Bill Nygren, Harris Associates

Interview with *Graham and Doddsville*, an investment newsletter from the students of Columbia Business School

Bill Nygren, CFA
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Bill Nygren has been a manager of the Oakmark Select Fund (OAKLX) since 1996, Oakmark Fund (OAKMX) since 2000 and the Oakmark Global Select Fund (OAKWX) since 2006. He is also the Chief Investment Officer for U.S. Equities at Harris Associates, which he joined in 1983; he served as the firm's Director of Research from 1990 to 1998.

Mr. Nygren has received many accolades during his investment career, including being named Morningstar's Domestic Stock Manager of the Year for 2001.

He holds an M.S. in Finance from the University of Wisconsin's Applied Security Analysis Program (1981) and a B.S. in Accounting from the University of Minnesota (1980).

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Graham & Doddsville (G&D): Can you walk us through your background and what brought you into the world of investing?

Bill Nygren (BN): I grew up in a middle-class family in St. Paul, Minnesota. In school, I always did better with numbers than words and baseball was one of my passions outside of school. One of the things that attracted me to baseball was how easily available all the statistics were. I played Strat-O-Matic Baseball as a kid and was always looking in our local newspaper at the full page of baseball box scores that they had. Coincidentally in the *St. Paul Pioneer Press*, the business section was right next to the baseball box scores and that section had all the stock quotes on it. I was intrigued by this page of numbers that I didn't know. When I asked my dad and he told me that they were stocks and that the numbers represented dollars, it suddenly became very interesting to me. So that interest in stocks and numbers was there from a young age.

I also grew up in a very traditional household. My dad worked outside the home and my mom raised the kids. My mom was always on a very tight budget for grocery spending. Therefore, she would always shop specials. When I was a little kid getting dragged to the grocery store with my mom, a weekly shopping trip would usually involve three different locations so we'd buy the stuff that was on sale at each store. If grapes were on sale one week and cherries weren't, we had a lot of grapes in the house. We would alter our purchasing habits based on prices that were charged. That was how I learned to behave as a consumer—always trying to expand what my dollars could buy by being very careful about the price that I paid.

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Additionally, there was a family trip out to visit an older cousin of mine who was serving in the Air Force. This would have been, I guess, the tail end of the Vietnam War. The trip took us through Las Vegas and my dad took my older brother and me into, I think what was the Kroger grocery store across the street from the Motel 6 that we were staying in. My dad pulled out five nickels and he said, "I'm going to show you two boys why you should never gamble." He

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put the first nickel into a slot machine and seven nickels came out. Then he put the next one in and a few more nickels came out. I could see my dad getting frustrated because his object lesson was going awry.

"It was important to have an investment approach that was consistent with the way I thought about money and all other aspects—trying to get the most value for my dollar and applying that same process to investing. I wasn't fighting any cognitive battles inside my own head. "

But I was standing there saying, "Dad, stop. You're way ahead, stop, stop." And he just got angrier and angrier and threw these nickels in until they were all gone and then said, "See boys, you should never gamble." By then my eyes were huge and I thought, "This is fascinating. I just watched my dad make multiples of his money. If only he hadn't been so foolish to throw it all away."

That created a fascination with understanding gambling versus investing. My dad worked in the accounting department at 3M Company. He had a business background, so I knew he understood probabilities and dollars and what made sense for investing. And here he was telling me gambling was foolish. So, I started studying all forms of gambling. I learned that lotteries gave you an expected value of about 50 cents on the dollar and horse racing was maybe 83 cents. If you played craps really well, you could get that up to 99. And if you counted cards in blackjack, you had a chance to get better than 100 cents.

All these things we called gambling had expected values less than 100 cents on the dollar, but the things we called investing gave you more; if you bought bonds, you would usually come out just barely ahead of inflation while stocks gave you a much more significant expected return. I became fascinated with stocks throughout high school. During college, almost all of my free time was spent reading investment books from our local library and over the course of a few years, I read most of the books they had about investing. That's not as heroic as it sounds today because I'm sure the local library would have hundreds of books on investing. Back then they had maybe 10 to 20 books because it hadn't really become the national pastime to figure out how to day trade and invest.

In my reading, I was always attracted to the people who approached investing the way my mom approached shopping. When Benjamin Graham said, "You buy stocks when they're on sale," that completely squared with the way I behaved as a consumer. I started to believe that my style of investing would be value investing. That's not to say that I believe that's the only thing that can work. But for me, it was important to have an investment approach that was consistent with the way I thought about money and all other aspects—trying to get the most value for my dollar and applying that same process to investing. I wasn't fighting any cognitive battles inside my own head.

Once I had the feeling that an investing career is what I wanted to pursue, I thought it made sense to spend a lot of time learning the language of investing, which is accounting. I majored in accounting at the University of Minnesota and I had an internship at Peat Marwick and Mitchell, which was one of the Big 8 eight accounting firms back then. But one of the things that bothered me about an accounting career was that it looked like if you were 10 or 20% better than

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the person you were sitting next to, you could maybe get paid 10 or 20% more than that person could. There wasn't leverage. In the investment business, the average investor doesn't add any value to an index fund, but someone who can outperform the market can deliver tremendous leverage on the value of their time and that had great appeal to me.

And then one last story. My dad was a credit manager at 3M. I enjoyed the outward focus of his job. It was an interesting contrast between my dad and one of my uncles who also worked at 3M. My uncle managed the forms department and knew more about the company than almost any other human did because he helped write the forms that drove the operations for every department. My dad, on the other hand, knew a little bit about a lot of companies because he had to be responsible for credit decisions to 3M customers. Anything that was in the business news usually overlapped with what my dad was doing. When Chrysler was going through its bankruptcy, my dad was involved in decisions about whether or not 3M should continue to sell them product. I loved the external focus of having very broad, but more shallow knowledge as opposed to knowing all the details about one company. That cemented that I wanted to study investments when I went to business school.

G&D: How did you decide where to attend business school and where to launch your investing career?

BN: I was at an internship at General Mills the summer before I started business school. The last couple of weeks there, they had executives from different departments taking us to lunch to try and convince us to work for them. I found myself saying, "What I'd really like to do is work in the pension department and work on investing the pension money." And one of the guys said to me, "If you're really interested in investing, General Mills probably isn't the place for you. A very close friend of mine, Steve Hawk, is running this interesting program at the University of Wisconsin called the Applied Securities Analysis Program. I'd suggest you go down there and interview with Steve because I think that program would be really interesting for you."

So I went and interviewed with Steve. Madison, Wisconsin wasn't really on my radar, but when I found out I could get my master's degree there in 12 months, I could start right after undergrad as opposed to waiting multiple years and I could spend most of my time in a program where the students got to invest real money, it was a no-brainer for me to go to the University of Wisconsin. Looking back, this was one of the best decisions in my career.

"I loved the external focus of having very broad, but more shallow knowledge as opposed to knowing all the details about one company. "

After Wisconsin, I took a job at Northwestern Mutual Life in Wisconsin and learned two key things during the two short years I spent there. First, it was important to me to work at a company where investment results drove the success or failure of the firm. Northwestern Mutual was driven primarily by its ability to sell insurance and the brand that it had with customers. It was important that they didn't screw up on the investment side but getting unusually good returns was not as important to them as the ability to sell insurance was. Secondly, I worked in a small department there with portfolio managers whose investment process was kind of a mix of momentum investing and trying to use

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Wall Street buy recommendations to drive what was in the investment portfolio. As an analyst there, my managers and I were like two ships passing in the night. I would look at something that was on the new low list.

I remember looking at a company called Allied Stores, which owned Brooks Brothers among other things, and getting excited because I thought the real estate value of its properties was worth more than the stock price. Nobody on Wall Street was recommending it. I presented my report and they said, "There just doesn't seem to be enough interest in this stock for us right now, so let's keep an eye on it." The stock did well and Wall Street started recommending it. They came back to me saying, "Hey, you like this Allied Stores, let's look at buying it." I responded, "Yeah, but I liked it when the stock was at $15 and I thought it was worth $30 and it's selling at $27 now. I think there are better things we could do." I learned that being good at executing one's personal investment philosophy didn't really matter if the people that you worked with were using a different philosophy. Not that theirs was right or wrong; the important thing was that it was different, so we had a mismatch. I decided that I needed to change firms and was looking for a company committed to value investing, where investment results drove its success or failure. I called Steve Hawk and told him that I was going to be looking for another position and asked that he please let me know if he were to come across anything.

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A couple of weeks later, my phone rang and it was Steve. He said, "Bill, an alumnus you don't know named Clyde McGregor from a firm you've never heard of, Harris Associates, is going to be calling you in a minute about a junior analyst job. You should take the job. I told him to call you so I have to hang up now."

A minute later Clyde called and invited me to come down to Chicago to go out to dinner with several Harris partners. They were asking about stocks I was interested in and were genuinely interested in all of the companies where I was hitting a brick wall at my current firm. There was an intellectual meeting of the minds that I'd never experienced before. I ended up joining Harris in 1983. My thought at the time was, "I can learn a lot here and I know the next three to five years will be good. I don't know beyond that." At that point, I wasn't worried about beyond three to five years. And here we are today, 37 years later, and I'm still in the same spot.

G&D: It sounds like you had the Ben Graham value mentality early on and you were drawn to the statistical and the numerical side of things. But obviously Oakmark is known for not only being a value investor, but also looking for high quality businesses that are well positioned. Could you talk a little bit about kind of how that transition emerged for you and maybe delve into the strategy at Oakmark?

BN: I think part of it is just how business has evolved more than how we have evolved. If you look back to Graham's time, businesses were hard asset-based. Fixed assets on the balance sheet were depreciated and there was a reasonably good correlation between stock prices and book value because competitive advantages that didn't get represented on the balance sheet tended to be

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relatively temporary. A textile company that was first to invest in the newer, faster looms for a few years would have a competitive cost advantage. They would do really well, then their competitors would make the same investment and they were back to the same lousy commodity-based business that they had always been in.

But looking for discounts to book value tended to identify average businesses that were out of favor. If you did that and were patient and waited for a reversion to the mean, you could be successful. In the early 1980s, Warren Buffett was instrumental in expanding the universe of what we called value. He invested in a consumer business that left a lot of his followers scratching their heads because it sold at a multiple of book value. Buffett's comment was, "If you look at the assets on the balance sheet, you won't even find brand value, and that's more important than any of the assets that are listed on the balance sheet." That started a move in the value community to look for important assets that weren't part of book value.

It could be real estate that was at a historical cost and today was worth way more than it was when it went on the balance sheet. It could be brand value that was created through advertising, which was expensed and not capitalized. The same applies to customer acquisition costs and R&D expenditures, which not only didn't increase book value, but also depressed earnings. At Oakmark, we were always open to the idea that GAAP accounting was not a perfect measure for how business value was growing.

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One example from the early days of Oakmark in the early 1990s is the cable TV industry. We were seeing a lot of private market transactions taking place at enterprise values of $1,000 a subscriber or 11x EBITDA. These were companies that didn't look cheap on net income or book value, but there was clearly business value there. We went through and reconstructed income statements and balance sheets acknowledging that customer acquisition costs had very long-term benefits and that depreciation of cable in the ground was occurring at a much more rapid rate on the accounting statements than it was in real life. If you made the accounting match real life, these companies had real book value and real earnings.

We also felt that way about a company like Amgen where very heavy R&D spending was depressing earnings and making it look very expensive relative to the pharma industry. But if you looked at enterprise value to EBITDA plus R&D, Amgen looked much cheaper than the pharmas and it also had much longer patent protection and much better growth ahead of it. That ability to make exceptions to GAAP metrics when we don't think GAAP reflects the real world carries through to today to positions that are important to us, like Alphabet, where its spending on "Other Bets" goes through the income statement, depresses earnings by something like $6 a share and is not reflected on the balance sheet.

If Alphabet were investing with Kleiner Perkins instead, it wouldn't be called an expense and there'd be an asset on the balance sheet called venture capital investments. But they do it themselves, which we think is even better because it helps them hire higher

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quality engineers. But as a result, it depresses the earnings and inflates the stated P/E multiple. Once you adjust for that and the cash on the balance sheet, which earns almost nothing today, you see that you're really not paying much more than a market multiple for the Search business.

Another example is Netflix, which very strongly rhymes with the way we thought about cable TV companies. It isn't reporting much in the way of income and its book value is relatively meaningless. A similar company like HBO got purchased by AT&T as part of Time Warner for a value of a little more than $1,000 per subscriber. On that basis, Netflix stock looked very cheap and based on the subscribers they were adding every year, it was selling at a single-digit multiple of the value it was adding. We don't think of value and growth as opposites. Growth is a positive characteristic in a company and as long as you don't overpay for it, it's a nice thing to have.

We also owned Apple for a long time, although we finally sold it last quarter. Almost the entire time we owned the company, it was selling at less than a market P/E multiple, yet it was always the first question we got asked by clients or consultants. "How can a value manager own a growth company like this?"

If we can get growth and not overpay for it, that's a huge positive. I think there are mischaracterizations of how value managers should think—that we should be confined into this universe of subpar businesses that are destined to fail in the long term. That's not how we at Oakmark think of value at all. We believe there's a way to value a business fundamentally and if we can buy a stock at a big discount to that value, whether it's a low P/E or a high P/E, it's a value stock.

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G&D: It seems like there are situations in your portfolio where you don't necessarily think that analysts' forecasts for the next few years are necessarily off base, but you think often the multiple that's being ascribed to those businesses is too low or people are not recognizing the quality. Could you expand on that?

BN: I think a lot of Wall Street analysis tends to be relatively simplistic, where someone will say, "Over the past 30 years, this industry has averaged X% of a market multiple, and based on that, the stock doesn't look cheap today." We've been attracted to industries like auto parts where the analysts who've covered auto parts for a generation are basically stuck on the idea that those companies ought to sell at 5-6x earnings. But we think the industry has changed a lot for the better over the past 30 years. A generation ago, GM would design a part themselves and would put it out to bid to a handful of auto parts companies and say, "Here are the specs of what we want, give us a bid."

Today, they will say, "We need you to design a thing. The thing can't weigh more than this and has to accomplish all these functions." The important change is now the intellectual property is sitting at the auto part company. It's not just a race to the bottom of who can be the lowest price supplier of a commodity product; these companies are actually designing solutions for the

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auto OEMs. It's important to the auto companies that their suppliers be successful because they've realized that it doesn't make sense to have one company supplying the United States and a separate company supplying China and yet another company supplying them in Europe. They want their parts companies to be successful global businesses that can follow them around the world. I think the market has been very slow to accept the idea that the relationship between OEM and parts supplier is no longer focused on the OEM just extracting a few pennies less in costs. It is actually a true partnership today and we believe that should express itself in a higher P/E multiple.

"We want to invest in companies that will utilize their free cash flow to eventually force a convergence of business value and stock price."

Banks are another example. We believe the banks that have much higher capital relative to their assets today than they had a generation ago are substantially less risky businesses. And because of that, their cash flows should be discounted at a lower rate and that should result in a higher P/E multiple. Most of Wall Street research still simplistically says the industry has typically sold at about 10-11x earnings, so that is still appropriate.

There's no acknowledgement that the businesses are better today and more competitively advantaged with larger scale that helps on mobilization, fraud protection and regulatory compliance. It's why the large banks are gaining more share today without having to buy the mid-sized banks.

G&D: If you're right, what causes stock prices to eventually reflect that reality?

BN: Either the market changes its opinion and willingly elevates these companies to higher P/Es or you get in a position like the banks and the auto parts companies are in today where there's almost no use for capital that can add as much to per share value as purchasing their own stock. Pre-pandemic, we had a number of the large banks that were not only paying a dividend yield that exceeded what you could get on a 30-year bond, but they were also repurchasing enough of their share base that they had double-digit EPS growth, even though top line was only growing a couple percent per year.

We want to invest in companies that will utilize their free cash flow to eventually force a convergence of business value and stock price.

G&D: With those two particular sectors, it seems like the market is very focused on cyclicality and risk of disruption. Do you think those concerns are overblown by the market?

BN: I think cyclicality fits well into discounted cash flow analysis and estimates of valuation. You just need to be careful that you are not projecting either peak or trough returns for a company into perpetuity. The way we will look at a cyclical company is to try to make as accurate a guess as we can of the next couple of years of earnings. But as we think out longer than that, we will look toward a reversion to the mean of what the company has typically earned on its equity or profit margin to try to get to metrics that make sure we're capitalizing normalized earnings.

As far as disruption risk, some of the auto parts companies that we own, like TE Connectivity and Aptiv, are leaders in electrification. Their content is significantly higher on EVs than it is on traditional vehicles. I think they benefit from disruption. Lear is a

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company we own that's dominant in seating. I think the concern there relates more to whether we will end up with a giant, shared car fleet in the United States of autonomous, utilitarian vehicles where nobody's really concerned about comfort of seating.

I think what people are missing is that as we move toward a more autonomous vehicle, you start thinking of the inside of your car becoming more like your living room or your den, where comfort becomes more important to you because you aren't constrained by needing to drive the entire time. We can see a future where the average price of a seat in luxury vehicles is multiples of what it is today because it becomes an entertainment center.

So, I think if we were invested only in auto part companies that relied on fossil fuels and combustion engines, there'd have to be some concern about disruption. But given where we are invested, I don't think our companies face that concern.

Shifting to banks, the most basic function of a bank is to collect deposits and loan them out at a spread. I think the fact that the most competitively advantaged banks in the world today are selling at less than a market multiple does a lot to discourage anybody from trying to compete with them. If a company like Ally Financial, which has the best auto lending business in the United States, sells at two thirds of tangible equity, who in their right mind would say, "I'm going to try and replicate that?" I don't think a company like Square is really trying to disintermediate the retail deposit to a retail lending business that companies, like Bank of America, Wells Fargo, Capital One and Ally, make the overwhelming majority of their profits from.

"A company like Netflix could report a much higher profit today if it chose to by curtailing spending on acquiring new customers, raising prices significantly and then generating significant cash flow to repurchase shares."

G&D: How do you evaluate management teams and capital allocation, and do you think about capital allocation differently for some of the higher growth businesses that you own like Alphabet and Netflix versus some of these auto parts suppliers and banks?

BN: Our view on capital allocation is that it's management's duty to deploy capital to the highest long-term return potential. A company like Netflix could report a much higher profit today if it chose to by curtailing spending on acquiring new customers, raising prices significantly and then generating significant cash flow to repurchase shares. When we look at the return that it is getting by giving us bargain rates on Netflix so that it grows its subscriber count as rapidly as it can and by spending to try to grow that internationally, it's much more attractive. Netflix is adding something like 25 million subscribers a year, even in non-Covid times. If you believe, as we do, that those subs are worth $1,000, that's $25 billion of value that they're adding. Netflix's market cap is around $200 billion today, so the annual return on spending for customer growth is 12.5%. That organic return is better than what it could likely achieve by just buying back shares.

For companies like banks, in a low loan growth environment, using capital to buy back their own business at a discount to stated book value is a very attractive use of capital, especially because we believe that the financials are worth a significant

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premium to book. We think they deserve to sell closer to 1.5-2x book rather than the three quarters of book that they sell for today. So the money that they're investing in their own stock is returning twice what they're paying for it. It's very hard to find that kind of organic growth opportunity or acquisition opportunity. We don't have a magic answer of what we want to hear a company doing with its capital, but we want to hear a thought process that's consistent with maximizing long-term per share returns.

G&D: What is your approach to selling?

BN: I've always thought that the reason people have so much trouble with the sell decision is because they didn't have a well-defined buy decision. If you really know why you decide to buy a stock and why you own it, then the absence of those reasons becomes the reason to sell. At Oakmark, we're looking for three things when we buy a company.

First, we want a significant discount to current business value. Second, we want that business value to grow over time at a similar rate as the S&P 500, so growth in per share value plus dividend income must at least match what we expect from the market. And finally, we want a management team that's aligned with us wanting to maximize long-term per share business value.

If we feel we've lost any one of those three items, we'll sell the stock. In an ideal world, we buy something at 60% of value and it goes up to 95% of value. If we don't think our value estimate has changed, it's no longer cheap, so we sell it and we move on to another cheap stock. But you also have mistakes where you thought a business was going to be able to grow and as you're tracking the results after you purchase it, you decided you were wrong with your original thesis. That's a reason to sell the stock. You originally thought management was acting in the shareholder interest trying to maximize long-term per share returns. Then you see them issue an undervalued stock for a full price acquisition. You ask about it and they can't explain it in terms that make sense to you. If you've lost confidence that management is trying to maximize long-term value, that's a reason to sell the stock.

The danger is when people will buy a stock without having a really disciplined investment philosophy. Then they're at sea when the stock goes up or down. If you buy something at $50 and three months later it's $30, that's not what you signed up for so you sell it. Or if you buy it at $50 and it goes up to $70, then you're excited because it's going higher, and why would you sell something that is going up? It becomes a very difficult and very emotional decision if you don't have a solid reason for owning that stock.

"If you really know why you decide to buy a stock and why you own it, then the absence of those reasons becomes the reason to sell."

G&D: We discussed earlier how businesses that have become higher quality should merit a higher multiple than they did in the past. How do you pick a new absolute multiple that a business should trade in order to drive your value estimation and your buy / sell decision?

BN: We use a lot of different methods and try to get to a reasonable average. In the auto parts sector we discussed, one thing we look at when comparable companies get acquired for cash is if somebody is willing to pay more than the 5-6x earnings at which analysts are valuing them. We keep close track of acquisition multiples in each industry because we think a buyer

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who's paying cash for an entire business is likely a more informed buyer than somebody who bought 1,000 shares of the stock.

We'll also look at what comparable public companies are trading for. We might argue an auto parts company today is becoming more like a high-quality cyclical industrial business, which is trading at 12x earnings in the marketplace, instead of 6x.

We'll do a discounted cash flow analysis. As a value manager, we think our crystal ball gets hazy faster than growth managers tend to think, so we'll build a detailed two-year forecast and then use a five-year growth rate after that. After those seven years, we model a regression to the mean because we think it's hard to project for any business that the advantages or disadvantages we see today persist beyond seven years. We'll set a discount rate based on risk levels, informed by where their bonds trade and where comparable companies trade, and then we'll do a discounted cash flow.

If we compare those three different methods and they're wildly different, we want to understand the differences. Once we understand, we can thoughtfully say something like, "Maybe the acquisition price is out of line with the others because there's always a big synergy opportunity," as opposed to computing a naive average of the different approaches.

"The most important message back in 2008 was simply to get your money invested in the market. Today, I don't feel that way at all."

I always find it funny when somebody says, "My fair value estimate for this business is $74.70." We're just trying to get into the right ballpark and that's one of the reasons we look for big discounts. If a stock is selling at $50 and we can't get pretty confident that there's a way of looking at it that says it's worth more than $70, we'll move on to something else. The precision isn't nearly as important. It's the idea that there is a compelling body of evidence that gets to a substantially higher number than where the market is offering it to us today.

G&D: What are your thoughts on the current environment, and how does it compare to prior market environments during your career?

BN: When people ask about the current environment, especially a few months ago when prices were more depressed than they are today, they would always want to make a comparison to 2008. I have a very hard time saying that this market bears any resemblance at all to 2008. In 2008, if you took a normalized earnings number for the S&P, the market was selling at 7-8x that number. The most important message back then was simply to get your money invested in the market. Today, I don't feel that way at all.

The multiple on the S&P is somewhat higher than the long-term average. I think you can argue that that's deserved given the lower interest rate environment, but I wouldn't argue that the current market level is so undervalued that you should be shifting your asset allocation much more to equities.

This reminds me much more of the market I went through earlier in my career in the late '90s, where the S&P looked a little high, not crazy high, but you had this massive divergence between where traditional businesses were selling and where dot-com stocks or large-cap, rapid growers were selling.

Banks were selling at 5x earnings and food stocks at 7x earnings, but GE was at 50x and Home Depot was

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at 70x. For the fastest growers, you couldn't even compute the multiple because they were losing money. Back then people would say, "Well, this massive gap is deserved because these traditional businesses are dying, everything's moving online." Having been through that before, it makes me less willing to believe it today.

The chart above compares multiples on the fastest growers to the lowest P/E stocks. If you look at that over the past 70 years, it looks like a sine wave going between 2-3x. So if the cheapest stocks were at 7x earnings, the most expensive growers were usually 14x to 21x. The line goes crazy around 1998 to 2000, getting up to about 10x. In the couple of years after that, it came crashing back down and started sine-waving between 2-3x again.

People talk about value underperforming for a decade, which is true, but for the first six years of that decade, there was a pretty tight correlation between the Russell Value and the Russell Growth. It's really the last four years where the divergence has become extreme. Today, that chart of relative multiples has again gone from 2-3x up to 10x.

One common argument supporting today's extreme price for growth is that the shortcomings of GAAP accounting are even greater today than they were two decades ago. As we discussed earlier, I believe that as well but not to the magnitude that would justify these stocks selling at 10x greater multiples than low P/E stocks. Another common argument is that the value of the future becomes infinite as interest rates go to zero. That's mathematically true, but we don't believe it makes sense to project interest rates staying at zero forever. Eventually you have to return to a world where investing is getting a return for being willing to defer the utility of present consumption. To lend money long term, people will have to get back more than they expect inflation to be. We are not willing to do a DCF at 3% for a rapid growth company today.

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In a normalized environment in which inflation is going to be around 2%, like the Fed is targeting, long government bonds would be 1% more than that, corporates a bit more than long bonds and then equities a couple of hundred basis points above corporates. I think as interest rates recover to sustainable levels, it makes sense that this P/E gap comes back to normal.

"We think this environment is very similar to that late 1990s, early 2000 environment."

The next question everybody always asks today and asked me back in 2000 is, "What do you think is going to cause a reversion?" Even having lived through it, it is difficult to pinpoint what caused the collapse of the dot-com and large-growth bubble of 2000. I think the rubber band expanded too far and finally snapped. Low-price companies were able to increase their value more through share repurchase while high-price companies started to make acquisitions of more traditional businesses–like the AOL/ Time Warner merger. In the midst of it, nobody knew why it was happening, but that 10x multiple premium that investors were willing to pay for growth relative to cheap started to collapse all of a sudden.

We think this environment is very similar to that late 1990s, early 2000 environment.

I'm writing my quarterly letter right now and going back to comments I made 20 years ago about how small companies with large valuations were taking over the large-cap universe. I wrote back then that investors who thought they were getting a low risk portfolio because it was large cap were actually deluding themselves because they were taking on a magnified risk with smaller businesses that had bigger ranges of fundamental outcomes on top of the risk of very high valuations.

This analogy is important today as we see big businesses that were previously large cap, like Schlumberger, Phillips 66 or Dollar Tree, falling out of the large-cap universe and being replaced by smaller companies with very high valuations. I think that creates a dangerous situation for the large-cap investor who thinks they have a relatively low risk portfolio.

G&D: Do you think this is a dangerous environment for the S&P index as a whole?

BN: I want to be careful there because we part ways with a lot of our value peers who believe the FANG stocks are grossly overvalued. As I mentioned earlier, we own Alphabet and Netflix, which we think are value stocks. Same with Facebook, which no longer looks that expensive based on its projected P/E because it's grown so much from the time people started complaining about how high the multiple was. Those three stocks alone are a pretty big part of the S&P.

We owned Amazon at one point. For a brief second, people thought we were brilliant as value investors buying Amazon in the $200s. We thought that on a percentage of sales, it was cheaper than the brick-and-mortar stores it was putting out of business and it was making an investment decision to depress earnings and grow the scale of the company. The stock hit $600 within a year as people started getting really excited about AWS. At the time, we were not equipped to make a reasonable business value case for AWS. Our thesis for owning it as a retailer was running out. We sold the stock too quickly. Instead of being the geniuses who bought it in the $200s, we

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became the idiots who sold it in the $600s. But where Amazon stock is today, I think it's tough to make a value case.

I mentioned Apple earlier, which we used to own. In the past quarter, you've seen almost no change in earnings estimates for Apple, yet its price has gone up nearly 50%. It's all multiple expansion. That's a tough one for us to understand at this price. But the craziness to us is not in the FANG names. It's in the companies that might have $1-2 billion of sales that are now large-cap stocks because they have capitalizations over $35 billion. And we think they have the fundamental risk of unexpected outcomes that you would expect from companies that are that small. Most of them have competitors that are very well funded. You don't know what the market share structure of their industry will look like a decade from now, much less knowing what the demand for the product will be.

Those names have very high fundamental risk coupled with very high valuations. That is the area we think could be very risky for investors.

One risk I do think is there for the S&P investor is concentration risk. We tend to run concentrated portfolios at Oakmark. Our typical peers own something like 150 stocks in their diversified funds, while we own about 50. We also run concentrated portfolios that have 20 stocks. I can't tell you how much time and energy we've had to spend explaining to people why we thought it was prudent to have positions that we really liked in a concentrated portfolio represent over 5% of the assets. The index investor today who owns the NASDAQ, or even the S&P, is starting to get a lot of wealth concentrated in just a handful of very large companies.

“The index investor today who owns the NASDAQ, or even the S&P, is starting to get a lot of wealth concentrated in just a handful of very large companies.”

I don't think that's necessarily a valuation risk, but it is a concentration risk that any problem at one of those companies can have a bigger impact on the portfolio than you would expect for an indexed portfolio.

G&D: How do you think the world of travel will evolve in post Covid-19? And also, how do you maintain a sense of optimism in the markets when something like Covid-19 hits in March?

BN: Part of what makes that easier is the history and temperament of people who are attracted to long-term value investing. In trying to estimate the value of a business and having that drive all of your decisions, the focus is much more on what you think the world will look like 5 to 10 years from now than what the first quarter of next year will look like.

When we went into lockdown in March, we immediately had our analysts change their estimates for companies to be based on the Fed's severe adverse scenario just because we thought that was a reasonably good indicator of what we could expect in this super sharp self-imposed decline we had in the economy. We modeled a slow recovery with 2022 being the first year that was above 2019 and then normal growth after that.

What it highlighted was how advantaged the asset-light businesses were that were in the eye of the storm, like the travel and leisure areas. We owned American Airlines at the time and it looked tough for

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them. The stock had been selling at 4-5x earnings, but the business has a lot of financial and operating leverage and was entering an environment they'd never seen before where global travel basically went to nothing. We didn't have confidence that airlines would survive, but an asset-light, franchise business model like Hilton wasn't even going to lose significant money. For Hilton, we just had to bake in a couple years of lost income. Same for a company like Booking Holdings. We thought Booking would actually emerge stronger because its traditional competitors were not as well financed and had asset-heavier models.

"We are invested in companies we think can survive even if this environment lasts for several years."

The fact that our valuation would have to drop by a couple of years of lost earnings doesn't really change the multiple that we believe these businesses are worth down the road. We've now had two quarterly earnings reports since we went into our adverse scenario and on average, the analyst revisions to those estimates have been slightly positive compared to what we estimated back in March. That's not what we're used to. Usually, value investors assume earnings are going to be a lot better for their companies than the market thinks, and over time, those estimates fall somewhat. In this situation, our earnings estimates have increased from the bottom.

In February and March, when everything fell by about 50%, our immediate move was to analyze our companies on an unlevered basis and see if we had an opportunity to trade up to higher quality balance sheets now because they've actually become cheaper than the companies that were highly levered. We also looked where the market was giving us an opportunity to move out of the eye of the storm to businesses that might actually benefit from the lockdown, without having to pay much of a premium. At the end of the first quarter, we bought companies like Match.com and Pinterest, while we sold a company like American Airlines.

Pinterest fell from low $30s to $14. It had $3 in net cash on the balance sheet, so the enterprise value fell more dramatically. With people spending more money on their homes, engagement was increasing on Pinterest. We thought Covid might have increased the business value and instead it fell more than the average stock. That's the kind of thinking that went into rearranging our portfolio. My only regret is that we were moving as fast as we could and I wish we could have gone faster.

G&D: Do you worry about the risks if the recovery from COVID takes longer than anticipated?

BN: I'll start by saying that the forecast we have of a gradual recovery from the trough isn't a non-consensus forecast. There are some people who are even higher than we are on 2021 earnings. We think 2021 starts to make significant progress back toward 2019, but is unlikely to exceed 2019. When you get into distinctions like, "Could S&P earnings be 20% worse than we had thought," the question I come back to is, how important is that 20% to the long-term discounted cash flow value of business? For an index that sells at 20x earnings today, 100% of one year's cash flow would represent only 5% of the current value.

So I don't think an extra year or even two years of getting past Covid concerns would change long-term discounted cash flow values by that much. The uncertainty of when Covid will end, whether it's at the end of this year, middle of next year, middle of 2022, is

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why we're focused more on the quality of the balance sheet. We are invested in companies we think can survive even if this environment lasts for several years.

That ties back to why we eliminated airline stocks early on. We think travel will come back because we're all getting sick of virtual meetings and we're anxious to sit down and meet in a room together. We want to do our management meetings in their offices across the table from them. It might be a couple of years until we can do that again. And if it's a couple of years, most of the airlines need help to get through that period. When you're relying on strangers to help you, that's usually not good for equity shareholders.

G&D: Are there any particular ideas you want to discuss in more detail?

BN: One holding we're excited about is Ally Financial. Ally's basic business is providing used and new car loans both to dealers and ultimate consumers. Traditionally, Ally had been funded by short-term debt, so there was a risk that when markets seized up, it would be unable to roll over all its short-term financing. When that happened in 2008, it led the company to shift to a business model that was funded with customer deposits.

In banking, you've got two basic business models today. You've got the companies that are spending about 100 basis points per dollar of deposits on a nice brick-and-mortar network with tellers where you can go into the bank and conduct your business. That's a model that we see Bank of America, Wells Fargo and JPMorgan using.

"Before Covid, Ally earned about $3.70 per share, which represents about 7x P/E at the current stock price. We expect post-Covid, it will very quickly get back to that number. "

Then you've got the companies, like Ally and Capital One, which are more internet-based businesses. They don't have the fixed costs, so they can take the 100 basis points that the largest banks are spending on brick and mortar and return it to the customer as interest income. A consumer will typically earn 1% better by putting money in Ally or Capital One than Bank of America in exchange for giving up the branch structure convenience. Ally has moved now to where it is almost entirely funded by retail deposits. The asset side of its balance sheet is almost entirely car loans. I think what investors seem to question is how a company like Ally can make money in such a low interest rate environment.

There is not a rush of new money trying to figure out how to create auto loans. Because of that, spreads on both new and used auto loans are higher than they have been traditionally and are more reflective of the rates that Ally is paying to its retail depositors. Ally is still earning a very good spread income. Additionally, even though Treasury rates are down to about zero, it can still pay 1% because it doesn't have the branch network. Ally is still collecting deposits and lending them out as car loans.

Ally's valuation is compelling. Book value is supposed to be about $31 at the end of this year and it sells at $25 now, so 80% of book, and that's after taking the hit from all of the charge offs that they expect Covid to ultimately cost them.

Before Covid, Ally earned about $3.70 per share, which represents about 7x P/E at the current stock price. We expect post-

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Covid, it will very quickly get back to that number. Ally was using most of its cash flow to repurchase shares because that swamps the return it could get on anything else. Because of Ally's leadership position in auto loans, we think it ought to be earning a low-teens return on equity. It should still be selling at a discount to the S&P, but if the S&P is going to be at a high-teens multiple, Ally could sell at a low-teens multiple. That would equate to 1.5-2x book value, which is 2-2.5x the current stock price.

If we're wrong on P/E multiple expansion, the company should be able to buy back more than 10% of its stock each year, pay us a dividend that's more than we could earn on a long-term Treasury and have the dividend grow by the same rate that its earnings per share are growing. We don't need to be right on everything for this to be a very good stock from current price levels.

"When we look through a pile of hundreds of resumes of students who are interested in one opening, somebody with a strong accounting background really sticks out."

G&D: How do you get comfortable with the default risk in their auto loan portfolio with unemployment so high and all the COVID disruption?

BN: Part of it is the accounting rules, which mandate that Ally has to estimate what it is going to lose throughout the life of a loan and record that as a charge against income. This impacted Ally heavily over the past two quarters. Second, we get to see how its charge offs are comparing to other public companies that have similar quality loan books. We're comfortable that Ally has been in line with those charges.

Additionally, we listen to what management says when they speak publicly. They have spoken about how delinquencies have not been as high as they thought they would have been. The individuals who took advantage of forbearance have come back current on their loans at a faster rate than Ally had projected. You can never be rock-solid certain, but we're hearing a consistent message from all of the consumer banks that credit losses do not look as bad as they had originally estimated they would be.

If the consumer doesn't pay, the ultimate protection is for Ally to go back and repossess the car. Back in March, we were all assuming that used car prices would fall dramatically because people wouldn't have as much money. Instead they've risen dramatically because people want more private transportation than they wanted pre-Covid. So the worst case outcome is if the customer stops paying, they now have to repossess the car and the salvage value is going to be higher than they had previously estimated.

G&D: What's your view on the risk of autonomous driving, which we discussed earlier, disintermediating Ally's business?

BN: It depends on what assumptions we need to get our money back. With Ally selling at 80% of book, if there's a disruption risk and we all quit buying personal autos so that Ally doesn't have a way to grow anymore, simply winding down the business and decapitalizing both debt and equity would get us more than our money back, so we don't worry too much about that as a downside case. We'd worry about it more if Ally was selling at 1.5x book and our target was 1.75x book.

G&D: What advice would you give to MBA students who are interested in pursuing a career in

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investment management?

BN: One thing I'm really surprised by is how little interest there is in accounting at most schools. When we look through a pile of hundreds of resumes of students who are interested in one opening, which we are in the fortunate position of being in today, somebody with a strong accounting background really sticks out. I also think it's so important for people who are going to be successful in this business to be passionate about it. If you're passionate about investing, you can't turn it off. I can't go into a store without seeing how shelf space has changed between different companies. My reading list is almost always about things that I think will make me a better investor.

I get puzzled when I'm interviewing a candidate who claims to have that level of passion about investing and you ask them what they're reading and they say, "Oh, my reading time is pretty much consumed by school. I don't get much free time to read." When I was in school, I was trying to get my hands on every Wall Street research report I could. I was reading investment books that were not part of any course I was taking. That passion comes through in an interview and I think it's really important to be able to demonstrate it. It's not something to fake because you're going to be miserable in this career if it's not an honest passion you're presenting.

G&D: How do you spend your time outside of work?

BN: I love wine. When I was younger, I had no interest in wine and couldn't understand people who did. Over a generation, it has become a passion. I joke that my hobbies basically involve either food or wine and one of the reasons I want to keep working is because I don't want to have more free time to spend on my hobbies—it wouldn't be healthy! I also love sports. Baseball is a passion, and despite the stock market being super exciting today, this afternoon, I'm going to be at a rooftop to watch the Cubs first playoff game.

I am also involved in charitable activities. Rather than mention any individual names, I'll just say that my passion is trying to give disadvantaged kids the same educational opportunities that I had. Most of my focus is on inner city education.

G&D: Thank you very much for speaking with us.

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As of September 30, 2020, the holdings mentioned above comprise the following percentages of the Fund's total net assets:

Security	OAKMX	OAKLX	OAKWX
Allied Stores	0.0%	0.0%	0.0%
Ally Financial	3.5%	6.3%	0.0%
Alphabet Cl A	3.8%	10.3%	10.0%
Amazon	0.0%	0.0%	0.0%
American Airlines	0.0%	0.0%	0.0%
Amgen	0.0%	0.0%	0.0%
AOL	0.0%	0.0%	0.0%
Apple	0.0%	0.0%	0.0%
Aptiv	0.0%	0.0%	0.0%
AT&T	0.0%	0.0%	0.0%
AWS	0.0%	0.0%	0.0%
Bank of America	3.0%	4.7%	6.1%
Booking Holdings	2.7%	4.1%	3.5%
Capital One Financial	3.1%	4.2%	0.0%
Dollar Tree	0.0%	0.0%	0.0%
Facebook Cl A	3.7%	5.9%	0.0%
General Electric	1.4%	2.9%	0.0%
General Motors	2.1%	0.0%	0.0%
HBO	0.0%	0.0%	0.0%
Hilton Worldwide	1.9%	2.8%	0.0%
Home Depot	0.0%	0.0%	0.0%
JP Morgan	0.0%	0.0%	0.0%
Lear	0.0%	3.7%	0.0%
Match.com	0.0%	0.0%	0.0%
Netflix	3.6%	5.1%	0.0%
Phillips 66	0.0%	0.0%	0.0%
Pinterest	0.0%	0.0%	0.0%
Schlumberger	0.0%	0.0%	0.0%
TE Connectivity	1.8%	5.9%	6.3%
Time Warner	0.0%	0.0%	0.0%
Wells Fargo	1.40%	0%	0%

Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks. Current and future portfolio holdings are subject to risk.

Please visit Oakmark.com to view the full list of holdings as of the most recent quarter-end.

The Funds' portfolios tend 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.

Because the Oakmark Select Fund and the Oakmark Global Select Fund are non-diversified, the performance of each holding will have a greater impact on the Fund's total return, and may make the Fund's returns more volatile than a more diversified fund.

Oakmark Select Fund: The stocks of medium-sized companies tend to be more volatile than those of large companies and have underperformed the stocks of small and large companies during some periods.

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The Price-Earnings Ratio ("P/E") is the most common measure of the expensiveness of a stock.

Book Value refers to a company's common stock equity as it appears on a balance sheet, equal to total assets minus liabilities, preferred stock, and intangible assets such as goodwill.

According to Morningstar, the Morningstar Manager of the Year award is presented to portfolio managers based on the managers' (i) "ability to generate exceptional returns;" (ii) "willingness to align their interests with shareholders;" and (iii) "courage to stay with their strategies in order to produce superior risk-adjusted returns in the end.

GAAP stands for generally accepted accounting principles.

EBITDA refers to Earnings Before the deduction of payments for Interest, Taxes, Depreciation and Amortization which is a measure of operating income.

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

The S&P 500 Total Return Index is a float-adjusted, capitalization-weighted index of 500 U.S. large-capitalization stocks representing all major industries. It is a widely recognized index of broad, U.S. equity market performance. Returns reflect the reinvestment of dividends. This index is unmanaged and investors cannot invest directly in this index.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. This index is unmanaged and investors cannot invest directly in this index.

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