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MONEY MANAGER INTERVIEW

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Striving for Margin of Safety, Preservation of Capital in a Global Growth Fund

JULIAN PICK, POLEN CAPITAL



JULIAN PICK joined Polen Capital in 2014 and is Portfolio Manager on the firm's Global Growth strategy. Prior to joining Polen Capital, Mr. Pick spent the majority of his career as a Research Analyst and Portfolio Manager with Janus Capital in Denver, Colorado, where he co-managed the Janus Institutional International Equity Portfolio and the Janus Advisor International Equity Fund. His prior experience also includes working at Sands Capital Management in Arlington, Virginia as a Partner and Senior

Portfolio Manager where he helped launch the Sands Global Growth Strategy. Mr. Pick also served as Managing Director of Global Equities with Deutsche Bank in London. Mr. Pick received his B.S. with distinction in economics from George Mason University and is a CFA charterholder.

SECTOR — GENERAL INVESTING

(AGT509) TWST: I was reviewing the fact sheet on the Global Growth Fund. So I was wondering maybe to begin with, you could just share with me your investment philosophy, and how you build your portfolio and how you manage it going forward. I see it's a fairly new portfolio.

Mr. Pick: Perhaps the first thing I should say is that Polen Global Growth is the second product or the second offering in Polen Capital's 29-year history. So for almost 30 years now it's been a one-product firm, and our flagship is Polen Focus Growth, which is a concentrated strategy that invests in relatively very high-quality businesses here in the United States, and today that strategy is close to \$11 billion in assets. So our goal is with the global strategy to work with the same philosophy and the same process, but to eliminate some of the constraints and to invest wherever the great businesses are. They are quite often there in the United States, but often there in other parts of the world, too. And the nice thing about investing globally — if you're a very long-term quality-oriented investor — is you can go and find the best of breed wherever they are. That's one comment I would share with you.

The other one is to make that a bit more specific: Today, the global strategy invests in 27 globally competitive, high-quality growth businesses. So as a manager, we believe that quality investing

works over time. It doesn't work in every single investment environment, but actually it does quite well in most environments, and above all, it does well over time.

The whole market of our portfolios here at Polen are compounding earnings growth, high-quality growth; we have a number of ways we can show that with you, but also a margin of safety. In fact, the whole business here at Polen Capital was established by our founder David Polen, whose insight was to apply a margin of safety to growth investing. So our Global Growth strategy will always be quite consistent with that philosophy, with no change with respect to quality. We set the same high bar for our growth business regardless of where it is in the United States or elsewhere.

TWST: You said there were three aspects: compounding earnings growth, the high-quality growth and the margin of safety. Why don't we talk a little bit about each of those components? When you're screening for companies, what are you looking for first and foremost?

Mr. Pick: We do use financial screens mainly to narrow down our investable universe. So for a global strategy like ours, the investable universe is actually huge. For the sake of argument, you could call it about 3,000 companies globally. In

fact, you could measure in some ways and come up with a much

Highlights

Julian Pick discusses his firm's Global Growth Fund. Mr. Pick says the theme around the fund is to invest where the great businesses are. It is long-term, quality-oriented investing with a large-cap basis. Mr. Pick says the heart of the philosophy is the concept of margin of safety, as it is important to filter out the macro, currency, political and other risks that come with global investing. He also says preservation of capital is very important.

Companies discussed: Nestle SA (ADR) (OTCMKTS:NSRGY); Colgate-Palmolive Company (NYSE:CL); Tencent Holdings Ltd (OTCMKTS:TCTZF); Facebook (NASDAQ:FB); Alphabet (NASDAQ:GOOG); JD.Com (ADR) (NASDAQ:JD) and O'Reilly Automotive (NASDAQ:ORLY).

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One of the first things we do in our process is screen out a number of companies with lower-quality earnings. And by screening them out, I mean that we eliminate those companies that tend to have large amounts of debt or might be generating earnings at rather low returns on capital or equity capital, or struggling in terms of underlying unit organic growth. Perhaps they are generating a lot of their growth from financial engineering or in fact are experiencing pricing or competitive pressures on margins.

So one thing I would like to mention here is that when we apply these simple financial screens, which really amount to a very fairer quality check, our investable universe immediately shrinks by almost 90%. In fact, it shrinks from about 3,000 companies to maybe 350, something like that. So although we're working with this huge investable universe, when you have this high-quality bar, things actually shrink down for you very quickly.

TWST: And so you said some of the things that would throw them out of the list would be lower-quality earnings or the heavy debt load, low return on invested capital, and so you screen that out. And you started with a universe of about 3,000 companies, and now you're down to a universe of about 350. I'm assuming these are all large-cap companies?

Mr. Pick: We tend to have a big, real large-cap bias. So if you look at our portfolio today of — as I've mentioned — 27 companies, the average market cap is more than \$100 billion. So what we actually have is a bias toward very high-quality growth businesses with tremendous competitive advantages for the globally competitive. So what comes on that is these companies are often quite large cap. And once in a while, we find what we're looking for lower down the market-cap spectrum. We will occasionally invest in companies with, let's say, less than \$20 billion of market cap, but in that situation, we're doing it because they have exceptionally strong competitive positions.

TWST: So you're going through your screening process, and now globally you have a list of 350 stocks you're going to take a closer look at. What is the next step in your process?

Mr. Pick: So, research process at Polen Capital, it's quite thorough. We're quite serious about doing our homework, taking our time, and the research process here is quite collaborative. So I, as the PM of Polen Global Growth, like our other portfolio managers, I work quite closely with the analysts. Any one of the analysts here is capable of undertaking an initial financial announces or shallow dive into something we're considering for an investment. And any one of us is quite capable of doing a subsequent deep dive if necessary in our process.

So just for you to explore that a little bit more, when a company screens really well for us, we do want to dig into that a little bit more. We tend to go back and look at financials for a company over a rather long period of time, five to 10 years. One reason for that is that we ourselves are quite long-term in our investment horizon. We don't consider any kind of investment unless we expect to hold it for at least the next five years.

Right now in the global portfolio, portfolio turnover is rather slow and consistent, with more or like a 10-year holding period. So we like to test what we're seeing in a company's financials over a longer holding period and a longer period of time. Once we've done that, our initial, or if you like shallow-dive research tends to narrow down our investment universe even more. And in my opinion, the true investable universe at Polen, like companies that we're working with the Polen Global Growth, is only 100 to 150 globally. These are the kind of companies that's not just on an initial screening, but on a first test, if you like really do meet the kind of quality criteria we're looking for.

After that it comes on more value-added research, which is the in-depth work that we do. I've often felt that it's an advantage to be located away from the major financial centers. It's good if it means your analysts and your research are more independent. And we do deep-dive independent research to look at every investment candidate for the portfolios. So the nature of research is inherently inefficient, and it's certainly true in the investment industry as well. We take as long as we need to. And sometimes we can't measure exactly how long our research process takes, but it clearly takes some months at minimum. This is where we really begin to understand a business and the industry it operates in a far more detail.

A lot of the most value-added research we do in my opinion is around the competitive space and the competitive advantage that a company has. We often visit or meet a company during this stage of our work. We will do a third-party research, so that is we will do our own research with third parties, so just supplies or competitors or employees sometimes. So this is why we do the heavy lifting in our research process. It's one reason that we have a really cohesive investment team at Polen Capital.

1-Year Daily Chart of Tencent Holdings Ltd



Chart provided by www.BigCharts.com

First of all, to be happy in this investment team, you have

to be very curious; you need that kind of insatiable curiosity that drives on finding out new facts, digging in. And you also need to be really patient, because as a firm we tend to invest rather deliberately with a very long-time horizon. So while we have quite a cohesive team and we work quite collaboratively, there's also quite a few people in the industry that wouldn't be happy in our team, because I've mentioned that we have this rather thorough collaborative research process, but the portfolios at Polen are all individually managed. So we like team-based research. We like decision-making by individuals who are 100% accountable to clients for everything and not to the portfolio manager role at Polen.

“We are here to first, preserve and protect our clients’ investment with us, and second, grow it. So margin of safety and preservation of capital are very important to us, and it’s what we strive for on behalf of clients.”

In the global strategy, as I mentioned in research, we are at the heart of our process and philosophies this concept of margin of safety. It's very important to us that we filter out a lot of the macro, currency, political and other risks that sometimes come with global investing. Our portfolio construction process is designed to do that. We want our 25 to 30 great businesses, we want them to carry on compounding, and we want that business performance by compounding to drive investment performance over many years.

So there's a number of steps we use to avoid the wrong kind of thing getting in the way. There are a number of countries around the world where there is too much economic, political or currency risk for us to invest. So sometimes we find the right businesses in the wrong part of the world, and both don't make the count in the portfolio. There are also a number of industries which historically have struggled to generate the kind of returns on capital we're looking for, that is 20% or more return on equity capital, but without leverage. And in fact, some of those industries are also rather volatile and cyclical in terms of their earnings performance. So part of my job as a Portfolio Manager is not just to be a gatekeeper, but it's also have to be proactive in protecting a portfolio from these kinds of macro sector and geographic risks.

TWST: Let's talk a little bit about the geopolitical situation. Which countries would be excluded from your investing process at present?

Mr. Pick: All frontier markets, most but not all the emerging markets. So for example, we have — since before the inception of the strategy, we've identified businesses that we certainly respect in, for example, Brazil, but we've also found the kind of macro and political risk in Brazil very difficult to work with. Same with South Africa, but with a little bit more of an eye on political risk, and same in Russia. In fact, out of the four-circle BRICS, we think that only China and India are investable for us right now in the global strategy.

TWST: OK.

Mr. Pick: In terms of sectors, there's actually quite a few of them. For us, it's really hard to find what we're looking for in sectors, including financials, at least certainly the banking component of the financials. Most materials, energy, industrials, utilities — it's quite interesting, when we rephrase that, it's just not easy to find earnings quality across these kinds of sectors, even though they can be a larger component of the benchmark.

TWST: Are you avoiding those sectors right now, and they would be underrepresented in your current portfolio?

Mr. Pick: They would; they've also been underrepresented in Polen flagship since its inception. So for example, Polen Capital is a firm that has not owned a bank or an energy service company throughout its history. And I think if we did, we would be impairing the earnings quality of our portfolios, and that's not what we're here to do.

We are here to first, preserve and protect our clients' investment with us, and second, grow it. So margin of safety and preservation of capital are very important to us, and it's what we strive for on behalf of clients. There are lots of other ways to achieve an investment return. It's possible to be a far more aggressive growth investor than we are. It's possible to track the stock market or benchmark performance quite closely, but that's not what we're here to do.

TWST: And again, just sort of on a geopolitical perspective, does the incoming administration, and because it's been quite a bit less traditional than what we've had before, causing any concerns or is it just keeping your nose to the grindstone?

Mr. Pick: So first of all, there is a degree of uncertainty. I mean, as you say, “incoming administration,” there's a great deal we don't know yet about the new administration on exactly what will be done and when. What we can say is there's been a very clear reaction by global capital markets, not just the stock market in U.S. And you can see this across equity markets, bond markets and FX markets as well.

1-Year Daily Chart of O'Reilly Automotive, Inc.



Chart provided by www.BigCharts.com

In the relatively short time since the election, global capital markets are signaling an expectation that there will be a significant degree of fiscal stimulus of spending in the U.S. coupled with the probability of rising interest rates over time. You can see that in the equity markets, the bond market and the FX markets, too. That feels to me like discounting quite a lot quite quickly. It's meant to a sector

rotation in the fourth quarter of this year that is certainly benefiting some of the sectors we as a firm do not invest in. We don't invest in them because they don't represent the kind of quality we're looking for.

“In the relatively short time since the election, global capital markets are signaling an expectation that there will be a significant degree of fiscal stimulus of spending in the U.S. coupled with the probability of rising interest rates over time.”

But that's what the stock market does. The stock market goes through different phases, and the stock market likes sector rotations, and it gets excited and then depressed. For example, I said that a big part of our mission was to let business performance or compounding earnings drive investment performance. Well, this year we will see approximately 15% earnings growth across our global growth portfolio in U.S. dollars, so after some currency drag. This year, through our broader markets, earnings growth will be closer to zero, perhaps a slight positive, zero to 2%. So our approach to investing is really to ensure that we are sustaining these kinds of double-digit earnings growth numbers year after year regardless of what the stock market is doing.

This is the second year for the Global Growth portfolio. For the first year, the number was very similar, also in double-digits in U.S. dollars in earnings growth. And by the way, that's also very similar to the history of our flagship over its 27 years. So on the one hand, it would be fair to say that we're not participating in this reaction or knee-jerk reaction, because we don't necessarily invest in highly cyclical businesses when they don't represent the kind of quality we want. On the other hand, from a longer-term investor, I think earnings growth, especially with the power of compounding, tends to drive returns over time, and I don't think that's changed.

TWST: Do you want to spend a few minutes talking about the holdings in your portfolio? Why do you like Nestle?

Mr. Pick: What if I might do if I may is, before we get to Nestle (OTCMKTS:NSRGY), just frame in a little bit more. About our holdings, I mentioned there were 27 of them. The average portfolio market cap is well over \$100 billion, \$136 billion to be precise as of September 30. I mentioned that we had double-digit earnings growth last year. We're very much on track this year. We expect between 14% and 15% U.S. dollar earnings growth from this portfolio for the next five years. That's not a one- or two-year forecast, that's a five-year forecast based on our own research, but also some rather conservative assumptions.

So the hallmark of this portfolio has to be these kinds of businesses that are competitively strong and quite predictable for us to have a strong sense of where they'll be in a few years from now. But there's one other dimension of the portfolio I'd like to mention if I may, and that is the portfolio in aggregate is in a strong net cash position; in other words, if you look at the balance sheet of each company in this portfolio, in aggregate they have more cash than debt on the balance sheet.

It's been several years since people thought too much about debt and indebtedness. We will just share the thought in passing that corporates in the United States, for example, have as much debt — almost as much debt today as they've ever had, more than \$6 trillion. U.S. corporates have been raising more than \$1 trillion in debt every year for the last few years. We see even extremely high-quality businesses like Colgate (NYSE:CL) for example, Colgate-Palmolive, Inc. raising debt in order to distribute more capital to shareholders in the forms of dividends and buybacks they've generated in the form of free cash flow every year for the last few years. This is the right unusual time in terms of investors, corporates, even societal attitudes toward debt. We saw the consequences of some of that in the last global financial crisis, but the world has continued to binge on that since then.

So we may go through periods of underperformance in a kind of risk-on market environment, but I would like to stress that for us, the importance of balance sheet strength doesn't go away. It's absolutely essential for the quality of earnings and the quality of the portfolio. That brings us to Nestle. And Nestle is one of the slower-growing businesses in the portfolio. In fact, we embrace companies, we embrace investments with different growth rates. We have some companies in the portfolio that might only grow perhaps around 10% in terms of earnings per share per year, but they can do that very steadily year in, year out despite different times in the market cycle. We have some companies that have a nice balance of recurring cash generative earnings growth, and we have some tend to grow faster.

1-Year Daily Chart of Nestle SA



Chart provided by www.BigCharts.com

So within this portfolio we do, in fact, have companies that would grow earnings per share between about 10% and about 30% over the next five years, and Nestle very much falls in that safety end of the spectrum. It's one of the largest companies outside the United States. The core of the business is food and beverage. It's a company that has been compounding steadily, and I think that if we look at the numbers, we would probably see that Nestle has compounded dividend growth at around 9% probably since the Second World War. So it's not as sexy as some of the holdings we have, and including Tencent (OTCMKTS:TCTZF), for example, or possibly Facebook, but going back to our concept of margin of safety, we're strong believers there's a place for steady compounding

in the portfolio as well as faster growth rates.

TWST: I'm going to cherry-pick a little bit and not go straight down the list, because we all know about Alphabet, but let's spend a minute also talking about Tencent.

Mr. Pick: Well, I'm glad you mentioned **Tencent**. There's an American secret about **Tencent**. **Tencent** has actually become the largest company by market cap outside the United States. As you mentioned, relatively few people are familiar with it. It's not like **Nestle** where we all know and use the brands. **Tencent** is based in China. The company is not necessarily — let me rephrase that, it's not — it doesn't quite perform to the kind of business that we're used to here in the West as consumers. In fact, **Tencent's** proposition to its customers, to its users is perhaps even stronger than what we're used to in the West.

What I mean by that is that **Tencent** is really based on social media. It's a social media company, and one of its core assets is the Weixin or WeChat app. You could start by thinking of **Tencent** as a little bit like the **Facebook** of China, except **Tencent** has gone far further, much further in terms of bundling other services, apps and features than **Facebook**. It therefore has other revenue sources.

For example, **Tencent** is one of the biggest distributors of online games globally. It also participates actively in online shopping through an investment in **JD.com** (NASDAQ:JD). It also has a number of premium and value-added services that users pay for, and its advertising business is growing rapidly, too. So **Tencent** has achieved an integration of services that make it, if anything, even more popular, with even more user engagement than **Facebook** has achieved in its markets. In fact, **Tencent** is generating more revenue per user than **Facebook**; it's become indispensable.

Another intriguing, at least to me I think, in terms — about **Tencent** is the concept that half of the users have already linked the app to their bank accounts. So **Tencent** has become part of the mobile experience and users' lives in China. It's not just a deeply entrenched business; it scales very well and is incredibly hard to compete with at this stage. And this is why **Tencent** has emerged as the most valuable company in this listed company outside the United States — of what you could find if you are prepared to step outside U.S. borders. There are many companies, there are some great companies here in the U.S., but there are some great companies in other parts of the world, too.

TWST: Yo finish up, I'm going to throw you a curveball here, because it couldn't be any more different from Tencent.

Mr. Pick: Please, go ahead.

TWST: O'Reilly Automotive?

Mr. Pick: Yes, well thank you for noticing that we are quite comfortable with some very different businesses; they represent the kind of quality we're looking for. The largest fleet of cars in the United States — sorry, in the world is here in the United States. People really depend on their cars here, I think you'll agree, whether it's a school run or getting to and from work or perhaps going to visit a relative, they are indispensable. So they need health care, they need over-the-counter health care just like people do, and **O'Reilly** (NASDAQ:ORLY) is a leading supplier of parts, not just to individual owners, but to the trade, to professional car repairs as well.

It's an intriguing business in a way, because when you need your car repaired, you really need it repaired today. You don't really have that luxury of waiting around for a couple of weeks for the right parts to come in. The other side — intriguing aspect of this is that most people are driving older cars than they have — sorry, let me rephrase that better — the fleet has aged, and people are driving older cars because they tend to be more valuable; they tend to be more reliable than they were a few decades ago. In other words, it's really worth investing or repairing your vehicle. You can expect more miles that in the same vehicle than you can before. Yet the industry that controls distribution of car parts is still rather fragmented.

O'Reilly is one of very few that achieved economies of scale in distributing car parts, meaning not just availability of sheer numbers of parts, but also speed of delivery and ability to work closely with you as an owner or indeed with the shop. So you're right, it's a different part of the world. It's a very different business model, but it also strikes us as a fairly compelling business that creates a lot of value for the shareholders as well as for its customers.

TWST: Absolutely, and you're correct every time I drive by an O'Reilly, I will see somebody with a hood of their car up trying to fix it in the parking lot.

Mr. Pick: Yes.

TWST: It's been an interesting discussion. Is there anything that you would like to add that we have not talked about?

Mr. Pick: Thank you for covering the ground. I think you have covered a great deal. I would just like to echo something else if I may, probably because it's something that our founder David Polen has said before in an interview with yourselves at *Wall Street Transcript*. Please bear with me one second. I was going to grab the — it's just from a *Wall Street Transcript* from February, 2010. One of your colleagues interviewed David Polen, our founder, and Dan Davidowitz, who is Portfolio Manager, Lead Portfolio Manager of our Polen Focus Growth strategy here in the U.S.

But where are we heading with this seems to be over six years ago, David commented — and we can send you this, it's useful — David's comment was in order to be a great quality company today, whether it's in technology or health care or any other business, it's usually necessary to be operating globally. This is where we're coming from. It can be a little limiting and artificial to say investing in the U.S., but not in the rest of the world. Keep in mind that U.S. companies themselves are investing and making significant — typically generating significant earnings and revenues from rest of the world. So I think we needed to extend David Polen's insight, apply the same philosophy to get rid of the constraints, invest globally.

TWST: Thank you. (JM)

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