ValueInvestor INSIGHT
The Leading Authority on Value Investing
April 30, 2020

Investing in Crisis

Warren Buffett captures an essential truth about investing when he says, "It's only when the tide goes out that you learn who's been swimming naked." The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they're navigating the roiling seas.

INVESTOR INSIGHT

Bill Nygren
Harris Associates

Know Your Strengths

The $10 billion (assets) Oakmark Fund he's managed since 2000 has beaten the S&P 500 index by nearly 300 basis points per year, but Harris Associates' Bill Nygren has never been one to rest on his laurels. Ask him a question about any of the companies in his portfolios and you'll get an articulate, complete answer that puts many managers with far less on their plates to shame. Here he explains where he was focusing his attention as the market swooned last month, and describes a few of the somewhat surprising opportunities he found as a result.

As the healthcare and economic crisis unfolded last month in the U.S., would you say the uniqueness of the situation impacted your response?

Bill Nygren: Let's start with when the news came out that there were COVID-19 cases building in the U.S. When adverse news hits, you go back to the times most similar to what you're hearing to see how the market behaved. The baseline in a number of cases – Ebola, swine flu, MERS, SARS, the Asian flu – was a very brief panic period in the U.S., maybe enough to cause a 10% correction, maybe not. Then a couple months down the road it had all been forgotten. So we started with this thinking that by summer, COVID-19 would be a distant memory.

This is a reminder that sometimes the worst case happens. Despite the fact that it previously turned out that the market had overreacted and it was off to the races in a couple months, this time was obviously different. It shut down the economy. There were dramatic changes to 2020 and 2021 earnings estimates. That was really different and, not surprisingly, would give an investor pause. It's uncomfortable to say, "I don't know if I've ever been through this before."

Our early focus was to sort through all the companies whose share prices had fallen significantly to identify those that fell less on an enterprise-value basis and that were more in the eye of the storm. Given the unique nature of what was going on, if we weren't being well paid to take balance sheet risk, we didn't want it. If we weren't getting paid for being in the eye of the storm, we didn't want to be there.

When we think about how undervalued a stock is, we always look at enterprise value rather than just equity value. A simple example: Say two stocks fall 50%, from $20 to $10. Let's say one has $3 per share in net cash, so its EV has fallen from $17 per share to $7, meaning the market is valuing the business at 60% less than it did when the stock was at $20. The cash presumably was worth $3 before and still is, so the business is worth incrementally less than the fall in the stock price. Compare that to an average company that might have $10 per share in debt. When its share price falls from $20 to $10, the EV is now $20, down from $30 before. So the business value is down only 33% compared to 60% in the other case. When share prices are indiscriminately cut in half, the company with net cash really has been much more heavily hit.

That exercise uncovered a number of opportunities where the market didn't seem to be distinguishing between strong balance sheets and weak balance sheets. At a time when you'd expect the better balance sheet to be favored, the opposite was often the case. We tried to take advantage of that, making new purchases in companies like Pinterest [PINS] and Workday [WDAY], whose stocks fell at least in line with similar companies that didn't have as strong balance sheets. To fund those purchases, we traded out of positions like American Airlines [AAL], which on an EV basis hadn't fallen as much and which couldn't have been more in the eye of the storm as a high-fixed-cost airline.

We are willing to take risk when we get paid enough to do so, but the way the market behaved, often the companies that were less affected and that had stronger balance sheets seemed to have the biggest overreactions. Another stock we added was Constellation Brands [STZ], the large importer of popular Mexican beer labels, including Modelo, Pacifico, and to their misfortune, Corona. The big market concern seemed to be that people are not going to bars any more, which is true, but we concluded that the 15% of Constellation's sales from restaurants and bars could be largely offset by increased consumption at home. We think it's very possible earnings won't go down at all even this year, but the stock price had been cut in half. That made it interesting to us.

Everybody has to have a belief on how we come out of this, and our belief is that 2022 can be a pretty normal year. We like that if we're wrong on that, the trades we've made in the past six weeks have given us a portfolio even better able to weather a longer storm if it turns out that way.

Why did American Express [AXP] make it off your prospects' list into the Oakmark Fund portfolio last quarter?

BN: You're right that this is one of those names we stay current on and have a price in mind where it's worth adding to our portfolio. In this case it hit that price and then went straight through.

With all of our lenders, banks and consumer-finance companies, as the crisis hit we switched our short-term estimates to match the Federal Reserve's severe adverse scenario for the economy and credit losses. We were comforted by the fact that for all of our holdings, the severe adverse scenario at most wiped out earnings for a year or so. There were no big losses. There wasn't the need for a capital raise. Dividends, at least from a financial perspective, were mostly safe.

With American Express, we believed the worst-case scenario was significantly better than all that. We think the company has done an excellent job in improving its cardholder value proposition in recent years by making significant investments in merchant acceptance, cardholder rewards and services, and small-business payment tools. Relative to entering the last financial crises, it has dramatically cut costs and strengthened its balance sheet structure. The payments-network side of the business is now more competitive with Mastercard and Visa. Given all that, in the adverse Fed scenario, we would still expect American Express to earn $4 to $5 per share this year. Two years from now, we think it should be earning more than twice that. With the stock where it is today [at a recent $96], we believe that's too cheap for this caliber of business.

You mentioned Pinterest as a new purchase whose stock you thought was unduly hit in March. Describe what attracted you to it.

BN: This is an example in a growing list for us of stocks you might be surprised to find in a value portfolio. It's losing 50 cents a share, so there isn't a price cheap enough you'd pay on a P/E basis that looks compelling.

Pinterest is actually the first of the examples I gave earlier of the two $20 stocks falling to $10. They have $3 per share in net cash on the balance sheet and the stock traded above $30 post its 2019 IPO, but it was in the low-$20s as the market was peaking in February. It then went to $10 at the trough, a nearly 60% decline.

Pinterest's basic business is as an online

INVESTMENT SNAPSHOT

Pinterest
(NYSE: PINS)

Business: Operator of an online "discovery" platform that helps more than 300 million average monthly users find ideas, products and services for any number of lifestyle pursuits.

Share Information (@4/29/20):

Price	**20.85**
52-Week Range	10.10 – 36.83
Dividend Yield	0.0%
Market Cap	$12.09 billion

Financials (TTM):

Revenue	$1.14 billion
Operating Profit Margin	(-121.5%)
Net Profit Margin	(-119.1%)

Valuation Metrics
(@4/29/20):

	PINS	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	n/a	21.0

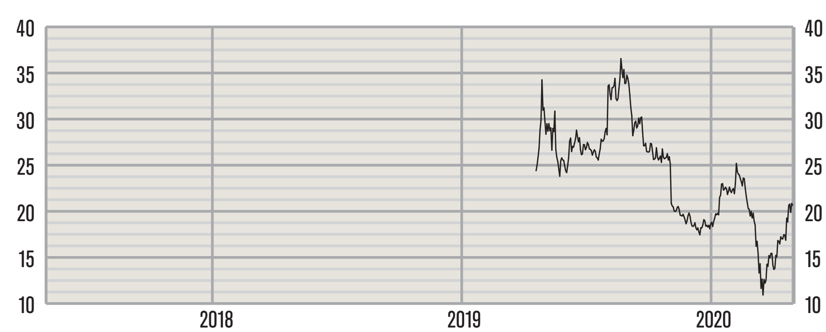
Largest Institutional Owners
(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	6.5%
Flossbach von Storch	6.1%
Fidelity Mgmt & Research	6.0%
Wellington Mgmt	4.5%
Capital Research & Mgmt	1.7%

Short Interest (as of 4/15/20):

Shares Short/Float	5.4%

PINS PRICE HISTORY



THE BOTTOM LINE

While the company may not be an obvious choice for a value portfolio, Bill Nygren believes its value is increasing at a much higher rate than the investment required. He thinks it by 2022 can earn $1.50 to $2 in EPS, at which point, he says, "You wouldn't have to put a very aggressive multiple on that to arrive at a share price well above today's level."

Sources: Company reports, other publicly available information discovery tool for people looking for ideas and inspiration for any number of things, from remodeling a room, to planning a wedding, to planning a vacation. You put on your board pictures that represent what you like and are then given suggestions consistent with your posts. Unlike many consumer-Internet companies, users and advertisers are fundamentally aligned. Customers are showing intention to spend on very specific areas, and welcome information from manufacturers and service providers who have something to sell that's consistent with what they have indicated they like. Advertising is welcomed, which is often not the case in a lot of social media.

The company isn't yet making money because it has incremental costs in preparing to be a much larger-scale enterprise than it currently is, and also because it is still in the early days of monetizing its platform. The priority to grow users – which now number more than 300 million on average each month, growing 15% a year – is higher than the priority to maximize advertising per user.

So key to our analysis is making an educated guess on where Pinterest can go in monetizing its platform, based on what we've seen in other businesses. A company like Twitter generates annual revenue per average monthly user in the low-teens, which is about half of what Facebook gets. In terms of time spent on the platform, Pinterest and Twitter are similar, but Pinterest strikes us as the more attractive environment for both the advertiser and user. Nobody's claiming the Russians used Pinterest, for example, to influence the last election. It doesn't seem heroic to assume as Pinterest's business model matures that its revenue-per-user ends up at a spot similar to where Twitter is.

How are you handicapping the impact of current crisis?

BN: There will be a short-term impact as users have less money to spend and advertisers cut back, but people are doing this out of their homes. They're planning positive things. Advertisers want to spend money reaching customers with a clear intent to buy. We really don't expect the business to be hit that hard.

How are you looking at valuation with today's share price at around $20.80?

BN: The company has been losing $400 million per year, but we'd argue that it is increasing its business value far in excess of that. If we assume Twitter's $13 annual revenue per user, operating margins in the low-30% range and a mid-teens EBIT multiple, that gets us to roughly $60 per subscriber in value for Pinterest. If they grow users by 40 million per year, that's a $2.4 billion increase in value, for which they're incurring $400 million in losses.

We arrive at valuing the shares in a couple ways. If in 2022 the company hits our revenue-per-user, user-growth and EBIT-margin expectations, that would translate into something between $1.50 to $2 in EPS. You wouldn't have to put a very aggressive multiple on that to arrive at a share price well above today's level. Alternatively, if we're roughly right on that $60-per-user value, at today's number of subscribers that would translate into an $18 billion enterprise value, almost twice the level at which the stock trades today.

We realize it's still early, but have you identified any potential lasting lessons from this latest interlude in the market?

BN: I don't know that this is a new lesson, but in situations like this you need to quickly realize where your skills might give you an advantage and where you have no business taking your own opinion seriously. We think we're pretty good at figuring out business valuations. We're pretty good at looking past current events and what companies could be worth on a long-term basis. That doesn't mean we're better than anyone else at guessing how the virus evolves or when the economy returns to normal. We need to make sure our portfolios don't depend on us being experts in areas where we are not. VII

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Average Annual Total Returns (as of 03/31/21)					
	1 Year	3 Year	5 Year	10 Year	Inception (08/05/1991)
Oakmark Fund (OAKMX)	87.83%	13.40%	15.83%	13.57%	12.93%
S&P 500 Total Return Index	56.35%	16.78%	16.29%	13.91%	10.41%

Gross Expense Ratio: 0.93%
Net Expense Ratio: 0.91%
Expense ratios are based on estimated amounts for the current fiscal year; actual expenses may vary.
Returns for periods of less than one year are not annualized.
The net expense ratio reflects a contractual advisory fee waiver agreement through January 27, 2022.

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. Total return includes change in share prices and, in each case, includes reinvestment of dividends and capital gain distributions. 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 most recent month-end performance data, visit Oakmark.com.*

As of March 31, 2021, the holdings mentioned above comprise the following percentages of the Fund's total net assets:

Security	OAKMX
American Airlines	0%
American Express	1.9%
Constellation Brands Cl A	2.2%
Mastercard Cl A	0.7%
Pinterest Cl A	0%
Twitter	0%
Visa Cl A	1.2%
Workday Cl A	1.4%

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 for the Oakmark Fund as of the most recent quarter-end.

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.

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

EV refers to Enterprise Value.

EBIT is a measure of a firm's profit that includes all expenses except interest and income tax expenses. It is the difference between operating revenues and operating expenses.

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.

Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

The Oakmark 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.