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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Deep Fundamental Research at Core of Bottom-Up Fixed Income Selection

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SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. Abbas: Of course. Harris Associates is a Chicago-based investment firm founded in 1976. Today, it has roughly $104 billion in assets under management. The lion's share of assets is in the large-cap value-oriented category, both domestically and internationally. We also have a dedicated fixed-income product, and balanced equity and income fund to round out the company's offerings. These two products — the Oakmark Bond Fund and the Oakmark Equity and Income Fund — are where I spend most of my time as a co-portfolio manager along with Clyde McGregor and Colin Hudson.

I'll focus on the Oakmark Bond Fund. We launched the product in June of 2020 as the first-ever dedicated fixed-income product in the Oakmark family of products. And although it's the first bond-only investment vehicle, the core investment philosophy is an extension of what Harris Associates has been doing for more than 40 years. That is bottom-up value investing with a focus on determining the intrinsic worth of a company over extended time horizons.

TWST: Is there a specific investment philosophy with the bond fund?

Mr. Abbas: Our fixed-income team, just like every other team at Harris Associates, follows a proven bottom-up investment process with deep fundamental research at the core. We look to identify debt securities that are trading at significant discounts to our estimate of intrinsic value and we invest over a multi-year time horizon. We also prioritize getting inside the minds of the management teams to understand capital allocation incentives and just general competency in running the business.

The Harris Associates investment process really focuses on deriving our edge at the company level where the balance sheets, cash flow statements, income statements and management teams all reside. It's not a key economic release or sentiment indicator scrolling across our computers in bold font that drives our process. It's really the nitty-gritty stuff buried away in the pages of the 10-K or a management transcript where we believe the investment opportunity reveals itself.

Applying this deep fundamental research DNA to debt securities means our fixed-income team spends a lot of time trying to understand a management team's capital allocation preferences and trying to understand how a company's free cash flow generation is being recycled, for example. This requires us to understand each team's preferences for debt paydown versus mergers and acquisitions, capital expenditures, stock buybacks and dividends.

We also spend time with our equity counterparts building out our best estimate of the true intrinsic value of the business we are analyzing. This means developing internal forecasts of future revenues, margins, profitability and understanding comparable transaction multiples that help define the best representation of future business value, which in turn allows us to more accurately appraise future default risk.

We believe traditional credit analysis can, in certain instances, rely too heavily on historical free cash flow and liquidity metrics to determine default risk and thus tends to overlook debt opportunities within companies that are running high cash deficits, but rapidly growing intrinsic value.

Finally, our bottom-up process extends all the way into the legal documentation. We dedicate extra time ensuring we understand key structural considerations in the credit agreement and indentures, as well as the collateral that is backing your piece of debt if things don't go as planned. The output of these qualitative and quantitative inputs is our fair value for our debt security. We then allocate to our vehicle based on the magnitude of the discounts available in the marketplace, alongside the considerations around liquidity, execution and other risk factors.

TWST: Looking at the fixed-income sector more broadly, can you look at what Treasury bonds might be paying in terms of yield and if inflation might start to go up? Would those have any impact on the fund?

Mr. Abbas: It absolutely would. I'll start with explaining the allocation process and then talk about how rates and other macro top-down factors influence our positioning. We're unique relative to many of our peers in the fixed-income space in that we start with a bottom-up process to find cheap securities, and then and only then, address top-down considerations like rates and curve positioning. A lot of our peers start their fixed-income process with a top-down macro view and then fill buckets according to that view. We think the bucket approach to allocation is suboptimal.

If you start at the company level, we believe it's far easier to create an edge that is idiosyncratic and differentiated, and then layer on a top-down view by selecting what part of the curve you want to be in or what part of the capital structure we want to play in. So we start at the ground level, the company's balance sheet, income statement, cash flow statement and management team, and then we transform that into a fair value. We then layer on a macro view to decide where on the curve is optimal, which is where we take our position.

This macro-overlay decision framework is the output of a quarterly meeting that the entire team participates in, where we go through leading indicators, deficit spending, Fed forecasts, recent Fed quotes, GDP expectations — all the key inflation metrics, etc.

Highlights

Adam Abbas discusses fixed-income investing for the Oakmark Bond Fund. He says the fund uses a bottom-up value investing approach with a focus on determining the intrinsic worth of a company over extended time horizons, They then identify debt securities that are trading at significant discounts to their estimate of intrinsic value. According to Mr. Abbas, traditional credit analysis can, in certain instances, rely too heavily on historical free cash flow and liquidity metrics to determine default risk and thus tends to overlook debt opportunities within companies that are running high cash deficits, but rapidly growing intrinsic value. Mr. Abbas says they are carefully watching various inflation gauges to ensure that the spike in prices they expect to see over the next couple of months can normalize over time. He says we should be prepared for higher rates as the probability of the Fed stepping back from its quantitative easing programs increases in the second half of the year.

Companies discussed: Netflix (NASDAQ:NFLX); Marriott International (NASDAQ:MAR); Hilton Hotels Corporation (NYSE:HLT); Southwest Airlines Co. (NYSE:LUV) and Tesla (NASDAQ:TSLA).

The second point I want to make is that even without inflation expectations rising from here, we believe the probability for Fed tapering will increase as we move into the summer. This is an equilibrium exercise: As market participants stop expecting Fed purchases of around $120 billion per month, a new higher supply/demand intersection will be found that doesn't necessarily require inflation.

TWST: Are you trying to add value in the bond fund through things like active management and maybe having more diversity? Do you have any examples?

Mr. Abbas: Yes. Active management is a feature that is essential to how we deploy our strategy because, at the end of the day, our goal is to create value from specific credit selection.

A good example of how we create value through active management is a portfolio holding, **Netflix** (NASDAQ:NFLX). Some of the best-performing bonds over the last several years at Harris Associates have been **Netflix** bonds. Now, under traditional credit lens, this name would have failed almost all of the standard metric tests, given the high cash burn and the company's reliance on the capital markets to fund the ramp up of content spend over the last five years.

Yet it became clear after work that we did in tandem with our equity counterparts that a total business value approach to understanding the default risk profile was required. Once we had demonstrated the scalability of the business, the potential future returns on capital, and ultimately, the incredible value of the underlying subscriber base, it was clear that the investment in content was actually lowering default risk over time, not raising it.

One could make a decent argument that the **Netflix** stock price had reflected these things by mid-2018, when the enterprise value was around $180 billion. But the credit markets were behind at the time, still stubbornly and incorrectly, I would say, waiting for free cash flow and EBITDA to inflect positively. Despite the amount of enterprise value, the debt securities at the time still employed a 25% to 30% chance of default, reserved for the lowest quartile quality of businesses in the high yield index, providing us with an attractive entry point.

"In the current context of monetary policy and the risk to inflation, it's important to remember that the Fed is not all knowing and history is an imperfect tool for forecasting the future. So although over the last 20 years inflation has indeed been transitory, we must remember there are risks that this time is different."

TWST: In terms of potential risk, inflation and what Treasury yields are paying, do you think those would have impact on the fund?

Mr. Abbas: I read a recent piece that I really enjoyed. It talked about how neither the Fed nor history are faultless. In the current context of monetary policy and the risk to inflation, it's important to remember that the Fed is not all knowing and history is an imperfect tool for forecasting the future. So although over the last 20 years inflation has indeed been transitory, we must remember there are risks that this time is different. As such, we are carefully watching various inflation gauges to ensure that the spike in prices we expect to see over the next couple of months can normalize over time.

TWST: What about with some government agencies and state and local governments now with the COVID pandemic? Has it been a challenge for them to meet their financial obligations? And how does that impact a fund like yours?

Mr. Abbas: It's a space that we've been skeptical to allocate to given the relatively tight spreads and the risks related to years of deficits. The stimulus package has changed some of those dynamics. There's no question that a lot of the municipalities on the local and state level are getting critical funding to help support their balance sheets — to ultimately lower default risk over time. So it's on our radar, but today we think the risk outweighs the opportunities in those asset classes.

1-Year Daily Chart of Netflix Inc.

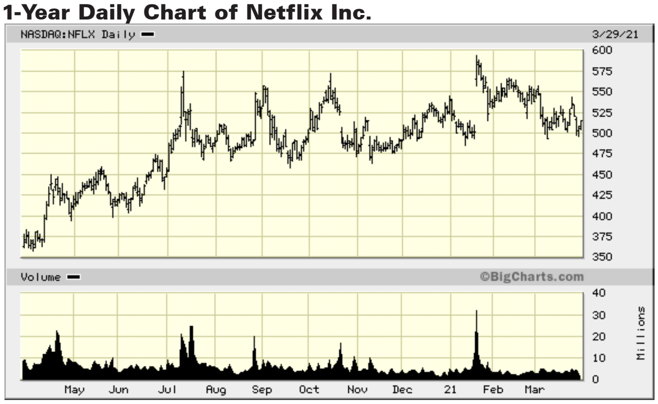

Chart provided by www.BigCharts.com

1-Year Daily Chart of Marriott International Inc.

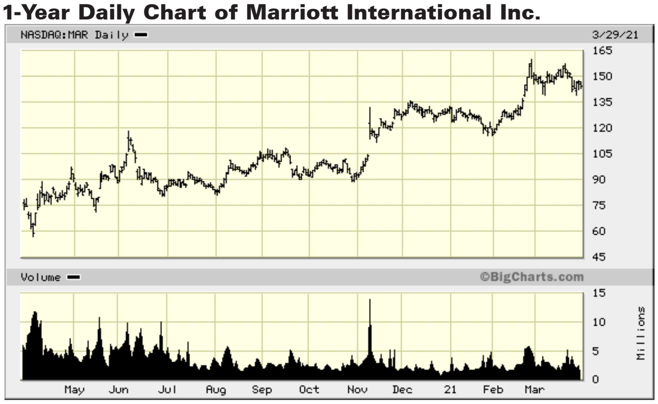

Chart provided by www.BigCharts.com

Instead, we'd prefer to be less dependent on a politically driven thesis and continue to allocate to corporates where we can understand the businesses, the management teams, and have a better ability to predict the future cash flows and profitability.

TWST: With a lot of those corporates, are you looking more at the micro level of the company? Or is it more looking at certain sectors or certain types of companies? When you drill down, what do you look at — to even consider whether to put it as part of the fund?

Mr. Abbas: We always start at the micro level, but our bottom-up work can sometimes uncover broader sector themes. For example, in June when we launched the bond fund, COVID-19 was well underway and one thing we quickly realized through our company-specific research was that the marketplace appeared to be overestimating the risk of default for a good amount of the cyclical universe, but most notably in the travel and leisure names.

The overestimation of default risks seemed to be rooted in two miscalculations. One was the underappreciation of the liquidity runway for most of the COVID-19-affected bond universe. And two was the refusal to give any credence to an eventual normalization of sales and profitability over a multi-year time horizon. Said more simplistically, the market didn't appreciate the war chest of cash most companies had raised in March, April and May and were not yet pricing in any meaningful reopening of the economy.

These exposures included companies like **Marriott** (NASDAQ:MAR), **Hilton** (NYSE:HLT) and **Southwest** (NYSE:LUV), just to name a few. Now we're seeing a lot of these names today get close to our fair value. So we're being disciplined around reducing this exposure as we get toward our fair value targets and replacing with new opportunities. The new opportunities don't necessarily have a sector theme as obvious as last June. We are now much more focused on identifying idiosyncratic opportunities against a backdrop for interest rates that is certainly more challenging.

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TWST: From the point of view of investors, why should fixed income be part of a diverse portfolio with equities and other types of instruments in that mix?

Mr. Abbas: Although we are total-return oriented, there are two reasons why we believe fixed income could complement a broader set of holdings. One of the main reasons is that fixed income can help diversify and ultimately lower correlations to a broader set of asset classes over time. When you look at the largest drawdowns in the equity category over the last couple of decades, one thing is always clear: High-quality fixed-income exposures have negatively correlated with equities, and therefore, an important function of bonds is to provide protection during the most difficult market environments.

The second important function is to provide a recurring income for investors. So, although it's harder to make a compelling case when the 10-year yield is at 1.5%, many of our investors, and more generally, fixed-income investors, rely on a recurring stream of income to take care of their spending needs.

TWST: That need for predictable income, that's maybe particularly the case for people in their retirement years who want also a less volatile type of investment.

Mr. Abbas: That's correct. I think given our view on the risk to rising rates, we would actually suggest that our investors, those who are not in their retirement years, who are younger than 55, that we'd actually prefer to see them with a higher percentage of the portfolio exposed to the equity asset class. However, for those in retirement, we think that the dual purpose of providing income and providing negative correlations to equity exposures plays a very important role.

TWST: Looking ahead for the next year, as far as investors in fixed income, what advice would you give them, given what might happen with interest rates, what the economy might do and what the Biden administration might do in terms of economic policy?

Mr. Abbas: Well, as I said before, I think even without inflation expectations rising from here, real rates will likely drive nominals higher as the probability of the Fed stepping back from its quantitative easing programs increases in the second half of the year. So we should be prepared for higher rates and we should prepare for some of the effects that this has across markets.

Another point is that the era of buying growth at any cost is likely coming to an end as rates normalize. So I'd like to caution people on their more speculative portions of the portfolio, their higher p/e multiple exposures. I think we should always be skeptical when an evaluation exercise relies more on imagination than math and that's what a fair amount of the speculative universe has evolved into. And as rates go higher and discount rates go higher, we believe more discipline will likely be injected into valuations. And we're already starting to see some of these names begin to deflate, such as a name like **Tesla** (NASDAQ:TSLA).

The last point I want to make is that the central bank tightrope act it has in front of itself is actually a very tough one. This is something that, obviously, Mr. Powell himself won't readily admit — and the market is giving them most of the benefit of the doubt, at least in the equity markets. But you can already see the bond market begin to challenge them. And I want to impress today that tapering even with economic tailwinds in the back half of the year or even with fiscal policy that will remain tremendously supportive could cause a lot of indigestion with the markets.

I don't envy the position that central banks are in. We have essentially been hooked on quantitative easing for more than a decade. And I do think withdrawal symptoms may be volatile. More broadly, the Fed and the central banks around the world have now reinforced to the marketplace, once again, that they are the backstop to markets in periods of crisis.

This occurred, albeit more slowly, in 2009 and 2010 and again in various forms in 2012 and then again in 2020 with the COVID-19 backstop. Market participants have been trained for over a decade that central banks will serve as a backstop in times of crisis. And so I have a longer-term question that I think we should all be asking: Can risk find its way back to an unaffected price over time? Or will the market begin to permanently underprice risk until this backstop bias is somehow dismantled?

TWST: Anything we haven't talked about you care to bring up?

Mr. Abbas: In our fund, we manage our debt risk in multiple ways. At Harris Associates, we believe the optimal way to manage risk is by price. We don't buy momentum, we buy value. And that means entering positions at a discount to our estimate of intrinsic value to not only provide asymmetrical return opportunities for investors, but to provide a certain degree of cushion if our thesis or ultimate valuation proves wrong.

We also stress test our portfolio on a monthly basis. This includes historical scenario analysis, interest rate shocks and custom credit shocks, as examples. This ensures that we don't have an overconcentration of risk built into the portfolio that would prevent us from properly running our strategy in all market environments.

TWST: Thank you. (ES)

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