Endeavour Investment Partners Presents

Q&A

With the Portfolio Manager

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TorrayResolute Growth Strategies

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Q Your firm's timeline mentions you merging your firm, Resolute Capital, with Bob Torray's firm in 2010. What brought you two together and what were you hoping to accomplish by merging your two firms?

Nicholas Bob and I met while managing separate investments for a common institutional client. Bob started his company in 1972, I started mine in 1998, so he had almost 40 years of operating experience under his belt at the time of the merger. What brought us together were consistent fundamental beliefs about investing – basically, patience and discipline. We each hoped to expand the business and continue delivering great service to our clients.

Q Growth investing comes in a lot of shapes and sizes, with some managers pursuing a momentum-driven approach while others focus on quality, and quality itself can mean different things. How would you describe your form of growth investing?

Nicholas We pursue a conservative approach to growth investing, so we look for quality investment opportunities. A lot of managers use terms like quality, durability or sustainability. For us, quality means consistency. We look for consistency in a company's operating performance. Stable topline growth, stable margins through a full business cycle, and generous cash flow. What we want to avoid are the wild swings that come with high-growth, momentum-driven companies. Ultimately, we think stock prices follow earnings and cash flow. To us, that means finding best-in-class businesses that have sustainable financial characteristics.

"For us, quality means consistency."

Q Do you think with the markets we've had over the last five, eight, or 10 years that the stock prices reflect the fundamentals of a company or is there something else at work in the marketplace?

Nicholas I think there is something else at work. The post-financial crisis period has been a unique period where we've had exceptionally low interest rates and low economic growth for a long time – a full decade now. What that's done is push fundamental factors like valuation and balance sheet strength to the sidelines. High growth compa-

Nicholas C. Haffenreffer

Mr. Haffenreffer is a Principal at Torray and the Lead Portfolio Manager for the TorrayResolute Concentrated Large Growth strategy and the Portfolio Manager for the TorrayResolute Small/Mid Cap Growth strategy. He began his investment career in 1991. He founded Resolute Capital Management in 1998 and merged with Torray LLC in 2010. Prior to founding Resolute, he was the Director of Research for Washington, DC-based Farr Miller & Washington, an equity analyst with T. Rowe Price Associates, Inc., where he worked on the Growth Stock Fund, and an equity analyst for Select Equity Group, Inc. in New York City. Mr. Haffenreffer received a BA from Brown University in 1990.

nies seemingly have become the substitute staples, the "safe bet", which is a bit counterintuitive. This is particularly true with the Tech sector. Given the duration of this cycle and the increasingly narrow nature of the market's leadership, we think it's important to exercise caution here.

"One of the ways we manage risk is to be disciplined about valuation."

Q With the past as an indicator of what might come in the future, but certainly not a guarantee, can you explain how I should interpret your performance and what attributes I should be aware of that may not show up in the top line numbers?

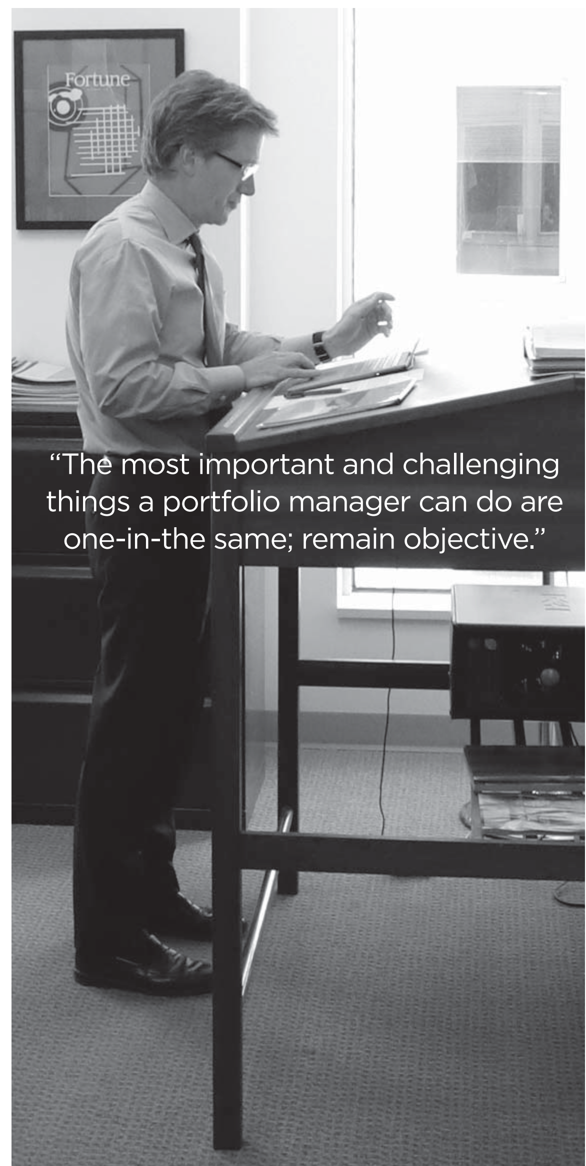
Nicholas Sure, our record is very clear on this. We have typically done well when prices are dictated by fundamentals and there is regular market volatility. We tend to underperform when momentum or early cycle companies lead. Momentum is associated with higher valuations. One of the ways we manage risk is to be disciplined about valuation. The reason why we tend to underperform when early cycle companies lead is because they are, by definition, characterized by more cyclical financial results. We generally avoid these. Based on these factors, we've faced some style headwinds recently. We believe this will change with time.

Q When I, as an investor, hear "risk-adjusted", I don't quite know what it means for the investment process. It sounds good because I'm concerned about risk, but I don't really know what that means you are doing behind the scenes.

Nicholas Institutions typically view risk as volatility. Individuals tend to be more focused on loss of capital. We definitely focus on the latter; the idea of risk as loss. A good scenario for us is to participate in a majority of the upside, but protect principal on the downside. If you were to quantify it over time, we would be satisfied to realize 90 percent of the market's upside and 70 percent of the downside. What we don't want to do is underperform in down markets. This is a characteristic that differentiates our strategy and is very important to us and our clients.

Q You've mentioned risk and made reference to using a "risk-adjusted approach", so how do you define risk?

Nicholas It's useful to break the process down into two categories; security selection and portfolio construction. On the selection front, we review a company's revenue, earnings, and cash flow growth over a full business cycle and discount growth rates for any observed volatility. How does that actually play out in the process? If we look at a company that's grown at 15 percent and another that's grown at 12 percent, but the company that has grown at 12 percent has done it in a much more stable fashion, we may select the slower-growing company because we believe the financial returns reflect something about the business that is more sustainable. The



"The most important and challenging things a portfolio manager can do are one-in-the same; remain objective."

most important part of our analysis is identifying what is unique to the business that has driven these results. In terms of selection, that's a key way that we manage risk. Of course, we're also looking for healthy balance sheets, high barriers to entry, and do not have a lot of interest in commoditized companies.

In terms of portfolio construction, we have rules in place that limit certain types of exposure, such as sector concentration. We do not own a lot of economically sensitive sectors. A basic tenet of risk management is diversification. A lot of times you'll

hear portfolio managers talk about how diversified they are across sectors. But sector labels only get you so far in terms of diversification. We actually analyze correlations and measure the way individual stocks have performed relative to one another. Our goal is to make sure we're getting effective diversification in the portfolio, not just with respect to sectors or industries, but at the stock level as well.

Q Does the potential for rising rates concern you at all?

Nicholas Sure, and we expect interest rates to rise from here, although gradually. As part of our correlation analysis, we look at each holding's historical sensitivity to interest rates and other factors such as commodities and currencies. Our goal is to limit the potentially negative impact of these factors.

Q You run a fairly concentrated portfolio. Why do you use a limited number of stocks and are there other risks that you need to address as a result?

Nicholas We believe growth investing is about leveraging our risk and taking a long-term view. There are only so many exceptional businesses and once you find them, they tend to do the work for you. We limit stocks to 30 of our highest conviction names that we believe will maintain risk characteristics below our benchmark and peers but allow us to participate in the upside. When you find a great company and have the discipline to stay invested over time, the probability of success goes up. However, in a concentrated portfolio, you also have to know when to move on from your mistakes.

> "One of the common concerns about growth investing as an asset class, is that investors must assume excess risk. We fundamentally disagree."

Q When you think about your ideal stock and you go to find those "right" companies, what do they look like? Do they share common traits?

Nicholas We want to find companies that grow consistently through full business cycles, that manage margins effectively, and generate attractive returns on invested capital. Additionally, we look for low correlation to the balance of the portfolio and some form of sustaining, thematic tailwind – something that will support growth separate-and-apart from the economic cycle. While the definition of a business or economic cycle is a matter of debate, our point is this – it is equally important to review a company's results through periods of economic contraction as it is during an expansion. It is a way to frame risks and opportunities. We are not particularly interested in trying to anticipate product cycles, commodity prices or other short-term factors, but prefer to measure how growth rates change, how margins are impacted, and how cash flow changes over time. What's important to us are things like pricing power and barriers to entry because they help smooth economic peaks and troughs.

Q You've talked about consistency of returns, growth in margin and cash flow, and then you also commented on pricing power and barriers to entry. Those last two are more qualitative, with the former being more quantitative. Does one type carry more weight in your process?

Q **You've talked about consistency of returns, growth in margin and cash flow, and then you also commented on pricing power and barriers to entry. Those last two are more qualitative, with the former being more quantitative. Does one type carry more weight in your process?**

Nicholas It's fair to say we give more weight to our qualitative work, but it must be supported by our quantitative analysis. The two approaches complement each other. It's hard to imagine a great qualitative business that doesn't generate attractive quantitative factors, and vice versa. For example, we use our risk-adjusted growth process, which is quantitative, to identify stable growth companies. Where we add value is by understanding how these companies produced their results in a sustainable manner.

Q **Are there sectors that you shy away from, and if so, why?**

Nicholas Yes, more economically sensitive sectors tend to be ones that we avoid, and lower growth sectors like Financials and Utilities. Consumer Discretion tends to have more of what I would call fashion risk, where the cycles are shorter, so we tread lightly there as well. One of the benefits of our risk-adjusted growth process is that we have been able to identify stable growth companies in sectors that are not typically characterized by growth or stability. Whether that's in Energy, Biotech, or Industrials. Some of our best investments have been in these sectors and were identified using this process.

Q **As a portfolio manager, what do you think the most important thing that you can do is, and what's the most challenging part of that role?**

Nicholas The most important and challenging things a portfolio manager can do are one-in-the same; remain objective. Human nature, short news cycles and a competitive industry make this a particularly tough aspect of the job. The best way to ensure you remain objective is build a great team, one that asks the tough questions and is intellectually honest. From a practical standpoint, leadership and communication are also important. An effective portfolio manager has to prioritize information flow, be decisive and clearly communicate to team members and clients. If you can't explain what you do, why, and where you want to go, no one will follow. One thing Bob has always been clear about, that has reinforced my own view, is the value of maintaining a long-term, disciplined approach – as I said earlier, patience and discipline. It is a fundamental part of our culture. The common market anomaly we are attempting to exploit is the time horizon; the inefficiencies that business and news cycles bring to bear on publicly traded companies. We believe if you get the company right, the stock price will take care of itself.

> "The common market anomaly we are attempting to exploit is the time horizon."

Q **Is there something I haven't asked about or something you think I need to know about the process or the strategy or even the firm?**

Nicholas Sure, I'd add one of our core tenets, which is that "process" is a better approach than "information advantage" or "intuition". If you step

back and listen to what an asset manager is proposing as its advantage, it's typically one of these three ideas – process, information advantage or intuition. While all of those can be effective, process is the most repeatable. Because of our intent to focus on the long-term, we believe repeatability is the key issue to focus on.

Q **How do you see an Advisor using the growth strategies within the context of a client portfolio?**

Nicholas I think for an Advisor who is looking for focused growth exposure but also wants to do so in a risk-managed approach, we are a good option. The asset class is dynamic and can be volatile. We believe this approach is one that can ideally participate in growth without the extreme volatility that can sometimes accompany the asset class. As far as the allocation, that is up to the Advisor to determine with the client.

Nicholas, thank you for your time today, we've enjoyed the discussion.

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