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Q&A

4 Big Value Picks From an Index-Beating Manager

C.T. Fitzpatrick, CIO of Vulcan Value Partners, makes the case for Oracle, Anthem, and one oil company.

By TERESA RIVAS

Value stocks have underperformed growth stocks every year since 2007, their longest losing streak for in more than 30 years. Historically, value investors have been rewarded after suffering through such periods, and recent market action suggests their day may have arrived. Since the start of 2016, the iShares Russell 1000 Growth exchange-traded fund has lost 0.3%, while the value ETF has gained 3.7%. Investors seem less willing to pay hefty premiums for last year's momentum darlings – of the four so-called FANG stocks, only Facebook shows gains for this year.

C.T. Fitzpatrick, chief investment officer at Vulcan Value Partners and manager of its eponymous fund, believes it is time for value investing to make a comeback, although he warns it may take longer than expected.

That may not sound surprising, given Vulcan's value bent. What is surprising is the Vulcan Value Partner fund's (ticker: VVPLX) consistent outperformance: The fund – which was No. 1 in its category year-to-date at the end of April – has beaten the Standard & Poor's 500 and its peers every year for the past five years save 2015, and it is ranked No. 3 in its category for the past five-year period.

How has Fitzpatrick been able to outpace the market despite value's difficulties? He attributes his success to his strict investing discipline that emphasizes companies with sustainable competitive advantages and strong balance sheets. While price-to-earnings is an important metric, he emphasizes free cash flow, which he says reveals a healthy company even when transitional changes temporarily depress profits. These attributes help him avoid value traps, while his three-to-five-year investing horizon means he's happy to scoop up oversold shares after a bad earnings report.

Today he sees opportunity in big tech names such as Oracle (ORCL), while mostly avoiding the energy patch. Read excerpts from his interview with Barrons.com below.

Barrons.com: For a number of years, value investing simply didn't work. Do you believe we're finally seeing that change?

Fitzpatrick: Value is beginning to work again and it's long overdue. There has been a lot of silly stuff that has been working, things that are trading at very risky valuation levels, so it is way overdue for a rotation into value.

Q: Is it difficult to be a value investor after such a long bull run?

A: Yes, it is way past time for value to take leadership from growth. But the contradictory statement is that this far into a bull market, it is getting a lot more difficult to find good values. Markets continue to rebound. In January things were looking really, really good…and now we've gone from being aggressive buyers to being more defensive as markets have rallied throughout the first quarter from the January lows and on into the second quarter.

Q: Is that part of an argument for active management then – to have the discipline to buy only when true value exists, even if it's getting tougher to find?

A: You are exactly right. You're late into a

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Fund Facts
(as of May 2, 2016)

Vulcan Value Partners Fund	**(VVPLX)**
Assets:	**$1.5 billion**
Expense Ratio:	**1.08%**
Front Load:	**None**
Annual Portfolio Turnover:	**64%**
Yield:	**0.68%**

Source: Morningstar

Top 10 Holdings
(as of Dec. 31, 2015)

Oracle	**ORCL**
Parker Hannifin	**PH**
National Oilwell Varco	**NOV**
Franklin Resources	**BEN**
Discovery Communications	**DISCK**
Swiss Re	**SREN.Switzerland**
MasterCard	**MA**
Cisco Systems	**CSCO**
Anthem	**ANTM**
Boeing	**BA**

Source: Morningstar

bull market and everything has been going up pretty much for years, and when that's happening there has not been a lot of dispersion among individual names. We've had a very aggressive monetary policy, interest-rate suppression around the world, and it has pushed up equity prices globally. When you're in an environment like that, it is hard to differentiate yourself from just the general rise in markets; indexing can look more attractive. Now when that reverses – and inevitably it will – and there is more dispersion between different individual securities, that's when active management is going to look a whole lot better. If you are holding an index fund and it just goes down and down, and there are individual managers who are exhibiting skill and have something to work with because there is more dispersion, active management could look a whole lot better than it does now.

Q: What about the energy sector. Should value investors be looking there?

A: We're value investors, but we don't look for cheap stocks. We look for businesses with inherently stable business values, and we wait for them to get cheap – and most of them are not cheap most of the time. Value stability is just really, really important to us; you can't have a true margin of safety if your values are as volatile as your stock prices. So, in the energy sector most companies' values are volatile as they're dependent upon a commodity price that ultimately determines their worth. A lot of them have a lot of financial leverage and their values are just not stable. So, you can buy things that are statistically cheap, but you would not have what we would call a sustainable margin of safety. So, we're way underrepresented in the energy sector. We've owned Schlumberger (SLB) in the past; we don't currently own it. We own National Oilwell Varco (NOV). It is one of our largest positions, we've owned that for a while now. So there are some companies in the energy sector that we find attractive. But when we look at the sector as a whole it kind of gets back to the index versus active management: If you just want to buy an ETF or something with energy exposure you are going to buy a lot of companies that have bankruptcy risk. The companies that we own are financially strong, have stable values, and extract superior economics from the industry.

Q: What is it about National Oilwell Varco that makes it stand out?

A: It is generating tremendous free cash flow while we're waiting for conditions in the industry to improve. It just reported results and its GAAP results were awful, but we knew they were going to be awful. At the same time its free cash flow production was fantastic. So our value actually went up just because of the cash that they generated.

Q: Can you talk about United Technologies (UTX), a relatively new addition to the portfolio?

A: We've owned United Technologies in the past, and it is one of the companies that has a very stable value. Its results have been hurt in the last couple of years by a very strong dollar and by weakness in some of their overseas markets, particularly in China. But the company's value continued to grow: It generated a lot of free cash flow even though its bottom-line results were hurt. That's the wonderful thing about companies that generate free cash flow – even if their GAAP results are not great, the accretion of cash is value additive and when a company like United Technologies can allocate capital intelligently, as it has, return on capital helps value grow even more. We're a big fan of the relatively new CEO, he used to be the CFO, and we like what he is doing. For the next year or two they're at a relatively slow growth mode, but they're focusing on efficiencies and cost reductions and we think they're doing the right things.

Q: Anthem (ANTM) is also a new addition.

A: Anthem is doing a really good job adapting its business model to the Affordable Care Act, and it has scale where scale really matters. So it is just very well positioned in the current health-care environment and, obviously, we thought the fundamentals of the company were not reflected in the stock price.

Q: Tell me about Oracle, your top holding.

A: Oracle and SAP (SAP) really are dominant in the large enterprise market. SAP is stronger in applications; Oracle is stronger in databases. But if you look at the overall picture of Oracle and its applications plus it database products, we think it's in a better position than SAP is. We like SAP, but if you had to compare the two companies and only choose one, we prefer Oracle. Oracle is way ahead in converting its customers to the cloud, which is a more profitable way to deliver products than on-premises enterprise solutions. Traditionally when a customer signed up for a product there was a one-time license fee, then ongoing maintenance fees where Oracle made all its money. In a cloud-based delivery of the exact same product there is no one-time license fee, so it hurts their revenue growth in the short run. But if you dig deeper, you see a traditional on-premise business that is growing slower than it used to and a rapidly growing cloud business. The more rapidly the cloud business grows in the short run, the more it hurts Oracle's growth rate, but the cloud will become big enough that more rapid growth will offset the slower growth at the on-premises business. Oracle's consolidated growth rate should begin to accelerate probably within the next 12 to 18 months.

Q: Thanks.

Disclosures:
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.

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Risks:

- **It is possible that the Fund may invest in securities offered in certain types of transactions (such as private placements) that, because of that Fund's size, may have a disproportionate impact on that Fund's performance results. The Fund would not necessarily have achieved the same performance results if its aggregate net assets had been greater.**
- **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.**

	As of March 31, 2016				
Inception Date: December 30, 2009	Current Quarter	1 Year	3 Year	5 Year	Annualized Since Inception
Vulcan Value Partners Fund (VVPLX)	**4.44%**	**-5.23%**	**9.96%**	**12.86%**	**12.45%**
S&P 500 Index	1.35%	1.78%	11.82%	11.58%	12.48%
Morningstar Large Growth Category	-2.45%	-2.37%	11.07%	9.88%	-
*Total Expense Ratio: 1.08%					

The performance numbers show the fund's historical 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 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, for the most recent performance and current price.

**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, 2016. 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 fund imposes a 2.00% redemption fee on shares held less than 90 days. The performance shown does not include the redemption fee, which if reflected would reduce the performance quoted.*

The Percent Rank in Category is the Funds total-return percentile rank relative to all funds within the same Morningstar category and is subject to change each month. Vulcan Value Partners Fund (VVPLX) was rated 89 out of 1,618 for the 1-year period, 61 out of 1,476 for the 3-year period, and 3 out of 1,296 for the 5-year period against Large Growth funds.

Definitions:

Alpha - a measure of the difference between a fund's actual returns and its expected performance, given its level of risk as measured by beta.
ETF- Exchange Traded Fund
FANG stocks – Facebook, Amazon, Netflix, and Google which is now Alphabet Inc.
GAAP – Generally Accepted Accounting Principles
Free Cash Flow- Amount of cash that a company has left over after it has paid all of its expenses, including investments.
Margin of Safety – The price to value ratio is a calculation that compares the price of a company's stock to our appraisal of the company's intrinsic value. Fair, or intrinsic value is our estimate of the price a willing buyer would pay and a willing seller would accept, assuming neither was compelled to enter into a transaction. Margin of Safety is a favorable difference between the price of a company's shares and our estimated fair value of those shares.
Price to Earnings Ratio – a calculation that compares the company's stock price to the company's earnings per share.
The S&P 500 Index - 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.

An investment cannot be made directly into an index.

The holdings referenced in the article, Oracle (ORCL), National Oilwell Varco (NOV), United Technologies (UTX), and Anthem (ANTM), had the following percentage of total net assets in the Vulcan Value Partners Fund as of March 31, 2016, respectively: 8.85%, 5.98%, 2.64%, and 3.19%.

The referenced holdings are subject to change.

ALPS Distributors, Inc. is the distributor for the Vulcan Value Partners Fund.

Please call 1-877-421-5078 to obtain a copy of the Prospectus, which should be read carefully before investing to learn about the investment objectives, risks, charges and expenses of the Vulcan Value Partners Fund.

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