ValueInvestor INSIGHT

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The Leading Authority on Value Investing

Collective Effort

T. Rowe Price portfolio managers John Linehan, Ryan Hedrick, Vincent DeAugustino and Gabriel Solomon describe what in their eyes sets their firm apart, the many ways in which the investment opportunity set has changed in recent months, and why they believe there's particular contrarian upside today in Wells Fargo, KLA Corp., PG&E and Fiserv.

While it lacks the profile of a BlackRock or the cachet of a Blackstone, T. Rowe Price Group over time has built a peerless reputation as a fundamental money manager. Morningstar in its latest report on the company summarizes why: "T. Rowe Price is the best positioned of the U.S.-based active asset managers we cover. The biggest differentiators for the firm are the size and scale of its operations, the strength of its brands, its consistent record of active fund outperformance, and reasonable fees."

In an effort to tap into the firm's formidable collective investing wisdom, we spoke with four of its equity portfolio managers about how they're navigating today's turbulent market. The byword is caution, but they see select opportunity in such areas as semiconductor capital equipment, financial technology, public utilities and banking.

INVESTOR INSIGHT

John Linehan

"I'm trying to take the macro out of the equation and have both strong offensive and defensive teams on the field."

T. Rowe Price is a big firm with equity portfolio managers pursuing a wide variety of strategies. Despite that diversity, would you say there are any key commonalities in approach?

John Linehan: To some extent what makes the firm successful is that I can't really answer that question. There is no quintessential T. Rowe Price stock or T. Rowe Price "way." We try to hire talented individuals who we think over time can be excellent investors, assign them to industries where they can become experts, and then give them the freedom to determine from an investment perspective what's really important in their industry. We have worked hard to create a meritocratic environment where people are assessed and compensated on the quality of the recommendations they provide.

A critical driver of our long-term success is that there are a lot of differing opinions expressed by investment professionals who look at things very differently, and we have a culture built around collaboration. It's also important that we all draw on a centralized research platform. Many organizations structure themselves around siloed pods, say large cap and small cap or value and growth. That sounds fine in theory, but that's not how companies and industries operate and we don't think we should structure our analyst coverage that way either. We're drawing on an ecosystem focused on finding the right stocks, where there's a respectful and productive discourse between and among analysts and portfolio managers in terms of framing the investment landscape. We hope that elevates the quality of decisions made by all those involved in it.

On what have you personally come to focus in finding the "right" stocks?

JL: There are three basic pillars to my investment philosophy. The first would be valuation – the price paid for a security is critically important to its longer-term performance as an investment. Empirical studies show that the longer the time horizon, the more valuation matters as a performance driver.

The second pillar revolves around having a long time horizon, which primarily means investing with an owner's mindset. Owners focus on the prospects of the business over time and we should do exactly the same thing – especially given that we think it gives us a competitive advantage over investors who don't do that. On average the holding period for stocks in the strategies I manage is four to six years.

The last basic pillar is a focus on fundamentals. Across our strategies we believe that if we know our companies better than others in the marketplace, that knowledge should translate into unique insight and a differentiated and positive portfolio construction process. People ask about an investor's "edge" – for us, it comes down to the fundamental research work put in every day to gain that insight.

So I'm trying to find ideas where there is a true balance of valuation and fundamental appeal. Valuation matters, but it's not sufficient. Fundamentals matter, but they're not sufficient either. Our sweet spot is in stocks with fundamental appeal trading at what we consider opportunistic valuations, often because the sentiment around them is misplaced or temporal.

How target-rich do you consider the opportunity set for such stocks today?

JL: The level of uncertainty in the market right now is really pronounced. If I think about the range of potential outcomes over the next year, it's probably as wide as it's been over the last 20 years. Just putting idiosyncratic company fundamentals up against the potential impacts of inflation and the government response to it would give you a fairly volatile range of outcomes. On top of that you've got the Russian invasion of Ukraine and the ongoing effects of Covid in China and elsewhere. There's a lot going on – and I don't claim unique insight on many of these fronts.

There are people who will end up doing very well in this market because they're taking a significant macro tilt. My hat's off to them. I'm more trying to take the macro out of the equation and optimize our holdings so we have both strong offensive and defensive teams on the field. On offense, we have companies positively exposed to an improving economy where we believe the rewards significantly outweigh the risks. On defense, it isn't as much about maximizing reward over risk, but more about protection on the downside. In all cases, of course, we're looking for companies with positive idiosyncratic elements to the story as well.

Where does General Electric [GE] fit in this context?

JL: Given the pro-cyclicality of its power and aviation businesses, GE is more of an offensive name, with an added kicker in our view from the potential for improved profitability across the board under CEO Larry Culp. We have tremendous respect for him and the job he did at Danaher in relentlessly improving the company operationally. We don't see much upside built into market expectations from him doing something similar at GE.

I would add that this investment also has an important defensive component. GE has announced that it's going to split into three pieces, and our sum-of-the-parts analysis around that gives us a share price well north of today's level [of around $79]. Many investors have the mindset with GE to wait for six months when there's more visibility into the business and the split. But that's not price determinant – at times like these, we believe with a little less visibility we can get a much better discount. When you see little downside and significant upside, that gets us very interested.

Volkswagen [Frankfurt: VOW] would be another example where we think the longer the time horizon you have, the more intriguing the opportunity. My crystal ball is cracked in terms of predicting the health of the global auto industry in the coming year, but with VW's stock [at today's €205] trading on consensus numbers at a 6x P/E, the valuation indicates that expectations are not very high. We'd make the case that the company is better positioned to benefit from the secular shift toward electric vehicles over time than the market seems to believe. The "diesel-gate controversy" [where the company was found to have chronically misrepresented the emissions-control standards of its cars] forced it to fundamentally rethink its strategy and resulted in a more than $7 billion investment program to build out its EV platform, the fruits of which are now coming to market. Tesla is not going to sell every electric car in the world going forward. We think VW will prove to be a real competitor in electric vehicles and the market is not pricing that eventuality into the current stock price.

The defensive aspect here is also important. VW does have a minority government shareholder that is probably more focused on employment than profitability, but we're encouraged by the fact that the board has indicated a willingness to realize value by selling off part of its Porsche division in an IPO. With significant value in VW-owned brands like Porsche, Audi, Lamborghini and Bentley, there's a very reasonable sum-of-the-parts argument for the stock today as well. We think that provides a great deal of protection on the downside.

Wells Fargo [WFC] is among the largest holdings in the strategies you manage. Why is it a timely idea today?

JL: One common type of opportunity for us is when a good-quality company is undergoing controversy that we think is correctable in the intermediate to longer term. Wells Fargo would be an excellent example of that. The company for some time probably over-earned its business model, as a result of a number of business practices that simply weren't right. In cases like this there is a lot of heavy lifting necessary to reconstruct and remediate and it often takes a lot longer than people expect. The market often gets impatient with the level of progress being made, and that's certainly been the case here.

An important element in our research has been to determine how much tangible damage has been done to the Wells Fargo brand. There are some dents in it, but we believe the brand reputation has stabilized and that from an image standpoint with customers, regulators and investors there's more upside than downside. That's important, and is a credit to the work Charlie Scharf has done since taking over as CEO in the last quarter of 2019. He's very focused on rebuilding regulatory relationships and the company's culture. While there's still work to do, we think he's accomplished a lot on both fronts.

Is banking an attractive industry?

JL: We're not arguing that the setup in banking, per se, is a tremendous tailwind for Wells, but we do believe some industry trends are likely to work in its favor. The minimum efficient scale in banking has gone up as technology plays an ever more important role. In lending and in funding the companies with the best scale and that can invest what it takes in technology have an advantage over smaller, less-efficient players. That should work to Wells' advantage, particularly if the industry – as we expect – increasingly consolidates.

We also don't believe the market fully appreciates the company's potential earnings power. It doesn't have the same volatile capital-markets and international exposure that the other large U.S. banks do, and as the regulatory limitations and consent decrees impacting it eventually come off, it should have more flexibility in putting the balance sheet to more productive work in generating higher returns. That may be delayed if the economy hits a rough patch, but given the soundness of the balance sheet the earnings power should remain intact.

How confident are you that the regulatory shackles come off?

JL: Wells has become somewhat of a poster child for the excesses of the banking system, so unfortunately there are political as well as regulatory aspects to how that all plays out. We're confident they're doing the right things, but less confident in predicting when the regulatory constraints lessen. The market is impatient with that – we think patience is still warranted and, in the end, will be rewarded.

We haven't yet spoken about interest rates. Are they a key part of your thesis?

JL: Interest rates going up should be a positive for Wells, increasing net interest income and net interest margin. How positive that impact is overall will depend on the health of the economy. If higher interest rates coincide with a recession, the benefits will likely be mitigated by higher credit losses. We're not counting on interest rates going up to make our investment case, but if they do it's probably more an option on the upside than the downside.

How are you looking at valuation from today's stock price of around $46?

JL: Wells' shares have typically traded at a premium to other large regional banks, but at today's 1.3x tangible book value they trade at a discount. The regulatory penalty box they're in continues to weigh heavily on the valuation.

We believe that they will put this all behind them, that returns on equity and assets will improve from already healthy levels, and that improved market perception will drive the shares' valuation at least to peer levels of 1.5x to 1.7x tangible book and well above today's 9.5x trailing P/E.

Going back to what I said earlier: the valuation is attractive, we think the fundamentals are working in the company's favor, and taking a longer-term perspective gives us a differentiated view. This is a great example of what we're looking for.

Coming back to playing offense and defense, are there any areas of the market where the defensive aspect of the investment today is most prominent?

INVESTMENT SNAPSHOT

Wells Fargo
(NYSE: WFC)

Business: U.S. bank holding company operating in four primary segments: consumer banking, commercial banking, corporate and investment banking, and wealth management.

Share Information (@5/27/22):

Price	**45.89**
52-Week Range	40.73 – 60.30
Dividend Yield	2.2%
Market Cap	$173.94 billion

Financials (TTM):

Revenue	$81.75 billion
Operating Profit Margin	34.3%
Net Profit Margin	25.2%

Valuation Metrics
(@5/27/22):

	WFC	S&P 500
P/E (TTM)	9.5	21.1
Forward P/E (Est.)	8.8	17.6

Largest Institutional Owners
(@3/31/2022 or latest filing):

Company	% Owned
Vanguard Group	8.1%
BlackRock	4.5%
Fidelity Mgmt & Research	3.7%
Dodge & Cox	3.2%
T. Rowe Price	1.9%

Short Interest (as of 5/15/22):

Shares Short/Float	1.0%

THE BOTTOM LINE
The market is impatient with how long it's taking the company to restore its brand reputation, but John Linehan believes its market position, scale and earnings power suggest patience is still warranted. He argues that improved returns on equity and assets combined with an even peer-level valuation would result in significant upside for the share price.

Sources: Company reports, other publicly available information

JL: I would put utilities, where we're overweight, in that category. The stocks have held up well, as you might expect from a sector relatively immune to the concerns impacting much of the market today. At the same time, we think there's an offensive component to these companies as beneficiaries of broader secular trends around electrification and the investments necessary – upon which they can earn a regulated return – in renewable-energy generation, transmission and distribution.

One of our large positions is in Southern Co. [SO], whose stock, like Wells Fargo's, has typically traded at a valuation premium but no longer does due to a number of operating missteps, most prominently around a large nuclear-power project in Georgia. Stocks like it are not glaring bargains today, but we like the long-term constructs for the industry and the individual companies we own, and think they are an important part of our having the right defensive team on the field today.

INVESTOR INSIGHT

Ryan Hedrick

"There's a lot of informed debate – people are comfortable speaking their minds and we don't have a lot of sharp elbows."

You worked at a number of investment firms prior to joining T. Rowe Price. What about how it does things sets it apart in your eyes?

Ryan Hedrick: One thing I find unique and quite refreshing about T. Rowe is the level of collaboration. Analysts are sector experts and work closely both with each other and with portfolio managers. Portfolio managers are in regular contact with each other. And it's not just checking in. We're sharing what we know and trying to learn more about what we don't. There's a lot of healthy and informed debate – people are comfortable speaking their minds and we don't have a lot of sharp elbows. I think that level of ingrained collaboration is critical in generating insight from the bottom up as well as the top down.

I would also highlight the depth and breadth of relationships we've built with companies. We put a lot of effort into understanding the drivers and dynamics of individual industries, which we think is critical in developing useful perspectives on the companies in them. That can make us a resource to companies too. I was at a healthcare conference earlier this month and in most cases by the end of our meetings with management teams they were looking for our opinions on top-of-mind subjects to them. We have to earn that, but the dialogue it fosters can lead to deeper insight along the way.

ON IDEA SOURCES:

The market tends to underestimate the durability and magnitude of growth in cyclicals with secular tailwinds.

On the subject of sector expertise, are there any industries today where you're finding incremental opportunity?

RH: I would say healthcare broadly and areas such as pharma and managed care more specifically. Pharma companies were largely left behind in the growth-stock run up and many still trade today at modest valuations. There are a number of moving parts – you have to understand the science as well as the revenue trajectory net of patent cliffs and new drugs, for example – but we think in an environment where it pays to be cautious, pharma stocks offer somewhat of a port in the storm. They're defensive, with low duration sensitivity which can help in a rising rate environment. AbbVie [ABBV] is an example of a name that interests us, trading at around a 13x forward P/E and with a 3.8% dividend yield. Attractive growth from drugs such as Skyrizi and Rinvoq and products such as Botox acquired in the 2019 acquisition of Allergan should more than offset the effects of its blockbuster Humira drug going off patent next year.

Managed care appears to us to be one of the more structurally attractive areas of the market in terms of the growth potential relative to valuations. Anthem [ANTM], for example, is the second-largest U.S. managed-care provider, offering commercial insurance, plans for government programs such as Medicare Advantage and Medicaid, as well as additional services such as a fast-growing value-based-care business. It has a variety of growth drivers, including a greater push into Medicare and Medicaid, expansion in pharmacy benefit management, and in actual care-delivery services that are higher margin for it and that could lower costs for the healthcare system overall. We think Anthem should be able to grow revenue at 9-10% and EPS in the low teens per year. Using a 16-17x P/E, it could be a $650-$700 stock a few years out. [*Note*: Anthem shares closed recently at just above $520.]

Another attractive type of situation for us is when a company is going through some sort of transformation and the market is slow to form an opinion on how it plays out. That would describe fairly well the case for International Flavors & Fragrances [IFF] today. The company is a leading provider of ingredients that help provide taste, texture and scent to mostly consumer products. They sell more than 100,000 different ingredients, which typically are a relatively small percentage of the end-product cost, but they're able to capture value because their products are important drivers of customer affinity. Manufacturers aren't quick to change suppliers to save a few percentage points on cost.

The company just over a year ago completed its merger with DuPont's Nutrition

& Biosciences business, and the jury is still out on the extent of the revenue and cost synergies the combination can foster. There was concern in the market that previous management wasn't fully up to the task around execution and capital allocation, which perhaps played a role in Frank Clyburn taking over as CEO in February of this year, joining from Merck, where he ran its Human Health division.

We think there's a significant margin-expansion opportunity as the two companies come together. If we assume 24-25% EBITDA margins within three years – up from about 20% today and below management's intermediate-term target – at a 16-17x EV/EBITDA multiple the stock would trade at $170-180. If the valuation was more in line with where European competitors such as Givaudan [Zurich: GIVN] and Symrise [Frankfurt: SY1] currently trade, the stock could be well into the $200s. [*Note*: IFF stock, trading below pre-pandemic levels, currently trades at around $133.]

From ingredients to semiconductor capital equipment, describe your investment case today for KLA Corp. [KLAC].

RH: It's not unusual for us to find opportunity in cyclical companies with structural tailwinds. The market tends to underestimate the durability and the magnitude of the growth in these businesses over time.

KLA is the market leader in the process control sub-segment of the semiconductor equipment industry. At each step of the fabrication process its equipment is monitoring and measuring the chips to make sure precise specifications are being met and that what's being produced is defect-free. It's all meant to improve yields, minimize downtime and ultimately improve profitability. With the cost of leading-edge fabs pushing $20 billion, there's an inherent value proposition in equipment that can do that.

One structural tailwind here is the rapid growth in demand for semiconductors in an increasingly digital, connected and cloud-based world. The semi-cap-equipment industry has probably tripled in size over the last six or seven years, and we wouldn't be surprised if it continued to grow at a low-double-digit rate over the next five years. That offers pretty good opportunity for the companies that supply into that.

At a time when demand is so high, there's been a breakdown in the productivity of manufacturing semiconductors. It's getting more difficult to shrink transistor sizes and there is increasing use of more complicated 3-D device structures. The number of process steps is increasing. New materials are being introduced. More wafers are necessary to produce larger chip sizes. As this all gets more expensive and capital intensive, KLA's process-control tools become more valuable. And the fact that they're so deeply integrated into the production process makes customer relationships quite sticky and long-lived. KLA's share in the main area in which it competes has been very stable at more than 50%.

Another positive industry dynamic is the increased emphasis in the United States and Europe on the security of semiconductor supply. There's a recognition that maybe it's not such a good idea that 70% of the leading-edge semiconductors

INVESTMENT SNAPSHOT

KLA Corp.
(Nasdaq: KLAC)

Business: Supplier of equipment used to enhance yield management, process monitoring, diagnostics, inspection and control in the semiconductor manufacturing process.

Share Information (@5/27/22):

Price	**371.27**
52-Week Range	287.44 – 457.12
Dividend Yield	1.1%
Market Cap	$55.41 billion

Financials (TTM):

Revenue	$8.65 billion
Operating Profit Margin	39.3%
Net Profit Margin	36.4%

Valuation Metrics
(@5/27/22):

	KLAC	S&P 500
P/E (TTM)	18.0	21.1
Forward P/E (Est.)	15.3	17.6

Largest Institutional Owners
(@3/31/2022 or latest filing):

Company	% Owned
Vanguard Group	8.6%
BlackRock	5.4%
Capital Research & Mgmt	5.0%
Primecap Mgmt	4.9%
State Street	4.1%

Short Interest (as of 5/15/22):

Shares Short/Float	1.3%

KLAC PRICE HISTORY

THE BOTTOM LINE

Ryan Hedrick believes the company should benefit from strong secular semiconductor demand at a time when challenges to manufacturing productivity make its process-control equipment ever more valuable. Assuming what he considers a conservative 15x P/E on his earnings estimate three to four years out, the stock would trade at closer to $525.

Sources: Company reports, other publicly available information

in the world are produced in Taiwan. It may be somewhat less efficient in the long run, but the trend toward domesticating supply likely means considerably more fab construction in the U.S. and Europe. That should only be good news for companies like KLA.

How do you see all this translating into upside for the company's stock, now trading at around $371?

RH: We recognize that cyclicality probably hasn't been banished from the semiconductor ecosystem and that the risk of recession has increased quite a bit of late. But if we extend our time horizon out three to four years, we could imagine KLA compounding revenues at a low-double-digit rate and that earnings per share over the period could rise into the mid-$30s. Put a conservative 15x multiple on that and the stock would be well above $500. It's unlikely to be a straight line from here to there, but we do think the longer-term secular industry backdrop is pretty compelling, and could even surprise on the upside.

In general, would you say you're seeing the glass as an investor today as half full or half empty?

RH: I guess I would describe my mood as an investor looking at today's environment as cautious. Covid didn't reset the business cycle, so we're now more or less back to a late-cycle economy with some challenging macroeconomic and geopolitical forces at play. If there is such thing as a Fed put, it's deeper out of the money than it's been for a long time, and markets are repricing in relation to that.

That said, I'm still optimistic about the prospects for value investing. Value investors may need to go a level deeper in terms of specialization and perhaps bring new tools to bear as intangible assets become more prevalent in a digital economy. But the upside in buying businesses that have strong moats and are trading for less than they're worth hasn't and won't change in my view. That's the crux of what we're trying to do – regardless of the environment we're in.

INVESTOR INSIGHT

Vincent DeAugustino

"The starting point for an idea very often comes from curiosity about 'what the heck happened over there?'"

Can you generalize about the types of ideas and situations you gravitate towards in seeking out investment opportunity?

Vincent DeAugustino: Like a lot of value investors, I would say I'm wired backwards. I love bad news – particularly from companies that I don't own – so the starting point for an idea very often comes from curiosity about "what the heck happened over there?" Consistent with that, I tend to lead with a downside analysis. If it appears that a stock is trading below where it should in what I can articulate as a reasonable downside scenario, that to me is a clear argument that it may be fundamentally mispriced and I need to dig in further.

Select Medical Holdings [SEM] is a longer-term position in the Mid-Cap Value Fund – for which I'm about to take over lead portfolio-management responsibility – but it's a relevant current example. The company operates recovery hospitals, outpatient rehab clinics and occupational-health centers, and the dominant issue it's dealing with today is a nationwide nursing shortage – exacerbated by the pandemic – that is significantly impacting staffing levels and driving up operating costs. The stock traded above $40 last summer and is now below $25.

Our basic view is that the spike in labor costs isn't permanent and we'll find an equilibrium below current levels as we return to a more normal healthcare environment. To the extent some of the pressure persists, Select Medical and its competitors will likely be able to pass on the related higher costs to payers. The market seems to be struggling with the timing on both of those fronts, but we're happy to take advantage of a time bet like this when we're as confident in the management and the business model as we are here. We think the shares today trade at below what we reasonably consider the downside looking forward, and within three years can trade at far above where they are today.

We see a similar type of set up today in RenaissanceRe [RNR], which is a leading property catastrophe reinsurer. For a variety of reasons, including concerns around climate change, the market has decided property cat reinsurance is just too risky, which for RenaissanceRe has resulted in the P/E on its stock being roughly cut in half, from the mid-teens to less than 7x today. [*Note*: RNR shares closed recently at around $155.]

There are a couple basic elements to the investment thesis here. Underwriting capacity in property cat insurance is shrinking, which to us signals the potential for more appropriate pricing of risk. That should accrue to the benefit of an incumbent like RenaissanceRe that has a long-standing track record as one of the smartest and most disciplined underwriters in the market. Any capital not deployed to adding gross written premium can be very productively put to use in buying back depressed shares.

There's also an idiosyncratic element here, which is that the company in recent years has built out its casualty-reinsurance book of business to an extent I don't think the market appreciates. As that book has been scaled and the reserve base has been built, this business hasn't yet shown a lot of profitability. We think that changes over the next couple of years and it starts to generate material incremental profits, especially if persistent loss-cost inflation pressures peers' older reserves. Combined

with the potential hardening in the property cat market, again, three years out we think today's share price will prove to be a considerable bargain.

Are you finding these types of ideas more or less common in today's market?

VD: In general, I'd say we've gone from being a bit stretched in finding new ideas not that long ago to having a lot of ideas to sift through today. There's a saying that sometimes the market wants everything to be true, and the fact that that can't be the case can sometimes signal opportunity.

For example, everyone's trying to think through the impacts of things like higher inflation and interest rates. So you'll hear arguments that rates are going up, so housing is going to be bad. Housing is going to be bad, so building products are in trouble. Then you'll see a negative report on State Street [STT], the big custody bank and index-fund manager, where part of the argument is that while rising interest rates would be good for it, the rate cycle is going to be quick and the Fed is going to have to reverse course, which would be bad for State Street. If that's true, does that mean things might be less bad for housing and building materials?

None of this is easy to sort through, but the fact that sweeping and sometimes contradictory assumptions are being made and driving share prices can create opportunity. If you can see through the fog in certain cases, usually with a longer-term perspective, there's a chance you'll find something interesting.

One caution is that the heightened interest in safety today has made some traditionally defensive stocks very expensive. I generally don't think expensive safety is all that safe. There are consumer-staples stocks out there trading at 30-year valuation highs. I guess they might go down less than some other things you could own over the near term, but that has never struck me as a great value proposition over time.

Describe the value proposition you see today in PG&E [PCG].

VD: This is the largest public utility in California, providing both electricity and natural-gas services mostly in the central and northern parts of the state. One question we ask early on in looking at a company is how essential it is – if it closed down tomorrow, how much would people care? Love it or hate it, you can't argue that PG&E isn't critical to its customers.

What the company is best known for, however, is its role in the devastating wildfires that have hit California over the years. Accumulated liabilities from wildfires led it to file for bankruptcy protection in January 2019, from which it emerged in mid-2020. While the wildfire risk won't go away, we think the actions taken by the state and the company since it last went bankrupt mitigate the potential damage more than the market appreciates.

In mid-2019 California passed Assembly Bill No. 1054, which created through bond issuance, utility-company contributions, rate increases, and other sources of funding a mechanism that would help pay liability claims beyond what's covered by the utilities' insurance. There's a lot in there and the viability of the new system still needs to be tested in real time, but our overwhelming takeaway from AB-1054

INVESTMENT SNAPSHOT

PG&E Corp.
(NYSE: PCG)

Business: Parent company of Pacific Gas and Electric, a regulated utility in central and northern California serving electricity and gas customers in 47 of the state's 58 counties.

Share Information (@5/27/22):

Price	**12.35**
52-Week Range	8.24 – 13.19
Dividend Yield	0.0%
Market Cap	$24.55 billion

Financials (TTM):

Revenue	$21.72 billion
Operating Profit Margin	14.9%
Net Profit Margin	1.2%

Valuation Metrics
(@5/27/22):

	PCG	S&P 500
P/E (TTM)	129.0	21.1
Forward P/E (Est.)	10.2	17.6

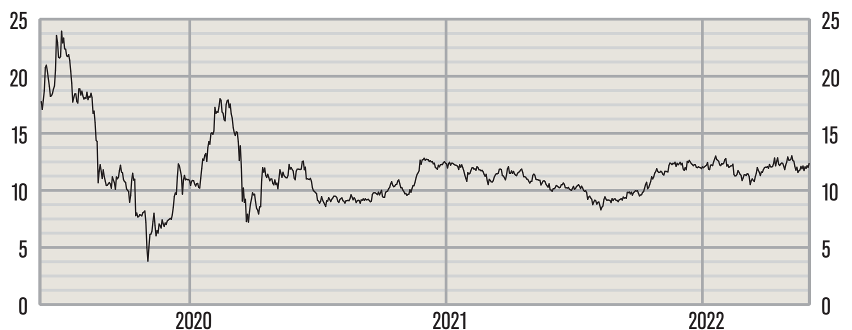
Largest Institutional Owners
(@3/31/2022 or latest filing):

Company	% Owned
Vanguard Group	8.8%
Capital Research & Mgmt	8.7%
Fidelity Mgmt & Research	5.5%
T. Rowe Price	4.1%
Third Point LLC	3.5%

Short Interest (as of 5/15/22):

Shares Short/Float	5.0%

PCG PRICE HISTORY



THE BOTTOM LINE

Wildfire risk will not go away, but Vincent DeAugustino believes actions by the state of California and the company in recent years mitigate the potential damage such risk entails. If earnings as he expects can grow 10% annually over the next three years and the stock earns even a below-peer 15x multiple, the shares would trade in the low-$20s.

Sources: Company reports, other publicly available information

is that California, in order to enact its clean-energy initiatives, needs its utilities to be viable, which includes having full access to capital markets. We think the new system accomplishes that by taking out much of the liability tail risk to PG&E from wildfires.

That wouldn't be enough if we didn't have confidence in management under CEO Patricia Poppe, who took over in November 2020. We think she's a straight shooter who gets things done and isn't constrained by how things have been done in the past. Very often in companies with reputational issues you need an outsider as a change agent who can rebuild relationships with all stakeholders, including politicians, customers, employees and investors. We think she's doing just that.

There's no better example than her announcement last July that the company plans to spend up to $20 billion to bury 10,000 miles of power lines to reduce wildfire risk. That had always been considered cost-prohibitive, but she made the case that it had to be done from a safety standpoint and that by reducing other operating costs – such as the $1.4 billion PG&E spends per year on trimming and cutting down trees – and working with regulators to get much of the capital spent included in the reimbursable rate base, it would make business sense as well.

How do you arrive at what you think PG&E's stock, now at $12.35, is more reasonably worth?

VD: While most utilities will tell you they can grow EPS reliability at 6-8% per year, we believe on the back of the new "undergrounding" initiative and from building out renewable capacity and other infrastructure that PG&E can grow earnings at closer to 10% annually. We would not argue that it deserves a peer 20x multiple, but even at 15x our $1.50-per-share estimate of earnings power within three years the stock would trade in the low-$20s.

We as a firm in our value strategies have fairly high exposure to utilities, which can fall in the relatively expensive defensive bucket I spoke about earlier. But generally for us there's also a company-specific element that is making the valuation much more interesting today. If we can buy defensive in an environment like this at a bargain price, all the better.

INVESTOR INSIGHT

Gabriel Solomon

"This isn't really a time when you can target a sector or industry basket and expect the cycle to make it all work out."

The market could be characterized today as a bit scary. Would you agree?

Gabriel Solomon: I always think the world is a rocky, scary and risky place. From an investment standpoint, though, it's most risky when people are not concerned about risk. When I officially joined the U.S. Large-Cap Value strategy last October you could argue that was more the case, and we were finding far more selling opportunities than buying opportunities. Today when much of the conversation is about risks, as that gets discounted into stocks we see more of interest to buy.

That said, we think the near-term risks to the economy are quite legitimate. Our solution to that is to try not to get overly caught up in making bets based on macroeconomic factors. We need to understand the exogenous and black-swan types of risks – say, the impact of China invading Taiwan on our portfolio companies that have large exposure to China – but we spend most of our time focused on the fundamental drivers for individual companies and the idiosyncratic elements of their stories that might make them compelling investments.

We try to find good, or at least decent, businesses and business models that are significantly discounted. We recognize markets can be fickle and inefficient at times, and we have what I consider a healthy willingness to be contrarian and often lean into situations where industry dynamics are changing or there are near-term concerns about a cycle or a turnaround. Time horizon is a big differentiating advantage for us – as the market gets more short-term oriented we can from time to time see through controversy and develop a unique longer-term view.

Qualcomm [QCOM] would be a good representative example. There are some reasons why such a profitable, high-quality company trades at 10.5x forward earnings. People are concerned about whether it has room to grow in the handset market. Is Apple going to move away from it as a supplier? Are supply-chain and economic issues in a zero-Covid China going to last? Is the semiconductor industry after a tremendous run about to turn down?

We have to be thoughtful in assessing the extent to which those risks are transitory or permanent, as well as the extent to which they're already priced in. We also want to recognize emerging areas where Qualcomm is investing and has strong momentum. It has tremendous potential in Internet of Things applications. It has excellent potential in automotive applications, including from a deal signed just this month with Volkswagen. Earnings in those areas would likely be more highly valued by the market than those today from Apple. When we pull that all together, we think the stock [currently at around $140] offers a pretty compelling value.

For something like Cummins [CMI], which makes automobile engines, you have to work through both cyclical and secular concerns. Describe where you come out on it today.

GS: As you say, there are two big concerns. This is a very early-economic-cycle stock, and there are a number of justifiable worries about the economy. The second issue is more a terminal-value concern, that

Cummins is going to be on the wrong side of change as the world moves away from internal combustion engines [ICEs].

With respect to the economy, we share many of the concerns, but would also make the case that those concerns have already been well discounted by the market. On 2023 consensus estimates, the stock trades at 10x earnings, which is at the very low end of historical ranges. Clearly the market thinks those earnings estimates are wrong, and the shares as a result have de-rated sharply and quickly. But just as early-cycle stocks are first to de-rate, they're also the first to re-rate, often before the economic clouds lift. It's important to be willing to buy them when people are most concerned.

We've concentrated our work on the secular-risk front, and our view is that Cummins has a greater chance of being part of the solution in the transition to electric vehicles than is commonly assumed. They've made strategic investments and acquisitions to position themselves in an increasingly EV world, most notably the acquisition announced in February of drivetrain company Meritor. It's a strategic bet, which we agree with, that engine technologies of the future will be intricately tied to the axle in EVs.

There's a ton of uncertainty here, so when we look forward five or ten years we can't make narrow estimates of earnings. But when we think about various scenarios from a probability standpoint, we conclude that the shares today [at a recent price of $208] trade at a discount that more than reflects the economic concerns, and we're getting a free option on the movement away from ICEs not being as bad for Cummins as the market expects. These are the types of situations we look for: a good company at a discounted valuation for transitory reasons, where we think there's limited absolute downside and asymmetric reward to the upside.

What do you think the market is missing today in Fiserv [FISV]?

GS: The company has two main businesses that are roughly equal in size. One is what's known as core processing, where they have a huge leadership position in handling the back-office processing for small and medium-sized banks. This part of the company has also expanded on the bank side into handling payments-processing for bank-issued debit and credit cards. The second primary business, acquired when Fiserv bought First Data in 2019, provides card payment-processing services for merchants.

While the banking services tend to have higher switching costs, there is concern that as customer banks become larger and more vertically integrated they're likely to bring more of these outsourced processes in house. What we've found is that the banks benefit from Fiserv's scale and expertise, and that they only tend to bring in house areas that for Fiserv are commoditized and low margin. This is not a high-growth business, but a stable and recurring one that can still grow over time.

The merchant-acquiring business has higher growth potential, as consumers pay less and less with cash, credit-card penetration continues to expand, and consumer spending just generally increases over time. One thing that has weighed on the company's stock, however, is the perceived

INVESTMENT SNAPSHOT

Fiserv
(Nasdaq: FISV)

Business: Provides a range for core processing, funds transfer, and other technology services for financial institutions as well as payment processing services for merchants.

Share Information (@5/27/22):

Price	**101.37**
52-Week Range	89.91 – 119.86
Dividend Yield	0.0%
Market Cap	$65.52 billion

Financials (TTM):

Revenue	$16.61 billion
Operating Profit Margin	15.2%
Net Profit Margin	10.2%

Valuation Metrics
(@5/27/22):

	FISV	S&P 500
P/E (TTM)	39.6	21.1
Forward P/E (Est.)	13.7	17.6

Largest Institutional Owners
(@3/31/2022 or latest filing):

Company	% Owned
Vanguard Group	7.0%
T. Rowe Price	6.7%
Dodge & Cox	5.7%
KKR & Co.	5.0%
BlackRock	4.1%

Short Interest (as of 5/15/22):

Shares Short/Float	1.7%

FISV PRICE HISTORY

THE BOTTOM LINE

The market appears reticent about the company's growth prospects, but Gabriel Solomon believes driven primarily by its payments-processing business that it can increase EPS at 10-12% annually over at least the next few years. If that happens and the stock returns more to historical valuation levels, he sees attractive upside from today's price.

Sources: Company reports, other publicly available information

threat from new fintech firms that raised billions and billions of dollars in recent years, many professing to have superior technology and gunning for Fiserv's big card-processing market share. We think that risk has been overdone, as evidenced by many of those new competitors failing or being on the precipice of failure. Fiserv has done a good job in deepening its customer relationships so that clients are slower to switch vendors, and it also has the scale to invest in its own emerging products that keep newcomers at bay.

How inexpensive do you consider the shares at today's price of around $101.50?

GS: Fiserv's stock used to consistently trade at a high-teens to low-20s P/E, but that multiple today on consensus 2023 estimates is now less than 14x. We think that discounts very little if any growth, which we just don't believe is reasonable. We expect mid-single-digit annual revenue growth to translate into 10-12% annual earnings growth, after some margin expansion and accounting for share buybacks. If the multiple got back to even the mid-teens on that nicely growing earnings base, that would translate into an attractive return for us from today's price.

Have any of the highest-profile tech names attracted your interest after some material share-price declines?

GS: We're always interested in excellent companies with strong long-term growth opportunities that we can buy at good valuations. We are doing much more work on fallen tech angels, but haven't taken any prominent action. We already have a small position in Alphabet [GOOG], which we bought during the worst of the Covid concerns at what we thought was a legitimate value price. I personally think Facebook, now Meta [FB], is quite tricky and we haven't gotten over the fence in terms of being comfortable with it. I would say the same holds true for Netflix [NFLX].

This really isn't a time – as arguably was the case for much of the past several years – when you can target a sector or industry basket and expect the cycle to make it all work out. Today it's much more about individual companies with individual drivers and unique opportunities and risks. That makes it a stockpicker-biased market, which is what we prefer. VII

EXPLANATORY NOTES—ARTICLE REPRINT

Value Investor Insights, "Collective Effort," May 31, 2022

When considering mutual funds, investors should look beyond historical performance. They should consider factors such as the fund's investment objective, the types of securities in which it invests, and its level of risk compared with other types of investments. There are inherent risks associated with investing in the stock market, including possible loss of principal. The value approach to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

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Value Fund Top 10 Holdings as of 6/30/22:

Becton, Dickinson & Company	3.9%	Microsoft	2.7%
Elevance Health	3.3	Johnson & Johnson	2.7
Southern Company	3.2	AstraZeneca	2.6
JPMorgan Chase	2.9	AbbVie	2.6
TotalEnergies	2.9	Chubb	2.5

Equity Income Fund Top 10 Holdings as of 6/30/22:

Southern Company	3.3%	Elevance Health	2.3%
Wells Fargo	3.1	GE	2.2
TotalEnergies	2.8	AbbVie	2.2
UPS	2.5	American International Group	2.2
Qualcomm	2.4	Becton, Dickinson & Company	2.1

Large-Cap Value Fund Top 10 Holdings as of 6/30/22:

Southern Company	3.6%	Johnson & Johnson	2.5%
TotalEnergies	3.0	Qualcomm	2.4
Wells Fargo	2.8	Becton, Dickinson & Company	2.4
UPS	2.7	Chubb	2.3
GE	2.6	Elevance Health	2.1

Mid-Cap Value Fund Top 10 Holdings as of 6/30/22:

Loews	2.4%	Cardinal Health	2.1%
PG&E	2.2	State Street	2.0
Textron	2.2	FirstEnergy	2.0
Franco-Nevada	2.2	News Corp	2.0
Flowers Foods	2.1	Select Medical Holdings	1.8

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