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ValueInvestor INSIGHT

The Leading Authority on Value Investing

Fresh Perspective

While "the future is uncertain," as legendary value investor Ben Graham deadpanned, top investors can see things unfold with a bit more clarity. Witness Oakmark Funds' Bill Nygren.

INVESTOR INSIGHT

Oakmark Funds
Bill Nygren *[l]*, Win Murray *[r]*

Investment Focus: Seek companies with stocks trading at steep discounts to estimated value, value that is growing over time, and management that is aligned with shareholders.

Ever thoughtful and measured in tone, you can almost get a rise out of Oakmark Funds' Bill Nygren when exploring investing's active vs. passive debate. "I think it's ironic that an increase in the number of dollars invested without thought as to where value is and isn't would make the game impossibly difficult for those of us who do think about these things," he says.

He speaks on the subject with earned authority. The $5.8 billion (assets) Oakmark Select Fund he launched in 1996 has returned a net annualized 12.8%, vs. 8.1% for the S&P 500.

Finding mispriced value in even the biggest companies, Nygren and co-PMs Win Murray and Tony Coniaris see upside today in such areas as Internet services, real estate, heavy industry and motorcycles.

We're assuming what you're looking for – stocks trading at discounts to your estimate of value, management teams aligned with shareholders, and value that grows over time – hasn't changed. True?

Bill Nygren: There hasn't been any significant change. From the time we started Oakmark Fund more than 25 years ago those have been the criteria we've used to find companies in which to invest. We still believe they're the three most important things on which to focus.

If you're missing any of those, you start to struggle with the investment idea. If the name isn't cheap, it doesn't even qualify as a value investment. If the value isn't growing, then you've got a clock that's ticking against you. And if management isn't focused on maximizing long-term per-share value, then no matter how good your analysis is of the business, the decisions being made can disrupt the rising path of value you'd otherwise see in the static business. It's only when all three of those things are present – discount to the value, value that's growing and management trying to maximize per-share value – that we have the confidence to make an investment.

Private-equity firms generally look for companies they believe investors will perceive differently five to seven years from now because of changes they can put in place. Investors today might be ignoring hidden assets or are overly focusing on a temporary problem, but a private-equity approach focuses on how business values could change over several years. That's a very different way of thinking from most investors who are trying to outguess each other on next quarter's or next year's earnings. We try to apply a private-equity approach to public-equity investing.

You invest in some of the best-known and most-followed companies in the world. What can make them mispriced?

BN: The easiest thing for investors to do is to extrapolate historical trends. The opportunities we find usually arise when that extrapolation leads to something that is very different than what we think is likely. That could come from new management and believing future margins are going to be very different than in the past. It could come from non-earning assets we believe over time will display their value. It could come from an overreaction to what we think is a short-term negative for earnings.

Liberty Interactive QVC [QVCA], in which we have an interest, is a good example. At the end of last year's second quarter the company reported a surprising decrease in U.S. sales. Wall Street analysts immediately concluded that this signaled the beginning of the end for this form of TV-based retailing – that cord cutting and increased Internet competition was going to make QVC's model no longer effective. Our conclusion was that the problem was likely due to short-term merchandising issues and not the sudden onset of secular decline. Almost a year later, indications are that it was short-term merchandising issues. Those kinds of opportunities still present themselves with regularity.

Win Murray: Frequently we're coming to companies that haven't been run particularly well and because of that the investor perception is that the business itself is not very good. With Baxter International

[BAX], for example, we saw a company with an operating margin of roughly half the 20% we thought was possible, with a new CEO, Jose Almeida, taking over at the beginning of last year after a very successful stint at Covidien, where we had been a shareholder. That type of situation is frequently interesting, combining a stale company perception with an executive who has a record of success. With our time horizon generally giving turnarounds time to work, you can find opportunity even in well-known companies. [*Note*: Baxter shares, at $38.15 when Almeida became CEO, recently traded at $59.20.]

Are you finding it hard today to find sufficiently discounted share prices?

BN: It's always hard. When prices get to a level where they look really cheap relative to history, it's usually in the midst of a news environment that makes investors reluctant to commit long-term capital. I used to think it must have been easy to be an equity investor back in the 1950s when the dividend yield on the S&P 500 exceeded the yield on ten-year Treasuries. When we experienced that environment in just the past few years, it didn't seem so easy.

I think it's dangerous to draw lines in the sand after which you'll just sit it out. Once you do, the temptation is to spend all your time trying to defend why now is not the time to be invested. I wrote a piece last year on the 25th anniversary of Oakmark Fund. At the time the fund had returned something like 20x investors' initial capital, while the S&P was up 10x. But when you look at the list of things investors had to deal with over that time – wars, hurricanes, global financial crisis, oil-price collapse, just to name a few – it's amazing the market returned 10-fold. It's surprising to me how many of our peers, who share our long-term belief that equities are likely to continue to be the highest-return asset category, believe they can enhance that return by figuring out those occasional periods where the equity market is at higher risk.

You could look at the market today and say the trailing P/E is 15-20% above historical averages, which could be enough to give one pause. On the other hand, dividend yields as a percentage of corporate bond yields are higher than normal. The economic growth outlook right now is positive. Retained earnings are higher than average and are being put to use to delever balance sheets, increase dividends and repurchase shares. There are always reasons to be bearish and there are always reasons to be bullish. We've just never been comfortable in making judgements on overall market levels.

ON TODAY'S MARKET:

There are always reasons to be bearish and to be bullish. We're not comfortable judging overall market levels.

WM: To make good portfolio decisions, we need to know what the best ideas are. What's "best" may have a different valuation profile now than it did in early 2009, but we never stop debating and vetting new ideas. We may conclude the best ideas are low-risk companies selling for 75% of what we think they're worth. In 2009 they may have been higher-risk companies selling for 30% of what they were worth. We want to own the most-attractive stocks available, without trying to time when to be in or out of the market.

We're curious about your take today on energy, a sector that hasn't been a favorite of yours over time.

BN: The energy industry is not one where we wake up in the morning and say, "Boy, I really wish I could put more dollars to work in that sector." It's a commodity business, and while the price of the commodity is the most important factor in whether or not business value increases or decreases, it is completely outside the control of management and is very difficult to forecast with any degree of precision. On top of that, it's an industry where managements have tended to invest every dollar in trying to grow the scale of their companies, rather than looking for putting capital to better use elsewhere or even shrinking when the situation ideally warrants.

Bill Nygren

National Pastime?

When first interviewed in *Value Investor Insight* in 2006, Bill Nygren described as a kid originally getting interested in investing by noticing the stock tables next to the baseball box scores he pored over during the summer. As he said at the time: "I joke that my interest in investing came originally from my passion for the national pastime, but that the national pastime today is investing, not baseball."

One financial crisis later, it's hard to see investing in the U.S. today as a national pastime. Will it ever be again? "I think there's very little in investing that you can ever say is here to stay or is permanently absent," says Nygren. "It goes through cycles and definitely many people – especially those who panicked at the bottom and exited equities – have decided this is not an appropriate hobby for them. You probably lose a generation there. But the time will come, maybe it will be their kids, when individual investors get really excited again about building their own portfolios."

As for baseball returning to its former glory, maybe not, he says: "When I was a kid, a game took 2½ hours and there was the same amount of action as in one today that takes 3½ hours. That's asking a lot from the fan base."

That said, I think analysts can be sloppy in valuing energy companies in a couple of important ways. One is in using short-cut valuation metrics like EV/EBITDA, which results in assets not currently producing cash flow to be effectively valued at zero. Even if analysts do a piece-by-piece valuation by specific field, they often use a point commodity-price estimate to assign values. That ignores an option value which is quite high due to the volatility of the underlying commodity price. In these cases, properties that don't produce positive cash flow until prices get to a specific level are effectively valued at $0 if the point estimate used is below that level.

With respect to the commodity price, we believe global GDP is going to grow at historically normal annual rates, 2-3%, and that that can't happen without increasing global demand for energy. Given that existing wells have a decline curve and demand will be growing, oil prices have to hit a level that induces companies to invest in finding and producing more oil. We don't think that investment makes much sense at $50 per barrel, but at around $70 per barrel companies can make a reasonable return on capital. So, our valuations assign worth to non-operating properties, assume an option value on out-of-the-money development, and assume a commodity price over time at a supply-demand clearing level that we believe is significantly higher than the current level.

With all that as a preface, we currently believe that both Apache [APA] and Chesapeake Energy [CHK] trade at substantial discounts to estimated fair value. Each has an inventory of property, very large relative to its enterprise value, that is currently producing *de minimis* cash flow. We also believe both are run by people whose thoughts on capital allocation and growing per-share business value are well aligned with our own. With Chesapeake, we also think the market has been very slow to recognize how much its balance sheet has improved over the past 18 months. As energy stocks pulled back in the first quarter, we added to our holdings in both companies.

You traded around your Chesapeake position using its bonds last year. Describe that.

WM: Earlier in 2016 investors were pricing in significant bankruptcy risk for Chesapeake. At the time we believed the liquidity risks were manageable, given the company's ability to sell assets representing a small percentage of future production for proceeds representing a non-trivial percentage of the current enterprise value.

ON PHARMA STOCKS:

Given how drug prices have been raised, we don't rule out the possibility some increases will have to be reversed.

We thought the bonds offered similar upside to the stock – with higher seniority in the capital structure – so we swapped most of our stock at approximately $4 per share, capturing a tax loss, for the company's bonds at $48 per $100 par value.

As commodity prices rose during the second quarter of last year, Chesapeake sold assets for cash without substantially reducing its current EBITDA and the bonds rallied to $85 per $100 par value while the stock ticked up to around $4.30. At that point the equity was more attractive and we swapped back into the stock. All we own today is the equity.

Healthcare has been of interest to you in the past but appears less so today. Why?

BN: We own nothing in the sector in Oakmark Select, but did invest in a few healthcare positions in the Oakmark Fund as stocks got hit over concerns that the new administration would push legislation decreasing the number of insureds. That allowed us to build a position in HCA Holdings [HCA], the hospital operator, and to add to smallish positions we held in device-maker Medtronic [MDT] and in Baxter, which Win mentioned earlier. We felt the stock-price declines had quite fully discounted the potential decrease in the number of insureds. At the same time we thought that even if the Affordable Care Act was repealed, it would likely be replaced with something that would mitigate any decline in the insured population.

A lot of value investors today seem to be increasingly interested in the pharma space, particularly specialty pharma where some of the P/Es are in single-digit territory. The typical argument is that even if these companies can no longer raise prices as they have, the P/Es are so low that just through share repurchase values will grow significantly. We're not comfortable with that argument. Given how aggressively prices have been raised, we don't rule out the possibility that some of those increases will have to be reversed. If that happens, the impact on earnings can make those single-digit P/Es go away quickly.

How generally do you arrive at estimates of fair value?

WM: For most of our companies we estimate a normal cash-flow level – we use earnings before interest, taxes and amortization as a short cut – and then ascribe to that a multiple that makes sense in the framework of a discounted-cash-flow model and relative to valuations on all the other names we look at. We recognize the difficulty in precisely pegging what a company is worth two to three years from now, but if we're making our best estimates in every case and arriving at those estimates in a disciplined and consistent manner, we should be surfacing the most-attractive relative ideas for each portfolio.

I'll ask analysts, "If you had to bet your entire salary on whether or not the company will exceed or fall short of your cash-flow estimate, which way would you go?" If they're able to answer that question in either direction, then they're using the wrong number. We want them to be torn and not know if they'd bet the over or the under. Just because we're value investors doesn't mean that we want everything to be portrayed as conservatively as possible. When it comes to making portfolio-management decisions, it's the absolute value of the error that is going to cause the investment mistake, not just being too high.

It's more difficult than ever to distinguish between permanent and temporary issues facing companies and their industries. Describe how you deal with investments that aren't working out as expected.

BN: When an analyst makes a recommendation, he or she is presenting a model for the business – how they expect the income statement and balance sheet to change over time and what that should mean for per-share business value – that stretches out for the next five to seven years. When we get to a point where the fundamental results have deviated significantly from that plan, say by a double-digit percentage level, that triggers a process where we completely revisit our assumptions to see if we'd have enough confidence to buy it today if it were a new investment.

Investors often struggle when a business hasn't performed as expected. When do you challenge your thesis and ask yourself, was I wrong? Value investors take great pride in their patience, but for patience to be a good thing, your thesis has to be right. At some point you may have to recognize when new information presents enough of a challenge to your thesis that you should revisit whether or not this is an investment you would make today. That's the process we go through when fundamentals are negatively deviating from our thesis. Likewise if they positively deviate, which is a much more pleasant situation.

When something happens like I mentioned with QVC, and we're not sure what to think of it, our default is to sell. That may differ from many investors whose default when they throw up their hands and don't really know what's going on is to maintain the position they have. In QVC's case, if you looked at hours watched, there was no evidence of a decline. There was no evidence of a decrease in the continuing migration of QVC's business model to online sales. We weren't seeing any of the quarter's problems in the U.S. showing up outside of the U.S. If it was a secular issue related to cord-cutting or to losing market share to other Internet sellers, it wasn't showing up in the statistics. On top of that, management, which has been very adept at increasing share repurchases when it is attractive and decreasing buybacks when it is less so, actually stepped up share repurchases. All those signs to us pointed to a fundamentally intact model that was suffering from temporary problems. We did some tax trading, but continued to hold our position.

ON MISTAKES:

One easy one to misjudge the comparable set and overestimate the quality of the business you're considering.

In this year's first quarter you added to your MGM Resorts [MGM] position after the casino operator's stock tumbled after an earnings release. What was your thought process there?

BN: One interesting thing about MGM is that two of its important but not main businesses are represented in other public securities: a real estate investment trust, MGM Growth Properties [MGP], and a Macau business trading in Hong Kong, MGM China Holdings [2282:HK]. When the parent-company stock fell on the earnings news, the other securities didn't, effectively taking the market value of the U.S. piece down by something on the order of 30% due to a marginally disappointing quarter that management and we concluded was no indicator of future trends for the business. Especially in the casino business you can have good-luck and bad-luck quarters that over time tend to offset. We thought that's all this was and that the fall in market value was a dramatic overreaction, so we were confident in increasing the size of our investment.

When you make a mistake, why does that tend to be?

BN: There are two things that stand out. One is that the art of estimating value starts with what is comparable to the investment we're considering and how is or has that comparable company been valued. One of the easiest ways to make a mistake is to misjudge the comparable set and overestimate the quality of the business you're considering relative to others that on the surface look similar.

When I took CFA exam #1, the essay section was to write an argument on the investment merits of Kmart versus Wal-Mart. I thought that was the easiest thing, to justify why a value investor would want to purchase Kmart, which based on any of the statistics we as value investors considered important looked stunningly cheap compared to Wal-Mart. In hindsight, of course, Wal-Mart was not a comparable of Kmart's. They both sold consumer merchandise at discounted prices, but they ran their businesses very differently. It was patently wrong to say Kmart was just a cheaper version of Wal-Mart.

The second area where mistakes are easy to make is in judging management quality and, more important, their goals. There's not a nice easy place to go to look up what management goals are. You're trying to make reasonably informed guesses based on the incentive plans and on what has happened at companies they've been at previously. But it's still difficult to get right and more often than you'd like you wake up and find management has done something that indicates they're more interested in growing the size of their empire than in maximizing per-share value. In those cases our general course of action, and the right thing to do, is to sell the shares and move on.

Howard Marks talks often about the importance in investing of second-level thinking, which at its most basic level is going beyond, "It's a great company, buy the stock." The rationale being that if everyone knows it's a great company, that is at least fully reflected in the share price and it probably isn't a great investment. What that as a preface, describe your investment case for Alphabet [GOOGL].

BN: I see I'm going to have to convince you there's third-level thinking here.

Alphabet stock trades today at around $985 per share. The consensus estimate for this year's earnings is just under $34 per share, so the stock trades at 29x earnings, about 1.5x the market multiple. It would be very easy to stop right there and say, yes, Alphabet is a good company, but obviously everyone recognizes it given the premium at which it trades.

Let's start with that $34 in earnings. That includes about $5 per share of investment in what they call "other bets," which are things like autonomous vehicles and artificial intelligence. If they weren't investing the way they are and took that $5 per share and invested with Kleiner Perkins instead, they'd report $39 per share of net income and they'd have an asset on the balance sheet of accumulated venture capital investments. So we think of the company as earning $39 a share.

Then let's go to the balance-sheet side. Consensus for the end of this year is that the company will have $140 per share in cash. Short-term interest rates are close to zero, so that's earning close to zero. Effectively they could make a $140-per-share special distribution and they'd still earn about $39 per share.

With respect to the "other bets," people in the venture-capital community are very impressed with the intellectual property the company is assembling both inside and outside high-profile projects like autonomous vehicles. In autonomous driving in particular, we're told the IP is better than that owned by Mobileye, which Intel is buying for ballpark $15 billion. Without assuming any precision in our estimate, we believe the other bets are worth something like $50 per share, twice the cost of what they've put in. As with the cash, that's another asset that isn't required to generate earnings in the core business.

Then you have YouTube, a fascinating business for the company. Like Amazon, Alphabet has made a decision to forfeit current earnings in order to radically grow the scale of this operation. If YouTube is profitable, it's trivial today because they're investing for a business they expect to be twice the size in two to three years. It's very difficult to guess when YouTube will report an income statement that will look like a cable network, but in the long run we expect a convergence in the monetization per hour watched between YouTube and the rest of the cable industry.

If you apply to YouTube's viewership last year the current market valuation of cable companies of about 80 cents per hour viewed, this business would be worth something north of $400 per share. And remember, viewership is growing something like 40% per year.

So come back to the market asking us to pay $985 per share for Alphabet. I'm getting $140 per share in cash. I'm getting $50 worth of other bets. To be conservative, let's say I value the YouTube hour of viewing at about half of what cable-TV networks are valued at today, which results in around $210 per share in value. That's $400 per share of value that contributes a trivial amount to current earnings. Subtract that from the stock price, I'm paying $585 for the Google business that earns $39 per share. That's a P/E of 15x. I've read a lot of arguments about the multiple the Google business deserves,

INVESTMENT SNAPSHOT

Alphabet
(Nasdaq: GOOGL)

Business: Dominant global competitor in Internet search and related advertising, with key other business lines including YouTube, Android, Chrome, Nest and Google Capital.

Share Information (@5/30/17):

Price	**996.17**
52-Week Range	672.66 – 997.62
Dividend Yield	0.0%
Market Cap	$680.01 billion

Financials (TTM):

Revenue	$94.76 billion
Operating Profit Margin	26.3%
Net Profit Margin	21.8%

Valuation Metrics
(@5/30/17):

	GOOGL	S&P 500
P/E (TTM)	33.7	23.9
Forward P/E (Est.)	24.6	19.1

Largest Institutional Owners
(@3/31/17):

Company	% Owned
Vanguard Group	6.7%
Fidelity Mgmt & Research	5.6%
BlackRock	4.2%
State Street	4.0%
T. Rowe Price	2.6%

Short Interest (as of 5/15/17):

Shares Short/Float	1.2%

GOOGL PRICE HISTORY

THE BOTTOM LINE

After ascribing value to assets – cash, YouTube and "other bets" – that don't contribute to current earnings, Bill Nygren argues that investors today are paying only a 15x earnings multiple on the company's core search-advertising business. Rather than a below-market multiple, he believes that business is reasonably worth a 50% premium to the market.

Sources: Company reports, other publicly available information

but not once has it been for a below-market multiple.

What multiple does it deserve?

BN: The search business continues to benefit from the significant tailwind of advertising moving from traditional media to online, such that if you're forecasting out for five years, we think mid-teens annual growth is easily achievable. When thinking about a multiple for that, you also have that it's a very capital-light business model, so that cash flow available to be reallocated is much higher than it would be for an industrial company to even support slower growth. I'd have a hard time arguing either direction from 1.5x the market multiple for the Google business. That's twice the multiple we believe we're paying today if you subtract out the other assets.

You also own Apple [AAPL], but not in your more-concentrated portfolio. Why?

BN: With Apple there's been tension for us between a good growth rate and low P/E multiple, which makes it attractive, and then on the other side the history of consumer-electronics innovators who spawn imitators and can't control their markets long-term. The question with Apple is whether by creating its whole ecosystem it has changed the model so that switching costs are so high that customers will remain loyal in the face of lower-priced comparable equipment. While we think it warrants a position in our 50-stock portfolio, we haven't been able to answer that question to our satisfaction to make it a holding in our 20-stock one.

What do you think the market is missing about General Electric [GE]?

WM: We like to look for management catalysts in companies that we think have a stale perception in the marketplace, and this fits that profile precisely.

We have always admired GE's businesses – we really like businesses where you sell a big piece of OEM equipment at a low margin and then collect a 40-year stream of high-margin service revenues that the customer is essentially locked into. GE has a lot of those businesses.

The problem we had with GE is that the culture of capital allocation developed under Jack Welch and continuing under Jeff Immelt was one that bought high-multiple businesses and sold low-multiple businesses in a way that destroyed shareholder value. They bought expensive healthcare, Amersham, when oil and gas was really cheap. Then they bought expensive oil and gas – Lufkin Industries, Vetco Gray, Dresser, and others – when healthcare was really cheap. They expanded financial services at the worst possible time. They sold NBC at the bottom of its ratings cycle at a very low multiple of cash flow. It was one thing after another that made us put a big discount on cash flows because of how they were being reinvested.

When Jeff Bornstein took over as GE's Chief Financial Officer in mid-2013 you can draw a line when capital stewardship changed. They bought Alstom's power-equipment business for a single-digit multiple of cash flows. They sold Synchrony Financial in a tax-efficient spinout and effectively used the proceeds to buy back shares. They sold the appliance business

INVESTMENT SNAPSHOT

General Electric
(NYSE: GE)

Business: Industrial conglomerate with key worldwide operating segments focused on airplane engines, energy services, medical imaging, power generation and transportation.

Share Information (@5/30/17):

Price	**27.36**
52-Week Range	27.10 – 33.00
Dividend Yield	3.5%
Market Cap	$237.59 billion

Financials (TTM):

Revenue	$119.93 billion
Operating Profit Margin	9.2%
Net Profit Margin	7.7%

Valuation Metrics
(@5/30/17):

	GE	S&P 500
P/E (TTM)	27.9	23.9
Forward P/E (Est.)	14.5	19.1

Largest Institutional Owners
(@3/31/17):

Company	% Owned
Vanguard Group	6.9%
State Street	4.1%
BlackRock	4.0%
Capital Research & Mgmt	1.5%
Northern Trust	1.3%

Short Interest (as of 5/15/17):

Shares Short/Float	1.1%

GE PRICE HISTORY

THE BOTTOM LINE

The overhaul being led by CFO Jeff Bornstein in how the company allocates capital and compensates its senior executives should have a far-reaching positive impact on performance that isn't currently recognized by the market, says Win Murray. At a high-teens multiple of his 2020 earnings estimate the shares would trade in the low- to mid-$40s.

Sources: Company reports, other publicly available information

for a high multiple. They combined the oil and gas business with Baker Hughes at the bottom of an oil cycle in an asset-light way. They dismantled GE Capital swiftly and at a good multiple of book value. All very impressive and executed as a contrarian value investor would.

In another significant move, Bornstein drove a change in how GE's top 6,000 or so executives are paid. The new incentive system put in place at the beginning of 2016 was a complete revamp of a 1950s-era plan that was almost union-shop in construction, based more on seniority and your bonus last year than how you actually performed. The new plan pays out based on a scorecard of factors under managers' direct control and tracked in real time, and it's far more possible to get paid a lot or a little than under the old system. That's a big change we expect to have a very positive impact over time.

How well positioned do you consider GE's key operating divisions?

WM: Aviation is a powerhouse that has been taking global market share and is currently rolling out its biggest product launch ever – the LEAP jet engine developed with France's Safran – which is showing great uptake. The medical-equipment business is well positioned in its core ultrasound and imaging markets and has good growth potential in developing markets and with an expanded product line for the development of biologic drugs.

In power, while the broad segment may not grow quickly, there is significant upside for GE through cost synergies and cross-selling after the Alstom purchase. The last big piece is oil and gas. The Baker Hughes transaction filled holes in both companies' portfolios with little overlap and now the merged company has access to GE's balance sheet. Many national oil companies are resource-rich but cash poor and to develop their fields they would like to partner with an oil-field service company that can help finance the exploration and development. As the oil market recovers, the new Baker Hughes has the potential to gain share as a result.

Some analysts, citing a lower conversion of earnings into cash flow, have questioned GE's earnings quality. Is that a concern?

WM: We don't believe so. The company has been preparing for big product launches and has by design been less efficient with working capital in order to ensure smooth rollouts. We think that's fully explainable by where they are in the launch cycles and that the cash flows they're going to produce from those launches are well worth any short-term mismatch between GAAP earnings and cash flow.

ON NEXT STEPS:

I can't find anything that I'm as excited to get up in the morning and do than manage an investment portfolio.

How inexpensive do you consider the shares at today's $27.40 price?

WM: At today's price the stock trades at 16.8x consensus earnings estimates for this year. We believe that by 2020 the company is likely to be earning $2.25 to $2.50 per share. Given the extent to which the earnings are driven by long-term service contracts and with the new philosophy on capital allocation in place, we'd expect the shares to earn a high-teens multiple. That would result in a share price in the low- to mid-$40s.

It takes time for investor perceptions of a company like this to change. But if the improvements the company has made turn out to be as impactful as we expect, it will happen.

Harley-Davidson [HOG] has been on value investors' radar for some time now, without much benefit. What upside do you see from here?

WM: Before we purchased the company's shares in Oakmark Select, we visited Milwaukee to meet with the CEO, Matt Levatich, who took over in May 2015. I was worried Matt would be too much of a caretaker CEO, kind of stewarding the strong brand along as it dealt with slow secular decline. We came away concluding that wasn't at all the case.

Prior management had spent a decade trying to optimize capacity for demand and improving manufacturing efficiencies. That was all well and good, but the challenge now has been to correct for years of underinvestment in new products, marketing and geographic expansion. Today they're investing more than 200 basis points of margin into marketing and new product development. They're opening dealerships in markets like China, India and Vietnam. They're marketing heavily to customers outside the traditional demographic of white males over the age of 35.

Is all that enough to compensate for traditional baby-boomer customers aging out of the market?

WM: Investors seem to be implicitly worried about the number of motorcycles current 50-to-70-year-olds will be buying in 10 to 15 years. Obviously that isn't a high number. What's more important is how many motorcycles 25-to-50-year-olds around the world will be buying in 10 to 15 years. We think that's going to be a surprisingly high number.

According to industry data, current 25-to-50-year-olds are more likely to own a motorcycle than baby-boomers were when they were that age. According to Harley, people under the age of 35 are buying more Harleys per capita than the boomers did at the same age. Internationally, it's not a question of demand for motorcycles – there are roughly eight million motorcycles in the U.S. out of 150 million worldwide – but the extent to which rising disposable incomes support the purchase of higher-end brands like Harley. We think the Harley brand is vibrant and healthy outside the U.S. as well as inside, and that it will benefit significantly as an aspirational brand. International now represents 36-37% of the company's unit volumes.

How do you handicap the competition?

WM: The most buzz is around Indian, which is Polaris's relaunched brand that has a lot of cachet among the type of rider that likes Harley. But Indian is a drop in the bucket relative to Harley, and its volumes are a long way from being large enough to incent Polaris to invest the large dollar amounts required to build significant additional Indian capacity. Our bigger worry would be competitors like Honda and Yamaha that do have the capacity.

This points to a key element of our thesis that will need constant scrutiny. We're arguing that the company is navigating a customer-base transition, but that the strength of the core brand underneath will win the day with a long-enough time horizon. If the brand isn't resonating with new customers as it has with old, that will clearly be an issue.

How are you looking at valuation with the shares now at $53?

WM: Assuming annual revenue growth in the 3-4% range and adjusting somewhat for incremental current expenses to drive growth, our normalized estimate of EBIT over the next year or two is $1.25 to $1.35 billion, $7 to $7.50 per share. Applying what we consider a reasonable 11-12x multiple, that would result in a share value in the low- to mid-$80s.

Given the strength of the brand and the business's ability to generate cash, we think with the right time horizon you'd be happy to own this as a private company. Occasionally rumors hit that people are looking to take it private. If the company hadn't been buying back stock as aggressively as it has, keeping the balance sheet tight, that interest would probably be even higher.

Turning to another transforming business, describe why you're high on the prospects for CBRE Group [CBG].

WM: This also has been on value investors' radar, but we believe the story still has considerable room to run.

CBRE is one of only two truly global competitors in commercial real estate services. Based on fee income generated, roughly one-third of its business is leasing brokerage, one-third is sale and mortgage brokerage, and one-third is outsourced property management. It provides a small percentage of revenue, but there's also a nice investment-management business with around $90 billion in assets under management.

The market still treats the stock as a trading vehicle to bet on the real-estate cycle, but we think there are durable sources of organic growth that should provide excellent performance through the next cycle. That's driven primarily by the property-management business, which essentially allows large firms like JPMorgan to outsource their oversight and day-to-day management of company properties. That encompasses things like facilities management, expansion projects, relocations, market analysis and real estate accounting.

It's a scale business, which allows CBRE to continue to take more of the pie in a market where the pie is getting bigger as large companies increasingly conclude it makes sense for them to get out of the real-estate-management business. On top

INVESTMENT SNAPSHOT

Harley-Davidson
(NYSE: HOG)

Business: Manufactures and sells heavyweight motorcycles, motorcycle parts and related accessories and merchandise through a global network of independent dealers.

Share Information (@5/30/17):

Price	**53.01**
52-Week Range	41.63 – 63.40
Dividend Yield	2.8%
Market Cap	$9.21 billion

Financials (TTM):

Revenue	$5.75 billion
Operating Profit Margin	16.9%
Net Profit Margin	10.9%

Valuation Metrics
(@5/30/17):

	HOG	S&P 500
P/E (TTM)	15.1	23.9
Forward P/E (Est.)	12.8	19.1

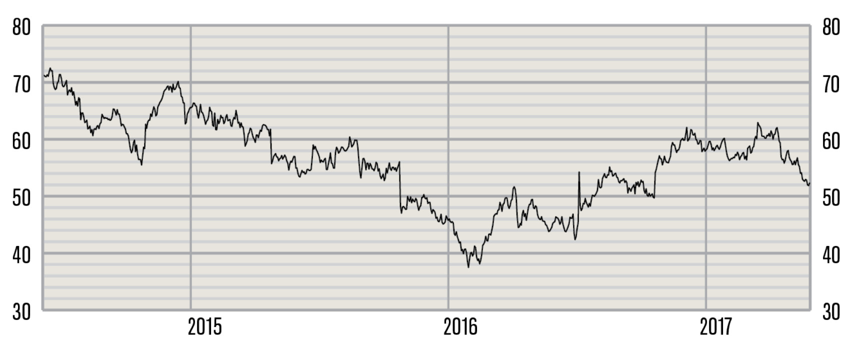
Largest Institutional Owners
(@3/31/17):

Company	% Owned
Vanguard Group	9.8%
BlackRock	6.0%
Dodge & Cox	5.0%
Massachusetts Fin Serv	4.9%
State Street	4.5%

Short Interest (as of 5/15/17):

Shares Short/Float	9.0%

HOG PRICE HISTORY



THE BOTTOM LINE

The company is navigating a customer-base transition, but Win Murray believes the underlying strength of its brand and of global demand for higher-end motorcycles provide it with a brighter future than the market appears to expect. At 11-12x his normalized EBIT estimate over the next year or two, the shares would trade in the low- to mid-$80s.

Sources: Company reports, other publicly available information

of that, when CBRE manages a property, it typically ends up winning about 60% of the brokerage business associated with that customer – almost 4x its current overall market share. That dynamic adds further to the benefit: Local brokers realize they're at a disadvantage and CBRE often has its pick of the best talent, further driving brokerage market share.

We're assuming the cycle still matters. How do you assess that here?

WM: Economic growth has been relatively modest, so while vacancy rates have fallen, they remain around or just a bit above historic averages. Real rents remain below normal levels. The spread between real-estate cap rates and Treasuries is at an historically average level. Property prices are at record highs, but interest rates are at record lows – it looks like real estate investors are still demanding a spread that's in line with history. With the caveat that cycles are quite hard to predict, couple all this with the fact that pending new construction doesn't at all appear overheated, it's difficult to see how commercial real estate activity should fall dramatically at this point.

What upside do you see in the stock from today's price of $34.40?

WM: Historic multiples applied to the overall business miss the secular changes that are occurring within it, so we believe prospective cash flows should warrant a much higher multiple. That so far has been slow in coming, in part because the analyst coverage is mostly by people who follow REITs and are likely more focused on cyclical inputs than business-model evolution.

We estimate normalized earnings over the next couple years at around $2.50 per share. Property management is a much better, more stable business than leasing and sale brokerage, and as it becomes a larger piece of the business, we expect CBRE's multiple to expand from historic levels. At the 20-21x P/E we think the business will deserve, that would result in a share price in the low-$50's.

How do you consider your portfolios positioned against ever-increasing passive competition?

BN: At Oakmark we've always said we want to run more-concentrated portfolios than peers, and one of the reasons is that we have tremendous respect for the passive alternative that can match the market at no fees. Some investors have chosen to diversify to the extent that their mistakes don't hurt them, without recognizing that if you do that you're also at the point where your successes can't help you. Those investors I think are being forced to re-visit how they invest.

We're all taught in Finance class that diversification is a free good and you should get as much of it as you can. At the extreme, that leads you to indexing. Underlying that is the notion that every stock is appropriately priced relative to its risk/return profile and your only real option to increase your return is to take higher risk.

But if you make one change to that underlying notion – that individual stocks can get mispriced – the situation changes. You believe investors can be too euphoric

INVESTMENT SNAPSHOT

CBRE Group
(NYSE: CBG)

Business: Global provider of commercial real estate services including sales and leasing brokerage, facilities management, investment management, research and consulting.

Share Information (@5/30/17):

Price	**34.41**
52-Week Range	24.11 – 36.81
Dividend Yield	0.0%
Market Cap	$11.46 billion

Financials (TTM):

Revenue	$13.21 billion
Operating Profit Margin	6.7%
Net Profit Margin	4.7%

Valuation Metrics
(@5/30/17):

	CBG	S&P 500
P/E (TTM)	18.8	23.9
Forward P/E (Est.)	13.4	19.1

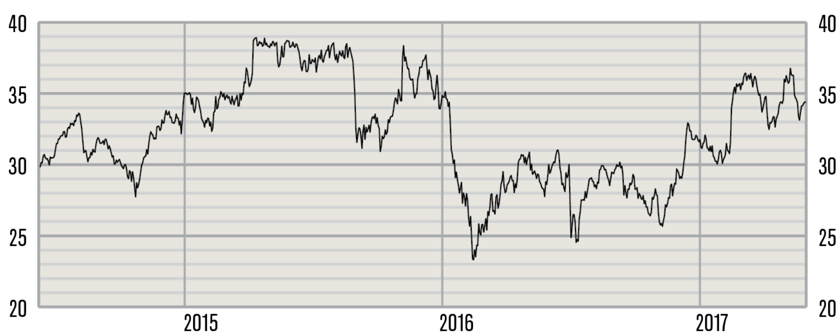
Largest Institutional Owners
(@3/31/17):

Company	% Owned
ValueAct Capital	12.4%
Vanguard Group	8.2%
BlackRock	5.7%
Harris Associates	5.0%
State Street	3.6%

Short Interest (as of 5/15/17):

Shares Short/Float	3.2%

CBG PRICE HISTORY



THE BOTTOM LINE
As the company's business mix continues to shift toward property management from brokerage, Win Murray expects both earnings power and the multiple placed on that earnings power to improve. At the 20-21x P/E he believes the business will deserve, on his $2.50 per share normalized earnings estimate the stock would trade in the low-$50s.

Sources: Company reports, other publicly available information

or too pessimistic. That assets investors ignore actually have meaningful value. That short-term results can be mistaken for long-term trends. Now you don't want your portfolio to be as completely diversified as possible because you want more of the stocks with better-than-average risk/return profiles. Now active management makes sense – or at least it does to us.

Has the rise of passive investing to your mind changed the way stocks trade?

BN: We don't see the opportunity set as having materially changed. If anything, I'd say the proliferation of ETFs and in quantitatively managed money that has share-price momentum as a key input does seem to have made momentum a bigger factor in the market over the past decade. When bank stocks started to go up after the November election, you could see an ETF effect of all of them moving in lockstep. That type of effect can be very frustrating in the short-term, but it does lead to opportunities when it helps drive prices away from a fundamental business value.

I think it's proven very difficult to try to out-guess the non-fundamental drivers of stock prices, so we don't spend much time trying to do that. We're still driven by the gap between business value and price – I don't expect that to change.

Bill, at 58 are you in this for the long haul?

BN: Unlike some people I've known in this business who have a burning desire for a second act – teaching, or politics, or writing a book, or running a business – I can't find anything that I'm as excited to get up in the morning and do than manage an investment portfolio. Unless that suddenly changes, I don't see any reason I won't be sitting at this same desk five or ten years from now.

I tremendously enjoy the people I have the privilege of working with daily. It's easy to take for granted the luxury we have of daily interaction with highly intelligent people who are curious about the world and bring interesting points of view to the table. I imagine it would be very difficult to find that elsewhere and I would miss it very much if I wasn't here. VII

Value Investor Insight – May 31, 2017 | ***Fresh Perspective*** with Bill Nygren and Win Murray

Average Annual Total Returns (as of 09/30/17)					
	1-Year	3-Year	5-Year	10-Year	Inception (08/05/1991)
Oakmark Fund | OAKMX	23.79%	10.43%	15.42%	9.64%	12.93%
S&P 500 Total Return	18.61%	10.81%	14.22%	7.44%	9.67%

Expense Ratio (as of 09/30/2016): 0.89%

Average Annual Total Returns (as of 09/30/17)					
	1-Year	3-Year	5-Year	10-Year	Inception (11/01/1996)
Oakmark Select Fund | OAKLX	22.61%	8.51%	15.45%	8.79%	12.89%
S&P 500 Total Return	18.61%	10.81%	14.22%	7.44%	8.30%

Expense Ratio (as of 09/30/2016): 0.98%

Past performance is no guarantee of future results*. The performance data quoted represents past performance. Current performance may be lower or higher than the performance data quoted. Total return includes change in share prices and, in each case, includes reinvestment of dividends and capital gain distributions. The investment return and principal value vary so that an investor's shares when redeemed may be worth more or less than the original cost. To obtain most recent month-end performance data, visit Oakmark.com.*

As of September 30, 2017, the holdings mentioned above comprise the following percentages of the Fund's total net assets:

Security	OAKMX	OAKLX
Alphabet Cl C	3.3%	8.6%
Apache	1.9%	4.1%
Apple	2.5%	0.0%
Baxter International	1.8%	0.0%
CBRE Group Cl A	0.0%	6.6%
Chesapeake Energy	0.5%	2.8%
General Electric	2.6%	5.5%
Harley-Davidson	0.9%	3.3%
HCA Holdings	1.2%	0.0%
Intel	2.1%	0.0%
Liberty Interactive QVC CL A	1.5%	3.5%
Medtronic	1.0%	0.0%
MGM Resorts International	1.5%	4.2%
Mobileye	0.0%	0.0%
Polaris	0.0%	0.0%
Wal-Mart	0.0%	0.0%

Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks. Current and future portfolio holdings are subject to risk.

Please visit Oakmark.com to view the full list of holdings for the Oakmark and Oakmark Select Funds as of the most recent quarter-end.

The Price-Earnings Ratio (“P/E”) is the most common measure of the expensiveness of a stock.

The EV/EBITDA ratio is a comparison of Enterprise Value and Earnings Before the deduction of payments for Interest, Taxes, Depreciation and Amortization which is a measure of operating income.

EBIT is a measure of a firm's profit that includes all expenses except interest and income tax expenses. It is the difference between operating revenues and operating expenses.

The Oakmark Fund's portfolio tends to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

Because the Oakmark Select Fund is non-diversified, the performance of each holding will have a greater impact on the Fund's total return, and may make the Fund's returns more volatile than a more diversified fund.

Oakmark Select Fund: The stocks of medium-sized companies tend to be more volatile than those of large companies and have underperformed the stocks of small and large companies during some periods.

The S&P 500 Total Return Index is a market capitalization-weighted index of 500 large-capitalization stocks commonly used to represent the U.S. equity market. All returns reflect reinvested dividends and capital gains distributions. This index is unmanaged and investors cannot invest directly in this index.

The discussion of the Fund's investments and investment strategy (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) represents the Fund's investments and the views of the portfolio managers and Harris Associates L.P., the Fund's investment adviser, at the time of this letter, and are subject to change without notice.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please call 1-800-OAKMARK (625-6275).