



A Fundamental Investing Strategy for Today's Environment

By Robert Huebscher

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Tim Hartch and Michael Keller are co-managers of the Morningstar 5-star BBH Core Select Fund (BBTEX) from Brown Brothers Harriman. The fund's strategy is strictly bottom-up, with investments in established, cash-generative businesses that are leading providers of essential products and services with strong management teams and loyal customers. The fund seeks to purchase stock in such companies at a discount to their intrinsic values.

I spoke with them on August 12.

Tell me a little bit about the history of your fund and how it is now positioned for investors, including its fee structure.

Keller: The fund and the current management team have been in place since the fourth quarter of 2005. Tim and I are the primary co-managers of the fund. We also have a team of nine analysts with whom we work, who are divided by sector expertise in the financial, consumer, healthcare, basic materials and energy industries.

Core Select is the flagship equity strategy that we use within Brown Brothers' investment management and wealth management businesses for institutional separate accounts and high net worth clients. We manage the Core Select mutual fund in a very similar fashion as our other Core Select accounts. For most of BBH's wealth management clients, Core Select represents a substantial allocation of their assets. Over the past six years, the Core Select team has been cohesive, and we've had zero turnover. Because of our strong track record, we decided two years ago to start marketing the mutual fund outside of Brown Brothers. We have been able to grow the assets of the mutual fund through that process, and that brings us to today.

Hartch: I am very proud of our investment team. We have a great team of analysts. Michael and I consider ourselves business analysts as well, and we all do a lot of due diligence on our companies. It is really the work that our analyst team does that drives our decisions.

Keller: The fee structure is an expense ratio of 1%. We recently introduced two share classes. So there is BBTEX, which is the one percent fee. We lowered that fee recently. It had been a little bit higher than that. We also have a separate share class — the BBTRX — that has a 12b-1 fee.



In your communications with fund investors, you discuss using the intrinsic value of the stock as the key metric in your valuation process. How do you calculate intrinsic value?

Keller: The concept of intrinsic value, as we define it, is really the value attributable to equity holders that represents the full-lifecycle cash flows coming out of the business. It's really a long-term value concept. It's not a price target. It's what we believe the business is worth today based on the cash that it can generate and its cost of capital. There are obviously a lot of other factors that go into calculating intrinsic value.

We use several different discounting models, but the basic approach is to conservatively forecast near-term cash flows, capital usage, margin trends, sales growth and balance-sheet metrics. We use that to construct a stream of free-cash flow and price it in today's money.

The model is a guidepost, but there's more to understanding a business than just constructing a model. The model is very helpful, and ultimately, the intrinsic value work that we do guides our valuation-driven decisions. But we really start by selecting companies first based on their fundamental characteristics and then we focus on identifying which of the companies that meet our qualitative criteria trade at a discount to intrinsic value. We generally only invest in companies when they are trading at 75% or less of our estimate of intrinsic value.

What are the key characteristics of the companies in your portfolio?

Hartch: Our basic approach is to identify very high-quality companies. One of the first criteria we look for is a company that has a very loyal customer base, one that has a high level of retention and high level of customer satisfaction. Any business that is able to retain its customer base is going to have a much easier time growing, because when you win new customers or you are referred new customers from satisfied customers, that is actually growth, as opposed to just replacing customers who are leaving. One of the first things we look at then is, who are the customers? How satisfied are they? And why do they use the product?

That really gets to the second criterion, which is a product or service that is essential, or "have-to-have." We are trying to identify businesses that have a product that is important to their customers and that the customer typically uses on a regular basis, as opposed to episodically, like once every couple years. We want a product that is being used on a regular basis, whether by a consumer or an enterprise customer.

Those two criteria are important, because if you have a loyal customer base and an essential product, you have a very resilient business. Particularly in recessionary periods or a financial crisis, companies that have those characteristics tend to hold up better at the operating level. And that operating stability certainly impacts the share price as well.



Another key attribute of our approach is that we are trying to get a lot of our return through the actual cash flows of the business over time. If you think about what is important about owning a business over a long time period, it is the competitive advantages that a company has — the advantages that differentiate it from its competitors in its industry and prevent new entrants from competing against it in the future.

We try to identify businesses that have very clear advantages over their competitors. Sometimes it is technology, but more often it is scale, a low cost structure, knowledge of a particular industry, or a stellar company culture. If it's a consumer products company, it could be very strong distribution. These are the characteristics that create competitive advantage, and we really try to understand them and confirm them through our due-diligence process.

Lastly, we look a lot at industry structure. We identify businesses that are market leaders in an attractive niche in an attractive industry. We want a company that is in an industry where the profit pools are relatively stable and the competition is not based solely on price but also on value-added services.

What financial characteristics do you look for?

Hartch: We emphasize a strong balance sheet, and that has clearly helped us in the last five years. We want businesses that — even in a difficult financial crisis like 2008-2009 or at present — have the balance sheet to continue to operate business as usual and to take advantage of the challenges that others are facing.

We like businesses that have high levels of free-cash flow, which is the operating cash flow less the capital expenditures. That cash flow enables businesses to have a lot more flexibility, whether it is to buy back stock when it has been driven well below intrinsic value, to make acquisitions of distressed competitors or to simply return cash through dividends to shareholders.

We look for businesses that have a high return on invested capital. At a minimum, we want our companies return on invested capital to exceed their cost-of-capital.

We also carefully assess the company management teams with whom we partner. With our approach of owning cash generative companies, a lot of our return over time depends on how management deploys that cash. We want managers who have a proven track record of deploying capital effectively to create value for shareholders.

Let's talk about some of the holdings in your fund, starting with the financial sector. You own Progressive Insurance, GEICO, US Bancorp, Wells Fargo and Berkshire Hathaway. How do those firms fit into the criteria that you just articulated?



Keller: The financials we own are great businesses with a high degree of fit with our criteria. If you start with a company like Progressive, the auto insurer, it clearly provides an essential product. Anyone who has a driver's license and operates a vehicle here in the US has to have insurance. It's also a competitively advantaged business in so far as they have a good brand and predominantly a direct-sales model. Their cost to write a policy is lower than that of most of their industry peers, and that has allowed them to offer more attractive prices, and they have been taking market share as a result.

They also have a great underwriting algorithm that has helped them to underwrite more profitable business over time. A combination of those factors has led to what we believe is a structural advantage that provides an essential service with a good degree of customer loyalty. Their retention rates on insurance policies are reasonably high.

You would also find the same characteristics with the auto insurer GEICO, which is an important part of the Berkshire Hathaway group of businesses. Berkshire also is a major reinsurer and its unparalleled claims paying ability makes it the reinsurer of choice for many insurance companies. Berkshire's reinsurance operations have performed quite well this year despite a large number of catastrophes worldwide.

The other insurer that we own is Chubb, which sells personalized home insurance, particularly high-value home, boat, and valuables policies. Chubb's larger business is its commercial insurance business, which includes some property and casualty, directors' and officers' liability and a variety of other commercial insurance. Chubb has a tremendous underwriting record and offers essential financial products to a wide range of consumers. It also has a loyal customer base, a good brand and an excellent reputation as far as claims paying and customer service. It's a very conservatively run company with a great balance sheet.

The banks are an area where exposures have created problems over time for many investors. We have focused on the banks that we believe have an advantaged liability structure, insofar as they are deposit funded through a branch network with loyal customers. Banking is a fundamentally essential service for both consumers and businesses, so it certainly meets our criteria on that aspect. But the ones that we are attracted to have a deposit-funded structure, which is a much more reliable and low-cost source of financing for the business as opposed to wholesale funding or short term repos.

When we are looking at banks, we look for that liability structure and deposit funding, and we also look for conservative asset structure, which means careful loan underwriting and prudent investing. The banks we own – Wells Fargo and US Bancorp – have been among the more conservative players in their industry as far as their underwriting of risks on the asset side of their books. Their loan loss position has gotten much better as the economy has rebounded. Both companies are still in a very conservatively provisioned position on their loan books, and as a result they have quite a bit of embedded earnings power as the



economy normalizes, the loan books stabilize and the amount of provisioning continues to stabilize.

We also are attracted to the efficiency of those two banks. They are well-run, cost-focused banks, and they are good operators. They have a strong presence in their markets and good market share. Their customers tend to be pretty loyal.

Hartch: One of the great advantages of the two banks that we own – US Bancorp and Wells Fargo – is that they are simple. Often people say we own boring and simple businesses. But those are often the best businesses. In this case, these are relatively straightforward banks, unlike some of the other large banks like J.P. Morgan, Citibank or Bank of America. If the financial crisis in Europe worsens, Wells Fargo and USB will likely fare much better than the money center banks that have greater capital markets exposure. Mark Curnin, who is our financial services analyst, has done an excellent job helping us select lower risk and attractively valued financial institutions.

Have you used the volatility in the last week to increase your holdings in any of the financial positions?

Hartch: We can't talk about trades for the mutual fund until we disclose them at month end, but we have added selectively to a number of companies whose share prices have fallen.. We are very pleased to have the opportunity to purchase most of our companies at current levels.

Let's talk about your holdings in the energy sector. You own Occidental, EOG Resources and Southwestern. How dependent are these firms on commodity prices, specifically oil prices? And how would a recession that would be coupled with weak commodity demand affect their earnings?

Keller: One of the things we firmly believe about investing in the energy sector is you don't want to be over-reliant on commodity price predictions. In contrast, we are focused much more on the structural advantages of our companies and finding good management teams who are running the businesses not only for growth but also with careful capital usage and an eye on returns on capital.

Our approach to the energy sector is to focus primarily on a very specific set of criteria: companies that have long-lived low-risk reserve bases, are low-cost operators, are run by good management teams with good operational track records, have some engineering or technology leadership and are focused on returns on capital as opposed to just undisciplined growth.

We like the independent exploration and production companies, and that is where we are currently positioned with our investments in Occidental Petroleum, EOG Resources and Southwestern Energy. These companies are generating significant production growth and



largely living within their means as far as the financing of that growth. Our investments in these companies are not dependent on having the underlying commodities rebound in a short period. Instead, our team has identified companies that are finding and developing low-cost reserves and translating that into production growth over time, because that is really how you drive value in these companies. Using this approach doesn't require us to be directionally correct on commodity prices in the near term.

With that said, we believe if you go out several years, natural gas prices will normalize toward the marginal cost of production, which is higher than today's prices and likely as high as \$6, whereas gas has been trading in the \$4 range for quite some time. With oil, we believe the marginal cost of production is probably in the \$90s at the moment, so with crude trading back near \$80 it becomes somewhat more favorable in terms of the trade-off between the spot price and what we believe is the marginal cost of production.

Let's turn to your consumer holdings such as Nestlé and Coca-Cola. How do those fit into your criteria? You had mentioned earlier the chance of a double-dip recession. How do you assess that probability, and what effect will slower consumer spending and continued high unemployment have on those holdings?

Hartch: We also own Pepsi, with the great Frito-Lay franchise, and we own Diageo which is a leading spirits company. They are all great fits with our criteria: a loyal customer base, essential products and strong competitive advantages.

They have very strong brands, some of them literally over 100 years in age. They have extremely broad and sophisticated distribution on a global basis. They are very strong in the United States and Europe and have some of the most global businesses in the world. When you travel in Latin America or Asia, these brands are there, and they are making significant progress.

A company like Diageo even has a very strong presence in Africa, and a number of its beer brands are the leading brands in certain African countries with large populations. They have the opportunity to grow at a reasonable rate over a long time period, because of the expansion of the middle-class in many of these emerging countries around the world. They have very strong cash generation from their more mature markets in the US and in Europe.

With respect to the potential for a double-dip recession, our investment approach is not predicated on trying to predict whether or not there is going to be an economic contraction. Certainly if there was, it would put additional pressure on all of our companies. For the consumer companies, this would mean more trouble growing volumes, particularly in mature markets, and it would make it more difficult to push through price increases. Consumer spending is already pretty weak. But our consumer businesses are much better positioned than most second- or third-tier competitors to manage these kinds of challenges. They have invested enormously in their brands, which gives them the



flexibility to do things like change their packaging, marketing and pricing to address weakness when it occurs.

In this past year there has been a lot of pressure on consumers, with unemployment being quite high. Yet Nestle, which is one of our largest holdings, reported results last week that showed very strong – 7% or 8% – revenue growth year-over-year on an organic basis, despite what was obviously a very tough consumer environment, particularly in Europe and the United States. Nestle is a company that has managed through tough times before. If you look over a five-, 10-, or even a 20-year period, we have a lot of conviction that these companies are going to be able to remain the leading companies in their respective categories.

One of the bigger challenges this year for our consumer businesses is the rise in commodity costs, and that's been putting pressure on their input costs and requiring them to raise prices. If there is a second recession, there may be a moderating of some of that commodity price pressure. From that perspective, that might be an offset to some of the challenges from a weakening economy, but there is always the possibility of stagflation. But again these are the businesses one wants to own in very difficult economic times. From a share-price perspective, our consumer companies did quite well through the 2008 period, and so far in this most recent downturn, their share prices have again held up quite well.

As a value-oriented investor, I recognize that you do not generally focus on macroeconomic issues and that you rely mostly on bottom-up analysis. Are there any aspects of the macroeconomic environment that you are watching closely now or that you're particularly worried about?

Keller: Tim just mentioned commodities prices, which clearly impact input costs for companies, but also create the potential for crowding out effects, not only in developed markets but in developing markets, particularly where the food costs are a much bigger portion of the consumer basket. To the extent that we have a general commodity price increase, you could see smaller amounts of disposable income available for purchasing consumer products and electronics. There is potential for demand destruction in energy and oil.

But we're not using macroeconomic judgments to make investment decisions. We use macroeconomics to help us make better risk assessments and look at what could go wrong — at the scenarios that could impact our stocks and what that could ultimately mean for us. We wouldn't typically make a prediction about how a near term macroeconomic event is going to play out and then buy certain stocks that might benefit. Our process works in the other direction.

Hartch: Another macro concern that has not gotten as much press as perhaps it should is the bigger regulatory burden for a lot of industries. We speak with the executives of our



businesses and increasingly they cite regulation as one of their major challenges. It is not just financial services, which is an obvious area where there have been increased regulatory burden. But increasingly throughout the economy, there is a bigger regulatory burden on private-sector businesses. It is not just more regulation but also uncertainty with respect to regulatory rules and requirements. That is a challenge. I'm not saying it factors into our stock-picking analysis, but it is something that we are aware of as a risk. It is a challenge for a number of businesses.

What is the market price of the fund now relative to its intrinsic value?

Keller: We look at that as being an important barometer and a useful indicator. We look at the portfolio on a price-to-intrinsic-value basis, which is calculated on a weighted average based on the positions. Over the years we've seen it as high as close to 90% in 2007 and below 50% briefly in March of 2009.

These intrinsic values really represent the lifetime cash generation of a very fine business, and therefore intuitively, that number doesn't really change that much. However, market prices do, and we have seen share prices moving violently up and down recently. When we looked at it last week, we were in the high 60s as a percent of intrinsic value, but the market was up pretty sharply yesterday, so it might be a little bit higher than that today. Consider it right around 70%.

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