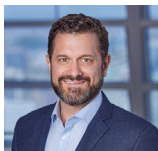




The Active Investor: Seeking Quality and Value in Today's Market



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In this podcast, Lord Abbett Portfolio Manager John Hardy discusses the current equity market environment, and how an active, value-oriented approach can help investors uncover long-term opportunities.

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BRIAN FOERSTER: Value investing has gone through a transformation over the last 30 years as disruptive technologies have changed the way many companies operate. And we spent about half that time in a zero-interest rate environment where high-growth stocks trounced value. Now, however, in a world where normal interest rates again, and quality matters a lot, value has seen a renaissance.

However, a few big things have changed in this space. This is Brian Foerster, and welcome to *The Active Investor* Podcast. I'm excited to have John Hardy with us today to help us navigate the current world of value investing. John is a portfolio manager here at Lord Abbett, and a long-time value investor. John, great to have you on the podcast.

JOHN HARDY: Thanks, Brian. Good to be here.

FOERSTER: This is the first time you've been on the podcast.

HARDY: Yes.

FOERSTER: Maybe just give us a little bit of background on how you got into investing. I know you've been with Lord Abbett since 2011, been in the industry for over 20 years. How did you first get into being a value investor?

HARDY: Yeah. Definitely. It certainly wasn't straightforward. I went to school. I thought I was going to be an arbitrator for Major League Baseball, so I went to the ILR [Industrial and Labor Relations] school at Cornell. I realized pretty quickly that I didn't want to go to law school. And then I had to sort of figure it out from there. I knew I wanted to work in finance. I got really lucky. I got a job as a trading assistant in a small firm in Greenwich, Connecticut, called American Technology Research.

I really loved the traders. Had a blast. But I also really fell in love with the research that our analysts were producing. We were primarily a technology research company, covering things like semiconductors and software. Shortly thereafter, I went out to San Francisco, to work on our semiconductor team. Semis were an excellent industry to cover sort of out of the gate as an analyst.

It has a lot of obviously interesting components to it, but it's primarily a cyclical and a secular industry, so you get to learn both sides. I was on the sell side for seven or eight years. Worked with a lot of really smart investors, hedge funds, long-only firms like Lord Abbett, private equity firms, and realized that I wanted to be a lot closer to investing. That's when I moved over to the investment management industry and came to work for Lord Abbett. Sort of started to express my own views of companies.

FOERSTER: Got it. Let's talk a little bit about the markets today. And we're seeing a little bit of volatility right now. I think AI [artificial intelligence] has definitely had a big impact in a very positive way. But you're also seeing some disruptive impacts like what you're seeing in software right now. Are you just thinking about the market environment today as an active investor?

HARDY: Definitely, I think over the past several weeks, people have been really concerned about industries and sectors being potentially disintermediated by AI. I think what people are confused about is, who are the potential beneficiaries? And we think that a lot of the companies that we invest in are going to benefit. If you think about, you know, innovation cycles over the years, most recently, software, or cloud adoption, that's really helped companies that we invest in on the value side increase efficiency, increase margins, increase returns.

We think there's going to be a ton of benefits for companies in our universe. In terms of top-down [investing], I wouldn't say AI is all that different from how we think about other changes in industries over time. They can be at a micro level or at a macro level like we're seeing the impact of artificial intelligence. We really place companies into four buckets.

The first being companies that we think are going to benefit, and the market also thinks that they're going to benefit. Those are typically fairly valued or potentially expensive, because the market thinks that they're going to benefit. The second bucket is companies that the market thinks is going to benefit from AI and we disagree with.



Those are obviously companies that we're not going to own at Lord Abbett. The third bucket is companies that we think are going to lose from the adoption of artificial intelligence, and the market also thinks so. Those aren't very interesting to us. Where we're spending most of our time today is on companies where the market thinks that those companies will be impacted negatively by AI, and we disagree with the market. Those are the ones that we're really digging in on, where we think there are opportunities.

FOERSTER: Interesting.

HARDY: Yeah.

FOERSTER: Well, it sounds like it's a good environment for active investing then.

HARDY: Absolutely.

FOERSTER: Let's take a little bit of a walk back to the zero-interest rate environment. Where some might say fundamentals mattered less. I'm not sure if that's totally true. But it does seem like since we had the big spike in interest rates and now sort of a gradual leveling off to a more normal interest rate environment, that the whole idea of quality seems to matter a lot more again. How do you guys think about that? Because I know that you talk about quality a lot. I don't know that there's a lot of investors out there that say, "we buy garbage." Right?

HARDY: Right. Exactly.

FOERSTER: A lot of people have their own definition of quality. But how do you think about this current environment and kind of what's changed from the prior environment?

HARDY: I'm glad you used the word "normal" for the current environment. I'm old. I remember when my first mortgage was 7% or 8%. It's not unusual for interest rates to be at the levels we're seeing. Most of the pain that we saw in 2022 was really the sharpness of moving off that zero-bound [zero interest-rate level]. I think what it's done is reinject an actual cost of capital into the market.

Again, people paid attention to fundamentals when interest rates were at zero, but the bar was much lower for companies to create economic value. If you think about a management team that's making a capital allocation decision, whether to do M&A [mergers and acquisitions], or buy back stock, or invest in their business, if they were wrong about that decision, the penalty was much lower.

With interest rates where they are today, companies have to be earning well above their cost of capital to create that buffer so that they can invest in their business or give capital back to us as value investors [through stock buybacks], which we like. What you've really seen is when interest rates are pinned at zero, the stock performance-- the really simple definition of quality, whether you make money or you don't, we like companies that make money-- the difference between stock performance between companies who made money and didn't make money was very low during that period.

And beginning in 2021, when interest rates started to increase, you've seen that gap really widen, and that's been to the benefit of not just us, but all active investors.

FOERSTER: Speaking for your particular approach to value investing, and this whole idea of quality, it does seem like if you go back to Graham-Dodd, but then up to like the Fama-French study in the early '90s, that really said the number one thing you want to look for just from a pure metric standpoint is cheap price-to-book [ratio] stocks. You fast forward over the last 30 or so years, it doesn't seem like that has worked very well anymore. How do you think about just valuation from a more holistic standpoint in this kind of new world of more innovation, and different types of companies?

HARDY: It's actually really intuitive. We've lived through a lot of changes over the course of the last 30 years. And how that's impacted companies the most is a lot of the value that companies are driving today is driven from intangible assets. Much more so than how many plants you own, if you're a manufacturing company. Price-to-book doesn't really tell you anything about the return on that book. It doesn't tell you about how much free cash flow that company is producing.

I think less intuitively, because we talk so much about price-to-earnings [ratios] in our industry, price to earnings doesn't really tell you anything about the capital associated with producing those earnings. It doesn't tell you anything about working capital. It doesn't tell you anything about capex [capital expenditures]. That's why we use exclusively free cash flow to underwrite the companies that we invest in. That's a real number. That's what a management team has to invest in that business, again, do smart M&A or buy back stock, which we love.

FOERSTER: As you think about the types of companies, any examples you can give as to what might fit into that framework that you just described?

HARDY: I'll give you an example of a company, Google, which we've owned for a long time. We've owned it for well over five years. And I often get asked by clients, "Is Google a value company?" But if you compare that to a company like Delta Air Lines, for instance, you would assume that Delta Air Lines is significantly cheaper than Google.

But if you move from the income statement to the balance sheet, there's a lot of working capital associated with running an airline, whereas Google has almost none. When you think about capex, there's a lot more capex historically in a business like Delta than there is in Google. Obviously, Google has invested a lot today, in their data centers, to grow their AI business. But that's another example of how we would normalize that down. Even though Delta looks optically cheap on P/E [price-to-earnings], the free cash flow yields are relatively similar for a much higher quality business.

FOERSTER: That's interesting to hear Google from a value investor, but what you said makes total sense from a rationale standpoint. If you think about other industries, that kind of fit within this process, but maybe have nothing to do with AI, maybe another example of a company that sort of fits right into the way you approach things.



HARDY: I think a great example of how we look at the world, specifically around normalization, is Boeing. Boeing has obviously gone through quite the journey over the last several years. But a lot of things have changed. We initially purchased Boeing after they did their recent equity raise, about 12 months ago or so.

At that time, they were literally not manufacturing any planes. They had significant issues with their union workforce, which were beginning to be ironed out. They were losing a significant amount of money, and a lot of cash was going out the door. I told you that I care a lot about free cash flow. That doesn't like a company that I would be interested in. But again, we normalize all of the companies that we underwrite.

Looking out four years, when you're thinking about normalizing, and a company is not manufacturing anything, it's pretty easy to figure out where the normalization is going to be. And that's up. Obviously, that was dependent on them coming to an agreement with their union and beginning to manufacture planes again. But we saw a path forward.

Obviously, the market structure for Boeing is really strong. It's an oligopoly with Airbus. They have really strong pricing power. Historically, they've had really strong margins, high returns as a result of that. Now, fast forward that a year, they've begun producing planes again. They've recently flipped to free cash flow positive. If you look forward over the next couple years, they're going to [potentially] de-lever their balance sheet.

That's going to accrue to the equity holders. And then two or three years from now, they're [potentially] going to begin buying back stock again, returning cash to shareholders. We think the path forward in a normal environment, for Boeing, is going to be really strong for investors.

FOERSTER: I'll put my compliance hat on and just say that obviously things can change, so this is not--

HARDY: Absolutely.

FOERSTER: --an advertisement for buying the stock. But this sort of fits your process and what you think about value investing.

HARDY: Absolutely.

FOERSTER: One thing you often have to think about too is risk. Right? How do you think about when something is not going right? And how do you think about managing risk in the portfolio?

HARDY: I would say there's a couple different ways that we think about risk management. The first is up front, before we start doing deep due diligence on a company. We look for certain characteristics in the companies that we own. The first being attractive free cash flow valuation, which we've already talked about. The second is quality. As you said, most investors say that they like to buy high-quality companies. But we're very systematic in how we think about quality.

We literally stack rank every company in our universe based on our internal quality metrics. The third thing that we care a lot about is something that we call stability. You can really think about that as us trying to stay out of value traps. Are the fundamentals of that

company stable to improving through time? There are many investors that buy companies thinking that they're attractively valued today, but if those fundamentals are deteriorating four years from now, that price you're paying is significantly more expensive than what you think you're paying.

The other thing I would say, from a top-down perspective, on risk management, is that we are always making sure that the largest risk in our portfolio is stock-specific. We have an excellent analyst team on the Value team. We have 14 senior analysts who are very experienced in their sectors. And given the fact that that's where we spend most of our time, doing bottom-up due diligence on companies, we want to make sure that that's the biggest risk in our portfolio.

FOERSTER: Let's come back to the current environment again, and just as a value investor, no one ever likes to say, "Oh, my category doesn't have a favorable outlook for the next few years." And most want to say that it does. I mean, if you look at this environment now, it does seem like one that should be very favorable to value for the next few years, and just given the demand for quality, the demand for not over-leveraged companies, or companies that have no earnings in sight for the next few years. How are you thinking about the next one year, but also maybe the next five years, both for the market, but also for your style?

HARDY: There's a couple of things I would say about that. If you think about the makeup of value companies, there's heavy exposure to financials, heavy exposure to industrial companies. We also own technology companies, energy companies. I think one of the things that is a little bit confusing to investors is the market is at an all-time high, so people think that the economy has been booming for the last several years.

But if you really look back at things like global PMIs [purchasing manager indexes, surveys of manufacturing sentiment], post-COVID, we've really been living through this period of what I would call middling GDP [gross domestic product] outside of some of the things that we're seeing in technology. A lot of those excesses from COVID are finally burning off. If you think about trucking, for instance. Pricing has been very weak. The market is now starting to tighten up again. If you think about metrics like the ISM [Institute for Supply Management manufacturing survey] are starting to hook up. Employment is still very good.

As a value investor who thinks about downside risks, that's actually a positive to me. We're not moving from a period of overexuberance going forward. Things have actually been relatively weak on that front. Housing is another good example of that, which has been quite weak for the past couple of years. For all those reasons, that setup is pretty good for value.

And then to your point about where there are potential risks, I do think it's important to maintain that quality bias going forward. You mentioned specifically leverage. Spreads are really tight today. That's not usually a very good time to be an over-levered company, because things don't get better from there. Things are already quite good for over-levered companies. As a result of that, you want to own companies that are going to be able to invest through



any tough period. But again, we look at most things on a bottom-up, company-by-company basis. That's sort of what we get excited about.

FOERSTER: Great. A lot of great stuff there to chew on. We'd love to have you back sometime. There's probably a lot more to talk about. Thanks for coming.

HARDY: Thanks, Brian, that was fun.

FOERSTER: We'll leave it there. For investors wanting to learn more about Lord Abbett's views on the markets, please visit the Insights section of LordAbbett.com. and you can also follow us on LinkedIn, Instagram, and YouTube for more perspectives from across the firm. And if you have any comments on today's episode, or ideas for future episodes, email podcasts@lordabbett.com.

This has been Brian Foerster with *The Active Investor* podcast. Thanks for listening.

GLOSSARY OF TERMS USED IN THIS BROADCAST

Buy-side refers to firms that purchase securities, including investment managers, pension funds, and hedge funds. Sell-side refers to firms that issue, sell, or trade securities such as investment banks, advisory firms, and corporations.

Capital expenditures (capex) represent amounts spent by an organization or corporate entity to buy, maintain, or improve its fixed assets.

Cost of capital is the minimum rate of return or profit a company must earn before generating value.

Fama-French: In 1992, Eugene Fama and Kenneth French released their influential research on how to define value companies, growth companies, and the high-minus-low (HML) factor, which showed, historically, how value companies had outperformed growth companies, i.e., the value premium. Value companies were defined as companies with lower price-to-book values (P/B), while growth companies had higher P/B ratios.

Free cash flow (FCF) represents the amount of cash generated by a business, after accounting for reinvestment in non-current capital assets by the company. Normalized free cash flow attempts to smooth out a company's FCF by excluding non-core operations and one-time items.

Graham-Dodd: First published in 1934, the book *Security Analysis* by Benjamin Graham and David Dodd, professors at the Columbia Business School, laid the intellectual foundation for value investing.

Growth/Value Investing: Growth stocks may be characterized as equities of companies that have demonstrated better-than-average gains in earnings in recent years and that are expected to continue delivering high levels of profit growth. Growth equities typically carry higher price-to-earnings multiples than the broader market, high earnings growth records, and greater volatility than the broader market. **Secular growth stocks** are stocks of companies whose economic performance is relatively immune to economic cycles. **Value stocks** may be characterized as equities of companies that have fallen out of favor with investors but still have good fundamentals, or new companies that have yet to be recognized by investors. Value stocks typically feature lower price-to-earnings multiples than the broader market, and often industry peers, and somewhat lower volatility than the overall equity market.

Market capitalization: The U.S. Financial Industry Regulatory Authority, or FINRA, defines the following categories of stocks based on their market

value: mega cap stocks, \$200 billion or more; large cap stocks, between \$10 billion and \$200 billion; mid cap stocks, between \$2 billion and \$10 billion; small cap stocks, between \$250 million and \$2 billion; and micro cap stocks, less than \$250 million.

The **price-to-book ratio** compares a company's market value to its book value. The market value of a company is its share price multiplied by the number of outstanding shares. The book value is the net assets of a company.

Price-to-earnings ratio: Stock analysts calculate a price-to-earnings ratio by dividing a stock's current price by its earnings per share on a trailing 12-month basis. A forward price-to-earnings ratio is calculated by dividing a stock's current price by estimated future earnings per share.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

Tangible assets are assets with a physical form and that hold value. Examples include property, plant, and equipment. **Intangible assets** lack physical substance and include are patents, copyright, franchises, goodwill, trademarks, and trade names.

A **top-down** investment process generally places more emphasis on macroeconomic forecasts than on individual stock picking. A **bottom-up** approach typically relies on selecting individual securities as the primary driver of investment returns.

Value trap refers to a stock that appears to be attractively priced based on company fundamentals and the stock's market price but ultimately provides either a negative or subpar return.

Working capital is the difference between a company's current assets and its short-term liabilities.

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