a problem.

Even with all that, Nike's stock went from a high of \$105 in January to as low as \$60 in March.

SA: Which we believe shows the extent of the indiscriminate selling that went on last month. We added to the position then, and while it's not now selling at a deep discount [the shares recently traded at around \$88], we're happy to have been given the opportunity to own more of it.

Describe why you think Experian [London: EXPN] will prove equally resilient.

SA: You probably know the company primarily as a credit bureau, providing a variety of credit reports to lending organizations in what is in the U.S. an oligopoly with Equifax [EFX] and TransUnion [TRU]. The databases of the incumbents and related high switching costs in this core business make it almost impossible for new competitors to successfully enter the market.

The company also provides decisioning software and data analytics. One example

would be underwriting software that takes bank lending officers through the lending process to an end decision. They also sell decision-analytics tools that might combine data from the credit bureau, the lender itself and many external sources to enable a bank to assess credit risk in its own portfolio or help it decide on target geographies and customers for launching a new credit product.

As it continually expands revenue per customer, Experian has generated pretty consistent overall sales growth in the high single digits annually, which we think is a sustainable trajectory. Its operating mar-

gins have averaged 27% over the past seven years and returns on capital have been 12% or more since 2008. We just think this is a very low-risk business.

How are you handicapping the impact of the current economic upheaval on the company's business?

SA: The lockdown and economic recession this year will impact the business negatively in a few ways. Sales of new software licenses in their decisioning and analytics area will likely fall as banks defer some of their information-technology spending.

INVESTMENT SNAPSHOT

Experian
(London: EXPN)

Business: Global provider of credit bureau services as well as a wide variety of decision-support and data-analytics software to inform and facilitate primarily lending-related decisions.

Share Information
(@4/29/20, Exchange Rate: \$1 = £0.80):

Price **£24.83**
52-Week Range £18.23 - £29.26
Dividend Yield 1.5%
Market Cap £22.23 billion

Financials (TTM):
Revenue \$4.99 billion
Operating Profit Margin 24.3%
Net Profit Margin 14.6%

Valuation Metrics
(@4/29/20):

	EXPN	S&P 500
P/E (TTM)	36.3	22.5
Forward P/E (Est.)	29.8	21.0

Largest Institutional Owners
(@12/31/19 or latest filing):

Company	% Owned
WCM Investment Mgmt	5.0%
Vanguard Group	3.0%
Fidelity Mgmt & Research	2.8%
Capital Research & Mgmt	2.4%
Jupiter Asset Mgmt	2.0%

Short Interest (as of 4/15/20):
Shares Short/Float n/a

EXPN PRICE HISTORY



THE BOTTOM LINE

Having concluded that the value of the business was not lower because of current economic events, Stephen Arnold found the company's shares particularly attractive as they dropped nearly 40% over four weeks last month. Having retraced some lost ground, he still expects a low-teens compound annual return on the stock over the next five years.

Sources: Company reports, other publicly available information

The fees Experian receives from loan applications for new-home purchases and auto sales will decline, perhaps sharply. On the other hand, banks will need more sophisticated software to deal with the volume of loan refinancings and modifications and in dealing with missed payments. Also, some 20% of Experian's revenue comes from helping healthcare providers, such as hospitals, get paid, which is an area of likely increased demand. Any benefits to the business overall will probably follow the headwinds by a year, but our conclusion is that the value of the business is not lower because of current economic events.

Having clawed back half of its original decline in the virus-related panic, how are you looking at upside in the stock from today's price of £24.80?

SA: We expect Experian to report adjusted earnings of about £1.05 per share for the year ended in March 2020, up from 97 pence in the prior fiscal year. Earnings

will likely decline for the fiscal year ending next March, but we view that decline as cyclical and believe something approaching the latest fiscal year's EPS is a reasonable estimate of "normal."

ON POTENTIAL TRAPS:

For certain areas of the market now considered safe havens, I think that status will likely prove to be temporary.

Our expected low-teens return on the stock over a five-year horizon can be decomposed as follows: We expect organic growth in operating profit of about 6% per year, capital reinvestment in share buybacks and bolt-on acquisitions adding another 3%, a revaluation from today's multiple adding roughly 2%, and then another 1.5% from the dividend yield. That's quite

attractive for what we consider a low-risk business with owner-minded management and a formidable and strengthening competitive position.

We're curious if any of the sectors that have held up well, like large-cap technology or non-discretionary consumer products, have attracted your interest at all.

SA: The best-known technology names, for the most part, have been too expensive for us for some time. With respect to other areas of the market that are now considered safe havens, including grocery retailers and consumer-packaged-goods companies, I'd argue that the underlying structural competitive issues facing many of those businesses haven't gone away despite the fact they've been relatively strong performers of late. When people remember next year what they didn't like about those businesses last year, I think their safe-haven status will likely prove to be a temporary phenomenon. **vii**

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