Oakmark Equity and Income Fund: First Quarter 2022

March 31, 2022

The Ukraine War Changes the Narrative

It has been two years since the Covid-19 pandemic began to afflict our world, and now yet another plague has struck, a land war in Ukraine that began in February. We have been writing these reports for the Equity and Income Fund for more than 25 years, but in all of that time, this is the first report to require discussion of a major land war's impact. We hope and pray for a quick, peaceful resolution to this conflict and regret the need to reflect on the war's financial effects.

Western governments sanctioned Russia for this invasion, and even though the Russian economy is only the world's 11th largest (and Ukraine's economy is much smaller), these sanctions will have significant ramifications, some of which are not yet well defined. Ukraine and Russia export large quantities of many different commodities and this has caused war news to intensify commodity price volatility. Wars are often associated with an acceleration in price inflation, and this war began at a moment when price inflation was already accelerating. Examples of other effects include western countries pledging to increase their defense budgets, many American and European companies shuttering their Russian operations, and uncertainty growing around the repayment of certain bank loans and aircraft leases. As the pandemic unfolded two years ago, it produced behavioral changes that benefited some companies and businesses while impairing others. The war may develop similarly, although short-term volatility has made predictions untrustworthy so far. Perhaps the most significant immediate impact on the international economy has been to increase fossil fuel prices.

When we began to think about subjects for this quarterly report, we did not contemplate including a section discussing a war and its impacts. Our hearts go out to all whom this war has touched.

Recession/Stagflation?

During the quarter, economists and investors began to shift their economic projections away from continued growth to stagflation (low growth/high inflation) or even recession. The pandemic disrupted globalized supply chains, and the war has intensified that disruption. At the same time, many central banks have begun to increase short-term interest rates in an attempt to decelerate price inflation. Given the war's location, many forecasters now anticipate a recession or material slowdown in Europe unless the war ends quickly. In the U.S., the bond market has experienced yield curve flattening such that yields on intermediate-term issues now exceed those of longer term. This inversion (when short-term yields exceed long-term) is often a precursor of recessions, although in this case, the picture is more muddled because the yield on very short-term issues is still well below that of longer term. The most bearish investors note

that the Federal Reserve has never before tightened monetary policy at a time of a shooting war, a pandemic and a flat yield curve. As well, inflation has never before been measured this high so early in what still seems to be an economic expansion.

We invest the Equity and Income Fund primarily in U.S. securities, so we will leave the discussion of international economies to our colleagues. Despite the factors mentioned above, we do not see a recession developing in the U.S. in the near term. Monetary stimulus has been significant during the pandemic, and history shows that the growth-enhancing effects of such stimulus continue long after it ends. Fiscal stimulus programs strengthened consumer balance sheets over the past two years, and corporations took advantage of low interest rates to refinance. Corporate executives to whom we speak generally see continued economic strength and momentum. The combination of high price inflation and a flattening yield curve does concern us, but every cycle is different. The idiosyncratic circumstances coming together at this time may mean that previous economic history has little predictive value.

Quarter Review

The Equity and Income Fund declined 3.7% in the quarter, which contrasts with a 5% loss for the Lipper Balanced Fund Index, the Fund's performance benchmark. Since its inception in 1995, the Fund's compound annual rate of return is 10.0%, while the corresponding return to the Lipper Index is 7.2%. Once again the Fund's short duration of its fixed income allocation aided relative performance in the quarter. To repeat ourselves, we have argued that exceptionally low interest rates meant that longer term bonds had become biased toward risk rather than return. The benchmark 10-year U.S. Treasury's 6.6% loss in the quarter demonstrated that riskiness.

Oakmark Equity and Income Fund – Investor Class
Average Annual Total Returns (03/31/22)
Since Inception (11/01/95) 10.01%
10–year 8.51%
5–year 8.86%
1–year 6.13%
3–month -3.73%
Gross Expense Ratio: 0.86%
Net Expense Ratio: 0.84%

Expense ratios are based on estimated amounts for the current fiscal year; actual expenses may vary.

The net expense ratio reflects a contractual advisory fee waiver agreement through January 27, 2023.

Past performance is no guarantee of future results. *The performance data quoted represents past performance. Current performance may be lower or higher than the performance data quoted. The investment return and principal value vary so that an investor's shares when redeemed may be worth more or less than the original cost. To obtain the most recent month-end performance data, visit Oakmark.com.*

The war's impact on stock market action defined the quarter's list of contributors and detractors. Energy, defense and commodities benefitted while automotive sector holdings declined, most likely because of their potential sensitivity to rising gasoline prices. PDC Energy, Glencore, ChampionX, General Dynamics and Diamondback Energy led the contributors while General Motors, TE Connectivity, Charter Communications, Lear and Meta Platforms detracted most from return. For the first six months of the Fund's fiscal year, PDC

Energy again headed the contributors' list, followed by CVS Health, Glencore, Carlisle and Diamondback Energy. Charter Communications detracted most followed by Citigroup, Thor Industries, Ally Financial and General Motors.

Transaction Activity

We were unusually active in the quarter as increased price volatility provided us with what we viewed as attractive opportunities. As interest rates rose, we added to the fixed income allocation and increased the portfolio duration by one year. In terms of equities, we initiated six new holdings and completed the sale of three. Befitting the erratic and uneven investing environment of the past few months, the new equity positions represent a mix of traditional value names and growth-oriented issues.

Perhaps the best example of an issue on the growth side of the ledger is Amazon. Amazon's share price had languished for roughly a year, and we had the opportunity in the recent quarter to purchase shares at prices discounted by roughly one-fourth from their previous high. Amazon is the leading e-commerce retailer and cloud computing company. In e-commerce, two-thirds of U.S. households are Amazon Prime subscribers, and over half of all online product searches begin on Amazon. Amazon has also built a delivery network that will soon surpass UPS and FedEx in packages shipped. We believe Amazon's customer loyalty and infrastructure are strong barriers to entry in a growing e-commerce market. Separately, Amazon Web Services (AWS) has nearly half of the market in cloud computing. AWS has the significant technical expertise and operates a large and growing number of data centers that run entire IT departments for businesses. We believe AWS has become utility-like in nature and scale and expect it will continue to grow as IT workloads move to the cloud. Despite strong share price performance since the pandemic, Amazon lagged behind its peers in retail and technology. As a result, the company trades at a discount to its peer-weighted sales multiple, the first time this has happened since 2015. We believe the reason is Amazon's investment in e-commerce, which is largely expensed through the income statement. We believe Amazon's normalized margins are higher than today, and the company is undervalued on normalized earnings.

Next alphabetically is BlackRock, the investment industry's largest asset manager. BlackRock's assets are well diversified across region, client type, product and style (active, index and ETF). The ETF category has consistently gained market share due to its ease of use and tax advantages. BlackRock is the global leader in ETFs through its iShares brand (~40% of revenue). iShares' organic revenue growth has consistently been around 10% and we believe it can sustain around this level of growth for many more years. BlackRock's active business has grown well in excess of most other active managers due to its dominance in fixed income and leadership in multi-asset, sustainable investing and alternative assets. We believe this positioning should lead to mid-single-digit organic revenue growth, and with normal market returns, overall revenue growth should be in the high-single-digits with earnings per share growth of around 10%. Despite this outlook, the stock price has declined much more than

global markets due to worries about rising interest rates and the Russian-Ukrainian war. At a mid-teens multiple of next year's earnings, we believe that the stock is undervalued.

KKR is one of the largest alternative asset managers in the world, managing $471 billion in assets across various investment vehicles. Approximately 80% of the company's assets under management are held under capital commitments of eight years or longer, creating a highly stable stream of fee earnings. Moreover, KKR's assets under management have been growing at double-digit rates as the company has drawn on its established brand and relationships to expand into new strategies and geographies. We believe many of these newer strategies have a considerable runway for future growth. Furthermore, we think the market is undervaluing KKR because of its large balance sheet investments and the volatility of its performance fees. We estimate that the company's investments are worth approximately $19/share today or close to one-third of its current market capitalization. After adjusting for these factors, the company's shares trade at a low-teens multiple of our forward earnings estimate. We find this valuation too cheap for a business with KKR's growth outlook and return profile.

Next up is Lithia Motors, the largest franchised auto dealer group in the U.S. The company has a long history of creating shareholder value through best-in-class operations and consistent acquisitions of smaller dealers at attractive returns. There is a long runway for management to continue creating value through such acquisitions, and management believes this will drive earnings per share to more than $50 by 2025, even as automobile prices return to pre-pandemic levels. Meanwhile, Lithia has a significant opportunity to accelerate growth through Driveway, its online auto retailing platform. We believe Lithia's existing nationwide infrastructure provides Driveway with significant competitive advantages in e-commerce that smaller dealers will struggle to replicate. Driveway is not generating any earnings today but could become a major contributor over the next five to seven years. With the stock priced at less than 7x management's 2025 EPS target and with substantial future growth potential from Driveway, we believe Lithia shares are a bargain today.

Netflix is the leading streaming entertainment service with 222 million subscribers and $30 billion of revenue. This scale creates a valuable moat allowing Netflix to buy more content than its competitors in aggregate but pay less per subscriber. This dynamic has created a more valuable customer proposition as the business has grown, which we expect to manifest in a larger subscriber base over time. Netflix stock declined significantly over the past several months as market participants reacted to slowing subscriber growth and margin pressure. We believe it is likely that both of these issues are temporary. Growth decelerated as the economy reopened, but this occurred on the heels of a rapid acceleration period earlier in the pandemic. Weak foreign currencies in the company's international markets were the primary source of margin pressure. Netflix's cost base is primarily dollar-denominated, meaning that declining foreign currency values pressure profit margins. After the pullback in the stock, Netflix trades for 5.5x consensus 2022 revenue and 34x consensus EPS, which is compelling in the context of our expectations for future growth and profitability. We greatly admire Netflix's management

team and the company's unique corporate culture. We are excited to invest alongside them as they capitalize on the enormous opportunity in streamed entertainment.

The next purchase is a return appearance to the Fund, Parker Hannifin. In our opinion, investors have a stale perception of the company. It is still viewed as a short-cycle, diversified manufacturer that is heavily tied to industrial production. This ignores the fine job that CEO Thomas Williams has done since his promotion in 2015. He has vastly improved operations and shifted the portfolio to longer cycled, higher growth, higher margin and higher return end markets. The results are impressive. Margins, returns and earnings have increased substantially. With the expected closing of the Meggitt acquisition in the calendar year third quarter, the highly depressed aerospace segment will be the largest end market. We anticipate a rebound in aerospace revenue, which—combined with the company's strong position in attractive businesses including clean technologies and factory automation—should accelerate revenue growth. Parker Hannifin trades at a discount to other high-quality industrials, which we believe is unwarranted since its growth and returns should be similar or better. At a low-teens multiple of next year's normalized cash earnings, Parker Hannifin is an attractive investment in our view.

We eliminated three equity holdings as well as a very small spinoff distribution received from Zimmer Biomet in the quarter. We sold Nestlé and Regeneron Pharmaceuticals as they approached their sell targets. Zimmer Biomet was also a profitable investment that we sold as we reevaluated its growth in intrinsic value to be less compelling. The net impact on equity asset allocation was quite modest.

We thank you for your interest in the Equity and Income Fund.

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The securities mentioned above comprise the following preliminary percentages of the Oakmark Equity and Income Fund's total net assets as of 03/31/22: Ally Financial 2.7%, Amazon 0.6%, BlackRock 0.2%, Carlisle 2.0%, ChampionX 1.2%, Charter Communications Class A 2.0%, Citigroup 1.8%, CVS Health 1.0%, Diamondback Energy 0.7%, General Dynamics 1.0%, General Motors 2.4%, Glencore 2.5%,KKR 0.5%, Lear 1.3%, Lithia Motors Class A0.2%, Meggitt 0%, Meta Platforms Class A 0.7%, Nestlé 0%, Netflix 0.5%, Parker Hannifin 0.5%, PDC Energy 2.1%, Regeneron Pharmaceuticals 0%, TE Connectivity 2.4%, Thor Industries

0.9% and Zimmer Biomet 0%. **Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks.**

To obtain a full list of the most recent quarter-end holdings, please visit our website at www.oakmark.com or call 1-800-OAKMARK (625-6275).

The Lipper Balanced Fund Index measures the equal-weighted performance of the 30 largest U.S. balanced funds as defined by Lipper. This index is unmanaged and investors cannot invest directly in this index.

EPS refers to Earnings Per Share and is calculated by dividing total earnings by the number of shares outstanding.

The price to earnings ratio ("P/E") compares a company's current share price to its per-share earnings. It may also be known as the "price multiple" or "earnings multiple", and gives a general indication of how expensive or cheap a stock is. Investors should not base investment decisions on any single attribute or characteristic data point.

The compound return is the rate of return, usually expressed as a percentage that represents the cumulative effect that a series of gains or losses has on an original amount of capital over a period of time. Compound returns are usually expressed in annual terms, meaning that the percentage number that is reported represents the annualized rate at which capital has compounded over time.

The Fund invests in medium- and lower-quality debt securities that have higher yield potential but present greater investment and credit risk than higher-quality securities, which may result in greater share price volatility. An economic downturn could severely disrupt the market in medium or lower grade debt securities and adversely affect the value of outstanding bonds and the ability of the issuers to repay principal and interest.

The Oakmark Equity and Income Fund's portfolio tends to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

The information, data, analyses, and opinions presented herein (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) are for informational purposes only and represent the investments and views of the portfolio managers and Harris Associates L.P. as of the date written and are subject to change and may change based on market and other conditions and without notice. This content is not a recommendation of or an offer to buy or sell a security and is not warranted to be correct, complete or accurate.

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All information provided is as of 03/31/2022 unless otherwise specified.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please visit Oakmark.com or call 1-800-OAKMARK (1-800-625-6275).

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