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# Graham & Doddsville

An investment newsletter from the students of Columbia Business School

## Inside this issue:

2019 Pershing Square Challenge	p. 3
“From Graham to Buffett and Beyond” Omaha Dinner	p. 4
L.A. Alumni Event	p. 4
Value Investing Welcome Reception	p. 4
Paul Moroz	p. 6
CBS Students’ Investment Ideas	p. 16
Mohnish Pabrai	p. 22
Ellen Carr	p. 30
Matthew Peterson	p. 42

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## Paul Moroz, Mawer Investment Management

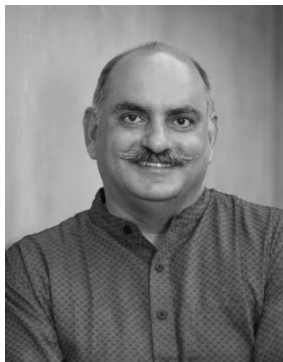


**Paul Moroz**

**Paul Moroz is Chief Investment Officer and a director at Mawer Investment Management Ltd., a Canadian firm with over CA\$55bn AUM which he joined in 2004. He is also co-manager of the Mawer Global Equity Fund and the Mawer Global Small Cap Fund. As Chief Investment Officer, he has broad responsibility for the research and analysis of global equities and fixed income securities. Mr. Moroz relocated to Singapore during 2016 to 2017 and served as CEO and Director of Mawer Investment Management Singapore Pte. Ltd. In 2013, Mr. Moroz won the prestigious Morningstar**

*(Continued on page 6)*

## Mohnish Pabrai, Pabrai Funds



**Mohnish Pabrai**

**Mohnish Pabrai is the Managing Partner of the Pabrai Investment Funds. Since inception in 1999 with \$1 million in AUM, Pabrai Investment Funds has grown to over \$580m AUM in the 2<sup>nd</sup> quarter of 2019. The funds invest in public equities utilizing the Munger/ Buffett Focused Value investing approach. Since inception, the funds have widely outperformed market indices and most investment managers. A \$100,000 investment in Pabrai Funds at inception in 1999 would have been worth over \$1.2 million as of June 30, 2019, an annualized gain of 13.3% (versus 7.0% for the Dow).**

*(Continued on page 22)*

## Ellen Carr, Weaver C. Barksdale



**Ellen Carr**

**Ellen Carr is a high yield bond portfolio manager at Weaver C. Barksdale (WCB), a boutique institutional fixed income management firm. She has two decades of leveraged credit research, analysis, and**

*(Continued on page 30)*

## Matthew Peterson, Peterson Capital Management



**Matthew Peterson**

**Matthew Peterson is the Managing Partner of Peterson Capital Management and he manages Peterson Investment Fund I. Matthew has**

*(Continued on page 42)*



Ellen Carr

## Ellen Carr, Weaver C. Barksdale

portfolio management experience through several cycles.

Prior to joining WCB in 2013, Ellen was a high yield analyst and portfolio manager at Capital Group from 1999 to 2012, where she was responsible for \$4 billion AUM across Capital's high yield strategies, including a sleeve of its flagship high yield fund (ticker AHITX).

Additionally, Ellen is an adjunct professor at Columbia Business School, where she teaches courses on the credit cycle and cash flow forecasting. She has published articles in the Financial Times and is co-authoring a book about the dearth of female portfolio managers to be published by Columbia University Press.

Ellen splits her time between Asheville, NC and New York. She serves as a board member of her local NPR affiliate, the national NPR Foundation, the Wilma Dykeman Legacy, the Thomas Wolfe Memorial, and is a member of the finance committee of the Western North Carolina Community Foundation. Ellen also manages a family foundation ([carrfamilyfoundation.org](http://carrfamilyfoundation.org)) which awards college scholarships in rural communities.

Ellen received a BA (magna cum laude, Phi Beta Kappa) from Harvard College and an MBA from the Kellogg School of Management at

Northwestern University. She is a Chartered Financial Analyst (CFA) Charterholder.

**Graham & Doddsville (G&D):** Thank you for taking the time to interview with Graham & Doddsville. Can we start by discussing your background and how you got into the investment industry?

**Ellen Carr (EC):** I went to Kellogg Business School a long time ago (I just had my 20-year reunion, actually). Before that, I worked for a small consulting firm in Los Angeles and had no background in investment management. When I got to Kellogg, it was the lead-up to the dot-com bubble. Equity analysts were quoted all the time in the Wall Street Journal and it just seemed like an attractive career, one where people would care about your thoughts on a company. These were the days of Mary Meeker (a Morgan Stanley tech equity research analyst in the late-90s), who was known as "the internet queen" back then. Sell-side analysts had a lot of sway and influence over companies, influencing which stocks went up. I liked the fact that you could translate company analysis into actionable ideas for investors.

While at Kellogg, I focused heavily on sell-side recruiting for the summer because this was where most of the jobs were. Although I had never thought about fixed income before, I worked at Morgan Stanley over the summer, rotating across fixed income sell-side research and the trading division. I liked the people I met during the interview process at Morgan

Stanley the best, so I thought this would be an interesting place to try something out. It was the summer of 1998, when Long-Term Capital Management failed, a predecessor to a lot of much bigger failures that happened in later years. At the end of the summer, Russia defaulted, many emerging markets were having issues, and a crisis started in Asia. It was a difficult time for full-time employees at Morgan Stanley (I saw a lot of traders with their heads down on their desks), but it was a great time from an intern's perspective, experiencing all these market events.

By the time I got an offer from Morgan Stanley to go back, I figured out that my personality was more suited to the buy-side. I liked an environment where I could take more time to dig into a company and adopt an entrepreneurial approach. On the sell-side, everybody learns to do the same model, which was valuable training. Yet, I wanted to spread my wings and approach investing from a more creative perspective. I received an offer from Capital Group thanks to a referral by a Morgan Stanley colleague and decided this was where I wanted to go; it was also an opportunity to go back to California.

**G&D:** How did going through the market volatility of the late '90s influence your career and investing philosophy?

**EC:** A lot of that filtered through my first 5 years in the investing business. During my summer at Morgan Stanley in 1998, a lot of bad things happened. I then went to

(Continued on page 31)

## Ellen Carr, Weaver C. Barksdale

Capital Group in 1999 and equity markets peaked before starting to unravel in 2000. I was in the High Yield bond market and it wasn't a great time there either. Then 2002 was an especially bad year. On the equity side, Capital had just been through a difficult underperformance period because we stayed away from the internet bubble. None of the analysts could figure out how to value these companies and it turned out they were right to stay on the sidelines. There were some very painful moments, especially on the institutional side of the business, an area where clients are looking at performance relative to a benchmark.

I witnessed that, and with it the vindication that came from sticking to your guns and demanding common sense valuation metrics for the companies in which you invest. That was also the era of Enron and WorldCom, which was another one of Capital's great "avoid" moments on both the equity and fixed income sides. The analysts could not model Enron; anybody who said she could was lying. Watching some of the most senior equity analysts struggle with the valuation and say "I don't understand how the investing universe has gotten into a love affair with this company that doesn't generate free cash flow" was powerful.

The most important thing that I learned during that time was to be cautious. That might have hurt my investing career sometimes, because I am a very conservative investor. When I was still at Capital Group, I was always the most conservatively positioned and

that manifested in a lower yielding portfolio than the other portfolio managers. However, I started managing money a couple of years before the credit crisis and my results were the best during that time period because I tended to be more conservatively positioned. To anybody thinking about a career in investment, going through a cycle, and particularly a bear market, is an invaluable experience.

***"I don't know how to value any of the FANG stocks, but it can be helpful to sit on the opposite side of the capital structure table.***

***If I were to truly challenge myself, I would try to take an equity perspective. Conversely, if I were an equity analyst, I would probably take a fixed income approach."***

**G&D:** How did the internet bubble impact the High Yield market in the late '90s?

**EC:** We had a very different experience on the debt side versus the equity side. On the debt side, those internet companies didn't come to the High Yield market. They were looking for equity capital,

which was absolutely the right way for companies such as Pets.com to fund themselves. However, during the 2002 High Yield bear market, the TMT sector had grown to about a third of the market. The High Yield group at Capital was substantially overweight those sectors because the analysts who followed them were very passionate about the companies. The High Yield TMT analysts were spending a lot of time talking to their equity counterparts, yet managed to blind themselves, failing to realize that the same things that equity analysts were worried about were relevant to the companies that they were looking at even though they were different companies.

It was an interesting lesson about the need to look at all the data points. A great example is the paging industry. The paging industry financed a lot of its capital requirements in the high yield market from 1999 through 2001. The analysts liked some of the paging companies, yet they didn't consider the fact that if you liked the wireless sector, which was nascent at that point, then you probably shouldn't like the paging sector too because it would likely be disintermediated. Connecting the dots is certainly a lesson I learned and still spend a lot of time attempting to do today.

An analogy today would be the FANG stocks. I don't know how to value any of the FANG stocks, but it can be helpful to sit on the opposite side of the capital structure table. As an example, I don't own Netflix bonds. They trade very well. It's a BB-rated company and

*(Continued on page 32)*

## Ellen Carr, Weaver C. Barksdale

I've always been very skeptical of any company that doesn't generate free cash flow. If I were to truly challenge myself, I would try to take an equity perspective and think about why the equity market has so much comfort in a company's ability to march towards free cash flow, asking myself "what is it I'm missing here?"

Conversely, if I were an equity analyst, I would probably take a fixed income approach to Netflix and say "this company doesn't generate cash flow. In fact, its operating cash deficit seems to be growing because it's investing so much in content. How could that possibly translate into the valuation that it has in the equity market?"

**G&D:** Do you see any bubbles in the market right now? Are you cautious against any industries?

**EC:** I think the biggest bubble right now is in the corporate debt market. There are a couple of different aspects of it that are particularly troubling. The first one is the explosion of BBB-rated bonds. A certain percentage of BBBs get downgraded to junk within five years of issuance based on rating agencies' seasoning models. Over the next five years, there will be pressure on the High Yield market because the capital structures of Investment Grade companies are much larger. Take GE for example: there were concerns they would be downgraded to High Yield earlier this year. If that had happened, GE would've represented about 10% of the High Yield market value. It would be really difficult for the High Yield market to absorb

that tremendous "issuance". Investment grade portfolio managers are overweight BBBs. They tend to overweight the highest risk part of the market because the default statistics on BBBs are virtually nil, yet you get paid some incremental spread over higher-rated corporate bonds. The fact that a lot of money has been invested in that part of the market makes me nervous about what will happen if there is either a recession or an exogenous shock.

***"Fallen angels' bonds are structurally inferior to other bonds in the High Yield market, because High Yield bonds generally enjoy covenant protection and are issued at the operating company level with subsidiary guarantees."***

I'm also worried about the Leveraged Loan market, which is exhibiting the same type of underwriting behavior, exuberance, and frothiness that it did in 2007. I think of High Yield bonds as a pretty stable asset class. There are ups and downs in covenant quality and deals underwritten at this point in the cycle are typically not great, but the High Yield market doesn't boom and bust the way the Leverage Loan market does

because it has a pretty stable investor base. High Yield investors don't change that much from cycle to cycle, whereas there is often new money flowing into and out of the Leveraged Loan market. The collateralized loan obligations, or CLOs, that we saw in 2005 to 2007 are back. Most of these investors are not sophisticated analytical buyers; they are buying primarily because something has a certain rating, although in some cases what they're buying isn't worth as much as what they think it is. Those buyers are also the ones who will probably be forced sellers at the wrong point in the cycle.

**G&D:** Could fallen angels be attractive, given their relative safety and liquidity?

**EC:** I think they could be in the long-term. During the 2005 fallen angels' cycle, the auto companies got downgraded to High Yield. Ford, GM, and Chrysler combined became 15% of the High Yield issuances. The market wasn't ready to absorb all that volume. These issuers were downgraded to High Yield because they were deteriorating, so it took them a long time and, in the case of Chrysler and GM, a Chapter 11 process to get back to Investment Grade. I don't anticipate a similar thing to happen in this cycle, but rather that some companies will gently slip from Investment Grade to High Yield. That will give us a chance to buy better issuers, which is positive.

However, even in the case of a perfectly good company that's become risky in terms of leverage and gets downgraded

*(Continued on page 33)*

## Ellen Carr, Weaver C. Barksdale

to High Yield, there are two factors that will make an orderly transition difficult. First, the sheer amount of supply will require some time to be absorbed. When there is massive selling pressure, with Investment Grade holders forced to sell bonds from previously BBB issuers which get downgraded to High Yield, it creates a vacuum until High Yield buyers have had a chance to research the credit and get to know the individual bonds in the capital structure.

Secondly, the fallen angels' bonds are structurally inferior to other bonds in the High Yield market, because High Yield bonds generally enjoy covenant protection and are issued at the operating company level with subsidiary guarantees. To the contrary, Investment Grade bonds are for the most part lacking these structural protections. Even if you like AT&T better than Sprint as a company, you still might look at Sprint's secured bonds and prefer the collateral protection as opposed to a general unsecured obligation at the parent company level for AT&T bonds. These may look like technical differences, but in the High Yield market they matter a lot.

**G&D:** If an Investment Grade company gets downgraded to High Yield, would the return be attractive enough for High Yield managers?

**EC:** It depends on the point in the cycle. The spread between BBB and BB bonds is fairly compressed now, but there's still about 100 bps of spread pickup. If the spread stands at 100 bps between BBB and BB, with the wide bid-ask spread in

High Yield market dislocation, valuations usually overshoot to become truly cheap before High Yield managers get really excited and buy a fallen angel.

***“Contrary to what happens in the Equity market, if you sell something at a high price in the High Yield market, then good luck on ever buying it back below or finding something reasonable to replace it with.”***

**G&D:** Are there any industries in the BBB market that you are worried may be downgraded to High Yield?

**EC:** I don't think it would be an industry phenomenon. If you take the 2000 to 2002 cycle, it was very industry focused. It was Telecom, Media, and Tech, the latter to a lesser extent. This time around, there's good diversification among the various BBB industries; same thing in High Yield. Hence, I'm not that concerned about any particular industry. Take sectors like Energy or Commodities: a lot of shakeout happened in 2015 and 2016. I think it will be bottom-up oriented, without any particular industry stress.

**G&D:** Do you usually hold bonds to maturity, or is your return coming more from spread compression?

**EC:** By and large I'm not looking for capital appreciation as much as I'm looking for something to mature at par. At my firm, the primary mandate on the High Yield side is a short duration one. We have a five-year maturity limit. Once I buy, unless the credit deteriorates meaningfully, I intend to hold it to maturity, particularly due to the high trading costs in High Yield.

Early in my years as a portfolio manager I made selling mistakes. I would sell a company that was up four points because I knew it didn't deserve to trade at that valuation. Yet contrary to what happens in the Equity market, if you sell something at a high price in the High Yield market, then good luck on ever buying it back below or finding something reasonable to replace it with. Once I get invested in a name it takes a pretty big change in my credit opinion to sell it.

Having said that, I'm not afraid to sell something if my credit opinion has changed. I recently sold Pitney Bowes, which became a fallen angel a couple of years ago. When it entered the High Yield market I liked the bonds for two reasons.

First, a number of bonds had coupon step-up protection, meaning that every time the bond got downgraded by a notch, the coupon increased by 25 bps to a maximum of 200 bps, meaning a holder of the bond was protected from spread widening as the

*(Continued on page 34)*

## Ellen Carr, Weaver C. Barksdale

downgrades occurred (i.e. the increased coupon offset the spread increase). Second, I liked the company's free cash flow generation. So even though it had been downgraded and had several businesses under assault from different internet business models, Pitney Bowes still had a tremendous amount of free cash flow, and it was also investing in new business lines.

I owned the bonds for about 18 months and, every quarter, things didn't exactly go the way management said. There was always some new story about why this business line wasn't as profitable as they had hoped or, even if the revenue trend was good, management had overestimated the margin potential. Finally, after five or six quarters, I decided to exit the position because my initial thesis that the company would both continue to generate good free cash flow as well as maintain its margins was gradually disproven. When something goes against my thesis for more than a couple of quarters, I sell.

**G&D:** When a company goes from High Yield to Investment Grade, do you usually sell?

**EC:** It depends on how I feel about the market at the time. Given the current environment, I generally have not sold rising stars. In some cases, that is because by the time they get Investment Grade ratings, the maturity has become short. For example, I held onto Constellation Brands when it got upgraded to Investment Grade more than a year ago as it is maturing later this year. Still, you don't always have the flexibility to do that.

With some of the institutional clients who are more benchmark-focused, I would be more likely to sell something that gets upgraded.

***“I think that at this point of the cycle the better trade is to increase the credit quality and give up a little bit of yield. When the downturn comes, that's when I want to buy the lower-rated, lower-quality issuers because the spread will become much greater.”***

**G&D:** As a bond investor, do you place more weight on the valuation or the fundamentals?

**EC:** I think valuation is more important in Equities than in Bonds. People in my market can make bad sell decisions based on valuation alone, but they generally don't make the wrong decision if it's based on fundamentals. If a credit is deteriorating from a fundamental point of view, you really want to get out of it. Eventually you will feel really good about having gotten out of a bond that is down five points from par when the company goes through restructuring and ends up

paying 50 cents on the dollar. Of course, you have to consider valuation and should not pay too much for something. Yet what people tend to do at this point in the cycle is they don't want to own things like HCA because it looks too rich. Investors are getting greedy and are only looking at valuation. They look at spreads between wireless telecom issuers going from a B to a CCC and say "I'm getting paid 100 bps to get the CCC, so I'd rather own that," while I think that at this point of the cycle the better trade is to increase the credit quality and give up a little bit of yield. When the downturn comes, that's when I want to buy the lower-rated, lower-quality issuers because the spread will become much greater.

In Fixed Income people tend to sell too early. What they do is look at a spread or a yield target and sell once the bond hits that target. The problem is that when that happens, it's a classic example of selling your house because you thought the housing market was overvalued; but guess what, you now have to go find another house and you may end up in a worse house. The High Yield market is very much like that. Oftentimes the house you're in is the best one, and even if you could get the right price for it, it would be hard to replace it with something you liked as much.

My view on this has evolved since the time I was at Capital. At Weaver, where I manage millions rather than billions, I have more opportunity to do transactional things. I can sell something based on valuation because the liquidity

(Continued on page 35)

## Ellen Carr, Weaver C. Barksdale

constraints aren't as material as they were at Capital, and I can probably get reinvested more easily. Still, generally speaking, if my credit view on a company hasn't changed, I would continue to own it unless I see something really exciting that I want to replace it with.

**G&D:** How comfortable are you with counting on assets to mitigate risk when issuers operate in a declining industry?

**EC:** I always value collateral. If there is a secured and an unsecured option in the capital structure, and if I can only buy one, I will almost always buy the secured position. Between the OpCo position versus the HoldCo position, I'll always take the less risky position in the capital structure.

However, you still have to be comfortable with the collateral. For example, in the Chrysler 2007 leveraged buyout, the second-lien was worth nothing because it was secured by the subsidiaries' stock, and by the time the first-lien holders got paid out at par there didn't remain enough collateral to go around.

It will be interesting to see how the High Yield market evolves to evaluate the lack of what High Yield investors would consider good collateral. A lot of the new tech business models like the FAANGs don't really have buildings, factories, or tangible assets; it's much more about intellectual property. The Equity market has always been cognizant of the value embedded, whereas High Yield investors usually want to be able to point at something and

say: "that's mine if this company files." I think the degree of value we've placed on hard collateral is going to decline over time because real assets are becoming a meaningless concept.

***"I'm wondering how the market is going to evolve and if hard collateral will be less valuable... It may not be valuable to have as collateral an old mall that nobody goes to anymore or a factory that's worthless because production has moved."***

It's not as important any more to own a factory or a building in this age of more technology-oriented business models. I'm wondering how the market is going to evolve and if security or "hard collateral" will be less valuable. It might become equally valuable to have subsidiaries' stock as collateral, whereas it has previously been perceived to be inferior collateral, since today it may not be valuable to have as collateral an old mall that nobody goes to anymore or a factory that's worthless because production has moved.

In a bull market the market doesn't care about collateral. Take HCA for example: the spread between the secured and unsecured debt is around 75 bps right now. I'm very happy to sacrifice 75 bps yield for HCA's secured paper. In a bear market, that discount would balloon to over 200 bps, even for HCA, which is not a distressed issuer. Since the market is not paying a lot for that unsecured risk, you are better off in the secured part of the capital structure. When the market turns to a bear credit market, I expect to rotate out of some of the secured structure to buy the unsecured paper.

**G&D:** In addition to collateral, what other fundamental factors do you look at when assessing an issue?

**EC:** I always focus on free cash flow and that takes many different forms. I'm looking for companies that generate free cash flow and are interested in deploying that free cash flow beyond giving it back to their shareholders. That might be paying down debt, reinvesting in the businesses, or maintaining capex to keep the businesses in good shape.

The focus on free cash flow allows me to think bottom-up as opposed to taking an industry view. In top-down industries, such as the Commodities sector, no matter what the management team does, the company's fortune will be dictated by what's going on in the Commodities market. If you go back to the Exploration & Production (E&P) cycle, Chesapeake had bad management before they

*(Continued on page 36)*

## Ellen Carr, Weaver C. Barksdale

booted the former CEO. The new management was good and did everything they could to position the company for a down market. But when the cycle hit, it overwhelmed even the new management team's best intentions. The company was too levered and hit a rough patch. In these industries, you want to have a view on the industry and that's why I tend to avoid the more commoditized sectors.

I like bottom-up industries because even during an economic slowdown, if management executes well, the companies will do well. The retail sector is a great example of that: if you have a great value proposition and sound execution, even if there is a recession, customers will still come to you because you built a better mouse trap.

**G&D:** How do you put together a portfolio?

**EC:** We manage our portfolios to meet client guidelines. My typical approach when starting a portfolio is to cap industry exposures at about 2x the benchmark level. If an industry represents more than 10% of the High Yield market, as the Energy sector currently does, I'll typically have an upper bound at index plus 500 bps. My lower bound stands at zero, meaning I'm not afraid of not owning anything in an industry.

Having said that, most of the time you can find something to invest in, especially in a large industry such as Energy. For institutional clients who are paying for exposure to the High Yield market, I find it irresponsible not owning any

Energy issues when the benchmark is 15% Energy. Because there is so much variety in operating models and capital structures, you can find something attractive. At the issuer level, we have a 5% limit. When I first invest in a company, I usually take about a 2% starter position and monitor it for a couple of quarters to make sure the investment thesis plays out. My average positions are usually in the 3% range, with only a couple of issuers at the 5% level. In all cases where I own a position of more than 4%, I have both the secured and the unsecured positions in the same capital structure. A great example of that is Tenet, which is a hospital company. Tenet is not the best hospital company by any means, but it is a 4.25% position in my portfolio. Two-thirds of that is secured because secured hospital bonds are bulletproof, unless there's fraud. The other third is unsecured. As Tenet had its share of issues and there is some noise around the Healthcare sector, you get paid to hold the unsecured part of the capital structure: there is a 150 bps spread pick-up.

**G&D:** When you add positions to your portfolio, do you use any metrics to gauge whether they are a good fit for the overall portfolio or is it a pure bottom-up exercise?

**EC:** It's rare to uncover an investment that the market hasn't priced appropriately. Yet something can be priced appropriately and still generate a 6% return, with good conviction on the company's long-term commitment to its ratings. As an example, a lot of High Yield managers probably

don't own as much HCA as I do. It is a 4% position in my portfolio, and I own both the secured and unsecured paper. Most people would say all the juice has been squeezed out of the HCA orange because it trades like Investment Grade, even for the unsecured bonds. Howard Marks, who is the god of the High Yield market, always says "you don't have to know exactly where you are, but you have to know if you're closer to the end or the beginning of the credit cycle." Looking at every single indicator, from corporate leverage to the duration of this bull market by way of valuations, it should be clear that we are much closer to the end than to the beginning of the credit cycle. That's why staying in HCA capital structure and under-yielding my benchmark still feels okay.

The place where I would like to have a buy list, yet don't have any at this point, is the CCC part of the market. I am generally underweight CCCs as I believe it's not the right time to invest in them. Still, from what I have seen in the last few market cycles, when the market turns you need to be ready to buy quickly because windows of opportunity will close and shut. Some bonds get marked down 20 points on a one-million-dollar trade—that's just how illiquid the market can be when it turns. I think it would be worthwhile to come up with a list of lower-quality issuers that are trading at lofty valuations. The market will punish them when it turns, and those are the names I would like to add in such a period.

*(Continued on page 37)*



## Ellen Carr, Weaver C. Barksdale

**G&D:** How do you screen for opportunities? Do you source your own ideas or do analysts bring ideas to you?

**EC:** I work with another portfolio manager and an analyst. That's been helpful, but I do not invest in any company unless I build a model from scratch and go through the 10Ks, financial statements, and the earnings' transcripts. I think doing the foundation work on a firm sets you up for a good investment decision.

I tend to start with companies displaying a stable or improving ratings trajectory. I also have a couple of industry biases. First, I don't like financials because High Yield financials are a contradiction: financial companies should be Investment Grade since accessing capital is so important to their business model. I tend to be underweight the Commodities and Energy sectors, simply because leveraging a highly volatile company eventually leads to ruin, which we saw in 2015 and 2016.

I had good success in some melting ice cube industries, for example with an incumbent wireline company or some retail issuers that have found a home in the High Yield market. Those companies are under assault from changing business models and evolving technology, but they take a lot longer to die than they might appear to. I wouldn't touch the equity of these companies, but firms like Frontier or CenturyLink can offer attractive Fixed Income opportunities in the very short end of the maturity curve. A company may not be viable

long-term, yet it could still have a bank revolver available, cash on the balance sheet, and assets that it can sell, all of which would make it investable under a two-year maturity, but much less so with a five-year or eight-year maturity. The poster child for that is J.

***“20 years in the fixed income market is a lifetime... You don't always have to have a constructive long-term view about a company to get comfortable with its short-term maturities.”***

C. Penney. Retail was my first sector; I started covering it in 2000. It was when everybody started talking about the internet and its impact on the mall sector. Everybody decided that the mall was dead and no one was ever going to shop at Macy's again. It turns out it was true, but it took 20 years for that to come home to roost. J. C. Penney is on the verge of filing for bankruptcy and Macy's is still BBB, albeit trading more like a BB. We are finally seeing Amazon and the other internet alternatives take a bite out of the cash flow of these companies... But 20 years in the fixed income market is a lifetime. There might have been five new issues and bond maturities in that timeframe, which means

you don't always have to have a constructive long-term view about a company to get comfortable with its short-term maturities.

**G&D:** Do you usually buy companies that you have known for a long time?

**EC:** At least two-thirds of my portfolio is comprised of companies that I have known for over five years, even for the very short-term holdings. An example is Nielsen, which I have known for a long time. It became private equity-backed during the 2005-2007 LBO cycle. I like the company and its underlying cash flow generation, but there have been many questions about the sustainability of its business model. Nielsen has a clear pathway to paying down debt, but there is the risk that if it is acquired it will be levered up, so I have only been comfortable owning a short maturity bond.

As another example, Sprint is a company with which probably every High Yield investor has a love-hate relationship. Yet you would still be hard-pressed to find a High Yield portfolio manager not owning any of its bonds. There are many investment theses on Sprint. Some hold it because of the M&A thesis: they assume that under the Trump administration, there is going to be a way to get the T-Mobile/Sprint merger done that didn't exist in the Obama administration. That is not my investment thesis. My investment thesis is spectrum value, which covers the bonds easily. There is a whole class of High Yield investors who have known Sprint over the many

*(Continued on page 38)*

## Ellen Carr, Weaver C. Barksdale

troubled iterations of its history. The company still burns cash and is one of the only companies I own that doesn't generate free cash flow, but I'm still comfortable with it, because the spectrum Sprint owns would be very valuable in somebody else's hands. Although they're not managing the spectrum well, bond holders take comfort from the underlying asset value of the wireless spectrum.

**G&D:** ESG mandates are witnessing rising popularity. What's your experience on that and what do you think is driving this rising demand?

**EC:** We received a lot of interest in ESG mandates recently and I think this is an area with a lot of growing pains right now. We currently don't do anything labelled as SRI or ESG because that means such different things to different firms. For example, if you look at PIMCO's total return fund that calls itself ESG, it owns Exxon. You can argue that Exxon is doing some things about the climate, but I think a lot of investors who buy an ESG fund do not want to invest in big oil firms.

The investment management business faces long-term issues, which is illustrated by fee compression and a shift to passive. One area that I think will continue to grow and thrive is ESG. But we should take a step back and think about what we are trying to achieve with ESG and who should be proposing the ESG criteria. Should clients come up with a list of companies? Or should asset managers create ESG buckets, exclusions, approved lists, and work it into

the DNA of how their analysts analyze companies, similar to what AI Gore's firm Generation Investment Management does?

***“There are firms such as Generation Investment Management that have done a good job of generating superior results under an ESG framework, but I think that is the exception rather than the rule. To gain real traction, it's going to take a lot more in terms of specific criteria and transparency into the way firms define ESG.”***

I think what has been driving the popularity of ESG is the millennial generation. My son, who is only seven, is already having conversations with me on this. One of his favorite shows is *The Lorax*, and it's basically about climate change. My son and I had this philosophical debate about what we are doing to the Earth, and he talks about how if he had land, he would never cut down any trees. The younger generation picks things they want corporations

to address, and I think it's rippling through the market. If it's having this much of an impact today, just think about what it's going to look like in 50 years, when this generation oversees all the wealth. The evidence to date on the performance of ESG mandates is mixed at best. Nobody is making a ton of money in ESG versus non-ESG mandates. There are firms such as Generation Investment Management that have done a good job of generating superior results under an ESG framework, but I think that is the exception rather than the rule. To gain real traction, it's going to take a lot more in terms of specific criteria and transparency into the way firms define ESG; but I think ESG will get there.

That being said, I think returns should still be an important factor. I get excited about the prospect of combining a focus on returns with an attention to things you want to see companies do. But as an analyst who models companies all day, I don't have a framework for incorporating that. Bloomberg now has a function that gives companies an ESG score, and it's very quantitative. It goes through everything from board composition, diversity by gender/race, to employee practices. Still, it can sometimes generate counterintuitive results. There is still a lot of work to really understand how to translate corporate culture and practices into a set of quantitative metrics. This is a real opportunity; right now, there is no substitute for bottom-up research.

## Ellen Carr, Weaver C. Barksdale

**G&D:** On the topic of passive vs. active, what do you think will be the key value-add factor for active going forward?

**EC:** Weaver's CIO wrote a white paper titled "The Top Ten Reasons Against Fixed Income Indexation and Why Passive Fixed Income Management Doesn't Exist." In line with him, I think it's much more difficult to adopt a passive approach in the Fixed Income space.

The first reason comes from the lack of liquidity: since Bonds are not exchange-traded, it's difficult for ETFs to move around and get invested. Until the liquidity challenges are fixed it will be difficult for passive to take the kind of share it has taken in Equities.

The second reason is that passive represents maybe 5% of the High Yield market but tends to be a big marginal contributor to volatility. On down days, ETFs programmatically sell bonds as retail investors pull out, and the opposite thing happens on the flip side. As a small nimble active manager, you can pick up good bargains on days like that. Another big problem with passive in Fixed Income is that it does not discriminate between big issuers, which are usually more levered and thus poorer credit, and good issuers. It's a similar structural issue to the one you have in Equities, when you are buying overvalued companies, but there is a big difference between buying the stock of an overvalued company and investing in the bonds of a company which is so levered that it's a potential distress candidate. These are structural

issues that I think passive players just can't address in Fixed Income.

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**G&D:** What are some of the investments you are most excited about these days?

**EC:** I'm not super excited about anything right now because valuations are stretched. Occasionally, I'll stumble across a good company while reading a sell-side research report or hearing something from a trader, and then dig in.

A great example is a chemical company called Olin. Its 2022 bond is BB-rated. The management team has been stable and the founder is still involved in the company. It has always managed its capital structure conservatively, with an eye on the BB rating, and it generates a fair amount of free cash flow after dividend. Given

its leverage trajectory it's a rising star candidate, meaning it has the potential to be upgraded to Investment Grade. Some of the biggest winners in High Yield are companies that have Investment Grade ratings potential but are still priced and rated as BB. Because of the 100+ bps spread compression that occurs when a company goes from High Yield to Investment Grade, these firms' bonds offer a lot of upside potential.

Another example is Penske Automotive, an auto retailer. I'm concerned about the auto cycle long-term, but Penske and its peers generate a lot of free cash flow from their parts, service, and repair operations. That's a sticky, more stable part of their business that does not fluctuate a lot over time. They have a BB/B split rating and management is comfortable with that rating. Unlike Olin, they don't have Investment Grade potential, but they are a steady company that I think should hold up well in a down cycle. Given the performance of the auto sector and the potential downturn, looking back to 2008 can provide the worst-case scenario and, in 2008, Penske still generated free cash flow and managed to take a lot of costs out. It makes me feel confident that the firm should hold up well, even in an Armageddon scenario.

**G&D:** What was the most unexpected investment in your career?

**EC:** Some of my worst mistakes were two companies that defaulted in 2015. The first one was Peabody. I now focus more on the industry

(Continued on page 40)

## Ellen Carr, Weaver C. Barksdale

and if it's a terrible industry I don't care how good the management team is. At the time, I got coal completely wrong. It was during the Obama administration, which declared war on the coal industry. It's difficult to price political risk in, but that was one of the factors that contributed to the default. I also underestimated how quickly the cycle would turn. I was not taking a skeptical enough view of the coal sector and focused on the large component of the world that uses coal, not realizing how quickly it can turn for an individual company. I ended up owning Peabody's equity, mostly for option value, even though it was trading at something that represented 10 cents on the dollar.

During the same cycle I also owned Linn Energy, a natural gas company that was a darling of the High Yield market. There, I made a different mistake. In the years leading up to the Commodities crash of 2015, Linn had done all the right things from a balance sheet perspective. It made a big acquisition in 2014, financed with equity, and de-levered as a result. Linn wanted to further de-lever, but it hit the Exploration & Production cycle at the wrong time. I then made the mistake of placing more emphasis on what the management wanted to do and not enough on what the company was actually capable of doing. In a good environment, the fact that the management wants to de-lever is important. Yet when the cycle turns, as was the case for Linn then, management is not capable of de-levering before it gets hit by the cycle.

**G&D:** Can you discuss the differences between working for a large fund like Capital Group versus your current firm, Weaver C. Barksdale?

**EC:** It's been a delight to go from managing billions of dollars to millions of dollars, because it opens my investing universe while also narrowing it in a very positive way. When I worked at Capital, we managed about \$25 billion in High Yield and I was directly responsible for about \$4 billion. That meant I had to own at least 100 issues in the portfolios, which translated into 80 issuers. A lot of times I found myself owning low or weak conviction names simply to get invested.

Today, I own between 30 to 40 issues in my portfolio, which translates into 30 to 35 issuers. I love being able to invest in a much smaller number of companies. When you are only investing millions of dollars, you can get invested in the bonds and the issuers that you are excited about.

A great example is Ingles Markets, a supermarket company which happens to be headquartered in Asheville, NC, where I live. I have followed this company for years and watched it deal with new entrants, from Whole Foods to Kroger by way of Trader Joe's. There are now all kinds of competitors that didn't exist when the company was founded many years ago, and yet it has continued to do well. This is a company that makes a big difference in my portfolio today, and which would not have worked at Capital. The bonds outstanding represent around \$500 million,

and at Capital it would have been too small for it to have made a difference in my portfolio. At Capital, positions less than \$50 million wouldn't really impact a portfolio, but at Weaver even \$1 million positions make a big difference.

In terms of portfolio construction, when I was at Capital, I would sometimes struggle to get something to a 2% position because I just couldn't find the bonds, while today I can. Being able to focus on a smaller group of higher-conviction names has been one of the joys of working at my new firm.

**G&D:** Do you have any advice for students going into the investment management industry?

**EC:** Make sure to thoroughly interview the company before you start working there. I think it's a great career, but more than ever your professional path is going to be highly dependent on who you work for. In the next decade, there is going to be a tremendous amount of shakeout, consolidation, and fee pressure. Think critically about the industry and the company, taking an analyst perspective. There is a lot of political pressure to invest in passive alternatives, and a lot of investment committees are blindly switching from active to passive management to satisfy their boards.

Different funds have different ways of dealing with this. Some are rolling out no-fee alternatives, experimenting with novel ideas, while trying to protect core active management by positioning

*(Continued on page 41)*

## Ellen Carr, Weaver C. Barksdale

themselves for an environment where active management continues to witness fee compression. Others are doubling down on active management, making a conscious choice to not deviate from it and to continue investing the way they have. It helps if they have lower fees than their peers, making them more competitive with the passive universe. You need to understand the mentality of a company and figure out what their competitive advantage is.

The whole industry is still trying to figure out how to evolve from here. The most knee-jerk way to evolve is to cut fees. Probably every firm has been in a position of fee-cutting for the last decade or more, ever since the passive revolution took hold. The firms that are thoughtful are thinking not just about cutting their expenses in response to fee pressure but also about investing in technology and exploring other areas of improvement, such as diversity, in order to come up with other sources of competitive advantage. Investing, especially portfolio management, is one of the least diverse industries. This is also an industry that has consistently charged high fees while not being able to justify them. The passive providers came in, provided the same thing at lower fees, and it worked. But I think what will prove active management works is more diversity in investing teams.

More diverse teams make better decisions. Most portfolio managers make individual decisions, yet if teams of people making

individual decisions become more collaborative, this could probably lead to better outcomes. The investment management industry can definitely increase diversity by having more women, more people from different ethnic backgrounds, and more people who went to different schools. One of the equity analysts who covered retail at Capital had actually worked on a Macy's floor for years before he ascended the ranks and eventually went to work at Capital. He had a great knowledge base.

***“More diverse teams make better decisions. Most portfolio managers make individual decisions, yet if teams of people making individual decisions become more collaborative, this could probably lead to better outcomes.”***

One of my mentors at Capital, who was the CIO of the balanced funds, started her career as the head of investor relations at International Paper and then moved to the sell-side—a transition which would be much less likely today. I think having people like that would contribute to results over time because of the

multiple perspectives it allows for. Valuing diversity and putting it in action is going to be very important in the years to come for the industry.

**G&D:** Thank you very much for your time.