Contrarian and Disciplined

Good-quality companies, when purchased at a reasonable price to their long-term earnings capacity, can generate significant gains for shareholders. Over the last three decades, John W. Rogers, Jr., Chairman and CEO of Ariel Investments, has rarely wavered from this principle. With the additional support of a stable research team, he has infused the stock selection process of its flagship fund with the company’s discipline in buying stocks trading at a discount to intrinsic value.

What is the history of the company and the fund?

The firm and its flagship fund, Ariel Fund, have a long history spanning across three decades. We are very proud of our history and the long-term record, because we have worked hard to build a strong culture and keep our research team together—something rare in our industry.

We are contrarian and independent thinkers. When the Internet bubble was peaking at the turn of the century, there was a lot of pressure on our core values to start chasing the hot stocks of the day and ignore value. However, we did not follow the crowd, because we not only felt that technology stocks were overvalued, but also believed in our value investment principles.

In 2008, an investor could become a true contrarian and buy his favorite stocks at bargain prices. We bought more of our favorite companies during that time, which has been a key driver for our performance to date (both short and long term).

Have you changed your investing style in those thirty years?

Initially, we focused primarily on small- and mid-size companies, but mid-cap companies have evolved over the years. In the beginning, you could find a lot of smaller, high-quality companies.

Despite their small size, these companies could be at the top of their fields. However, many industries consolidated over the years, and nowadays, the smaller gems are fewer, while the mid-cap space seems to offer more opportunities. We look for companies that are high quality and a good value at the same time.

How would you describe your investment philosophy?

Our philosophy is to blend value investment principles with our selection of high-quality companies, which we find most often in the mid-cap universe. We believe that a really great business has a wide moat around it that inhibits new competition.

We look for companies that we can own for years, and we feel confident that they will still be leaders in their industries with high returns on capital, high profit margins and consistent growth rates.

I would say that we follow a value investment style popularized by Warren Buffett. We always read his letters and have been attending Berkshire Hathaway annual meetings for many years.

This learning has helped us not only sharpen our commitment to value investment principles, but also deliver outstanding returns for our shareholders.
What is your investment strategy and process?

Since we are looking for companies with strong balance sheets, we have our own proprietary ratings to ensure strong financial characteristics. We look for a quality, dynamic management team, and we spend a lot of time getting to know management.

Our strategy is oriented to running a concentrated portfolio with approximately 40 names or less. As we aim to be true experts in the industries in which we invest, we do not try to own a lot of everything. I believe that to make successful decisions in an industry, an investor has to know the companies extraordinarily well. The overarching theme is focus.

When buying stocks, we look for a significant discount to our estimate of intrinsic value of the business, which means a discount of at least 40 percent. With a detailed cash flow analysis of the company, we attempt to estimate what a financial or strategic buyer would pay for the entire company.

The stocks we buy should also be cheap on an earnings multiple basis. Here, we look for companies selling for less than 13 times next year’s earnings.

What is your research process and how do you look for opportunities?

We are open to ideas from all kinds of sources. To begin with, we read business publications, newspapers and reports from the brokerage firms. We also like to study and understand what our peers own.

Our group of analysts also searches for ideas. Each of our analysts is very experienced and covers one to two sectors. Our small but tightly knit team has been together nearly since inception. This type of stability in our research organization has helped us keep a lot of knowledge in-house, and we have been seasoned by going through severe markets and economic cycles together.

We meet with companies and competitors alike. We screen for ideas within the industry, looking for companies that may be trading down significantly from their 52-week highs or closely approaching their 52-week lows. These companies should have high returns on both assets and investments, as well as free cash flow through several different types of market cycles. We will avoid companies with high leverage on their balance sheets because even good companies or industries can go through challenging times.

Could you give us some specific examples of stocks that you own? How did you find them?

A good example would be WMS Industries Inc, a gambling company that makes slot machines and systems for casinos. We have known the company since the late 1990s. Originally, we shied away from the gambling slot maker because it was highly leveraged and its market space was crowded.

We owned a company called International Game Technology at least three different times in its history as a public company before it was acquired by an Italian lottery operator. IGT was the largest player in the space and had a good record until a change in management occurred. The new management team was not nearly as good, so we started looking for other companies within the same industry. We had been meeting with IGT and attending the G2E gaming conference in Las Vegas for many years, which gave us a better understanding of the competitive marketplace.

At the same time, WMS was trading at a high valuation for a long period of time. We patiently waited for the opportunity, and when the company missed its projected earnings for a few quarters, we were able to initiate a position at an attractive price. Subsequently, a year later, the company was acquired at a higher price than we paid.
All the research in that market space and the conversations with management led to building a position with another competitor, Bally Technologies. We waited for the stock price to meet our investment criteria in order to build that position as well. Bally was eventually acquired by the same company that acquired WMS.

Our research process is rooted in finding quality businesses with defensible market positions, but we are prepared to wait for the price in the market that will allow a patient investor like us to create value for shareholders in the long run.

What are the key elements of your portfolio construction process? How do you go about building positions?

We are a bottom-up stock-picking firm, and our portfolio consists of 40 names or less. We build one stock at a time without looking at how the portfolio treats each individual stock and different industries.

We are mindful of our benchmark, the Russell 2500 Value Index, but we do not focus on what goes in and out of the index and how the index allocates its weights across members. At present, the mid-cap benchmarks are not very representative for our fund because they carry many REITs and utilities, which have benefited from lower interest rates in the last decade.

In terms of market capitalization, we look for companies in the range between $1 billion and $7.5 billion at the time of purchase. The portfolio turnover is typically between 20% and 25%. Last year, at 30%, it was a little higher than usual.

For new positions in Ariel Fund, we will not buy more than a 5% weighting at time of purchase, and we will not let a holding exceed a 6% weighting at market. When it comes to industry exposure, we will not let an industry weighting exceed 10% at market.

How do you define and manage risk?

We define risk as the possibility for permanent loss of capital. We manage that risk through our work on the balance sheets of the companies that we research. Although at times we may not generate the returns we expect from our holdings, we make sure that each company has the strength to avoid permanent loss of capital.

Another critical element is the wide moat, which I mentioned earlier, for each company in the portfolio. Without that moat to protect the business, a company could have a strong balance sheet and still experience a permanent loss of capital.
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Past performance does not guarantee future results. Investing in small and mid-cap stocks is more risky and more volatile than investing in large cap stocks. The intrinsic value of the stocks in which the Fund invests may never be recognized by the broader market. Ariel Fund concentrates a significant portion of its assets in the financial services and consumer discretionary sectors, and its performance may suffer if these sectors under perform the overall stock market. The Fund pursues long-term capital appreciation.

In this article, John W. Rogers, Jr. discusses a number of stocks that previously were, but are no longer, held in Ariel Fund. These stocks do not represent any of the holdings in the Fund. Portfolio holdings are subject to change. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of Ariel Fund.

An economic moat is a perceived competitive advantage that acts as a barrier to entry for other companies in the same industry. This perceived advantage cannot protect investors from the volatility associated with stocks, incorrect assumptions or estimations, declining fundamentals or external forces.

Investors should consider carefully the investment objectives, risks, and charges and expenses before investing. For a current summary prospectus or full prospectus, which contains this and other information about the funds offered by Ariel Investment Trust, call us at 800-292-7435 or visit arielinvestments.com. Please read the summary prospectus or full prospectus carefully before investing. Distributed by Ariel Distributors, LLC, a wholly-owned subsidiary of Ariel Investments, LL