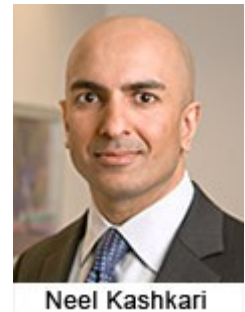


Neel Kashkari on PIMCO's Equity Strategy

By John Heins
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The following interview with Neel Kashkari, Charles Lahr and Anne Gudefin of PIMCO appeared in the January 31, 2012 issue of Value Investor Insight, a monthly newsletter for investment professionals that spotlights through in-depth interviews the strategies and current ideas of the most-successful investors in the business – which in past issues have included Seth Klarman, Bill Ackman, Mason Hawkins, Jeremy Grantham, Marty Whitman and many, many others. To receive the entire January 31 issue and one other as part of a no-obligation free trial subscription, please visit <http://www.valueinvestorinsight.com/freetrial>.



Bond titan PIMCO has been methodically building its equity-investing expertise. Here the architect of that effort and his first major hires describe their strategy and where it's uncovering value in today's market.

Known for its global prowess as a fixed-income investor, giant money manager PIMCO decided three years ago to build an active equity management business from scratch. To head the effort it hired former Goldman Sachs investment banker Neel Kashkari, who also ran the U.S. Treasury's Troubled Assets Relief Program (TARP). The firm next lured Anne Gudefin and Charles Lahr from Franklin Templeton's highly successful Mutual Global Discovery Fund to create a deep-value equity strategy for PIMCO, which has thus far attracted more than \$3.5 billion in assets. We spoke recently with Kashkari, Gudefin and Lahr about the strategy behind the firm's foray into equities, how they're executing it, and where they are – and aren't – finding opportunity in today's market.

Why after all these years did PIMCO decide it wanted to be an active-equity money manager?

Neel Kashkari: There were three main reasons. The first was that coming out of the financial crisis, it became clear to us and to our clients that traditional narrow-style-box investing wasn't enough, and that in order for us to be a full solutions provider to our clients we couldn't just be in fixed income alone. Number two, we believed there were certain active strategies using bottom-up research as a base that could perform even better when combined with the global economic, currency, hedging and cash management expertise that already existed at PIMCO. Finally, post-crisis we were in a strong position to recruit the best equity talent in the industry, and if we were careful about ensuring a cultural fit, they would bring additional expertise to the firm's overall investment process.



One pleasant surprise has been how easy it's been to get the best talent on the phone to talk about the opportunity to work here.

You decided to grow organically rather than by acquisition. Why?

NK: We thought that was the best way to maintain quality and to protect PIMCO's very strong investment culture. There's an acute focus on performance, a deep intellectual curiosity for investing and a collaborative team-based orientation. Making a large acquisition could make us big in equities overnight, but along with all the people who fit perfectly into the culture would be a lot of people who didn't. We'd rather cherry-pick the right ones and build from there.

It plays to your strengths, but are there other reasons for pursuing only equity strategies that are global?

NK: It does play to our strengths, but we also believe the world is moving away from narrow style boxes and that the best way to serve clients is by giving the very best investment talent the flexibility to invest across capitalization sizes, geographies and security types – forget about benchmarks, just build the best portfolio you possibly can. The fact that the style boxes of yesterday performed so poorly during the financial crisis is further justification for this strategy.

Charles and Anne, how tangibly has being a part of PIMCO been of benefit?

Charles Lahr: Probably most important, given the way Anne and I invest, is tapping into the expertise here to help us avoid false positives that come out of our bottom-up approach. The best example of that was 12 months ago when a number of banks in countries like Spain, Italy, Ireland, Portugal and even Greece were flashing all of the traditional bottom-up, deep-value signals. As we all know now, of course, there was something much more sinister at play, a sovereign debt crisis which PIMCO had already been digging into for more than two years.

I don't know if we'd have taken the plunge had we not been here, but it certainly helped us avoid the sector entirely. I would add to that by saying we have no exposure today to any large-cap continental-European banks, or to any peripheral-country European equities at all, in any industry.

More generally, the ability to tap into the depth and quality of the credit research in-house has been quite beneficial. Many successful equity investors take a relatively human-capital-lite approach, with small teams covering the world and looking for the best ideas. It's inevitable that opportunities will slip by you. At PIMCO there are more than 70 different credit analysts covering just about every credit on the planet and producing research that very often has a valuable read across to the equity. That includes being on top of specific



financing events that may be debt-negative, equity-positive, or vice versa. All of that is a very rich source of ideas and fundamental insight into companies.

NK: All of our strategies at some level are anchored in value, so our fixed-income managers also benefit from the analysis Anne and Chuck produce, which is fundamentally rigorous and heavily valuation oriented. It's not a coincidence Anne and Chuck were the first people we hired – they think a lot like bond people.

Has your core investing strategy evolved at all since joining PIMCO?

Anne Gudefin: The basic strategy of investing in equities with a long-term, deep-value bias and supplementing returns with merger arbitrage and distressed debt has not changed at all. It's a flexible approach, using different methods to value companies. Chuck may focus on returns on equity in the case of financial companies, while I may focus more on high free cash flow yields to help identify value in consumer-oriented stocks.

We have always taken a global approach, but have historically found more value in European markets than elsewhere. You can argue for hours and hours why that tends to happen – the markets are less liquid, investors are less sophisticated, investors are more momentum-oriented – but our largest portfolio share is typically European. We have about 45% of the portfolio there today, with roughly one-third in the U.S. The next biggest exposure is in cash, at about 10% of the portfolio.

Neel mentioned currency and hedging expertise. How is that manifesting itself in your portfolio today?

AG: Our risk management is focused on thorough fundamental research on a company-by-company basis and disciplined buy and sell strategies based on discounts to our estimates of intrinsic value. But we also believe that in the current environment it has become more and more important to hedge, particularly with respect to currencies and to tail risks.

CL: Being value investors we're finding a lot to do in Europe, but we are not comfortable with un-hedged exposure to the euro. One thing we've learned at PIMCO is that when a crisis hits and correlations go to one and betas go to two or three, currency options actually don't have the basis risk you might think. They can be quite effective as equity hedges and are much cheaper than equity options. So our first primary hedge today is in dollar/euro puts.

We're also using broad equity-index puts – struck at about 10% out of the money or a bit more – to hedge against things going very wrong in Europe, where as Anne mentioned we have roughly 45% of the portfolio. We're seeing a brief respite in the European crisis based on what the European Central Bank has done to backstop funding, but it doesn't



really solve the underlying solvency issues we're seeing in many of these peripheral countries. Those issues pose a pretty clear risk to equity markets.

Is your large gold ETF holding a complementary hedge?

CL: Yes. When macroeconomic and political risk is high – especially given the potential for adverse outcomes on fiat currencies – we're quite comfortable owning gold as insurance against extreme outcomes. Gold would be a natural habitat if things deteriorated, making it a good hedge. That said, I would add that we're very constructive on the supply/demand characteristics of gold as well and at today's prices consider it a good independent value.

Are there any over-arching themes evident in what you're finding attractive today?

CL: One would be a focus on quality multinationals, both in the U.S. and Europe. These are companies with strong market positions, pricing power, and high growth potential in emerging markets. We find it difficult to imagine you'll go wrong over the next five years holding stocks in technology like Intel [INTC] and Microsoft [MSFT], in tobacco like Imperial Tobacco [IMT:LN] and British American Tobacco [BATS:LN], or in consumer products like Danone [BN:FP]. In the case of Danone, its stock trades 30% short of the multiple it had three to four years ago, while its growth opportunities in products like yogurt and bottled water are still very strong.

In many of these companies we're seeing a quasi-arbitrage between developed and emerging-markets profit streams. BAT is a good example. The company gets a substantial proportion of its earnings before interest and taxes from emerging markets, where tobacco consumption is rapidly growing. It has a publicly traded Indian subsidiary that sells for 25x earnings, but you can buy that as part of BAT, which today has a 7%-plus free cash flow yield and a 4.5% dividend yield. Sometimes when you buy emerging-market businesses within developed-market companies, you're setting up the developed-market piece at a steep discount.

Your overall exposure to financials is relatively high. Where's that coming from?

CL: We're absent from large money-center banks in the U.S. and continental Europe, but we have established positions in Barclays [BCS] and Lloyds [LYG] in the U.K. We believe they are high-quality franchises with fewer macro risks, but they currently trade at roughly 60% of tangible book value while banks on the Continent are at closer to 80% of tangible book value. As they restructure themselves, we expect both Barclays and Lloyds to generate at least low-double-digit returns on equity. Banks with that kind of ROE capacity should not be trading at 60% of book.

Much of our financials exposure is in insurance, both in intelligent capital allocators like White Mountains Insurance [WTM], and in specialty insurers with unique underwriting skills, like Lancashire Holdings [LRE:LN].



Walk through your investment case for Lancashire.

CL: This is a London-listed, Bermuda-based specialty insurer that was born along with many others in 2005 to capitalize on the hard pricing markets expected after hurricanes Katrina, Rita and Wilma and the losses left in their wake. It operates in four key markets – property, energy, marine and aviation – and its policies typically cover high-severity, low-frequency events.

The company distinguishes itself in a few key ways. It is selective in moving in and out of markets depending on the opportunity. Pricing of late has been strong in energy markets and in Asia, for example, so it has stepped up activity in both areas. It has also been very skilled in underwriting risk. Many insurers struggle to hit a 100% combined ratio [meaning their underwriting losses and expenses match their premium revenue], but Lancashire typically books combined ratios of 40-70%. All that has allowed it to produce 20% returns on equity and to grow tangible book value per share by 23% per year over the past five years.

All the excess capital generated gets returned to shareholders in the form of dividends and buybacks, consistent with CEO Richard Brindle's philosophy in building the company that total shareholder return is the only thing that matters. He's not an empire builder, which is a pretty rare attribute, not just in insurance but broadly among CEOs. The dividend yield last year was close to 10%, consistent with past payouts.

Are you betting, as many are in similar companies, on overall insurance pricing finally improving?

CL: The entire sector is cheap and a harder market across broad industry lines would likely be that bolt of lightning where you'd see the entire sector re-rate. That's what a lot of investors are waiting for. We actually own Lancashire because of the quality of its business, its underwriting prowess and the expected capital return. A harder market is an option on the upside we're not paying for.

How are you looking at valuation with the shares now trading at £6.90?

CL: The stock today trades at less than 6x this year's \$300 million in estimated earnings and at around 1.3x tangible book value. We think an insurance business of this quality, with sustainable returns on equity of close to 20% and book value growing at 20% annually, is worth something closer to 2x tangible book. That might be conservative. Putting that multiple on the insurance business, adding \$400 million in excess capital that should be generated this year and backing out \$130 million in debt, we arrive at an intrinsic value for the business of around £9.25, nearly 35% above today's price.



In a harder pricing market, you'd put a multiple on the excess capital generated as well because they'd be putting it back to work. In the stronger bull case, you could easily imagine a share price nicely above £10.

Turning to a top energy holding, what's behind your interest in drilling company Enscoco [ESV]?

AG: After Seadrill [SDRL], which we own as well, Enscoco has the second-largest global exposure to the ultra-deepwater drilling market, one where we find the balance between supply and demand to be extremely favorable. You basically have only four shipyards in the world that can produce ultra-deepwater rigs, constraining supply at a time when demand is extremely high and broad-based, from places like Brazil, Angola, Mexico and off the U.S. Gulf coast. Announced day rates in parts of the world for deepwater rigs are pushing close to \$600,000 per day already this year, in line with our expectations and up from closer to \$450,000 or so a year ago.

Enscoco, which doubled in size through last year's acquisition of Pride International, has one of the industry's youngest and most modern fleets, which translates into both incremental demand and higher day rates. Post the Macondo spill, oil companies are less likely to try to save a bit of money by using second-tier equipment – the premium for more modern equipment is considered a small price to pay for limiting risks.

The company is well-positioned because of its size. Clients want to deal with service providers who can serve them around the world. Scale also plays a big role in cost efficiency, in equipment procurement and elsewhere. Pre-acquisition, Enscoco's operating margins were among the industry's best, and it still has significant overhead cost savings to realize from the integration of Pride.

At a recent \$52.20, how cheap do you consider the shares?

AG: Our goal is typically to buy a dollar of assets for 60-70% of what we believe they're worth. You can buy Enscoco today for less than 9x expected 2012 per-share earnings of around \$5.90, with a dividend yield of 2.6%. Given our constructive view of the industry and Enscoco's favored position in it, we think that multiple is way too low. This is a sector where you've seen multiples at comparable points in the cycle of 12-15x. Apply that to an increasing earnings stream and the upside is quite attractive.

Neel, you've said how tough it is to find great equity managers to hire. Elaborate on that.

NK: I'd have to say that for the vast majority of the people we've met – even those with great track records – we just walk away unconvinced that they have a repeatable process that works.



We put people through what we affectionately call the PIMCO brain scan, which can include as many as 20 interviews with various portfolio managers from around the company. The focus is on trying to understand how someone makes decisions, looking at key inflection points in their performance and asking specifically why they made the decisions they did. We've honestly been surprised how many investors can't really articulate a logical, intellectually rigorous rationale behind their decisions. Absent that, we're not confident in the repeatability of the process and wouldn't trust it with our own money, let alone our clients' money.

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