THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Owning Out-of-Favor Companies with the Ability to Exceed Expectations

HARRY BURN III, MBA, CFA, is Co-Chairman, Investment Committee and Portfolio Manager of Sound Shore Management, Inc. Mr. Burn founded the firm in 1978. He previously was at Chase Investment Counsel. Mr. Burn graduated from the University of Virginia, Colgate Darden Graduate Business School.

MAYO T. SMITH is Head of Client Service at Sound Shore Management, Inc. Mr. Smith joined the firm in 2013. Previously, he was employed by Breeden Capital Management. Mr. Smith graduated from Muhlenberg College.

SECTOR — GENERAL INVESTING

TWST: What is the history of the Sound Shore Fund, and why did you decide to establish the fund?

Mr. Burn: I was working for Chase Investment Counsel, a value investment firm, and knew a couple of other people that were in the business, and it was a period when both banks and insurance companies were not doing well. There was an opportunity for firms to get started. So in the late 1970s, we went out to people who were upset with the major banks and explained our philosophy. At that point, people were looking for a different approach, and we had a good grounding in value and a strong understanding of what the opportunities were in the marketplace. So we marched out there and talked to people and got going.

Mr. Smith: Harry and our Co-Founder, Gibbs Kane, started the firm in 1978. As Harry was referencing, initially, we went out and talked with corporations and foundations. That is really where the roots of the business are. Fast-forward to 1985 when the Sound Shore Fund was launched, that became the vehicle for the firm to offer our institutional asset management service to investors at a lower minimum. So the fund was really just an outgrowth of the institutional business that Sound Shore had been working on since 1978.

TWST: What is your universe of companies?

Mr. Burn: We really haven't changed that from the beginning. We have always used the largest 1,000 U.S. listed companies as our universe. We look at those companies that we think are cheap using relative p/e to help screen for what is out of favor. We have always looked at the company's absolute p/e, as well as how its p/e ranked relative to the company's own history. That has allowed us to own better-quality companies with stronger growth prospects and healthier balance sheets. From our fundamental work, we believe these companies give us the opportunity to own out-of-favor companies that have lost investor support but not their ability to exceed expectations.

Mr. Smith: It's definitely a contrarian value mindset that we have here. We focus very closely on stocks that are out of favor for one reason or another. Reality and perception can be very different. Our process looks to arbitrage the spread and close the gap between perception and reality.

Mr. Burn: We have always taken relatively concentrated bets, owning between 35 and 45 names. We believe this gives us appropriate diversification, providing the risk tolerance that our institutional and endowment clients look for. Through our fundamental research, we try to understand the potential risks in an attempt to structure our portfolios in a way that gives us better-than-market rates of return with lower risk. We do not feel compelled to own a stock just because it is in the S&P 500 or because everybody else owns them. So we will go through periods where we will have outperformance, and we'll have periods of underperformance, but over longer periods, this philosophy has given us the ability to outperform.

Mr. Smith: We have been fortunate to have been recognized by a number of people for our performance. Certainly just being in business as long as we have, I think, is a tribute to sticking to our knitting, and that knitting being effective and a driver of our outperformance. The Sound Shore Fund has been nominated for the MONEY 50 for the last 19 years. Of course, Morningstar has the fund rated four stars, and it's been one of their silver analyst picks for years now. More recently, we've been recognized for the Sound Shore Fund's high sustainability ratings by Morningstar, and *Barron's* just named the fund one of the top sustainable mutual funds. So as Harry said, being in business a long time and sticking to that knitting has proven successful for our clients.

The other thing I would add is the tremendous tenure of the team, not just Harry and Gibbs, our Founders, but the entire investment team has been working together for a very long time. One of the things we pride ourselves on is the very low turnover that we've had in the staff here. Harry and Gibbs have been managing the portfolio since 1978; John DeGulis joined them as a co-portfolio manager 13 years ago. Our Head Trader has been with us since 1984.

I think it's a testament to the culture that Harry and Gibbs started right from the get-go. People have wanted to stay here, and we're all focused on this one investment strategy. This is all we do. The firm's entire profit-sharing plan is invested in the Sound Shore Fund. So the success of all of us at Sound Shore is entirely hinged on the success of this strategy for our clients.

TWST: Merck is one of your top-10 holdings. What is it about that company or that stock that you like?

Mr. Smith: At a high level, we like **Merck** (NYSE:MRK) because of the valuation. Because we're value investors, we always start with price. We're going to do some high-level screening, and it's just a blunt instrument to help create an opportunity set for us. We will screen the largest-cap stocks for those cheap p/e versus the market and relative to a company's own history.

So we were able to look at **Merck** at a time where it was trading at 11 or 12 times earnings for what we felt was a premier global pharmaceutical company with a durable free cash flow stream, strong research and development capability, and a solid pipeline with optionality. We basically felt like we were getting the pipeline for free at that valuation, and not that we knew or that we know today exactly what's going to work in that pipeline, but we like that type of risk/reward profile.

Mr. Burn: When we were doing the work, **Merck** was about 12 times earnings, and **Bristol-Myers** (NYSE:BMY) was over 25 times earnings. **Bristol-Myers** was considered to be the leader in the new immuno-oncology cancer treatment called PD-1. The "smart money" said **Bristol** would be the winner. We thought that **Merck** had a long history of successful research and had promising indications, but the clinical test results had not been completed. Since we bought the stock, it has turned out with some of the data that **Bristol** does not seem to have the strongest result and that **Merck** may in fact be in a leading position in this new area. KEYTRUDA is the name of **Merck's** immune-oncology drug. It is still early, but we're off to a good start, and the stock is up about 20% from our cost.

Mr. Smith: Getting back to perception versus reality, as Harry was saying, the perception in the marketplace at the time when we were looking was that **Bristol** had the edge here, and the market was discounting **Merck**, even though they had been working on a similar drug. And again, not that we knew that **Merck** would win and **Bristol** would struggle with its trial, but at the valuation that we referenced, we felt like the downside risk here versus the upside potential was much more attractive.

TWST: You also own Flex Ltd. Tell us about that one.

Mr. Burn: Flex (NASDAQ:FLEX) is a company that has been gaining share of market in the supply-chain side of the electronics business. They have used their strong cash flow to buy back stock consistently. **Flex** is a low-10 p/e stock that we think can be revalued much higher as the market recognizes that the company has become more predictable, less volatile and a more dominant provider in the technology production chain.

Mr. Smith: We know **Flex's** CEO Mike McNamara well. He runs the business out of San Jose, California. The company is actually domiciled in Singapore. McNamara has done a great job at running the business. He's a very dynamic guy and has really focused the business for more consistent returns. They are a go-to outsource manufacturer for **Nike** (NYSE:NKE), **Microsoft's** (NASDAQ:MSFT) Xbox, **Dell** (NASDAQ:DELL), **Ford** (NYSE:F) and others. And because they have plants all over the world, it's efficient for consumer product companies to have **Flex** be the outsource manufacturer closer to their end markets.

Highlights

Harry Burn III and Mayo T. Smith discuss Sound Shore Management, Inc. From a universe of the 1,000 largest U.S. companies, Mr. Burn and Mr. Smith use relative p/e to find cheap companies that are out of favor. They want to invest in better-quality companies with stronger growth prospects and healthier balance sheets. Through their fundamental work, Mr. Burn and Mr. Smith aim to identify companies that have lost investor support but still have the ability to exceed expectations. Mr. Burn and Mr. Smith run a concentrated portfolio of 35 to 45 names that are weighted fairly equally. They try to keep their process flexible and limit industry weightings to 25% rather than enacting sector constraints.

Companies discussed: Merck & Co. (NYSE:MRK); Bristol-Myers Squibb Co. (NYSE:BMY); Flex Ltd. (NASDAQ:FLEX); Nike (NYSE:NKE); Microsoft Corporation (NASDAQ:MSFT); Dell (NASDAQ:DELL); Ford Motor Company (NYSE:F); Hewlett Packard Enterprise Co. (NYSE:HPE); Applied Materials (NASDAQ:AMAT); Intel Corporation (NASDAQ:INTC); Qualcomm (NASDAQ:QCOM) and HP (NYSE:HPQ).

TWST: You mentioned that you have about 35 to 45 holdings. What other portfolio construction guidelines do you have?

Mr. Smith: We have tried to keep the process as flexible as we can, but we do have a couple of constraints. We limit a position to 5% at cost, but practically speaking, we're going to run the portfolio with an average position size between 2.5% and 3.5%. So fairly equally weighted. You won't see a name in the portfolio at 1%, and you wouldn't see one over 4% really. We will rebalance to get back to that more normal 2.5% to 3.5% position.

Mr. Burn: We've always kept the cash at a nominal zero to 5% level, so there's usually some frictional cash in there as you are selling or are in the process of buying a new position, but that's not a market-timing decision that we are making.

Mr. Smith: We don't have any sector constraints. The sectors are so broad. Whether its financial services or energy or health care, the sectors are so diverse underneath that we really think more on the industry and subindustry level. That's where correlation and risk are higher. Our limitation there is a 25% maximum industry weighting, so more fine-tuned than a sector weighting, and that gives us some flexibility.

we favored because of valuation, whether that's **Applied Materials** (NASDAQ:AMAT) or **Hewlett Packard Enterprise** versus some of the more volatile names in the space like **Intel** (NASDAQ:INTC) or **Qualcomm** (NASDAQ:QCOM), we've felt more comfortable investing in the names that we think give us multiple ways to win, and **Hewlett Packard Enterprise** is actually a great example. **HPE** is a name that we invested in earlier this year. The **Hewlett Packard** name is certainly one that you recognize; this is one of the split-offs. The company split into **HPQ** (NYSE:HPQ), which kept the printer and PC business, and **HPE**, **Hewlett Packard Enterprise**, which we own, took the enterprise services and software businesses.

HPE is being run by Meg Whitman and is backed by a really tremendous board that has a lot of experience in dealmaking and creating shareholder value. So we really like the management team in place there. Within our ownership here, they've announced spinoffs of their software and services units, which are creating value. Management is committed to returning that cash to us as shareholders, and we think two years out, **HPE** doesn't look the way it does today with the restructuring that Whitman and the rest of the group there is going to do. At some point, it may become a takeover candidate.

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1-Year Daily Chart of Hewlett Packard Enterprise Co.

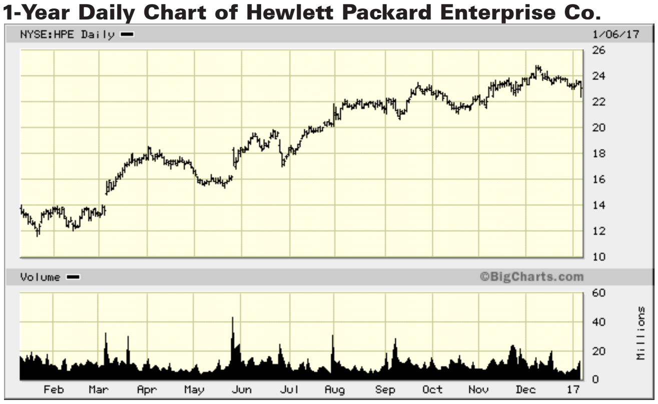

Chart provided by www.BigCharts.com

TWST: You do have about 26% of the fund in information technology right now. Is there something about that particular sector, or is that just sort of where things are falling out?

Mr. Smith: It's really where things are falling out, and as you might imagine, given our discussion here, it's really one stock at a time. We mentioned **Flex**; that's obviously in there. Another name is **Hewlett Packard Enterprise** (NYSE:HPE). What we've tried to do is go at it stock by stock and go where valuations lead us. What you own within information technology really matters.

If you take a look at the performance of some of the names that

Mr. Burn: To put some context around the cadence of our process, the team of seven investment professionals will do anywhere between 150 and 200 direct meetings or calls with company managements each quarter. In any given year, we're going to do about 700 direct contacts with company managements as part of the due-diligence process. A portion of that work is on the 35 to 45 names we own. But then, there are another 80 or 100 stocks that are on the "farm team" that we're doing work on at any given time or that we are using as cross-checks against names that we already own.

A lot of the discussions that we have with companies we're considering may be geared toward gaining a different perspective of a business that we already own in the portfolio. You can often get a competitor to talk about their peers more so than their actual company. Of course, we understand when we have these conversations that management is biased. That's part of the experience and judgment the team will apply. Once all the inputs are analyzed, we form an opinion as to whether or not it's a stock and a management team that we want to partner with.

TWST: What would you say are the most important differentiators that separate Sound Shore from the competition?

Mr. Burn: We start with price, and it's just very important to really begin from a valuation perspective. We do the fundamental research work to try to understand what the critical drivers are. We try to quantify the risk/reward opportunities. Then, patience is required, which would be another ingredient that I would put in there.

Mr. Smith: I always like to mention focus, and we can apply that focus to a number of different things here at Sound Shore.

If we're talking about the portfolio, we're running a portfolio of 35 to 45 names. In today's parlance, it's a high-active-share strategy combined with the patience that Harry just referenced. We want to own these companies for years, not months, so we're really partnering with companies and managements that we want to be focused with and have a long-term relationship with.

And then, the philosophy, it's unchanged and disciplined. We stick to it and don't veer off course when times are tough or when times are good. We've got very strict guidelines as we go about hitting price targets on the upside and taking another look if the stock has underperformed. So there's focus there as well.

Finally, the focus of our alignment with our clients. Again, this value strategy is all that we do. I mentioned that we've got our entire profit-sharing plan invested in the Sound Shore Fund, so we're eating our own cooking. Actually, that's another thing that Morningstar has given us good marks on. They have written numerous articles focused on the benefits of Fund managers that have large personal investments in their fund, and Sound Shore is certainly one of those.

Mr. Burn: As a firm, which is 100% owned by its employees, we are totally committed to helping our clients achieve superior investment returns through our valued-oriented investment approach.

TWST: Thank you. (LMR)

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