Quality at a Discount Large-Cap Investing in 2022

Jenna Dagenhart:
Hello and welcome to Asset TV. Joining us today to discuss the critical importance of quality in large-cap investing is Brad Hinton, Co-Chief Investment Officer at Weitz Investment Management. Brad, thank you for joining us today.

Brad Hinton:
Thanks for having me, Jenna.

Jenna:
Of course, and to kick things off, let's talk a little bit about your general outlook on the markets today. As we move into the final stretch of 2021 and look forward to 2022, what are some of the things that you and your team are paying the most attention to?

Brad:
Sure. So, to start off, the economic backdrop, in our view, remains generally constructive. You know, the rebound from the pandemic is continuing. Heavy stimulus is still working its way through the system. Company earnings are coming in nicely and growing well. And for the most part, consumers are in very good shape. That said, inflation has been perking up. We're seeing wage pressures and supply chain disruptions. And what's happening right now is really less important than what's going to happen going forward. So, we're really looking out into the into 2022 for our outlook because that's going to be what helps shape the Fed's response from here.

So, we really view it as kind of a time of heightened uncertainty with a lot of different potential paths. We're watching how the economy handles the Fed's asset purchase taper, which is going to be going from now until probably the middle of 2022. And then potentially what happens with Fed funds rate increases beyond that. And fiscal policy decisions out of Washington also matter a lot. You know, the Infrastructure Investment and Jobs Act has been helpful for a few of our companies. So Vulcan Materials, for example, a rocks and gravel company, the benefits from spending on roads, bridges and the like, it's a company that we've followed since before the Great Financial Crisis, and Nathan Ritz has made a lot of timely buy recommendations on that stock over the past several years. The larger Build Back Better bill is still evolving, so we'll kind of see what that brings over the coming weeks and months.

But overall, valuations seem, in our view, a little bit full, but not particularly scary for the companies that we own at least. But we may have certainly had some pull forward of returns. We do see some notable pockets of excesses forming out there, but generally they're outside of our coverage universe. And while excesses in general are concerning, we don't see many direct linkages to our portfolios.

So overall, the conditions seem ripe for our companies to continue growing at healthy rates over the next several years. Of course, if interest rates spike, we may see some more rapid multiple contraction offset some of that progress. But to us, that's really more about the timing of the returns rather than whether we'll ultimately earn them. And so our summary is that there's just a lot of crosscurrents out there and with higher valuations in general, there's less margin for error in the system. Assets seem priced, in our view, for much lower returns than what we've seen over the last three to five years. And we certainly would expect some more volatility in 2022 and beyond, which puts even more emphasis on owning productively growing businesses, which tend to be right in our quality wheelhouse.

Jenna:

Certainly, a lot of crosscurrents, a lot of moving parts, as you just outlined. And at Weitz, you describe your approach as Quality at a Discount investing. We drilled into this philosophy in past conversations, but just as a refresher, what does Quality at a Discount mean for how you build and manage portfolios and specifically within the large-cap portfolio that you manage?

Brad:
Right, right. So, our philosophy has always been to think like owners, identify and research strong to exceptional businesses, and then buy shares in those companies when they trade for less than what we think they're worth. So, there's two elements to this Quality at a Discount approach, and both of them are important.

The first, like the name implies, is quality. We use our proprietary Weitz Quality Score Matrix as a roadmap to identify the types of companies we'd like to own. And we've identified six elements that we think are really the key drivers of business value creation. Those are our competitive position, return on invested capital or capital efficiency, reinvestment runway, cash flow consistency, financial leverage, and then last but not least, the management team. So, we rate, we evaluate and rate each of these elements on a one to seven scale, with one representing the best businesses.

So for large-cap specifically, we spend most of our time researching companies that cluster in that one or two quality score bucket. To simplify, we think we're looking for better businesses than what traditional value managers do. And we think we're more price sensitive than many growth managers out there. The style offers a nice balance of staying out of trouble by avoiding value traps while also investing in companies with longer growth runways. So, because these businesses tend to have strong existing moats, we focus pretty heavily on how durable the competitive positions are and what might disrupt them. So, when stellar performers like Mastercard see their stocks wobble, we're spending most of our research time looking at competitors and people who might knock the payment networks off their high perches.

Our companies also tend to generate excess cash flow, so savvy capital allocation is critical. Most of our businesses, like industrial gas company Linde can reinvest in their own companies at healthy incremental returns. Some, like AutoZone, create per-value share by systematically repurchasing stock when it trades at a discount. And others, like life sciences companies Thermo Fisher and Danaher are skilled acquirers. So, effective capital allocation is not one-size-fits-all, but this is the area where management acumen really shines brightest.

And while quality is key, it alone is not enough. The second part of our approach is also vital, and that's buying at a discount. Price matters, and no matter how great a business is, we won't sacrifice on requiring a discount when putting capital to work. And for us, this means seeing a path to double-digit annualized returns over our five-plus-year investment horizon. And ultimately, we're looking to have two different ways to win with our investments. The first is growing business value per share, which is where quality plays a central role. And the second is closing the gap between price and value, which is driven by the initial discount. If we get both of those right, we think our investors have a chance to earn strong, differentiated returns.

Jenna:
And to follow up on your point about discounts, the markets have been soaring for much of 2021, we've seen dozens of record highs. How does your approach enable you to find discounts in a high-priced marketplace?

Brad:

Well, for starters, it's definitely more challenging for valuation-sensitive investors at a time like this, but challenging or difficult does not mean debilitating. We do think our approach offers several advantages in this kind of market. First, we have a well-defined priority universe. We know what we like and exactly what we're looking for, which allows our analysts to dig deep and have a strong view on valuations. So, when price dislocations do occur, we can be ready.

Second, we run concentrated portfolios at 25 to 30 stocks, which means we only need a couple of new ideas each year to move the needle, and our team has been able over time to find a few unique gems in almost any market environment.

The third thing, our low turnover and long time horizon allow us to invest with the true owner mindset. Part of our edge is the freedom to think expansively about business valuation, rather than focusing on what may drive the stock over the next quarter or two.

So, a good example of this is Costar Group, which is a leading provider of commercial real estate information services. They have three primary businesses. The Costar Suite is the original real estate data service. It's a free-to-submit, pay-to-view subscription service that's become the gold standard for commercial real estate professionals. A lot of people call it the Bloomberg of CRE. Second business – LoopNet. It's a pay-to-submit, fre-to-view listing venue for commercial properties that are for sale or lease. And then finally, Apartments.com is a collection of online consumer marketplaces that allow apartment owners to advertise vacancies to apartment hunters. So, Jon Baker has followed the company for nearly 20 years, which is kind of hard to believe, and CoStar is the rare company that earns a one quality score across all of our elements. Some of the highlights include a really thick moat with strong competitive leads, durable businesses with very long growth runways, high incremental margins and returns on investment, and a top-tier management team that's been very strategically savvy and operates with an owner's mindset. So price has long been our sticking point, but the business traded into our range back in the earlier days of the COVID pandemic. Our view is that recent weakness in the multifamily revenue stream will prove to be temporary, and we think the stock continues to offer decent value to a long-term owner.

So, another quick example, Roper Technologies is a company that owns more than 40 businesses, most of them with strong market shares and smaller, distinct niches. The company has a decentralized culture that provides authority and accountability to business unit leaders. Roper's core focus has always been on good companies, with high cash return on investment. Most of their recent acquisitions have been in areas like application software and network systems, as well as businesses that have marketplace elements. So in short, we think they're buying in quality neighborhoods. Barton Hooper has covered Roper for our team for several years, and he also follows the industries into which they're deploying capital. So, with his unique lens into software company economics, we viewed Roper as cheaper than it looks earlier this year when we were able to establish a position at a discount to our value estimate.

Jenna:
Finally, Brad, market commentators spend a considerable amount of mental energy trying to predict the next market correction. With market indexes hovering near record high levels, do you think investors should be concerned about a potential drawdown, and do you think it's possible to effectively time the market?

Brad:
Well, drawdowns are a part of investing life, and while they're uncomfortable in many ways, we think they're kind of a necessary ingredient to long-term compounding. And for our investing approach, we just don't think it makes sense to try to time the market. It's extremely difficult to do it well, and it's really not our game. Our strength is in security selection. You know, we're out trying to assemble what we think of as

an all-weather collection of high-quality businesses purchased at sensible prices that we think can grow at healthy rates and make their own breaks over time.

Some of our companies will certainly zig when others zag. But on balance, time should be the friend of a portfolio like that.

We talked earlier about looking for two ways to win. So, when discounts narrow because valuations are high, more of our forward return is definitely more likely to come from business value growth. And that's not a problem, since our companies tend to grow at really healthy rates. But it is less exciting than getting the double dip. The key is really taking what the market gives us rather than trying to force it. And to be clear, we do expect some more volatility in '22. We think that may shake loose some more buys from our actionable list. But in the meantime, we still see pockets of above-average return potential. Our digital advertising companies, kind of led by Meta Platforms; the payments complex; our broadband holdings; and a few of the companies that we've already discussed today. And some of the areas that seem more fully priced, such as life science tools, have been growing underlying value at exceptional rates.

They may well be poised for a breather, or it's possible that they'll continue to surprise us to the upside. But either way, we want to be around for what the next five to ten years hold for these great businesses.

So, while we respect drawdowns and their impact on investors, we just don't spend much time predicting the broader market. Our focus is really on researching companies, valuing businesses, and actively managing differentiated concentrated portfolios.

Jenna:
Well, Brad, always great to have you. Thank you so much for sharing your outlook as we head into 2022.

Brad:
Appreciate it. Thank you very much.

Jenna:
And thank you to everyone out there watching. That was Weitz Investment Management's Co-Chief Investment Officer Brad Hinton. I'm Jenna Dagenhart with Asset TV.

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- CoStar Group, Inc.: 0.0%, 3.3%, 2.4%, 3.5%, 3.8%
- Danaher Corporation: 2.1%, 0.0%, 0.0%, 0.0%, 4.2%
- Linde PLC: 1.2%, 0.0%, 0.0%, 0.0%, 2.2%
- Mastercard, Inc.: 1.6%, 0.0%, 4.4%, 3.3%, 3.6%
- Meta Platforms, Inc. (Facebook, Inc.): 0.0%, 0.0%, 4.8%, 3.5%, 4.7%
- Roper Technologies, Inc.: 1.2%, 0.0%, 0.0%, 0.0%, 2.4%
- Thermo Fisher Scientific, Inc.: 2.1%, 0.0%, 0.0%, 0.0%, 4.2%
- Vulcan Materials Company: 1.7%, 2.4%, 1.2%, 3.6%, 3.4%

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