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MONEY MANAGER INTERVIEW

CHARLES K. BOBRINSKOY

Ariel Investments, LLC

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Identifying Stocks with Long-Term Prospects but Short-Term Problems

CHARLES K. BOBRINSKOY, ARIEL INVESTMENTS, LLC



CHARLES K. BOBRINSKOY, Vice Chairman, Head of Investment Group and Portfolio Manager, oversees Ariel Investments, LLC's domestic investment team. He also manages the firm's focused value strategy — an all-cap, concentrated portfolio of U.S. stocks. Prior to joining Ariel Investments, LLC in 2004, Mr. Bobrinsky spent 21 years as an investment banker at Salomon Brothers and its successor company Citigroup, where he rose to Managing Director and head of North American investment banking branch offices. Mr. Bobrinsky

actively serves the Chicago community, sitting on the corporate board of InnerWorkings, Inc., a publicly traded print procurement company, as well as the boards of the Museum of Science and Industry, La Rabida Children's Foundation and the Big Shoulders Fund. He also teaches monthly investing classes at two Chicago inner-city schools. Mr. Bobrinsky graduated with an A.B. in economics from Duke University and earned an MBA from the University of Chicago.

SECTOR — GENERAL INVESTING

(AGT508) TWST: Can you explain your role in the firm and also the fund that you want to speak about today?

Mr. Bobrinsky: I am Vice Chairman of Ariel, and I have the domestic equity investment group reporting to me. I am also the Portfolio Manager of the Ariel Focus Fund, which is our all-cap value strategy.

TWST: Can you talk a little bit about what type of investor the Ariel Focus Fund is for?

Mr. Bobrinsky: The fund is for both institutional and high net worth clients, targeting people with a value orientation and a long-term approach. It is an independent-thinking contrarian fund with a focused strategy that invests in less than 30 stocks in any market cap. We talk about it as being the best ideas that Ariel finds across any market cap.

TWST: Is there a reason why you keep it so concentrated to, say, 30?

Mr. Bobrinsky: It comes from something that Warren Buffett teaches, how you get better returns if you invest in your 20 best ideas rather than diversifying into 100 stocks, the average number for most mutual funds. We agree with that. We think there is

a lot to be said for investing in your best ideas. Now, it does mean you have a little more concentration and a little bit more volatility, but we do think it is much easier to produce alpha in a concentrated portfolio than in a 100-stock portfolio.

TWST: And why is that?

Mr. Bobrinsky: It comes from one of the four pillars of our investment philosophy, namely, expertise. It is very hard to be an expert in 100 names and much easier to spot the opportunity in 28 names. The danger is if you own more names, you start to look more and more like an index, and any great idea will, by simple mathematics, have less impact on the portfolio.

There is of course a trade-off; you don't want to take this to an extreme. You could have only one stock or two stocks, and that would produce, in our judgment, too much volatility and risk. We think the sweet spot for this strategy is in 20 to 30 names where we can have real expertise on the companies, invest in our best ideas but not have the kind of volatility that would come from a nine-stock portfolio.

TWST: What are the assets under management currently?

Mr. Bobrinsky: In the strategy it is about \$170 million, while firm-wide in this style of investing that we call Buffett-

Highlights

Charles Bobrinsky talks about his firm's all-cap value strategy. This strategy targets investors with a value orientation and a long-term approach. Mr. Bobrinsky says the fund is made up of less than 30 stocks in any market cap. He says the practice is focused on finding great companies with great long-term prospects and that have some kind of short-term problem. Companies discussed: KKR & Co. L.P. (NYSE:KKR); The Western Union Company (NYSE:WU); Microsoft Corporation (NASDAQ:MSFT); International Business Machines Corp. (NYSE:IBM); Laboratory Corp. of America Holdings (NYSE:LH); Mosaic Co (NYSE:MOS); Morgan Stanley (NYSE:MS); Goldman Sachs Group (NYSE:GS); Barrick Gold Corporation (USA) (NYSE:ABX) and National-Oilwell Varco (NYSE:NOV)..

style traditional value, it is about \$7 billion.

“The idea is, buy stocks trading at a big discount to their intrinsic value because of a short-term problem. Buy, be patient, wait for that short-term problem to go away, return to the normalized earnings power of a company, and then have the market focus again on the longer-term strength of the company.”

TWST: Can you give us a little bit more explanation on the process you go through in order to select those 30, and as you do so, mention how often you would adjust the holdings?

Mr. Bobrinsky: Yes. It is a low-turnover strategy with turnover of less than 40%, when the average mutual fund is more like 100%. This comes from another pillar of our investment philosophy, which is patience. We think the stock market is very efficient, but the one glaring inefficiency is excessive focus on the short term. The value of a stock is the present value of the cash flows that will be earned in perpetuity. When you do the math, you find that the cash flows from year two through 30 represent over 90% of the value. Yet, we would argue that the stock market and investors spend 90% of their time focused on the next 12 months.

Our practice is focused on finding great companies with great long-term prospects that have some kind of short-term problem. The mechanics of that are we start with a watch list of companies that we think are high-quality companies, and then we wait for some kind of short-term event. It might be a missed quarter, a regulatory problem, a trend in the industry that is producing a short-term headwind or a short-term macro factor like a strong dollar. If that hits the stock and makes the short-term outlook appear challenged, the stock may drop abruptly, although there has been no material change in the long-term value. The stock will jump to the top of our watch list, and we will update our valuation analysis.

We are hoping to find a company with a long-term opportunity in the face of that short-term problem. The most glaring example of that might have been six months ago, when we made **KKR** (NYSE:KKR) our biggest holding in the Focus Fund. People were nervous about the short-term outlook for IPOs. A change in the regulatory environment might tax capital gains and carried interest on a different basis. The stock market drove **KKR** stock down from \$24 in 2015 all the way down to \$12 in July of this year.

Nobody would deny that **KKR** is a wonderful company with a great business and spectacular margins in a growing industry. And yet, admittedly, the short term was going to be bumpy. We made it our largest position. As often happens in value investing, a catalyst developed that we had not expected. Republicans swept the White House and Senate, and all of a sudden the out-of-favor asset management industry is now back in favor, and the stock is behaving much better, although still well below our calculation of its intrinsic value.

Another example of this process in a similar industry would be **Western Union** (NYSE:WU), one of our top five

positions. Again, it is a great company with a network of thousands of money transfer offices around the world. The network is a clear competitive advantage producing real economies of scale. **Western Union** had faced concerns about new regulations from a Democratic-controlled Senate and new regulations on money transfer fees. **Western Union** was trading at 10 times earnings in a market trading at 17. We acknowledged the short-term headwinds, but thought this was a business that would survive any change in the political environment. That short-term headwind has gone away, and the stock has performed very, very well.

So the idea is, buy stocks trading at a big discount to their intrinsic value because of a short-term problem. Buy, be patient, wait for that short-term problem to go away, return to the normalized earnings power of a company, and then have the market focus again on the longer-term strength of the company. That, in a nutshell, is our process.

TWST: I noticed in your writing about the process that you mentioned a “devil’s advocate” step. Could you describe what that is?

Mr. Bobrinsky: Yes, and this is a very important step. We spend a lot of time studying behavioral finance, which came out of psychology. One of the most powerful findings in behavioral finance is the endowment effect, which is that all human beings and almost all investors tend to systematically overvalue that which they own as opposed to that which they don’t own. If you own stock in **Microsoft** (NASDAQ:MSFT), you tend to think it is a better company than it is, and you tend to have confirmation bias and search for evidence that supports your thesis. You will also be resistant to evidence that contradicts your thesis.

1-Year Daily Chart of KKR & Co. L.P.



Chart provided by www.BigCharts.com

At Ariel, we have introduced a formal “devil’s advocate” for every stock, both in the portfolio and new ideas. It becomes the devil’s advocate’s job to state the bear case and also to examine the valuation assumptions to help resist this endowment effect and confirmation bias. The reason we make it formal is that there isn’t any organizational or social pressure to avoid contradicting your partners and peers. It is very common in institutions like ours for people to be reluctant to push back against a thesis, particularly if that thesis is held by a senior professional. Formalizing the devil’s

advocate makes it someone's job to give the other side, and this reduces the drama around producing the bear case.

“We buy stocks that we think are trading at significant discount to their intrinsic values. That discounting has clearly clustered over the last several years.”

TWST: Do you make sure that the devil's advocate person is outside of the fund? Are they in some way structured internally so that they are insulated from retribution or any kind of adverse reactions?

Mr. Bobrinsky: Well, that is the beauty of the formal designation in that the Director of Research assigns the devil's advocate. The analyst recommending the stock knows that the devil's advocate is not arriving at his or her negative view for any personal reason. It is that professional's job. After we formalized this process in 2009, we actually found a dramatic reduction in those tensions that you are talking about. Today, there is much less drama around a contrary opinion being expressed.

TWST: Because you have kind of woven it into your culture, and it feels less threatening to everybody involved?

Mr. Bobrinsky: Right. It is not so much that it is involved in the culture as it is involved in the process. It is a formal step in the process. When any professional recommends a stock, the devil's advocate is required to analyze the assumptions and to point out any assumptions that he or she thinks may be aggressive.

TWST: Can you describe a little bit more about why the fund has the composition that it does today in terms of both the sector and market-capitalization allocation?

Mr. Bobrinsky: We buy stocks that we think are trading at significant discount to their intrinsic values. That discounting has clearly clustered over the last several years. We would not be the first to point out that there has been a rush toward safer, defensive stocks that are less-cyclical stocks and a rush toward bond substitute stocks like REITs, MLPs, etc., as investors search for yield in a declining interest rate environment. The result has been that certain companies that are perceived to be more cyclical and less defensive have become very cheap, most particularly finance companies and industrials. The Focus Fund has been overweight those sectors for more than two years while underweight consumer staples, telecom stocks and utilities.

That was a headwind in 2015, as investors continued to pile into these safe and bond substitute stocks, but we are delighted to report that this has changed in 2016. As the outlook for regulation has improved and interest rates have increased from 1.35% on the 10-year to 2.40%, investors are coming our way and noticing that many of these high-quality financial stocks represent real value, as do some of the higher-quality industrials and producer durables. As a result, we are having a very good year beating our benchmark and the broad market.

TWST: Do you at all try to evaluate companies that

have a high degree of innovation or even some degree of speculation as part of their mandate or portfolio, and if so, how do you handle that?

Mr. Bobrinsky: Generally, we as value investors are going to be less likely to invest in a company whose future performance is based on developing a new technology or new product that doesn't exist today. Because a further finding of behavioral finance in psychology is that people tend to be overoptimistic, and tend to exhibit planning errors and overestimate a company's ability to generate new revenues in the future that they haven't produced in the past. We, as a result, overweight the portfolio with companies with proven track records and proven assets rather than on speculative future development.

Now, many of the best companies have both. **IBM** (NYSE:IBM) has a spectacular existing consulting business, but it is on the forefront of developing Big Data applications through its Watson technology. We love that **IBM** trades at only 11 times forward earnings. We think we are getting a consistent and predictable, proven business plus the upside from new technologies. Many of our health care companies exhibit similar characteristics.

TWST: Can you provide some examples or an example from that area?

Mr. Bobrinsky: **LabCorp** (NYSE:LH) is a company again trading at a very modest forward p/e multiple of 13 times earnings based on their core testing capabilities. We believe that preventive testing is already an important part of health care, but will become even more important in the future. **Labcorp**, however, has made an exciting investment in the drug-discovery industry through its merger with **Covance** that will put the company on the cutting-edge of new small-molecule development for the pharmaceutical industry. Again, we think we are getting the best of both worlds: a great existing business that will grow modestly combined with real upside from **Covance's** products in the biotech and drug development industry.

1-Year Daily Chart of Laboratory Corporation of America



Chart provided by www.BigCharts.com

TWST: What is a name that you think that is a sort of another very misunderstood or under-appreciated name that one wouldn't necessarily connect to a value fund?

Mr. Bobrinsky: I am going to say **Mosaic** (NYSE:MOS),

which is the fertilizer company. It is trading at a big multiple of earnings because of depressed fertilizer prices, so many people might not think of it as a value stock, but fertilizer prices are low because of a dispute between east European suppliers and a price war that developed as a result. We believe **Mosaic** is trading at approximately 50% of the replacement cost of its mines and that longer term, as in 10 to 15 years, worldwide population growth will absolutely require greater consumption of agricultural products, which will in turn require a greater consumption of the agricultural fertilizers which **Mosaic** produces. So the forward multiple makes it look like a growth stock, but only because earnings are temporarily artificially depressed.

Coming back to **KKR**, many people would be very surprised to see that this highly respected, very profitable alternative asset manager was trading at only 8 times projected earnings. We think it is one of the real hidden gems in the stock market today.

TWST: I noticed on your most recent fund profile that other than for the small-capitalization grouping, you have quite a bit of clusterings in all the other capitalization groupings at the moment. Is that on purpose?

Mr. Bobrinsky: We do call this an all-cap fund. We do think that value clusters sometimes by market cap. Today it is relatively well-spread, but my personal opinion is that there are modestly less opportunities in small-cap value today, as institutions have dedicated relatively large allocations to the small-cap value asset class. In larger market capitalizations, more money has moved to indexed products, which can produce individual stock opportunities as there are less stock pickers today than 20 years ago.

TWST: Why today should somebody choose your value fund over another one? Can you give us reasons why they might make that selection?

Mr. Bobrinsky: Value as an asset class has been challenged for several years. But we really do believe that the tide

is turning. The Ariel Focus Fund is trading at a very reasonable 14 times forward earnings compared to the S&P at over 17. In addition, we are less exposed to the bond substitute stocks I described earlier, and therefore are less sensitive to the increase in interest rates, which we expect. In fact, an increase in interest rates and/or an increase in inflationary expectations will be very positive for the Ariel Focus Fund. Many of our largest positions are companies that will benefit from a return to a more normal interest rate environment. For example, of the large investment banks, **Morgan Stanley** (NYSE:MS) and **Goldman Sachs** (NYSE:GS) will earn significantly higher returns on equity in a normal interest rate environment.

TWST: Is there anything else you wanted to add that we haven't covered about the fund?

Mr. Bobrinsky: The fund should also perform well when inflationary expectations return, and fertilizer companies, gold and copper companies like **Barrick Gold** (NYSE:ABX), oil exploration and development companies like **National Oilwell Varco** (NYSE:NOV), should all do better as inflation returns to its historical norm.

We are having a very good year in the Ariel Focus Fund with performance in the top 5% of our category according to Morningstar. We feel there is a fundamental shift going on in the markets that is coming our way.

TWST: Thank you. (KJL)

CHARLES K. BOBRINSKOY

Vice Chairman, Head of Investment Group and Portfolio Manager

Ariel Investments, LLC

200 East Randolph St.

Suite 2900

Chicago, IL 60601

(312) 726-0140

www.arielinvestments.com