Endeavour Investment Partners Presents

Q&A

With the Portfolio Manager

Shawn M. Hendon

Co-Portfolio Manager, Torray LLC
Large Value Strategy

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Q **You returned to Torray fairly recently as a co-portfolio manager with Bob Torray. Are you pursuing the same approach or have you made changes to the process?**

Shawn We're implementing the same approach as has been historically used, which is to invest in large capitalization companies using a value orientation with a long-term investment horizon.

Q **Lots of value managers say they invest like Buffet or Graham, but anyone can say something like that. What makes you a value manager?**

Shawn Well, as for Buffet and Graham & Dodd and others, it's not so much the technique that they offered, as a way of thinking about investing. I think it's fair to say that every advisor wants to get value for the money they invest over time. What I think distinguishes a value-oriented advisor such as ourselves is that we're not willing to pay much for anticipated growth or growth above historical norms. Investing always involves uncertainty. What we're trying to do is reduce the uncertainty by focusing more on a company's demonstrated record than on some distant forecast.

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Historically, we are attracted to companies with operating profitability, strong balance sheets and dominant market share when they are priced for minimal expectations. We prefer opportunities where, in our view, the valuation implies expectations of little or no growth. We all remember the high-priced technology shares which collapsed in 2000-01 as results missed expectations. Value investors like ourselves were able to invest in a number of these companies that had long records of profitability, at valuations we felt unduly discounted future prospects. Over the following years many companies experienced earnings growth below inflated expectations at the 2000 market peak, but well above the pessimistic outlook of investors after the downturn in 2001. We believe the combination of modest growth and attractive valuation can result in very satisfactory returns for long-term investors.

Shawn M. Hendon, CFA

Mr. Hendon is a Principal at Torray and the co-Portfolio Manager for the Torray Large Value Strategy. He began his investment career in 1976. He previously served as co-manager of the Torray Fund (2008-12), before establishing Harewood Partners LLC (2012). Prior to 2008, he was co-founder and Partner of Rockledge Partners, and Managing Director and Portfolio Manager for Lockheed Martin Investment Management Company. Mr. Hendon received a BA degree from Georgetown University (1973), an MBA from George Washington University (1976) and holds the designation of Chartered Financial Analyst.

Q How do you evaluate or compare qualitative aspects of different companies? Do you have techniques or approaches that you utilize to assess one versus another from a qualitative standpoint?

Shawn One thing we delve into is the annual letter to shareholders. To review it carefully can be very revealing. It has to be substantiated by the historical record, but you know, there aren't a large number of companies whose managements actually are candid with shareholders in terms of the things that shareholders really need to know about the operations of the business. Importantly, that deals with the issue of capital allocation and the use of free cash flow. Capital allocation decisions over time can be most important to the future value of a business. We want to see management address that issue annually in their letter to shareholders.

For example, there are many companies that have ongoing share repurchase programs where there is no discussion about the issue of valuation, and why repurchasing at one level as opposed to another level is beneficial to shareholders. In many cases it appears as if they're indifferent to that question. Another matter has to do with their approach to mergers and acquisitions. When they discuss acquisitions, are they telling shareholders why this acquisition is going to add value to the business over time as opposed to reinvesting the money back into the business, or paying dividends or repurchasing shares? This has to do with a shareholder orientation that is somewhat like running a private business or being in a partnership. I would say this isn't typical of annual reports to shareholders and it is the type of discussion we look for in a report.

> "There aren't a large number of companies whose managements are actually candid with shareholders."

Q As an advisor and investor, we know that investments run in cycles. When does your approach do well and when is it most challenged, and why?

Shawn I think broadly because of our value orientation - trying to focus on businesses where expectations are modest for one reason or another – we will typically face headwinds in markets where there are factors which contribute to unusual interest in growth, such as the very low interest rate period we've been in.

Periods like the Nifty 50 in the seventies, the telecom media environment in the early part of the 2000's, where the market gets focused on certain ideas or certain groups of companies, that's not a period where we would likely do as well. We're not focused on trying to anticipate when those cycles begin or when they end. We're just focused on the long-term results of our portfolio and the collective results of the businesses we own. Over time, we think that's going to add value.

We're not deep value / contrarian investors, however. We are not prone to buying companies just because they happen to be cheap, or they are selling at some discount to asset value. You would expect coming out of recessions like 1982, 2001, or 2008-2009, many of these kinds of companies would do well because of the operational leverage in their businesses, but we likely wouldn't consider them to be good long-term investments.

Q Looking at the relatively small number of holdings in the strategy, why did you choose to go that route? Do you think that adds risk to the portfolio or makes the portfolio something that's more manageable?

Shawn Well, it's certainly a smaller portfolio than many you'll see. We think that doubling or tripling the number of holdings might add more risk to the portfolio, as it tends to be very difficult to be a good long-term owner with so many names. We think that this number of names can be properly diversified by sector and at the company level, and it allows us to have a portfolio we can fully understand well over time. We don't have a farm team approach where some managers will take a small position in a stock to try them out, we don't do that. When we decide to invest in a company, we're looking to invest for the long term. I would say that our average holding period for the portfolio today is eight years. So, it's a relatively low turnover portfolio, but we think that with about 30 or 35 names, the portfolio can be properly diversified.

"When we decide to invest in a company, we're looking to invest for the long term."

Q Are there sectors historically that you and Bob have stayed away from just because you don't find enough opportunities?

Shawn I think technology is one area that we normally find very challenging. We typically don't do much in technology because valuations normally require us to make judgments about the next big product, a product extension, you know, those kinds of things. So that's an area where we don't typically find we have an advantage, but when we're not required to assume much growth in a business of that size and financial strength, we will look at them.

When you can find a company where the expectations of an increase in cashflow over time are much below normal results, we would expect to have a margin of safety which offsets the changing nature of a technology business. Retail is another area where it's a low margin business. It's very competitive and sales trends are tied to popularity, fads and things like that. That is not in our comfort zone.

Q How do you think about risk and risk management and the steps you might take to address those?

Shawn We don't view risk as short-term volatility, we view risk as a permanent loss of capital. We address that by investing in large capitalization businesses with demonstrated records of profitability and conservative balance sheets. We try to pay reasonable prices for modest expectations and diversify across industries, sectors and companies, with limits on industry and company exposure. We think that approach is poised to provide a good collective result, where if there's an unfavorable result in one or two names, it's not going to hurt the portfolio. We feel we can mitigate some of the risk over the long term by doing that and short-term volatility is not a concern when your average holding period is eight years.

"We don't view risk as short-term volatility, we view risk as a permanent loss of capital."

Q One last question, how did you get to know Bob Torray and how did he convince you to join him as a portfolio manager?

Shawn Well, I've known Bob for over 35 years, beginning when I was with the pension fund at Martin Marietta and then subsequently Lockheed Martin. We had retained Torray as an advisor to our pension fund. So, my initial exposure to Bob was back in the early eighties. We managed a good portion of the pension fund internally at Lockheed Martin and it was in a value-oriented investment approach. The approach used by Torray was similar to the approach that we used at the pension fund.

Shawn, thank you for your time today, we've enjoyed the discussion.

Past performance is not indicative of future results. Historical observations are based on past market environments may not be replicated in the future. There can be no guarantee that any strategy will be successful. All investing involves risk, including the potential loss of principal.

This interview was prepared by Endeavour Investment Partners, LLC. The opinions expressed by Shawn Hendon do not necessarily reflect the view of Torray LLC, or Investment Planners, Inc (IPI) and are not intended to be investment recommendations.

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