

Getting high returns and preserving capital through discipline

Going For Growth

An Interview with Silas Myers and Brian Massey • As principals and portfolio managers of the newly formed Mar Vista Investment Partners, Silas Myers and Brian Massey insist on buying superior growth businesses, but only at the right price.

The two proved their investment acumen in the large-cap space during their tenure as portfolio managers at Roxbury Capital Management. Silas joined Roxbury in 2000 after stints at both Utendahl Capital Management and Hotchkis and Wiley. Brian came to Roxbury in 1996 as an analyst and was promoted to director of research in 2002. Together, they ran Roxbury's large-cap strategies for nearly five years.

In November, with the full support of Roxbury, Silas and Brian started Mar Vista and oversee the firm's two strategies: Strategic Growth and Focus. Both invest in large-cap growth companies, though Focus is more concentrated.

Where are Silas and Brian finding their most promising ideas these days? And what does it take to make their strict cut? As you'll learn, at the heart of their strategy is the search for durable growth franchises trading at significant discounts to intrinsic value with deep competitive advantages.

Q: *Let's begin by talking about your overall investment approach.*

Massey: In a nutshell, every company that gets into the portfolio must fit four criteria. First, it needs to have a wide economic moat that will allow it to grow returns on capital relative to its costs of capital well into the future. Second, the stock has to be trading at a significant discount to what we think the company is really worth. Third, the company must have the ability to grow shareholder value. And fourth, the company's management team must have a proven ability to allocate capital wisely. There is obviously a lot of work that goes behind those four items, but they make up the



Brian Massey, CEA (left) and Silas Myers, CEA are co-founders of Mar Vista Investment Partners. The two are intent on finding quality growing businesses, but insist on only paying the right price for such companies.

basic factors we think about whenever we are analyzing a company.

Q: *What do you mean by "wide economic moat?"*

Myers: A moat is a company's competitive advantage, or way of defending its business model from the competition. We find that most companies have narrow moats, meaning they face a lot of competition. This often causes reversion to the mean, even for the most innovative businesses. We're looking for companies that are able to sustain their advantages and generate higher returns on capital over extended time periods. That allows such companies to enhance shareholder value over the long haul.

Q: *Tell us what makes your approach unique relative to other growth managers.*

Myers: I think we are different from most growth managers in that we place as much emphasis on the valuation as we do on the growth potential of a company. We prefer businesses that can grow profits at high rates relative to capital, but we won't invest if the stock price already reflects these growth opportunities. We'd much rather buy a company that can grow profits by 15%, where current valuations only reflect 12% growth, rather than one able to grow by 20% with a stock price reflecting expectations of 25% growth. In other words, valuation is just as important as growth.

Massey: Another thing that differentiates Mar Vista is our willingness to be longer term in our thought process and approach. A lot of times the market only looks out for one quarter, or perhaps the next year. We focus our analysis on the next three- to five-years and beyond. The vast majority of value is created years down the line, not in the next few quarters. This often means we have to go against conventional wisdom by buying a growth stock with near-term prospects that may not be as rosy as its longer-term outlook.

Myers: We define growth a little differently from most. Revenue and earnings growth are important to us, but how much capital a company invests to generate that growth and the sustainability of that growth are also important to the story. By looking at only revenue or earnings per share growth, an investor misses half the story. We are intently focused on never deviating from our discipline no matter what the market environment. We put each company through the same process, regardless of the business model or what sector it is in. Every time we look at a company, we ask a series of questions. What are the future cash flows? How much are we willing to pay today for those cash flows? How are we different from the consensus? What is the downside if we are wrong about the future? How much weight should be applied to the probable outcomes? How does this stock fit into the overall portfolio? If we are right on our projections a majority of the time, we will be providing a valuable service to clients.

Q: *Where do you find most of your investment ideas?*

Massey: Everywhere. We turn over a lot of rocks. We run screens to find companies with consistently high returns on capital and a solid history of sales, earnings, and free cash flow growth. Also, we use what Philip Fisher famously called “scuttlebutt” by networking and talking to other investors we respect. Importantly, we all have an industry focus, which helps us to identify what we call “Mar Vista-style”

stocks. These are companies with great business models. We look across all the different economic sectors, but we’ve learned that certain areas generally don’t fit our criteria. For instance, in some commodity markets it’s nearly impossible to have an economic moat or sustainable growth, so we don’t spend a lot of time there. We’ll scout the market for great growth businesses that have hit a temporary speed bump and might even be trading at historically low valuations.

Q: *Your focus on valuation makes you sound like a value manager. Does this discipline keep you out of some of the faster-growing names?*

Massey: Not at all. Experience tells us our approach of combining growth investing with a valuation discipline is the best way to grow capital for our clients, while protecting their assets on the downside in more difficult markets. Now, don’t get me wrong. We own many fast growing names. But, as a general rule, those companies with high growth rates usually have sky-high valuations, as too many investors have fallen in love with the story. If we can identify the attractive business models early in the cycle, before they are recognized by the market, we can buy when others aren’t interested and sell as the valuation exceeds fair value. We’re happy hitting singles and doubles and missing the homeruns. Granted, we don’t run the portfolio like many other growth managers. We tend to pay a bit more attention to valuation. But even though our average P/E is lower than the Russell 1000 Growth Index, our portfolio companies are growing faster. Estimated earnings growth for 2008 is 16% for both Strategic Growth and the index. Consensus earnings growth for the portfolio over the next five years is similar to the index, though we actually think our companies can do better than that. By comparison, earnings for the S&P 500 are only expected to grow by 6% over the next year and 8% over the next five years. It’s true that we often don’t own some of the popular high growth stocks of the moment that everyone seems to be in love with, such as the Googles and Research in Motions

of the world. While we’re happy owning these at the right valuations, we’d rather buy other companies offering similar growth prospects at much lower prices. This allows us to reduce the portfolio’s volatility and gives us a much larger margin of safety.

Q: *Is there a minimum growth rate burdle you require in order to buy a stock?*

Massey: No, we don’t have a stated minimum amount of earnings per share or revenue growth. We really define growth based on expanding returns on capital. If you can grow profits relative to your capital base, you are a growth company in our book. We’re happy to buy a company that can keep current profit levels flat while taking lots of capital out of the business. This means returns on capital are improving, shareholder value is growing, and eventually the stock will reflect that. Nevertheless, over time you typically have to grow revenue and earnings to create shareholder value. We think that is another thing that makes us unique from other growth managers who define growth as purely revenue or earnings per share growth.

Q: *Let’s talk about a few of the names in your portfolio, starting with Cisco Systems.*

Myers: We first bought Cisco in August 2006 for Focus, when we were at Roxbury. We felt the stock was significantly mispriced at the time, given its industry dominance. The stock was trading at about 12 times free cash flow and growth expectations were improving, particularly in the company’s advanced technology business. Based on our assessment of future cash flows at the time, we thought the stock was worth \$33. Our entry point was \$17.60. Today it trades for about \$30, having come down from some recent highs. Management is committed to continuing to grow the business with investments that have very high returns. There is significant cash on the balance sheet net of debt, so financially Cisco is quite strong.

Q: *The First American Corporation is another long time holding. What's so attractive about this company?*

Massey: First American is involved in title insurance, which is a terrific business, albeit cyclical. Pricing and licensing requirements are determined by state regulators. This helps to further protect First American's franchise. Title insurance makes up about half of First American's profits. This segment is declining in importance as the company's higher-growth, higher-margin real estate information services ramp up. First American boasts the most complete collection of mortgage and property data available to lenders or brokers. The company has leveraged this competitive moat and transformed itself into a real estate information services provider.

First American has compounded revenues, earnings, free cash flow, and book value at rates in the high teens over the last decade, while expanding returns on capital to as high as 25%. There is a huge amount of underappreciated shareholder value growth here. The company is just beginning to leverage its database of information and that could prove to be very lucrative over the next 10 to 20 years. There is little competition in this space and few could replicate the business model that First American has built.

Q: *How do you control risk in the portfolio?*

Myers: We define risk as permanent capital loss. We think the best way to control risk is by paying the right price in the first place. When you buy stocks at a discount to fair value, capital loss is minimized, even when you're wrong. Preservation of capital is very important to us. Avoiding losses is crucial.

Q: *What is your sell discipline?*

Massey: We'll typically trim or sell a position as it approaches our estimate of fair value, when the original thesis is altered, upon seeing a change in the fundamentals, or to make room for bet-

ter ideas in the portfolio. We review stocks based on any price weakness, which we define as a drop of 10% from cost or 20% from a recent high. That's because such activity may be an indication of important fundamental information making its way into the marketplace. More often than not, price weakness is an opportunity to add to a long-term position.

Q: *Large-cap growth as an asset class has been very out-of-favor over the past five years, though it has started to come back of late. What's your outlook for this area of the market going forward?*

Massey: It's always difficult to make macro calls about which asset categories will or won't do well over any period of time. That said, as we analyze the market right now using our discipline, we are finding a lot of opportunities in mega-cap stocks.

Q: *Does that mean people should be overweighting large-cap growth right now?*

Massey: We think clients should remain appropriately allocated across all asset categories. We would never be ones to ring the bell and say now's the time for large-cap growth to outperform. That's not how we invest client money. We're looking at every single individual opportunity and assessing whether it fits our four criteria, regardless of whether it's a \$3 billion or \$300 billion company. That said, these things typically go in cycles. From 1995 to 2000, large-cap growth was far and away the best performing asset category. The absolute wrong thing to do at that time was cast aside value strategies and go to growth. The last five years have been the exact opposite of that. Large-cap growth has been the worst category, while value has been the best. History suggests those trends will revert to the mean and large-cap growth at some point will have a more favorable period of performance. Whether or not we're at that point, or whether it comes a year or two from now, is unknown. We're just focused on implementing our discipline in all types of markets and across different cycles.

Myers: This could be a nice opportunity for clients who have had good performance in their value portfolios to think about reallocating some of these gains to get back to a normal allocation among the different asset classes. If you have an outsized weighting in small-cap, value, or mid-cap stocks, it might be time to dollar cost average into some of the other asset classes where you've had underperformance.

Massey: In the end, picking stocks is hard enough. Trying to time the market in asset category performance is almost impossible to do well over the long term. Reallocating your portfolio to make sure you're well-balanced between the different capitalization sizes and value versus growth strategies is probably the appropriate thing to do.

Q: *How many stocks do you keep in the Strategic Growth portfolio?*

Massey: It tends to range from between 35 to 45 stocks, depending on what opportunities we're seeing in the market.

Q: *While you own a number of traditional large-cap stocks, you also hold several mid-cap names. What's your criteria for selecting stocks in terms of market capitalization?*

Myers: We keep a range of capitalizations in the portfolio. We go as low as \$2 to \$3 billion and as high as the biggest mega-cap out there. Right now our median market cap is about \$25 billion. The weighted average market cap is around \$79 billion. Typically the mid-caps we're interested in are emerging large-caps with the same economic moats and long-term growth potential. They're entering and penetrating their markets, and in some cases developing these markets. Our bias is clearly toward the larger end of the market cap spectrum. We may keep around 10% or 20% of the portfolio in mid-caps. It's really based on where we're finding the best opportunities.

Q: *What's the main difference between Focus and Strategic Growth?*

Myers: Focus is also a large-cap growth portfolio. The main difference is one of concentration. Focus generally owns between 15 and 20 stocks, representing our highest conviction ideas. Studies have shown that 20 stocks give you about 90% of the market's diversification.

Q: *Speaking of diversification, with 20 stocks, how much do you keep in each holding in Focus?*

Myers: The average weighting is 5%, but that number tends to be higher in stocks with better risk-reward characteristics. When stocks we like come down in price, we use that as an opportunity to add to our position.

Q: *We've seen a lot of volatility in the markets of late, with concerns about interest rates, the price of oil, etc. How does all this fit in to your thinking when putting portfolios together?*

Massey: These macroeconomic factors are really impossible to accurately predict with any kind of consistency. We look at them in the same way a golfer looks at the weather. If you're going out and it's a cold day, you might change what you wear, but you're not going to change the way you swing the club. That's the same way we invest. We consider the threat of inflation, higher interest rates, and higher oil costs on our companies. But, regardless of the environment,

we're looking at the long-term potential for our individual portfolio companies. A boom or recession, bull or bear market, or the latest GDP number really don't change our approach or the analysis we're doing on these businesses. We may adjust our exposure to certain sectors, or change our appetite for risk, but we're not trying to make a macro call on oil, inflation, or the direction of semiconductor pricing. We look at every individual company and try to predict the fundamentals and resulting cash flows. Experience tells us you can have a lot more success in predicting those variables with accuracy than you can macroeconomic factors.



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