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Ariel Investments 3rd Quarter 2022

Portfolio Manager Conference Call

00:00:14 JENN DIGRAZIA: Welcome to the Ariel Investments Portfolio Manager Market Update call. I am Jenn Digrazia, Head of Institutional Client and Investor Relations at Ariel Investments. Prior to delivering our prepared remarks, I must read the following disclosures.

00:00:28 Please note performance data quoted represents past performance, which does not guarantee future results. Performance data also assumes reinvestment of dividends and other earnings. With regards to holdings, please be advised that we cannot speak about any current activity regarding a specific stock held within Ariel's mutual funds. As such, a discussion may lead to selective disclosure.

00:00:52 Please visit our website at arielinvestments.com for additional information. After today's presentation there will be an opportunity to ask questions. You may submit online questions at any time using the window to the right of the video player. Please note this event is being recorded.

00:01:11 In anticipation of any questions you might have, I am joined by John Rogers, Jr., Chairman, Co-CEO and Chief Investment Officer, Melody Hobson, Co-CEO and President, Rupal Bhansali, Chief Investment Officer of International and Global Equities, Charlie Bobrinskoy, Vice Chairman and Portfolio Manager, Ariel Focus, and Tim Fidler, Co-Portfolio Manager, Ariel Mid Cap Value Portfolios.

00:01:43 This call is scheduled to last an hour. We will have opening comments from Melody Hobson, and then we'll begin to field the questions submitted in advance of this call, as well as any questions you submit in real-time using the window to the right of the video player.

00:01:58 We would also be delighted to make any of our teammates available following this call should you request a deeper dive on any specific issue. I will now turn the call over to Melody Hobson to discuss performance results.

00:02:11 MELODY HOBSON: Thank you so much, Jenn, and it's great to be here with my colleagues to talk to you

about admittedly what has been a very challenging time in the markets. We actually really welcome these opportunities when times are very tough, so that we can help you understand what we're thinking, what we're doing, what we're seeing, how we're positioning the portfolio, and what our outlook is, not only for our own portfolios but for the markets in general.

00:02:39 So thank you for being here. We have a big group of people on the call, so we know there's a lot of interest right now in the markets and our thinking. In just two months we're going to be 40 years old. It is remarkable to think about that as a firm. We have four decades of history under our belt. This milestone is significant not just for the time that we've spent honing our craft and really developing and evolving our patient investing philosophy, but it's significant for the types of markets that we've lived through, particularly the difficult markets.

00:03:11 By our count this is our fifth market that has been quite challenging. In our earliest days the crash of 1987 challenged us and it was a period we talk about often, where we went to our clients and asked them on

that fateful day to send us more money because we thought we were seeing once in a lifetime values. Now of course that was extremely naïve, when you think about the markets that have followed since then.

00:03:38 Of course in the dot com era that was a very challenging time for value managers, but when that bubble burst we were vindicated. And then of course the great recession, 2008, the hardest period in the history of our firm. Our most challenging period for not insulating on the downside, but ultimately coming out of that period extremely strong by doing what we do, and staying committed to value investing.

00:04:02 And then of course a period that took all of our breaths away, the COVID drop. The fastest bear market in stock record history, but also one of the fastest recoveries we had ever seen. And so now it seems we're back again in another difficult period in the market, in 2022. In some ways I feel like we've all become firefighters.

00:04:24 But the one thing I can tell you about this period, even though these periods feel very painful, even

though I can tell you, we hate losing money, we also know these periods create great opportunities and we say this time and time again. We go to the Ariel playbook. It's a time of great calm in our firm because we realize that we're sitting, as we pick through the wreckage, we're shopping for years of future performance. And that's what you will hear us talk about today.

00:04:51 So let me start with performance specifically, since I just mentioned that. And we'll put the performance charts up for you to see. For our domestic equity portfolios, a difficult third quarter did negatively impact our year to date returns ending September 30th. More specifically, our small, small concentrated, SMID, MID and focused value domestic equity portfolios underperformed our primary value benchmarks, either closely tracked or slightly underperformed our core indices through September.

00:05:25 A more granular look shows the sector biases that we have that have really made the difference. More specifically, our focus on fee-generating versus interest rate sensitive financials are underweight in

the hard to predict energy sector. Market backlash related to any issues that even have a whiff of cyclicality, that all led to us being penalized for the quarter.

00:05:50 Now it's worth noting the October numbers are not locked yet; but we did close the gap in October because we did have a significant outperformance during that period as the market staged a comeback. By contrast, when you look at our international and global portfolios, they too had a more difficult third quarter. However, it did not dislodge their strong outperformance for the year to date.

00:06:17 And contrary to the domestic portfolios outperformance of the month of October, the international and global strategies lagged which is not surprising given their positioning. So since we have received, and we can take the performance charts down, since we have received a significant number of questions, we got flooded with questions before this call, when this call was announced we've decided to forego any opening comments and instead go right to the questions.

00:06:46 And since there was a question very much about performance of the international and global portfolios, we're going to lead with that and I'll let Rupal respond to that specifically and how those portfolios are positioned. But before we dive in I have one last note. I think you all know we are bottom-up stock pickers at Ariel.

00:07:04 We don't spend a lot of time on macroeconomic prognostications or forecasts. However, we know that the current economic environment is on a lot of peoples' minds and we got a lot of questions about that as well. We'd like to give you our views on the economic environment; however we also want you to know there are differing views within our firm.

00:07:26 It's one of the things we most value about Ariel is our diversity, and that includes diverse opinions. So you may even hear us not agree in that regard as it relates to some of the macroeconomic backdrop that exists today and what it might be in the future. So with that, I'm going to turn it over to Jenn and ask her to then start the questions. Thanks so much.

00:07:46 JENN DIGRAZIA: Thanks, Melody. So as Melody mentioned, we're going to start with Rupal. Rupal, the global and international portfolios are outperforming on a year to date basis, but gave up some ground over the third quarter. Can you please speak to the trends of these atypical results?

00:08:04 RUPAL BHANSALI: Sure. You're correct to note that it's pretty typical for us to outperform in a down quarter and yet this quarter in the markets were down high single digits, we were down even more than that. It's not because anything has changed about the way we manage money for you or the way the portfolios are positioned; it was a coincidental development because of intra-quarter developments which don't show up in the full quarter.

00:08:32 If you look at our month by month performance, in the very first column you see the month of July which was a risk on rally in the markets and that's the period during which our performance lagged the most. In the two subsequent months when the market corrected, we were either in line with the market, or slightly ahead as is, again, typical for us.

00:08:53 So rest assured that even though for the quarter it appears like we under-performed during down months, our performance patterns have not actually changed. Now what happened that led to this outcome? It was really idiosyncratic developments that occurred coincidentally in this quarter, they could have occurred in June, they could have occurred in October, but they happened to be in this quarter and they hurt us quite a bit.

00:09:17 Those three big detractors are GlaxoSmithKline, a healthcare company, Baidu, which is a Chinese media company and Direct Line, a UK auto insurance company. As you can tell already from these three names, they're businesses are quite different from each other, which is why I say they were uncorrelated idiosyncratic developments that hurt us, not some sort of overall positioning.

00:09:43 With respect to Glaxo, there was a class action lawsuit that gave the market fright. This is in regards to Zantac, which is a drug that had been on the market for almost 40 years. It's a very routine

antacid that's prescribed for heartburn. Maybe of us may be familiar with it. We can buy it over the counter, antacids, in the early days it used to be prescribed.

00:10:08 There was one particular laboratory testing that got the attention of the FDA in 2020 again, 38 years or so after the drug had been on the market, that there could be some ingredient that causes cancer. Now this ingredient is also present in other drugs, and it's also present in food products that we eat. It's a question of the dosage and the way that particular ingredient and the drug were stored.

00:10:32 The jury is out on this. Obviously that's why there is litigation going on to settle who is, what is at stake here. However, when there's a jury trial and it's a class action lawsuit, it is often the case that the stock market takes fright and fears the worst. And that certainly happened in this case where close to $40 billion dollars' worth of market cap was lost in a slew of companies, predominantly Glaxo, which had been the predominant owner of this drug over this period.

00:11:02 Because there's been M&A activity, this drug has changed hands and most recently sits with Sanofi also not a company in the portfolio, but nonetheless Glaxo was hit the hardest because of its longest period of ownership. Our assessment, and again, with any litigation, it's always hard to make a poll, but generally speaking looking at other proxies and doing some deep diligence or due diligence ourselves, we believe the case is more likely to be settled with a liability in the low single digit billions, whereas a kind of market cap that got wiped out across the spectrum was, as I said, almost ten times as large.

00:11:41 And so we do not agree with this degree of selloff. We understand that we took it on the chin this quarter. I'm pleased to report that the stock has already started to rebound as we expected. And we did take advantage of the selloff to act to the position again. It's not pieces busting, it's certainly a wrinkle and certainly a sort of risk that does emerge from time to time, but nothing that shakes us for the overall pieces or exposure to the company.

00:12:03 The other two stocks that corrected hard as I mentioned were Baidu. This was not unique to Baidu. All the Chinese stocks have sold off hard in the third quarter of this year. A lot of it is driven by the very weak economic activity in China. Because unlike the rest of the world that has pretty much put COVID behind it, China continues to have a pretty draconian zero COVID policy.

00:12:30 And that has caused dislocation, especially for companies who depend upon economic growth for their earnings, as Baidu does to a large degree because it is advertising-led business model and advertising is linked to GDP. We do believe that this is a delayed demand, not a denied demand. As we have seen in most parts of the world when the COVID situation normalizes, you see a lot of pent up demand unleashed and we expect that to happen in China as well.

00:12:57 And the third stock, Direct Line, happens to be a UK based auto insurance company. We all know that there's been a shortage of autos, of car production, because of the shortage of semiconductor chips, as well as a shortage of auto parts. Now for any insurance company

the biggest cost tends to be when a car gets into an accident, replacing the car or repairing the car.

00:13:20 And the cost of doing that has gone up a lot which is why Direct Line had a profit warning and the stock got hit hard. It is not unique to this company. It is across the entire sector, which is why we are seeing that all the UK car insurance companies are raising their prices. However there's a lag effect because not everybody renews their car insurance policies all the time. It happens once a year.

00:13:42 And as these quarters roll off, as we look ahead to 2023, not only will the price increases have taken hold, by that time we do believe some of these supply shortages would have abated and their claims inflation cost would have come down such that the profit picture improves dramatically.

00:13:58 So I think overall nothing more to report except that it was a difficult quarter for us performance-wise. We're never pleased. But rest assured nothing has changed about the way we manage risk on your behalf or the downside protection that we are known for. Many of

these stocks have been hit temporarily in our view, and the earnings power and the overall risk reward looks quite compelling and we continue to own those names.

00:14:22 JENN DIGRAZIA: Thanks, Rupal. John, could you provide some color around the headwinds for the small and mid-cap value portfolios have been facing in 2022 relative to the Russell 2000 Value and Russell 2500 Value benchmarks? And also as Melody just mentioned, while it’s not depicted on the performance charts that were just up on the screen, you have seen a noticeable pickup in October. Can you elaborate on how performance is evolving?

00:14:50 JOHN ROGERS: Thank you. As Melody suggested earlier, we’ve been through several cycles like this over the 40 year history of Ariel. And I have to say, this has been one of the most unusual ones. It’s seemingly companies that have any touchpoint to being slightly cyclical, whenever the markets are down and there’s a fear there’s going to be a recession, stocks seem to be getting crushed way more than what we think is valid.

00:15:21 We've been on the calls just in the last several days with half a dozen of our portfolio holdings. And in every instance, the managements cannot quite understand why the stocks are so significantly underperforming their peer group and the benchmarks during this period. They're sort of confounded by it. They seem to think the stocks are all sort of again significantly undervalued. And it's this really, really unique time.

00:15:47 We think these companies are well-positioned that as the economy stabilizes and peoples' fears start to stabilize and things get back to normal, these companies are going to react very, very strongly and October gave a sense of that, but we think that you'll start to see that as we go into 2023 and into 2024. There's just a sense that these great, great businesses that we've been investing in have strong balance sheets, strong brand, strong moats around them, will thrive as we go through the cycle.

00:16:17 The other thing that I would say that is different this time is that energy has been such a strong

forceful power of performance. Melody mentioned it during her opening remarks. And we have not, over the 40 years invested in pure commodities. That's something that has not been part of our playbook. And there was a story just the other day where Larry Summers talked about the fact that even as Exxon has outperformed this year dramatically, it still has underperformed significantly over the last five years.

00:16:50 So our lack of energy has helped us over the long run. So hard to predict commodity prices, but in this environment, the war in Ukraine raging, energy price has gone much higher than anyone anticipated which really has given us a significant headwind to go up against.

00:17:07 But at the end of the day one of the things that Charlie and I talk a lot about, you know, the data is that right now in our research group our companies are selling at more than a 40 percent discount to its private market value. And that has happened very rarely, only four times and I know we'll touch on that a little bit later, but I just wanted to reemphasize it.

00:17:24 That we have always bounced back significantly whenever our stocks are this cheap relative to the market. And as was mentioned earlier, it is really fun and exciting to be able to see great businesses that you can buy at bargain prices. And when you get, have a chance to take advantage of the volatility, we think it ultimately is what's provided us the opportunity to outperform when we come out of these cycles.

00:17:46 So really appreciate the question and we do think that our small and mid-cap value products are very well positioned in the current environment for outperforming to the end this year, and move into 2023.

00:17:59 JENN DIGRAZIA: Thanks, John. Before I move on to another question, Charlie, do you have anything to add in terms of sorts of comfort in this bear market environment? Anything that you'd like to add to John's comments?

00:18:09 JOHN ROGERS: Sure, maybe I can quantify some of the points that John made. Do you have the slide showing

our discount to intrinsic value? Great. So Rupal and John and Melody all mentioned that we think our stocks are trading at good values and we want you to know that that's not just a seat of the pants observation. Every day we calculate an intrinsic value, what we call a private market value, for each of our stocks and then we compare it, stock price, to that value.

00:18:37 And then we track over time the discount that our portfolio is trading at to that private market value. And private market value is three inputs. It's a discounted cash flow analysis of each stock. It's a full and fair trading value of where a stock should trade once the short-term headwinds are gone.

00:18:56 And then it's, very importantly, the change of control valuation. What could this company be sold for if they hired an investment banker to sell the whole company? We average those numbers and come up with a private market value. And then over time we graph the discount that our portfolio is trading to that private market value.

00:19:12 And what you can see is that over the last 15 years there have only been four times when the portfolio has traded at more than a 40 percent discount to that intrinsic value. The first time was in March of 2009 at the very bottom of the market when it was at a 50 percent discount. In September of 2011, when we had the European sovereign debt crisis and S&P downgraded the US government from triple A to double A. We had a 43 percent discount.

00:19:39 Then at the very bottom of COVID, in March of 2020, we had a 46 percent discount. And then this September 30th we had, after this downturn related to cyclicality and fear of a recession, we had a 44 percent discount. Now as all the lawyers always say, past performance doesn’t guarantee future results.

00:20:01 But in each one of these times it’s been a wonderful time to invest in value stocks. And there is a fair amount of research that shows that one of the best predictors of future performance is low PE, low valuation tends to be a good time to invest for the long run. Now we should say these were numbers at the end of September. We had a great October, so this

discount is going from maybe 44 to 39, but still a very, very attractive discount for this mid portfolio.

00:20:32 JENN DIGRAZIA: Thanks, Charlie. And I want to emphasize that Charlie is speaking about the domestic value portfolios. It's small, small concentrated, small mid or SMID portfolio, as well as focus when he was talking about those slides. Rupal looks at a different characteristic. She buys when there's a sufficient margin of safety between our calculation and the intrinsic work of the business and the stock price and she doesn't necessarily calculate PMV or Private Market Value the same way the domestic team does.

00:21:04 So moving on, as Melody mentioned earlier, we are not macroeconomic. We don't look at the things in terms of macroeconomic forecasts, but we do have views and opinions on them. So we're going to move on, and we're going to talk about that. The next couple of questions are related to macro economy. And we're going to start with Charlie. And the first question is, it appears the Fed has not finished tightening and the US yield

curve remains inverted. Is the recession becoming more likely in the US? Is it priced in?

00:21:34 CHARLIE BOBRINSKOY: That is the question. So we came to the beginning of this year with really four big macro themes. As everyone has said, we're not macro investors. We try to invest in great companies when they're trading at a discount. But sometimes macro themes do drive the market, do drive short-term performance and do give us opportunities, and now is one of those times and clearly the Fed is driving that.

00:21:58 So we came into this year thinking that inflation was going to be higher than people thought and be persistent. We thought that interest rates were abnormally low at a 1.6 percent ten years and they would rise a lot. We thought that rising interest rates would be relatively better for value stocks than growth stocks.

00:22:16 Those were three themes that we think we got right. The fourth theme was that we thought the market was over-estimating the probability of a recession. When

we talked to our portfolios, they thought that their customers were in good shape, the consumer was in good shape, the labor market was in good shape. So we did think the market was over-estimating the probability of a recession.

00:22:37 Now the good news is as long-term investors, we could be wrong on that and still come out right in the long-term. But what has happened is that as the Fed went from extremely accommodative, buying $90 billion dollars’ worth of bonds per month to taking its foot off the accelerator, to slamming its foot on the brakes. And now going from accommodating to extremely restrictive, we now have a Fed that does seem to be almost intentionally trying to cause a recession or at least a big downturn in the labor market in order to relieve inflation.

00:23:15 And that is a change, and I do have to admit that we would say the probability of a recession is higher today than we would have thought at the end of the year. We’re still not sure it’s a hundred percent. We don’t think the market is even saying it’s a hundred

percent, but there just is no denying that the Fed seems to be intent on slowing down this economy.

00:23:35 JENN DIGRAZIA: Thanks, Charlie. Tim, with persistently high inflation many companies are passing along the increase in costs to the consumer by way of price increases. Are margins holding up? Are you beginning to see signs of demand destruction?

00:23:51 TIM FIDLER: Yes. So, this phenomenon started taking place in Q1, was in full swing in Q2, and then continued in Q3. And we're talking double digit price increases here, and that's fairly well-distributed across all industries. On the cost side the primary culprits are labor, input costs, supply chain related pressures, still working its way through the value chain, eventually making it to the end market consumer.

00:24:15 But you know, now we're there. These prices have showed up at sort of final markets. We see in our later cycle industrials, our consumer discretionary names, in the form of materially higher finished good prices. But the silver lining result here is that

margins have been resilient and stable for the most part.

00:24:34 So that really begs the question, you know, what are we seeing on demand destruction. And if we start with this assumption that monetary policy works on sort of a six to nine month lag, which is a reasonable rule of thumb for sure, the evidence is high that this is actually playing out at our portfolio companies consistent with this timeframe and very much as the Fed would hope to see it play out.

00:24:55 And if we think about the transmission mechanism that the Fed policy follows, it shows up first in higher interest rates, first in our financials. We see net interest margins expanding, we see loan growth moderating, we see cost of capital increasing and capital basis are affected. Additionally, obviously risk assets including real estate began to reprice broadly across the space.

00:25:14 So from there we see it spread to housing, other big ticket items that need more expensive financing, and now at higher prices. And again we've seen clear

evidence that we're moving along those demand curves that are certainly more elastic than say consumables or services. And eventually we'll more than likely see wealth effects spread too.

00:25:33 So, specifically in the Q3 reports from our companies, we're still seeing inventory channels normalize from heavy COVID related disruptions. We're not done with that and that muddies the demand picture a little bit. There's additionally strong concern around Q4 in Europe which we've already brought up a number of times here.

00:25:48 The general consensus at our companies is definitely that Europe is in recession. A strong dollar isn't helping translate those earnings back either. So net-net, low visibility for sure, but it's hardly a collapse in demand at this point. It really, as John alluded to earlier, our companies are surprisingly constructive if you sort of look past the headlines.

00:26:07 There's some talk of employment attrition policies being put in place, and some isolated cost cutting. But that's more for those further along the curve

that's been impacted by the Fed actions. But all things considered, the impact and scope is mild.

00:26:20 I guess in summary and to conclude, I'd be remiss if I didn't point out that the health of the financial system and consumer balance sheets are in excellent shape certainly relative to '08, '09, and that we believe will moderate any downturn we do experience. I could say the same thing for corporate balance sheets as well.

00:26:37 You know, it's reasonable to assume that things are going to get bumpy as Fed policy actions continue to take firmer root in the economic landscape, but we've certainly seen worse. So I'd say that's a pretty good survey of what we're hearing from our companies.

00:26:49 JENN DIGRAZIA: Thanks, Tim. As Charlie mentioned, Rupal, he things the risks of recession in the U.S. have gone up. Do you agree, and globally what do you think's ahead?

00:26:59 RUPAL BHANSALI: Yes, I think on this one we do agree. In fact, I think that even what Tim says is something

that we have seen as well from our company portfolio holdings as well which is to say that currently the situation is not as bleak or bad, but I think stock markets tend to discount the future. And while the U.S. consumer currently is very strong, and clearly we just did another stimulus in the form of the student loan forgiveness that was almost another half a trillion dollars, you know, put into the economy, $450 billion dollars perhaps to be more precise and I think that that has really helped the U.S. economy and the U.S. consumer.

00:27:44 But I think we want to be careful. You know, markets look forward, not back. And because consumer spending accounts for 70 percent of GDP, in most developed markets, but the U.S. especially, it's no wonder that the U.S. economy has held up. That actually is exactly the problem, frankly, because the Fed needs demand to slow down.

00:28:06 And this is working against what the Fed is trying to accomplish, which is bring inflation under control. And part of that equation implies that the rate hikes are going to remain with us at a higher rate and for a

longer period. This is what (unint.) has been trying to broadcast because the Fed lost some credibility in the prior period. It’s going to take some time for the market to digest this change point of view.

00:28:31 I think 2022, clearly, we have not seen a recession of any consequence and I don't think we’re going to see one. Monetary policy acts with a lag, so I think this is much more of a 2023 development. I also believe that the bigger picture to focus on is not just the dot plot or the Fed rate increases, although they’re important and clearly they’ve caused a reset in the risk re-rate, and therefore all risk assets get re-priced.

00:28:57 The larger issue I think we need to focus on is the regime change that is underway from a decade long period of quantitative easing post-financial crisis to perhaps a protracted period of quantitative tightening because during COVID we did have to stimulate a lot, and taking away that punchbowl is going to be quite painful.

00:29:22 I would argue that this is the beginning or early stages of that development. We're not even in the middle innings, which is why our portfolio remains positioned squarely underweight cyclicals like energy, materials and industrials and overweight, secular and in more stable industries like healthcare. That is not to say that we are top down investors. This is where we are finding value to be clustering and where the risk to reward looks more attractive.

00:29:52 But does not surprise us because we do stress tested scenario analysis and in many of our pessimistic, worst case scenarios, when we try to price in a recession, we can see that the stocks are not pricing that at all. In many instances we are finding stocks still pricing in best case scenarios. And that gives me a lot of cause for concern, that the market is still not digesting the more difficult macroeconomic environment out there.

00:30:20 Talking about international markets, while I do believe that this is going to be a global recession because inflation is certainly a global problem, and

even the ECB has broadcasted that they need to raise rates and will continue to remain hawkish.

00:30:38 Historically these central bankers have had to raise rates to turn them real positive rates. Right now we are still in negative rate territory, which is to say that the interest rate at the short end needs to be higher than the rate of inflation. And currently that is not the case.

00:30:54 So even though we have seen a lot of rate increases, and they've come in fast and furious, we're still not quite to the end of the cycle, in my opinion. And so I would brace myself for still more to come for a bit more of an extended period of time. That said, against stocks that are discounting mechanisms, a lot of this has begun to reflect itself in many portions of the market, but not sufficiently so.

00:31:18 So we remain positioned with strong balance sheet companies, more recurring revenue streams, a stable revenue stream, more defensively positioned, especially with an eye towards dividends because I think it will hold us in good stead during these

difficult times when you might experience capital depreciation as opposed to capital appreciation. Back to you, Jenn.

00:31:40 JENN DIGRAZIA: Rupal, what have you – is value clustering in China, any new thinking on the country in terms of your thoughts on the recent party congress meeting that just happened?

00:32:05 RUPAL BHANSALI: Sure. Geopolitics is top of mind and China's certainly in the vortex of it. As everybody knows, Xi has really consolidated his power. He has removed term limits and that was expected and he certainly got reappointed as the premier in this latest NPC meeting. What was surprising and caused a bigger sell-off in the markets, in China in particular, is that the standing committee, which is a very senior committee of a handful of people, there was an expectation in the market that it would be more balanced in terms of the choices that he made.

00:32:39 Unfortunately, the market did not like the choices he made. A lot of the people that he picked, in fact all of them, were his loyalists, people who were hoping

for a little bit of dissenting views or people who were more in the camp of prioritizing the economy and trying to get GDP going in the country, and that did not appear to be the case. And so that caused a bigger sell-off than otherwise would have occurred, in my opinion.

00:33:06 The other reason the market did not like the speech is that there was far more reference made to the word 'security' and that the market took to infer as a priority given towards foreign policy, towards politics over the economy. I would actually point out that the word 'security' can be taken in two ways.

00:33:29 Certainly he implied foreign policy in a number of areas, but it also implies stability. There is a great desire to have stability in China. This has been a longstanding goal and policy of the government. I don't think that has changed. I think that the government is committed to trying to stimulate the economy to get it back on track.

00:33:51 While it is clear that they have intervened more in the internet sector, and I'm not suggesting that

that's going to stop anytime soon, it is very clear that their priorities are to try to help China become a national champion in certain leading technologies. And to the extent that there are companies that are aligned with their agenda of common prosperity, they should benefit, whereas those who are not are likely to suffer.

00:34:14 Our portfolio tends to be more in the camp of those companies who will benefit from this new policy rather than suffer from it. Nonetheless, we are more circumspect with respect to the earnings recovery of many of our Chinese companies. And the reason for that is not so much the latest NPC meeting; it is to do with the fact that the COVID lockdown policy shows no signs of abating.

00:34:40 Certainly there was no indication of that in this latest congress party meeting. And that was another source of disappointment for the investors who were hoping that after this major event occurred, that there would be some relaxation. Now there are some silver linings that I would also like to point out because there's been a slew of negativity around China

and the Chinese stock market, and it's been particularly volatile of late.

00:35:04 One of them is that last night there was a glimmer of hope, and that is why the Chinese stock market rose a lot, including many stocks were up double digits, because there was a hint that there would not be as draconian in their COVID lockdown policies as they have been. That is a very good sign.

00:35:22 But again, I would not get carried away to be seen. But the second good sign, and I think this is an important one, was that the Xi premier met with, the German chancellor and said publicly that they're looking forward to having a good relationship with Europe.

00:35:39 Now Europe is our ally. We all know that the relations between Europe and the US improved a lot on the back of the Ukraine conflict where the two have become much more aligned around geopolitics than before. And for China to say that they want to be on good terms with Europe, as I read across, they would also like to be on good terms with the rest of the world.

00:35:59 So I think we need to be mindful that China is not trying to deliberately rock the boat. They can't afford to. They actually don't have the wherewithal. And so I don't think that the Chinese situation is akin to the Russian situation where we actually have a war on our hands. There is a concern that China is doing much more talking and taking some actions in Taiwan, but that is in line with a long-standing policy that they want to reunite Taiwan with China.

00:36:31 Beyond that point, I think that talk only takes you so far. In the foreseeable future, we do not see a war on the horizon. Thankfully, China is not prepared nor is it equipped to win that war. It is also watching very closely with what happened with the Russia-Ukraine conflict. It was expected to be quick; it is not that at all.

00:36:51 And the last point I would make is that despite all the bad relations and war of words that has occurred between the two countries, China did agree earlier again in the quarter, last quarter, for the US to be able to inspect the books and records and accounting

and auditing of Chinese companies, which had been a longstanding dispute and one they had actually been very much against for all these years. And finally there was some resolution on that front.

00:37:21 So it's not all a one-way street, is all I want to observe. That said, risk payments have gone up. We have taken the opportunity to raise the cost of equity for all companies around the world, on the back of both inflation and this geopolitical risk. To the extent it exists in China, I would argue it exists for the entire world because whatever happens in China, we are simply too interconnected for it not to impact all of us. So we are watching the situation carefully. But at this it me, again, I think that the glass is both half full and half empty, if that makes sense.

00:37:56 JENN DIGRAZIA: Thanks, Rupal. All right, we're going to move from macro to micro. So the travel or leisure names across the domestic portfolios have been under pressure this year despite changes in COVID policies. John, MSG continues to be a large detractor. What do you see in Madison Square Garden Entertainment that you believe the market's missing?

00:38:17 JOHN ROGERS: Thank you Jenn. Madison Square Garden Entertainment has been a favorite of ours for quite a while. It is, we think, currently selling at about a 70 percent discount to private market value. We haven't seen companies sell at that kind of discount until the height of the '08, '09 financial crisis. It just seems extraordinarily, extraordinarily cheap.

00:38:38 What the market is missing I think is a couple of things. I think people are still concerned about the potential that you could have more lockdowns if COVID comes back and you have to close down Madison Square Garden again. And that's been one of the fears that's out there.

00:38:56 Madison Square Garden Entertainment has spent $2 billion dollars on the new sphere that opens next year. And there's again the fears of recession that we've talked about today, and people feeling that if a recession comes to Las Vegas next fall, the sphere will not be able to open and not be as profitable as people hoped.

00:39:13 And there are still a lot of concerns around the fact that the regional sports network that they own is going to continue to be troubled as people do the cord cutting, as is happening throughout the nation. But what we see and what we love is that we think Madison Square Garden is an iconic building. It's an extraordinary building.

00:39:34 There's no other garden like it. It is the world's best arena and it's right in midtown Manhattan. And they own, not only do they own the Garden, but we own part of the land surrounding the Garden, as well as the air rights above it. So if you have redevelopment in that area that's being talked a lot about, Madison Square Garden Entertainment will be a prime beneficiary of that.

00:39:55 They also have had no trouble at the Garden, and we think this is going to happen with the sphere of having great opportunities for sponsorships within the arena. We know JP Morgan Chase has been a name sponsor at the Garden for a long time, and we think with the new sphere you're going to have great opportunities like that, as well as a great naming opportunity to

rename the sphere, or to name the sphere for the first time. You'll be able to get an enormous amount of ad dollars and sponsorship dollars from that. So we think that's going to be something that is not really well-understood by the markets.

00:40:28 The other thing that when you own those two great facilities, the gaming revenue is so important. We know you all see on television what Fanduel is doing and the kind of expenditures that are going on there, with Draft Kings. We think the Garden in particular will benefit from new sponsorship there supporting, for these new sporting networks that have become so important. People being able to support, advertise, and bet on the professional sports. So we think that's going to be a big benefit that people have really not understood in the marketplace.

00:40:59 And at the same time Madison Square Garden Entertainment has other assets. They own Hakkasan, the nightclub chain. They own Tao which is a wonderful brand, they're very, very big in Vegas, but also big around the world, and those are really important. I think people are underestimating the power of those

brands and the growth rates of those companies that are being, that are doing exceedingly well in today's environment.

00:41:23 The other thing that's being missed is the idea that if the sphere takes off in Las Vegas as we hope next year, it'll be able to be franchised around the world. And they will have a capital light opportunity there that we don't hear enough being talked about by the analyst community, and is really being misunderstood, and so we think that's going to be a tremendous benefit.

00:41:42 And then, of course, they have the steady Eddies that are still there. The Rockettes are extraordinarily profitable. The last several years, of course, were not what people would have hoped because of COVID. They were shut down for a couple years, shut down part of last holiday season. But this year they should be back full speed ahead and people will be able to see the cash flow and the profitability from the Rockettes.

00:42:03 And at the end of the day, these are just iconic assets that cannot be replaced. We think the market truly does not understand that. So we're still highly confident that the stocks are selling at roughly 70 percent discount and we think it'll be more clear when we have the spinoff this year where they're going to split the businesses into two and that will create a more clear way for the market to see the value in each business.

00:42:27 JENN DIGRAZIA: Thanks, John. The domestic portfolios also own Norwegian Cruise Lines and Royal Caribbean Cruise Lines, which have both historically done really well during recessions. What's driving the recent under-performance and what's your outlook for these stocks? Tim, could you take that one?

00:42:44 TIM FIDLER: Yeah, sure. So travel and leisure companies were among the companies hit hardest by the pandemic. I don't think that's any surprise. Cruise lines were also the laggards, though, coming out of that group to bounce back as COVID fears ebbed. In fact, they were still dealing with the aftermath as late as this summer, wrestling with COVID testing

requirements for guests and aftershocks from pretty liberal customer friendly cancellation policies.

00:43:11 And just when they were finally starting to see the light at the end of the tunnel, the market started to fret about recession fears. So it's been a little bit of one after the other. But in short, the stock performance from here is really driven by two things – one, and John noted this in his talk about Madison Square Garden, the potential impact of a recession on customers and discretionary spend and then the second would be the risk of future COVID related stress on the cruise lines.

00:43:37 And the thinking here is that either of these risks could lead to further equity dilution, as the cruise lines continue working their way out of their businesses being shut down, frankly, during COVID. But you know, we have to be clear here at this point. Recessions are a whole different kettle of fish than what we went through in 2022 and 2021.

00:43:57 It is hard to imagine a worse shock to the system than what they went through the last few years. Yet, they

survived and the business we're looking at today is, the outlook is far from dire. You know, we think the markets overlooking a number of pretty important things.

00:44:13 First of all, major cruise lines have virtually their entire fleets back in the water. This doesn't seem to really be well understood among the sort of common perception around these stocks. They expect occupancy rates to be near 100 percent by year end, which is a pretty extraordinary rebound from the COVID depths.

00:44:31 You know, additionally pricing for cruises that are sailing in '23 and '24 is currently running at levels above 2019 prices. So you have occupancy has recovered, you have yields have recovered. And customers are spending at record levels onboard the ships themselves, both in terms of pricing, but also penetration. So customers are spending more for more excursions and they're getting deeper into the customer base. And the spend that occurs on the ship is incredibly high margin, as you can imagine, for excursions that for offshore and spa services and things of that nature.

00:45:03 And then lastly the balance sheets have stabilized and have ample liquidity certainly to get through what we think should be a fairly moderate recession here. So to that end if you look at the recent third quarter reports from the industry participants, it spurred a rethinking in the sentiment around these names. The stock prices have rallied significantly off their summer lows, as investors have really evaluated the sort of existential questions that they had for the industry.

00:45:29 So what about recessions? It's real. You know, the potential impact is not being seen by the cruise lines themselves to the point that they're seeing any sort of change in behavior, but that could change. As of now customers are still continuing to put deposits on for future trips. Operators continue to book excursions and in general bookings remain quite strong.

00:45:52 The second one, which I think is the more interesting one, which is turning to the topic of the potential COVID impact. We are seeing regulations around the

globe shifting more towards opening up travel restrictions, with a few rare exceptions, and I think Rupal talked about China a little earlier. But it's also important to note that the majority of our exposure to this industry is through cruises that are sourced from North America and that it's hard to ignore the fact that COVID related restrictions have really lost steam here as time has passed.

00:46:19 So, overall we continue to believe as long as these cruise lines can operate without severe COVID restrictions and distress impacting their business, we think these companies have a very strong ability to significantly increase earnings power and improve the balance sheet strength. So despite the move in prices, we continue to think the risk-reward remains pretty attractive.

00:46:42 JENN DIGRAZIA: Thanks, Tim. Charlie, Mohawk Industry is another name that has traded down this year. What are your thoughts on Mohawk? Why the recent underperformance, as well as could you provide your outlook for the US commercial real estate and housing

market, both commercial and residential housing market.

00:47:00 CHARLIE BOBRINSKOY: Sure. So, if you get a little more granular about the Fed, when the Fed is trying to increase interest rates, what are they really trying to do? The one industry that gets hit hardest by an increase in interest rates is housing. And an increase in interest rates increases mortgage rates, which reduces the price that people can pay for a house. It also, if housing prices are down, makes people less interested in spending on repair and remodel.

00:47:28 So when we talked earlier about how our portfolio companies were generally not seeing a recession yet, the one exception I would call out is housing related companies. There we are seeing early signs of a recession and Mohawk is in that category. They did very well when housing was very strong last year. There's been a real shift in the kinds of floorings that people put on their, in their houses. It used to be all carpet; now it's luxury vinyl tile, hard woods, lots of different products and people are spending more and more money.

00:48:01 This company has done very well, grown very well, it's an industry, Shaw Industries is owned by Warren Buffett. It's a good business. But this year as people worry about housing, Mohawk has been hit hard. And now the stock is trading at about a six times multiple, times our forward earnings estimate. We think the market is absolutely baking in a recession in housing. Again I'm not going to say the market's wrong, but I am going to say that in the long run people are still going to put carpet and hardwood tile and luxury vinyl into their homes. And this company will do fine in the long run, although I'm acknowledging this is going to be a choppy next 12 months.

00:48:45 JENN DIGRAZIA: Thanks, Charlie. We still have a long list of questions to get through, so I'm going to ask if everyone could shorten and tighten up their answers. The next question we're going to go to Rupal. How are some of the recent currency fluctuations affecting your portfolio, and how are you managing it?

00:49:03 RUPAL BHANSALI: Sure. I think it's clear that the US dollar has been strong against almost every currency

out there, whether it’s emerging markets or developed markets. Big currencies, major markets like euros, yen, but also emerging market currencies like the Indian rupee, et cetera. The strength of the dollar tends to hurt US exporters just from a translation perspective and it actually is helpful to a lot of companies that we own internationally.

00:49:33 Because a lot of our companies such as the healthcare companies I mentioned, we are overweight. Swiss Pharmaceuticals, or some of the Japanese exporter stocks that we own, tend to benefit from the translation effects. We don’t make investment decisions based on, you know, currency fluctuations.

00:49:48 Generally what we find is, we think of them as short-term. They can have, again, a benefit or a detractor, like we did in Microsoft where the strong currency did hurt their quarterly numbers and their outlook, as I said, for US companies, it’s a different story than for international companies.

00:50:08 That said, what I have observed over 30 years of managing money, during which times it’s often been the

case that the Japanese yen has been super strong and the dollar has been super weak and vice versa and of late we are seeing the opposite. Over a full market cycle, generally speaking, companies' earnings power and balance sheets and valuations tend to reflect their underlying businesses and not so much these currency translation effects.

00:50:37 So I would just remind people not to over-rotate to this very strong currency development that has occurred. Now that said, because the dollar is so strong and has been strong for a very long time, and we are seeing a very large current account deficit developing, generally speaking when that happens there is a reversal of trend.

00:51:00 We don't predict currencies, and suddenly it's been a fool's errand to predict currencies in any short length of time. But when you look at it from a multi-decade period from a very long-term perspective, generally speaking countries that have current account deficits tend to have weakening currencies over time, like you see in a country like India, or you see in a country like the US.

00:51:21 And on the flipside countries with large current account surpluses, like Japan, like Switzerland, and even a China, tend to see appreciating currencies because that's how the net, you know, investment demand and demand for the currency changes. So, short run, it's been painful for US multinationals and beneficial for international multinationals. In the medium to long-term, don't get too fussed up about it.

00:51:46 JENN DIGRAZIA: Thanks, Rupal. John, are markets oversold?

00:51:53 JOHN ROGERS: Are markets oversold? I felt at the end of September for sure that there was just so much negative sentiment everywhere. Everywhere you went people were talking about how bad the market was, people were talking about the recession coming for sure.

00:52:10 You saw the, again the sentiment indicators from *Investors Intelligence*, one of the more pessimistic reads we've ever seen in the 40 years of reading that publication. And so, for sure we thought it was

oversold. And we still continue today again to think the overall market is very, very cheap. There's still so much negativity.

00:52:30 And when you sit and you talk to board members and people who are in the investment world, everyone is so fearful of this recession and we think all that bad news is already reflected in the price of the companies. It just has to be, we think. And so we think we really have been bottoming out and we bottomed out at the end of September and we think we're going to start to recover from here.

00:52:52 We think also there's maybe some potential good news that'll be catalyst for that. And where we think over time we will be able to, hopefully. But we really do believe that sometime in the foreseeable future that war in the Ukraine will come to an end. We'll get a negotiated settlement and that will be a real tailwind for the markets. We think that's going to be very, very important. It will help a lot with energy prices and help a lot with investor confidence and consumer confidence. I think the worst is behind us.

00:53:23 JENN DIGRAZIA: Thanks, John. Rupal, same question. Do you believe markets are oversold?

00:53:29 RUPAL BHANSALI: Actually in the very, very short run I actually think markets are oversold. And you could very well see a rally, and you are seeing one. But I regard it as much more of a bear market rally. I lived through the big correction that occurred post-2000 between 2000 and 2002, when the NASDAQ corrected about 78 percent. There were seven bear market rallies of 20 percent plus. So we should be mindful that simply because markets go up, that it' not going to be able to sustain that.

00:54:03 In my opinion, a recession is not yet priced through to the markets, and a higher risk premium is still not priced through to the markets. And so we remain circumspect about a medium term rally. If anything, I think it gets worse before it gets better, but that's probably a 2023 outlook rather than a near term outlook.

00:54:19 That said, if you ask me about my long-term outlook I'm actually far more bearish because we are coming

off an extremely high base, especially in the US, of high corporate margins, high growth rates, high valuations, and it being quite over-owned from a global stock market perspective. The US counts for 60 percent of the global markets and that’s off the charts high.

00:54:45 In that context, if we were to have a lost decade which I can’t rule out given where we started out from a valuation standpoint, I think dividends are going to cushion the blow. So it’s not enough to talk about a macroeconomic environment. It’s more important we as money managers to understand, how do you position a portfolio to still deliver total returns which are positive a decade from now, even in the face of some very big challenges?

00:55:16 And as you can see on this table that we put together, in the previous bear market environments that we had in the US, or when we had internationally, dividends can cushion the blow substantially. And that’s what we are trying to do in our portfolios, own the more resilient companies with stronger balance sheets where

dividends will look more likely to get paid rather than not.

00:55:38 And by clipping coupons as you know, Ariel is all about slow and steady wins the race, this may well prove to be the way out in terms of generating returns for our investors relative to the portion that might come from capital appreciation.

00:55:54 JENN DIGRAZIA: Thanks, Rupal. John, is there a difference between your outlook between growth stocks versus value stocks?

00:56:03 JOHN ROGERS: I think, again, the overall market is still really well positioned for a substantial recovery here. And as you know, a year ago, two years ago, we talked a lot about we thought that growth stocks were way, way too expensive and we thought that the interest rates that were historically so low would ultimately rise significantly higher as inflation came back because of all the spending that was going on and the money supply was growing so rapidly.

00:56:30 And we felt strongly as you had higher inflation, higher interest rate, those growth stock multiples wouldn't persist. We did a discounted cash flow analysis, you would get a much lower valuation for growth. Well, now that's all played out. Everything that we thought was going to happen in that regard has happened.

00:56:47 And so we think growth now has come down to a reasonable place and it's not so vastly over-valued relative to value stocks. So I think it's a more even playing field. We're still, as I've said a couple of times today and Charlie said, we're very excited about where our value stocks are positioned in our specific portfolios, and get quite excited about that. But we do think that there is more of a balance now between value and growth and they both should be able to do well as we come through this recovery.

00:57:16 JENN DIGRAZIA: Tim, do you have a different outlook for small stocks versus large stocks, or small cap versus large cap?

00:57:26 TIM FIDLER: I don't think it's meaningfully different than anything that John's laid out there. You know, when you look across the portfolios and look at the valuation relative to the benchmarks in the larger market, we see the same trends across all cap ranges. You know, another way to test what we see is where we're finding new ideas; we're finding new ideas across the entire cap spectrum.

00:57:49 And when we actually look at the fundamentals to look through earnings of our portfolio companies, it's very consistent across that gradient. So I don't think there's any reason to think you'd see a difference than what John said on the cap range.

00:58:05 JENN DIGRAZIA: Thanks. And one of the questions from someone listening right now in the audience, could a change in the makeup of Congress be a positive catalyst for the market? Charlie, can you take that one?

00:58:16 CHARLIE BOBRINSKOY: Ooh, that's a dangerous question to try to answer. So one thing we do look here is that the betting markets, the betting markets right now

have the Republicans with a 70 percent chance of taking the Senate, about an 85 percent chance of taking the House. I think that feels about right.

00:58:36 One of the truisms of history is that the market tends to like divided government. So a democratic White House and a Republican Congress would probably be reasonably well received by the markets. So that, if everything comes out the way it looks like it might with very closely divided Congress and Senate and the democrats controlling the White House, that's probably a decent outcome for the market.

00:59:02 JENN DIGRAZIA: Thanks, Charlie. And Melody, could you provide an overall - of the health of our business – flows, AUM, S's under management, and any update you can on Project Black?

00:59:13 MELODY HOBSON: Sure, thanks so much, Jenn. So I would say overall we feel very good about how things are going at Ariel in terms of the health of the business. I'll start with just the team. The team is motivated, everyone is working extraordinarily hard. As I mentioned at the top of this conversation, in these

kind of environments I think people have this false perception of investment firms, that you're running around with your hair on fire and we're just the opposite.

00:59:37 There's a focused approach, not only on the investment side of the firm, but very, very focused on the rest of the firm. We've been working extraordinarily hard to over-communicate with clients, like this call, and in our writings and the like, to make sure we're explaining what we're doing.

00:59:51 And I think for that reason we've held assets very nicely. We have not had any meaningful client reductions at all despite the environment that we've been in and even some of the soft results that we've had. I think people are very, very clear about how Ariel performs in certain kinds of markets and I think we've been able to make a compelling case about the positioning of the portfolios right now on a going forward basis.

01:00:14 You know, there is that famous line, the stock doesn't know that you owned it. We're also thinking of

tomorrow; not yesterday. And so I think a lot of our clients are thinking about tomorrow as well as they look at our portfolios and they think our case about the discounts that we're seeing and the compelling nature of the individual buys that we're making, I think that it is really translating. As well as in the international and global side, the ability to insulate and all the treachery that's going on around the world.

01:00:43 So from that perspective, we've seen solid, solid asset retention. We've also seen new business come in. Now that said, when the market goes down like this, you take a hit in terms of assets under management, and so that has been the case for us. So we're hovering just under, just over $15 and a half billion or so at the end of the 3rd quarter.

01:01:04 And that number can fluctuate a lot because again, you can have a terrific October in domestic and it moves the number up quite a bit. But, I would say that we feel, we don't play to those day to day, month to month, kind of moments; we play to the long-term

story, not just in terms of how we invest, but in terms of how we business, we build the business.

01:01:22 We've added a couple members to our team, so we're very excited about that. Particularly some of you who are our clients will see new client servicing professionals that we're extremely excited to introduce to you. We'll also continue to, we continue to be thrilled with the diversity of the firm. You're going to see people from all walks of life, from all backgrounds.

01:01:42 It's so much of what we believe. We so celebrate that at Ariel. And to be able to find best and brightest from around the country and from different ethnicities, different points of view, orientations, whatever it might be, it is something that we really do celebrate because we think it makes us better.

01:01:59 And then last, but not least, Project Black. That team has just been really coming together in a wonderful way. They are in their new offices in New York. I have yet to see the final-final, but we're so excited about that team now being together. They were in temporary

space before, practically a basement, but now they're in these beautiful new offices.

01:02:19 We had our first close. We expect our second close to be at the top of the new year and we are feeling very, very good about how things are going. So all in all, I think despite the treachery that we're seeing in the markets, and we get, this is not fun. But we have, over 40 years, have gotten comfortable with being uncomfortable in these moments. And we know that if we can be very, very calm in these periods of discomfort, we can serve our clients well and deliver out-performance over a full market cycle, and that is what we're focused on doing.

01:02:55 JENN DIGRAZIA: Thanks, Melody. I think we're out of time. Does anyone have any closing remarks? Melody, do you have anything else that you would like to share? Go ahead.

01:03:06 JOHN ROGERS: Just to say thanks everybody for joining us today and thanks for your patience during this difficult year. As Melody said, we're working really,

really hard and building out an even greater team than we’ve ever had before, so it’s very exciting.

01:03:20 MELODY HOBSON: We also invite you to speak to us offline about any questions or concerns you have. We want to be responsive to anything that we haven't covered. And last, but not least, in the spirit of the holiday season that is upon us, just express our gratitude to you for the opportunity that you give us to serve you, to continue to communicate with you and really just to do the work that we love so much. So even when it’s bad, it’s good at Ariel and you give us that opportunity. So thank you so much.

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