Defense Wins Championships Transcript

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Portfolio Managers: Brad Hinton & Dave Perkins

Weitz | INVESTMENT MANAGEMENT

Operator: Good day, and welcome to the Weitz Investments Large-Cap Value Update conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Jo Ann Quinif, Director of Marketing and Client Services. Please go ahead.

Jo Ann Quinif: Well, hello. Welcome to our first Weitz Investment Management call of 2015. Thank you for joining us today. Our call today is going to focus on our Large-Cap Value Strategy, and is the first of a five-call series for the year. On April 23, Wally Weitz and Drew Weitz will host a webinar focusing on our Small and Mid-Cap Value Strategy.

Since the day Wally started our firm over 32 years ago, we have focused virtually exclusively on research and investing. It is simply who we are. This shows through in our deliberate and measured manner in which we grow our business, our decision to remain independent and employee-owned, and how we work as a team. We now have 38 employees with 35 of those here in Omaha. John Gabriel, Sean Mihal and our newest addition Kelly (Kratz) work remotely, serving our clients across the country. We've had no departures from our Investment team or Client Service teams. We are looking to add to our team, and hope to identify exceptionally talented individuals that will be a natural fit into our collegial and collaborative work environment over the next year.

Our nearly $6 billion in assets are primarily in five main offerings: Large-Cap Value, which we're obviously talking about today; Mid-Cap Value; Multi-Cap Value; Multi-Cap Alternative; and a Short-Intermediate Fixed Income Strategy. We offer separate accounts and mutual funds. In 2014 we launched an Institutional Share Class for our Value Fund, the Large-Cap Strategy, and our Partners Value Multi-Cap. In addition, as a natural complement to our fixed income capabilities, we launched a Core Plus Income Fund, which is co-managed by Tom Carney and Nolan Anderson.

We have one philosophy of process when it comes to equity investing. So as you listen to this series of calls over the next year, you will certainly hear our core principles that resonate across all of our Strategies. We don't try to over-complicate it, and we believe much of what we do is based in common sense. Having the right temperament and patience to identify undervalued stocks and buy them at the right time, we believe, is a unique skill and one where we can add great value. Information on all of our offerings is available on our website at weitzinvestments.com.

Well, I think that takes care of some of the housekeeping items about the Firm in general, and so we'll get the party started, so to speak, with the people of why you're here today. So Brad Hinton joined Weitz in 2001 and is currently our Director of Research. He is a Portfolio Manager on our Balanced Fund and joined Wally in managing our Large-Cap and our Multi-Cap Strategies in 2006. Dave Perkins has been with our Firm for over ten years now and joined Wally and Brad as a Co-Portfolio Manager on the Large-Cap Strategy in 2011.

One last item. We will take questions following the prepared remarks today, but you are also welcome to e-mail questions to advisors@weitzinvestments.com throughout the presentation, and we will answer as many as possible at the end of the call today. I do believe they threw a wrench in and there is a Q&A tab on the webinar site as well, and we will address those questions at that time too.

So with no further ado, I will turn this over to Brad Hinton.

Bradley P. Hinton: Thanks, Jo Ann. Let's turn to the agenda and jump right in. First, we'll take a minute to briefly review our core principles; it just wouldn't be a Weitz call without it. Next, we'll do a look back at the last few years, followed by a recap of our major activity during 2014. After that, I'll turn things over to Dave; he'll discuss positioning heading into 2015 and provide deeper looks into a pair of hot topics: specialty pharma and energy. Dave will close with a snapshot of our on-deck list, and then we'll open it up for Q&A.

So starting with core principles. In all that we do, we think like business owners, which demands that we take a long-term view. Our longer investing horizon allows us to take advantage of fear and greed in the market, and we think the value of this edge is only increasing as the world becomes ever more short-term focused. We're an independently owned Company and we think for ourselves. Our portfolios are different, with no predetermined asset allocations or industry weightings. There's no closet indexing here at Weitz. We take what the market gives us and we don't try to force things. When we do make a mistake, we admit it and we move on.

Valuation is our north star. Everything that we do comes back around to Ben Graham's principle of margin of safety. "What is the business worth?" and "Where does the stock trade?" are the two questions we ask every step of the way. We believe the good ideas are rare, so we try to concentrate on our best ones. We manage 25 to 35 stock portfolios where every holding matters.

And finally, we're aligned with our investors. We all invest heavily in our Strategies alongside you, and there's a lot of passion and belief throughout the Organization in what we do.

Our title for today's call is "Defense Wins Championships." That might seem like an odd choice after a long stretch where more aggressive investing has paid off. Still, we think it's always a good time to be thoughtful about balancing risk and reward; and from our seat, it's certainly relevant today.

A couple of points we'd like to make from this performance review chart. You will see that our relative results were stronger earlier in the cycle, when in our view, stocks were trading more cheaply and there were more bargains to be had. While our absolute returns have been strong over the past three years, it has been much tougher to keep up with the benchmarks as valuations rose. This shouldn't come as a surprise to anyone, given our investing style. Taken as a whole, we're reasonably pleased with the resulting five-year returns. We kept pace with a hot market, after all expenses, despite cautious portfolio positioning throughout; and it's a similar story since the Strategy's inception back in mid 2008.

To be clear, our goal is to beat our benchmarks, period, over longer stretches of time, but by any measure the Strategy's risk-adjusted returns look pretty solid over the last five years.

So let's take a closer look at the last three years. It has been a period of low volatility and rising valuation levels, which has meant we've seen more sale candidates and fewer buying opportunities, which has led to higher than normal residual cash and fewer overweight high-conviction positions. You can see the price-to-value levels creeping higher in the table at the bottom of this page; and at the bottom right you can also see that our top ten positions have been hovering around 40% of the portfolio. We would prefer to see this weighting closer to 50% or even higher, but it's all a function of valuations.

So what has worked over the past few years? Astute capital allocation has carried the day. We think this is always the case, but it's been very evident over the last couple of years. Mike Pearson at Valeant has created tremendous value through acquisitions, which ironically includes a big deal that he walked away from this year in Allergan. Greg Case at Aon has done it through operational execution and capital return, especially buying back stock at big discounts to value. And it's also not surprising to find Warren Buffett and John Malone near the top of this list. While their approaches differ, both keep adding to their stellar long-term track records. All the companies on this list remain core holdings.

What hasn't worked? Energy, with virtually all the pain coming in the past few months. Dave will talk at length about our approach to the sector in just a few minutes.

And we'd like to highlight Mosaic, which is an example of an investing mistake that we've made. Mosaic is a potash and phosphate company, which is not in our traditional wheelhouse, but we liked the industry structure because of the highly concentrated nature of potash supply. Our thesis reflected an industry with pricing discipline that was controlled by a small group of rational players. We studied the company closely during the financial crisis, but we didn't buy it until 2011. What changed? In the summer of 2013, competitors Uralkali and Belaruskali dissolved their marketing arrangement. In effect, the potash supply oligopoly broke down and both started chasing volume at the expense of price. Mosaic stock went down 20%, and after updating our models to reflect lower potash prices, our valuation declined even more. Most importantly, our original investment thesis around the supply structure had been broken. So, we sold the stock at a loss; and fortunately it was only a 1% position so the damage was limited.

Turning to Slide 7, here's a quick look at some of our successful harvested investments over the past few years. Texas Instruments was a quintessential Weitz investment, albeit in a newer industry for us. What was the spark? Wally spent a day-plus with CEO Rich Templeton at a small gathering of value investors in June of 2010. He liked what he heard about the strategy, so Barton did a deep company dive, building off of his existing base of semiconductor industry knowledge. Barton quickly warmed to the story, and his work confirmed that the stock was trading cheaply. We liked that the company was rationalizing down to two very good businesses, analog and embedded processing. The consolidated earnings picture was choppy, as the planned roll-off of the legacy wireless baseband business was masking the underlying strength of the core. This provided our opportunity. The company is also a beacon of exemplary capital allocation in a tech industry known for the opposite. They bought a lot of modern manufacturing capacity and equipment for cents on the dollar around the financial crisis, demonstrating very long-horizon thinking. They acquired National Semiconductor in 2011 to strengthen their analog platform. They've always paid taxes on their overseas earnings, so that capital is available for them to use. They've aggressively bought back stock when it trades at a discount, and paid a nice dividend along the way. They also treat investors as partners. We had several opportunities to spend time with many layers of Management, which gave us the conviction to keep holding until full value.

A few quicker thoughts on the rest of the list. Disney stock fell sharply in the summer of 2011, due to a temporary earnings disappointment. The company has been hitting on all cylinders since then and the stock tripled. CVS Caremark and Hewlett Packard were two other Class of 2011 investments. CVS was our first foray into the pharmacy benefit management sector. We probably sold this one too early, as the marriage of the CVS retail business and the Caremark PBM business has been even better than we modeled. In contrast, we always viewed Hewlett Packard as more of a trade. We bought this stock into the teeth of extreme skepticism. We simply had more confidence than the market about the staying power of HP's core businesses. As Meg Whitman stabilized the company, we were fine taking the easy part of the move after the stock rebounded. We left early, but we're okay with it.

Barton's investment thesis on Microsoft was spot on, but it took time and a Management change to play out, which dampened the IRR on the investment.

And we sold Target after a few pillars of our investment thesis changed. Business value didn't progress at the pace we originally expected. Still, we bought the stock with enough margin of safety that we realized a nice return over our holding period. It was a favorable outcome for a sub-optimal investment, which is really what we're looking for in buying with substantial margin of safety.

Slide 8 shows our Class of 2014 investments. While it was one of our busiest new idea years ever, it was not the result of one year's work. We bought nine new stocks, drawing on the team's collective work over a much longer period. It highlights that our research efforts are cumulative over time. With 21st Century Fox, we were refreshing detailed work that was done from 2008 to 2010 when we owned NewsCorp. Fox represents our favorite parts of the old News business, especially the cable networks, their focus on sports and news, and the company's international opportunity. The stock had been a consensus long. We had a chance to buy it pretty well back in October, and with the latest earnings reset, we think it trades cheaply again.

We've owned Liberty Media well over a decade in our other Funds. Now it's large enough and again cheap enough to own in the Large-Cap Strategy. The core subscription businesses, Sirius XM at Liberty Media and Charter Communications at Liberty Broadband, are both cut from the Weitz mold, and top tier capital allocation gives us added conviction.

Discovery Communications is another one where we dusted off and updated prior research. We owned it when it was part of Liberty, and again as a separate company coming out of the financial crisis. Discovery's content is cheap to produce and most of it is portable globally. They have a nice mix of channels catering to different passionate audiences, all run by a terrific Management team. The weakness in the U.S. advertising market and foreign exchange headwinds have overshadowed the compelling international growth story. We also think the domestic business will prove more resilient than people fear. In particular, emerging channels like ID are gaining viewers and are under-monetized.

Pioneer Natural Resources is a company that we've seen at conferences for many years. CEO Scott Sheffield visited our offices in June of 2013 and most of Dave's detailed diligence work was done later in that year. Dave and I both went down to Dallas to see the company in January of 2014, cementing our view of the company's Midland Basin resource base. More on Pioneer later from Dave.

Precision Cast Parts is a high quality manufacturer that Dave had been circling since at least 2012. We paid even closer attention after the Titanium Metals acquisition. Our initial company report was done in early 2013 and Dave and I again both visited this company out in Portland in March of 2013. Precision have strong barriers to entry, pricing power, they are relentless cost cutters and they enjoy good tailwinds in their core commercial aerospace business. Several small group meetings since we first purchased the stock have confirmed our positive impressions of Management.

Catamaran followed on from diligence that was done for CVS and Express Scripts in the PBM space. We like their position as the third independent national player, coming at the business from the technology side with its widely-used claim adjudication engine. We initially wanted to analyze the competitive impact of Catamaran's growth, and came away with increased confidence that all three companies could win over the next several years.

Motorola Solutions is a business that Barton had been familiar with for a while, but most of the heavy lifting on his diligence was done this year, shortly before purchase. The catalyst for us was when the company decided to divest its lower-quality commercial business. It committed to using the proceeds to buy back stock, which we think should increase the per-share value of the remaining higher-quality public safety business.

On MasterCard, several team members have done a lot of work on the payment space over the years. It's really been a collective effort. John's looked at it, Barton's looked at it, Dave's looked at it. We've owned PayPal a couple of different times via eBay, and Visa was put on deck back in 2008 during the crisis. MasterCard was a natural extension of this research effort. It's a good example of paying a slightly higher price for an exceptionally high-quality business. We have confidence in the durability of the business, and we need it to compound at a nice rate in order to win.

Overall we feel very good about the Class of 2014 stocks. As you see, they represent a big part of the portfolio and will be drivers of our future performance.

Moving back up to a slightly higher level on Slide 9. While our research is always done one company at a time, we have found that good ideas tend to cluster. I'd like to make three main points on this slide. First off, you'll notice a pretty diverse group of clusters. All of them matter, yet none of them are make-or-break. Showcases again the breadth in our industry research. You'll also see diversity within the clusters. Take media distribution, for example. Liberty Global is a European cable operator; Liberty Broadband, via Charter, operates in domestic cable; and DirecTV is a satellite distributor in the process of being acquired. So we're not taking the same risk even within clusters.

Second main point. The groupings represent a mix of out-of-favor industries and others that have tailwinds. Energy and ad-supported media are pretty beaten up and unloved. We always use a rifle shot approach in these areas and pick our spots very carefully. In contrast, specialty pharma and aerospace have had pretty solid fundamentals. The businesses are doing quite well, with nice runways for growth still ahead. For us, there is not just one type of value investing. If a company trades at a discount to our estimate of value, then we're interested, whether it looks cheap on the surface or not. A great example is Tranzyme, which has never looked like a classic value holding but has been a great stock for us because Management has compounded value extremely well over the years.

Third and final point. The clusters do evolve over time. Some of the areas are relatively newer, like pharma and aerospace. Others are ones that have come back around to us again, like media content. And some have fallen off the list, at least for now. A few years ago, tech would have been heavily represented. We still own technology companies, but there are just fewer themes there today; it's more one-off, one software company, one semiconductor company, one Internet company, et cetera. So, while we'll always have clusters, they do change as the opportunity set changes.

With that, I'll turn it over to Dave and he'll talk more about our portfolio positioning.

David A. Perkins: Thanks, Brad. I'd like to talk in a little more detail about how our Large-Cap Strategy is positioned as we enter 2015. Our bread and butter over the years has been investing in businesses with a high degree of recurring revenue. These companies typically sell products or provide services that are well entrenched in the plumbing of everyday life, and tend to be less impacted by economic cycles. Examples of recurring revenue models in the portfolio today include cable TV and broadband providers, payments, software platforms, and replacement or aftermarket aerospace component manufacturers, to name a few. We prefer these businesses because they typically produce consistent excess cash flows that can be reinvested to drive per-share business value. As such, we are often particularly attracted to those recurring revenue businesses run by Management teams who have proven to be highly skilled at investing capital. Most of our largest holdings today boast a combination of durable cash flow generation, attractive reinvestment opportunities, and Management with a keen eye for opportunity, healthy appreciation for risk of permanent loss, and a broad tool kit with which to create value.

We've listed a few of our favorites in the portfolio for you on the middle of Slide 10. Perhaps most important to us, in an environment with generally elevated valuations, are Management teams and Boards who are willing to pass on marginal opportunities today in favor of potentially more attractive ones in the future. Price paid for any asset, financial or otherwise, is often the primary determinant of future returns. So what our Managers aren't doing, during periods where opportunity is lacking, is in many cases as important as what they are. We also esteem those Management teams and Boards who are willing to buy back their own stock when it is trading at a discount to intrinsic value. Over 1/3 of the Fund is invested in companies that are presently buying back significant amounts of stock at what we believe are attractive price points.

Finally, we are not averse to cyclical risk when we believe we are being adequately compensated for the possibility of being wrong about timing. We are generally unwilling to combine secular and cyclical risk, however. As the bottom of Slide 10 outlines, our current more direct cyclical exposure primarily consists of high-quality, competitively entrenched businesses where we deem the risk of competitive vulnerability and/or technological obsolescence as minimal.

Turning to Slide 11. This is a snapshot of the Weitz Value Fund, which is a representative portfolio inside our Large-Cap Strategy, over the past three years. The blue line, which corresponds to the percentages on the left-hand axis, is the Fund's residual cash position as a percentage of net assets over the past 36 months. The red line, which corresponds to the percentages on the right-hand axis, represents the estimated weighted average portfolio price to value, which is a measure of the relative discount of the Fund over time versus our estimate of its business value. Portfolio price to values have hovered in the mid to upper eighties over most of the past two years, which is at the upper end of our Large-Cap Strategy's historical range. A natural question, in looking at this graph, is why our residual cash position has come down over the past several quarters while the overall P to V of the strategy has only declined modestly. We attribute this to a couple of factors.

Coming into 2014, price to values across our investment universe were relatively narrowly dispersed.

Said another way, most stocks had been moving in tandem with one another, in some cases despite diverging business performance and risk profiles, creating less opportunity for us to take advantage of fundamental mispricing. As we moved deeper into the year, and particularly into the early fall and winter, we began to see a much greater degree of dispersion among individual stocks, presenting us with attractive buy and sell opportunities. Several of our existing portfolio holdings closed the gap between price and underlying business value, warranting sale. We were also presented with a greater number of good businesses at qualifying discounts than we've seen in quite a while. Hence our more active level of purchase activity during the fourth quarter. The net result of these price movements and our related repositioning leaves the Large-Cap Strategy with a higher degree of valuation dispersion than we've seen in some time. We have a greater number of companies approaching full valuation than normal, as well as a significantly higher percentage of the Strategy invested in sub-70 cent dollars. We are being patient with a handful of our 95 cent dollars, as several of their business models are prone to more lumpy, discrete value-creating events. We also believe a number of them have a higher probability of reaching our high case valuation scenarios, which has led us to hold slightly larger position sizes as these stocks approach our more conservative base case valuations. You can rest assured, however, that we will be disciplined sellers if and when any of our holdings trade meaningfully above full value.

I'd like to take some time to discuss a couple of the present themes Brad outlined earlier in a little more detail, beginning with an update on a key area of contribution for the Large-Cap Strategy over the past several years: specialty pharmaceuticals. Valeant remains the Strategy's second largest holding at present. We find its core dermatology and ophthalmology platforms to be highly attractive. Valeant has built an enviable competitive position within medical dermatology in particular, and there remains significant opportunity within ophthalmology for continued growth, organically and via M&A. Importantly, both platforms create reliable and growing excess cash flow streams upon which CEO Michael Pearson and his team can look to reinvest. We continue to have a high degree of confidence in Management's ability to identify and execute on value-creating acquisition opportunities as they arise. This past year's pursuit of Allergan was a high-profile event for the company. We were disappointed that Allergan got away. It was a hand-in-glove fit for Valeant and one of the most attractive specialty pharmaceutical business models we are aware of. At the same time, however, it would have been inconsistent with Management's long-held financial discipline to enter a bidding war with Activis. The only outcome worse than losing out on Allergan would have been meaningfully overpaying for the company and being saddled with a significant chunk of low-returning capital.

The silver lining of missing out on Allergan has been threefold. One: Management was given the opportunity to focus a more significant portion of its time and energy refining and improving its core businesses. Second, the absence of significant M&A over the past 15 or so months has also enabled the financial strength of its underlying operations to be more evident in its GAAP accounting, an area that had come under scrutiny early last year. And third, the company's balance sheet has de-levered nicely, fulfilling the company's prior commitment to creditors and giving Valeant flexibility as it pursues the highest and best use of our cash. Valeant shares presently trade at a narrower discount to our base case estimate of value, and we have been lightening up some as a result.

Endo International, formerly Endo Health Solutions, is our other core specialty pharmaceutical holding. Under new CEO Rajiv De Silva, Endo has rebuilt the company's portfolio, seeking to create a well-diversified, organically growing set of long-lived niche pharmaceutical assets spanning the branded, traditional generic, and branded generic marketplaces within and outside of North America. Endo is in some ways a less aggressive version of Valeant, though the companies operate in different therapeutic areas. Endo's core focus lies in pain management and urology. The two companies are similar in that each prides itself on identifying under-managed and/or under-valued existing medications, as opposed to betting on the future success of early-stage drug research. As with Valeant, our Endo due diligence has centered around the value and durability of the company's existing franchises, their forward opportunity sets and Management's capital allocation and operational acumen. We believe Endo's recent $2.6 billion acquisition of Auxilium Pharmaceuticals further enhances the company's organic growth profile and creates an attractive platform in urology that Management can build upon in the future, particularly internationally.

At present, we are in the process of evaluating another specialty pharmaceutical company for a potential investment. Encouragingly, we are beginning to view the so-called spec pharma sector as a growing niche within our healthcare circle of competence. We believe both Valeant and Endo are good examples of the kind of attractive, high return and relatively predictable businesses that have served as the cornerstone of our investment discipline over time.

Let's switch gears now to an area that has garnered a lot of press and investor attention of late: energy. In a moment we'll address our strategy and thought processes in the sector, but first we wanted to provide a little background on our present positioning and how we got to where we are now. Coming into the fall of 2014, the Large-Cap Strategy had a combined energy exposure of 6.7% of net assets, consisting exclusively of a collection of three exploration and production or E&P companies. Our two largest investments as of September 30, 2014, were Range Resources and Apache Corp. In addition, we owned a smaller starter position in Pioneer Natural Resources, as Brad outlined earlier.

Earlier in 2014, we had lightened up our Range and Apache positions by 15% each, attempting to take advantage of the strength in commodity prices and the companies' stocks. With the benefit of hindsight, we did not trim aggressively enough. By our math at the time, all three companies still traded at reasonably attractive discounts to our estimates of intrinsic value. As energy prices weakened, however, their discounts widened further, and by early January all three had given up their previous gains and were trading at prices 10% to 20% below our average cost. Our initial investment thesis for Apache centered around the potential rationalization of its broad portfolio of oil and gas assets, and a contrarian opinion on the value of the company's position in Egypt. This thesis played out nicely, with Management executing a thoughtful and relatively aggressive pruning strategy, effectively whittling the company down to its most attractive assets. Unfortunately, just as Apache neared the completion of its makeover, the energy market stole the show. While the company's remaining portfolio was undoubtedly more attractive, the cost structure underlying its largest remaining assets made it more vulnerable in a prolonged period of commodity price weakness. As a result, we chose to sell our Apache stock, harvest a tax loss, and focus our capital in the two companies we believe offer the best combination of downside protection and long-term upside potential: Pioneer Natural Resources and Range Resources.

Before digging into these two energy companies in more detail, let's first review the key assumptions underlying any energy investment we undertake, and our focus on playing good defense in what is an admittedly volatile sector.

For both crude oil and natural gas, we use the marginal cost of production as our best gauge of normal and sustainable prices. Over longer periods of time, each of these commodities has tended to gravitate toward and hover around its marginal cost, reflecting the natural economic equilibrium present in most commoditized markets. We have consistently used $75 crude oil and $4 domestic natural gas as our center of gravity, since making our first investments in energy during the financial crisis in 2008. We believe both continue to represent relatively conservative estimates of the prices necessary to incent sustainable incremental production over time.

Our net asset value or NAV-based valuation scenarios assume these underlying commodity prices. Depending upon the oil or gas price environment at any given point in time, these can look either aggressive, as they might now, or unduly conservative, as they might have a year ago. We find that consistent tether to long-term supply and demand fundamentals allows us to remain more objective, when others with shorter time horizons choose or are forced to respond to temporary price dislocations.

Finally, we are willing to place a conservatively calculated value on a producer's unproved resource potential if we believe the underlying asset has been de-risked, boasts a very low cost of extraction, and lies in the hands of a prudent Management team. In most cases, we would rather pay a higher headline multiple of cash flow today than buy something statistically cheap while bearing the risk of being unable to replace existing reserves in production at reasonable prices several years from now. We believe this is reflective of our longer-term investment horizon at work.

Our primary risk, then, is future cash flows being pushed out into the future, as is the case today, as opposed to waking up with a structurally challenged asset. Our margin of safety is thus derived from a three-legged stool of asset quality and longevity, Management competence, and by purchasing shares only at a sizable discount to a conservatively calculated estimate of intrinsic value.

Our lone crude oil-focused investment today is in Pioneer Natural Resources, which was a new holding in the Fund as of last January. We believe we have purchased shares at an attractive discount and that the company's underlying business value has grown over the past year, despite the sharp downdraft in oil prices. Pioneer's core asset is based in the Permian basin in West Texas, where it has produced oil and natural gas throughout its history. Two years ago, Pioneer commenced a large horizontal drilling program that the company now estimates, includes an inventory of roughly 11,000 future wells and over 10 billion barrels of oil equivalent in resource potential.

So why specifically do we like Pioneer? The blue chart in the middle of Slide 18, courtesy of Deutsche Bank Research, outlines the estimated price required to produce a 10% internal rate of return on a barrel of oil from the various unconventional reservoirs within the continental United States. Pioneer's core assets are in the Wolfcamp Shale which, you can see, carry very low costs and sit among the most attractive portion of the domestic cost curve. Pioneer boasts an attractive combination of a very low-cost position, tremendous future drilling inventory, a conservative balance sheet, and an operationally strong and strategically savvy Management team. It also has an attractive hedge book that will help bridge what most anticipate will be a difficult 2015. Longer term, we believe Pioneer is well positioned to produce double-digit production, reserve and cash flow growth on a debt-adjusted per-share basis for many years within its current Midland Basin acreage.

Our other significant energy holding is Range Resources, a natural gas and natural gas liquids or NGL producer with a strong core position in the prodigious Marcellus Shale. We first began buying shares in the low $60s almost three years ago, and once again began buying shares this past fall at similar and now lower price levels. As Slide 19 outlines, we believe Range's underlying value has grown nicely over time, despite its stock price having fallen approximately 15% to 20% from our average cost. To put its present discount in perspective, consider that Range traded at a higher price three years ago when it had 1/2 the proved reserves and current production it boasts today, 25% to 30% higher production costs, and 50% to 75% less EBITDA than we estimate Range would produce in a more normal gas environment at present. As well, competitor Southwestern Energy recently purchased a sizable piece of acreage and production from Chesapeake that we believe mirrors Range's primary asset. We believe the price Southwestern paid confirms that Range would be worth well in excess of where the public markets presently price the company's shares, to a strategic buyer.

So why Range? We own Range for many of the same reasons we own

Pioneer. Range's core position in the Southwest wet and super-rich Marcellus Shale sit at the very low end of the domestic natural gas cost curve, as outlined by Deutsche Bank on Slide 20. As well, Range has an attractive multi-decade runway of visible natural gas and NGL reserves already in hand, a simple and relatively strong capital structure and skilled operating team at the helm. We believe growing infrastructure investments in the Northeast will eventually lead to a much narrower discount for Marcellus gas, boosting Range's cash flow back toward more normal levels in two to three years. In the meantime, its low cost position should enable the company to continue growing while earning attractive returns through a period of lower natural gas prices.

Are we considering any other investments in the energy sector, given the present cyclical downturn? We have looked closely at a number of service companies and are choosing to remain patient for the time being. Many of the large-cap service companies are relatively unattractive to us, though there are pockets we would definitely be interested in at the right price. The graph from Bank of America Merrill Lynch on Slide 21 is a bit busy, but generally supports our willingness to remain patient. Using a zero-based time plot, Bank of America graphed the Oilfield Services Index or OSX's performance during the last four downturns, from peak to trough. The black dotted line is the present downturn, as of early January. Excluding 2011, each of the past three downturns lasted for a prolonged period of time and/or was quite a bit deeper than the pain we have witnessed thus far. This makes intuitive sense to us, as most service providers are price takers and capacity additions made during stronger times in anticipation of future growth often create multi-year periods of excess supply that must be worked through before profit margins are able to normalize. At present, we have one large energy service company on deck, awaiting a more attractive price, and another presently in the due diligence process. We will keep you abreast of any future activity in our quarterly updates.

Turning to Slide 22. I won't spend a lot of time outlining the bigger picture risks in energy, as most are already familiar with them; but you can see them here outlined on this slide. We don't believe we add anything particularly insightful about how or when they might be resolved, but we are monitoring each closely.

Before turning the call over to your questions, we wanted to conclude with a current snapshot of our on-deck list. The red line on the graph is the estimated average price to value of the securities on our on-deck list, looking back over the past five or so years. Using the left axis, one can see on-deck price to values have hovered between 90 cents and 100 cents on the dollar for most of the past two years. The blue line represents the percentage of the companies on our on-deck list that trade at or below 70 cents on the dollar, which, as many of you know, is our buy target.

While we are encouraged at the prospect of having a few more bargains to take advantage of, today's opportunity set is a far cry from what it was during the market's last 10% correction in the fall of 2011, when over 1/2 of our on-deck list qualified for investments. We remain poised to take advantage of such a dislocation, should we be so fortunate.

In closing, we appreciate your confidence in us and the opportunity to steward your capital alongside ours. We hope this call provided a useful lens into how we position the portfolio, and the opportunities and risks we see amidst the current investment landscape. With that, we'd be happy to take your questions.

Operator: Thank you. If you would like to ask a question, please signal by pressing star, 1, on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, 1, to ask a question. And we'll pause for just a moment to allow everyone an opportunity to signal for questions.

And once again, just as a reminder, if you would like to ask a question, please signal by pressing star, 1, on your telephone keypad.

Jo Ann Quinif: Travis, we did have one question submitted - well, two questions, on the webinar, that I think we'll just go ahead and ask those two, and please feel free to continue to submit questions via e-mail, pressing the star 1, or via the webinar system, but, the first question was: "What exactly constitutes a deep dive into a business?" And I think Brad had alluded to that in his comments, so maybe Brad, you could take that question.

Bradley P. Hinton: Yes, sure, I'll start off on that. The specific question came up when we were talking through the Texas Instruments example, so we'll give you a little bit of color on that one. That was a little bit of a unique situation, first off, just because Wally was able to spend several hours in a very intimate setting with the CEO of the company on the front end, so, that's a level of access that's somewhat unique but was a very helpful starting point. Mentioned that Barton Hooper did the detailed work for us, and it really starts with reading everything we can get our hands on, and the first place we go is the primary SEC documents, the company filings, so we really want to understand the financials and tear those apart. We're trying to get a good handle on the industry landscape and the company's competitive positioning. In the case of TI, you know, they had a nice manufacturing cost edge, a really broad, strong portfolio of analog semiconductor products. We want to understand how and why a business generates the results that it does, and are they sustainable. That's really what we're trying to get at there. And a lot of what we do is really compare words and actions. On the case of capital allocation in particular, a lot of companies talk a good game but when you actually dive through the financial statements, do they back it up with the way they behave? In the case of Texas Instruments, they certainly have in the past, and they continued to do so after we purchased the stock.

Another layer, you know, we talk to Management. We were very fortunate with Texas Instruments that Ron Slaymaker is probably one of the most knowledgeable investment relations professionals we've ever encountered. He was just terrific at helping educate us on some of the blocking and tackling questions that Barton had, at a very granular level. We also had multiple touch points, as we've mentioned, both with the CEO and the broader Management team. There was a visit down to Texas that was in a kind of a medium-sized group, but Barton and Wally both went and had informal sessions with several of the Managers. I had the opportunity a couple of different times, went to a financial review they hosted in New York, and then also an update in the Bay Area on their Silicon Valley analog business, which is basically what they bought from National Semiconductor, so had an opportunity to spend, you know, multiple hours at a time talking about specific segments of the business, which was good. Barton has been to China a couple of different times; a big part of why he was going was doing supply chain channel checks on the technology space, so Texas Instruments and other companies that we've owned there, so that is something that plays into it as well; and then we - Barton, in particular, goes to at least a couple of technology industry conferences a year, where he gets a chance to spend time with Management of a company like TI but also catch up with a lot of their competitors, and, you know, he's obviously followed some of them over the years as well.

And then we also talk to other smart investors. We're fortunate in the case of TI, we have a - Barton in particular has a pretty good friend who is a big holder, who's a very savvy, smart tech investor, and so we were able to kind of compare our investment thesis and challenge it with someone else who's a good tech investor versus, you know, maybe the rest of us on the team who are more generalist-oriented, so we can bring the whole poking on the capital allocation side and maybe he gets a little bit more of that with others in the industry when it comes to the really detailed knowledge.

So, those are some of the things that we do, and, you know, it all kind of comes together in a company report that outlines our investment thesis, the industry structure, the business's strengths and weaknesses and then our, you know, financial model which pulls it all together. So quite a bit of time is spent modeling our base case view of how the business is likely to evolve at both, you know, the division operations level and then also what they're - what are they going to do with their free cash flow, in terms of, in the case of TI, buying back a lot of stock and paying out a dividend along the way, which has helped create substantial per-share value that would not typically be captured in sell-side models, for example, where the more traditional approach is to maybe model out the next year, including share repurchases that in years two, three, four and five just assume that free cash flow kind of builds up on the balance sheet and we're not doing that on our end, we're really trying to capture what kind of value comes out of that as well.

So I'll stop there; Dave, do you have anything you would add to that?

David A. Perkins: No.

Jo Ann Quinif: So the question - the second question, and we actually have several questions now, so, but we'll kind of just tick through these and then please feel free and interrupt us, Travis, if we have a live call question as well. But the second one is: "When you visit companies, are there any particular must-answer questions you have or is every situation and approach a one-off basis?" And maybe Dave, you could answer this one.

David A. Perkins: Sure. We don't have any magic questions or specifically-worded things that we ask at every visit that we take, but I would say there's two primary areas where we spend a lot of time trying to figure out how Management thinks. Brad alluded to this a little bit earlier with some of his comments, but we really want to understand how Management thinks about allocating capital. And a lot of them have pretty good answers for the first two or three that will sound like they're coming right out of a consultant's book, but we really want to dig a little deeper and understand if they really - if they're really good at ferreting out opportunities relative to each other, whether that's buying back shares of their own business, whether that's thinking about M&A, or whether it's reinvesting. And what we're specifically looking to avoid are empire builders, people that enjoy or get a thrill out of being big as opposed to just being good, and then also those who like to grow just for growth's sake, so they're willing to spend money at very low returns as long as they can grow at a certain rate. And we want to find people who are most focused on returns first, and they're willing to allocate capital, even if it's less glamorous, to things like share buy-backs.

The other area we spend a lot of time trying to ferret out is really appetite for risk, and that's both inside the business itself and then also in terms of what they're willing to spend money on, and how much of the future they're willing to bet on something, whether it's a pet project or something that we think is really attractive.

So those are really the two areas I think we drill down on most, in addition to the things that Brad outlined earlier that are much more company-specific. So those would be two big common threads in all of our meetings, and then there are lots of questions that we ask that can be specific to that individual industry or company.

Jo Ann Quinif: One other question that was somewhat related to both of those questions was: "Since we - since you like good capital allocators, you've mentioned buying stock back at one point, do you like this when there are no deals or are there better ways to allocate cash?"

Bradley P. Hinton: I think our view is it's all about the price at which it's repurchased, relative to - certainly our view, but more of - as importantly, Management's view of the value of the company. So there can be times when buying back stock at a very substantial discount is the single smartest thing that a company can do, almost regardless of competing uses of capital, outside of maybe reinvesting internally in the business, but there's a lot more risk associated with M&A. There is a price at which that doesn't make sense, and we're probably, in aggregate, closer to that today than we would have been four or five years ago. So we want companies who are much more selective about when they buy their stock back, and if it's had a really nice run and is trading closer to intrinsic value, that that is not the lever we'd like to see them typically pulling with excess cash flow, you know, paying out a dividend is fine in that case, or looking for, you know, potentially M&A in the case of a Transzyme or a Valeant, or something along those lines. So it's all, you know, what you pay versus value received, in any of those uses of capital.

David A. Perkins: One thing that we think's always kind of interesting, when we talk to Management teams too, is they'll know very specifically what they should pay for something they're going to acquire, but they have no idea at what price to buy back their own stock, and that's a big red flag to us when we hear those types of comments. And so they'll be able to say very definitively, with a business they don't know as well as the one they run, that that was the right price to pay, and we'll ask them why they're not buying back their own stock, and they'll say, well, stock buy-backs don't really work. So if we hear that kind of language, which we don't from our owners and our Managers that run our businesses in the portfolio, but when we hear that with a prospect, that's generally a turn-off.

Bradley P. Hinton: Yes, and just as an example, Discovery Communications reported earnings today and they said again, as they have said many times and it's always been their approach, is that they think their stock is a very compelling bargain right now, and it is explicitly a result of forecasting out what they think their business is likely to do over the next three to five years, and putting a value on that, and comparing every other possible use of capital to the return that they think they can generate by buying in more of that asset that they know best, which is their own company. And not too many companies - fewer companies than you would think do that, but that's a really good starting point. And that doesn't mean they're exactly right about the assumptions either in their business or in something they might acquire, but that's the right mindset, in our view.

Jo Ann Quinif: Good. So the next question that came through is: "Are you finding opportunities outside of the U.S. and - or just outside of North America in general?"

Bradley P. Hinton: Sure. Let me start - this is Brad. We have done research on several companies that are based outside the U.S. Several luxury goods manufacturers are on deck now, which are European-domiciled and have a lot of their base of business outside the United States. We also own certainly a number of companies that are either headquartered outside the U.S., in the case of - which now is true of Liberty Global, even though operations are based locally, all their business is outside the U.S. I think our international revenue exposure across the entire portfolio is roughly 1/3, a little over 1/3 maybe, and that's pretty typical in larger-cap businesses where they tend to have a global spread. We own a lot of companies that have business far beyond the U.S. But we're not spending a lot of time looking in emerging markets or extremely far afield, but we're very open to, you know, any business that's good enough, kind of regardless of where it's headquartered; we don't care if it's in Switzerland or Omaha, from that standpoint.

David A. Perkins: Each of us - this is Dave - are traveling a little bit more internationally. Barton's been the tip of the spear there. But I'd just say we're being really thoughtful and methodical about it, and we want to make sure that we have a good understanding of each of the various countries that we might be involved in, in terms of rules of engagement, et cetera. So it's a growing area of focus, but we're being disciplined about where we choose to put our money.

Bradley P. Hinton: Yes, Barton's next visit is - he's going down to Brazil in a couple of weeks.

And one area that didn't show up in our clusters is agriculture, even though it's been a little bit beaten up, but we're doing some more work there, and I would say the fieldwork he's doing in Brazil is much more around companies that happen to be based here but have business globally spread.

Jo Ann Quinif: So the next question that we have came from (Irv), and he is asking: "How would you rate Mike Pearson of Valeant with respect to capital allocation?" In addition to that, we also had another question about M&A in general in the portfolios, and maybe if you expect to see that to continue. So Dave, I know you cover Valeant, maybe it's best for you to start with that, and then you can talk about that trend in general.

David A. Perkins: Sure. Happy to. So first with specific regard to Mike Pearson at Valeant, we do think he's a very good capital allocator. That does not mean, however, that we will follow him carte blanche into anything. We go through very carefully each one of the deals that Valeant has done, to make our own assessments about the returns. One of the things we really like is he's put out, and Valeant in general, the whole company has put out some very basic guard rails that they say they're going to stay in between, and one of those is that they expect to earn a 20% IRR at a statutory tax rate on any capital that they deploy, whether that's buying back their own shares, purchasing another company, or making internal investments behind some of their own drugs. And so we can, with our own math - we obviously don't have perfect information from the outside, but we can assess that. And the other metric they use is a five- to six-year cash payback period, and so we go and pencil all of that math. And as we look back at the sizable deals that they've done to date, we think they've done a very good job staying within that discipline. And perhaps most importantly, the quality of Valeant's core business has only improved over the last few years as they have continued to buy things.

And the other thing we like there specifically, with regard to accountability, is that each year the Management team at Valeant gives a presentation to the Board of Directors with a look back on every transaction that they've done, and Valeant has actually even published that, the last couple of years, in a slide deck once each year, basically showing whether the transaction is above, below or right in line with what their expectations were when they made the transaction. So they're very forthright about that. And we also go through and try to evaluate all the deals that are being rumored as well, so. The short answer would be, we think one of the things that he does better than most of the CEOs that we've been around over time, is remain disciplined on the subject of price. And obviously he's walked away from two very high-profile deals, most notably Allergan here within the last year.

On the subject of M&A more broadly, we do have a number of acquisitive companies in the portfolio right now. We don't necessarily go out looking for companies that acquire; what we do like, I think as we may have mentioned during our prepared remarks, are companies that we think have a really good nose for value, and then also companies that have a good reinvestment runway in front of them. And it just so happens, with the case of Valeant and Endo too, that they are doing this within an industry that has a lot of excess capacity and frankly a lot of bloat and waste. We're seeing this in a few other sectors as well, most notably some of the consumer packaged goods businesses, also beverages; but pharmaceuticals is an area that was built over 20 years with the expectation of a lot of growth, and so they're able to go in and run a lot of these assets more leanly. So I would say, in general, we don't aspire to own acquisitive companies necessarily, but when we find good Managers who happen to have the opportunity to do that, we're happy to invest heavily alongside them.

Jo Ann Quinif: I know we're closing in on an hour here, but we did have several more questions, but there are three that have a general tie together that I thought maybe we could answer in one fell swoop here. And essentially they all revolve around our on-deck list. And the first one, basically, is asking: "Can you discuss what makes you pull the trigger on buying a company that's on your on-deck list?" The second one was: "Can you clarify how many on your on-deck list actually qualify for this portfolio," meaning the Large-Cap Value Strategy, "versus all of your other Strategies?" And then lastly: "How often are new ideas and companies presented to the Portfolio Management team to be put on that on-deck list?" I know that's a lot in one mouthful there, but maybe Brad, if you could …

Bradley P. Hinton: I'll take the first - maybe I'll take the first and third part, and let Dave opine on the middle question in the sandwich there. So, what trigger causes us to buy a company off of our on-deck list? The single biggest factor is price, in particular in relation to the rest of the portfolio, but from an absolute standpoint, we're looking to buy securities at 70 cents on the dollar or less, sometimes substantially less, depending on where we are in the opportunity set cycle. Where we sit today, I think anything under 70 cents on the dollar is definitely fair game. Back in 2008, 2009, we might have had our pick of the litter, so it might have taken more like 50 cents or 60 cents on the dollar. But 70 cents is a pretty good starting point. Anything that gets on the on-deck list is typically a business that we would own at the right price, so we don't get to that stage of our research if there's something that we think is fundamentally flawed with the business, so it really does come around to a combination of price and comfort with the business and the Management team. So some - an industry and a Manager that we're exceptionally comfortable with, we'll be a lot more likely to start in size, nearer that 70% range, if it's something that's newer to us, or a Management team that we're still kind of getting to know a little bit better might require a more substantial discount on the front end.

The other part of the question, the third question I guess in the mix, was how often do things come up to be added to the on-deck list? It's a continuous process throughout the Investment team, but in general we see an idea or two a month, on average, that is reaching completion, and there's obviously a whole lot more than that in various stages of the due diligence process. So it tends to - we tend to describe our approach as taking anywhere from three weeks to three months to fully bake a new idea from the ground up. And the shorter end of that range tends to be industries that we have spent an awful lot of time in over decades, not just years, so the next cable company that we analyze is not going to take nearly as long to get up to speed on the industry structure and things of that nature, whereas when we started in specialty pharma a few years back, I think Dave spent several months, you know, getting more comfortable with a lot of the dynamics around that area.

David A. Perkins: You bet. I think one of the other questions that Jo Ann mentioned there was the number of companies that we have that would be qualifying for a Large-Cap Strategy on our on-deck list, and right now that list is about 28 companies long. We, as you know, look to own anywhere from 25 to 35 businesses across really most of our Strategies, but in particular the Large-Cap Strategy and so, with a 20% to 25% annual turnover rate and let's say 30 stocks in the portfolio, we're looking at meeting, you know, potentially seven to eight a year. That's certainly not always true, but if one were to just look at the math, that's what it might suggest. And so we have about four years' worth of inventory, if one wanted to think of it in that way, on-deck at present. Right now we do not have any that are under 70 cents on the dollar as of close today.

Jo Ann Quinif: Great, thank you. I think that we will conclude the call on that note, unless there are any calls - questions in the queue. Travis? Maybe ((inaudible)) check there?

Operator: There are currently no questions in the queue. Just as one last quick reminder, if you would like to ask a question, please signal by pressing star, 1, on your telephone keypad.

There are currently no questions in the queue.

Jo Ann Quinif: Perfect. We'll take that as we've worn everyone out this afternoon. We greatly appreciate your time. If you do have additional questions, please don't hesitate to reach out to one of your Regional Directors or call in the office directly. And our website certainly has a wealth of knowledge and information. And we will look forward to visiting with all of you again on April 23 for the call with Wally and Drew. Thank you.

Operator: That concludes today's presentation. Thank you for your participation.

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