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Higher Highs with Limited Downside

Stephen Goddard and his team managing Touchstone's Mid Cap Fund seek downside protection first while taking the approach of a private business owner. Many times we're looking at the balance sheet and how we could restructure it if we had control of the company. We avoid speculating on growth and margins but rely on the tangible assets underpinning valuation to increase our margin of safety and downside protection.

In addition to managing the Touchstone Mid Cap Fund and Touchstone Small Cap Core Fund, **Stephen M. Goddard** is Managing Director and Founder of The London Company, and heads the firm's investment committee. He has over 27 years of investment experience, beginning his career as an Analyst in 1985 for Scott & Stringfellow, followed by Senior Portfolio Management positions at CFB Advisory and Flippin, Bruce & Porter. Mr. Goddard is a CFA charterholder, member of CFA Society Virginia, and a former Board member of the Virginia Asset Management Investment Corporation.

What is the history of the fund?

The London Company has been managing money since 1994 and we have managed Touchstone's Small Cap Core Fund since September 2009. We were selected as the sole sub-advisor to manage Touchstone's Mid Cap Fund in December 2011.

What is your investment philosophy?

Our primary focus is capital preservation. We believe the market is much less efficient at assessing risk than reward. In today's market, investment horizons are incredibly short, often focusing on the next week or quarter, causing stocks to occasionally deviate from its true intrinsic value. When that happens, less attention gets paid to the assets a company has backstopping its value or the flexibility a strong balance sheet gives it to work through a problem. Because we pay so much attention to how we're protected on the downside, we think that can help us uncover an opportunity when the market overlooks it.

We approach stocks like a credit analyst would and put little faith or emphasis on future growth. Our focus is on the balance sheet and how we can extract value there. Additionally, we look for long-term strategic value enhancing strategies versus trying to follow and outguess the other analysts on a quarter-by-quarter basis. That's a very efficient segment of the market. By investing from the perspective of a founding family or private equity owner, we take a long-term view and determine the optimal cost of capital for the business. Frankly, we're looking at the balance sheet and analyzing how we could restructure it if we had control of the company.

We do not assume the company is going to grow in the future so if there is an expectation that the company is going to grow 15% over the next five years, we are going to use a growth rate between zero and three. The benefit is that if we are wrong, the fund should not get hurt by any one stock.

We typically hold between 30 and 40 names and our top ten could be as much as 50% of the portfolio. We strongly believe that to beat any benchmark you have to be different from that benchmark. As a high-conviction manager, we avoid over-diversifying the portfolio so our best ideas can meaningfully contribute to returns.

Over time, markets tend to reveal hidden assets on a balance sheet that can create value through actions such as debt recaps, asset sales, or spinoffs. We like following this path, as we feel it provides us additional downside protection because companies do have physical assets that can act as a value anchor.

"The key to our philosophy is making sure we avoid large mistakes…because we believe in the long run you can add value if you can avoid significant drawdown…We focus on facts rather than future-based estimates so if the company misses earnings or revenue growth our downside should be limited and protected. "

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It sounds like you invest as a private equity investor would? What is your investment strategy?

We definitely employ a private equity focus in our strategy. If you start by playing defense, attempting to insulate the portfolio from holdings that could be down 30% to 40%, then portfolio upside tends to take care of itself. That has been our strategy all along and it follows how a private equity owner or a private business owner would look at it. We look at things that are within management's control, and could be done tomorrow to create value, versus trying to outguess the other thousand analysts on what their projected growth rate is going to be next quarter or for the next five years.

We are drawn to companies that have earned high returns on capital. These companies tend to throw off a lot of cash and are generally more predictable. They have far more flexibility to create value through capital allocation and their balance sheet. Wall Street is very short-term oriented and tends to focus on revenue and earnings growth, but I've always believed sustainable high margins, capital allocation, and cash returns on tangible operating capital drive value more than anything else.

Ideally, we like companies that are oligopolies. They are usually more mature and stable with few competitors. These companies dominate their market and have pricing flexibility, high operating margins, and high returns on capital. Once we find a company that meets our return and cash flow criteria, we determine how we can optimize the balance sheet to discount that capital back at the lowest cost. We try to take speculation out of it as much as we can and look at the balance sheet as if we control the company. We ask what we can do, absent of any future forecasts, to increase the value for shareholders today.

The majority of companies out there have no net debt on the balance sheet. Our belief is if you are a decent company with a good business model that is reasonably profitable, then you should be able to support a 30% debt structure. This is especially the case today when you can borrow at record low rates. If your equity is trading at five-times cash flow, that translates into a 25x multiple on earnings. Why would you not borrow money at 3% or 4% and buy back your stock all day long?

We want companies that have such high margins and cash flow that they are still investment grade. I am not talking about levering it up to seven times operating earnings before interest and depreciation. We are just restructuring the balance sheet to a normal debt-to-cap ratio where the interest coverage is still high but not to the point it puts them in financial peril.

The downside to our strategy is that it takes patience, and at times that can be taxing. Because the marketplace is highly efficient overall and management teams may have different incentives, our approach requires fortitude. It can be three to four years before a value-creating catalyst occurs. A key part of our process is the assessment of management and making sure their interests are aligned with shareholders. We always try and look at what companies are doing versus what they are saying. We take a cynical view of what they are telling the street because, of course, they are going to give you the best pitch. We believe actions speak louder than words.

What kind of companies are you seeking?

We look at companies that we believe are stable, dominant in their marketplace and have high margins. We do not want to get into a situation where economic downturns could put them in trouble. In an ideal world, we like to have a company that is trading at three- times cash flow and has annual returns on capital of 55%. We prefer a stable and predictable business with no competitors whose management team is buying back shares regularly and returning 100% of free cash to shareholders through dividends or buybacks. Unfortunately we seldom encounter such ideal conditions thus comb through the real world opportunity set.

We employ quantitative and qualitative sources for new ideas. We screen for top decile companies using a few factors: high return on capital, free cash flow and earnings yield. We focus on those 200 names that screen up into the top decile of our universe.

After that it is just a matter of going through qualitative features and looking at the balance sheet, the management team and change in amendments. Are they buying stock or selling stock? We like to rely more upon independent analysts, who can be more objective than Wall Street analysts.

The one thing that is consistent with all of our products is that through any rolling five-year period our downside protection has always been good. We believe we excel at playing good defense and avoiding portfolio holdings that will hurt performance. We focus on that part of it and do not worry about which stock is going to be the next homerun in the portfolio. Over a five-year period we believe we are going to outperform by not losing materially on the downside.

Can you give us an example of how your research process works and how you look for opportunities?

One example is Cabela's Inc., which is a hunting and sporting goods retailer. When we first bought this stock years ago it was trading at about book value. The catalogue business was eroding but they still had fairly high returns in their stores. The Board of Directors brought in Thomas L. Millner as President and CEO from the outside and he changed the corporate focus to increasing returns on capital, increasing margins, and changing the delivery format to more of a bricks and mortar destination store. Slowly, margins started increasing, the returns on capital began improving, and the management incentives were aligned

with our interests. We bought Cabela's stock at a deeply depressed price, but the company's margins and top-line have been growing at a double-digit pace since the transformation.

Additionally, we also noticed one of the older directors, a non-Cabela family member, was buying stock in the open market, something we pay close attention to. Importantly, that director continued to buy stock as the price rose and reached the mid-60s.

Another example is NewMarket Corporation, a competitor of Lubrizol. There are three or four major players that supply additives and lubricants for cars and fuel and they are all rational competitors. The returns on capital for that business is in the 25% - 30% range, and operates as a good oligarchy should, with a few players dominating the category and all enjoying pricing flexibility. Basically, demand is driven by the increase in mileage driven, with particular benefit from the emerging markets in Latin America.

It is not an industry that is growing fast on a unit-buying basis but NewMarket is able to get increased margins through price increases. It is a family owned company, or at least the family is still involved in the company. They have done a good job of returning capital to shareholders through increased dividends, special dividends, and buybacks. They have reduced the outstanding share count from 17.5 million shares down to about 13.3 million in the last five years.

Typically when we are buying a stock, the company and the stock are out of favor for some reason or another. We hope to benefit from any earnings growth and improving perception in the investment community that lifts price multiple. But when we buy at the bottom, our downside is limited and protected.

What drives your sell decisions? Do you establish price target at the time of purchase?

Our price targets are dynamic; they are changing and are not static, so hopefully the price target is moving up. The earnings and the cash flow have to move up with it. As long as we are not uncomfortable with the multiples, which would usually be somewhere north of 20x, and we feel the company is still trading below its intrinsic market value, we are going to hold it.

Usually when we sell a company it is because the management squanders capital and destroys shareholder value through some type of expensive acquisition. We would rather see that excess capital carried on the balance sheet returned to shareholders. At least nine times out of 10, capital misallocation is probably the most aggressive reason we sell.

When we do make mistakes we have a quantitative sell discipline to help protect us from large losses. If a company negatively affects the portfolio by 1% at cost, our soft-stop loss triggers and we review the thesis, and more often than not, start trimming the position. We want to remove underperforming positions and not turn small mistakes into large ones. Other reasons might be that the valuation becomes less attractive. We have sold some of the REITs because we felt they were getting close to maximum value. Additionally, we see a lot of insider selling going on that makes us nervous and we will want to cut back on that name. Any of those three reasons are the primary sell triggers.

What is your portfolio construction process?

The Russell Mid Cap Index is our benchmark, but we do not get too hung up on sector weights relative to the benchmark. New positions are typically 3% and are limited to a maximum position of 5% at purchase. We maintain the holdings between 30 to 40 stocks, any number north of that would begin to dilute the portfolio.

Touchstone Mid Cap Fund

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About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

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I always tell the team that they have to have enough conviction to theoretically make a new idea a 10% to 20% position. We want new ideas to be very high conviction. It makes no sense to us how other funds can a hold 100 stocks and expect to outperform. Your best 1% position is not going to meaningfully add to results when it's handcuffed by 99 other mediocre positions.

What is your portfolio turnover?

Our portfolio turnover is fairly low over a five-year timeframe and typically 25% or less. Unlike many value managers, we do not add to underperforming positions, while we do let our best performing names appreciate to drive excess returns. Our focus is avoiding left tail risk, meaning no large disasters in the portfolio. By not adding to mistakes and having our soft stop-loss tool in place, we have historically protected capital and participated less in down markets.

How do you define and manage risk?

We do it strictly from a bottom-up perspective. We look at risk from what the permanent downside to our original investment could be, and try to minimize that by sticking with companies that we believe, in terms of capital, have predictable cash flow, have strong competitive positions with a strong balance sheet and a strong management team.

We try to avoid being over-exposed in one sector and limit the sector exposure to two times a sector weighting in the index. So if the Financials sector is 20% of the index, we are not going to exceed 40%.

We are not going to allow any one position get to exceed 7% - 10% of the portfolio.

How have you changed your investment process since the turbulent market years of 2008/2009?

The markets have changed much more than our process has. We will stick with companies that we believe have strong markets and competitive positions that are not going to suffer if we experience another 2008/2009.

We are not focused on where the stock quote is on any given day. We are focused on what the true private market value of the company is and try to hone in on a discount to that number.

I think 85% of the trading volume on exchanges is driven by speculators with exposure to ETFs, or hedge funds, and by high-frequency traders. Fortunately, we do not trade frequently so we do not get too caught up in that but markets in general have become more volatile in the last decade. Institutions are holding positions not for a month, but for a day or sometimes less, so that tends to fluctuate prices quite a bit more than the merits of the business might justify.

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