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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Focusing on the Company-Specific Microeconomics

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SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Goetz: Yes. Pzena Investment Management is a classic value investment firm. We manage about $38 billion, investing with the same value philosophy all over the world. We manage these value strategies for institutional and high net worth clients. We've been doing this since we started the firm at the beginning of 1996. At this stage, we have 24 people on the investment team. I'm happy to go into the process we use to identify good investments.

TWST: Sure. Why don't we talk a little bit about the process and maybe explain a bit about your philosophy?

Mr. Goetz: If I start at the broadest level, our philosophy is that at any given moment, there are probably some good businesses that are trading at very low valuations. Typically, you don't get a low valuation without some significant controversy or problem that's developed, but if we could systematically identify and then research those situations, we could form portfolios of good businesses with temporary pain that could be very rewarding in terms of the stock price over the longer term. So our philosophy is to be longer term.

We identify businesses where we think the issues are temporary, meaning the short-term issues involve some degree of pain in the earnings of the business, but over the longer term, it is exactly that pain that gives us the opportunity to buy a good business currently selling at a low price. The way we do that is with a very disciplined quantitative front end.

In the case of emerging markets, we just take the 1,500 largest companies in the emerging markets. We rank those from the cheapest to the most expensive. We do that by looking at the history for the industry, at the history for the company and use that history quantitatively. It's our modeling software. We'll create a forecast for the future from that history. That's assuming history is valid at this point.

We also take the company's stock price and compare it to its future earnings power and say, "Wow, this company is trading at four times its future earnings power, whereas another company is trading at 30 times earnings." So we can rank the whole universe from the cheapest company to the most expensive.

Out of that whole ranking process, we're only going to look at the cheapest quintile, the cheapest 20%. What this does for us is it eliminates 80% of the world. We're only looking at the stocks that have promise to be very inexpensive, if history is valid. It's a screening tool, so it's all naive up until that point. What it does is it allows us to identify the possibilities for further research, and then from that list, when a company screens up cheaply, we put it up for further research.

The process begins with a two-week review where we identify the issues that are besetting the business and ask if we could figure out these issues. There are many issues where, after two weeks, we decide it's beyond us. The business is in decay. Maybe the history isn't valid because it was just a boom. That's my favorite example.

In China, the boom was so big that there were a bunch of lousy businesses that just looked really profitable for the last 10 years. We're really trying to identify interesting projects where we can identify what's causing the pain and then go to work on the issues in a company. I'm happy to share an example at this point if you'd like.

TWST: OK. Sure.

Mr. Goetz: One of the things that happened a couple of years ago was we saw some Chinese utilities, electric power companies, screen up cheaply. **Huadian Power** (HKG:1071) is one. **China Resources Power** (HKG:0836) was another. And what was strange was, all of a sudden, returns that were low-double-digit, think of it like a 12%, 13% return on equity in the business, had collapsed to mid-single-digit or even worse.

If you think about the way utilities work around the world, this is a regulated industry. Theoretically, the profits are regulated and targeting low-double-digit return on equity, but these were earning half of that. The first thing you see is, you see an industry where profitability has come down, and then, you see a couple of companies within that industry, with current earnings that look way off from what history would tell you. And that's what the model really does for us.

What we do then is we assign that case to our analyst who is covering utilities. In this case, the gentleman doing utilities is covering the companies globally. Our 24 research people are organized by industry globally, and that's because you need some framework to understand these problems. So we assign it to an analyst. In two weeks, what he or she comes back with is identifying what the issues are.

And in two weeks, what we came back with was, wow, this is really interesting. What happened was, the coal price, the main feedstock for these power utilities, had gone up dramatically. And the tariffs, the price they're charging for electricity, had not followed it up. So basically, the regulatory model, which ultimately passes through any cost to maintain a regulated return, did not happen. Then, we kicked off a research project.

I just want to emphasize that, at this stage, maybe 70% of the time, we just say forget it because the history is invalid, or we discovered an issue that we can't understand or figure out. We would then throw out the case. Typically, after two weeks, we've thrown out about 70% of these opportunities because we think the history is not relevant. But in this case, we think the history is relevant.

These power companies are going to be here for a long time. There's no reason for us to believe that the regulatory structure in China is changing. We have to understand that, but these are the type of projects we want to dig into. Now, to make a long story short, once we turned the analyst loose on the project, he did a lot of work and did verify that the regulatory structure wasn't changing.

What happened was an interesting story. Coal prices during the boom in China, up until 2013, 2014, had been very high. Then, they collapsed all the way from above $100 per ton to $50 a ton. The year 2015 was a very tough year in China, so by the front end of 2016, all commodities collapsed. Everyone was worried about China.

At this stage, China was worried about their whole coal industry at $50, and they started rationalizing it. They shut down the little guys that were big polluters. And then, in the 2016 rebound, coal demand took off because the economy was coming back. They had curtailed the supply so much that coal prices spiked up. Coal went soaring up from $50 back toward $100. And when you think about that drama coming into 2016, the local regulatory authorities at a provincial level decided they can't pass through tariff increases at this pace because they could have a revolt.

This is where understanding how China works comes in; they're constantly managing public opinion from a centralized authority. And we looked at it and said, "Well, we get the fact that they don't want tariffs, electricity prices to go up that fast, but we do think it's probably more reasonable to believe that, longer term, the coal prices may collapse again. Even if they don't collapse, the tariff would probably be gradually adjusted upward." This became a thesis, and we did research around the thesis.

And the process includes actually talking to companies and meeting company management and going through our view of their future. And this is always a very nice part of the process. People ask how we get access. Generally, these companies in struggles like to see new shareholders. We share our research with them. We share what we're envisaging and say, "Hey, this is our research. This is what we think should happen longer term." And then, we can get their input on our research.

In this case, we actually believe that coal prices were going to go back down. In an odd way, actually, we're saying this investment was partly a short of coal. What I like about something like that, when you think about portfolio construction — now, I'm actually saying our investment in the utilities, **Huadian Power** and **China Resources Power**, is actually going to do better if China slows down again, which is what's currently happening. So as demand for electricity slows down, demand for coal slows down, coal prices start going back down, and the utility returns, counterintuitively, start going back up.

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Highlights

John P. Goetz discusses Pzena Investment Management. As a value investor, Mr. Goetz's philosophy starts with the premise that there are probably good businesses trading at low valuations. He identifies the issue causing the low valuation and determines if it is temporary. Mr. Goetz uses the short-term pain as an opportunity to buy a good business at a low price. The process is focused on company-specific microeconomics and takes a long-term view.

Companies discussed: Huadian Power International (HKG:1071); China Resources Power Holdings Co. Ltd. (HKG:0836); Lenovo Group Limited (HKG:0992); IBM (NYSE:IBM); Hewlett Packard Enterprise Co. (NYSE:HPE); Huawei Culture Co. Ltd. (SHE:002502); Apple (NASDAQ:AAPL) and Samsung Electronics Co. Ltd. (KRX:005930).

And this is an investment that we're way into, and so we're kind of on the journey toward the other side. But I think it serves as a good, simple illustration of when we identify a possibility, we take it to research, then we say, "This is really interesting." We think these companies are trading at maybe seven times normal earnings or about half-price. That's when it's a candidate in a portfolio.

It is worth mentioning that when something becomes a candidate for our portfolio, we're taking it through a process of understanding the risks, meaning looking at the downside and looking at what bad looks like, how bad could it be if coal prices continue to go up. In that kind of analysis, looking at the balance sheet, etc., we prove to ourselves that the stock is basically reflecting a very negative scenario. A normal scenario is mostly upside to the analysis. That's a perfect kind of investment that we like.

1-Year Daily Chart of Huadian Power International

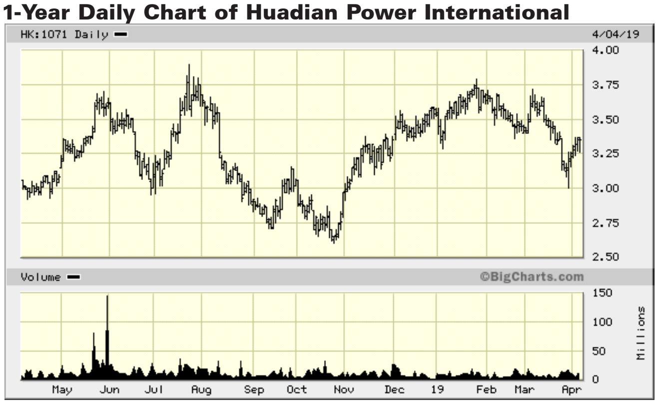

Chart provided by www.BigCharts.com

1-Year Daily Chart of China Resources Power Holdings Co. Ltd.

Chart provided by www.BigCharts.com

Typically, it might be that you look at the physical assets and ask if the company could even liquidate physical assets if needed, to get to the value reflected in the stock price. There are many, many ways that we can construct a downside scenario protection for these stocks. So we really care about the range of potential outcomes in a business.

The second dimension of risk is the gearing. We don't really like leverage. We're not people who figure out which companies are going to go bankrupt or not. So we tend to lean toward companies that are leaders and well-positioned in the industry, not over-levered. Too much leverage is a big problem that impairs the profitability of a company.

The last dimension of risk has been very helpful to us. We identified that the extremely volatile stocks, the most volatile stocks, don't generally generate alpha. The goal of value investing is to generate alpha, and you might think the more volatility, the better, which is what I thought for many years. But we did a study of this over time, and we found out that, yes, volatility is good, because obviously if the stock fell by 50%, it's volatile. But the most volatile stocks within the cheapest quintile are not better than the rest of the cheapest quintile.

What this has done for our value research process is picked up some situations where the reason the stock is volatile is something that's not easy to understand. Sometimes the issues are unknowable rather than knowable. I call it a waving yellow flag on companies that are in the most volatile quintile.

The three dimensions of risk are a range of outcomes for the business, understanding what bad looks like and measuring bad, as I like to call it. Then, there's understanding the balance sheet and the financial structure so that you're not going to get into an excessively risky situation. Lastly, we also make sure we don't get involved in extreme volatility. So those are our measures of risk.

One thing that was magical about our China utilities' investment to me was it brought something very different to the total portfolio. The fact that, in essence, we were betting on a coal price drop is very different than betting on **Lenovo's** (HKG:0992) turnaround, which I can talk about as well. We do like diversification. It's why the portfolio has a lot of stocks. This is why we operate with 50 to 60 stocks in our emerging markets portfolio. It's to get the diversity of different things that are unrelated.

TWST: Sure. And from what you've been saying, you mentioned that things sometimes are counterintuitive, so with some emerging markets' investments in other firms, they might look at the macro picture, what products might be in demand, but you're saying you have to be more sophisticated, more micro than that?

Mr. Goetz: Yes. I like to say, just as you said it, we like to focus on the company-specific microeconomics. We have to understand whether the macro will blow us up. But many times, the macro has been negative. People don't understand how negative it's been, and there might even be something else; I call it Murphy's law.

At the same time that the macro has been tough, you actually have another company-specific issue that has also been tough. Then, you get these weird situations, where both the exogenous variables and the company specifics move in your favor. Those are actually generally the best. Now, you have to have the courage to make that investment when the momentum might still be negative.

TWST: And did you want to mention another company?

Mr. Goetz: Yes. I think I would because it shows you the scale of differences in how we build value portfolios. I mentioned **Lenovo**, a

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well-known name. Everyone knows that **Lenovo** acquired **IBM's** (NYSE:IBM) laptop and personal computer business years ago and made a real business out of that, including being the dominant PC and laptop supplier in China. If you wanted to be in that computer business space and also pick a country or geography to be in and lead, it would have been China going way back to when they acquired the **IBM** ThinkPad business.

So that business is still there, and it's a global business. As you know, people around the world still buy the **IBM** ThinkPad product. It is now branded **Lenovo**, but that business is a pretty good business. But that's not what created the problem. What made it interesting was they've gotten involved in two other things. One was they've gotten involved in smartphones because they thought, "We're in electronic devices. The digital device of your laptop is like a phone. It's just a bigger device." So they got into phones.

Now, we know that the phone, the smartphone, can be a bloody war. We knew that early on, but what happened was not only were they losing money and hemorrhaging in smartphones, but they had taken the additional step of acquiring the **IBM** server business. Now, when they acquired the **IBM** computer server business, they were automatically thrown into one of the top three server vendors in the world. It was obviously a business that IBM wanted out of, but the server business is better than the PC business in terms of the structure and the historic earnings.

But instead of them buying the business and leaving it alone and earning the returns that a **Hewlett Packard** (NYSE:HPE) might in servers, they actually decided they didn't need **IBM's** sales force to service the servers in the United States because they already had a sales force and client service that serve their PC clients. They actually didn't take the server support network from **IBM**, and it blew up the business.

It was kind of an interesting situation. The stock had fallen because they were hemorrhaging in phones and hemorrhaging in servers. It was in the server business that we saw the opportunity for the turnaround because, conceptually, we could trace the steps they've taken to lower their profitability by building back the service network, primarily here in the United States. It was an interesting issue and, again, counterintuitive. Who would have thought that a stock trading in emerging markets, **Lenovo**, that their biggest problem would be right here in the United States?

That's why I say, always locate the problem, identify the problem and then decide whether the path out of the problem is possible or not and judge the credibility of the company's management plan. The good news on the valuation was when we were buying it, we bought it for less than the worth of just the historic PC and laptop business, which was doing fine. The other two divisions were hemorrhaging. We were buying them for less than free, if you can think of it in a sum-of-parts way.

These are the types of opportunities that are intriguing to us because the exit from both smartphones and servers would have caused the stock to go up. I'm not saying that that's the right strategy, but you could see how if they really continue to lose money in these businesses it would be positive for the stock.

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1-Year Daily Chart of Lenovo Group Limited

Chart provided by www.BigCharts.com

Instead, we believed the company could turn the server business. We believed the management plan was credible, and that's the journey you've seen in the stock. If you just look at a stock price chart on **Lenovo**, you'll see the tremendous performance over the last 18 months. It is just the turnaround of the server business primarily driving that. And that's what we invested in.

TWST: And looking ahead for Lenovo over the next year or two, do you continue to see a turnaround, and what other things might come on the forefront for them?

Mr. Goetz: Yes, the server turnaround is incomplete, so that's part of our answer. The other thing is that the smartphone business is kind of interesting. We continue to think there's some optionality at **Lenovo**, meaning there's nothing in the stock for phones today because there isn't any profit, but if you think about it conceptually, you see **Huawei** (SHE:002502) has entered, and it's been a big problem for **Apple** (NASDAQ:AAPL) in China. The reality is that **Lenovo** has a potential place too.

If you think about the evolution of the form factor here, and if you've kept up, both **Samsung** (KRX:005930) and **Huawei** have introduced foldable phones. I don't know if you've seen that, but the foldable phone is interesting because what they're saying is that, at some point, our smartphone should be capable of us reading our email, doing spreadsheets and watching a movie in a better format than what you think of in the phone today. Even **Apple** is making the screen bigger.

When you think about that, doesn't it start to sound like a small laptop, a small foldable laptop — like you realize these things are related? And I'm not saying what's going to happen. I'm just saying **Lenovo** has a way of playing in the evolution of our mobility, which is where, of course, everything's going. We think there's some optionality there that could show up for us, but I think, more importantly, the turnaround in the server business is continuing.

Having said all that, it emphasizes something else in our value research process, which is that once things start to work and the valuation goes up, we have a thorough sell discipline. At the midpoint of our ranking system, we must be out of the stock completely. We don't ride any momentum. We don't have a thesis of how we think the stock will do better next quarter, it's just pure valuation discipline, and we must sell at the midpoint. Because **Lenovo** has done so well, we've actually been trimming **Lenovo** as the stock has gone up.

TWST: So why don't we talk a little bit about emerging markets? A lot of people right now, they might be considering going into emerging markets. What precautions should they take if they're investing, and what things should they look out for?

Mr. Goetz: I actually worked and lived in Asia back in the day. And one of my observations from many years ago was that stock prices and people's perceptions about stocks are pretty volatile, meaning big swings. People fall in love, there's lots of positive momentum, then there's lots of negative momentum. I will call it a volatile market overall.

Sometimes, Brazil is in crisis, and then, Brazil is coming back. It behooves an investor to actually have done due diligence: Are you buying a good business or not, or are you just buying the hot dot? And I think the history has been buying emerging markets for growth and momentum. And those two things are sometimes related.

The reality is that the type of due diligence can be bad, and what happens is you just buy a flaky business while it's doing well. There are a lot of flaky businesses in the emerging markets. We really do think value works in emerging markets. We did a backtest on it, and now we've demonstrated it over 10 years. We do think valuation works, mostly because it's a due diligence to make sure you buy a good business when there's temporary pain and not getting caught up in short-term issues such as: Is Brazil going to do better or worse next quarter?

That idea of, we're just shifting money from country to country based upon whether the country is going to do better or not, that is a form of momentum trade that many, many people have been involved with. And we certainly know that we wouldn't differentiate ourselves by calling that out. Instead, we would buy a good business in Brazil when Brazil is viewed negatively. But the key is in the due diligence on the individual businesses.

And if you think about our process of identifying a problem and then determining whether that problem is temporary or permanent, we are running the due diligence on these companies, including ESG issues. So we're running the due diligence on every investment we make. And we think, long term, that's important. We don't want to buy something that is a temporary win. By temporary, I mean it works for a while, and then, you just get absolutely creamed on the other side. I do think emerging markets is an exciting place to invest. I don't think it's inherently safe.

TWST: So it could be part of a balanced portfolio for many investors?

Mr. Goetz: Yes. I'm going to just share with you that, as in the case of 2015, when everyone feared China was falling apart, the fact that China's been very weak partly because of the tariff discussion with the United States. I do think that we're at a good point if you were thinking about putting money to work in emerging markets. I think we're at a good point because there is higher fear today in emerging markets. So emerging markets' valuations overall are more attractive relative to the rest of the world. We had that attractive period at the end of 2015 and early 2016.

Recently, it provides another opportunity to enter for the long term. I would tell you it's a pretty good opportunity to enter today. And what we're seeing in our portfolio is anything with a cyclical tilt is out of favor. We own some auto dealers because the auto sales have fallen. Cyclical things are viewed very negatively at the moment, and I do think as long as you can do the due diligence, you can invest in an attractive valuation portfolio today because of the fears about the China slowdown.

TWST: Is there anything we didn't talk about you care to mention, either about the firm or some trends out there?

Mr. Goetz: One of the things I just want to mention is people may ask what we're doing in a New York firm investing in emerging markets. Don't you need to be on the ground in Asia or Latin America? I get asked that question. We run a European portfolio. I get asked the question: What are you doing running a European portfolio from New York? I think what's important about the firm is to realize we don't run the portfolio from New York.

What do I mean by that? We reside here. It's where the team comes together, but the culture of the firm is very international. You would see that the team is from all over the world, and obviously, we're traveling all over the world to meet the companies that we've identified and done work on. What we do is, we're just flying in to do the research, instead of just living in China full time. In that sense, it gives us the flexibility to come in only when there's opportunity.

Whereas if you were to locate a team in emerging markets, where would you locate them? You can have one in China. Then, you get one in Brazil. Which city in Brazil? You quickly get into this almost unmanageable structure of having teams in every country in the world. We've chosen to organize our team by industry, so we get this industry understanding that brings perspective to the utility industry in China when utilities in China are cheap. That's the way we've decided to organize.

But I want to say and emphasize that the culture of the team is very much global. This is not a team of New Yorkers trying to figure out how to get a plane to China. These are people from China, from India, from other parts of the world coming together on a team that has perspective on the globe. I think that's one of the most fascinating and wonderful things about our culture here — a truly diverse culture.

TWST: And I would think, too, that it would allow people to communicate directly because you're working out of the same location and that can be helpful.

Mr. Goetz: Yes. I think when you're in a debate on a really

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tough issue, you have lots of numbers in front of you, but it's a really critical debate with lots of graphs, and you can imagine what a research review looks like here. To be across the table in that argument is still much superior to even a video conversation. So you have to think about us going out to do the research, going to China, going to Latin America, the trips are a big part of what we do, but then, we come back together to debate what one person saw in this industry and another person saw in maybe an industry that's just downstream from that industry. And we come together with all that perspective that we've developed over Pzena's 23 years. We need to come together to do that, and we come together in New York.

TWST: Thank you. (ES)

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