Fundamentals Over Forecasts: The Case for Quality in 2022

From fears over a recession, to concerns about inflation, to questions over impending interest rate hikes – there is much to feel uncertain about in today's investing environment. But Weitz Investment Management director of equity research Barton Hooper explains that rather than making forecasts, remaining focused on identifying high-quality businesses available at a discount is a stronger long-term strategy.

Jenna Dagenhart:

Hello and welcome to Asset TV. Today we're talking to Weitz Investment Management's director of equity Research Barton Hooper. Barton, thanks for joining us.

Barton Hooper:

Hey, thank you, Jenna. Hope your summer is going well so far.

Jenna:

Thank you. And same to you. It's certainly been quite a wild ride in terms of markets. And there is an old quote by Warren Buffett "It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price." And this year, stock prices almost across the board have been coming down. From your perspective, Barton, has the market decline of 2022 effectively brought so-called wonderful companies into the fair price realm.

Barton:

Well, it's certainly been an interesting ride for the first six months of the year, and markets certainly have gone down. But it hasn't been in a straight line. There's been peaks and valleys. Unfortunately, there's been far more valleys than peaks. And, you know, certainly our companies haven't been immune to that. And, you know, this is sort of a be-careful-what-you-wish-for market, because investors always talk about "Yes, I would like to have lower prices for the companies I want to own." And that's what they really mean. They don't mean all prices, because nobody wants the price of the companies they already own to decline. And no one's immune from that. And as I said, we haven't been immune from that either. But that means we have had some opportunities to selectively add to some of the businesses that we already own and really like. And a few examples of those are, we added incrementally to positions in CoStar Group, FIS, Liberty Broadband, and CarMax. And then on the new opportunities side, I think a good example of this that reflects our investment process and patience is the addition of Adobe in the second quarter. And Adobe is a wonderful business. Many people know it because of, say, Photoshop or the PDF format, but it does dominate with its Creative Cloud. The tools that creators use to create this explosion of content that we've seen, whether it's first on the web, then on phones, now in video, you know, everything you see and Instagram Stories or Tik-Tok, there's probably something that Adobe's done or provided behind the scenes. And then professionally of course in media and even in companies now, the tools are so easy to use that their usage is growing. So it's not just in the hands of photographers or media creators now. It's really, the Creative Cloud is for tools for everyone. So we really like that part of the business. And then it has the Document Cloud, which houses Adobe Sign and as I mentioned, the ubiquitous Adobe Acrobat which created the PDF format. And then finally it has the Digital Experience Cloud which is complementary to the other two businesses. Digital experience cloud is what marketers and advertisers use to create the tools that take advertising or marketing content.

Most of that created with the Creative Cloud tools and put that out into your email or on your phone or reach you in store. And so when you add up all three of those businesses, you get high-quality company that still growing and should do so for a while. And we've loved this business and admired it for 3 to 5 years. And did a lot of work. But the price never came into an area that we thought, as you say, fair and reasonable. And finally, this spring, as the market took a big downturn, Adobe finally reached that area where we say high quality at a reasonable price. And the discount made sense. So we were able to add it into some of our strategies. So I think that's an example where, as I said, we added to positions that we already like and then were able to take advantage of the market to add a new a new business to the portfolios in Adobe.

Jenna:

Well, speaking of that big downturn this spring, this year we've seen the stock market fall into bear market territory, with some market prognosticators saying that a recession is less a matter of if than when. Have you been factoring in the possibility of a recession into your estimate of stock values?

Barton:

That's a good question. You know, you can't avoid headlines that are talking about a recession is imminent. A recession is near. The recession is here. We're, you know, we've already been in one for a couple of months. They're all over the place. And from where I sit as director of research and what our team of analysts here at Weitz are thinking is not – is there recession? When will there be one? What will rates do? What we're really trying to understand are, do the businesses we own or the businesses we would like to own, what happens if there is a recession? And we talk a lot about quality here at Weitz. And it's not just the buzzword of the day for us. You know, we live and breathe it. We've been thinking about it for a long time. You know what makes a quality business? What are the elements that that constitute it? And how can you measure it? So that's what we're doing day to day. And as we think about quality and what can happen with a recession or a geopolitical event like a war or a pandemic, you know, we're looking at, well, what can these businesses do? And one characteristic that we've identified is resiliency. And resiliency, the way we define it in our investment process, is how can a business withstand, respond, and maybe even prosper when something happens like a recession or a quick rise in inflation or rates or war. And as part of that, I've talked in previous appearances here about the Weitz Quality Score and the elements that really can indicate a high quality or a resilient business are capital efficiency, return on invested capital, and cash flow consistency. And really if you get high scores in all of those, that's kind of indicative of a resilient business. And then another way that we think about how can recessions or wars impact our companies is through our valuation models. And we ask ourselves a lot of “what if” questions. Now, keep in mind, we don't believe we can predict outcomes. We don't believe we can predict a recession. We can't predict when it will start, when it will end, or the level of interest rates. But we can ask what happens if they do occur and what's the impact financially to the businesses that we own or like to own? And then working through that, we come up with – we boil down all these scenarios and to, down, base case outcomes. And what that really does is allow us to avoid analysis paralysis, so we can ask a lot of questions and then we sort of take the average of each one of those and we end up with three cases. And the outcome of all this work in terms of looking at quality and how do events affect valuation allows us to then have the confidence in our portfolios to be to be on the offensive when downturns occur. And that's because we've done the work beforehand. We understand that the businesses that we own do have resiliency in them. And when you have resilient businesses, you can be confident that over time, you know, prices may, near-term, not reflect the strength, but over time they will. In other words, intrinsic value will win over the market emotions.

Jenna:

Especially during volatile and tough times.

Barton:

Yeah, you're right. I mean, like we often say, we like what we own. We like the businesses. But at the end of the day, you can't really control what the prices are going to do from one day to the next and even beyond that. So you just really have to be confident in the work you've done and that you've bought businesses at a reasonable discount.

Jenna:

And another thing that's kind of impossible to predict these days is inflation. One of the biggest and perhaps the most impactful economic stories happening right now is surging inflation. Are there any businesses on your radar, Barton, that you consider strong inflation hedges?

Barton:

Well, you know, I'm going to piggyback a little bit on my prior answer there. You know, we do talk about, we can't predict what's going to happen next or when. I'm not sure we need to predict inflation, because if you've bought coffee, gas, food, or taken an airline trip, I think inflation's here. And so the question that you really need to ask is, how can the businesses that you own or want to own respond? And one of our quality score elements, a big one, is competitive positioning. And inside of competitive positioning, we always try to understand pricing power. And pricing power is hard to tease out because businesses don't go around whether it's a business to consumer, or business to business. They don't really advertise that they can raise prices when they want. And another part of that is even if a business can raise price, are they providing value? So we need to make sure that the businesses that have pricing power are also delivering real value over time to their customers, or they'll leave. So the pricing power isn't real. Now, as it relates to inflation, in normal inflationary times, if a business does have pricing power, it's a source of incremental profits that they can use to reinvest in the business, either organically or through opportunistic M&A. Or if those aren't available, they can just simply return it to us, the share owners, through dividends or share repurchases. I would take a scenario where prices are declining, in deflation. There, pricing really acts as a break. You may not see actual price increases, but you'll see real pricing power. And what I mean by that is that a business's revenue declines far less than its cost. So again, you're creating at least even or incremental profits that then go into the reinvestment that I just discussed. And now here we are today, which is clearly an inflationary environment. And in that it's critical that a business has pricing power because it needs to maintain its capital stock, whether that is the machinery and equipment or increasingly today, it's can it be competitive in a labor market where wages are increasing? And if you don't have real pricing power, meaning take away the headline inflation rate, you know, the real dollars that come to the business through that, then eventually you're going to fall behind. Either can't hire the best workers or your equipment is going to get old and it won't be efficient coming forward. So we look at businesses that that have pricing power to respond in some of those environments. And I'll give you three quick examples. One that a lot of people might not think about is our holding in Markel, which is a specialty insurance company. And where Markel's pricing power comes from in a commodity business is that it's a specialty insurer. It must pick the lines very carefully in which it participates and therefore in an environment right now where you have claims rising and their internal labor cost rising as well, they've been able selectively to raise prices and the insurance lines in which they do compete. And what we believe is at least slightly ahead of where their claims and labor costs are going. And another element to that is, it's an insurance company. It has a large investment portfolio, a lot of which is in fixed income. And as rates respond to rising inflation, by going up, that will increase their investment income, which is again, just another sort of hedge against that. And then finally, two examples are the card networks, MasterCard and Visa. They have inherent pricing power. Their revenue model is the price of the transaction times a very, very small fee. So as you pay more for your coffee in the morning or your dinner at night, they have automatic pricing involved in that. So that's a great business. That's a great example of businesses that have a good hedge. And so when you add it all up, in our portfolios at least, we think across the board we have businesses that at least have some element of pricing power in them. So the portfolio perspective is that we feel okay about that.

Jenna:

And that's a great point. I didn't really think about the card companies. A lot of that pricing power's just baked in.

Barton:

Yeah, that's nice because that's one where I talked about, you know, you have to identify it and it's hard to figure it out sometimes, and that's obvious. So we like that.

Jenna:

And finally, Barton, to end on a positive note here, given the present market environment and the drawdowns that we've seen in 2022, what are some of the factors that give you and your team a reason to feel optimistic for the remainder of 2022 and beyond?

Barton:

Yeah, in times like this, you really, you really want to find some silver linings and optimistic outlooks. And we do feel optimistic for the long term. Now, that doesn't mean that we're saying tomorrow things are going to be better or even six months, you know, as I've said before, several times, we just don't know. But we do think, again, the work we've done sets us up well for the future.

And just to highlight that a little bit, you're looking right now at a visual that we've prepared and it's called the price-to-value heatmap. And so, on the left side or the Y-axis vertical, you see the quality scores. And just for everyone watching, keep in mind our quality score, the highest one is a one and a two. So if you have a high quality portfolio, it's near the bottom. And then across the horizontal or X axis, we have our price-to-values. And then the dots in that graphic represent the companies, and the color of the dots represent the market caps. And here we just, to make it simple, just use mid-cap and large cap.

So we start the graphic June 30th, 2021. And as you can see, if you wanted a really good portfolio that was high quality and it had low price-to-values, that would mean your forward returns look really good. June 30, 2021. It's almost the opposite at Weitz. We still have very high quality portfolio, but as you can see, price-to-values are somewhere in the nineties, about the mid-nineties. And what that means is that the businesses we own or are looking at generally are fairly valued, and that translates into they're probably going to earn our discount rate over time. And then on top of that, there's really not that much dispersion. You see in terms of quality, everything seems to be priced very fairly, and there are very few opportunities for us to switch out into other businesses, because almost none there are below a price-to-value of 80.

So now we go to the end of the year, 2021, and there has been some movement, there's some dispersion between quality. Other words, higher quality businesses are still fairly valued. Lower quality ones might be getting a little, little cheaper, but all in all, price-to-values then are still in the nineties. And as Brad and Wally wrote in their year-end letter, there wasn't much margin for error across the board. So now it's six months later, it's at the end of June 2022. And what does the graphic show? Well, there's been a war started by Russia in Ukraine. There has been increasing inflation. The Fed has responded to that by raising rates. Then, you have lockdowns in China happening periodically, which is, again, messing with supply chains. So stock prices have responded to that and they haven't responded well. But what that means now, as you see the dots all moving to the left. So we end up in a situation where we have high quality businesses that are trading at much more reasonable values. And as I discussed earlier in our conversation, we've done a lot of work to understand which businesses can be resilient in terms of their ability to respond to events. And we always look for quality. You know, we talk about pricing power as well. So when you look at that, our portfolios as they sit today are priced well from a price-to-value standpoint. And generally, that means when the market starts responding to business fundamentals versus, oh my gosh something might happen, that will win out over time. So that should mean good forward returns for investors. But again, I want to caution, we're not talking about today, tomorrow. We're just saying over time, we like the businesses that we have and we've got reasons for that. And so that's why we're optimistic.

Jenna:

Well, Barton, thank you so much for joining us today.

Barton:

All right. Thank you. Can't wait to come back.

Jenna:

And thank you to everyone watching. Once again, that was Weitz Investment Management's director of equity research, Barton Hooper. And I'm Jenna Dagenhart with Asset TV.

IMPORTANT DISCLOSURES

Holdings are subject to change and may not be representative of a Fund's current or future investments.

Past performance is not a guarantee of future results.

Consider these risks before investing: All investments involve risks, including possible loss of principal. These risks include market risks, such as political, regulatory, economic, social and health risks (including the risks presented by the spread of infectious diseases). In addition, because the Fund may have a more concentrated portfolio than certain other mutual funds, the performance of each holding in the Fund has a greater impact upon the overall portfolio, which increases risk. See the Fund's prospectus for a further discussion of risks related to the Fund.

As of 06/30/2022, the following portfolio company constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows:

- Adobe, Inc.: 0.0%, 0.0%, 0.0%, 0.0%, and 2.8%.
- CarMax, Inc.: 0.0%, 4.7%, 4.3%, 3.5%, and 3.5%.
- CoStar Group, Inc.: 0.0%, 5.9%, 3.7%, 4.9%, and 5.0%.
- Fidelity Information Services, Inc.: 1.3%, 0.0%, 5.6%, 0.0%, and 3.9%.
- Liberty Broadband Corp.: 1.3%, 9.1%, 6.6%, 4.7%, and 4.4%.
- Markel Corp.: 1.9%, 3.5%, 5.3%, 3.5%, and 0.0%.
- MasterCard, Inc.: 1.7%, 0.0%, 4.2%, 3.8%, and 4.3%.
- Meta Platforms, Inc.: 0.0%, 0.0%, 4.9%, 2.7%, and 4.1%.
- Visa, Inc.: 1.7%, 0.0%, 5.8%, 4.4%, and 4.4%.

References in this video to particular companies are for illustration only and are not a recommendation to buy or sell any security.

Investors should consider carefully the investment objectives, risks, and charges and expenses of a fund before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com/resources/product-literature or from a financial advisor. Please read the prospectus carefully before investing.

Weitz Securities, Inc. is the distributor of the Weitz Funds.