

# ValueInvestor

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The Leading Authority on Value Investing

## INSIGHT

The following excerpt, reprinted with permission, is from a feature interview with John Rogers that appeared in the May 28, 2010 issue of *Value Investor Insight*.

### INVESTOR INSIGHT



**John Rogers**  
Ariel Investments

*"Looking out more than a year, there are plenty of values out there, particularly in what we consider light cyclical stocks."*

**Where do you give yourselves high marks in navigating the crisis?**

**John Rogers:** We've traditionally been active investors in financial services, but we did a very good job avoiding the financial companies that could – and, as it turned out in some cases, did – spiral down to nothing. We did a lot of work on companies like Countrywide, MBIA and Ambac, but stayed away from them when it counted because we didn't overly discount the fact that these types of companies, and some of the banks, could literally go away. As dyed-in-the-wool contrarians, we could have assumed the worst expectations were being overdone, but in these cases, thankfully, we didn't.

We also didn't let the pain of the decline keep us from buying our favorite stocks as they got cheaper and cheaper.

You can basically do three things in such a situation: sell, hold what you have, or buy more. In most cases we bought more, which accelerated our comeback as the market turned up. From the market bottom on March 9, 2009 our largest mutual fund, the Ariel Fund, was up more than 150% through the end of April. The standouts for us over that time were Gannett, the newspaper publisher, real estate services companies like CB Richard Ellis and Jones Lang LaSalle, and higher-end retailers like Nordstrom and Tiffany.

**Where have you been critical of yourself?**

**JR:** We didn't manage our exposure to media companies well. In our newspaper holdings, we didn't put enough weight on the erosion in classified advertising that just wasn't coming back due to competition from the Internet. When that important secular decline was combined with the terrible cyclical downturn in advertising spending, our newspaper stocks got hit pretty hard. A second broader problem was that if you'll remember, media was considered this great cash-flow business, so companies got comfortable with higher leverage to finance acquisitions or in some cases to appease shareholders through stock buybacks or increased dividends. When the recession hit, those more leveraged media companies got particularly slammed.

**Have you made any strategy or process adjustments in the aftermath of the crisis?**

**JR:** We're putting increased importance on our senior portfolio managers being fully engaged in the ongoing dialog with management. That's not something to delegate and then read a report on. I have to be visiting people face to face, attending conferences, and sitting in on the conference calls. Successful investing, especially during times of stress, requires conviction, which is hard to truly have unless you're really out there yourself.

Another thing we've worked on, as I'm sure many have, is to tighten up our balance sheet analysis. We think we've always been conservative, balance-sheet-aware investors, but the crisis has only reinforced the importance of being certain that even the greatest business you've identified can't be driven into the ditch because of risks on the balance sheet. One key aspect of this is looking closely at what the credit markets – for example, in terms of bond or CDS prices – are saying about the companies we own.

**Where are you seeing opportunity today?**

**JR:** We've been increasingly optimistic that the economic recovery is real, which should lead to upside surprises in select areas. Looking out more than a year, we believe there are plenty of values out there, particularly in what we consider the light cyclical stocks. Those include companies in financial services such as Lazard [LAZ], T.Rowe Price [TROW] and Janus [JNS], and industrials like Illinois Toolworks [ITW] and IDEX [IEX]. In the restaurant-equipment business we

like Middleby [MIDD], which is well-positioned to benefit as people start eating out more as the economy improves and delayed restaurant capital improvements get made.

**You're still a large holder of Hewitt Associates [HEW], which you recommended when we first spoke [VII, October 30, 2005] as a beneficiary of the secular trend toward the outsourcing of corporate services. Is that still the thesis?**

**JR:** That, as well as the fact that the human resources-related consulting expertise Hewitt is known for is more important to companies than ever. That's a function of the need to compete in an increasingly global competitive environment, as well as having to deal with significant changes coming out of Washington in areas like executive compensation and healthcare.

Hewitt's business-process outsourcing division has been a drag on operations over the past few years, a result of the company emphasizing market share over profitability in taking on earlier big contracts. We think that business has stabilized, is much better managed, and has excellent growth potential as cost-conscious companies continue to outsource administrative HR tasks. The market doesn't seem to have bought into that yet, with the shares [at a recent \$37.40] trading at around 11x the consensus \$3.25 per share earnings estimate for 2011. Our fair value on the stock is closer to \$60.

**Describe what you find interesting about Lazard?**

**JR:** Lazard is the world's largest independent financial advisory firm, with three legs underpinning its business. The first two have kept it in the game through the crisis and the third is a big reason we think the stock is undervalued.

The brightest spot for Lazard has been the firm's restructuring business, which provides advisory services to companies in financial distress. We believe their independence and experience in this business is a key competitive advantage, and

would expect restructuring to be a core area of growth over the next few years as companies work through damage done by the economic crisis.

The second leg of the business is asset management, which had around \$135 billion in assets as of the end of March. Given the company's global footprint, it has been quite successful in creating and selling global and non-U.S. investment products – particularly those investing in emerging markets – which is where the most attractive growth is likely to continue to be in years ahead.

The crown jewel of the company historically has been its mergers-and-acqui-

sitions advisory practice, which suffered in the crisis. Lazard specializes in advising large-cap, cross-border M&A transactions, which we believe are going to accelerate from an already picked-up pace as economies mend, cash-rich companies look to improve their competitive positions, and as some of the enormous amount of private-equity cash out there starts to be deployed.

We don't think any investment bank has the combined contacts, management, expertise and reputation that Lazard has in the deal business, which positions it perfectly as more deals get done. A great example of this is the company's recently

**INVESTMENT SNAPSHOT**

**Lazard**  
(NYSE: LAZ)

**Business:** Global provider of financial advisory and asset management services to corporations, governments and high-net-worth individuals.

**Share Information**  
(@5/27/10):

<b>Price</b>	<b>32.96</b>
52-Week Range	25.20 – 44.62
Dividend Yield	1.5%
Market Cap	\$2.96 billion

**Financials** (TTM):

Revenue	\$1.71 billion
Operating Profit Margin	7.2%
Net Profit Margin	(-6.4%)

**Valuation Metrics**

(@5/27/10):

	<b>LAZ</b>	<b>S&amp;P 500</b>
Trailing P/E	n/a	17.7
Forward P/E Est.	15.0	13.2

**Largest Institutional Owners**

(@3/31/10):

<b>Company</b>	<b>% Owned</b>
Lord Abbett & Co	6.8%
Bank of New York Mellon	6.7%
T. Rowe Price	5.4%
Pioneer Inv Mgmt	4.9%
Deutsche Bank	4.6%

**Short Interest** (as of 5/14/10):

Shares Short/Float	2.4%
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**LAZ PRICE HISTORY**



**THE BOTTOM LINE**

No investment bank matches the company's contacts, management, expertise and reputation in the mergers-and-acquisitions business, says John Rogers, making it a prime beneficiary of a more active deal environment. Based on both DCF and sum-of-the-parts analyses, he believes the fair value of the shares today is around \$53.

Sources: Company reports, other publicly available information

being named to manage General Motors' public offering. It surprised people that Lazard got the engagement, but we think there are many more opportunities like that to come. The Street isn't giving them nearly enough credit for that.

**With the shares just under \$33, what upside do you see as that credit is earned?**

**JR:** We come at valuation in a variety of ways, including a discounted cash flow analysis and a sum-of-the-parts calculation based on market comps for their compo-

nent businesses. At today's price, the shares trade for 12x consensus 2011 earnings estimates of around \$2.75 per share, which we think is likely to turn out to be conservative. Our fair value on the shares today is around \$53, which puts them at nearly a 40% discount. That's quite significant in the current environment.

**What's the biggest investing lesson you've learned from the past two years?**

**JR:** It's nothing people like Warren Buffett and Charlie Munger haven't been saying

for decades, which is the importance of thinking long-term. You may or may not be right about your long-term views, but if you get swept up in the daily or weekly ups and downs of the market, what's most likely to happen is that you give up on the market at exactly the wrong time. We have a resilient economy that over a long time – and through crises worse than what we're currently experiencing – has always gotten back on track. Focusing more on how that plays out than on what's happening to your portfolio right now is just a far saner way to invest. **VII**

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