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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Alphabet and Netflix: Both Industry Leaders, Both Cheap

ROBERT F. BIERIG is a Partner and Portfolio Manager at the Oakmark Funds. Mr. Bierig has been a portfolio manager of the Oakmark Fund and the Oakmark Select Fund since 2022. He has been a portfolio manager and U.S. investment analyst at Harris Associates since 2012. Previously, he served as managing director at GEICO Investments, investor at Frist Capital, investment analyst at ESL Investments and investment banking analyst at Morgan Stanley. Mr. Bierig earned a B.A. in economics from Duke University (2000).

SECTOR — GENERAL INVESTING

TWST: Please introduce your funds under management.

Mr. Bierig: I manage the Oakmark Fund with Bill Nygren and Mike Nicolas and the Oakmark Select Fund with Bill Nygren, Tony Coniaris and Alex Fitch. Both funds own what we believe are the best risk/reward opportunities in domestic equities and seek to magnify the effect of stock selection. The Oakmark Fund focuses on large companies and holds approximately 50 to 60 stocks. The Oakmark Select Fund focuses on mid to large companies and holds approximately 20 stocks. At Oakmark, we're fundamental research-based value investors who take a private equity approach to the public markets. Our goal is to provide clients with above-average investment returns on an after-tax basis over the long term.

TWST: Give us a closer look at what you mean by "a private equity approach to the public markets"?

Mr. Bierig: Our investment philosophy is based on three principles. First, we seek to buy stocks at a discount to our estimate of intrinsic business value. Second, we look for companies that we expect to grow per share value over the long term. Third, we want management teams that think and act like owners.

We believe in the concept of investing with a margin of safety. If we buy a business at a significant discount to what we think it's worth, then we are both reducing risk and increasing return at the same time. We construct portfolios such that our largest positions are our best ideas.

TWST: How resilient have each of your funds been to all of the headwinds that we've been seeing? Which strategies and sectors have been most impacted? And what were any silver linings?

Mr. Bierig: As of the end of the third quarter, both funds were overweight sectors like financials, communication services and energy and underweight sectors like health care, consumer staples and electric utilities. This positioning shouldn't be a surprise to our clients because they know that we tend to be "greedy when others are fearful and fearful when others are greedy."

Right now, most investors are scared of economically sensitive and cyclical businesses, such as financials, which makes those areas a fertile hunting ground for undervalued stocks. On the other hand, most investors think it's safer to own less economically sensitive businesses, such as health care or consumer staples. But we believe those businesses tend to be priced at a premium because of their perceived safety. Therefore, in our view, they don't offer attractive returns relative to the opportunity set for those investors who have a long-term time horizon and who can ride out the volatility.

The sector that has performed best for us this year — by a wide margin — has been energy. Our holdings include names like **EOG Resources** (NYSE:EOG), **APA Corp.** (NASDAQ:APA) and **ConocoPhillips** (NYSE:COP). The industry has gone through a decade of under-spending, and it took a long time for that under-spending to start reducing supply. On the flip side, it could also take multiple years of higher-than-normal capital spending to increase production. As a result, we could see a scenario where oil prices are higher for longer. That doesn't mean as high as today's $85-$90 a barrel level, but it could be above the $50-$60 level that oil prices have averaged over the past several years.

At current oil prices, the companies we own are generating free cash flow yields against their market caps in the 15%-20% range. And they're returning a lot of that capital to shareholders through share repurchases and dividends.

TWST: What's your process for buying and evaluating a particular name? You mentioned buybacks; is that always something you'd look at?

Mr. Bierig: Let me start with our process. Our analytical team generates investment ideas through fundamental research across industry groups. I'd call the sourcing process "eclectic" in that a new idea could come from anywhere. It could be an idea generated from a quantitative screen, it could be a name that an analyst looked at a few years ago, or it could be a company that came up in the course of researching a competitor. In short, we don't care where the idea comes from as long as it's a good idea that is practical for us to buy.

At Oakmark, we all drink from the same research fountain. Once the analyst determines that a particular stock is undervalued, he or she presents it to the broader investment team at our weekly Stock Selection Group meeting. If the team agrees that the stock in question is cheap, it is added to our Approved List with buy/sell targets and an expected rate of return. Our Approved List consists of more than 100 eligible stocks from which individual portfolios are then constructed.

TWST: Do you take into account possibilities like a deeper recession, rising inflation or a stronger dollar? Anything like that?

Mr. Bierig: Well, we are mindful of the macroeconomic backdrop. For example, fear that a recession could lead to larger-than-normal credit losses has caused financials to trade at low multiples of current earnings. We've said for several years that credit losses are running below normal and that they would eventually revert to the mean. However, we've also said that strong demand for unskilled labor would keep unemployment lower than is typical in most recessions. If our view turns out to be correct, then peak credit losses are likely to be below levels that most investors fear. This dynamic has contributed to our opportunity to own high-quality financials at bargain prices.

TWST: Any recent sector weighting changes or rebalancing? Or latest buys and sells?

Mr. Bierig: At Oakmark, we don't take a top-down approach to sector weightings nor do we rebalance to look like a particular index. Rather, we take a bottom-up approach to identifying the most attractive individual stocks in the context of a diversified portfolio. The Oakmark Fund has recently made new purchases or increased holdings in financials — **KKR** (NYSE:KKR) and **Wells Fargo** (NYSE:WFC); communication services — **Warner Bros. Discovery** (NASDAQ:WBD) and **Netflix** (NASDAQ:NFLX); and industrials — **Fortune Brands** (NYSE:FBHS) and **Masco** (NYSE:MAS). We've eliminated or reduced holdings in health care — **Humana** (NYSE:HUM) and **Regeneron** (NASDAQ:REGN). The Oakmark Select Fund has made similar changes.

TWST: Any health care names you've held on to?

Mr. Bierig: One of our investments in the sector that we continue to hold is **HCA Healthcare** (NYSE:HCA). **HCA** is the largest for-profit hospital company in the country, and it operates in some of the most attractive markets, including Florida and Texas. **HCA** faced a big challenge during Covid-19, and it came out of the pandemic a stronger organization. The stock is selling for approximately nine times its 2024 earnings, and we expect the company to buy back around 10% of the stock this year. We think it's a really well-managed business, and we've owned it for a long time.

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TWST: Can you share two or three of your top names in the banking or financial space where you see a buying opportunity?

Mr. Bierig: Yes. One sector that would benefit from rising inflation and higher rates — or at least would be less adversely affected than most — is the banks. Our largest bank investments, such as **Wells Fargo**, **Ally Financial** (NYSE:ALLY) and **Capital One** (NYSE:COF), should earn a greater spread between what they pay on deposits and what they receive on loans as the asset side of the balance sheet reprices faster than the liability side.

These banks sell at discounts to tangible book value and are buying back stock aggressively because they earn more money than they can profitably reinvest in the business. We view this capital allocation decision as an intelligent way for management teams to enhance per-share value for continuing owners.

1-Year Daily Chart of Alphabet Inc.

Chart provided by www.BigCharts.com

TWST: What are a few more names that you like?

Mr. Bierig: Alphabet (NASDAQ:GOOG) has been our largest holding for a long time. It is a collection of some of the best businesses in the world, including Google Search, YouTube, Cloud and several others. We value the company based on a sum-of-the-parts analysis. However, we talk about an adjusted p/e multiple as a short-hand way to give a sense for how cheap the shares are today. The headline multiple for **Alphabet** is 18 times consensus 2023 earnings. That's not bad for a company of this caliber and growth potential, but we think the reality is far better than it looks on the surface.

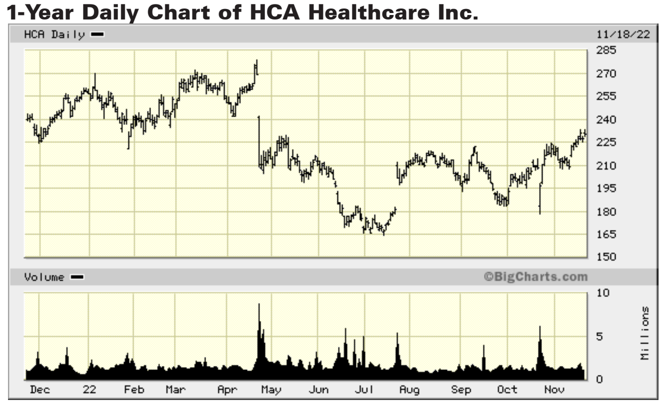
To get the adjusted p/e, we have to make a few calculations. First, we back out the reported losses in the Other Bets segment and treat them as if they were invested through a venture capital fund such that they are dollar neutral to the value — i.e., the investments as a group are worth what the company spent. This assumption seems reasonable because **Alphabet** has already executed third-party capital raises in Other Bets like Waymo — self-driving technology — and Verily — life sciences — and could spin out these businesses at favorable valuations if they chose to do so.

Second, we value the money-losing Cloud business as an asset at a discounted revenue multiple to what analysts think **Amazon's** (NASDAQ:AMZN) AWS and **Microsoft's** (NASDAQ:MSFT) Azure are worth. No one doubts that **Google** Cloud would warrant a big valuation as a standalone entity.

Finally, we give the company credit for the net cash and investments on its balance sheet. When adjusting for Other Bets and Cloud and stripping out cash, the core business that's left — primarily Search and YouTube — is selling for less than 10 times next year's earnings even though it's likely to grow at an above-average rate for many years.

This year has been a difficult one for the company and a volatile period for the stock. Despite the near-term challenges, though, **Netflix** remains likely to sustain above-average growth through further penetration of international markets, the creation of an ad-supported tier and monetization of password-sharing.

1-Year Daily Chart of HCA Healthcare Inc.



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Another name that may be less familiar to some readers is **First Citizens BancShares** (NASDAQ:FCNCA). It's an under-the-radar community bank based in North Carolina that has been family-run for three generations and that had never held public conference calls or investor meetings until recently. It has leveraged prudent lending practices, a strong deposit franchise and accretive M&A to compound tangible book value per share faster than the industry for many years.

In January, **First Citizens** completed the most significant deal in its history when it acquired **CIT Group**. We believe the merger will be substantially accretive to per-share value because of cost synergies and the ability to pair **CIT's** high-quality assets with **First Citizens'** low-cost deposit funding. We see the combined company as on pace to generate around $115 in earnings per share in 2024. Yet the stock sells for only seven times that number, a discount to banking peers, despite the company's history of attractive returns and book value growth that justify a premium.

TWST: Is Netflix still one of your heaviest-weighted names? If so, what is your related investment thesis?

Mr. Bierig: Yes. **Netflix** pioneered streaming video on demand — SVOD — and is by far the largest player in the industry. It's run by a first-rate management team that has a track record of adapting to changes in the media landscape. We believe that SVOD is a superior model to linear TV due to its ability to offer on-demand programming at a global scale. And we think that **Netflix's** massive cash content spending creates barriers against competition.

At today's price of four times next year's revenue, we think investors are paying only a low-double-digit multiple of normal operating profit — too cheap, in our view, for a well-managed industry leader with a long runway for growth.

TWST: What's your overall view of the technology space now? Do you own any names in the space?

Mr. Bierig: We like certain parts of the technology sector where stock prices have declined this year and the businesses are profitable. We own several names in the area. **Alphabet** is one of them. Another that we own in the Oakmark Fund is **Oracle** (NYSE:ORCL). **Oracle** is sort of the value investment within large-cap enterprise software. They've bought back almost half their shares outstanding in the last decade, and the stock is selling at approximately 11 times earnings in 2024, excluding cash.

We believe that the progress of the business has been obscured by the cloud transition. But now growth is really picking up in applications as well as infrastructure. We think that the business can start growing at close to double-digit rates, which is an inflection up from what they had been doing for the last several years. They also have opportunities for faster growth and higher margins related to their recent acquisition of **Cerner**.

TWST: Overall, as you look into 2023, what are your worries? And where, if any, do you see silver linings that might boost the market?

Mr. Bierig: We don't bring much to the game when it comes to making macroeconomic forecasts in general. And we don't think we'd be successful in outguessing other investors about when a recession might occur. Instead, we value businesses based on an assessment of long-term earnings power over the life of the enterprise.

In modeling out cash flows, we know that all businesses are going to encounter recessions from time to time — about once every seven years on average. For a typical large business in the U.S., approximately 85% of the value is generated after the next three years. In other words, even if a recession were to occur this year or next, it wouldn't make that much difference to what the company is worth, in our view.

The last thing I'll mention on this topic is that we do want to make sure that we only invest in companies that are well-capitalized. It's common sense that if a company doesn't have a sufficient financial buffer to get through downturns in the business cycle, then it will not work out well for investors. Many of our holdings have greater resources at their disposal than smaller competitors. We expect them to be able to play offense during tough times when others are forced to retrench.

TWST: Where is your conviction strongest, if you had to name just one stock to buy now?

Mr. Bierig: If I had to pick just one, the name I feel most strongly about is probably **Alphabet**. That's our largest holding, and I think that it's just in such a strong financial position. It's a collection of so many outstanding businesses with so many brilliant people working there. We think the future will be bright over the next decade and beyond.

TWST: To conclude, any silver linings you see as you look ahead?

Mr. Bierig: Well, we're in a time when the market is down, but the silver lining is that the cure for low prices is low prices. Bill Nygren, our Chief Investment Officer-U.S., wrote in a recent quarterly commentary about equity returns in the immediate aftermath of bad periods for the stock market. For the 11 previous bear markets in the United States, two years from the time the market first hit down 20%, the median gain was 33%. That is notable because the two-year price increase from a random purchase date has been 17% — or just over half as much.

I know it can be gut-wrenching to remain invested in stocks — or even to commit additional capital — during a bear market or a recession, but the data suggests that returns have tended to be above-average coming out of periods resembling the one we're in today.

TWST: Thank you. (VSB)

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