Taking Stock
Money managers “hug” their benchmark for many reasons, beating it not among them. Which explains why Clyde McGregor takes a different tack.

Ask Clyde McGregor his preference today between equities and bonds and the manager of the $19 billion (assets) Oakmark Equity and Income Fund says there’s really no contest. “Fixed income today is basically a holding tank for money waiting to be applied to something more attractive,” he says.

McGregor’s acumen in matching capital with opportunity has been well documented. He’s run the Equity and Income Fund since its 1995 launch, a period over which it has earned a net annualized 10.5%, vs. 6.5% for the Lipper Balanced Fund Index.

With the equity share of his portfolio at an all-time high, he’s finding overlooked value in such areas as parcel delivery, auto parts, pharmacy services, scientific instruments and diversified industrial equipment. 

Clyde McGregor
Harris Associates
Investment Focus: Seeks companies trading at deep discounts to a private-market value that persistently grows, run by managers who behave like fellow owners.

Inside this Issue
FEATURES
Investor Insight: Clyde McGregor
Finding far less opportunity in bonds than in the stocks of such companies as FedEx, Lear, Bruker, Dover and Omnicare.

Investor Insight: Jay Kaplan
Stressing quality over quantity in underappreciated ideas such as Jos. A. Bank, Helmerich & Payne, Buckle, and Netgear.

Uncovering Value: Stolt-Nielsen
Delayed as the investment upside has been, why Bob Robotti is convinced it won’t be denied.

Uncovering Value: Spark
Assessing the true inner beauty beneath the surface of this online matchmaking pioneer.

Editors’ Letter
On the merits of independence vs. benchmark “hugging.”

INVESTMENT HIGHLIGHTS
INVESTMENT SNAPSHOTS PAGE
Bruker 8
Buckle 14
Dover 9
FedEx 4
Helmerich & Payne 15
Jos. A. Bank Clothiers 13
Lear 5
Netgear 16
Omnicare 8
Spark Networks 18
Stolt-Nielsen 17

Other companies in this issue:
Ascena Retail, Blount, Chemed, Devon Energy, Diageo, eBay, Federated Investors, Lab Corp., Lincoln Electric, ManTech, Quest Diagnostics, Reinsurance Group, TD Ameritrade, UnitedHealth, Wolverine World Wide

www.valueinvestorinsight.com
Investor Insight: Clyde McGregor

Harris Associates’ portfolio manager Clyde McGregor and U.S. research director Win Murray describe the measure of intrinsic value they find most instructive, why small caps make it into even big funds, the reason other than valuation they’ll dump a blue-chip holding, and why they see mispriced value in FedEx, Omnicare, Bruker, Lear and Dover Corp.

Funds with “Equity” and “Income” in their names are quite popular these days. Describe how your rendition of such a fund differs from the trendier versions.

Clyde McGregor: Recognize that the name is Oakmark Equity and Income Fund, which started life as a traditional 60% equity/40% fixed income balanced fund and which remains fairly true to that original conception. History has taught that a balanced asset allocation in average time periods tends to produce sufficient investment return and buffer volatility to a degree that makes it possible for the average investor to sustain a long-term investing approach. I attempt to construct a fund that allows for our human frailties.

We do move the asset allocation of the fund around, based on our ability to discern value in the two major asset classes in which we invest. By prospectus we can go as high as 75% in equities, and today’s 71% allocated to equities is the highest it’s ever been. Historically we’ve found opportunities in even the safest U.S. Treasury and agency securities that we considered solidly additive to returns. That is not the case in today’s world of repressed interest rates, where the only thing our very short-duration holdings are doing is buffering the volatility of the stock market.

Is income generation from your equities important to you?

CM: I would like it to be more important than it is, but in general we think income-oriented equity names today are fully priced, if not overpriced. Diageo [DEO], the global spirits company, has been a great holding for us and something that we bought in part because of its excellent dividend yield. It and other similar types of companies have performed very well and are now much closer to their sell targets than buy targets.

Harris Associates has a well-defined approach to equity research and analysis. Describe the key elements you’re looking for in a stock.

CM: The simple three-part mantra we use is that we’re looking for equities selling for 60 cents or less on the dollar of intrinsic value, where those intrinsic values per share are persistently growing and where the management teams act like owners in running the business.

Win Murray: Our analysts typically value a name two to three years out. That means we’re actually making projections out three to five years, which can provide a real edge in buying the types of names we typically do in which everyone seems to be concerned by a macro issue and/or recent earnings trend.

Our primary valuation metric is enterprise value to EBITA – with EBITA a proxy for cash flow – but it’s also important to look at the metrics relevant to the specific industry. For cable companies it could be per-subscriber metrics, for oil and gas companies the PV-10 value of the proved reserves, for pharmaceutical companies the net present value of the marketed portfolio. We want to understand what a strategic buyer in the industry would pay for the assets and why.

CM: Ideas that make it through the vetting process are put on an approved list of stocks, with intrinsic-value estimates attached. It’s then up to the individual portfolio managers, based on the goals and objectives of each portfolio, to select the stocks for their funds. Bill Nygren’s Oakmark Select Fund has a meaningfully different objective and should have different investors than the Equity and Income Fund, so he and I will make different choices about what goes in each of those portfolios.
Give an example of how your choices differ today.

CM: Let’s talk about banks. I continue to think long and hard about whether the environment has stabilized enough for something like Bank of America, JPMorgan Chase or Comerica – all of which are on our approved list – to have a risk/reward profile worthy of inclusion in the Equity and Income Fund. That’s not at all to say any of those names aren’t right for other Oakmark funds, just that my uncertainty about what “normal” may be for these banks may not make them appropriate today for this fund and its investors.

Your research team consists of generalists as opposed to industry specialists. Why?

WM: We build into our research and analytical process a great deal of peer review and challenging of ideas. I’ve worked at firms with sector specialists and what can happen is if the pharmaceutical analyst says his best idea is Eli Lilly, the knowledge base around the table often isn’t deep enough to challenge that. Here when you have four different people following pharma companies or six following retailers, no one is standing on top of a mountain dictating about any given industry. We think a give and take from more people rather than less results in a more robust process and, ultimately, better decisions.

Morningstar says you tend to favor some industries, such as consumer staples and healthcare, over others, such as financials and technology. Do you think that’s true?

CM: I don’t construct the fund based on industry weightings and I’m always surprised what they are when I see them on a quarterly basis. That said, for Equity and Income I’m looking for those investment cases that are right for what is meant to be the least-risky, least-volatile product we offer. I have felt consistently since about 2006 that banks have been too risky for inclusion in the portfolio. In technology, a name may look inexpensive on cash flow, but for this fund I’d also want more confidence in the durability of the business model than you often see in that sector.

What I’d like to believe is that I’m particularly drawn to large discounts to private market values that I can understand. As those discounts migrate from one industry to another, I would hope to follow them with an open mind. I own eBay [EBAY] in the portfolio now, which I would have said was highly unlikely even three or four years ago. But it was a case where the natural economic momentum behind the business and the private-market value in the PayPal electronic-payments piece were so compelling that, at the right price, I could not not own it.

ON HEALTHCARE:
At the prices we’re paying, we’re getting more or less for free the demographic tailwind behind the business.

You do appear to own a lot of healthcare-related stocks today. Why?

CM: Each healthcare name we own was bought for a company-specific reason, but one common denominator is that we think at the prices we’ve been paying that we’re getting more or less for free the demographic tailwind behind the business. I just turned 60 and am an early middle baby boomer. I take medications today I didn’t ten years ago. I didn’t have arthritis ten years ago. I need more lab tests in a year than I used to. Companies with the wind behind their sails can have a misstep here and there and still do very well.

Can you give an example or two?

CM: We have felt that the stocks of the lab companies, Quest Diagnostics [DGX] and Lab Corp. [LH], have been unduly deflated at times out of concern both over healthcare reform and cyclical headwinds as people cut back on going to the doctor in tougher economic times. That has allowed us to build positions in an area that we believe will clearly benefit from an aging population – in one company, Quest, with an improving management story, and another, Lab Corp., that we think has been consistently well managed.

WM: UnitedHealth [UNH] is another example. We bought into it at a time when the market seemed extremely concerned by the inability, because of healthcare reform, to forecast cash flows looking out past a year or two. Our assessment was that as the most-diversified company in the space, no one line item in the bill would hurt the business model unduly, and there was a good chance the company could continue to grow its earnings in line with increases in healthcare costs and utilization, both of which we expected to continue to rise. We also believe management is deploying capital exceptionally well, with accretive acquisitions, getting out of business lines that aren’t working, buying back shares and paying dividends. The investment case today is as intact as ever.

We have to ask about your one lonely financial, discount brokerage TD Ameritrade [AMTD]. Why does it make the cut?

CM: You’ve picked one where the wind is not behind its sails, but what makes it interesting is that even in an obviously tough environment the company continues to grow accounts and assets nicely. I’ve met the management several times and find them impressive. All we’ve been is wrong in saying interest rates can’t go much lower, but we think we’re getting for free the upside that would come along if short-term interest rates approached normal, which would have a significant positive effect on TD Ameritrade’s profits. It’s not a big position for us today, but if we saw the industry environment becoming more positive, that could change.

Why in a $19 billion fund do you own names like Blount International [BLT], which has a market cap of $675 million?

CM: I guess I’ve always felt that if I have a dollar to pick up off the street for the
fund, why not do so? I’m happy to have an eclectic portfolio as long as that eclecticism is based on extreme valuation considerations.

Blount is the global leader in the production of cutting chain for chainsaws. It’s a classic razor-blade business, as professional loggers need to replace their chains every five to ten days. Its international sales, especially to emerging markets, are a large and increasing percentage of the total. In May the company lowered its fiscal 2012 earnings guidance and the stock, which had been above $17 in February, fell to $13. That in our view was enough of an overreaction to warrant adding the shares to the portfolio.

Is the impetus to buy often an errant earnings report?

WM: When a stock moves sharply after an earnings announcement, the question I want the analyst to answer is whether something in today’s earnings report impacted the value of the company in 2015. Are we three years from now going to look back at today’s earnings as a seminal moment in our understanding of the business and its competitive dynamics? That can be the case, but more often than not what’s perceived as a bad quarter doesn’t impact the value of the enterprise.

That often means adding to existing positions. One of our top energy positions is Devon Energy [DVN], which has a diverse and high-potential reserve base and a first-rate management team that is working effectively for the benefit of shareholders. The company’s earnings report earlier this month disappointed the market and the shares fell from $60 to $54, even though we saw little change at all in intrinsic value. We’re not doing our job if we don’t respond to opportunities like that the market gives us.

Describe the opportunity the market is giving you today in FedEx [FDX].

WM: FedEx is generally viewed by the market as a global air-shipping company. That’s its heritage and also where results have been quite cyclical, with margins going up and down depending on the utilization of assets in what is an asset-intensive business.

Our focus instead is on the company’s domestic ground parcel-delivery business, where we believe FedEx is the better- positioned player of the two, along with UPS, that dominate the business. UPS still controls 65% of the market vs. FedEx’s 25%, but FedEx has gained more than 150 basis points of market share per year since 2000. That’s happened because its more technologically advanced network using only trucks allows it to beat UPS on delivery times in about 30% of all shipping lanes and match it virtually everywhere else. We see that advantage as structural and expect the market-share shift to continue for some time. The only thing that might stop it would be if UPS aggressively cut prices, which it has concluded – we believe rightly – isn’t in its best interest. The overall pie in U.S. ground should grow nicely, partly due to the increase in e-commerce-related shipping but also because about 1% of total shipping volume domestically moves from express to ground every year as ground delivery times continue to decrease. That’s posi-

FedEx  
(NYSE: FDX)

Business: Global provider of express, parcel and freight delivery services as well as, through FedEx Office, business services such as copying and digital printing.

Share Information  
(@11/29/12):

Price  90.80
52-Week Range  76.95 - 97.19
Dividend Yield  0.6%
Market Cap  $28.5 billion

Financials (TTM):
Revenue  $42.95 billion
Operating Profit Margin  7.9%
Net Profit Margin  4.7%

Valuation Metrics  
(@11/29/12):

FDX  S&P 500
P/E (TTM)  14.2  16.5
Forward P/E (Est.)  11.6  13.2
EV/EBITDA (TTM)  5.2

Largest Institutional Owners  
(@9/30/12):

Company  % Owned
Primecap Mgmt  6.4%
Dodge & Cox  5.8%
Southeastern Asset Mgmt  5.3%
Wellington Mgmt  4.2%
Vanguard Group  4.1%

Short Interest  
(as of 11/15/12):
Shares Short/Float  1.9%

Sources: Company reports, other publicly available information

THE BOTTOM LINE

Overly focused on the company’s traditional and more-cyclical express-shipping business, the market is not recognizing the growth, profitability and potential of its domestic ground parcel-delivery business, says Win Murray. On a sum-of-the-parts basis, he estimates the intrinsic value of the company’s shares at more than double the current price.
tive for FedEx’s return on investment. It doesn’t own its trucks and the drivers are not employees, so growth in this business produces franchise-type returns. Ground margins have moved from the low double digits to closer to 20%, more than twice those in a good year for the express business. Those margins will increase even further as volumes increase and route density improves.

FedEx hasn’t scrimped on expanding its international network. Will that be money well spent?

WM: The company has made investments through the downturn in new long-haul Boeing 777 aircraft, sorting facilities and international terminals, mostly for trans-Pacific routes. You can certainly quibble with the timing, as it turns out they built out capacity further in advance than they should have, but we believe this spending has greatly improved FedEx’s competitive position and its long-term earnings power. UPS and DHL, the other big international competitors, haven’t made the same level of investment and won’t benefit to the same degree when volumes return.

How do the travails of the U.S. Postal Service impact FedEx?

WM: If you’re trying to ship anything of consequence where the service level matters, the postal service is a less and less viable competitor. With a much-higher-cost system, it will continue to lose business to the more-efficient competitors like FedEx and UPS.

With the shares just under $91, how are you looking at valuation?

WM: The market today is valuing the company as if it’s a mediocre cyclical that trades on the volatility in express margins. The P/E on consensus estimates for next fiscal year is around 11.5x.

We do a sum of the parts, applying what we believe are appropriate multiples to our 2014 EBIT estimates for the small freight business, the express business and domestic ground. For freight we use an 9x multiple, for express we use 11x because of the barriers to entry and likely secular international growth, and for ground, which has the best return and growth characteristics, we use 14x. Add it all up and we come to an intrinsic value that is more than twice the current stock price, with 55% of the value in the domestic ground business.

We understand why investors who only have six-month time horizons have no interest in this. But as asset utilization increases over time and capital investments already made start to pay off, we think the bottom-line impact over several years could be dramatic. That very well could be accompanied by a shift in capital-allocation priorities toward dividends and share buybacks, enhancing shareholder value further.

What do you think the market is missing in auto-parts maker Lear [LEA]?

WM: Unlike FedEx, this actually is a mediocre cyclical company, but it’s just phenomenally inexpensive. With net cash on its balance sheet, the shares go for less than 4x EBITDA.
INVESTOR INSIGHT: Clyde McGregor

What attracted us to Lear was the naming about a year ago of Matt Simoncini as CEO. While the stock had been cheap before, we could not get comfortable with the prior CEO’s record of levering up for acquisitions rather than entertaining any other capital-allocation possibilities. Matt had been the CFO and we’re comfortable with his willingness to invest in sustaining the company’s competitive position, while at the same time focusing on returns and maximizing shareholder value.

The auto-parts industry has also structurally improved following the severe hit most companies took in the Great Recession. The wave of bankruptcies finally addressed huge legacy liability issues and prompted the removal of significant excess capacity. Lear itself closed nearly 50 facilities and now 80% of its manufacturing and a higher percentage of its employee base is in low-cost countries. It’s partly due to a slowed pace of new-product launches, but the industry is earning record margins and is well-positioned to benefit from increasing automobile demand in emerging markets, as well as a cyclical rebound in the U.S.

Lear’s biggest business, seating, accounts for roughly three-quarters of its revenues. Are there any particular trends of note in that business?

WM: Lear is one of the two major global players, along with Johnson Controls. In addition to still-below-normal vehicle sales in North America and Europe, the seating business has also been negatively impacted by the reduction in vehicle size in North America. We’re not counting on big changes in any of that, although we do believe North American unit sales will continue to improve and that the trend toward smaller vehicles has stabilized.

The real opportunity is in the rest of the world, where Lear generates roughly 30% of its revenues and where seating content per vehicle is extremely low. Seating systems in emerging markets aren’t nearly as complex as we’re used to, but we’d expect increasing demand for mechanical controls and other bells and whistles to be a secular tailwind behind this business going forward.

What do you believe the stock, now around $44, is more reasonably worth?

WM: Through increased seating-content penetration and somewhat higher margins as a result of the manufacturing overhaul, we think EPS two to three years out can reach the mid-$6s, from around $4.80 this year. At 6x our estimate of EV/EBITDA over the same period, we arrive at an intrinsic value for Lear of well over $80 per share. We understand why the market may take a wait-and-see approach here, but the lack of appreciation for the improvements the company has made is rather startling.

Why is Omnicare [OCR] one of your favorite healthcare-related ideas?

CM: The company is the largest provider of pharmaceuticals and related services to long-term-care facilities, primarily nursing homes, but also other institutions such as prisons. We’ve always liked that it was a niche business and that Omnicare had a dominant share of it – it’s more than three times the size of its #2 competitor, Omnicare (NYSE: OCR)

Business: Provider of pharmaceuticals and related services primarily to geriatric clients living in nursing homes, hospices, assisted-living centers and prisons.

Valuation Metrics (@11/29/12): OCR $P 500
P/E (TTM) 24.3 16.5
Forward P/E (Est.) 10.1 13.2
EV/EBITDA (TTM) 7.6

Largest Institutional Owners (@9/30/12):
Company % Owned
Harris Associates 7.0%
Iridian Asset Mgmt 6.9%
First Pacific Adv 5.8%
Vanguard Group 5.3%
Fidelity Mgmt & Research 4.0%

Short Interest (as of 11/15/12):
Shares Short/Float 8.6%

As the company’s focus has shifted from growth through acquisition to successfully leveraging its dominant market position and better serving customers, Clyde McGregor expects strong earnings growth and a positive response to that growth from the market. At a 12x market-cap-to-EBITDA multiple on his 2014 numbers, the shares would near $60.

Sources: Company reports, other publicly available information
PharMerica [PMC], which itself is twice the size of the next-biggest player. What didn't excite us was how the company was run. The long-time CEO was an acquisitions engineer more than anything else and the company never found a way to leverage its size and market position into the type of competitive advantage and financial success it should have. Customer retention rates were appallingly bad. It’s a testament to the strength of the business that the company maintained its dominant position.

Things started changing when the board brought in a new CEO from McKesson nearly two years ago, John Figueroa, who has since decided to retire and has been replaced by John Workman, who had been the company’s president. Both are straight shooters who make a lot of sensible decisions. They have streamlined purchasing, reduced costs and put greater emphasis on customer service, resulting in higher margins and retention rates now at 93%, from the 80s in the fairly recent past. They have also put more emphasis on the company’s specialty-care group, which provides logistics services for the biopharmaceutical industry and end-of-life drug-management services for hospices. Operating profits in specialty care have been growing 25% per year and now make up 15% of the company total.

Is the demographic tailwind particularly strong here?

CM: We think so. It’s not just that baby boomers are getting older and moving into the target demographic, but equally important is that the already elderly are living longer. That increases the population of assisted-living facilities as well as the per-capita consumption of pharmaceuticals. That’s obviously of benefit to a company like Omnicare.

What upside do you see in the shares, now at $35.60?

CM: The stock today trades at less than 70 cents on the sales dollar and at 11x the $3.20 or so in EPS we estimate (after adding back amortization) for 2014. It’s difficult to make private-market comparisons here because the only real comp is what Omnicare itself was willing to pay for PharMerica in a deal the Federal Trade Commission blocked earlier this year.

We expect earnings to grow for at least the next few years at 10% per year, through organic growth, more effective operational management translating into higher operating margins, and incremental growth in the higher-margin specialty-care business. On our 2014 numbers, we believe a 12x market cap to EBITDA multiple is reasonable, which would translate into a share price of close to $60.

What risk does healthcare reform pose?

CM: It’s really not part of our thesis one way or the other. Most of the end users are covered by Medicare or are prisoners, so there’s not a lot of reason for reform to impact Omnicare’s business.

Describe the case for one of your smallish-cap names, Bruker [BRKR].

CM: This is a diversified scientific-instrument manufacturer with a strong reputation for innovation and product quality. It tends to have high market shares of small niches, such as in nuclear magnetic resonance machines that analyze molecular structures of a sample, or x-ray machines that can measure minute variances in materials surfaces. Customers tend to be research laboratories, drug companies and industrial manufacturers.

Bruker historically has been run more by engineers than from a financial standpoint. The positive side of that for us is that management has been willing to make sensible investments even if they promise returns only well into the future, a factor that often discourages broader investor interest. Less positive is that margins are considerably substandard relative to competitors. While peers like Agilent or Danaher’s Scientific Instruments division have operating margins in the upper teens, Bruker’s are in the low teens today.

The CEO, Frank Laukien, owns more than 20% of the company and appears to have accepted that it needs to be managed more efficiently. He recently went outside the company for the first time to hire a CFO and has set an operating-margin goal of 18%. They won’t hit that with one or two simple measures, but we believe they have a lot of headroom to take out costs, improve working capital and better manage the portfolio of businesses to increase profitability. One important decision, for example, will be what to do with the fast-growing but still loss-making Energy and Supercon Technologies business, which uses magnet technology in a variety of energy, healthcare and research applications. It is depressing overall margins and obscuring the strengths of the mature businesses, but also has value that could be highlighted through a sale or partial sale.

Is one potential headwind here that scientific research funding is at risk in times of austerity?

CM: People who are negative on Bruker are likely assuming that, but we disagree. Just because we’re in a slow-growth global environment doesn’t mean the world is getting any less competitive. Spending for fundamental science is if nothing else meant to enhance the competitiveness of countries, industries and companies. Could there be moderation in spending? Of course, but we just don’t see major cutbacks for the type of applications the company supports.

How inexpensive do you consider the stock at a recent $14.75?

CM: The share price today is weighed down by the weak margins and a large
European exposure, but if we look out five to seven years we believe the steps the company can take to improve operations can translate into earnings growth of 10% annually.

What particularly grabs me is that Bruker trades at 1.25x our 2014 revenue estimate, while private-market transactions in this space typically take place well north of that. Thermo Fisher Scientific paid 5x sales for Dionics. Germany’s Merck bought out Millipore at over 4x. Danaher paid 2x for Beckman Coulter. At even 2x revenues, the stock would be worth $23-24 per share.

They’ve proven to be very good buyers, looking with rare exceptions to arbitrage paying, say, 6x EBIT for something that is worth 9-10x within Dover because they’re able to extract costs and incrementally grow the business. There are sometimes manufacturing synergies, but more often the leverage comes from things like purchasing skill or the cross-selling of products and services to the same customer.

The company has also proven more than willing to shed businesses, such as semiconductor testing, for example, when it felt it could no longer compete effectively. There’s no undue attachment to what they own and they don’t fight losing battles. As a result the business mix can evolve quite significantly over time, so far consistently for the better.

How do you assess what something like this, now trading at $64, is worth?

CM: We look at each of the four operating lines and focus first on potential revenue growth. We’re looking for better-than 10% annual growth in communication technologies, 8% growth in energy, 7% growth in what they call printing and identification, and 6% growth in engineered systems. Management has been very good at margin control in the various units, so we assume modest operating leverage as they grow. That all results in an estimate of 9% annual growth in earnings power over the next few years.

To arrive at intrinsic value we apply a less than 12x multiple to our $1.7 billion 2014 estimate of earnings before interest, taxes and amortization. That yields a per-share value of around $110.

This would appear to be a particular bet on management’s acumen.

CM: That’s always an important element of our investment cases, but success here clearly hinges on management’s ability to continue to effectively manage the portfolio of businesses. What’s kind of interesting is that you don’t come out of a meeting immediately wowed by their articulation of what they’re doing. But the more you
INVESTOR INSIGHT: Clyde McGregor

INVESTMENT SNAPSHOT

Dover (NYSE: DOV)


Share Information (@11/29/12):
- Price: 64.01
- 52-Week Range: 50.27 - 67.20
- Dividend Yield: 2.2%
- Market Cap: $11.46 billion

Financials (TTM):
- Revenue: $8.43 billion
- Operating Profit Margin: 15.4%
- Net Profit Margin: 11.0%

Valuation Metrics (@11/29/12):
- P/E (TTM): 12.8
- Forward P/E (Est.): 12.3
- EV/EBITDA (TTM): 7.8

Largest Institutional Owners (@9/30/12):
- Vanguard Group: 5.1%
- Harris Associates: 5.0%
- FranklinTempleton: 3.6%
- BlackRock: 2.7%
- Capital Research Global Inv: 2.7%

Short Interest (as of 11/15/12):
- Shares Short/Float: 2.7%

DOV PRICE HISTORY

THE BOTTOM LINE

While the market appears to perceive the company as an old-style and uninteresting industrial conglomerate, it has in fact proven to be a dynamic manager of an ever-evolving portfolio of solid-growth businesses, says Clyde McGregor. At 12x his 2014 estimate of earnings before interest, taxes and amortization, the share price would near $110.

Sources: Company reports, other publicly available information

watch them, the more you see they make a heck of a lot of sensible decisions and definitely know how to execute.

Describe something you sold recently for a reason other than valuation.

CM: PepsiCo [PEP] was something we owned mainly for its industry dynamics and dividend yield. It was a profitable holding for us, but let’s just say that occasionally our thesis that management is aligned with shareholders’ interest evolves. As our exposure to management increased, our confidence decreased meaningfully. We’ll see – believe it or not, there are a few companies that have thrived even though we have sold them.

Can you generalize about your mistakes?

CM: The big mistakes in my investing career have been in looking for reversions to the mean in businesses with good cash flow and balance-sheet attributes, but where the mean was shifting meaningfully downward. One painful example was Idearc in the Yellow Pages business. It did not occur to me early enough that the business would just disappear as it has because of the Internet. A reversion to the mean would have produced a very good outcome, but the mean disappeared. That’s why getting the durability of the business right in our analysis is so important.

Many investors we speak with today could be characterized as short-term pessimists but long-term optimists. How would you describe yourself in that regard?

CM: For me the first issue in assessing risk exposure is how the equities in the portfolio are priced versus their intrinsic value per share. Overall that has typically been in the 60-70% range. We’re right in the middle of that range today, and that’s with all but maybe 8 of the 50 or so equity names in the portfolio showing a profit.

American industry is showing considerable resilience and ability to, maybe thrive is too strong, but do fairly well in a low-growth, uninteresting economic environment. Were things to become meaningfully better, there’s likely to be a levered benefit to equities as a whole, which we’re betting should be even more pronounced for the stocks we own.

A more robust economy accompanied by rising interest rates makes it a dicier call. The history of rising interest rates has not been a happy one for equity investors. John Templeton is famous for saying that the most dangerous words in investing are “This time things are different.” We can maybe hope that this time things will be different, given that the reason interest rates are so low is artificial, caused by financial repression rather than the best estimate of the bond market of where interest rates should be today. I don’t mean to imply it’s a perfect analogy, but after World War II the long bond was held down by the Fed for a number of years and as rates went up in the 1950s it did not have a negative effect on the stock market. It is possible, at least, that interest rates could go up over the next few years accompanied by a decent equity environment as well.
### Average Annual Total Returns
(as of 9/30/12)

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<td>17.19%</td>
<td>7.40%</td>
<td>3.77%</td>
<td>8.75%</td>
<td>10.57% (11/1/1995)</td>
<td>0.77%</td>
</tr>
</tbody>
</table>

*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. 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, 2012, the following equities were held as a % of the total net assets:

<table>
<thead>
<tr>
<th>Security Title</th>
<th>Oakmark Equity &amp; Income Fund (OAKBX)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agilent</td>
<td>0.0%</td>
</tr>
<tr>
<td>Bank of America</td>
<td>0.0%</td>
</tr>
<tr>
<td>Beckman Coulter</td>
<td>0.0%</td>
</tr>
<tr>
<td>Blount International</td>
<td>0.1%</td>
</tr>
<tr>
<td>Bruker</td>
<td>0.2%</td>
</tr>
<tr>
<td>Comerica</td>
<td>0.0%</td>
</tr>
<tr>
<td>Danaher</td>
<td>0.0%</td>
</tr>
<tr>
<td>Devon Energy</td>
<td>2.0%</td>
</tr>
<tr>
<td>DHL</td>
<td>0.0%</td>
</tr>
<tr>
<td>Diageo ADR</td>
<td>3.1%</td>
</tr>
<tr>
<td>Dover</td>
<td>2.5%</td>
</tr>
<tr>
<td>eBay</td>
<td>0.9%</td>
</tr>
<tr>
<td>Eli Lilly</td>
<td>0.0%</td>
</tr>
<tr>
<td>FedEx</td>
<td>1.9%</td>
</tr>
<tr>
<td>Johnson Controls</td>
<td>0.0%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>0.0%</td>
</tr>
<tr>
<td>Lab Corp of America</td>
<td>2.0%</td>
</tr>
<tr>
<td>Lear</td>
<td>0.9%</td>
</tr>
<tr>
<td>Merck</td>
<td>0.0%</td>
</tr>
<tr>
<td>Millipore</td>
<td>0.0%</td>
</tr>
<tr>
<td>Omnicare</td>
<td>0.9%</td>
</tr>
<tr>
<td>Pepsi</td>
<td>0.0%</td>
</tr>
<tr>
<td>PharMerica</td>
<td>0.1%</td>
</tr>
<tr>
<td>Quest Diagnostics</td>
<td>1.9%</td>
</tr>
<tr>
<td>TD Ameritrade</td>
<td>0.4%</td>
</tr>
<tr>
<td>Thermo Fisher Scientific</td>
<td>0.0%</td>
</tr>
<tr>
<td>UnitedHealth Group</td>
<td>3.2%</td>
</tr>
<tr>
<td>UPS</td>
<td>0.0%</td>
</tr>
</tbody>
</table>
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.

To view the full list of Oakmark Equity and Income Fund holdings, please visit Oakmark.com.

The Oakmark Equity and Income Fund invests in medium- and lower-quality debt securities that have higher yield potential but present greater investment and credit risk than higher-quality securities. These risks may result in greater share price volatility. An economic downturn could severely disrupt the market in medium or lower grade debt securities and adversely affect the value of outstanding bonds and the ability of the issuers to repay principal and interest.

The Lipper Balanced Fund Index measures the performance of the 30 largest U.S. balanced funds tracked by Lipper. This index is unmanaged and investors cannot invest directly in this index.

Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

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.

The discussion of investments and investment strategy of the Fund (including current investment themes, the portfolio manager’s research and investment process and portfolio characteristics) represents the investments of the Fund and the views of Clyde McGregor, Win Murray and Harris Associates L.P., the Fund’s investment adviser, at the time of this call, 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 (1-800-625-6275).

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