

## Q&A

# Spying Value in Financials and Tech Stocks

*C.T. Fitzpatrick of Vulcan Value Partners practices patience, but his fund has quickly delivered sizzling returns.*

By **TERESA RIVAS**

Ancient Romans worshipped Vulcan, the god of fire. Today, investors are worshipping the hot returns generated by C.T. Fitzpatrick, chief investment officer at Vulcan Value Partners.

Fitzpatrick manages nearly half a billion dollars in assets in the firm's eponymous fund (ticker: VVPLX), which earns a five-star rating from Morningstar, and has outperformed both its peers and the Standard & Poor's 500 in the past one- and three-year periods.

Fitzpatrick has a five-year investment horizon, but patience is only one part of his strategy. He also looks for companies that he believes can expand their multiple over time, thanks to sustained competitive advantages. Currently, he sees a number of opportunities from banks to technology.

Read excerpts from his interview with Barrons.com below:

**Barrons.com: Most of your top five holdings— Bank of New York Mellon (BK), Franklin Resources (BEN) and CME Group (CME)—are in the financial services industry. What attracted you to them?**

**Fitzpatrick:** We don't own any commercial banks because the business quality of what's available to us does not meet our criteria. All of our companies have very strong balance sheets, produce a lot of free cash flow and have sustainable competitive advantages. Even though they are financials, they have much better business models than what you might think. For example, Bank of New York Mellon is a custody bank—not a commercial bank. It has very different free cash flow, bal-

ance sheet and return on capital characteristics. The company is discounted because after growing earnings steadily for years, it is having flattish earnings right now [as] interest rates are at record lows. There is nothing fundamentally changing in their business. Their earnings growth has been interrupted, but if you kind of dig deeper into the numbers, all of the foundational things that lead to value growth are in place, and sooner or later interest rates will normalize to more normal levels, and their earnings power will be sustainably higher than it is now.

Franklin Resources is an extremely well managed and very diversified asset-management company. It has global distribution, with a lot of customers domiciled outside the U.S., so it is one of the most internationally diversified money managers in the U.S. We think that it can grow over time in line with the growth in global financial assets. It is a company with a strong balance sheet, high free cash flow and a great track record, both operationally and from a capital allocation perspective, over many years.

CME Group is absolutely dominant in the contracts that they trade, and the high liquidity that they provide creates a barrier to entry to competitors. Others have tried to take market share from them in their core products but have not succeeded. Just like Bank of New York Mellon, CME's results are being held back by record low interest rates. As interest rates normalize we think earnings could accelerate quite a bit. Until then, we get a really large free cash flow coupon and the company remains competitively entrenched; all the long-term factors that

### Manager's Bio



**Name:** C.T. Fitzpatrick  
**Age:** 49  
**Title:** Chief investment officer  
**Education:** B.S. in corporate finance and minor in English, University of Alabama;

M.B.A., Owen Graduate School of Management at Vanderbilt University

**Hobbies:** Fly fishing

### Fund Facts

(as of March 1, 2013)

**Vulcan Value Partners Fund (VVPLX)**  
**Assets:** \$444 million  
**Expense Ratio:** 1.5%  
**Front Load:** None  
**Annual Portfolio Turnover:** 49%

*Source: Morningstar.com*

drive results are in place. So that's why we are five-year shareholders. We don't know when cyclical conditions will improve, but while we are waiting our value is growing steadily through the production of free cash flow; we are thrilled to own this wonderful business at a fraction of our estimate of its worth and also at a fraction of comparables.

**Is Dover (DOV) a name that could benefit as U.S. manufacturing strengthens?**

I agree with that thesis, but that's not

*(over please)*

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## Top 10 Holdings (as of Dec. 31, 2012)

Apple	(AAPL)
Bank of New York Mellon (BK)	
Franklin Resources	(BEN)
CME Group	(CME)
Dover	(DOV)
Tesco	
Nasdaq OMX Group	(NDAQ)
InterContinental Hotels Group	(IHG)
Cisco Systems	(CSCO)
Everest Re Group	(RE)

Source: *Vulcan Value Partners*

why we own it, that's just kind of icing on the cake. We bought it because it is a really well-managed company that meets our criteria. They are dominant in their industries. They generate a lot of free cash flow. They allocate that free cash flow coupon very well, and it is a company that has been able to steadily grow its value for many, many years.

### Most of your holdings are based in the U.S., but Tesco is one exception. What drew you to it?

Tesco is generally not cheap. Over the last couple of decades it has been fully valued or even overvalued. The new management team has taken steps in the short run

that are holding back results, but that will strengthen the company longer term, and we really applaud them for it. Free cash flow is increasing and they are improving their competitive position, but it is hurting margins in the short term. However, as long-term investors it's wonderful that the stock price is reacting negatively for short-term reasons. The underlying long-term fundamental drivers for the business are getting better, not worse, and that's the kind of situation we look for.

### You also own a fair amount of tech, including Apple (AAPL), Google (GOOG) and Cisco (CSCO).

With Apple, leaving technology aside, you have one of the most recognized brand names in the world and global distribution—that is a really powerful combination. It is an extraordinary company obviously, with a very strong balance sheet, and it trades net of cash at about seven times free cash flow. That is just ridiculous for a company that has the resources and the competitive advantages that it has; on brand name value alone it should trade for more than seven times free cash flow.

Cisco is growing much more slowly than Apple. They dominate their core businesses, and they just can't gain much more market share. So they are kind

of locked into the growth rates of their markets, which is mid-single-digit kind of growth. But they generate an enormous free cash flow coupon—the record isn't perfect, but overall the batting average is very good, and they've allocated capital very intelligently, which has led to double-digit value growth for Cisco.

Google just goes from strength to strength. People don't say "search it," they say "Google it," so they have a brand, and that brand is reinforced around the world millions of times a day whenever anyone searches the Web. Google has used its search dominance to reinvest and protect the moat around its business. Think about the transition from desktop to mobile search and what Google has done with Android. They are focused on the long term and on protecting their competitive advantages even at the expense of short-term earnings and we, as long-term investors, applaud management for that.

Thanks.

### Investment Philosophy

Fitzpatrick is a value investor primarily concerned with reducing risk and investing in stocks with competitive advantages. He looks for companies with healthy free cash flow and return on capital, which he views as harbingers of sustainable performers.

## Vulcan Value Partners Funds:

The Vulcan Value Partners Fund seeks to achieve long-term capital appreciation by investing primarily in mid- and large-capitalization U.S. companies believed to be both undervalued and possessing a sustainable competitive advantage.

The firm's AUM as of December 31, 2012 was \$1,281B.

Inception Date: December 30, 2009	As of December 31, 2012			
	Current Quarter	YTD	1 Year	Annualized Since Inception
Vulcan Value Partners Fund	2.20%	24.38%	24.38%	12.47%
Russell 1000 Value Index	1.52%	17.51%	17.51%	10.49%
S&P 500 Index	-0.38%	16.00%	16.00%	10.48%
*Total Expense Ratio Net: 1.25%				
Total Expense Ratio Gross: 1.51%				

\* Vulcan Value Partners, LLC ("Vulcan" or the "Adviser") has contractually agreed to limit the Fund's total annual fund operating expenses (exclusive of Acquired Fund Fees and Expenses, brokerage expenses, interest expense, taxes and extraordinary expenses) to 1.25% of the Fund's average daily net assets. This agreement is in effect through August 31, 2013. If the Adviser foregoes any fees and/or reimburses the Fund pursuant to this letter agreement with respect to a particular fiscal year, then the Adviser shall be entitled to recover from the Fund the amount foregone or reimbursed to the extent Fund's expenses in later periods fall below the annual rates set forth in the relevant agreement. The Adviser may not discontinue this waiver without the approval by the Fund's Board of Trustees.

*The data quoted represents past performance. Past performance is not indicative of future results. Investment return and value of shares will fluctuate. Upon redemption, shares may be worth more or less than their original cost. The performance figures do not reflect the deduction of any taxes a shareholder might pay on distributions or redemptions. The current performance may be higher or lower than the quoted performance. Vulcan Value Partners does not have a sales charge. Please call 1-877-421-5078 or visit our website, [www.vulcanvaluepartners.com](http://www.vulcanvaluepartners.com), for the most recent month-end performance results. Recent growth in the stock market has helped produce short-term returns for some asset classes that may not continue in the future.*

### RISKS:

The S&P 500 Index is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index. The S&P 500 Index figures do not reflect any fees, expenses, or taxes. Investors cannot invest directly in this index. The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. An investment cannot be made directly into an index. The Russell 1000 Index measures the performance of the 1,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. **Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market or economic developments. Value stocks can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Recent growth in the stock market has helped produce short-term returns for some asset classes that may not continue in the future.**

Referenced Holdings as of December 31, 2012	% of Total Portfolio
Apple Inc.	6.1%
Bank of NY Mellon	4.9%
Franklin Resources	4.8%
CME Group	4.8%
Dover Corp	4.6%
Tesco PLC	4.6%
Nasdaq Stock Mkt	4.6%
Intercontinental Hotels	4.5%
Cisco Systems	4.5%
Everest RE Group	4.5%
Google	3.9%

Large-growth funds invest in big companies that are projected to grow faster than other large-cap stocks. Most of these funds focus on companies in rapidly expanding industries.

\*Investment performance reflects fee waivers and in the absence of waivers returns would be reduced and ratings may have been lower. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) **Vulcan Value Partners (VVPLX) was rated 5 Stars out of 1503 for the 3-year period against Large Growth Funds. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated**

**with its three-, five- and ten-year (if applicable) Morningstar Rating metrics, as of December 31, 2012.** Morningstar Rating is for the retail share class only; other classes may have different performance characteristics. © 2012 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. All information in this report is as of the date shown in the upper right hand corner unless otherwise indicated.

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*For more complete information, please download the funds' prospectus available on [www.vulcanvaluepartners.com](http://www.vulcanvaluepartners.com), or call 1-877-421-5078 for copies. You should consider the funds' investment objectives, risks, charges and expenses carefully before you invest. Information about these and other important subjects is in the funds' prospectus, which you should read carefully before investing.*

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