

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Investing in Defensive, Quality Names in the Small-Cap Space



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SECTOR — GENERAL INVESTING

TWST: What are you seeing right now in the small-cap space as a whole?

Mr. Tugman: Off of the lows in 2009, we felt coming into 2014 that the small caps were susceptible to more volatility, as well as possibly a breakdown of correlations with the market, and we continue to feel that way today. We started to see that in 2014, where quality stocks really started to matter, after a long period of underperformance for the quality names. And I think as we continue through 2015, we believe that if you want to continue to be invested in the market, small caps certainly offer opportunities, but we also think it makes sense to be defensively positioned in what we consider to be defensive, quality names.

Valuations, in general, have improved. I think at the start of 2014, we thought small caps were expensive. They have pulled back some, and I think probably more importantly, relative to mid- and larger-cap names, where earnings estimates have come down more for the midcaps and large caps than they have small caps, the valuations are about in line now.

TWST: How do you define defensive names?

Mr. Tugman: Our first focus is on understanding the downside, or how much we could lose if we make a mistake. We would consider defensive, quality stocks to be those with strong balance sheets, quality managements, good competitive positioning in their marketplace, strong and recurring free cash flows throughout the course of the cycle.

TWST: Do you look at the macro situation when you are selecting stocks for the portfolio?

Mr. Tugman: We aren't experts on the international or the macro front, but we do have to pay attention to situations like Greece and China. We have to be able to look at those issues and understand how these issues could impact the markets or the financial results of our individual holdings. I think, additionally, with in excess of 20% of our

benchmark exposed to lower interest rates, we certainly have to keep that in mind as well. The Greece situation, I think, frankly is more of a side show. China is much more important in the longer term.

TWST: Why is that? Why is China more important in the long run?

Mr. Tugman: China is more important for a number of reasons. It is a significantly bigger economy than Greece. China has really been, for the past decade, the biggest growth driver around the world. As they have started to slow down, we have seen significant impact and ramifications on everything from commodities, whether it be iron ore, coal — there's certainly risk to oil as well — to manufactured products to just about everything else. So China is certainly the biggest risk out there right now.

TWST: Where do you get ideas for the stocks for your portfolio?

Mr. Tugman: We look for ideas all over. We typically run screens first; the portfolio managers run screens, and the analysts run screens. We look at things like the 52-week low list, the most down on a particular day, various research reports to look at peer companies. We try to find those stocks that are underperforming, and what we want to find are those that are underperforming for what we would believe are temporary reasons.

TWST: Explain the process of adding stocks to the portfolio. After you have identified an idea you like, something that is underperforming for a temporary reason, what do you do next?

Mr. Tugman: We have some basic questions that we have to get answered before we dig deeper into a company. First, we want to see what the balance sheet is like. If it's too levered, then we will move on. We don't want something with a lot of debt. Second, we'll look at the free cash flow. Where is it now? What is happening at the company or at the industry level? Is that free cash flow sustainable? And then third would be the competitive positioning of the company. What is their advantage relative to their peers, and is it sustainable?

Once we get comfortable with those questions, then we begin to do deeper-dive analysis on the names. When we get to that point, the first thing we focus on is potential downside. We will look at what trough earnings could be on trough multiples, what happens if we take both margin compression and topline compression, and we try to calculate what we believe the downside risk is. If the absolute downside risk of a stock is too great, we won't add it to the portfolio.

If we are comfortable with the absolute downside, then we begin to calculate our upside target, and we don't look at peak earnings or peak multiples. We try to look at a normalized earnings environment as well as normalized multiples in arriving at our upside target. What we do then is compare our downside and upside versus the current stock price. If that reward to risk is favorable, and we feel comfortable with the stock, and it is added into our overall portfolio reward to risk, then we would look at adding the name to the portfolio.

TWST: From what you're saying, it also sounds like risk or keeping downside risk to a minimum is important. Is that accurate?

Mr. Tugman: This really goes back to the defensive nature of the portfolio, in understanding what our risk is and how much we could lose if we are wrong. So yes, limiting the downside risk is extremely important.

TWST: Are you finding more ideas in certain industries right now?

Mr. Tugman: I would say that we are starting to find more interesting ideas in industries such as industrials, where the stock sold off on concerns about the macro environment coupled with the uncertainty about what is going to happen with oil and gas capex. Energy has been a beaten down sector. We have found some interesting opportunities in the energy sector, but I would also say that we still remain cautious on energy.

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And other than that, it has been kind of one-off situations in various industries, whether it's in the financials or in other areas. In the recent selloff, we found some interesting values in REITs, but in general, we would still say that that group seems a bit expensive. So it's hard to say that any one sector is really giving us great ideas over others right now.

TWST: Do you have sector weightings, or do you mirror the benchmark?

Mr. Tugman: No, we certainly understand the weightings of the benchmark, but that's not how we drive our portfolio. Our portfolio is driven by where we are finding the best reward-to-risk opportunities regardless of the sector.

TWST: One of the major holdings in the portfolio is Tidewater. What it is about Tidewater that made it a good fit for the portfolio?

Mr. Tugman: Tidewater (NYSE:TDW) has underperformed the market, as most other energy stocks have, but we also believe that the stock is trading below liquidation value. They have gone through a significant capex period over the last decade to refurbish their fleet. We do think that they have one of the better fleets out there. And more importantly, despite the downturn in the energy cycle of late, we believe that **Tidewater** will be getting back to generating positive free cash flow within the next several quarters.

TWST: Another holding is Bank of Hawaii. What about that one?

Mr. Tugman: Bank of Hawaii, it sounds simplistic, but frankly, they have one of the widest moats out there for a bank. They operate in a market with basically three competitors, so the pricing dynamics are very attractive. It's a bank that has great credit quality and expense control. The net interest margins are in the twos. Historically, they have been in the fours, and we believe that over time the net interest margins will improve, and with

the company's focus on cost control throughout the course of the cycle, we believe that over time the earnings will start to accelerate to the upside.

TWST: You mentioned that some of the recent detractors in the portfolio were Potlatch and NetScout. Did you make changes to the portfolio based on their underperformance?

Mr. Tugman: The way we think about it is, the first thing we have to ask ourselves is: Has the investment thesis changed? And if it hasn't, then we need to understand why the stocks have underperformed. For a name like **Potlatch** (NASDAQ:PCH), we believe that it is somewhat of a temporary issue. The stock has lagged on declining

Highlights

Justin Tugman discusses Perkins Investment Management and investing in the small-cap space. Mr. Tugman believes there are opportunities in small caps, but it is best to be positioned with defensive, quality names. In defining defensive, quality names, Mr. Tugman first focuses on understanding the downside. He then looks for companies with strong balance sheets and management, competitive positioning in the market, and strong and recurring free cash flows. Mr. Tugman gets his ideas for the portfolio from all over and tries to find stocks that are underperforming for temporary reasons. Rather than driving the portfolio by sector weightings, Mr. Tugman focuses on the best reward-to-risk opportunities.

Companies discussed: Tidewater (NYSE:TDW); Bank of Hawaii Corporation (NYSE:BOH); Potlatch Corporation (NASDAQ:PCH); NetScout Systems (NASDAQ:NTCT) and Danaher Corporation (NYSE:DHR).

lumber prices and the continued muted outlook for new home starts. Additionally, the strong U.S. dollar in the first half of the year has led to more lumber imports into the U.S., putting more pricing pressure on lumber. We think, over the longer term, that those are more temporary issues, and with the stock yielding a dividend of about 4.3%, we are getting paid to wait for the turn in what we consider to be a quality long-term holding.

In the case of **NetScout** (NASDAQ:NTCT), this was a stock that has lagged on the uncertainty over the purchase of **Danaher's** (NYSE:DHR) communication business, which — now that the deal is closed — will probably come close to tripling the size of the top line

at **NetScout** over the next few years. This is the biggest deal that management has done, and so it certainly adds some risk to the situation, but we also believe that there's limited downside in the stock. The acquisition should allow for both better customer and product diversification, and post the deal, **NetScout** will still have net cash on the balance sheet. So those two cases did not cause us to change the holdings in the portfolio.

1-Year Daily Chart of Tidewater



Chart provided by www.BigCharts.com

TWST: What would make you sell something? What makes you take something out of the portfolio?

Mr. Tugman: There are really two things that make us either exit a position or trim it. The first is if the reward to risk becomes unfavorable. And that's typically if the stock price has increased significantly, and therefore, the reward to risk is skewed less in our favor. The second one would be if the investment thesis were to change.

TWST: How often do you re-evaluate your holdings?

Mr. Tugman: We look at our holdings every day. We

update our up and down targets, which are critical in calculating our reward to risk as we get new information — whether that's earnings releases, the release of the company's 10-Q or 10-K — so we are always updating our up-downs. But what we are doing in terms of the daily activity in monitoring our positions is looking at where we are finding better reward-to-risk opportunities, looking at adding to positions there and trimming those names that have less favorable reward to risk.

TWST: What is your general outlook for the markets and for the small-cap space, and are you comfortable with where the portfolio is positioned based on that outlook?

Mr. Tugman: We would expect volatility to continue in small caps, and I believe that over time that volatility will begin to work its way up the market-cap spectrum. We started to see a little bit of that this year. And frankly, we welcome the volatility, as it allows our higher-quality names to differentiate themselves from their peers and allows us as a firm to begin to expand our shopping list of new ideas. We continue to focus on owning quality, defensive companies with attractive reward-to-risk ratios that we feel will outperform over the long term. And so if we're right in our belief that the volatility will continue or even increase, we feel very comfortable with our portfolio's position.

TWST: Thank you. (LMR)

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