HARRIS ASSOCIATES
OAKMARK FUNDS

The High Price of Low Volatility - U.S. Equity market commentary 2Q23

June 30, 2023

"Risk has a very good colloquial meaning – a substantial chance that something could go horribly wrong." - Charlie Munger

At Oakmark, we are long-term investors. We attempt to identify growing businesses that are managed to benefit their shareholders. We will purchase stock in those businesses only when priced substantially below our estimate of intrinsic value. After purchase, we patiently wait for the gap between stock price and intrinsic value to close.

"Risk" could be the word that investment professionals most disagree about. We agree that an investment with higher risk requires higher return, but we don't agree on how to measure risk. Business owners say risk is the chance their business is worth less in the future than it is today. Academics get frustrated by that definition because it isn't easily quantified. They measure daily stock price changes and use risk metrics like beta, standard deviation and correlation. Many portfolio managers think of their risk of getting fired, so to them, tracking error (how much their portfolio return differs from their benchmark index) becomes the most relevant risk measure.

In the 1940 Act, the SEC said mutual fund investors should be alerted to a fund's high risk if it isn't adequately diversified. It determined that a diversified fund should have no more than one-quarter of its assets in positions that each represent over 5% of its portfolio. Funds that were more concentrated in their largest holdings could have up to half their portfolio invested in positions that were each over 5% of assets, but they must register as non-diversified funds to alert investors to their higher risk level.

Concentration Risk in Index Funds

Though index funds have generally been considered low-risk relative to actively managed funds, some now require the "non-diversified" risk alert. One might expect that a portfolio tracking the NASDAQ 100 Index would be a highly diversified portfolio. After all, it owns almost twice as many stocks as the Oakmark Fund. But a closer look shows that because the weightings are based on market capitalization, its five largest positions account for 47% of assets, and its largest, Microsoft, accounts for 13%. By comparison, the Oakmark Fund's five largest positions account for only 15% of assets, and its largest, Alphabet, accounts for less than 4%. Further, the technology sector accounts for 51% of the NASDAQ 100, while the Oakmark Fund's largest sector, financials, accounts for only 38%. Finally, the total of positions each over 5% of a NASDAQ 100 index fund is 47%, and Tesla and Meta are each just below the 5% threshold. Should either of those companies pass 5%, the SEC would not allow the fund to invest new capital at the same weightings as the index. IRS rules also prohibit any Registered Investment Company from purchasing any position that is over 5% of assets if the total of those positions crosses 50%. That means the index fund would lose its pass-through status and be taxed as a typical corporation. Investors looking to lower their risk by buying NASDAQ 100 index funds are clearly not accomplishing their goal.

Investors in the Russell 1000 Growth Index might also think they are investing in a highly diversified portfolio. But a Russell Growth index fund also requires the "non-diversified" warning because 37% of its assets are invested in stocks that each account for over 5% of its portfolio. And despite a name suggesting that one's assets are being divided across 1,000 positions, the 10 largest account for over half the portfolio, and the technology sector accounts for 43% of assets.

It's no wonder that managers of many actively managed growth portfolios have asked shareholders for permission to manage their portfolios using the riskier "non-diversified" category. Without the non-diversified status, a growth manager benchmarked to either the NASDAQ 100 or the Russell 1000 Growth Index can't express a favorable view on the largest stocks in their benchmarks. (Interestingly, the Russell 1000 Value Index has nothing like its growth sibling's concentration risk. Its largest weighting is Berkshire Hathaway at 3%; its top 10 positions account for only 17%; 71 holdings account for half the portfolio; and its largest sector, financial services, is just under half the weighting that technology is in the growth index.)

This excess concentration risk extends to the S&P 500 as well. The Oakmark Fund is often considered to be an above-average risk fund because it typically owns only 50-60 positions. In fact, when we publish commentary about the Fund, we are required to include this disclosure:

> *"The Oakmark Fund's portfolio tends to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities."*

Alphabet is the Fund's largest position because we believe it has the most attractive risk-return profile. We kept buying it until it reached a 3% position, which is as large as we will make any single security. Because it performed better than our portfolio, that position has grown to 3.5% despite us trimming when the weighting exceeded 4%, which we consider the upper limit for a portfolio that shareholders expect to be diversified. Through no effort on our part, the Fund's weighting for Alphabet happens to match its weighting in the S&P 500. But Alphabet isn't even the largest company in the S&P index. Apple has over twice the weighting of Alphabet, at 7.7%, and Microsoft is at 6.8%. Further, the top 10 positions account for 31% of the S&P 500 compared to 26% of the Oakmark Fund. Yet S&P 500 index funds are not required to give the same warning as Oakmark is about volatility due to large individual security weightings!

Drawdowns and Recoveries

A risk measure we consider important is how much a fund loses when the market declines. From the S&P 500 high on January 3, 2022, until its bottom on October 12, the index fell 24%. Over those same dates, the Oakmark Fund lost 20%. At the end of June, the S&P remained 5% below its January 2022 high, while the Oakmark Fund had regained all of its losses over the same period. It would be logical to conclude that the S&P 500 has become a very risky portfolio relative to the Oakmark Fund. But index fund investors believe the S&P 500 is the low-risk gold standard. They view risk as the amount that active managers' performance differs from the S&P 500. They deem Oakmark higher risk because it has a higher tracking error than the average equity fund, 10.5% versus 8.9%, over the past three years.

Oakmark Fund - Investor Class
Average Annual Total Returns (06/30/2023)
Since Inception (08/5/91) 12.55%
10–year 12.05%
5–year 11.03%
1–year 27.11%
3–month 8.64%
Expense Ratio: 0.89%

Expense ratios are from the Fund's most recent prospectus dated January 28, 2023; actual expenses may vary.

Past performance is no guarantee of future results. *The performance data quoted represents past performance. Current performance may be lower or higher than the performance data quoted. The investment return and principal value vary so that an investor's shares when redeemed may be worth more or less than the original cost. To obtain the most recent month-end performance data, visit Oakmark.com.*

We don't equate high tracking error to high risk. We see it as a natural result of high active share (little overlap with the index). We make no attempt to mimic S&P weightings at either the company or industry level. Because the Fund invests with a very long-term horizon, we don't worry about tracking error or short-term volatility. I like the way Howard Marks of Oaktree Capital expressed it: "I've never heard anyone say, 'The prospective return isn't high enough to warrant bearing all that volatility.' What they fear is the possibility of permanent loss." We consider the loss of capital to be the most important risk, and on that score, the Oakmark Fund stacks up quite well. Over the three-year period ending June 30, 2023, when the Fund had an above-average tracking error, it had an upside capture ratio of 115% and downside capture of 94%. That means when the S&P went up, we tended to go up 15% more, and when the S&P went down, we tended to go down 6% less. That doesn't sound like above-average risk to me.

The High Price of Low Volatility

Having said that, on some metrics, such as standard deviation and beta (measures of volatility and sensitivity to changes in the S&P, respectively), the Oakmark Fund has become more volatile than it was 20 years ago. Our three-year standard deviation for the period ending June

30, 2023, has increased from 17% to 22%, and our beta has increased from 0.7 to 1.1. There are two reasons why. First, low volatility stocks have become more expensive, so we own fewer of them. Second, industries that often sell at low multiples (autos, financials, energy, media) now have much higher betas than they did 20 years ago.

We looked at stocks with over $1 billion market cap that have been less volatile than the S&P 500. We didn't find one we thought was as attractive as the stocks we own. They are mostly below-average growth businesses with above-average P/E ratios. But as a group, their standard deviation has declined by 23% compared to 20 years ago. Not owning them increases our relative volatility. When faced with the choice of buying businesses we believe are attractively priced but have high day-to-day volatility or businesses we deem more expensive but have lower volatility, we will always pick the former.

Similarly, we looked at the betas of industries that we and other value investors have often owned, such as autos, media, banks, asset management, insurance, consumer finance, payment processing and energy. Over the past 20 years, their average beta has increased by over 40%. We choose to own these stocks despite their higher betas because we believe they are meaningfully undervalued, and importantly, we don't believe their business values have become any less predictable. (If you want to read more about the high price of low volatility, I'd suggest the excellent piece on the Oakmark website written by my colleagues Alex Fitch and Robert Bierig.)

Value investing requires zigging when the consensus is zagging. We believe that index fund investors have become blind to the concentration risk that has crept into their portfolios. Further, we believe that investors who think they are decreasing their risk by buying low volatility stocks are blind to the valuation risk they are taking. We believe that owning cheap stocks that have become more volatile and sizing them based on their attractiveness rather than their market capitalization not only reduces our risk of loss but is one of today's most attractive opportunities. We expect that eventually, the premium investors pay for low volatility will diminish, and we would expect our Oakmark portfolios to again become less volatile. But while we wait, as Warren Buffett said, "We prefer a lumpy 15% return to a smooth 12%."

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The securities mentioned above comprise the following preliminary percentages of the Oakmark Fund's total net assets as of 06/30/2023: Alphabet Cl A 3.5%, Apple 0%, Berkshire Hathaway 0%, Meta Platforms Cl A 1.8%, Microsoft 0% and Tesla 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

Upside capture ratio measures a strategy's performance in up markets relative to an index.

Downside capture ratio is a statistical measure of an investment manager's overall performance in down-markets.

Standard deviation is a measure of how dispersed the data is in relation to the mean.

Beta is a measure of the magnitude of a portfolio's past share-price fluctuations in relation to the ups and downs of the overall market (or appropriate market index). The market, or index, is assigned a beta of 1.00. A portfolio with a beta of greater than 1 would generally see its share price rise or fall by more than the market, while a portfolio with a beta of less than 1 tends to exhibit less share price volatility than the market.

The NASDAQ-100 ETF ("QQQ") is being used as a proxy for the NASDAQ 100 Index. The QQQ is an exchange-traded fund that tracks the NASDAQ 100 Index. The QQQ is a marketable security that trades on an exchange. It offers traders a way to invest in the 100 largest non-financial companies listed on the NASDAQ. The NASDAQ 100 Index includes 100 of the largest domestic and international non-financial companies listed on The NASDAQ Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.

Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. This index is unmanaged and investors cannot invest directly in this index.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. This index is unmanaged and investors cannot invest directly in this index.

The S&P 500 Total Return Index is a float-adjusted, capitalization-weighted index of 500 U.S. large-capitalization stocks representing all major industries. It is a widely recognized index of broad, U.S. equity market performance. Returns reflect the reinvestment of dividends. This index is unmanaged and investors cannot invest directly in this index.

The price to earnings ratio ("P/E") compares a company's current share price to its per-share earnings. It may also be known as the "price multiple" or "earnings multiple", and gives a general indication of how expensive or cheap a stock is. Investors should not base investment decisions on any single attribute or characteristic data point.

The Oakmark Funds' portfolios tend to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

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All information provided is as of 06/30/2023 unless otherwise specified.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please visit Oakmark.com or call 1-800-OAKMARK (1-800-625-6275).

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