

HARRIS ASSOCIATES

The Private Investigator of Asset Management

Daniel Nicholas, Client Portfolio Manager at Harris Associates, sat down with Allnews.ch to discuss why pinpointing the true value of a quality stock is like an investigative job.

From the brothers Irving and Neison Harris, natives of Saint Paul (Minnesota), who sold their company in 1946 to the leader of Gillette razors, Harris Associates has retained the spirit instilled by the parents of these entrepreneurs who left Yale: "You should be no. 1 in your class". The Chicago boutique affiliated with Natixis Investment Managers, an equity specialist, manages its \$118 billion in assets (as of March 31st, 2022) through various vehicles, faithful to its history. With the conviction of an entrepreneur, the patience and precision of a private detective.

What makes you say that your job resembles that of a private detective?

Our methods of investigation are similar. We don't stop at appearances (e.g. price/accounting ratio), but rather look for evidence that we believe cannot be disputed. This approach has become essential since the economy shifted from manufacturing to providing services, where 90% of a company's value is intangible, and therefore does not end up in the calculation of book value. The ratio has simply reversed from 90% tangible value and 10% intangible value in the 1970s to 90% intangible value and 10% tangible value today. In other words, the correlation between the book value and the intrinsic value of a quality company has become very weak. The era of approximation valuation of a company by a simple multiple of book value is over. This is why our profession as managers is, more than ever, a profession of investigation.

How does this investigative profession translate in terms of the selection and investment process?

Unlike managers who may use a quantitative matrix to narrow down their investment universe to just the cheapest stocks, we seek out high quality companies and management teams first, then wait patiently to get the right price for these companies. This requires extensive research to identify the management teams that we believe will make long-term strategic decisions to increase long-term shareholder value. Therefore, we spend time discussing with management before deciding to invest. Selecting savvy management teams is crucial as we estimate that 85% of a company's value comes from after year three and extends far into the future where business investments are made. today create future income. Once we have determined intrinsic value, we only invest when we get a discount of at least 30%, which is our margin of safety. With a margin of safety in hand, our valuation criterion is met, which makes classifying the index between "growth", "value" and "mixed" irrelevant.

Can you give an example of an investment you have made based on this investigative work?

Alphabet is one of the best examples of our approach. When we initially invested in 2011, we did so based on our analysis that, despite management's use of its excess free cash from its research business towards venture capital activities, we expected this allocation to strengthen future revenue growth.



Daniel Nicholas, CFA®
Client Portfolio Manager
Harris Associates

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To estimate the value of intangible assets, we use many different techniques depending on the type of activity. For Alphabet's cloud business, we run a multiple of the 10-year discounted cash flow model and compare its fundamentals to those of its main competitors, Amazon Web Services and Azure. For YouTube, we value as a cable company using a price per subscriber framework in comparison to the price paid by AT&T for HBO. We also value its self-driving division, Waymo, using valuation information from Cruise Automation's private market transactions. By adding up the value of their venture capital investments and comparing them to the current share price, we believe that Alphabet's core business, Google, is trading at less than a market multiple, despite its growth and returns superior to those of an average company. Our process allows us to identify value where a quantitative manager might overlook it based on a metric like the price-to-book ratio.

How do these values you are looking for better respond to current challenges?

When a company generates significant free cash flow, it provides its leaders with leeway to manage long-term risks, such as the energy transition, or medium-term risks, such as inflation. General Motors has dramatically improved production capabilities, reduced reliance on sedans

in favor of more cost-effective trucks and SUVs, made the necessary investments for electrification, and appropriately addressed the issues of supply chain and semiconductors. Despite these challenges, its operating margins have increased and the company is showing the market that its business model is much more resilient than that of automakers of the past. When we evaluate our US companies, we look for an average annual return of more than 7% per year of growth in value per share over three years as a benchmark rate for investment. Companies domiciled in China expect more to compensate us for the additional risks - 14% and 10% in Switzerland.

Do you have an example in your portfolio?

Glencore is a very good example: when we invested in 2015, they were supposedly on the brink of bankruptcy. The plans they presented to us proved not only that they were successful in reducing debt, but also that they planned to generate free cash flow, even as commodity prices fell. In addition, they have implemented a "net zero" strategy, consisting of gradually reducing their coal production. In the current context of record coal prices, they illustrate their commitment to reducing global emissions. In addition, Glencore owns and produces raw materials essential to the energy transition: cobalt, zinc and copper.

Other Swiss stocks in the portfolio?

In our many portfolios, we are exposed to Holcim, Julius Baer, Novartis and Credit Suisse, as Switzerland is rich in quality companies. Credit Suisse has taken restructuring measures to emerge from the current turmoil. We have spent a lot of time with management and we trust the board and the management team to carry out the strategy of reducing the capital allocated to the investment bank and reallocating it to its franchise. top-notch wealth management.

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ADDITIONAL NOTES

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