THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Hunting for Value: Better, Safer, Cheaper

THOMAS A. REYNOLDS IV is a managing director of Artisan Partners and a portfolio manager on the U.S. Value team. In this role, he is a portfolio manager for the Artisan Value Equity and U.S. Mid-Cap Value Strategies, including Artisan Value and Mid Cap Value Funds. Prior to joining Artisan Partners in October 2017, Mr. Reynolds was a portfolio manager for Perkins Investment Management at Janus Henderson, where he co-managed the Perkins Small Cap Value strategy and the Perkins All Cap Value strategy. Mr. Reynolds joined Perkins in 2009 as a research analyst covering the U.S. financials sector and was later promoted to portfolio manager. Earlier in his career, he worked at Lehman Brothers in the financial institutions investment banking group and fixed income sales and trading. Mr. Reynolds holds a bachelor's degree in anthropology from Dartmouth College and a master's degree in business administration from the University of Chicago Booth School of Business, where he graduated with honors.

SECTOR — GENERAL INVESTING

TWST: Please introduce your team at Artisan and tell us about your focus.

Mr. Reynolds: The Artisan U.S. Value team has an absolute-return, risk-aware, value investing focus. We seek cash-producing businesses in sound financial condition, selling at undemanding valuations. Said differently, we're looking for opportunities where the business is on our side, the balance sheet is on our side and valuation is on our side. These are our margin of safety criteria. Our structure is intentionally flat — with three generalist portfolio managers and one research analyst taking a very collaborative approach to investing — which is a result of high trust and confidence in each other's capabilities.

TWST: Give us a closer look at your approach and the principles that guide you in overseeing the Fund.

Mr. Reynolds: My background has led me to be a value investor for a number of reasons, and I've been in the business two decades, having seen a number of economic cycles and witnessed the behavior of investors and companies in a variety of scenarios. But the main ideas are having a margin of safety, and of looking carefully at both reward and risk, so you can compound returns at a safer level over time.

Summed up, our overall philosophy is selecting stocks with better, safer and cheaper attributes. And that's the margin of safety requirement that we look for to get the odds on our side. We're looking for a better business — something that has an identifiable moat and a strong competitive position. We're looking for safer companies, with strong balance sheets, good coverage ratios of their interest or fixed charge. We're also evaluating off-balance-sheet issues. And of course, we're looking for discounted stocks.

TWST: What do you typically see as the best investment scenario for a value fund versus a growth fund or dividend stocks?

Mr. Reynolds: We're not single outcome investors, so we don't have an official outlook. There is no in-house economist or CIO driving decisions. We get this kind of question a lot, but I think the better framework is to contrast value stocks against the demand for growth at any price. I tend to paraphrase this as value versus YOLO — You Only Live Once.

I recently wrote about this on our firm's blog, the Artisan Canvas. As valuations continue being stretched, we see momentum stocks are often leading the market. Growth-oriented investors often speak of paying a reasonable price for growth, and the disciplined ones continue to do that. But it seems increasingly popular for many market participants to buy growth at any price. This reminds me of what happened during the dot-com bubble.

Research suggests that the demand for growth corresponded this summer with a surge in retail participation in options markets. Social media and fintech collided with idle capital to drive a flurry of speculative activity and boost valuations. Imagine buying out-of-the-money call options on stocks trading at 30 times revenue with no earnings.

And as it turns out, large institutional investors like **SoftBank** (OTCMKTS:SFTBF) were reportedly making the same basic trades, amplifying the trend. I think those momentum trades, those so-called YOLO stocks, seem to be very different from growth-at-a-reasonable-price stocks or the FAANG stocks, which actually generate tons of free cash flow — at least some of them. Maybe not **Netflix** (NASDAQ:NFLX), but if you're looking at **Apple** (NASDAQ:AAPL) and **Facebook** (NASDAQ:FB) and **Google** (NASDAQ:GOOG), those have been very, very high cash-returning or cash-generative businesses over time.

So there's not a single environment that we think is better or worse. But what we're trying to do is anticipate a whole range of outcomes, and understand points where the market is taking the view that there's a single outcome, which results in mispricing of risk.

For example, we agree with secular trends, such as e-commerce, online payments, social media's dominance of ad spend. And we also agree COVID-19 has accelerated the demise of levered and outdated competitors, such as malls and retailers within those malls. Still, it seems the broad consensus from both market participants and economists is we should treat COVID-19 as a transitory event and therefore position for continued cyclical economic recovery. Now while we consider that an outcome, it isn't the only outcome, and we need to take into consideration any number of items that could knock that consensus off-track.

TWST: How have your funds been impacted by COVID? Which might have benefited from the pandemic?

Mr. Reynolds: We did take advantage of the severe COVID-19-related correction in Q1 to invest in some high-quality, but out-of-favor stocks. We also benefitted from some companies that caught a tailwind from COVID-19. We own **Facebook** and **Google**, for example. Initially the market viewed these as vulnerable to the pandemic, and they sold off. But they recovered much quicker and then appreciated as advertising dollars shifted toward them and away from traditional metrics and outlets.

TWST: Can you share your view of holdings that might have been under-loved, or unfairly punished, and that now might be a good investment opportunity for investors?

Mr. Reynolds: One holding, which is in our mid-cap strategy but is emblematic of our process, is **Lamar Advertising** (NASDAQ:LAMR). It's one of the largest outdoor advertising companies in the United States. Think billboards, highway signs, what you see on a bus or on the subway, in airports, etc. — what's known as out-of-home advertising. This industry has been outside of digital media's onslaught, making it pretty much the only traditional advertising segment that's been able to grow over time because its reach and efficacy are unchanged by digital media.

If you think newspaper, yellow pages, magazines, radio, they've all been significantly disrupted — even TV is being disrupted more recently. But digital media has a harder time disrupting the act of viewing a billboard while sitting in traffic or driving between cities in the Midwest because America still drives, and billboard advertising cannot be skipped or blocked. It's a good business to be in. And the measurement keeps improving thanks to data analytics.

Over time, digital billboards have been added into the traditional analog mix — the customer mix is evident as you drive around. You see local services and entertainment, local attorneys or doctors, you see restaurants, whether it's a local restaurant or national chain like **McDonald's** (NYSE:MCD).

Now this whole market in 2019 was close to $9 billion in revenues, and **Lamar** approaches this market differently than peers. A publicly listed peer like **Clear Channel** (NYSE:CCO) or **Outfront** (NYSE:OUT) will derive three-quarters of its revenue from urban markets, and **Lamar** is actually the inverse. It's more focused on smaller local and rural markets — a focus which leads to attenuated business results, especially on the downside. So it's kind of a perfect get-rich-slow, steady-compounder-type niche.

Lamar owns and operates about 157,000 billboards, about 3,500 of which are digital billboards — the growth area of the industry. Prior to the COVID crisis, the company was adding about 200 of these billboards a year, which, depending on location, can drive 5 to 10 times more revenue than an analog peer. And the turnover of the digital billboards can be quicker, which can lead to higher profitability.

The company has an attractive moat, due in part to federal, state and local regulations prohibiting rapid billboard proliferation, such as the Highway Beautification Act. For example, you can't put another billboard within a certain distance of an existing structure. And so that helps control supply.

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Highlights

Thomas A. Reynolds IV discusses his investment philosophy as part of the Artisan Partners U.S. Value team. Mr. Reynolds emphasizes having a margin of safety and looking carefully at both reward and risk so you can compound returns at a safer level over time. The team also evaluates the full range of outcomes for any given thesis, noting points where the market is taking the view there is only a single outcome, which results in mispricing of risk. He also emphasizes how much balance sheets matter, not only to provide support through downturns and disruptions, but to be in a position to capitalize on new opportunities when cycles turn. Mr. Reynolds acknowledges the broad consensus that COVID-19 should be treated as a transitory event, but cautions investors to consider factors that could knock that consensus off-track.

Companies discussed: JSoftBank Group Corp. (OTCMKTS:SFTBF); Lamar Advertising Co. (NASDAQ:LAMR); Clear Channel Outdoor Holdings (NYSE:CCO); Outfront Media (NYSE:OUT); Airbus SE (OTCMKTS:EADSY); Blackstone Group (NYSE:BX); Netflix (NASDAQ:NFLX); Apple (NASDAQ:AAPL); Facebook (NASDAQ:FB); Alphabet (NASDAQ:GOOG); McDonald's Corp. (NYSE:MCD) and Boeing Co. (NYSE:BA).

On the demand side, **Lamar** focuses on areas where it can own 80% of the market, which helps create a disciplined pricing environment. And the company has a strong balance sheet. Luckily, it refinanced its capital stack in Q1 2020 before COVID concerns hit, putting it in a strong position. It has very strong cash flow and an attractive valuation. Furthermore, the Reilly family runs **Lamar** like a family business, focused on the long term — something we like and appreciate as investors.

1-Year Daily Chart of Lamar Advertising Co.

Chart provided by www.BigCharts.com

TWST: What do you expect the impacts will be of the new administration set to come in?

Mr. Reynolds: If you look ahead six months to a year from now, while the election outcome will be important, the more important market-driver will be the pandemic's path. As for the political outcomes, changes to taxes, health policy and defense budgets are all in play. In a divided government, likely outcomes include higher deficits, but perhaps also less robust and less targeted stimulus. The flipside is there would be less concern about higher taxes. The advantage of our range-of-outcomes approach is we incorporate all these potential scenarios into our purchase price. However, we're not gaming out political scenarios as part of our base-case investment thesis.

TWST: Beyond what you've already discussed, can you share a closer look at your sector allocations? And with a view to your most current 'buys' and 'sells'?

Mr. Reynolds: We're fundamental investors. We evaluate companies individually from the bottom up. We don't make macro forecasts or take sector bets. Sector weightings are simply a residual of our investing process.

Let me say a little more about how the process works. First, we conduct deep research on the company and its industry, providing background documentation to all team members using our internal notes system. From there, we develop our thesis. As we focus the argument, the team goes on an internal mission to find disconfirming evidence, seeking to poke holes in the proposed investment. We have thorough, robust debate about each stock, holding every piece of evidence — pro and con — to rigorous standards.

Essentially, we are making sure everything holds up to our criteria. If we meet those standards properly at the single security level, in aggregate, our stocks should form an attractive conglomerate. In our value fund, for example, our ROE is almost 16% versus 12% for the benchmark index. Our fixed charge coverage ratio is 50% higher than the index. And yet we trade cheaper than the index on an EV-to-EBIT basis.

So bringing this back to sector weights, our value fund has a fairly significant weighting in the communication services sector. We have a concentration in consumer discretionary as well. We have a significant amount of financials, but we're not far from the benchmark. Sector weights are not an endorsement of any sectors' attractiveness, but a reflection of the opportunities available when we got involved.

In general, given our philosophy and process, new ideas often tend to be in areas where there is significant pressure on an industry and poor investor sentiment, so relative to a market cap-weighted benchmark, we might very well be adding in sectors where price weakness is shrinking that sector's index weight.

TWST: Looking at the value fund, what are two of your strongest holdings there?

Mr. Reynolds: Our portfolio is aligned off the margin of safety criteria, so the more strongly a company meets those criteria the more weight it will generally have in the portfolio. Some of our highest potential return ideas may have a small weight to account for the greater risk inherent in the investment. Our highest conviction theses tend to get a larger weight in the portfolio. However, some of the larger holdings also might be the result of appreciation — victims of their own success in some sense.

So rather than rank holdings by strength, let me discuss an idea readers might find particularly interesting: **Airbus** (OTCMKTS:EADSY) is a name we recently added and as a very out-of-favor stock, it will strike many readers as a traditional play. But if we think about the commercial aerospace market in general, we do believe that while **Airbus** won't get back to what people thought it was going to make in 2022 and 2023 anytime soon, **Airbus** is attractive on what it can make in a more normal environment. And should the environment regain even a marginal sense of normalcy, it's incredibly attractive on a free-cash-flow basis.

The commercial aerospace segment is driven by its narrow-body A320 plane, which is the preferred plane among airlines in that space. Narrow bodies were the preferred type of plane before COVID-19 and should remain so. Demand for long-haul international routes is falling, and consequently, so is demand for wide-body jets to service those routes, whether the **Boeing** (NYSE:BA) Dreamliner or larger

"As for the political outcomes, changes to taxes, health policy and defense budgets are all in play. In a divided government, likely outcomes include higher deficits, but perhaps also less robust and less targeted stimulus. The flipside is there would be less concern about higher taxes."

Airbus A330. Domestic flights within the European Union and U.S. should recover a lot quicker, and we're actually seeing that in China already. This might not immediately translate to a recovery in revenue per seat, but the return of domestic travel is itself incredibly positive for **Airbus**, which manufactures the best plane for those routes.

1-Year Daily Chart of Airbus SE

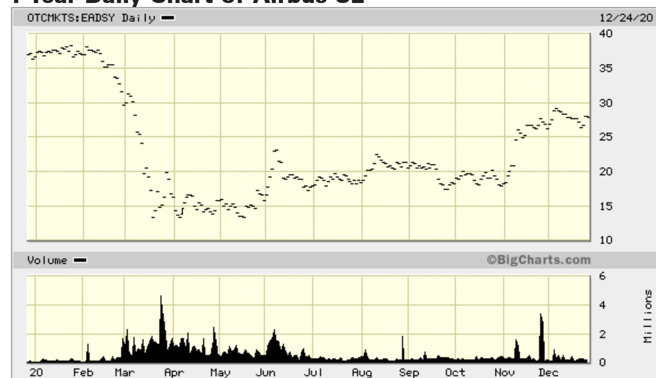

Chart provided by www.BigCharts.com

Since making planes is a capital-intensive process, working capital stresses are a particular challenge for **Airbus** at the moment, but we believe the company can manage through the trough of the cycle. In terms of liquidity and capital, it returned to a positive free cash flow in Q3 and should be positive free cash flow in Q4 and all of 2021. Additionally, **Airbus** secured additional financing to endure longer-than-expected weakness, and coming into the downturn, it added cash to the balance sheet.

TWST: What are your biggest worries now? Where do you advise caution? Any sectors or stocks that you're particularly worried about?

Mr. Reynolds: If we step back and think about the disconnect between the economy and the stock market, we just can't view COVID-19 as transitory and expect the Federal Reserve can save the day. We must recognize that a significant segment of our economy is struggling right now. And while some sectors are doing well, some are under immense strain.

Subsequently, that puts individuals under immense strain. So I do worry that as the stimulus fades, we'll see increasing pressure on the American consumer, which will then pressure American business. As such, we're really focused on making sure we're very comfortable with our normalized free cash flow numbers and our valuations. But we're also assigning appropriate risk to the next year of outcomes and perhaps focusing a bit more on the downside in the next year than in times past due to this uncertainty.

TWST: Can you share any notable upside or downside results from third-quarter financials that impacted your portfolio?

Mr. Reynolds: During Q3, we added one stock, the **Blackstone Group** (NYSE:BX), which is among the largest alternative investment managers in the U.S., led by its real estate and private equity segments, and is overall a very well-run company. Although the market is concerned about **Blackstone's** real estate and office exposure, in the past it's done very well through downturns — a distinction that has allowed it to become such a successful asset manager, compounding by outperforming in downturns. And we believe the company will do that again.

Its portfolio also maintains notable exposure to logistics. As e-commerce logistics has benefited greatly during this crisis, we believe management can realize some of its successes there to the benefit of shareholders.

TWST: Are there any other thoughts you'd like to share before we wrap up?

Mr. Reynolds: Value is not dead. It's an important point to make. There is not an existential crisis for value investors. Instead, we see it as an extended period of opportunity. And yes, in many ways, it's testing the patience of investors. But the reports of value's death are greatly exaggerated. We are highly disciplined when it comes to our margin of safety criteria, acknowledging that the value we deliver to shareholders has a lot to do with the prices we pay for high-quality businesses. Owning quality business at discounted prices: this rigor will never go out of style.

Furthermore, it's important, we think, as we evaluate the range of outcomes for any given thesis, to consider which potential holdings are best positioned to play offense when the context shifts in their favor. In other words, while we are careful to not overpay, and we insist on quality businesses with good management, we also keep in mind how much balance sheets matter. Not only to provide support through downturns and disruptions, but to be in a position to capitalize on new opportunities when cycles turn and exogenous shocks fade away.

TWST: Thank you. (VSB)

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The discussion of portfolio holdings does not constitute a recommendation of any individual security. These holdings comprise the following percentages of the Artisan Value Fund's total net assets as of 31 Dec 2020: Airbus SE 2.9%, Alphabet Inc 5.6%, Facebook Inc 1.6%, The Blackstone Group Inc 2.0%. These holdings comprise the following percentages of the Artisan Mid Cap Value Fund's total net assets as of 31 Dec 2020: Lamar Advertising Co 2.6%. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. Securities named but not listed here are not held in the Fund as of the date noted. The portfolio holdings mentioned are subject to change and the Fund disclaims any obligation to advise investors of such changes.

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