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OAKMARK FUNDS

Bill Nygren Market Commentary | 4Q22

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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.

Last quarter I was interviewed by John Rotonti of The Motley Fool. Below is an excerpted version of the interview. The full interview is available at Oakmark.com.

TEAM

John Rotonti: What is the ultimate role of an analyst?

Bill Nygren: I think too often, young analysts believe that the goal of an analyst is to demonstrate how much they know about a company and build a perfect earnings model. I don't think I've ever seen an analyst model their way to a great stock idea!

I view the goal of the analyst as developing conviction that the consensus is wrong about something important. Then their job is to communicate why they believe they are correct and the consensus is wrong and to compute the valuation impact. Once we own a stock, their job is to actively monitor new information to assess if their view or the consensus view is coming to fruition.

There are a lot of important areas the consensus can be wrong: management quality, business quality, long-term potential differing from current results, valuable non-earning assets, and so on. To make excess profits, you need to hold a nonconsensus view and be right.

Rotonti: How does the role of analyst and portfolio manager differ at Oakmark and is there a clear career path of going from analyst to portfolio manager?

Nygren: Our analysts are all generalists. Their job is to find mispriced companies and to do so, they look across all industries. So, our analysts think like portfolio managers. They aren't just asking whether Charter is more attractive than Comcast. Rather, they are thinking about how it compares to EOG (EOG -0.56%) or Wells Fargo (WFC -3.56%). When an analyst becomes a partner, they are typically added to one of our portfolio teams.

Rotonti: Does Oakmark have an economist or macro strategist? If so, what role does that person play?

Nygren: We do not. We are very much "bottom up" at Oakmark and have a much longer time horizon (five to seven years) than most investors. Our forecast is always that the economy will be at a "normal" level by the end of our time horizon. Typically, that is a very center-of-the-road forecast. Sometimes when investors embrace extreme forecasts (either positive or negative), our view that the world will eventually be "normal" is an outlier that influences our portfolio construction. A recent example was a couple years ago when nobody understood Covid-19 very well: the belief that travel would eventually return to levels that were considered normal pre-Covid-19 made most travel-related businesses appear very cheap. Owning companies like Booking Holdings, Hilton, and MGM boosted our performance as both business and vacation travel resumed.

PROCESS

Rotonti: Does Oakmark have an investment committee and if so, what is the role of the committee?

Nygren: We have a Stock Selection Group that includes me as CIO, our Chairman Tony Coniaris, and a third person who rotates among our partners. This group votes on which stocks are on our Approved List, the list from which we purchase stocks for all of our portfolios. So, none of us have the power to walk in one day and start buying, say, Microsoft. It first needs to be written up and presented in front of all our investment professionals, then the three of us vote on whether it goes on the Approved List.

Rotonti: How often do you hear stock pitches and what are your analysts expected to deliver during a stock pitch? How often does your team discuss existing positions in the portfolio?

Nygren: Informally, our analysts are talking all the time about stocks that we already own or that might be attractive. Formally, our investment team meets every Tuesday morning to review new stock ideas. At that meeting, we also review existing holdings and do Devil's Advocate reviews of our large positions. For a new idea, the analyst prepares a report that includes brief background on the business and management, their valuation models showing why the stock is cheap, forecasts showing how we expect value to grow, and discussion about management's history and why we should trust their goal is to maximize long-term per-share value. The report also includes an earnings model and several standardized attachments. The report is distributed by noon Monday, and the entire investment team spends Monday afternoon and evening trying to find holes in the arguments. Then on Tuesday, we all sit around a large table and discuss our concerns before voting on whether or not the stock gets added to our Approved List. It can be an intimidating environment for a new analyst, having a dozen people attacking your idea and telling you why they think you are wrong. But, analysts quickly learn it isn't at all personal and we are simply trying to identify as many of our mistakes as possible before we invest client capital in them.

Rotonti: How do you factor interest rates into your stock picking and portfolio management?

Nygren: Nominal interest rates factor into our growth assumptions (over time, companies can generally pass through most inflation) and real interest rates affect the P/E multiple.

Additionally, for financial companies, interest rates affect net interest margin, which is a much larger impact than just adjusting the growth rate for nominal rates.

Just as in bonds, higher rates decrease the value of near-term cash flows less than more distant cash flows. So, on a relative basis, when interest rates rise, value declines less for low P/E stocks than high P/E.

Rotonti: Please remind us of your definition of a high-quality business and how business quality factors into your decision-making process?

Nygren: I recently read an interview with Berkshire Hathaway's Todd Combs where he said the worst business imaginable is one that grows and needs infinite capital. I thought that was an interesting way to describe it because it shows that worse businesses exist than the typical low-multiple, low-growth cash cows. Inverting that definition of worst would say the best businesses grow rapidly without needing much capital. Companies that we own or have recently owned that would fit that definition of great businesses would include Mastercard Moody's, and Alphabet.

Our process incorporates quality in several ways. First, our analysts forecast out earnings for the next seven years, then apply a P/E multiple to that seven-year forward estimate that assumes the business becomes average over the next five years. So, a higher-quality company would be accorded a higher current P/E multiple based on its higher expected near-term growth, higher cash return to owners, and lower discount rate due to lower risk.

Rotonti: Can you please remind us what valuation tools and metrics your team uses? Do you build discounted cash flow models? Do you look at P/E ratios and free cash flow yields? Something else?

Nygren: Yes, to all. Depending on the company, we could use any of those methods and often we will use multiple valuation methods for one company to make sure that they are all getting us in the same ballpark. Our goal is to compute a reasonable estimate of the price a buyer could pay for the entire business and still earn an adequate return on their investment. Price-to-sales might give a better estimate than price-to-earnings when the potential profitability is obscured by growth spending or by a subscale company. Price-to-book can be useful for banks, especially when current earnings are far from trend. The trick is to find the balance between being very disciplined in applying different valuation metrics yet giving enough freedom to find the most appropriate metrics for each company.

Rotonti: When picking stocks, do you consider an upside potential-to-downside potential ratio? If so, what do you look for?

Nygren: Kind of. First, instead of looking at how much a stock should go up if our forecasts prove accurate, we look at what percentage of our estimated business value the total debt and equity of a company currently sell at. Though that might sound like a distinction without a difference, it is a very meaningful difference for levered businesses. Here's a simple example: Business 1 has no debt, its market cap is $80 billion and we think it is truly worth $100 billion. If we are right, the stock has 25% upside. Now consider Business 2, which is also deemed to be worth $100 billion, but it has $80 billion of debt and the stock sells for $10 billion. You could say that if we are right, the stock could double from $10 to $20 billion. But we would look at those two companies and say Business 1 is cheaper. Its total price is $80 billion whereas Business 2 has a total price of $90 billion. So, we could be off on our valuation estimate of Business 1 by 20% before we were paying the full value, but our cushion is only 10% on Business 2.

We also penalize companies where we believe the range of possible earnings is wider and where we believe management or business quality are less positive. Though we don't end up with a simple upside to downside ratio, we are trying to measure both upside and downside. We adjust both our buy/sell targets and our position sizes accordingly.

Rotonti: Do the numbers pretty much tell the whole story of a business?

Nygren: No. Numbers are probably more effective than words for telling the story of where a business has been. However, finding good investments is more about identifying businesses where the future will be different than the past -- and for that, I believe you need to explore the qualitative side.

Rotonti: How do you measure management quality, and can you please give us an example of a CEO (either in your portfolio or not) that you think does it right?

Nygren: The best management teams focus solely on maximizing the long-term per-share value of the company's stock. "Long-term" is important because a management focused on maximizing short-term earnings might damage a company by mistreating customers, employees, etc. If the management is focused on the long term, they must treat all stakeholders appropriately. "Per-share" is important because that is really the only metric the owner of the shares cares about. If a management doubles the value of a business but doubles the share count in the process, the owners have gained nothing. I don't think many managers or investors would think any of that is controversial.

Where we spend much more time than most investors is analyzing how free cash flow gets invested. Our view is that free cash flow belongs to the owners and should be returned to them through share repurchases or dividends unless a business has investment opportunities, due to competitive advantage, that are expected to earn excess returns. A recent example that concerns us would be in the energy industry. Many of the large companies have decided to diversify by investing heavily in renewable energy, an industry where they have no obvious edge, but these managers are generally applauded for investing in green technology.

Last year we went to ConocoPhillips to meet with its management because we thought the stock looked too cheap. CEO Ryan Lance told us that Conoco would only invest where it was advantaged, and there was no reason to believe Conoco was competitively advantaged in green energy. Because shareholders have a much broader opportunity set to invest in, Conoco would return capital to shareholders rather than investing in an area there was no reason to expect excess returns. We bought the stock immediately.

PORTFOLIO MANAGEMENT

Rotonti: When do you trim and when do you sell out of a stock completely?

Nygren: Allow me to give some background. We buy stocks only when we believe they are selling at a large discount to intrinsic value, when we expect that value to grow at least as fast as the S&P, and when we believe management is capable and economically aligned with shareholders. When all three of those conditions are present, we will purchase the stock. We think of 2% of the portfolio as a normal-sized position but based on our estimate of the risk/return trade-off of the stock, we will invest between 1% and 3% of the portfolio.

We sell when we lose any one of those three pillars. If we lose confidence in either management or the ability to grow intrinsic value, we will sell out of the entire position. If the stock rises to a price above our estimate of intrinsic value, we will also sell the entire position. We automatically trim an Oakmark position when appreciation takes it above 4% of the portfolio (twice a normal position). Over the years we own a stock, we will trim or add to the position size as our assessment of the risk/return trade-off changes.

Rotonti: I think you have eight stocks in the Oakmark fund that have weightings of less than 1%. Are these positions you are building up or selling off? Is it normal for the fund to have so many positions less than 1%?

Nygren: The Oakmark Fund typically owns about 55 stocks, give or take, and its typical stock is owned for about five years. So, over the course of a year, you'd expect roughly 11 stocks to get added to the portfolio and 11 to get sold. If 22 stocks are in transition over the course of a year, that would mean five to six per quarter would be either on their way in or out. Having eight is a touch high, and it is because the extreme volatility in 2022 gave us more opportunity than usual to make changes in the portfolio. There is no change in our thinking that if a stock is worth owning, we should invest at least 1% of the portfolio in it.

Rotonti: The Oakmark Fund has about 55 holdings and the Oakmark Select Fund has about 20-25 holdings. Is it easier to manage a fund with 55 stocks or 20-25 stocks and/or which takes more of your time?

Nygren: It might seem like it would be easier to manage a portfolio with fewer stocks, but the opposite is true.

The Oakmark Fund owns most of the large-cap names on our Approved List. Our job as managers is to figure out which stocks we'd prefer to exclude from the portfolio because we have less confidence in our thesis or because we believe we have more attractive stocks that express the same thesis (such as banks are too cheap compared to their history). We end up owning about 55 of the 75 or so stocks that are on our Approved List that are large enough businesses for Oakmark. When each of the three of us who work on the large-cap strategy list how the portfolio would be invested were we the sole decision maker, we end up disagreeing on only about three names, so those are the stocks we focus our discussions on.

For Oakmark Select, we are winnowing down the list of 55 stocks we own in Oakmark plus some smaller businesses that we consider too small for Oakmark to a portfolio of our favorite 20 stocks. When the concentrated strategy team goes through the same exercise of each constructing a model portfolio, there might be 10 names that one manager would include that the other wouldn't. So there is more work in getting to a consensus on the concentrated portfolio than the diversified portfolio.

Another way of looking at it is that each individual stock has a larger impact on the portfolio performance in a concentrated portfolio. So, selecting a stock to include requires a higher confidence level than for a diversified portfolio.

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The securities mentioned above comprise the following preliminary percentages of the Oakmark Fund's total net assets as of 12/31/2022: Alphabet Cl A 3.4%, Berkshire Hathaway 0%, Booking Holdings 1.9%, Charter Communications Cl A 1.1%, Comcast Cl A 2.2%, ConocoPhillips 1.4%, EOG Resources 2.4%, Hilton 0.8%, Mastercard 0%, MGM 0%, Microsoft 0%, Moody's 0.4% and Wells Fargo 2.8%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

The securities mentioned above comprise the following preliminary percentages of the Oakmark Select Fund's total net assets as of 12/31/2022: Alphabet Cl A 9.1%, Berkshire Hathaway 0%, Booking Holdings 0%, Charter Communications Cl A 3.8%, Comcast 0%, ConocoPhillips 0%, EOG Resources 3.6%, Hilton 0%, Mastercard 0%, MGM 0%, Microsoft 0%, Moody's 0% and Wells Fargo 3.5%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

The securities mentioned above comprise the following preliminary percentages of the Oakmark Global Select Fund's total net assets as of 12/31/2022: Alphabet Cl A 10.1%, Berkshire Hathaway 0%, Booking Holdings 3.4%, Charter Communications Cl A 4.4%, Comcast 0%, ConocoPhillips 0%, EOG Resources 0%, Hilton 0%, Mastercard 0%, MGM 0%, Microsoft 0%, Moody's 0% and Wells Fargo 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

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The stocks of medium-sized companies tend to be more volatile than those of large companies and have underperformed the stocks of small and large companies during some periods.

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