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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Using Volatility as an Advantage When Investing in Value-Stable Companies

C.T. FITZPATRICK, CFA, is the Founder, CEO and CIO of Vulcan Value Partners. Mr. Fitzpatrick founded the firm in 2007 to manage his personal capital. Since inception, all four strategies have peer rankings in the top 1% of value managers in their respective categories. Prior to founding the firm, Mr. Fitzpatrick worked as Principal and Portfolio Manager at Southeastern Asset Management. During his 17-year tenure, the team at Southeastern Asset Management achieved double-digit returns ahead of inflation and was ranked in top 5% of money managers over five, 10 and 20-year periods according to Callan and Associates. Mr. Fitzpatrick has an MBA in finance from the Owen Graduate School of Management at Vanderbilt University, and a B.S. in corporate finance from the University of Alabama.

SECTOR — GENERAL INVESTING

TWST: Give us a quick overview of the firm, please.

Mr. Fitzpatrick: We started Vulcan Value Partners in 2007 to manage our personal capital. One of the things that's unique about us is that everyone who works here is required to invest their money exclusively through Vulcan. That means we are completely aligned with our clients.

We had no idea we would ever grow to the size that we have; we just wanted to manage our own personal capital and fund other clients who would be our partners and who share our view of risk, and who have our time horizon and provide stable capital. We didn't know whether there would be a lot of people who were interested or just a few, but the way we view it is we do what we do, it appeals to some people, it doesn't appeal to other people.

We are not for everybody, and we enjoy working with other intelligent investors who view the world the way we do. We have been very, very fortunate to find some some wonderful clients. We really are just doing what we would do anyway, whether we had one client or a bunch of clients. We were very fortunate to have some wonderful clients from all over the world.

TWST: What is the current status of the markets?

Mr. Fitzpatrick: The market is pricey now. It is a lot tougher to find qualifying ideas than it was, and we think that risks are much higher today than they were a few years ago. It's kind of counterintuitive, but if people become more relaxed and volatility drops as it has, and memories of the financial crisis fade, people become less cautious and valuation levels go up, and that actually introduces more risk.

We have a kind of perverse view of the world. When everybody else was freaking out in 2008 and 2009, we were in a really good mood. Now everybody is in a better mood, and we find ourselves in a worse mood.

TWST: Is volatility a good thing or is it a bad thing or is it neutral?

Mr. Fitzpatrick: For some people, volatility is a bad thing. For us, it's a very good thing, and that's because we are extremely disciplined in the types of business in which we will invest, leaving price aside. Our businesses have inherently stable values, so therefore when there is stock price volatility, it works to our advantage, and we love volatility.

But if you were doing something different than we were doing, volatility could be very bad. So it really depends on your position and what kind of investments you make. For the kinds of investments that we make, the volatility is good.

TWST: What are the characteristics that you look for of companies to include in the portfolio?

Mr. Fitzpatrick: There are a lot of characteristics that lend themselves to value stability, but the key thing is that stable value. We are really looking for stable values. We like sustainable competitive advantages, for example, because that is one of the things that lends itself to value stability. But the end goal is value stability.

TWST: Are you looking at it quantitatively or qualitatively or both?

Mr. Fitzpatrick: The quantitative can only take you so far. You have to get behind the numbers and really understand what they mean and why they are where they are, and ultimately that is a qualitative process. We start with quantitative data, we start with the numbers, and then we try to understand, OK, what's driving these numbers? Why do they look the way they do?

And if we can't answer that question, we really can't know whether a company has a sustainable competitive advantage. The numbers might look great, but it might be right before they begin to look terrible. So you have got to understand what's behind the numbers.

TWST: You don't have small-cap funds. Why is that?

Mr. Fitzpatrick: Well, we do actually invest in small cap, but it is closed to new investors. That is because we didn't what to allow it to get so large that it would impede our ability to perform. In order to protect our existing clients, we closed it to new clients a little over a year ago, about a year and a half ago.

TWST: What about valuations? Is there a specific valuation ratio you're looking for?

Mr. Fitzpatrick: Yes. We have really detailed long-hand spreadsheets of our companies, and we value them by segments and use long-hand math, and all that can be reduced to a multiple. But our process is a lot more complicated than just a multiple. We can take that data and do the ratios and divided our value for different parts of the business by whatever you wanted to do — after-tax earnings, pre-tax earnings, operating income, operating cash flow and revenue — whatever you wanted to do and come up with multiples, but we think the multiples are a little simplistic. Again, we do look at the numbers, but there is a lot of qualitative work that goes on behind those numbers and behind those multiples.

Highlights

C.T. Fitzpatrick discusses his firm's investment strategy. Right now Mr. Fitzpatrick believes the market is pricey, and says it is more challenging finding qualifying ideas as the risks are much higher. However, he does point out that for his firm, volatility is a very good thing, because the firm is very disciplined in the types of businesses in which it invests.

Companies discussed: MSC Industrial Direct Co (NYSE:MSM); T. Rowe Price Group (NASDAQ:TROW); Waters Corporation (NYSE:WAT); CME Group (NASDAQ:CME); The Coca-Cola Co (NYSE:KO); Express Scripts Holding Company (NASDAQ:ESRX); Marriott International (NASDAQ:MAR) and QUALCOMM (NASDAQ:QCOM).

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TWST: What about management? How important is that when you are looking at ideas?

Mr. Fitzpatrick: Management is very, very important and in fact there are companies that would not qualify for investment because we don't think that their management teams are the kind of people we want to have as partners. Even if they qualify on every other metric, if we don't like and respect and trust the management team, they don't qualify for investment no matter how good the rest of it looks.

TWST: You keep a list of companies that you like but are currently overvalued in your opinion. Can you talk about that?

Mr. Fitzpatrick: We have an actual separate list of companies, and we actually spend the majority of our time reviewing that list and making sure our values are current and accurate, and making sure we understand these businesses. Even though they are not attractive in terms of valuation at the moment, we want to have done our homework and be ready to activate them when they do become attractive. We don't want to have to scramble to get up to speed when they become attractive. We want to already understand the business.

It's like studying for a test. You never know when you're going to get a pop quiz, but you want to be ready whenever it occurs. That's how we think about it.

TWST: What about sectors? Are there certain areas right now where you are seeing more opportunities?

Mr. Fitzpatrick: Well, I wished that was the case. It's a lot tougher out there than it used to be. I really can't point at any industry that we say, "Boy, this industry is really, really interesting." I guess if I really push myself, we do see somewhat more opportunities in the insurance area than anywhere else. That is potentially interesting, but even that's not like it used to be.

TWST: Are there areas where you will not invest?

Mr. Fitzpatrick: Sure. Actually there's quite a few places, and I'll rattle off a few of them. We don't like commercial banks, we don't like energy, we don't like airlines, we don't like mining companies, we don't like commodities, we don't like utilities. Those are the most obvious ones.

But basically we don't like companies that don't control their own destiny. Companies that are tied to the price of a commodity, for example, are very difficult because you may know the value of the company today based on that commodity, but you have no idea what the price of that commodity will be next year. Therefore no matter how good the company is you really can't value that company, because you can't see into the future to guess what the commodity price is going to be.

TWST: Do you invest internationally?

Mr. Fitzpatrick: We do. We look around the world, and we think very globally. We own companies that are domiciled outside the U.S., and a lot of our companies that are domiciled in the U.S. generate a significant portion of their revenues and profits from outside the U.S. So yes, we are a U.S. manager, but we really think it very much in terms of a global perspective.

TWST: You run a concentrated portfolio. Why do you take that approach?

Mr. Fitzpatrick: The size of the portfolio, the number of positions that we will own, will vary. Even when we are the most diversified, we are more concentrated than most people who do what we do. We are off the charts in terms of active share. We have lot more active share than most people do, and the reason is that there are not a lot of businesses that we want to own, and when a business comes our way, we want to own it so that it can make a difference in the portfolio.

We view that there is a trade-off between valuation levels and diversification, so if you are in a position like 2009, our portfolios were highly concentrated. We had about 17 names in our large-cap program. Our core position would be a 5% position and then a few of them were overweighted more than that, and we had some incredible businesses and they were incredibly discounted.

Fast forward to today, and we still own incredible businesses, but they are not as discounted as they were. Therefore they have more risk. We size positions according to discount: The deeper the discount, the larger the position and the smaller the number of names. When discounts are not as attractive — they are not as attractive now as they were five years ago — we have more names and smaller weights. So today we have around 40 names. The portfolio is basically double the size that it was in 2009, because discounts aren't as deep as they used to be.

1-Year Daily Chart of MSC Industrial Direct Co.

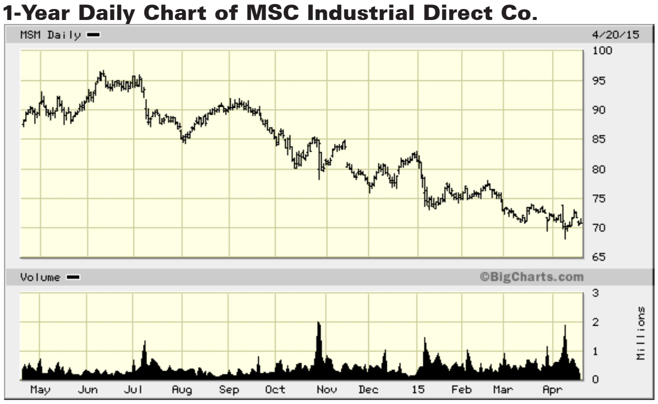

Chart provided by www.BigCharts.com

TWST: You added MSC Industrial Direct, T. Rowe Price and Waters Corp. What makes these names attractive?

Mr. Fitzpatrick: Every company that you mentioned first of all has a stable value. Each of them has a sustainable competitive advantage that we think we understand. All of them generate a lot of free cash flow. They have very strong balance sheets, and they are well-managed by people that we respect, and of course, they are discounted or we wouldn't have bought them.

TWST: You also sold five. You sold CME Group, Coca-Cola, Express Scripts, Marriott International and Qualcomm. What makes you sell something out of the portfolio?

Mr. Fitzpatrick: Well, all of those companies were good investments for us. Some of them were outstanding investments for us, and it was just a matter of discount. Some of them we sold literally at fair value, some of them we sold very close to fair value, but we were able to redeploy the capital into things that were much more discounted that the things we sold. Most of those were just a function of really good businesses going to fair value.

The one exception is **Qualcomm** (NASDAQ:QCOM), where they had some issues with the Chinese government that increased the risk profile of **Qualcomm**. It was also a function of valuation, but in addition to valuation there were also some issues that we thought were raising the risk of **Qualcomm**.

TWST: You talked about risk several different times. Are there other ways you manage risk inside a portfolio?

Mr. Fitzpatrick: Yes. Well, the first thing is being disciplined in the kinds of companies you buy. You have got to have stable values. The second thing is to make sure that you don't overpay for a great business. If you buy a wonderful business and you pay too much for it, it's still very risky, so we demand discount. If we can't reduce risk through discount, then we'll be more diversified. So everything we do is about preserving capital.

We talked about volatility. Volatility is not risk, and I think that's one of the most misunderstood things about investing. Volatility and risk are two different things, and you can actually reduce risk by using volatility when you limit yourself to outstanding businesses that have stable value.

We view our job as first and foremost to protect capital. Secondarily we'll try to earn a return on the capital. But the first thing is don't lose the capital. Our definition of risk is the probability that we will lose permanent capital, and we want that probability to be as close to zero as possible.

TWST: There is a lot of talk about active versus passive management, or about index funds versus active management. Why don't you just index?

Mr. Fitzpatrick: The short answer is because we want to protect our capital. There are things in the index that we would not own ever. They are overvalued or terrible businesses, and a lot of the things that end up having a lot of the impact on the index or things that are, A, the most overvalued, and B, the things that have the most hype.

In addition to those industries I told you about that we won't invest in, we won't invest in companies that we think are unethical. Those are in the index. We don't want to own that.

If you look at our numbers at our portfolio, we are a taking less risk and we're generating higher returns. So why would I want to take on more risk and generate a lower return, which is what I would have to do with a lot of the index? Instead, we've got less risk and more return. So I think this whole thing of active management versus passive is maybe not the right way to frame it. How about passive versus good active management? To me is the argument not active versus passive, it's good active versus passive.

TWST: What is your overall outlook?

Mr. Fitzpatrick: Our outlook is risk averse. We think that there is a lot of risk, and we are positioning ourselves very sensibly. We have a lot of liquidity, we have smaller position sizes, and we are hoping for increased volatility which will allow to reposition the portfolio into deeper discounts. We are very well-positioned to do that should volatility occur.

In the meantime, we own fabulous businesses that are constantly compounding and growing their values, and we are patient. One day things will get rocky and we will be ready. Until then, the portfolio will continue to compound, and we will hold smaller position sizes and admittedly less discounted companies than they were before, but those companies can be converted very, very quickly into large positions when better opportunities present themselves.

TWST: Thank you. (LMR)

Note: Opinions and recommendations are as of 03/25/15.

C.T. FITZPATRICK, CFA
Founder, CEO & CIO
Vulcan Value Partners
Three Protective Center
2801 Highway 280 South
Suite 300
Birmingham, AL 35223
(205) 803-1582
www.vulcanvaluepartners.com

Note 1 Source: Vulcan Value Partners Large Cap, Focus and Focus Plus Composites versus peer group of the eVestment US Large Cap Value Equity Universe. Vulcan Value Partners Small Cap Composite versus peer group of the eVestment US Small Cap Value Equity Universe. Information provided is supplemental information for the Large Cap Composite, Focus Composite, Focus Plus Composite, and Small Cap Composite for period ending December 31, 2014 as of February 3, 2015.

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