ValueInvestor INSIGHT

The Leading Authority on Value Investing

July 31, 2015

Patient Capital

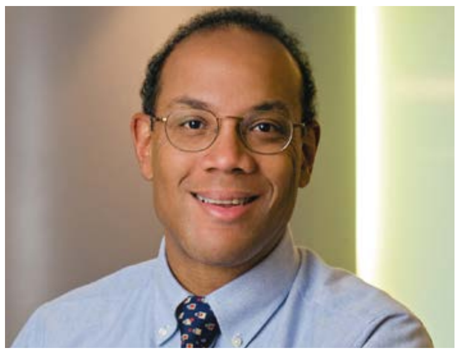
While he says he's toned down his "knee-jerk" contrarianism, John Rogers' independent streak remains as important to his investing success as ever.

While in many ways a man in a hurry – he started Ariel Investments in 1983 at age 24, prompting a write-up in *People* magazine – John Rogers as an investor has always been more tortoise than hare. Ariel's motto from the outset: "Slow and steady wins the race."

And that it has. Ariel now manages nearly $11 billion and over the past 32 years its flagship small-cap strategy has earned a net annualized 12.4%, versus 9.4% for the Russell 2000 index.

With a penchant for businesses facing secular and/or cyclical challenges, Rogers and his Chicago-based team are currently finding opportunity in such diverse areas as helicopter transport, financial advisory, private equity, cutting tools and local television broadcasting. See page 2

INVESTOR INSIGHT



John Rogers
Ariel Investments

Investment Focus: Seeks competitively advantaged companies for which long-term conventional wisdom appears to be inappropriately and excessively negative.

Inside this Issue

FEATURES

INVESTMENT HIGHLIGHTS

Investor Insight: John Rogers

Ariel Investment's John Rogers, Charles Bobrinskoy, Timothy Fidler, Kenneth Kuhrt and John Miller describe the many virtues of patience in investing, how they navigate secularly challenged businesses, how they've added discipline to their sizing of positions, and what they think the market is missing in Bristow Group, Kennametal, KKR, Tegna and Lazard.

Ariel's motto has long been "slow and steady wins the race." Why do you believe that's true?

John Rogers: Being patient is at the cornerstone of everything we do. It shows up in our effort to see past the short-term noise about a company and focus on how the business can develop over three, five or seven years. It shows up in waiting for the perfect pitch that provides enough margin of safety in buying and in our willingness to give companies we own the time to realize their intrinsic value.

With so many investors thinking short-term, share prices can be much more volatile than underlying business values. We believe taking advantage of those short-term dislocations is what drives long-term outperformance.

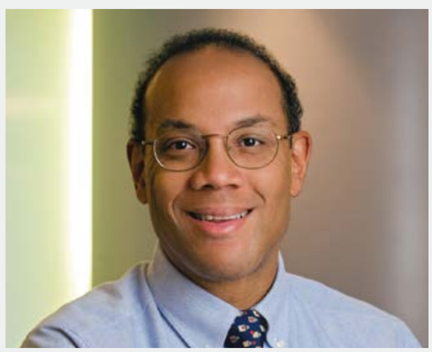
To expand on this a bit, 15 years ago I would have been more of a knee-jerk contrarian, trying to prove the market wrong and what an independent thinker I was. But we've learned to be more patient in pulling the trigger. Our experience and the research and data show that it's better to take your time to gain insight into a company. Earnings disappointments are often not one-off events and despite the market's efficiency, it takes time for Wall Street to go from surprised by bad news, to angry, to finally capitulating and assuming the company will never recover. We obviously don't always get it right, but we're trying to engage fully when everyone else seems to have given up.

Timothy Fidler: While we regularly respond to the market turning on a company's shares, our process focuses first on identifying companies with competitively advantaged positions that should result in predictable cash flows over a multi-year period. As an example, for 10 years we had been watching Progressive [PGR], one of the relatively few insurers with what we consider comparative advantages from its brand, low costs and underwriting discipline. The low-interest-rate environment led to competitors pushing to take share in the agent-sourced business, which makes up 50% of Progressive's total revenues. Analysts took down estimates and from the fourth quarter of 2013 through the first half of 2014 the stock was very weak, which finally gave us a chance to buy in based on valuation. The shares were down for reasons we didn't expect to persist, whereas the underwriting discipline, brand strength and cost advantage we did expect to persist. That's the type of situation that attracts us.

While we're patient, we're not indifferent to timing. We're looking to buy companies with depressed earnings at depressed multiples, but it has to be a situation where we can identify a path to double-digit earnings growth from our initial purchase over the next three to five years. When things work out, we can benefit from both the earnings growth and the market eventually re-rating the shares.

You frequently traffic in names with secular challenges on which you have to make a call. Describe how you think through those types of situations.

JR: It's true that with many of our companies we're assessing the challenges coming down the pike, a lot of them stemming from technology-related change. We re-



John Rogers

Knowledge is Power

Rather than receiving toys as gifts from his father, John Rogers after he turned 12 instead got shares of stock. "He believed in teaching me about the value of money," says Rogers, "but you can imagine the look on my face the first time it happened."

The lesson from his father well learned, Rogers and his Chicago-based Ariel Investments have been pioneering advocates for improved financial education for the young. Ariel since 1996 has sponsored the Ariel Community Academy, a 500-student public school on Chicago's south side serving students from kindergarten through eighth grade and incorporating financial education into both the broad curriculum as well as dedicated after-school programs. Among the initiatives: each first-grade class receives a $20,000 gift, invested first with professional oversight but increasingly turned over to a student-run investment board after the class reaches sixth grade. The most recent graduating class more than doubled its initial stake.

"Greater financial literacy isn't just about learning how to invest or manage credit-card debt – though all that is very important," says Rogers, who for the past two years served as chairman of President Obama's Advisory Council on Financial Capability for Young Americans. "The more financially literate have more career paths open to them. They're more apt to start businesses and create jobs. They're more empowered as citizens in a capitalist democracy. It's a topic that's easy for me to be passionate about because of how important it is to our society."

cently had a lively discussion in our research meeting about how new blood-test technology from Theranos, a high-profile private company, might impact our holdings in LabCorp [LH] and Bio-Rad [BIO]. Will it have a huge impact or is it more of a fad and not that big a deal? For the time being we've concluded that the new technology – focused on doing tests with just a pinprick – will not have a transformative effect on the testing industry. But these are the types of questions we must constantly ask ourselves when investing in out-of-favor stocks.

We had a difficult 2008 in large part because several of our holdings – in media in particular – didn't hold up as well as expected to negative secular trends. One of the lessons learned is that we need to challenge each other more and not just defer when I or another senior person is sticking to our guns on an unpopular idea. Holding firm may be exactly the right thing to do, but we weren't fostering the free and open discussion we should have. One way we've addressed that is to assign to every holding in the portfolio a devil's advocate, whose job it is to make sure the negative case gets a full airing.

Charles Bobrinskoy: We challenge ourselves to identify specifically what it is that we're seeing differently than the market. For example, with Western Union [WU] the perception has been growing that sending money by smartphone will disintermediate its business. Our eyes are wide open to that, but our view is that the barriers to entry are higher than generally perceived and that Western Union's global network, especially with respect to convenient locations in countries receiving payments, is a defensible competitive advantage.

Meredith [MDP] is another great example. Conventional wisdom has been that its women's magazines are dying and therefore you should avoid the stock. One problem with that is not assigning proper weight to the company's broadcasting business, which we think has a wide moat and now accounts for more than 50% of total earnings. We'd also argue that women's magazines with more timeless home-life content and strong brands like *Better Homes & Gardens* and *Parents* have more value, even in an increasingly digital age, than is generally understood.

TF: It's one thing to qualitatively identify a moat, but we also want to see ongoing quantitative evidence of it as well. The profitability is high and consistent. The company is gaining market share. Pricing power is intact. The more hard evidence in support of our contrarian take, the less chance there is of falling into a value trap.

ON 2008 LESSONS:

We need to challenge each other more when senior people are sticking to their guns on an unpopular idea.

CB: One other upgrade we've made to our process is to formally assign a moat rating – zero, narrow or wide – to every company we own. We make the analyst justify why they consider the moat stable, increasing or decreasing, and then compare all that to Morningstar's moat ratings to highlight whether we're seeing something differently.

At what point do you consider the price to be right to buy?

CB: Because we're trying to invest in companies that we believe have great businesses we could own for 20 years, we're focused on valuing the business rather than just the stock. Underlying that is our estimate of private market value, which is what an informed, rational investor would pay for the entire company.

The first input to that is a discounted-cash-flow analysis based on three-statement, five-year financial models we create for every company we're looking to buy. The second input is a change-of-control valuation, based on prices paid in relevant industry deals. Third is what we call the full and fair trading value, which is our estimate of where the stock should trade on normalized earnings at a normalized multiple once short-term clouds have passed.

While all that is easy to say, it's obviously harder to do well. Our 12 analysts are organized around industry specialty, so each person should be operating well within his or her circle of competence in assessing the strength of the competitive moat and making credible future projections. We only own 40 names or so in the Ariel Fund [the firm's flagship small- to mid-cap mutual fund], so we're able to conduct the detailed analysis necessary to arrive at what we believe are well-supported, differentiated views.

To arrive at a final private-market-value estimate we weight each of the three inputs based on our judgment of the particular situation. Some companies are very unlikely to be sold, so little weight should be given to the change-of-control value. In other cases that might be the most-important piece. We own Madison Square Garden [MSG], which owns professional basketball's New York Knicks and professional hockey's New York Rangers. When Steve Ballmer bought the Los Angeles Clippers for $2 billion, the change-of-control value became much more important in arriving at what MSG is worth.

In the end we are trying to buy new names at a 40% or more discount to our estimate of private market value.

You started a "deep-value" strategy in 2009. How does that differ from what you've described so far?

Kenneth Kuhrt: With the deep-value strategy think Graham and Dodd, where we'll buy lower-quality assets as long as they're super cheap. We like to say that with deep value we're following more the first half of Warren Buffett's career, while Ariel's traditional value strategy follows more the second half.

We're looking for companies trading below tangible book value, with net cash on the balance sheet – across the portfolio usually 20-25% of the market cap is in excess cash – and with management whose incentives are fully aligned with ours. The person making $1 million a year and regularly cashing in options isn't as likely to think like us as the person making $100,000 a year and with $10 million in stock. So if we have a cheap asset, leverage isn't going to kill us and the management team is a good steward of capital, we think we can be patient for value eventually to be realized.

What's a current example?

KK: One would be Rosetta Stone [RST], the language-learning company. The stock trades at $7.25 and there's $3 per share in net cash. There has been pricing pressure on the consumer side of the business, which is why the stock is so cheap, but we believe the brand has long-term value and that the firm's Enterprise and Education business – where customers want more than just a free smartphone app – has very good potential. The board has become more active and a board member recently took over as interim CEO. The company announced it had received an unsolicited buyout offer in the $9-10 per share range, but the board turned it down because it believed the stock was worth at least in the mid-teens. If they execute, we believe that would be conservative.

You spoke about trying to get the timing right on your buys, one of the biggest challenges for value investors. Explain how you thought that through in purchasing shares – too early, as it turned out – of oilfield-equipment firm National Oilwell Varco [NOV] late last year.

TF: In energy there aren't in our market-cap range that many Ariel-like companies, with good balance sheets and distinct competitive advantages. But National Oilwell Varco fits the bill. Virtually every rig around the world has some tie to its equipment, parts or services and in deep-water-rig equipment it has close to 80% global market share. It has exhibited pricing power over cycles and its management has proven to be conservative and skilled at capital allocation.

When we bought our first shares in early December, oil prices and oil-rig counts had already come way down and the company had an 18-month backlog worth about $13 billion in contractual revenues. Our feeling was if oil prices stayed around the levels at the time, we would do fine on the stock, but if and when they normalized at a higher level we would do extremely well. As our conviction grew, we could ramp up the position size.

ON GOING GLOBAL:

Rather than try to replicate what we do out of Chicago in picking U.S. stocks, we took a different approach.

Today the stock is off maybe 30% since we first bought in and we've slowly increased our position. But it's still not a big holding and we're working on it daily to determine if it deserves to be a much larger position. As John said earlier, especially in a situation like this where a commodity price is an important factor, we'll be very methodical about building out the position.

Describe how you size positions.

JR: We won't invest more than 5% at cost in a single position and generally when something grows beyond 6% we'll cut back. Otherwise we've adopted a tool we call "the buckets." Each holding is assigned a conviction rating and a valuation rating, both of which are determined by portfolio managers and revisited on a weekly basis. We then assign every stock to a "bucket" with prescribed position-size guidelines. For example, high-conviction holdings trading at large discounts should be 3.5% to 5% positions in the portfolio. Moderate-conviction stocks trading at large discounts or high-conviction names selling at medium discounts should be 2% to 3.5%. The last category, moderate-conviction holdings at medium discounts or high-conviction stocks trading at small discounts, should be 1% to 2%. We should be selling out when the conviction becomes either low or moderate and the discount has become small.

We've always thought in these general terms when it came to sizing positions, but this process, which we instituted a few years ago, just adds a higher level of discipline. It helps us align risk and return better and more consistently with the weighting in the portfolio.

Since we last spoke [*VII*, May 28, 2010] Ariel has launched a separate international strategy, run by a separate team, with some key differences in approach. Why do it that way?

JR: As a firm it made sense for us to diversify in this direction, but rather than try to replicate exactly what we do out of Chicago in picking U.S. stocks, we took a person-first approach in hiring an extraordinary global investor in Rupal Bhansali [who joined Ariel in 2011 from MacKay Shields] and having her execute for Ariel the strategy she has employed so successfully in the past. It's clearly a value approach, but she focuses on larger-cap companies, holds a greater number of positions and maybe trades a bit more often. That's perfectly okay with me – she and her team have been an excellent fit.

Turning to some specific U.S. ideas, describe the investment case for Bristow Group [BRS].

KK: Bristow is a helicopter company primarily focused on shuttling personnel to and from offshore oil and gas platforms. It operates around 370 of the estimated 1,700 helicopters servicing the global offshore market, and generates 85-90% of its revenues outside of the U.S. Its only other big publicly traded competitor is CHC Group [HELI], which has about 230 aircraft but is in financial trouble and just received a large capital infusion that has more or less wiped out its equity value.

The relationship between Bristow and its customers is somewhat unique among oil-services providers. It's moving customers' employees, sometimes 200 to 250 miles offshore, while flying a high-speed projectile at a very large and expensive production rig. That makes reliability and safety of the utmost importance to customers, and Bristow's reputation in that regard is the best in the industry. In every meeting we have with management they won't talk about the business until they have first walked us through a briefing on the company's safety record and performance. That's the mentality they have to have and it's an important competitive advantage.

The extent to which the company is insulated from the vagaries of oil prices is misunderstood. Around 60% of total revenues come from production, and big companies by and large don't turn the spigots off at up-and-running offshore platforms based on oil-price volatility. They've made enormous investments and need the production, particularly at big national oil companies, to generate much-needed cash. Bristow also tends to operate with three- to five-year contracts that include large fixed fees for having dedicated machines available at all times. Roughly 70% of operating profit comes from fixed standing charges, with the other 30% based on variable use. There is an impact when oil prices fall, but we believe it's much less than is generally perceived.

The company recently announced a big contract with Her Majesty's Coastguard in the U.K. Does this kind of diversification from the core business make sense?

KK: Bristow excels at managing and operating a fleet of helicopters, so in providing search-and-rescue services in this type of deal we believe it's playing to its strengths. It's a 10-year, $2.5 billion contract that involves getting new bases up and running and equipped with 22 aircraft costing more than $30 million each. While the capital spending involved may crimp earnings and free cash flow in the near term, our view is that the economics of the deal over time are better than for many of the oil-and-gas contracts in place. There's a good argument that governments around the world will more actively look to outsource their own similar search-and-rescue operations. If that happens, Bristow is likely to be a big beneficiary.

What upside do you see in the shares from today's price of $46?

KK: If we look out to 2019 when we assume the U.K. contract is fully operational and the core oil-and-gas business is at a mid-cycle level, we think cash earnings power is $7 or so per share. If we apply a mid-teens multiple – consistent with where Bristow and what we consider comparable companies with similar business models have traded over time – and then discount the result back to today, we arrive at a private market value of around $84. It's one of our highest-conviction ideas.

I should also mention the strength and flexibility of the balance sheet. Bristow owns 70-75% of its helicopters, allowing leases on the remaining equipment to roll off during downturns or extending them in upswings. That helps deal with volatility. In addition, at $49 per share, the current value of the company's net assets exceeds the current share price. In a busi-

INVESTMENT SNAPSHOT

Bristow Group
(NYSE: BRS)

Business: Provides helicopter services for transporting personnel and supplies to and from onshore bases and offshore energy production platforms and drilling rigs.

Share Information
(@7/30/15):

Price	**46.00**
52-Week Range	43.88 – 75.00
Dividend Yield	3.0%
Market Cap	$1.61 billion

Financials (TTM):

Revenue	$1.73 billion
Operating Profit Margin	12.4%
Net Profit Margin	4.9%

Valuation Metrics
(@7/30/15):

	BRS	Russell 2000
P/E (TTM)	19.5	75.2
Forward P/E (Est.)	11.5	19.0

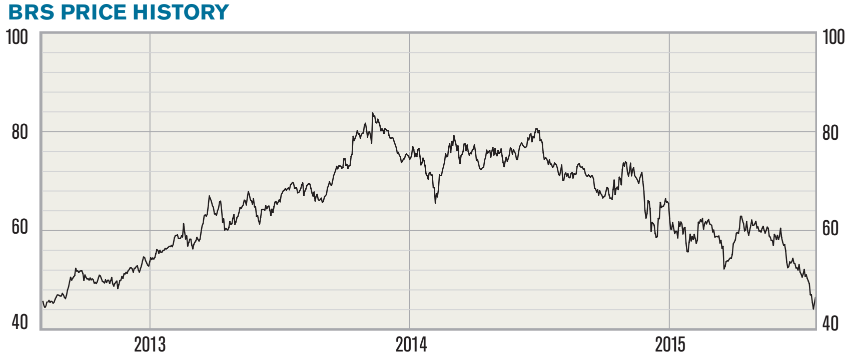
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Ariel Inv	13.6%
BlackRock	8.9%
Dimensional Fund Adv	8.5%
Vanguard Group	7.0%
Franklin Templeton	5.4%

Short Interest (as of 7/15/15):

Shares Short/Float	8.9%

BRS PRICE HISTORY



THE BOTTOM LINE
Given the nature and composition of its contracts, the company is more insulated from oil-price volatility than the market seems to have perceived in punishing its stock, says Ken Kuhrt. Assuming mid-cycle performance in its core business and success with an important diversification effort, he pegs the shares' current private market value at $84.

Sources: Company reports, other publicly available information

ness where capital and financial soundness is so important, Bristow stands on its own in that regard.

Is energy exposure a market concern for Kennametal [KMT] as well?

KK: The company provides cutting tools and cutting-tool systems. The best way to think about it is as a materials-sciences company, making durable tools to be used in heavy-duty as well as precise applications. Three big players – Sweden's Sandvik, Kennametal and Berkshire Hathaway's Iscar – control some 50% of the global market.

The concerns here are broader-based than just energy. General-industrial end markets account for about 30% of revenues and that business has been sluggish due to high levels of economic uncertainty, particularly outside the United States. Just less than a quarter of the business is tied to energy, 9% oil and gas and the rest from power-generation and petrochemicals. Roughly 10% of sales come from mining, which has hardly been robust.

We're fully cognizant of the end-market challenges, but we think those are obscuring the positive operational changes going on under Don Nolan, who took over as CEO in November of last year. Under previous management the primary focus on getting bigger allowed a number of inefficiencies to go unchecked. To illustrate how out of whack things had gotten, if you separate out Sandvik's manufacturing facilities that compete head to head with Kennametal, they number in the single digits. The comparable number at Kennametal is closer to 60.

The game plan now is all about operating efficiency and focusing on businesses and markets in which the company has a differentiated market position and product offer. There are no sacred cows, and while management has yet to fill out a lot of the specifics, the announced goal is to take $115 million to $135 million out of the cost base by March 2017. They have also said businesses generating a total of $150 million to $400 million in annual revenues are candidates for sale at the right prices. The cash generated from cost savings and asset sales is primarily earmarked for paying down debt and returning cash to shareholders. All this is a clear and welcome change in attitude.

How do you see that translating into good news for the stock, now at around $33.20?

KK: With all the end-market headwinds, Kennametal's current high-single-digit operating margins are maybe half of those earned by a competitor like Sandvik. When we try to fill in the blanks on all the levers management can pull to increase margins, we think it's reasonable to expect at least 12-13% mid-cycle margins. With that and a more normalized revenue environment in general-industrial and energy markets, we arrive at earnings power in 2018 for the existing businesses of around $3.50 per share. (The company may sell things, but we wouldn't expect that to have a big impact on earnings per share.) Applying what we consider a fair 18x multiple and then discounting back to today, we come to a fair value of around $51.

What we like here is that just cleaning up the cost structure drives a lot of the earnings growth we're counting on.

INVESTMENT SNAPSHOT

Kennametal
(NYSE: KMT)

Business: Supplier of metalworking tools, engineered components and advanced materials used in a variety of industrial and infrastructure-related production processes.

Share Information
(@7/30/15):

Price	**33.16**
52-Week Range	27.63 – 45.41
Dividend Yield	2.3%
Market Cap	$2.63 billion

Financials (TTM):

Revenue	$2.78 billion
Operating Profit Margin	10.3%
Net Profit Margin	(-12.6%)

Valuation Metrics
(@7/30/15):

	KMT	Russell 2000
P/E (TTM)	n/a	75.2
Forward P/E (Est.)	15.7	19.0

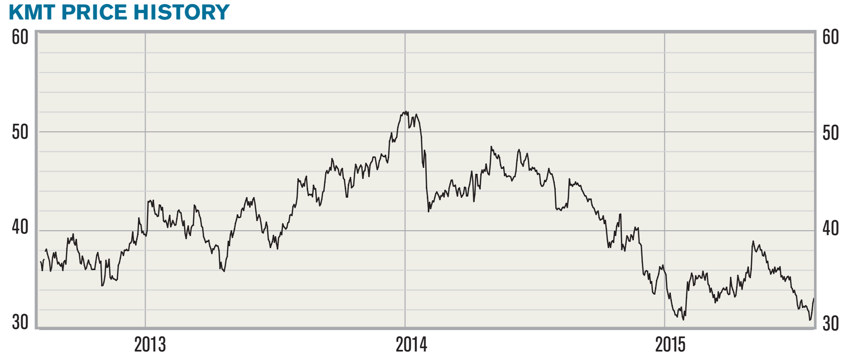
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Ariel Inv	10.3%
Artisan Partners	8.8%
Vanguard Group	6.1%
BlackRock	5.8%
Janus Capital	5.1%

Short Interest (as of 7/15/15):

Shares Short/Float	6.3%

KMT PRICE HISTORY



THE BOTTOM LINE

The company under a new CEO is much more focused on operating efficiency, optimizing its portfolio of businesses and improving capital allocation, says Ken Kuhrt. While these efforts are currently obscured by cyclical weakness in certain end markets, based on his 2018 normalized estimates he pegs the stock's fair value today at just over $50.

Sources: Company reports, other publicly available information

If the economic environment was to get better faster and/or they made some smart moves on the capital-allocation front, those should be additional kickers on the upside.

Describe your interest in Tegna [TGNA], the newly named home for Gannett's broadcast and digital properties.

John Miller: This is a business we've known for some time as shareholders of Gannett. It's one of the nation's largest local television broadcasters, with 46 stations, and it also controls two leading digital properties, Cars.com and CareerBuilder. The vast majority of Tegna's stations are affiliated with one of the big-four networks and the company is the top third-party partner of both CBS and NBC. In terms of annual EBITDA, broadcasting accounts for roughly two-thirds of the total and digital one-third.

We like the local broadcasting business. For one, it will be a prime beneficiary of what is expected to be a blowout year for political advertising in 2016. Local-market television advertising spending in the U.S. was a record $2.9 billion in 2012, but Moody's estimates that next year it will be closer to $3.5 billion.

Tegna's scale also gives it some leverage when it comes to ongoing contract negotiations with pay-TV operators over retransmission fees. Local stations in recent years have been playing catch-up in negotiating with cable and satellite operators for higher fees that better reflect their viewership levels. Network affiliates now earn $1 or more per subscriber on an annual basis from distributors, a rate that is still growing 8-10% per year.

Isn't there some risk to that wellspring drying up as the pay-TV operators face pricing and business-model pressures of their own?

JM: We don't think so. The Comcasts and Time Warner Cables of the world will increasingly offer pared-down packages at lower price points, but local network affiliates will almost certainly make the cut in any of those packages. We'd expect fees to be shifting more towards Tegna's stations rather than away from them.

Will they shift enough to compensate for the likely increase in so-called "reverse compensation" that Tegna will have to pay to the networks themselves?

JM: Tegna currently pays no reverse compensation at an estimated 45% of its stations, a percentage that will go down dramatically as existing contracts with NBC and CBS expire. We account for that in our model, assuming the company within the next couple of years is paying as much as 60% of the fees it receives back to the networks. We generally expect the rise in its overall fees to more than offset the added reverse comp.

Do you think the market is missing anything with Cars.com or CareerBuilder?

JM: We don't think there is a full appreciation for the growth potential, particularly at Cars.com. The site is the leading destination for individuals looking to buy a car and continues to capture an increasing share of both advertising and referral

INVESTMENT SNAPSHOT

Tegna
(NYSE: TGNA)

Business: Recently split off from Gannett, owns and operates network-affiliated U.S. television stations and digital businesses such as Cars.com and CareerBuilder.

Share Information
(@7/30/15):

Price	**28.95**
52-Week Range	25.95 – 38.48
Dividend Yield	2.7%
Market Cap	$6.57 billion

Financials (TTM):

Revenue	$6.14 billion
Operating Profit Margin	19.3%
Net Profit Margin	16.7%

Valuation Metrics
(@7/30/15):

	TGNA	S&P 500
P/E (TTM)	n/a	21.2
Forward P/E (Est.)	16.5	17.8

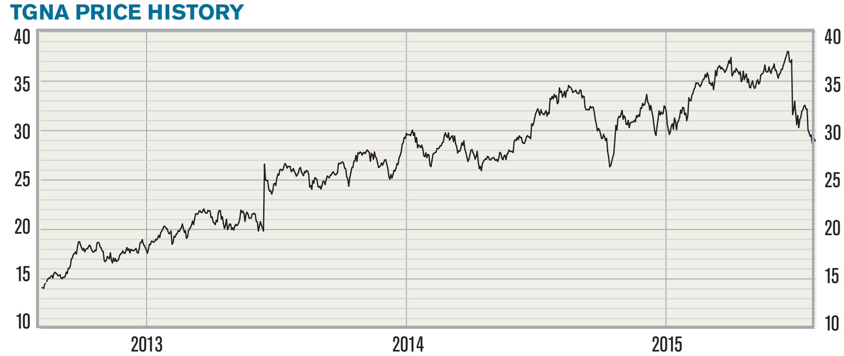
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Vanguard Group	7.7%
Carl C. Icahn	6.6%
JPMorgan Chase	4.4%
State Street	3.7%
Artisan Partners	3.0%

Short Interest (as of 7/15/15):

Shares Short/Float	6.8%

TGNA PRICE HISTORY



THE BOTTOM LINE

The market doesn't appear to be giving the recently split-off company adequate credit for the strength of its position in the U.S. pay-television value chain or for the growth prospects of its digital properties, says John Miller. At 10x his forward EBITDA estimate on an enterprise-value basis, the shares would trade at $40, nearly 40% above today's price.

Sources: Company reports, other publicly available information

fees from manufacturers and local dealers. The online vehicle ad market is projected to double over the next five years and we expect Cars.com to get more than its fair share of that growth.

At a recent $29, how inexpensive do you consider the shares?

JM: The stock currently trades at only 12.3x our forward EPS estimate of $2.35. To arrive at a fair value we apply a 10x blended multiple to forward EBITDA on an enterprise-value basis, adjusted for an underfunded pension liability. That results in a share price of around $40.

JR: We believe Tegna's CEO, Gracia Martore, is one of the best around. Since we first got to know her as CFO and then CEO of Gannett, she has done everything she said she'd do and has been just a terrific capital allocator. Unlike most media-company managers when times were good, she didn't overpay for acquisitions or make imprudent stock buybacks. I could imagine we give more value to her stewardship than the Street does.

You've long been active in financial services. Why is KKR & Co. [KKR] one of your favorites there today?

John Miller: The short answer is that we consider KKR a premier franchise in a market where the long-term fundamentals are very good. The core of its business is managing private-equity funds, but it has also been very successful in diversifying its global product line in areas like real estate, energy, credit and infrastructure. Assets under management are just over $100 billion, nearly double the amount at the end of 2009.

The alternative-investment space is a wonderful business. You have long-dated capital, clients pay you regardless of whether you've invested their capital, and they pay you a nice share of the profits. At the same time, large institutions looking for diversification continue to increase their exposure to alternative investments. Even better, those institutions are concentrating their money with the biggest players, like KKR, that have the scale, scope and management talent – as well as the long-term track records – to stand out.

This would seem like a difficult business to model. How do you arrive at an estimated private market value for the shares?

JM: We break it down into pieces. The most valuable is the $10.5 billion in partners' capital on the balance sheet, which is marked to market and worth around $12 per share. This reflects cash and other balance-sheet investments, less debt, that KKR can use to commit meaningful capital alongside its fund investors or to seed new strategies.

The company has fee-related earnings that are not tied to performance, which are worth around $5.50 per share at 15x our forward 12-month estimate. We also do a discounted-cash-flow analysis on the performance-based carried interest it can expect to receive on the current funds managed. That adds another $6 per share.

Finally, the most difficult piece is estimating the value of carried interest on future funds raised. For this we assume incremental assets raised through 2020 of

INVESTMENT SNAPSHOT

KKR & Co.
(NYSE: KKR)

Business: Global investment manager across multiple asset classes, including private equity, energy, infrastructure, real estate, credit and hedge funds.

Share Information
(@7/30/15):

Price	**24.04**
52-Week Range	18.84 – 25.04
Dividend Yield	7.6%
Market Cap	$20.15 billion

Financials (TTM):

Revenue	$7.63 billion
Operating Profit Margin	70.7%
Net Profit Margin	8.3%

Valuation Metrics
(@7/30/15):

	KKR	S&P 500
P/E (TTM)	15.5	21.2
Forward P/E (Est.)	8.6	17.8

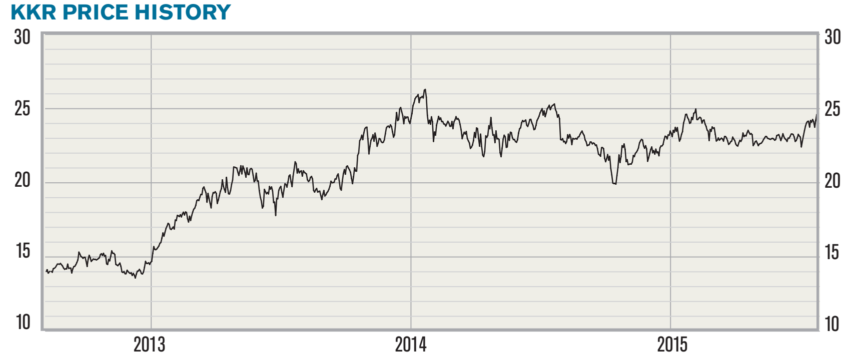
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Fidelity Mgmt & Research	9.2%
Morgan Stanley	5.7%
Lexington Partners VI	3.5%
Findlay Park Partners	2.5%
Deutsche Bank	1.9%

Short Interest (as of 7/15/15):

Shares Short/Float	2.1%

KKR PRICE HISTORY



THE BOTTOM LINE

The company is a premier franchise operating in a lucrative segment of the investment-management business that has strong long-term fundamentals, says John Miller. Based on his estimates of its primary stores of value – partners' capital, fee-related earnings and future carried interest – he arrives at a current $32 sum-of-the-parts value for the stock.

Sources: Company reports, other publicly available information

approximately $90 billion, annual returns on those assets of 11%, and then discount back the performance fees using a discount rate of 13%. That comes to another $8.50 per share in value. Add it up and we arrive at a private market value of $32, 33% above the current $24 price.

Are higher interest rates a threat here?

JM: The market seems to be somewhat worried by higher interest rates, which clearly would add to the company's cost of debt, impacting cash flow. But higher rates would likely also mean the economy is growing, which would be a positive for the underlying portfolio companies. As long as a rate increase isn't surprisingly rapid or surprisingly big, we aren't that concerned about the overall value impact.

Why is Lazard [LAZ] another of your financial-services favorites?

TF: The company is by far best known for its financial-advisory business, which has a storied history going back to the late 19th century. It is particularly strong in mergers-and-acquisitions [M&A] and restructurings, practices that have thrived following the financial crisis as more and more clients sought independent advice, on a global scale, that wasn't accompanied by pitches for some other services of a broad-based investment bank. We think that independence is a sustainable competitive advantage.

Probably 95% of the analysis of this company focuses on the M&A advisory business. For what it's worth, we think we're relatively early in an M&A cycle that only fairly recently has started to pick up. Based on prior peaks in such things as deal volume relative to global market cap or revenue productivity of investment bankers, M&A volumes would seem to still have a good way to run. That, however, is not our differential variant view.

Our variant view revolves around Lazard's other business, asset management, which almost no one pays attention to but we think accounts for nearly two-thirds of the company's value. Asset managers are broadly out of favor, to the point where the stock of a premier player such as T. Rowe Price [TROW], which in the past regularly traded at 25x earnings, now trades in the mid-teens. The general concerns are fee compression in increasingly commoditized U.S. markets and negative fund flows as money shifts out of actively managed strategies.

Lazard's business, with around $200 billion in assets under management, isn't showing those strains. Its expertise is largely in actively managed emerging-markets and international strategies and its fund flows have increased steadily and fees as a percentage of assets managed have been stable. We think that speaks directly to the differentiated strength of the franchise.

What do you think the shares, now at $55.70, are more appropriately worth?

TF: Making what we believe are conservative assumptions – particularly around M&A volumes and the valuation of the asset-management business – with all three of our valuation methodologies we come to around $62 per share in private market value. While that's not a significant

INVESTMENT SNAPSHOT

Lazard
(NYSE: LAZ)

Business: Global asset manager and provider of financial-advisory services that focus primarily on balance-sheet restructurings and mergers and acquisitions.

Share Information
(@7/30/15):

Price	**55.71**
52-Week Range	43.12 – 59.82
Dividend Yield	2.5%
Market Cap	$7.23 billion

Financials (TTM):

Revenue	$2.39 billion
Operating Profit Margin	23.6%
Net Profit Margin	29.0%

Valuation Metrics
(@7/30/15):

	LAZ	S&P 500
P/E (TTM)	10.7	21.2
Forward P/E (Est.)	14.2	17.8

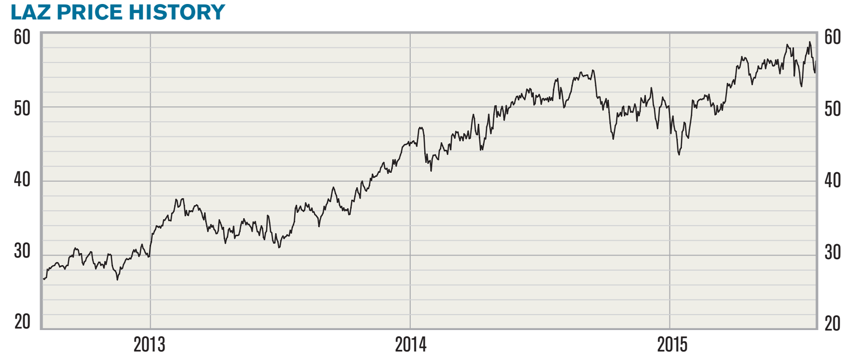
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Vanguard Group	6.9%
Standard Life Inv	6.2%
Ariel Inv	4.5%
T. Rowe Price	3.8%
Fidelity Mgmt & Research	3.0%

Short Interest (as of 7/15/15):

Shares Short/Float	0.4%

LAZ PRICE HISTORY



THE BOTTOM LINE

While the vast majority of the analysis on the company revolves around its M&A advisory business, Tim Fidler believes the larger share of its value is in its strong and growing asset-management business. If that business were valued at what he considers a fair multiple, he would estimate the stock's private market value at closer to $70 per share.

Sources: Company reports, other publicly available information

premium to the current share price, high incremental margins in advisory would increase our base-case earnings estimates quite a bit if that business grows more quickly than we've assumed. Also, if we used a multiple in the low-20s that better reflected the quality and predictability of the asset-management business, that alone would take our PMV to around $70.

With the Ariel Fund over the past several years you've been in the unusual position for a value investor of beating the market in good times and getting relatively slammed in bad times. Why has that been the case?

JR: We have spent a lot of time thinking about this. Typically when there is a broad market dislocation like that, we do relatively better than the market because of our focus on margin of safety and business quality. But in 2008 the fundamentals of several of the businesses we owned underperformed badly, and their balance sheets turned out to be less secure than we originally thought. That made it a tough year.

The good news is that we learned from that by refining our discipline around assessing balance-sheet risk, and we also were aggressive buyers as our favorite names got crushed. So when the market came roaring back, our portfolio more than fully participated.

In the 2011 mini bear market the out-of-favor companies we owned held up well operationally, but their stocks underperformed anyway because of the market's knee-jerk skittishness. Again, we held our positions, added what we could and benefited when the market snapped back.

CB: In both of those periods we didn't change at all what we do. I would say that there was even a calmness to our approach, based on experience and conviction, even though on the surface the numbers suggested something different. The betas on our portfolios have been less than one for most of the 32 years of our performance history. Those were just unusual times.

John, when we first spoke ten years ago you had a great quote about motivation: "When I started the business I was motivated by being a real competitor. I love to win, and the idea of being in an industry where you keep score and know where you stand every day was highly appealing to me and, in the end, seemed inherently fair." Now 32 years in, anything to add?

JR: I would say the market is more efficient than I thought it was when I started and the competition only gets tougher. When we launched Ariel Fund almost 29 years ago there were nine funds in its Morningstar category and now there are 396. But while it's difficult to outperform, the small percentage of investors with the passion for the research, who are truly independent thinkers and who avoid behavioral biases, can. We are as committed as ever to being in that exceptional company. VII