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Channing Capital Management LLC

The Wisdom of Experienced Investing

What's So "Intrinsic" About Intrinsic Value Investing?

- Intrinsic value investing offers an opportunity for managers to outperform benchmarks and peers by adapting the still-valid principles of Graham, Dodd and Buffett to today's variety of companies.
- Channing's approach of viewing investment opportunities as businesses, rather than stocks, helps create a long-term focus more reliant on company growth strategies than volatile short-term metrics and ratios.
- Concentrated portfolios represent high stock-picking conviction by managers and can offer commensurate returns with only modest increases in risk.

EXECUTIVE SUMMARY

In this paper, we seek to position Channing Capital Management's intrinsic value investment approach in the tradition of Ben Graham, David Dodd and Warren Buffett. We argue that an investment philosophy of intrinsic value investing offers an opportunity to outperform benchmarks and peers by adapting the still-valid principles of Graham, Dodd and Buffett to today's variety of companies. This approach relies on having a long-term perspective more in common with a private investor or corporate board member than that of a short term, price-focused market trader, and remains a powerful investment style in today's environment of hundreds of "value" products, benchmarks and styles.

We also recommend that investors and their advisors consider concentrated, or "best ideas" portfolios when reviewing investment options. Concentrated portfolios represent high conviction by asset managers in their stock-picking skills and can offer commensurate returns with only modest increases in risk resulting from holding fewer names.

High conviction strategies also offer greater opportunities than "diversified" portfolios to benefit from increasing merger and acquisition activity and are more in keeping with intrinsic value investment strategies that view candidates as "companies" rather than "stocks".

ABOUT CHANNING

Founded over a decade ago, Channing Capital Management is a Chicago-based investment management boutique serving institutional investors. Today, under the leadership of the three founding partners, the firm remains committed to these original core values:

- Competitive Excellence
- Collaboration and Teamwork
- Strong Ethics
- Clients First
- Mutual Respect

Channing's assets under management have grown to more than $2.25 billion (approximately as of 1Q 2015) since inception using a consistent and singular investment approach that focuses on identifying company Intrinsic Value and is available in Small-, Smid-, Mid-, Large-, and All Cap value implementations.

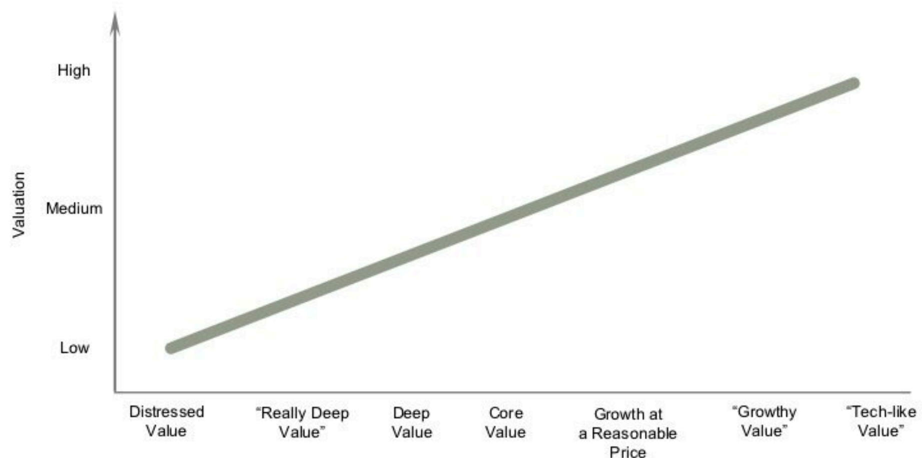
What's So "Intrinsic" About Intrinsic Value Investing?

While Ben Graham and David Dodd are credited with popularizing the concept of "intrinsic" investing in their 1934 book "Security Analysis", it is important to remember that they did not define intrinsic value by use of formulas that would enable investors to replicate their approach. Their seemingly simple admonishment was to only buy the stock of a company after a complete analysis of the company's financials indicates that the current price does not accurately reflect the company's value and that, over time, the market price will move to reflect "true valuation."

Similarly, Warren Buffett, an advocate of Graham and Dodd's approach and, by popular legend the only student to receive an A+ in Graham's investment seminar, appears to have a straight-forward—although somewhat more difficult to implement as successfully—approach to identifying intrinsic value. Graham, Dodd and Buffett all do agree on the need to measure what they define as the "margin of safety"; or the spread between current market price and the analyst's estimation` of the company's intrinsic value.

The phrase "value investing"[1] is also somewhat of a misnomer. No investor would advocate buying "overvalued" stocks which, by definition have only one way to go price-wise: down. The need to categorize money managers to allow for apples-to-apples comparisons has led to a plethora of categories used by intermediaries confronted with thousands of products. These include products reflecting a variety of approaches:[2]

Exhibit 1: "Value in the Eye of the Beholder"



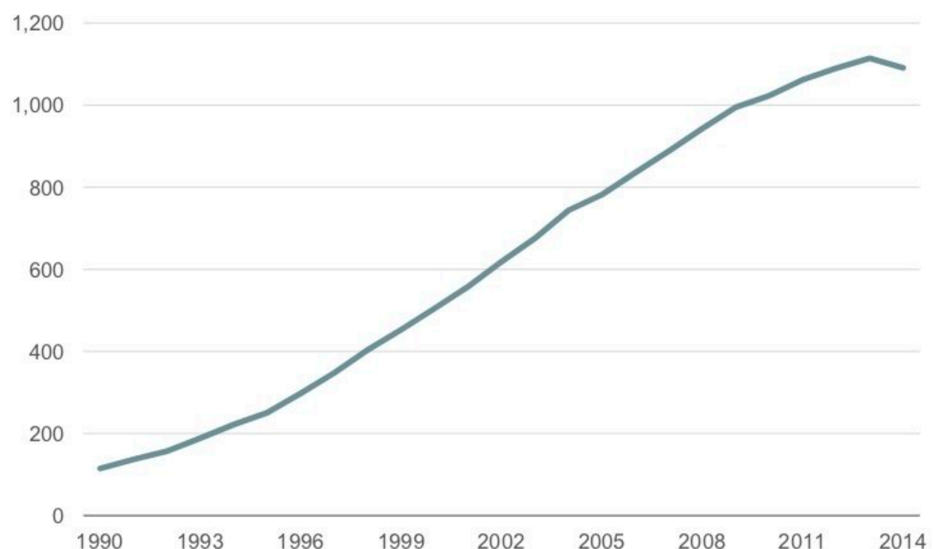
[1] In fact, Graham did not coin "value investing" as a phrase. "Value investing" came to be the term used to define the act of purchasing stocks that were not simply cheap versus peers but whose prices reflected a market misunderstanding of their prospects.

[2] Some of these categories are, candidly, not formal definitions but, rather, observations on how "value" managers occasionally stray into other fields given current market conditions in search of investor assets.

In their search for the "perfect" benchmark—one that captures their unique approach and, hopefully, has been outperformed in the past, managers have prevailed upon vendors to create an ever-expanding list of options based on style, volatility and market capitalization. Coinciding with the growth in categorization of managers is the increase in the sheer number of products investors and their advisors must contend with and select from. In the category of "value equity" alone, there were 1,127 strategies offered by 459 different firms as of year-end 2014 spanning capitalization categories from micro to mega cap—a far cry from the 115 products 25 years ago!

Much has changed in the 80-odd years since *Security Analysis* was published, but the philosophy of intrinsic value investing remains a compelling investment approach.

Exhibit 2: Number of Value Products in eVestment Database



Source: eVestment

Looking at the variety of categories, style boxes, indices and other means of differentiating and distinguishing one manager from another, observers, understandably, might ask "What ever happened to Ben Graham's advice to determine a company's intrinsic value and buy its stock if a sufficient margin of price safety is present?"

Much has changed in the 80-odd years since "Security Analysis" was published and, while the philosophy of investing in a business because the intrinsic value of the company is attractive remains a key investing method, the make-up of companies has changed and continues to change.

Companies which rely on intellectual capital, rather than physical capital, to drive revenue and profits are far more prevalent than they were only 25 years ago and their weight and importance in benchmarks requires managers to assess the attractiveness of the company's stock if only to decide not to hold it. In many cases,

media and technology companies, when subjected to traditional "hard" screening and valuation methods including price to earnings (P/E) or price to book (P/B), appear not to meet the test of intrinsic value with a margin of safety. This is particularly the case for investors who rely on P/B where calculating the book value of the creative people at a technology firm may be far more difficult than assessing the break-up value of a steel mill.

The challenge in this environment is to create a methodology which does not accept trading prices for stocks as gospel but, rather, relies on a bottom-up process which compares the actual worth of a company based on its long-term financial and competitive strengths compared with the market perceptions which often drive current prices. The process needs to be equally effective when analyzing companies in widely-ranging industries with different customers, products and competitors.

In a word – more Warren Buffett and less high-turnover trading!

One Approach to Determining Intrinsic Value

At Channing Capital Management, we believe our approach to defining intrinsic value provides an attractive method to identify and invest in businesses that the equity market has undervalued.

The first order of business is to ask ourselves "is this a good company?" rather than "is the current market price an "undervalued" one?" This requires a different frame of reference than that of many asset managers—an outlook more akin to a private equity investor or a board of directors member than a trading-focused worldview that leads to a focus on daily prices and metrics to peers. In a word, more Warren Buffett and less high-turnover trading!

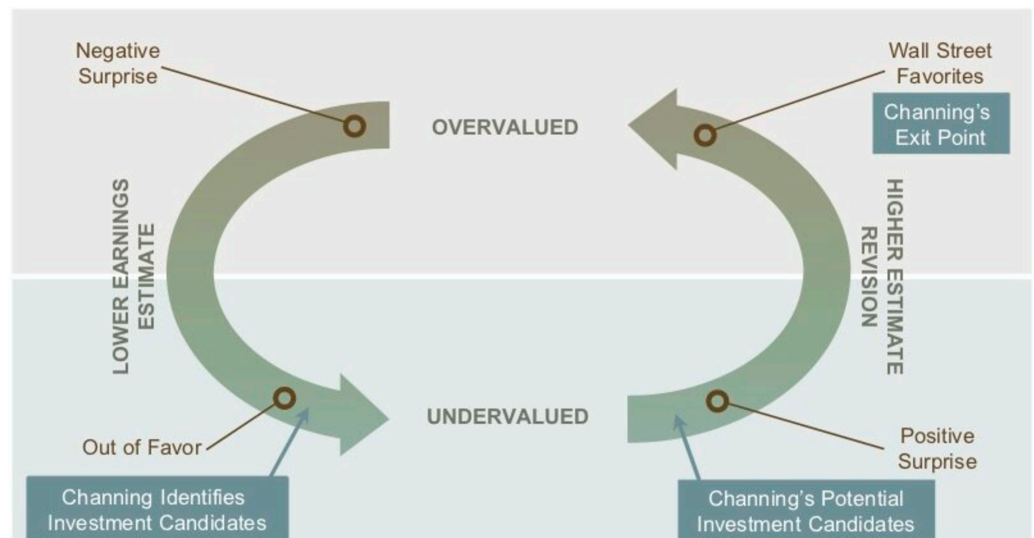
In keeping with viewing investment options from the standpoint of a private investor who wonders if the business deserves long-term investment, we are far more interested in a company's growth strategy, its plans to improve profitability, and the long-term business plan than whether the current stock price-to-book ratio is below median. We seek to determine a company's intrinsic value through a determination of the enterprise value of the business, often by employing a "sum of the parts" analysis to determine a company's intrinsic value, particularly when a firm has distinct divisions with little synergy across them. We believe that determining enterprise value through both quantitative and qualitative methods is the key to an investment philosophy that views buying companies, as opposed to trading stocks, as key to delivering long-term competitive returns to benchmarks and peers.

A key component of determining enterprise value is the role of company management in ensuring that firms earn more than their cost of capital and have a proven track record of protecting the value they have created. Once this has been established, a "margin of safety"—the second element in Graham and Buffett's

approach--can be implemented. For Channing, our margin of safety is that the company's stock must be currently priced at a significant discount to the measure of enterprise value.

Below is a graphic representation of our approach—in a word, we are looking for "Misunderstood/Underappreciated" companies—businesses that to borrow from Rodney Dangerfield "get no respect"— that have the potential to become darlings of Wall Street.

Exhibit 3: Hunting for Misunderstanding and Underappreciation



Enterprise Value in Practice

For Channing, one key to identifying misunderstood/underappreciated companies as potential candidates for our portfolios is simply to review the performance of names in our starting investment universe versus the market. Businesses which have declined significantly versus the appropriate benchmark over the last year are certainly not favored by the stock market! We then ask ourselves, are they misunderstood/underappreciated or are there good reasons for their apparent lack of respect?

The key to answering this question is the determination of the firm's enterprise value. Has the market's reaction been in accordance with company fundamentals? While the marketplace has become much larger, dynamic and more efficient over the years as a result of proliferating information and media coverage, the short-term nature of the market has not changed. To find misunderstood/underappreciated businesses that are trading at significant discounts to their intrinsic—or private market—values on a cash flow basis, meeting with company management across

the seniority spectrum is crucial. Below are a few of the topics covered during these meetings:

- Who are your major customers and suppliers? We plan to contact them.
- What companies and competitors in your industry do you admire and why?
- Are your products unique and generating significant cash flows?
- Is the market share of your base business defensible from competitors?
- How will you execute your growth strategy; specifically:
  - Will new products drive revenue expansion?
  - Do you have a plan to expand into non-U.S. markets?
  - Are you considering acquisitions to help implement your goals?
  - Are there developments that might derail your plans?
  - Are you using cash in an accretive manner to build shareholder value and growth or is it "parked" in short-term, near 0%, securities?

Many managers "bury" their good ideas in a large portfolio of names; many of which may be included primarily for their role in reducing risk compared to a benchmark.

Meetings with company management provide an opportunity to determine whether the market has accurately priced a firm's response to these underlying global/secular demand themes or if the market has misunderstood or underappreciated a company's unique business model. Many of the strongest-performing companies in Channing's portfolios fall into the latter category.

The Benefit of Concentrated Portfolios, or When Optimizers May Not Be Your Friend

"A policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it."

Intuitively, what Warren Buffett said above makes sense and at Channing we manage client assets in the form of concentrated portfolios. Yet relatively few other asset management firms, as we note below, implement their stock selection process in "best-ideas" or concentrated portfolios. We believe this is due to the conflation of business risk, e.g. the risk of losing revenue, with portfolio risk, or the risk of underperforming benchmarks and peers. In our opinion, too many managers "bury" their good ideas in a large portfolio of names, many of which may be included primarily for their role in reducing risk compared to a benchmark.[3]

[3] The goal of minimizing business risk by diversifying portfolio holdings is perhaps most apparent in large cap products where stock-level information not already discounted by the market is much more difficult to develop than for small cap management where far fewer sell-side analysts issue reports. Still, small cap managers are not immune to the temptation to reduce risk by increasing holdings; particularly as assets under management grow.

Are concentrated portfolios inherently "riskier" than those which include more names? Or does the level of conviction embraced by concentrated managers offset what may be higher levels of trading as more "diversified" products are re-constituted to reflect changes in their reference benchmark?

In an attempt to answer this question, we used the eVestment small cap value universe of 255 actively-managed products. On average, the managers in this group held 79 names at Q4 2014, ranging from a high of 769 names to a low of 12 stocks. (Index managers are not included in this group.)

We then divided the universe into several categories by number of holdings, including managers above and below the median level and a group of managers generally similar to Channing in terms of portfolio concentration which we set at 50 holdings or less. We then measured the standard deviation of the benchmark and the median manager in each group as shown below:

High conviction management styles may result in commensurate risk to more "diversified" approaches simply because conviction-based managers do a better job.

Exhibit 4: Risk (Standard Deviation) of Small Cap Value Products by Number of Holdings

	Index (Russell 2000 Value)	Full universe	More than 80 hldgs.	50 to 80 hldgs.	Less than 50 hldgs.
3 years	12.1	12.5	12.4	12.6	12.9
5 years	18.7	18.7	18.7	16.9	19.3
10 years	20.6	20.3	20.3	18.6	21.7
# of products		255	103	59	54

Source: eVestment Alliance

While there is an increase in observed standard deviation risk as the number of holdings declines from the index level of approximately 1,350 names, the differences are often quite small in percentage terms. For example, an investor who selected the median manager in the most concentrated grouping experienced only 3% to 7%, depending on the time period, higher risk than holding the Russell 2000 Value index and comparable risk levels when compared to the full universe and the other groups.

Could it be that Buffett was right when he linked level of conviction to knowledge of the intrinsic value of companies? One would think that holding less than 50 names would result in significantly higher risk than holding an index of 1,000 plus names or a median manager who holds more names than average, but the differences are relatively minor. High conviction management styles may result in commensurate risk to other approaches simply because these managers do a better job, given the depth of analysis required at the stock selection level, than their peers.

Successful high conviction managers are also well-positioned to benefit from increasing merger and acquisition activity which, over the last few years, has recovered dramatically from the Great Recession, with 2014 recording the highest corporate M&A activity in the last seven years. If one or two companies in a 40 stock portfolio are acquired, the impact on overall performance will be significantly greater than the impact accruing to a "diversified" portfolio of 100 holdings. At the same time, companies of all sizes—particularly small and mid cap firms—which are using excess cash to acquire other businesses to successfully implement their growth strategy, rather than holding outsized cash balances, are being increasingly rewarded in the marketplace. Companies such as these are also well-represented in Channing's portfolios.

Many managers, particularly those at the larger end of the universe in terms of holdings, use risk management systems to recommend stocks and weights that will, they hope, "minimize" risk versus the benchmark. We take a different approach that does not make use of software to manage risk arising from our high conviction investment process: we rely on qualitative risk aversion, common-sense stock weightings versus the benchmark and sector/industry exposures commensurate with our insights.

CONCLUSION

In this paper we have argued that the concept of intrinsic value investing offers an opportunity for managers like Channing to outperform benchmarks and peers by adapting the still-valid principles of Graham, Dodd and Buffett to today's variety of companies that range from commodity-reliant industrial firms to creative-dependent media businesses. Channing's approach of viewing investment opportunities as businesses, rather than stocks, helps to create a long-term focus more reliant on company growth strategies than volatile short-term metrics and ratios.

We also recommend that investors and their advisors consider concentrated, or "best ideas" portfolios when reviewing which manager to select particularly in the small and small/mid cap arenas. Concentrated portfolios represent high conviction by managers in their stock-picking skills and can offer commensurate returns with only modest increases in risk resulting from holding fewer names.

In our next paper in this series, we will discuss small cap equity investing specifically and some of the advantages investors may receive by expanding the small cap definition to the broader small-mid cap, or SMID, universe.

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