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INVESTED IN THE LONG RUN

Alternative Sources of Diversification and Return

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Portfolio manager Nate Palmer, CFA, recently shared his thoughts on long-short investing and how it may be a practical approach for investors seeking diversification and a differentiated risk-return profile.

Nate Palmer, CFA, CPA
Portfolio Manager

How might a long/short strategy fit into an investor's portfolio?

Nate Palmer, CFA: We've learned over time that there are a relatively wide range of ways in which our long/short strategy might be used in investors' portfolios. Some of the common themes tend to be investors seeking favorable risk-adjusted returns, investors seeking the return of equities but with less volatility than the overall market, or investors seeking a return that's more dependent on alpha or value-added stock selection in each the long book and the short book rather than beta or the return of the equity market as a whole.

If we expect the environment going forward will produce more modest equity market returns, long/short strategies that have net exposure less than the market but can add value through stock selection — in the long and short books — seem to be appealing to investors who are seeking a different risk-reward profile than what's offered by long-only strategies.

What is your approach to long/short investing?

Nate Palmer, CFA: We view investing as taking an ownership stake in a business, so our research process is designed for us to think like business owners in the same way that an owner-operator would. We look for businesses that are being mispriced by the market. That said, the best value propositions aren't necessarily found in the most statistically cheap stocks or stocks trading at the lowest multiples of current earnings or revenue. Our process is designed to identify businesses that are mispriced relative to their long-term earnings power or mispriced relative to the fundamentals they'll be producing several years into the future.

I'd emphasize that being approximately right about the future fundamentals of a business is crucial in determining our estimates of intrinsic value. And if we're right about the future fundamentals — the revenue and the earnings power — we believe it will ultimately be reflected in the market price of a business.

What characteristics do you look for in a long position?

Nate Palmer, CFA: One of the key characteristics we like to see in long investments is durable competitive advantages. That might come in various forms — the ability to grow with attractive incremental profit margins; a product or service that provides a strong value proposition to customers; growing end markets; taking market share within those end markets; a product or service that's not likely to be susceptible to obsolescence or replacement; and a management team that we trust to operate the business in the best interest of shareholders over time.

You're almost never going to get all those characteristics in a single business. But it's important to emphasize that we want to get these characteristics at a market price that doesn't currently reflect their full value. We're focused on businesses where we can get some of these favorable characteristics at a discount to what they're worth.

We always want to be making long investments at prices that are at a discount to our intrinsic value estimate of the business. If we do that, then there will be two sources of our long investment return over time. First, a portion of our return will be attributable to price converging with the intrinsic value of the business. The other portion of our return will be attributable to the business growing its per share earnings power and thus growing intrinsic value over time.

Alternative asset manager KKR is an example of one of our long positions that enjoys some of these characteristics. KKR is benefiting from relatively strong industry tailwinds driven by growing allocations to private markets and private equity strategies. The company has been a market share winner over time, and we expect that to continue going forward. KKR has also generated growth from newer strategies and inflows from attractive channels, including public pension plans, which currently comprise about 50% of KKR's AUM.

We find situations like this appealing where we're able to identify a business in which we have high conviction in its future fundamentals, its intrinsic value is likely to continue to grow over time, and we're able to establish an ownership stake at a meaningful discount to its intrinsic value.

What role do short positions play in the portfolio?

Nate Palmer, CFA: To start, we're always looking for businesses that are being mispriced by the market. For the short book, that means we're looking for businesses that investors are currently overpaying for — and that's a function of having a differentiated view of the future fundamentals of a business. Our short positions collectively represent overpriced businesses that we expect to underperform the Russell 1000 Index over time. Our short book also helps reduce the market risk associated with the overall portfolio.

We value businesses for the short book the same way that we value businesses for the long book in that we project the future fundamentals of the business over the next five years and then we apply a normalized multiple to normalized earnings in year five. While there's nothing magical about our models, I do believe our process ensures that we have a deep understanding of the business and the industry in which it competes. As companies report results over time, our initial fundamental expectations become observable data points, and we evaluate whether actual fundamentals are consistent or inconsistent with our short thesis.

It's important for us to be objective about this because the risk-reward profile of shorts is different than longs. If a short position goes to zero, you've generated a 100% return, but that's also your maximum gain. On the other hand, if your thesis is wrong, you could lose multiples of the price at which you shorted the stock. So, the penalty for being wrong tends to be far more significant on shorts than on longs, and therefore properly understanding the range of potential fundamental outcomes matters immensely when we're evaluating potential short positions.

With our short positions, we really emphasize getting the future fundamentals of individual businesses right. Our intrinsic value estimates are a function of our projections of future fundamentals. So, it's important that we have a thorough and accurate understanding of the normalized fundamentals of these businesses. If we do that well, we tend to be pleased with our ability to add value through stock selection in the short book.

What characteristics do you look for in short positions?

Nate Palmer, CFA: When it comes to finding short ideas, we tend to like opportunities where the long thesis seems unappealing to us. Of course, there are plenty of instances in which, even if we don't necessarily subscribe to the long thesis, that doesn't mean we want to short it. Businesses growing their revenue bases at very high rates tend to fall into this category. We may think investors are overpaying for high revenue growth, but unless we have reason to believe the revenue growth is going to decelerate within a specific timeframe, or the normalized unit economics of the business are particularly poor, we're likely not going to get involved. We need to have reason to believe the revenue growth deceleration is likely to occur in the next two or three years for it to be an attractive short opportunity.

Two current short positions — UPS and Teradata — are great examples that illustrate the type of risk-reward profiles we view as favorable for the short book. UPS is a logistics and delivery company. During 2020 and a good portion of 2021, supply chain constraints created above normalized volumes and pricing for UPS's business that we expect to normalize to previous levels over the coming years. Amazon is a relatively large customer for UPS, representing over 13% of the company's 2020 revenue and roughly 12% of its 2021

revenue. Amazon has been investing significantly in its own delivery capabilities, and we believe it's likely to offer those capabilities to third parties, which would pose a meaningful headwind for UPS's business. Additionally, UPS hired a new CEO in recent years who had been a longtime CFO at Home Depot, and the company began heavily emphasizing margin expansion. While there's nothing wrong with margin expansion — we tend to admire businesses that are run in a cost-disciplined fashion — growing operating income through margin expansion is not necessarily a recurring source of operating income growth.

A far more appealing way to grow operating income is to grow your revenue base persistently over the course of many years. With UPS, we suspect the company is being disciplined on costs in the near term but once you've taken out all the excess costs, if revenue growth disappoints (as we suspect that it's likely to), we think UPS investors may be disappointed with future operating income growth as there's little to no room for incremental margin expansion.

Teradata is a software company that provides data warehouse software. It's a business that has been statistically cheap at times in the past, so we had done work on it as a potential long investment. We never took a long position in the company, but it's a business where we had a substantial amount of historical knowledge. We believe Teradata is overexposed to the wrong portion of the enterprise data warehouse market. A lot of enterprise data warehouses are shifting to the cloud. Teradata has told a nice story about its cloud offering, but it competes against Snowflake and many other companies that have at least as appealing of cloud offerings. Ultimately, we don't believe Teradata is likely to compete successfully for the number of new customers it needs to justify the current market price.

In 2021, a lot of optimism built around Teradata's cloud strategy and its ability to compete against some of these cloud native data warehouse companies. Teradata has been able to transition some of its legacy on-premise customers to its cloud offering, but the company has had limited success at winning new customers. We believe this is due in part to the fact that changing customer perceptions is quite challenging, and we think a lot of customers view Teradata as a legacy software provider, not as an innovative cloud software provider. We believe the company will have a challenging time fighting those perceptions and optimism over its ability to win new customers is likely excessive.

Are there particular spots in the market today that are ripe for finding short ideas?

Nate Palmer, CFA: One of the advantages of having a deep and experienced research team is that we're always looking for opportunities in a lot of different places. There's always opportunity somewhere — we just have to find it. Most recently, we have found some short opportunities that we believe investors are overpaying for as they seek stocks they perceive to be "safe" or less economically sensitive.

Clorox and JM Smucker Company are two examples of stocks that we shorted in Q1 that fit that profile. With each company, we ask ourselves why the market was valuing these businesses at prices above what we believe will be justified by their future fundamentals. It seems to be at least partially because these stocks were perceived to be safe havens in the near term when market volatility ratcheted up in 2022. Our view is that price always matters, and when we believe others are overpaying for businesses, that creates opportunity for us in the short book.

Health care is another area in which we've been doing a fair amount of digging recently. Part of the appeal is the wide range of businesses and business models within the sector. There are times when rising tides tend to lift most businesses within a sector, but not all of them will generate future fundamentals to justify current market prices. It's our job to identify businesses that the market is valuing too generously.

Technology also served up some of those opportunities in recent years. While there are plenty of reasons to like technology businesses, there are at least two important caveats: first, there's no business so good that there's not a price at which it's a poor investment. And second, a mediocre business tends not to warrant a premium valuation just because it happens to be in the technology sector. Plenty of market participants seem to have forgotten one or both of those realities in 2020 and 2021. We were able to benefit from that at times in our short book.

I also think that even though some businesses have experienced significant share price declines this year, it doesn't make them cheap relative to any relevant fundamental metric. Some investors think just because a stock is down 30%, it must be cheap — that's just not necessarily the case. Eventually, stock prices will reflect the normalized fundamentals of a business. So, despite the market declining year to date there are still plenty of potential short opportunities for us to dig into and trust me we're going about it with a great deal of intensity and focus.

How do you measure success of your long/short strategy?

Nate Palmer, CFA: The purest measure of value add through stock selection in our portfolio is the long-short spread — the extent to which our longs outperform our shorts. We look at the long book and the short book individually, each relative to the Russell 1000 Index, to measure how much alpha is generated in each. Over the long term, the long book needs to outperform the Russell 1000 and the short book needs to underperform the Russell 1000. If we generate a favorable long-short spread, with each the long book and the short book contributing alpha relative to the Russell 1000, then we position the portfolio to generate favorable risk-adjusted returns for investors in the strategy.