Hotchkis & Wiley Summer Internship Overview

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Hotchkis & Wiley

Who is Hotchkis & Wiley? Listen in to a recent conference call featuring Jim Miles, Portfolio Manager and Principal, and Marshall Cowden, Investment Analyst, as they discuss H&W and the summer internship recruiting process.

Audio / Interactive Recording

Slide Presentation

Transcript

Operator: Greetings, and welcome to the Hotchkis & Wiley Summer Internship Overview. At this time, all participants are in a listen only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Jim Miles, Portfolio Manager, and Marshall Cowden, Investment Analyst of Hotchkis & Wiley. Thank you, Mr. Miles. You may begin.

Jim Miles: Thank you. Welcome to the Hotchkis & Wiley summer internship overview. As we get started here, a couple of key contacts for you through the recruiting process - Sue Ross heads up HR for Hotchkis & Wiley. She would be your primary point of contact for questions, logistical in nature and otherwise. Myself, Jim Miles, I'm going to be doing the phone interviews on the front end. So, if you interview with us, I'd be your first level of interviewing. And Marshall has been with us for two years, and he will be running the summer internship program. So, for very detailed questions and things along those lines, he could be a resource for you on that front.

So, let's start off with the big picture, who is Hotchkis & Wiley? We have some competitive advantages here. First, we're a disciplined long only investment manager. We generate our own proprietary research with an experienced team. We have a strong client base.

The firm was founded in 1980. We are known as a consistent steadfast value investor with nearly 40 years of experience, $30 billion of assets under management invested in US and non-US equities across all market capitalizations as well as high yield credit. All of our strategies have successful long term track records.

Our investment team is 22 permanent investment professionals and six pre-MBA research associates. We have a total of 60 employees in the firm. The investment team averages about 22 years of industry experience and about 14 years with Hotchkis & Wiley. Importantly, and this is a point that's very different than many firms you would be interviewing with, is at Hotchkis & Wiley, we are an analyst driven team process. At many firms, it's a portfolio manager with a team of analysts that report to the portfolio manager. Here it's really the analysts that drive the process.

In terms of our clients, you'll see that we're overwhelmingly institutional. About 80% of the asset base is institutional. Our clients generally have long investment time horizons measured in decades not measured in quarters. That's very important because that means they are really looking for long term wealth appreciation and are willing to or able to absorb the up and down volatility, which is inherent in public equity investing. And our view is that you need to have that long term investment horizon in order to generate performance.

Let me talk a little bit about our investment philosophy. First thing I would say is investors often extrapolate a company's value based on current condition. So, they look at what the company currently generates in terms of earnings, what is the current return on capital and anchor on that to evaluate a firm.

And what's interesting is that, if you look in the marketplace and you were to quintile companies according to ROE and then measure what happens to ROE over time, you see that it basically converges down to a long term average. In economic theory, it's basically that supply and demand change such that capital flows cause high return opportunities to compete down to cost of capital, and for businesses that are important to the economy, supply and demand will restructure, and below average ROE companies will revert up. So, at Hotchkis & Wiley, it's very important to focus on that long term mean reverting return on equity or return on capital.

The next point that I would make is behavior is really what is driving mispricing or inefficiencies in the market. So, investors are almost naturally hardwired to overlook important economic principles like mean reversion and extrapolate trends that really aren't sustainable. And the impact of that is pretty significant.

So, the chart here on the right shows that, if you look at companies that generate positive earnings surprises and trade at a high P/E, there's a positive return from the positive surprise. But, if you look at the low P/E stocks, the return for a positive surprise is even greater, and that's primarily because there's a change in sentiment or a reversal in sentiment for a company that has been under-performing to start to outperform, that attracts investor interest and kind of rerates the stock.

Conversely, when you look at negative surprises and you look at the high P/E stocks, they get torpedoed here, whereas the negative surprise is not nearly as negative as it is for those high P/E stocks. Again, a high P/E stock is discounting a lot of future growth, which investors no longer expect, and so there's a very large contraction in P/E as well as potentially declining earnings.

The way to exploit this is with proprietary research focused on determining normal earnings power, and that's easier said than done. Another important point in our experience is you need to have the right kind of investment culture in the firm, and you need to have a client base that is on board with that kind of strategy in order to be able to execute that.

So, let's think about this in a theoretical situation. Which stock is cheaper? So, on the left we have one company, and this is their historical ROE pattern, and you can see that there are some peaks and valleys in here, but it's basically been on a downward trend recently. And on the right, here's another company that is in the marketplace, and you can see a similar type of volatility, but their ROE trend is on the upswing here. If we observe how the market's pricing it, the company on the left is being priced at a 20 P/E, and the company on the right is being priced at a 15 P/E. So, at first glance, it seems like, wow, the company with the better ROE is trading at a lower P/E, so maybe that's the more attractive company.

If we look on a price to book basis, however, the company on the left is trading at one times price to book, and the company on the right is trading for three times price to book. And the implications of that are important, because again, the ROE for the company on the left looks like it's depressed compared to its average, whereas the ROE on the right is at a peak compared to its average.

I'd like to reiterate a simple relationship that P/E ratio is equal to price to book divided by ROE. This, whenever you're interviewing with Hotchkis & Wiley, is a handy relationship to know. And when you apply it to this situation here, what you'll see is that the return on equity on the company on the left is at 5%, and the return on equity for the company on the right is at 20%. And based on the prior slides, philosophically, if you believe that there's mean reversion, these ROEs are going to convert down to some average ROE – say cost of equity in the market is about 8% now, so you're go have this reversion.

Well, what’s the implication if that reversion occurs? The P/E ratio based on normalized earnings – an 8% ROE – is the stock on the left is trading for 12.5 times earnings, not really 20 times, and the company on the right is trading for nearly 40 times earnings, not the 15 times earnings. So, at Hotchkis & Wiley, this is what we focus on, and we would say that the stock on the left is a cheaper stock, or the better investment, whereas the one on the right is the value trap.

It's not that it happens all the time, but the odds are that's what happens. And at Hotchkis & Wiley, the way we approach it with our analysts is it's up to the analyst to prove why the exception is going to occur. Otherwise, the default assumption is that the reversion is going to occur.

Let me briefly outline what our investment process is. So, the first is to source ideas. We then analyze the ideas, review the ideas, put together a portfolio and then monitor.

On idea sources, we generate ideas through database screens, through industry contacts. This might be in managements that we've invested with prior, relationships that the analysts have developed over the 20 years they've been in the business. And then our internal research staff – these are ideas that are generated from the in-house research based on the body of knowledge of covering these industries for a long time.

And then in terms of analyzing, the first thing is really a study of the industry where we look at supply and demand in the industry and try to understand what's going to drive an equilibrium for that, and then at equilibrium, what is the incremental cost of adding supply in order to get a cost of capital return on that investment and then take that equilibrium unit price and run that through all the different companies in the industry, given their cost structures, and out of that will come normal earnings.

We also then look at a risk assessment of these companies, so what is the strength of their balance sheets, what kind of competitive moats do they have and how durable are those moats.

Those ideas are then brought to a sector team or to a PM and go through a review process where assumptions are challenged. Really, this is like a second look at the research that's done, and in that maybe some aspects of the investment are highlighted for further research. But, ultimately, this is the check and balance part of the process.

Then we get into portfolio construction, which as I mentioned, is analyst driven. So, the analyst is recommending the weight in the portfolio. And that might be moderated up and down by the decision of the group, but really, it's the analyst that's taking the lead on that. All portfolios are put together on a bottom up stock by stock basis. A weight is determined based on risk adjusted returns. And the typical portfolio at Hotchkis & Wiley is 50 to 80 stocks. We then monitor the portfolio for changes in the risk of the position or changes in the valuation of the position and then trade according to that.

Let me now talk a little bit about 'why work at Hotchkis & Wiley?' So, I took us through who's Hotchkis & Wiley, talked a little bit about what our investment philosophy is and went through an example of that and then our process. So, why would you want to have a career at Hotchkis & Wiley? First thing is our analysts are organized around industries, and I'll go into why that's important. Second is the investment culture that we have, the type of value investing that we do. And lastly, you know, we are an employee owned firm, and that has some very important ramifications.

In terms of industry focus, if you look here on the left, you can see all the different asset classes that we invest in. So, it's large cap, mid cap, small cap, all cap, US, non-US and then high yield. So, think of it this way - an analyst in our firm is going to be charged with being an industry expert in their industry, say automotive, and they're gonna be responsible for all market capitalizations, all regions of the world and all parts of the capital structure of the company. So, you're gonna be both a credit and an equity analyst.

Let's talk a little bit about investment culture. It is really important to have a group of people who have worked together for a long time period that have a healthy level of communication and trust in each other because the markets will create volatility and create a tremendous amount of pressure to force you out of a position before you realize the return, and selling low and then getting whipsawed is a great way to lose capital on a permanent basis.

So, you need an investment culture that's going to help insulate the employees from that bad force and again focus them on economically important parameters that drive long term investment performance. It's critically important to be non-consensus and have high conviction views that differentiate you from the marketplace and to be correct in those views. That's easier said than done. There are very few places that have the investment culture and the longevity of the team that we have.

So, importantly here, if you look at the stability of our team, it's very, very stable, low turnover. The average investment professional has spent two-thirds of their career with the firm. We've had only one investment professional leave the firm in the last 10 years. 20 of the investment professionals own equity in the firm. And it's this combination and this type of ownership structure that supports the investment culture that I talked about for independent decision making and a focus on long term performance as opposed to trying to meet quarterly performance results or try and do things that help other business units that are unrelated to investments.

Other reasons to work at Hotchkis & Wiley - well, Southern California's not a bad place. There's a lot of recreational activities available, cultural arts. Southern California beaches are legendary. There's something pretty much for everybody in Southern California.

With this, I'm gonna turn it over to Marshall, and he's gonna take you through the summer internship program. Marshall?

Marshall Cowden: Great. Thanks so much, Jim.

So, we are looking to hire one or two interns. I think, ideally, we'd like to hire two, but we really do have a high bar and want to hire people we think can be contributors and potentially a really good long term fit. So, ideally, we'll be hiring two.

And what we're trying to do is simulate the full time experience to the greatest extent possible. You know, we want the intern to be doing the type of analysis – looking at the industry, getting into the weeds on the company's unit economics, on their consolidated financials, talking with management teams in a way that's very much akin to what you would be doing in the full time position.

And, at the same time, we want you to get an up close look at our process to see how well that you think our investment philosophy aligns with your own and to understand the benefits of our team driven process. So, for instance, if you were gonna be covering alternative asset managers for the summer, you would sit with the financials team. So, you would also be exposed to the analysts covering insurers, covering banks and really get to understand the way that we're looking not only at the subsector you're analyzing but also get a better feel for how we look at a variety of different businesses.

There's also gonna be other opportunities to understand the broader business and an opportunity to socialize with the team and understand if there's a really good cultural fit with the firm. And I will say that the vast majority of investment professionals here come from MBA programs. We are very committed to this internship program and really, really hope to make full time hires out of it.

And in terms of the process now that we're gonna go through, it's gonna be something that probably looks relatively similar in many ways to the process that other investment firms have. So, there's gonna be initial phone screen with Jim, as he mentioned, and then we're going to eventually have an in person interview. And it's a mix of things that we're looking for. We are looking for quantitative aptitude, your ability to analyze financial statements, your accounting skills. But, we're also looking for your fit with the firm, your interest in the firm, kind of your thoughts on the value philosophy.

And as part of the process, I will just say, a good thing to remember is the reversion to the mean concept that Jim discussed earlier. You can be assured that as part of the investment analytical work that we're gonna have you do, some of it is gonna involve thinking through what that means for valuing businesses.

We have Sue's contact information up here. You can apply for the internship program directly to her with an application deadline of the 6th of December, and so would encourage you to do that as soon as possible. But, keep in mind the 6th of December is the deadline.

And our process is something where we are hoping to get telephone interviews done very early in January and then have final round interviews kind of some time later in January, so really hoping to push the process, have applications in in early December and then move the process through to its conclusion by the latter half of January.

And with that, we can open it up to questions.

Operator: Thank you. At this time, we'll be conducting a question and answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Our first question comes from Dennis Sherav with Stanford GSB. Please proceed with your question.

Dennis Sherav: Oh, hi. This question is mostly for Marshall but also Jim. I'm just curious a little bit about what it's like covering both the equity and the credit side as an analyst and just things about that that are a little different from being just an equity analyst and just kind of how much time you spend on that on your kind of week over week work. Thank you.

Jim: Sure. So, when you're here full time, as I said, you're covering all market capitalizations on the equity side and you're also covering all parts of the capital structure in all regions of the world. So, with respect to parts of the capital structure, our view is the credit analysis and equity analysis is largely the same with some notable exceptions at the extreme. But, say if it was a--you took 100% of the time to research a company, about 80% of that time is overlapped and needs to be done for both sides.

You will learn what are the things that are important for evaluating both equity and debt. What I would say is some of the primary differences is that equity investing is largely a game of finding winners because the winners will pay for your losers in the portfolio, whereas in the debt portfolio, it's about avoiding the losers because you cannot recover easily from losers. So, therefore, you're very much focused on the downside and margin of safety and trying to avoid stretching for yield or return in a debt portfolio, whereas on the equity side, while you don't want to take losers, you really want to find those winners because those are what are gonna move the portfolio. And if you do get stuck in a loser from time to time, the winners will more than compensate for that. Did that answer your question, or you want to know more?

Dennis: No, that's great. Thank you.

Marshall: And I would just add--this is Marshall. I would say that there is so much overlap that it's difficult to say exactly how you're allocating your time. But, I would say that my personal opinion is that I've gained a lot on the equity side from spending time analyzing the debt of a lot of private companies and that that has been kind of a valuable learning experience because you're seeing data points and interacting with management teams that many public equity investors may not be, and that just kind of helps you understand your industry all the much better.

Dennis: Thank you.

Operator: As a reminder, if you would like to ask a question, please press star, one on your telephone keypad. One moment please while we poll for questions. Our next question comes from Brent Robinson with Wharton. Please proceed with your question.

Brent Robinson: Hi. Thank you for hosting this. My question is, in the interns that you're looking for, are you specifically looking for folks with previous experience, are you open to career switchers or anything on that topic? Thank you.

Jim: Sure. We're open to career switchers. We--our philosophy is we want to find the person that has the characteristics that make a great investor. If you think about it in terms of a sports analogy, we're looking for somebody that has great physical attributes, and we can coach them in the art of the sport.

So here, we're looking for intellectual curiosity, we're looking for a high level of quantitative reasoning, we're looking for integrity, we're looking for teamwork and a sense of creativity in the way that a person thinks. How to analyze stocks and industries, we can train a person in how to do that.

Obviously, if you're coming with some experience that's relevant to our style of investing, that will be considered and be helpful, but also, sometimes, people have been trained in an investment style that might not be philosophically compatible to us. And so, there could be a process of, so to speak, unlearning bad habits - just depends on what your experience has been.

Brent: Great, thank you.

Operator: Ladies and gentlemen, we have reached the end of the question and answer session, and I would like to turn the call back to Mr. Jim Miles for closing remarks.

Jim: Okay. Well, thank you for joining us, and just to remind everybody the important deadlines here - the application deadline is December 6th. You can email your application to human.resources@hwcm.com. We will be getting back to people around the 18th of December to advise them as to whether we will have a telephone interview with them. Those telephone interviews are expected to begin on January the 8th with final in-house round interviews some time later in January and then final decisions at that point. Thank you for joining our presentation.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.