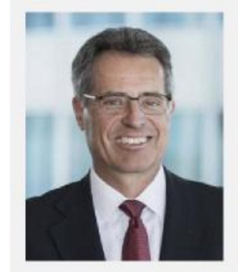
NATIXIS INVESTMENT MANAGERS

HARRIS ASSOCIATES L.P.

U.S. Equities: Mind the gap

"Price is what you pay, value is what you get." - Warren Buffett

At Harris Associates, 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.



Bill Nygren
Chief Investment Officer of U.S. Equities at Harris Associates

I recently participated on a panel discussing topics that most concerned investors. Of course, I was asked for Harris Associates' view on cryptocurrency. As you could guess, my answer was that we won't buy it because we have no idea how to value it. To my surprise, another panelist, a bull on crypto, said they completely agreed with me that its value can't be defined, but that's exactly why they own it. If a crypto coin is worth somewhere between $0 and $500,000, then they want to own it at $50,000.

Today, it's become so commonplace for price to become completely untethered from value that investors now actively seek out such assets rather than avoid them. When a CEO claims their company's stock is overvalued at $140 per share, then it increases to $1000, why couldn't it sell for $2000? If a company can teeter on the edge of bankruptcy while its stock price jumps from $2 per share to $70, then why couldn't it sell for $100 per share? Or $200?

Within these parts of the market, logic has been turned on its head, and the risk of speculative excess appears high. In contrast, we generally own the stocks that are inexpensive relative to their historical P/E ratios and that pay attractive dividends, which are expected to increase even further. Plus, these companies' management teams consistently use excess cash to purchase outstanding shares, meaning that our shares will represent an even larger stake of the business over time.

Because current trends have become so out of step with Harris Associates' time-tested approach to investing, I thought it would be useful to go back to the basics and explain why we believe U.S. Value Equity is an attractive choice for today's long-term investors.

Harris Associates calls itself a value investor. What does that mean?

Finance theory says that stock markets are efficient, meaning that every company's price is the best estimate of its fair value every day. If that is true, the only way to get an above-average return is to take above-average risk. If you believe that, then there is no way to "beat the market," so you might as well just buy the index.

At Harris Associates, we believe something different. While we concede that many stocks are priced close to fair value much of the time, it isn't all stocks all the time. Most market participants are not carefully calculating the present value of all future cash flows. They act on emotions. They often aren't thinking about next month, much less next year. As a result, stocks prices don't always match business value. We believe we can take advantage of that by forecasting further into the future and by unemotionally pursuing opportunities where other investors have overreacted.

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We will only buy a stock when it sells at a meaningful discount to our estimate of the company's intrinsic value. For example, we believe the greatest pocket of value exists in financials. Many investors are still scarred from the Great Recession of 2008 and are unwilling to consider investing in banks, despite their improved business quality and low multiples.

You also own Netflix and Alphabet. How is that "value?"

Harris Associates was one of the first value managers to acknowledge that accounting rules overly penalize the companies investing to grow their businesses. Thirty years ago, we were buying cable TV companies that lost money every year and had negative book value. Why? Because we saw an active private market for cable TV companies at about $1000 per subscriber, which was much more than their stocks implied. The income statement was charging these companies for 100% of their investment in acquiring subscribers even though subscribers tended to remain for many years. Further, the depreciation expense for underground cable was based on a much shorter useful life than the assets actually had. When we adjusted the income statements, the substantial profitability of the industry became apparent.

We see a strong analogy to Netflix today, where we adjust the income statement for customer acquisition cost and the strategic underpricing of its subscriptions. For Alphabet, we add back its research spending on Waymo and "other bets" and add an asset for the value of those money-losing ventures. We also value cash separate from the business because if you valued cash at a normal P/E today, you'd be valuing it at pennies on the dollar. When we make our adjustments to Alphabet's financials, we own its wonderful search business at less than the S&P multiple, which we consider to be a bargain.

How do you account for macro risks?

Our forecast horizon is very long term. Our implicit assumptions are that most companies will eventually become "average" growers and that the economic environment will also be "normal." We typically assume the economy will become "normal" within two years. So, the valuation impact of an abnormally bad economy is quite minor, just the shortfall from two years of normal cash flow. Occasionally, our view that the global economy will be normal two years from now is non-consensus and can be seen in our portfolio.

In the midst of the Covid-19 outbreak in 2020, we believed that things would return to normal in several years, which made us much more positive on financials and travel-related businesses than other investors. Today, as investors worry about the Omicron variant, we see a trivial effect on our valuation estimates, with small reductions mostly limited to travel-related businesses as normal demand gets pushed out to 2023.

With such a long-time horizon, how do you deal with disruption risk?

When we started Harris Associates, some of the businesses considered to be most predictable were newspapers, landline telephones and Pitney Bowes (machines to put postage on U.S. mail). Disruption risk is nothing new. Our process guards against it by forecasting many years into the future as opposed to assuming a low current P/E means a stock is cheap. Further, our recommendations must survive active peer debate and a devil's advocate review where an analyst presents the negative case on stocks we consider buying. An additional layer of protection is that we only buy a stock when it is selling well below our estimate of intrinsic value.

Having said that, we often believe investors overreact to disruption risk. Examples include fossil fuel and internal combustion engine businesses. Current prices suggest that renewable energy and electric vehicles will be adopted at much more rapid rates than we consider likely. Beyond pricing in rapid extinction, investors often ignore the new technology R&D spending of incumbents. Examples include General Motors' efforts in electric and autonomous vehicles and Fiserv's small business merchant acquiring platform, Clover.

Our valuation process explicitly values emerging businesses, often exposing an unjustifiably low P/E for legacy businesses.

How does your analyst team differ from other investment firms?

There are four important ways our research department differs from our competitors. First, all Harris Associates funds use a value approach. So, we only hire analysts who are predisposed to fundamental value analysis. That means every analyst has a large group of like-minded colleagues to bounce ideas off.

Second, our analysts are all generalists. Most investment firms assign industries to their analysts, meaning they have an auto analyst, bank analyst, health care analyst, etc.

We give our analysts the freedom to recommend any stock they believe is attractive, regardless of industry. Third, in many research departments, the analysts are told which stocks they should work on. Harris Associates analysts are encouraged to work on the stocks they find most attractive. We believe this structure makes our analyst jobs more interesting and also makes our analysts better investors.

Last, most of our competitors use the analyst role as training for the "more important" job of portfolio manager. We have a dual career ladder. If one enjoys being an analyst, that's great. There is no economic incentive for our analysts to become portfolio managers. Instead, they make that decision based on job satisfaction. These differences are why Harris Associates becomes a desirable destination for analysts who are value investors. And once analysts join Harris Associates, they are generally with us for a very long time.

How do you assess today's investment opportunity?

We aren't market timers, so I have no idea what 2022 returns will look like. But the further out we look, the more returns are based on fundamentals, and the more confident we are in our opinions. We believe that stocks are much more reasonably priced than bonds. The S&P 500 has a dividend yield that matches a 10-year government bond, and unlike a bond, its dividends and earnings are expected to grow. We expect equity investors to perform well relative to bond investors over the next decade. We also believe that our portfolios are more attractively priced than the S&P 500. We don't own the concept stocks that the financial media spends so much time covering. Most of our portfolios are traditional businesses that have below-average P/E ratios.

One of the best investment strategies over the past decade has been to buy exciting businesses, regardless of price. It isn't sustainable, in our opinion, and has resulted in an unusually large price gap between growth stocks and low P/E stocks. We believe that a reversal of that performance is warranted and is likely. We are well positioned for a return to normal.

And I have some rocks in my yard that are worth between $0 and $500,000 that I would happily sell for the bargain price of just $50,000!

Written in January 2022
Valuation estimates as of December 31st 2021

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