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Value Investor INSIGHT

The Leading Authority on Value Investing

All Needles, No Haystack

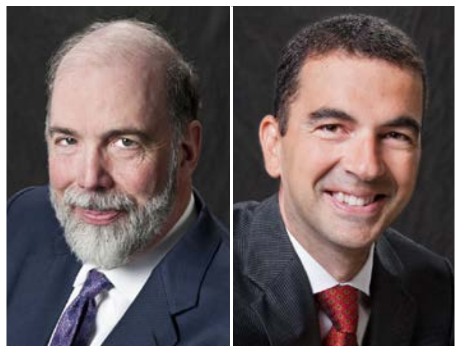
Mark Thomson says it's "basic math" to focus on limiting downside when trying to compound returns over time. His numbers certainly make the case.

Pursuing the latest and greatest tends not to occupy much of Mark Thomson's time in overseeing C$23 billion in equity investments for Toronto's Beutel, Goodman & Company. "We aren't in the business of buying dreams," he says.

Thomson's grounded approach has paid big dividends for Beutel, Goodman investors. The Canadian-equity strategy he manages has over the past 15 years earned a net annualized 10.0%, vs. 4.7% for the S&P/TSX index. Over the same period the firm's U.S. strategy has outperformed the S&P 500 on average by 270 basis points per year.

More readily finding quality on sale in the U.S., Thomson and U.S. co-portfolio manager Rui Cardoso see opportunity today in such areas as credit cards, telecom, software and industrial systems. See page 2

INVESTOR INSIGHT



Beutel, Goodman & Company
Mark Thomson [*l*], Rui Cardoso [*r*]

Investment Focus: Seek companies that consistently generate free cash flow and then reliably deploy it in ways that compound shareholder value over time.

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Investor Insight: Mark Thomson

Mark Thomson and Rui Cardoso of Beutel, Goodman & Company describe why they're attracted to unexciting companies, why they consider the U.S. fertile ground for finding high-quality but out-of-favor stocks, how they try to control their baser investing instincts, and why they see upside in American Express, Verizon, Symantec and Parker-Hannifin.

The first line in your firm's value philosophy is "Preservation of capital is paramount." As well versed in value-investing orthodoxy as we are, we've always wondered why growth in capital over time doesn't at least get equal billing.

Mark Thomson: For us it's basically the same thing: making capital preservation our first order of business is the best way to grow capital over time. To most effectively compound returns you have to mitigate your downside – that's just basic math. At the same time, for any investment approach to be successful it has to be consistent with the nature of the people who execute it. As a group we consistently lean to the frugal and risk averse.

We don't at all consider mitigating absolute risk just a portfolio-management exercise. It informs everything we do, from the types of companies we target, to the prices we're willing to pay, to the discipline we have around selling.

Start out by describing the types of companies you target.

MT: We're looking for companies earning beyond their cost of capital and consistently generating free cash flow over the cycle. With competent management – not always a given – companies generating free cash flow can reinvest in their businesses, pay down debt and return capital to shareholders. Business quality is the first line of defense in reducing risk.

Is focusing on free cash flow that much of a differentiator for an investor?

MT: Everyone wants it eventually, but I would say we're more focused than most on the consistency and reliability of the free cash flow year-in and year-out. That's not to say our preferred companies don't face cycles, competitive challenges or home-grown mistakes, but the baseline business still tends to operate at a very high level.

Rui Cardoso: We like to say that while other firms with less-concentrated portfolios are constantly screening for needles in a haystack, we start with a pile of high-quality needles and then are very particular about the ones we pick up. Of the U.S. stocks in the S&P 500, maybe 180 will meet our cash-flow and balance-sheet standards. At any given time we're actively engaged on the 60 or so of those trading at the lowest valuations – 25 to 30 of which that are already in the portfolio and the rest that are on our watch list.

We can imagine you have to watch these types of high-quality companies for some time before you get the price you want. What tends to instigate the opportunity?

RC: When you run a concentrated portfolio you can have the patience necessary to wait for the right company to be cheap. We followed American Express [AXP] for at least ten years and it finally got there last quarter in the aftermath of the announcement that its relationship with Costco was ending. It's not an insignificant loss – 8% of Amex cardholders are from that relationship – but when we look out two to three years we expect the impact to be indiscernible. Amex should again be regarded as a highly profitable, well-positioned player, with the best customers in a secular-growth business. Now everyone's just worried about how the next few quarters are going to look.

We also tend to find opportunity in companies that the market perceives as unexciting or without any obvious catalysts. An example of that would be Amdocs [DOX], which is the global leader in billing software and outsourced services to the telecom and cable industries. When we

Mark Thomson

Making Sense of It All

Having earned undergraduate degrees in math and fine arts, Mark Thomson initially chose the path of the artist, working as a sculptor and teaching at the university level until he concluded several years in that "the political aspects of academia didn't suit me well."

Switching gears, he parlayed an initial job as a stock broker into a portfolio-management position at Canada's Pemberton Securities, where his success running a U.S.-focused fund helped him land in late 1989 at one of Canada's premier value investing shops, Beutel, Goodman & Co. He since 1999 has had ultimate responsibility for the firm's equity strategies, which now manage C$23 billion in assets.

While his distinct left- and right-brain careers would appear to have little in common, Thomson does see a fundamental similarity: "The reality is that in both areas you're working with a wide array of disparate information and trying to make sense of it all," he says. Which is not to say he's continued to dabble in sculpture: "I'm not really a person that dabbles in anything – I either do it or I don't. To do anything well you have to be thinking about it when you're not doing it. With art right now, I just don't have the capacity for that."

bought it in the fourth quarter of 2013 we considered its existing relationships to be high-return, long-tail assets, with growth potential as the customers themselves expanded and as service offerings multiplied and got more complex. But even with that it was probably a mid- to high-single-digit grower, which Wall Street tends to find boring. The company has continued to execute quarter by quarter, returning excess cash through buybacks and dividends, and the stock has moved steadily and nicely higher, to the point where we're close to taking money off the table. It's been just the type of quiet victory we've been fairly good at uncovering.

MT: To elaborate on that briefly, the U.S. is actually providing the best opportunity today for us to find high-quality companies trading at out-of-favor prices. U.S. investors typically need strong growth to be excited. What excites us is quality – given that, growth tends to take care of itself.

Do heavily cyclical companies ever meet your quality standards?

RC: They can, but only when operating margins and free cash flow hold up well through the cycle. We've been an owner off and on over the years of oil-services company Halliburton [HAL], which has obviously been impacted by the latest fall in oil prices. We consider it extremely well managed, with earnings power that will likely be enhanced – especially if the announced plan to merge with Baker Hughes goes through – when the cycle moves the other way. We had sold down our position prior to oil prices cracking, but with the stock [at a recent $38.40] off more than 40% in the past year, we've been building our position again.

We see you recently bought Kellogg [K]. Is that partly a bet that the secular challenges facing the cereal industry have been overblown?

RC: As a general rule we try to steer clear of any whiff of secular decline in an industry. We're not at all growth investors, but it's hard to compound capital over time if the end market is in decline.

With Kellogg, the story is more about running a high-quality set of food assets better. The company is the world's largest manufacturer of ready-to-eat cereal, and after buying Pringles is the second-largest player in snacks. Even though we believe it's been poorly run, with a bloated cost base, it still earns 40% returns on invested capital. We're not minimizing the need to respond to changes in eating habits, but that's always been something the best companies have needed to do and we think Kellogg has the assets to continue to succeed. But if the current restructuring to streamline the business and reduce costs isn't aggressive enough, we wouldn't be surprised if someone came along to do if for them.

ON CANADIAN BANKS:

We think these are excellent businesses, with high returns on capital and low valuations that aren't justified.

Let's talk about Canada. How would you describe the opportunity set there today?

MT: A good chunk of our index is comprised of cyclicals, which as Rui said can provide opportunity when the market's response to the down cycle dramatically overstates the actual impact on the company. So we'll take interest in something like Finning [FTT:CA], the largest Caterpillar dealer in the world, which is exceptionally well run, generates a lot of free cash flow, and makes a significant amount of its money from less-cyclical aftermarket parts and maintenance. Another company we like that is facing a different cycle is Cameco [CCJ], the world's largest uranium producer. We don't know when uranium prices turn, but we can make a detailed argument why they eventually will, with Cameco as a primary beneficiary. In the meantime, the company still generates free cash flow and pays a healthy dividend.

Probably most interesting right now are the Canadian banks. These are franchises that held up very well in 2008 and 2009, with mortgage books that are largely guaranteed by the Canadian government. Valuations today are quite low. Banks account for maybe 20% of the S&P/TSX index value, but generate 40-50% of index-company profits. We think these are excellent businesses, with high returns on capital, and that the valuation disparity isn't justified. Of the five major banks in Canada, we own four of them: Royal Bank of Canada [RY], Toronto-Dominion Bank [TD], Bank of Nova Scotia [BNS] and Canadian Imperial Bank of Commerce [CM].

What goes into the determination if something is cheap enough to buy?

MT: For each idea we'll take two or three different valuation approaches, one of which is a discounted cash flow model. We don't do DCFs in isolation, marrying them with asset-transfer values conservatively arrived at by applying EV/EBITDA and/or P/E multiples on our estimates three years' out. We'll take a blend of the different valuation results to arrive at a target price. If the upside from today is 50% or more, we're willing to buy.

We at the same time using similar methodology but different assumptions will arrive at a downside target price as well. Our aspiration, which is usually met but not a hard-and-fast rule, is for the ratio of upside potential to downside risk to be at least 3:1.

One thing we may do differently is that we won't adjust our upside target higher until it happens to be hit. When it is hit, we then automatically sell at least one-third of the position and then do a formal review of the appropriate target price. If it increases sufficiently we will continue to hold the position, but if it doesn't we will start to fully exit. This just reflects our lack of appetite for risk. The point in time when we have the greatest clarity and the lowest risk is when the risk seems very apparent and everyone doesn't like the security. But there are a lot of reasons to hold stocks once they get expensive – we want our process to lean against that.

What happens if the downside price is hit?

RC: We'll also then do a formal review, and respond accordingly depending on the result. When we initiated a position in Coach [COH], for example, in March of last year, we thought the brand was much stronger and had broader applicability than the immediately following quarterly results showed. The stock hit our original downside price of $35 and on review we concluded the risk/reward wasn't as attractive as we originally thought and ended up selling shortly thereafter.

MT: One thing I'd add is that when the downside target is hit, the review is done by a different analyst. Human beings hate to admit when they're wrong, so this is just another way to try to take emotion out of the process.

How do you additionally manage risk at the portfolio level?

MT: As we've described, our first level of defense in a concentrated portfolio is knowing our stocks extremely well, including the potential downside. One key portfolio-level control is to limit our sector exposure to no more than 10 percentage points over the benchmark. So if industrials are 15% of the benchmark, we can't go higher than 25%. Again, we want to have as many controls in place to control our baser instincts. One potential baser instinct is overconfidence in how smart we are and falling in love with a particular sector. It doesn't work the other way, however – we have no problem having a sector weight of zero.

We don't pay any attention to benchmark-relative risk measures like "tracking error" and "active risk." The benchmark over time takes on market risk, so we want to avoid any false sense of security relative to a benchmark if the benchmark is excessively risky.

We haven't found Verizon [VZ] to be in value investors' sights for some time. Why is it in yours now?

RC: That lack of interest is one thing that attracted our attention. We had been Vodafone shareholders when Verizon made the deal to buy it out and take full control of Verizon Wireless, but there was little reaction in Verizon's shares. The U.S. telecom market in general is perceived as mature, unsexy and increasingly competitive. All that inspired us to take a closer look.

Verizon Wireless is one of the best wireless franchises globally, with very high quality assets and the best scale efficiencies in the U.S. It has the #1 share, at 35%, of a consolidated market in which it, AT&T, Sprint and T-Mobile control more than 90% of the total business. Wireless accounts for two-thirds of Verizon's revenues and around 80% of EBITDA.

There's no question the competitive intensity has increased in the U.S. wireless industry, led by Sprint and T-Mobile trying to shore up weak competitive positions. Our basic view is that if you're going to bet on the outcome of a price war, the player with the best balance sheet wins. Verizon's net debt peaked at 2.5x EBITDA

INVESTMENT SNAPSHOT

Verizon
(NYSE: VZ)

Business: Provider of fiber-optic, wireless and wireline communications services primarily by subscription to individual, business and government customers in the U.S.

Share Information
(@8/28/15):

Price	**46.07**
52-Week Range	38.06 – 51.73
Dividend Yield	4.9%
Market Cap	$187.31 billion

Financials (TTM):

Revenue	$128.99 billion
Operating Profit Margin	15.9%
Net Profit Margin	7.7%

Valuation Metrics
(@8/28/15):

	VZ	S&P 500
P/E (TTM)	19.4	20.7
Forward P/E (Est.)	11.3	17.5

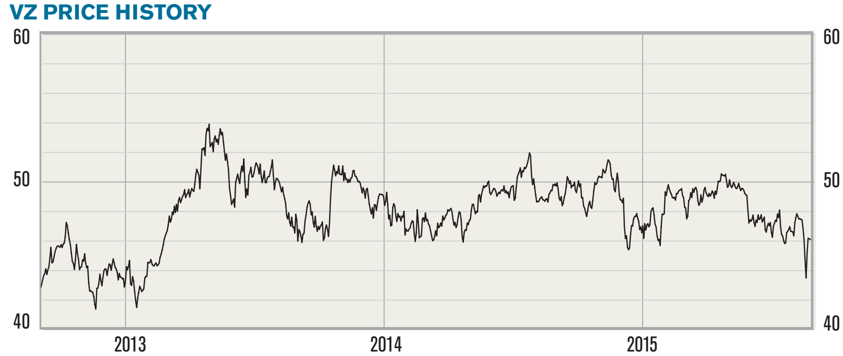
Largest Institutional Owners
(@6/30/15):

Company	% Owned
Capital Research & Mgmt	6.1%
Vanguard Group	5.7%
BlackRock	4.0%
State Street	3.9%
Wellington Mgmt	1.8%

Short Interest (as of 8/14/15):

Shares Short/Float	1.2%

VZ PRICE HISTORY



THE BOTTOM LINE

While competitive intensity in the U.S. wireless industry has increased, Rui Cardoso believes the worst has likely passed and that the company's competitive advantages will remain intact or strengthen. He considers the risk/reward in the stock today to be particularly attractive: his upside target for the shares is $71, his downside just under $40.

Sources: Company reports, other publicly available information

and finished last year at close to 2x. The company continues to generate tons of free cash flow and its biggest spending on the wireline side to build out its fiber-optic network is well behind it. That means it has the firepower to wait out attacks by Sprint and T-Mobile, both of which have net debt to EBITDA of more than 5x. The aggressiveness we see in the market today is eventually going to go away as competitors can't afford to keep it up, especially as they have to play catch-up in improving the lagging quality of their networks. We're already seeing some change in this respect, as industry subsidies on new phones are being taken away.

Do you consider the fixed-wireline business an ongoing drag?

RC: Verizon has been selling off wireline assets and in the footprint it's keeping it is very competitive in offering high-speed voice, TV and data services over its FiOS fiber-optic network to around 11 million households. There's considerable change going on in that side of the business industry-wide, but we think given the quality of its network that Verizon is well positioned to benefit as one of the few certainties in the space – that demand for high-speed data will continue to increase – plays out. We're not expecting great growth from the wireline business, but we believe it will prove more stable from here on out.

What's your take on the AOL acquisition?

RC: AOL is strong in Internet video advertising, owns numerous content properties and reaches in one way or another around 50% of the U.S. population. All of that should have value to Verizon, but we don't have a strong opinion on whether it was worth the $4.4 billion price. For a company the size of Verizon, it doesn't really change anything fundamentally.

At today's $46, how attractive do you consider the shares?

RC: We come at valuation in three ways, EV/EBITDA, P/E and discounted cash flow. Based on historical levels, we use a 7.2x EV/EBITDA multiple and a 16.5x P/E multiple on our 2017 estimates. In our DCF, we assume 3% terminal growth, a slight increase in EBITDA margins and a discount rate of 10%. When we blend the results of those three measures, we come to a target price of $71.

That's particularly attractive to what we consider our downside in this case, which assumes a 5.1x EV/EBITDA and 11x P/E on our 2015 numbers. At those levels the share price would fall to $39.

ON U.S. WIRELESS MARKET:

The biggest issue is how long desperate players are disruptive. We don't think it gets much worse from here.

The biggest issue will be how long desperate players are disruptive in the wireless market. We generally don't think it gets much worse from here, but the current environment could certainly go on longer than we expect. Given Verizon's staying power, we can be patient. It also helps in the meantime to receive a nearly 5% dividend yield, which we're comfortable is well protected. With the cash-flow characteristics of the business, there's even room to increase the dividend from here.

Did the recent announced sale of its data storage and recovery business spark your interest in Symantec [SYMC]?

RC: We actually bought into the stock nearly two years ago, so our interest predated the latest announcement. It's been a rather painful holding so far, but we're still confident in the value here.

Following the sale of the Veritas business, the company will be focused on endpoint security software for consumer and enterprise applications. Endpoint security refers to protection at the device level, so they're providing things like virus protection, identity-theft protection, encryption and digital-loss protection for desktop computers, laptops and mobile devices. Symantec is the leader in the market, well ahead of #2-player McAfee, and we very much like that some 90% of revenues are on a recurring basis.

What originally interested us was the restructuring underway at the company under Steve Bennett, the former head of Intuit who had come off Symantec's board in 2012 to take over as CEO and address a number of operational shortcomings. Operating margins were half the 30-40% level typical for software companies and he set about streamlining what had become an inefficient and ineffective organization with too many internal fiefdoms and agendas. He didn't shy away from tough decisions – like re-doing sales-commission plans or dumping uneconomic deals with computer original-equipment manufacturers – that might cause short-term pain but promised long-term benefit. In addition he reorganized and refocused research and development efforts to not only bring upgrades of existing products to market faster, but also to create new products for increasingly mobile applications.

Even though we thought he was doing all the right things – operating margins have increased to the mid- to high-20% range – the company's board in its infinite wisdom pushed Bennett out in March of last year and replaced him with another board member, Michael Brown. They apparently felt Bennett had ruffled too many feathers and that too many senior managers were leaving, which in our view was a good thing. In any event, the CEO change in the end hasn't resulted in fundamental changes in the restructuring plan and we believe the company continues to be poised for significant improvement.

How defensible do you consider Symantec's competitive position?

RC: We're optimistic that a number of new and updated products coming out will help bolter its position, but in general both consumers and enterprises are slow to change their security software. Symantec's scale allows it the resources to stay on top of new threats and update its products and services on the fly to keep customers protected. Given the continuously changing threat environment, we think the industry backdrop is a long-term positive, especially for companies like Symantec with strong reputations and broad and deep customer relationships.

Is the announced sale of Veritas to Carlyle Group a good idea?

RC: Endpoint security and data storage never had much overlap, so we support the split but think the $8 billion sale price is too low. That's another black mark for the board, and we'd argue one reason the stock is so cheap is the market's fear that the company will do something dumb with the $6.3 billion it will net from the sale. That is a risk, but we're taking the board at its word that its focus is exclusively on completing the restructuring and using excess cash to buy back stock.

How are you looking at valuation with the stock at a recent $20.85?

RC: Following the Veritas sale the company will have a total of $8 billion in net cash on the balance sheet, which is $11.70 per share. So you're paying today an effective price of $9 per share for a company that we expect to have around $1.40 in EPS for the fiscal year ending in March 2016. Based on both our DCF calculation and a more reasonable 15x multiple on fiscal 2016 earnings, our target price is closer to $35.

Given the inconsistency of execution over the last several years we're not surprised there is a lot of skepticism. But the underlying quality of the business endures. We think current management can realize the value inherent in the assets, but if it can't, somebody else likely will.

Describe in more detail your investment case for American Express [AXP].

RC: We consider this one of the preeminent financial franchises in the world, one of the three big global credit-card processors and a leading issuer of branded charge cards with unique strength in both corporate and high-end consumer markets. Among card issuers, the company benefits from unmatched global scale and brand reputation. The average Amex cardholder spends twice as much as holders of competing cards. Loan quality is excellent. Over time returns on equity have averaged 25%, and in the worst of the financial crisis the ROE went no lower than 15%.

If you look at the competitive landscape, there tend to be two types of credit-card companies. The network guys, Visa [V] and MasterCard [MA], collect fees by providing the background network and tend to be classified as technology companies, trading at P/Es over 20x. Then there are the classic card issuers like Capital One [COF] and Discover [DFS], which make 85% of their earnings off the spread in their loan books and trade today at more like 10-11x earnings. Amex is kind of in the no-man's land in between, trading more like an issuer even though 85% of its earnings come from fees rather than the load spread. We don't ultimately believe that's justified.

I mentioned earlier the near-term headwind from the loss of the Costco business.

INVESTMENT SNAPSHOT

Symantec
(Nasdaq: SYMC)

Business: Provider of computer security systems and software to consumers and enterprises; recently announced sale of Veritas data-storage business to Carlyle Group.

Share Information
(@8/28/15):

Price	**20.84**
52-Week Range	19.35 – 27.32
Dividend Yield	3.0%
Market Cap	$14.26 billion

Financials (TTM):

Revenue	$6.27 billion
Operating Profit Margin	22.1%
Net Profit Margin	12.1%

Valuation Metrics
(@8/28/15):

	SYMC	S&P 500
P/E (TTM)	19.1	20.7
Forward P/E (Est.)	10.5	17.5

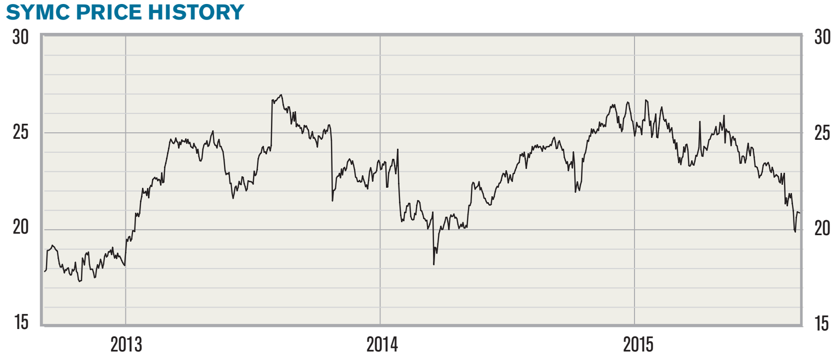
Largest Institutional Owners
(@6/30/15):

Company	% Owned
Dodge & Cox	12.7%
Franklin Templeton	5.7%
Vanguard Group	5.7%
BlackRock	4.4%
State Street	4.1%

Short Interest (as of 8/14/15):

Shares Short/Float	1.0%

SYMC PRICE HISTORY



THE BOTTOM LINE

Despite the company's years of inconsistent execution, Rui Cardoso believes the underlying quality of its computer-security business endures and that current management will realize the value it represents. Based on both his DCF calculation and putting a 15x multiple on his forward earnings estimate, his target price for the shares is around $35.

Sources: Company reports, other publicly available information

Again, while that will impact results when the relationship ends early next year, we expect the overall secular tailwinds in the charge-card business worldwide to make it a surmountable problem. We also think the loss of the court case earlier this year that will allow merchants to favor non-American Express cards in their promotions, while also a short-term headwind, just accelerates an already expected equalization in discount fees between Amex on one side and MasterCard and Visa on the other. Part of that will come from Amex fees coming down, which we can model fairly easily, but some of it will also come from Visa and MasterCard raising their own fees, which is happening.

Another big overhang on the stock is concern that new technologies will negatively impact the network swipe fees Amex earns in the future. Here we believe the barriers are extremely high, and that front-end payment technologies like PayPal and Apple Pay will still primarily use the global backend networks developed over decades by Amex, MasterCard and Visa. While Amex might not keep as much of the fee on certain charges, it would likely have offsetting savings on merchant acquisition. That should protect margins.

INVESTMENT SNAPSHOT

American Express
(NYSE: AXP)

Business: Global provider of branded charge- and credit-card services for buyers and payment-processing and payment-settlement services for sellers.

Share Information
(@8/28/15):

Price	**76.65**
52-Week Range	71.71 – 94.89
Dividend Yield	1.4%
Market Cap	$76.75 billion

Financials (TTM):

Revenue	$31.76 billion
Operating Profit Margin	29.0%
Net Profit Margin	18.6%

Valuation Metrics
(@8/28/15):

	AXP	S&P 500
P/E (TTM)	13.5	20.7
Forward P/E (Est.)	13.5	17.5

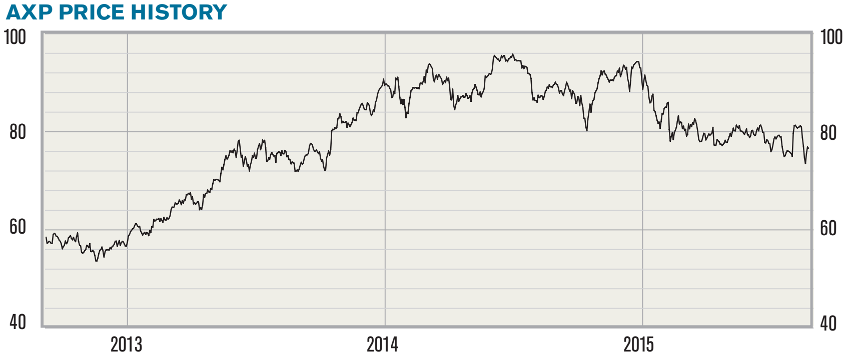
Largest Institutional Owners
(@6/30/15):

Company	% Owned
Berkshire Hathaway	15.1%
Vanguard Group	4.8%
Capital Research & Mgmt	4.3%
State Street	3.9%
BlackRock	3.2%

Short Interest (as of 8/14/15):

Shares Short/Float	1.5%

AXP PRICE HISTORY



THE BOTTOM LINE

"Near-term noise" over losing a large customer, losing a court case and the advent of new payment technologies is drowning out the core strengths of the company's business in a secular growth market, says Rui Cardoso. Using a blend of 16x his $7.50 EPS estimate three years out and a sum-of-the-parts calculation, he targets a $123 share price.

Sources: Company reports, other publicly available information

Do you read anything into activist-investor ValueAct Capital's recently announced stake in the company?

RC: Amex has already gone through a great deal of restructuring. When the latest effort is complete, the employee count will be down 30% from five years ago. They have spent a lot on upgrading their network, but much of that is now in maintenance mode and spending is shifting more toward marketing and promotion, which is where it's most needed. The balance sheet is overcapitalized and they've been using excess capital to aggressively buy back shares. So we don't really see the activist angle. We think ValueAct is in it because they see a well-run company with great returns that is too cheap for temporary reasons.

How cheap do you consider the shares at today's $76.65?

RC: Our target price is $123, which is a blend of 16x our $7.50 EPS estimate three years out and a sum-of-the-parts calculation that values the fee-generating business on discounted cash flow and the loan book at 1.15x book value.

What we'll watch most closely is how well the U.S. business gets back on track from the Costco loss and how aggressive the company needs to be with marketing spending. There's a lot of near-term noise and we expect to have to be patient. We'll likely pick our points and build our position if the stock gets weaker.

Is Parker-Hannifin [PH] one of the no-obvious-catalyst ideas you spoke of earlier?

RC: This is a true success story in the industrial sector, specializing in motion- and control-related products and subsystems for machines, vehicles and aircraft. The company focuses on custom-made and niche products for specific applications, fostering both higher margins and stronger customer relationships. Aftermarket revenues account for 40% of the total, a testament to an unmatched 12,000-store global distribution network and to how integral the company's componentry is to its customers' end products. Over the cycle, returns on net assets – which is the basis for management's incentive-compensation plans – have averaged 20-21%

Aerospace is the biggest end market, accounting for 17% of revenue and 30% of earnings before interest and taxes. But even with a sufficiently diverse revenue base, when several end markets experience weak fundamentals, as is the case today, the company's earnings can be somewhat volatile. That's been exacerbated lately by the currency impact of the strong U.S. dollar, which has hurt non-U.S. results.

Our basic thesis is that there's nothing fundamentally wrong with the company's business and that it is run by a very capable management team that has an exemplary record of capital allocation. That there's no obvious catalyst on the upside – which we do hear from analysts – is a positive if it helps us to buy into a great business at a great price.

Where is the primary capital-allocation focus today?

RC: Management has done an excellent job with acquisitions, showing discipline on price and in carefully integrating the acquired businesses. That's at least partly attributable to the fact that the division head leading an acquisition won't get his or her bonus if return targets for it aren't met. So we would support new deals they find interesting, but the focus now appears to be more on buying in cheap stock. The current authorization is for 35 million shares, 23% of the total outstanding, and we expect buybacks to be aggressive over the next 12 to 18 months.

What upside do you see in the share price from today's $107?

RC: At a better part in the cycle we see significant growth in earnings per share, from operating leverage, the benefits of a restructuring in Europe, and the reduction in share count. Assuming operating margins improve to 13.5%, we estimate by 2018 the company can earn $12.20 per share, up from just under $6.90 last year.

To arrive at a target price we use a DCF analysis as well as an EV/EBITDA multiple of 11x and a P/E multiple of 18x on our 2018 numbers. The blended target gets us to a share price of $224.

Macro headwinds appear to have investors' attention of late. Are any of those of particular concern to you today?

MT: The only real macro input that has weight for us internally is whether there is sufficient liquidity in global markets to support higher equity prices. Our perspective on that is that there is. Outside of that, our view is that even what's perceived as the most likely macro call is still going to be less likely than all the alternatives. If that's the case, why bother?

The debates over whether we're in a risk-on or risk-off market are meaningless to us. Our risk control is knowing what we own and what it's worth, and the best way we've found to deliver superior long-term returns is by finding great franchises we want to own forever and ensuring that we pay the right price for them. Looking for those great franchises is where we spend all our time. VII

INVESTMENT SNAPSHOT

Parker-Hannifin
(NYSE: PH)

Business: Manufactures and sells motion and control technologies and systems used in a wide variety of mobile, industrial and aerospace applications worldwide.

Share Information (@8/28/15):

Price	**106.98**
52-Week Range	99.74 – 133.41
Dividend Yield	2.4%
Market Cap	$14.81 billion

Financials (TTM):

Revenue	$12.71 billion
Operating Profit Margin	12.2%
Net Profit Margin	8.0%

Valuation Metrics (@8/28/15):

	PH	S&P 500
P/E (TTM)	15.4	20.7
Forward P/E (Est.)	15.3	17.5

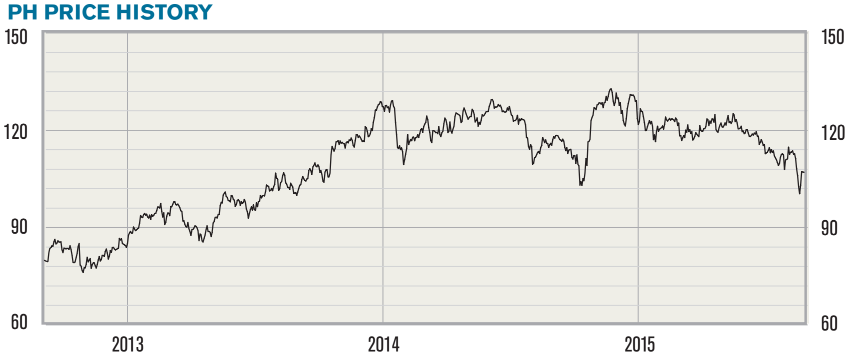
Largest Institutional Owners (@6/30/15):

Company	% Owned
Capital Research & Mgmt	9.0%
Vanguard Group	5.9%
Vulcan Value Partners	4.5%
State Street	4.5%
Longview Partners	4.5%

Short Interest (as of 8/14/15):

Shares Short/Float	7.9%

PH PRICE HISTORY



THE BOTTOM LINE

Rui Cardoso expects operating leverage, the benefits of a European restructuring and an aggressive share-buyback plan to lead to improved margins and much higher earnings at a better part of the cycle for the company's customers. At an EV/EBITDA multiple of 11x and a P/E multiple of 18x his 2018 estimates, the shares would trade at closer to $225.

Sources: Company reports, other publicly available information

Investment returns are expressed net of investment management fees and include reinvestment of dividends and income. Returns are time weighted and annualized for periods greater than one year. Values change frequently and past investment performance may not be repeated. Client returns may vary due to cash flow timing and client-specific constraints.

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