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VULCAN VALUE PARTNERS

C.T. Fitzpatrick on Vulcan Value Partners & Portfolio Management

Kevin Harris, SumZero: *What led you to choose Birmingham as your headquarters?*

C.T. Fitzpatrick, Founder and CIO of Vulcan Value Partners: Actually my wife picked Birmingham, and it was an excellent decision. Birmingham is comprised of a number of ssmall communities that make up the larger metro area. Many of us live in Mountain Brook, which has one of the best school systems in the country.

Birmingham also has one of the best food scenes in the country. Highlands Bar & Grill just won the James Beard Award for most outstanding restaurant in America, and there are always new places opening. The people are friendly, the city is beautiful and provides a great quality of life. People move here and don't want to leave, which gives us a deep talent pool and makes it easy to recruit great talent. Vulcan Value Partners has been very supportive of the community and vice versa – it is part of our culture.

KH: *What makes Vulcan's investment process unique? What about Vulcan are you most proud of?*

CF: We are value investors but we don't look for cheap stocks. We look for businesses with inherently stable values that can compound their values steadily over time. We get to know them very well before we buy them because they are overvalued, by our math, most of the time. On the rare occasions when they do become discounted, we can move very rapidly to take advantage of those discounts because we've been following the companies for many years, sometimes decades.

Our time horizon is five years and if we would not be comfortable owning a business for this time period, it does not qualify for investment. This is one of our competitive advantages.

In addition, we concentrate our portfolios into the most discounted companies while holding quality constant. As a result, when discounts are more plentiful, which was the case during the financial crisis, our portfolios become more concentrated. When opportunities are not as robust, they become more diversified. Simply stated, we weight our positions according to discounts. The lower the price to value ratio, the higher the weight in the portfolio. I am most proud of our culture. Everyone at Vulcan is passionate about our mission, which is not to be the biggest but to be the best money manager in the world. We take our fiduciary responsibility very seriously. In fact, everyone at Vulcan is required to invest in publicly traded equity securities exclusively through Vulcan. This policy aligns our interests with our clients and keeps us focused. We have an environment where everyone works hard, is passionate about their work, and has a positive attitude. We really are a team working together for our clients.

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KH: *What are the biggest challenges you faced growing Vulcan from a startup to now $15B in assets under management?*

CF: Initial conditions are very important. We were fortunate at Vulcan to invest heavily in infrastructure and human resources well in advance of our need for additional capacity. So, as we began to grow much more rapidly than originally planned, we could handle the growth without it impeding our performance. When we closed to new investors in 2015, we had to reorganize ourselves to ensure the right people were in the right roles for what we call Vulcan 2.0. We had highly successful people whose jobs changed. Reorienting the organization to closed status was absolutely the right thing to do, but some of the personnel changes we ended up making were very difficult decisions.

KH: *You've described your Vulcan team in the past as a "value investors [that] don't look for cheap stocks". How does that set you apart from classic value investors that myopically focus on price to value?*

CF: It changes everything. Our analysts are passionate about finding outstanding businesses that have sustainable competitive advantages. As value investors, of course we want to buy them at a discount, but great business are rarely discounted. We are like well-prepared students waiting for a pop quiz. We never know when the test is going to occur, but we want to be ready when it does.

KH: *Vulcan has been lauded for closing its strategies. Why did you choose to close the fund?*

CF: We closed well before we ran into any capacity constraints that would impede our ability to perform. We closed Small Cap in 2013, and everything else by June of 2015. One of the things that people don't think about enough, in my opinion, is that it is not just about the absolute dollars under management. It is about the relationship you have with your clients. Time is our most precious asset and we need to always keep our research process at the center of what we do. We are very fortunate to work for long-term investors who provide us with stable capital and hold us accountable by asking probing questions that make us better at what we do. We feel like we have the right balance between the time that we allocate to the research process and the time we are able to spend with our clients.

KH: *Could you walk us through Vulcan's MVP List investment style? What qualitative aspects of this strategy give it a moat against the rise of quantitative trading strategies?*

CF: We do of course look at quantitative metrics when we analyze a company. One of the things we demand in any company before it qualifies is consistent, high levels of free cash flow. Companies with consistent free cash flow are inherently stable companies compared to companies without free cash flow. We look for a variety of other quantitative metrics as well, but free cash flow is essential.

Quantitative metrics, however, are just the beginning of the analysis. We think our real value add is the qualitative work we perform to understand whether or not the company will be able to continue to produce free cash flow and hopefully grow it in the future. We want to thoroughly understand how our companies' businesses work. We want to understand the competitive threats they face. We want to invest in companies whose competitive positions are strong and avoid companies with competitive advantages that are eroding. Quantitative metrics provide limited insight into those sorts of questions. We think that those questions are the most important to ask. Therefore, the qualitative work we do cannot be replicated through quantitative strategies.

KH: *What sectors (geographic or otherwise) do you presently see the most opportunity in?*

CF: We see a lot of opportunities in selected tech companies. We also see opportunities in non-bank financials. In our Large Cap area, we are still finding more things to do in the U.S. than other parts of the world. In our Small Cap program, we are finding more incremental opportunities outside of the U.S.

KH: Would you cover 2-3 of the names that you are looking at right now? What makes them interesting investments?

CF: We like United Parcel Service (UPS) because of their competitive advantage in the industry. It is one of the leading delivery companies in the world, with roughly 6% of U.S. GDP and 3% of global GDP flowing through its network. It uses only one network for air and ground delivery which makes it more efficient compared to its primary competitor, FedEx, which uses separate networks. Over an economic cycle, UPS generates excellent free cash flow and the company is benefiting heavily from growth in ecommerce. It also has a shareholder-friendly mentality with large employee ownership.

We recently purchased Teradyne (TER), a global leader in semiconductor test equipment. The business produces robust free cash and returns on capital are high. In addition, Teradyne has a rapidly growing industrial automation business specializing in easy-to-operate robots that work alongside humans. These robots are commonly referred to as "cobots." This segment of the robotics industry is small but growing faster than the industry as a whole.

KH: *Generally, what is your view on the rise of passive and quant strategies versus traditional active management?*

CF: First, we think that many investors in passive strategies are taking on far greater risk than they realize. There is a statistic called Active Share. If you have an Active Share of 0%, then you are simply investing in the index. Our Active Share is close to 100%, which means we look nothing like the index. There are large parts of the indices that we would not want to own at any price. In our opinion, the businesses we own are far superior to most businesses in the indices.

Furthermore, our companies are more discounted than the indices, so, with our own personal capital involved, we would much rather have our money invested actively in our decisions. Which is why everyone here invests through Vulcan. Regarding quant strategies: first, they are not all created equal. Second, the best quant strategies do not take full advantage of resources that can improve investment

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performance because, by definition, they are limited strategies. By that, I mean that ignoring qualitative data is like walking down the street wearing only one shoe. You can go a lot further by taking advantage of both qualitative and quantitative data.

So, while we personally only want to invest actively through Vulcan, we understand that many of our clients use us as only part of a toolkit to meet the objectives for their overall portfolio. For many of our clients, it is not an either/or equation. We are almost always the satellite manager. Some of our clients have replaced "core managers" with low Active Share (i.e. closet indexers) with passive strategies, while using us to add value as an active satellite manager.

A number of investors are using "passive strategies" such as ETFs in an active way and moving large amounts of capital around based upon factors, industries, and sectors. These decisions are rarely grounded in fundamental analysis and can lead to mispricing of individual securities within those sectors. We think that this mispricing creates an opportunity for us and there will be more opportunities for us in the future.

KH: *What sector or names do you currently have the most contrarian view of? Why?*

CF: Pretty much everything we have is contrarian! We like insurance - there were a lot of hurricanes and fires last year. Many people are enamored by "new tech." We like old tech. As an example - Oracle is not going to grow quickly. However, its oft-discussed "threat" from Amazon is grossly exaggerated. AWS competes with Oracle's 'infrastructure as a service' segment, which represents an extremely small part of the overall business. Regarding new tech, Facebook has been under a lot of pressure due to privacy concerns. We were buying Facebook while Mark Zuckerberg was testifying to Congress. And I could keep going.

KH: *What is the most contrarian investment decision that you've made in your career? How did it play out?*

After 9/11, my former partners and I started buying Hilton Hotels when the markets reopened. The stock kept falling. At one point, we felt that we were buying the entire company for the value of the Waldorf Astoria and getting the rest of the company for free. We looked foolish buying Hilton at first, but it turned out to be a fantastic long-term investment.

Our investment ethos is to buy underpriced companies that are on our MVP list, most of which we've been following for years. We have a good understanding of the fair value of a company, and when something happens, be it a geopolitical, sector, or company specific event that causes the company's price to deviate significantly from its value, we'll buy. On the flip side, when we feel that a company we own is too richly priced, we sell and keep following the name until it descends back to a fair value. Some names, Hilton among them, I've been following in this fashion for decades.

Something else that we focus on is minimizing our weighted average price to value ratio. This isn't always straightforward - In the financial crisis, we found ourself selling 80 cent dollars - companies that were great investments - to buy 60 cent and 40 cent dollars. The lower the overall price to value ratios, the greater the margin of safety. Our overriding objective is first and foremost to protect capital and to earn a return on that capital.

About the Interview

C.T. Fitzpatrick founded Vulcan Value Partners in 2007, and has since grown the firm to $15B in assets under management across a variety of strategies. Prior to founding Vulcan, C.T. was a Principal and Portfolio Manager at Southeastern Asset Management for 17 years. Kevin Harris from SumZero sat down with C.T. to discuss Vulcan, value investing, and portfolio management.

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