Harris Associates
Oakmark Funds

Why We Still Believe in Concentrated Investing

February 8, 2023

When we started the Oakmark Fund in 1991, we believed that by applying a disciplined, fundamental, value-based approach we could create a desirable investment for both our shareholders' and our own capital. We thought most mutual funds over-diversified, therefore effectively closet indexing. We said that by investing in a much more concentrated portfolio, we would increase the effect stock selection had on it. We expected to grow investor capital significantly more than inflation, thus increasing its purchasing power, and we believed our returns would exceed market averages. Potential investors asked if that meant the Russell 1000 Value Index, which value investors often track, or if we expected to beat the S&P 500 Index. We responded that we wouldn't consider this a success unless we beat both. With Oakmark's track record now exceeding 30 years, we and our investors have been rewarded:

CAGR Cumulative Return	Annualized Since Inception	Cumulative Since Inception
Oakmark	12.6%	4082%
S&P 500	10.0%	1890%
Russell 1000 Value	9.8%	1822%
CPI*	2.5%	118%

Those results were achieved utilizing the same process we use today—concentrated investing using bottom-up stock selection. We make long-term investments in companies we believe are significantly undervalued, that have the sum of expected value growth plus dividends that is as high or higher than the average business, and are run by managements that we believe are trying to maximize long-term per share value.

After a successful first five years for Oakmark, we thought that since we had added significant value from our stock selection, we would create an opportunity for even better returns by further concentrating a portfolio into just our favorite investments. We started the Oakmark Select Fund, which would own only our 20 or so favorite stocks as compared to the 50-60 we owned in Oakmark. By magnifying the effect those 20 favorites had on the portfolio, we anticipated the Fund would have even higher returns than Oakmark, albeit with more volatility. As with the Oakmark Fund, we cautioned that concentration was no guarantee of success, but rather that it would simply magnify the impact of our stock selection, both for better and worse. Because of the elevated risk of such high concentration, we told investors that Oakmark Select would be a good fund for part of their assets, as one fund in a portfolio of funds or as a supplement to a portfolio that was primarily indexed. We didn't recommend following the action of the portfolio manager (me) who put most of his net worth in the Fund!

So, we went in with high expectations: we expected a long-term record that would beat the Oakmark Fund, the S&P 500, the Russell 1000 Value and the CPI. Here's the 25-plus year record:

CAGR Cumulative Return	Annualized Since Inception	Cumulative Since Inception
Oakmark Select	11.3%	1565%
Oakmark	9.5%	992%
S&P 500	8.9%	843%
Russell 1000 Value	8.6%	766%
CPI*	2.5%	88%

Again, we and our investors were rewarded. Stocks went up much more than inflation, the Oakmark Fund did even better, and Oakmark Select beat Oakmark by a nice margin. All the boxes were checked.

But a closer look at the recent track record raises questions. Despite very good records since inception, the past decade hasn't been nearly as favorable:

CAGR Cumulative Return	Annualized Past 10 Years	Cumulative Past 10 Years
Oakmark Select	9.3%	142%
Oakmark	12.6%	228%
S&P 500	12.7%	230%
Russell 1000 Value	10.2%	163%
CPI*	2.6%	29%

In the past decade, stocks again tremendously outpaced inflation as did both Oakmark and Oakmark Select. But that's the one, and only one, box that got checked. The Oakmark Fund modestly underperformed the S&P 500, and Oakmark Select significantly underperformed the Oakmark Fund. One client leveled a stinging criticism when they told me that if Oakmark Select is my favorite 20 stocks picked from Oakmark's 50, then we should have offered a "bottom 30" portfolio instead of a "top 20." Ouch. Criticism stings when it's on target.

So, what happened and why don't we expect it to continue?

First, value had a decade-long headwind relative to growth. The Russell 1000 Growth Index outperformed the Russell 1000 Value by over 100 percentage points in the past 10 years. Prior to that decade, the two indexes tended to cycle in and out of favor every couple of years. Over long periods of time, the performance difference was small, though the value side was usually slightly better. So, both the duration and magnitude of growth's outperformance went beyond normal expectations.

One of the reasons money managers ask clients to evaluate returns over at least five years is that most cycles reverse within that time, which means returns can be more attributed to skill than the approach that was used. In the past decade, the return differential between growth and value was so large that style rather than skill accounted for most of the difference across managers. Both Funds suffered, but Oakmark Select, owning the most undervalued stocks from the Oakmark portfolio, was hurt more by value's underperformance.

Second, smaller stocks had a rough decade relative to larger stocks. Over long periods, small caps and large caps typically cycle in and out of favor. Smaller stocks have generally returned slightly more, thus rewarding investors for taking on their incremental risk. But from 2013 through 2022, the S&P Midcap 400 underperformed the S&P 500 by 48 percentage points. This was also highly unusual in both duration and magnitude.

Why does that matter when comparing Oakmark to Oakmark Select? Since Oakmark Select is a smaller fund than Oakmark and because it is designed to be used by investors who are accepting a higher risk level, we don't limit our holdings to our 20 favorites from Oakmark. Instead, we also consider stocks in companies we deem too small for the Oakmark Fund. Oakmark Select usually owns several mid-cap stocks not held in Oakmark (at year-end there were three: Lithia Motors, First Citizens BancShares and Allison Transmission).

The flexibility to buy mid-cap companies significantly benefitted Oakmark Select's early record. However, in the past decade, which was so hostile to smaller companies, the stocks that were too small to be included in Oakmark reduced Oakmark Select's return by 26 percentage points. The decision to own some mid-cap stocks, despite the persistent outperformance by large caps, turned Oakmark Select's flexibility from an asset into a liability. We don't believe that fundamentals warrant a continuing advantage to the very large companies and we expect Oakmark Select's market-cap flexibility to again become an advantage.

Last, while it's tempting to blame the recent underperformance on a couple bad stocks, like General Electric and Chesapeake Energy, the truth is we've always had a few bad stocks in the portfolios. When we make mistakes, we conduct thorough retrospectives to see what we should have done better and we tweak our process in an attempt to improve. For example, today we introduce the devil's advocate review prior to the purchase of a stock rather than after it is held; we have improved our approach for valuing businesses separate from their capital structures; and we better track how fundamental performance deviates from our original thesis, which makes it more difficult to justify holding stock in a company where business results are falling short of our expectations.

But Oakmark Select's performance shortfall wasn't primarily due to mistakes. In the early years when the Fund was outperforming by a wide margin, we had USG and U.S. Industries, Inc., both eventual bankruptcies, and both higher weighted in the portfolio than our recent failures. The bigger influence on recent performance has been that our winners haven't outperformed by as much as they did in the early years. Our early ownership of stocks, such as Liberty Media, Cablevision and First USA, more than offset the mistakes. Because I take the mistakes more personally, it is somehow a little comforting that Oakmark Select's results were hurt more by having fewer big winners than by investing more heavily in mistakes.

Why did we have trouble identifying big winners in the past decade? Because there weren't as many of them. We compared 10-year performance of each of the 1500 largest companies in 1996 and 2013 to the S&P 500. In Oakmark Select's first decade, there were nearly five times as many stocks (83) that more than quadrupled the S&P 500 return as there were in the most recent decade (17). Our analysis of other time periods suggests that the decline in big winners is not structural, but rather a direct result of the recent dominance of the largest stocks, which we believe is unsustainable.

We've written recently about why we believe value investing is poised for a comeback and we saw the start of that in 2022. Despite the losses in growth stocks last year, the range of P/E multiples in the S&P 500 remains unusually high. We believe that means an investor who looks for bargains, like we do at Oakmark, has more opportunity to add value than usual. The zero-interest rate environment was very positive for growth stocks. When discount rates are near zero, an investor is nearly indifferent between getting cash back today or a decade from now. High P/E stocks have much less near-term cash flow than do low P/E stocks. That means that the intrinsic value of high P/E stocks is much more sensitive to interest rates, and those values can fall sharply when rates move higher.

We believe that the increase we've seen in rates should narrow the range of P/E multiples. Further, we believe the stock market has not yet fully adjusted. If we are right that a compression of P/E multiples toward historic norms is still ahead of us, that should be good for our investments in the Oakmark Fund and very good for our investments in Oakmark Select.

Further, we see no reason that smaller companies should fare as poorly this decade as they did in the past one. We would argue that the current P/E discount for smaller stocks suggests a reversal is more likely than a continuation, which should benefit Oakmark Select more than Oakmark. The 31- and 26-year performance results since inception of Oakmark and Oakmark Select contain an entire decade that was historically difficult for value investing and, despite that, show that the Funds met the goals we initially established. We think it is unlikely that the next quarter century will include an equally difficult decade for stocks that are inexpensive relative to their business value. And remember that in periods when our stock selection added value in Oakmark, that has been magnified in Oakmark Select where we concentrate our favorite ideas.

After an unsatisfying decade, a one-month reversal doesn't warrant a victory lap, but we do think it is worth noting how different January 2023 has looked. Stocks again increased substantially more than inflation, but value stocks did almost as well as the S&P 500 and mid-cap stocks provided a nice tailwind. That is an environment we would expect to be favorable for Oakmark and even more favorable for Oakmark Select, and it certainly was.

Those of us on the portfolio teams for Oakmark and Oakmark Select (Robert Bierig, Tony Coniaris, Alex Fitch, Mike Nicolas, Bill Nygren) are very excited about what we see today. In some ways it takes a year as disappointing as 2022 to provide the opportunity to construct portfolios that appear so undervalued and yet so high quality and well diversified. Over the past year, we've each put our money where our mouth is by adding to our personal investments in Oakmark or Oakmark Select.

It's not lost on us that it sounds almost foolish to say that the past decade wasn't long enough to fairly judge the prospects of Oakmark and Oakmark Select. But we strongly believe that the decade-long tailwinds that benefitted large-cap, high P/E companies are reversing. If we are right in that belief, the next decade will look very different than the past one did. For those of you who have been invested side-by-side with us in Oakmark and Oakmark Select, we thank you for your patience and hope you can be patient for a little longer. For those of you who have not been investors, we hope you'll consider joining us.

William C. Nygren, CFA
Portfolio Manager

*The CPI data is as of 12/31/22. All other numbers in the tables above are as of 01/31/23.

Average Annual Total Returns (as of 03/31/2023):

Fund	3 Month	1 Year	3 Year	5 Year	10 Year	Inception
OAKMX	8.10%	-3.82%	26.81%	9.67%	11.71%	12.36%
S&P 500 Total Return Index	7.50%	-7.73%	18.60%	11.19%	12.24%	9.95%
Expense Ratio: 0.89%						
Fund Inception: 08/05/1991						

Fund	3 Month	1 Year	3 Year	5 Year	10 Year	Inception
OAKLX	10.91%	-8.77%	23.55%	4.89%	8.69%	11.08%
S&P 500 Total Return Index	7.50%	-7.73%	18.60%	11.19%	12.24%	8.91%
Expense Ratio: 0.98%						
Fund Inception: 11/01/1996						

Expense ratios are as of the Fund's most recent prospectus dated January 28, 2023; actual expenses may vary.
Returns for periods of less than one year are not annualized.

To obtain most recent month-end performance data, visit Oakmark.com.

The holdings mentioned comprise the following percentages of equities and equivalents as of 12/31/2022:

Security	Oakmark Fund	Oakmark Select
Allison Transmission	0.0%	1.3%
Cablevision	0.0%	0.0%
Chesapeake Energy	0.0%	0.0%
First Citizens Bancshares Cl A	0.0%	4.2%
First Citizens Bancshares Cl B	0.0%	0.3%
First USA	0.0%	0.0%
General Electric	0.0%	0.0%
Liberty Media	0.0%	0.0%
Lithia Motors	0.0%	4.9%

Portfolio holdings are not intended as recommendations of individual stocks and are subject to change. The Funds disclaim any obligation to advise shareholders of such changes. Information about portfolio holdings does not represent a recommendation or an endorsement to Fund shareholders or other members of the public to buy or sell any security contained in the Funds' portfolios. Portfolio holdings are current to the date listed but are subject to change any time. There are no assurances that the securities will remain in the Funds' portfolios after the date listed or that the securities that were previously sold may not be repurchased.

Access the full list of holdings for the Oakmark and Oakmark Select Fund, visit Oakmark.com.

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.

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

The S&P MidCap 400® is a market capitalization-weighted index designed to measure the performance of mid-sized companies. It is comprised of 400 mid-capitalization stocks that are distinct from the constituents of the large-cap S&P 500®. This index is unmanaged and investors cannot invest directly in this index.

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

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The CPI is the most widely used measure of inflation and is sometimes viewed as an indicator of the effectiveness of government economic policy.

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.

Because the Oakmark Select Fund is 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.

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 information, data, analyses, and opinions presented herein (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) are for informational purposes only and represent the investments and views of the portfolio managers and Harris Associates L.P. as of the date written and are subject to change and may change based on market and other conditions and without notice.

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