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Value Investor INSIGHT

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Harry Burn says his firm's work starts with, "Mirror, mirror on the wall, what are the cheapest stocks of all?" It's what comes after that sets them apart.

INVESTOR INSIGHT

Sound Shore Management
(*l* to *r*) James Clark, John DeGulis, Harry Burn

Investment Focus: Seek absolutely or relatively out-of-favor stocks for which a change in perception – driven by company fundamentals – appears near at hand.

Harry Burn acknowledges that there may be a lack of pizazz in the value strategy his Sound Shore Management has pursued since he and Gibbs Kane founded the firm in 1978. "We used to call it 'Three yards and a cloud of dust,' until someone asked if that meant we always had to go for it on fourth down," he says. "Now we say three and a half yards."

The $6.6 billion (assets) firm serves as advisor to the Sound Shore Fund (SSHFX), which has generated net annualized returns over the past 15 years of 8.0%, vs. 4.2% for the S&P 500 for the period ending December 31, 2014.

Today Burn and his team are finding value in such areas as insurance brokerage, electronic measurement, commercial finance and life sciences. See page 10

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INVESTMENT HIGHLIGHTS

Investor Insight: Sound Shore

Sound Shore Management's Harry Burn, John DeGulis, James Clark and David Bilik explain how they try to distinguish their fundamental research, why maintaining equal position sizes is a virtue, what they consider active management's ace in the hole, and why they like the prospects of Aon, CIT Group, Keysight Technologies and Thermo Fisher Scientific.

Sound Shore is a case study in sticking to one's knitting since its founding 37 years ago. Describe how your investment philosophy hasn't changed.

Harry Burn: When we started we had a basic view of the world that price mattered, independent research mattered and that there were always opportunities in the marketplace because share prices regularly changed more than company values did. If our knowledge of companies allowed us to take advantage of that volatility and we made high-conviction bets, we'd at least have the opportunity to outperform. That worldview hasn't changed one iota.

Technology has obviously made it easier, but we still start the process by asking, "Mirror, mirror on the wall, what are the cheapest stocks of all?" That's nothing more than trying to identify what's out of favor so we know where to spend our time. There's a bell-shaped valuation curve with the market's current median in the middle and then left-hand and right-hand tails toward the extremes. We focus our research on the left-hand tail, trying to understand how the companies ended up there and what two or three fundamental things have to happen for that to change.

How would you define your opportunity set today?

James Clark: We screen the largest 1,200 or so U.S.-listed stocks and ADRs – with market caps today of at least $3 billion – for both low absolute valuation and low relative valuation based on the company's history. The relative valuation element has enabled us to own higher-quality companies with better balance sheets and higher growth rates. We'll end up owning in the same portfolio companies like regional bank Citizens Financial [CFG], which trades at only 70% of book value, and Google [GOOG], which when we bought it was trading at a 12x P/E rather than the 20x at which it normally traded. We think of our screening as an unbiased, blunt instrument at the beginning of the process to identify stocks saying "look at me."

Why $3 billion in market cap and above?

John DeGulis: Part of it is the risk and volatility aversion of our clients, but a lot of it comes down to liquidity. That opportunity set allows us to own 35 to 40 stocks at a time that we know extremely well and in which we have sufficient liquidity to still own a decent piece of the company without being what we call "stuck" holders. We've always found plenty of opportunity in this space, so there's been no reason to venture outside it.

How does the screening process narrow the field?

JD: The first cut is just on P/E, which we'll then further cross-check against other current and historical measures like price to cash flow, price to book value, price to sales and even returns on invested capital, with the goal of identifying false positives.

To give a recent example, machinery stocks on both the agricultural and construction sides have been screening cheaply in terms of P/E for probably three years. But if you look at where their sales levels, margins and returns on equity have been relative to historical levels, those were all near the very top. As a result, on measures like price to sales or enterprise value to sales – useful multiples in these types of companies – the stocks started looking more fairly priced and even expensive relative to history. Those are yellow flags for us and allow us to significantly shrink the field of prospects. After all the cross-checking we're usually down to 80 to 100 stocks, which is more or less the approved list on which we'll do fundamental work.

James Clark, John DeGulis, Harry Burn

Here We Are

Successful fund managers leaving their established firms to start new ones with hundreds of millions, if not billions, of dollars in already committed capital must sound like an alien concept to Harry Burn. He and T. Gibbs Kane launched Sound Shore Management in 1978 with little more than the conviction that investors were looking for an alternative to traditional bank and insurance-company offerings. "Because we didn't know any better, we basically went out to people and said, 'Here we are,'" says Burn. "After six months we still didn't have a client."

Slow start notwithstanding, Sound Shore has thrived under Burn and Kane, now managing $6.6 billion in a single strategy that has changed little from the firm's early days: make equal-weighted concentrated bets on absolutely and relatively cheap stocks of companies thoroughly vetted by propriety research. "People ask why we haven't launched new products and expanded the firm," says Burn. "But we've always thought the strategy had plenty of capacity as it was and that sticking to it allowed us to do almost exclusively what we enjoy, which is analyzing companies and making investment decisions. That's turned out to be in our interest, and we think in our clients' interest as well."

Can you generalize about the situations companies on this list are typically facing?

JD: Many times it's a company-specific setback of some kind. A good example of that in today's portfolio is Hospira [HSP], a specialty pharmaceutical company that following Food & Drug Administration intervention starting as far back as 2010 had to shut down significant capacity at its most important plant in Rocky Mount, North Carolina. That basically cut the company's earnings power and stock price in half, providing an opportunity if you believed the problems could be fixed and production capacity restored. It hasn't happened quickly or smoothly, but most of the issues have been resolved and the share price is now above where it was before the trouble started.

In the case of Oracle [ORCL] the situation is more about industry change. The stock's multiple has compressed over some time, first as the company's market shares and penetration levels got so high that growth slowed considerably, and second as concern increased that a shift from on-premise enterprise software systems – its specialty – to cloud-based software-as-a-service models would leave it behind. Our view is that it has taken a while, but Oracle is well positioned to navigate the industry transition and that, in fact, that transition will allow it to capitalize on its installed base, customer relationships and massive free cash flow to significantly expand its addressable market. If we're right, our being able to buy the stock at 12x earnings and a 9% free-cash-flow yield should turn out to be a pretty good deal.

The last situation I'd highlight is more the classic restructure. One current example would be CIT Group [CIT], which is buying OneWest Bank and bringing together two businesses that didn't make it through the financial crisis but that now have strong, complementary franchises and excellent capital strength. It may partly be a function of the history, or that the deal hasn't yet closed, but we believe the market is pretty significantly underestimating the earnings power of the combined company.

Citigroup [C] would be another good restructuring example. We've owned this for a few years, but came in well after the crisis and the business had been recapitalized. Many investors simply won't own something like this because they think it's too complicated and the regulatory outlook too uncertain. We would posit that Citi today is much simpler and more financially sound than it has been for a very long time, and that its international exposure is a real long-term asset. Even if this lower-beta version of itself becomes more utility-like, a single-digit earnings multiple on modest normalized earnings and a big discount to tangible book value make the stock well worth owning.

ON CONCENTRATION:

People now call what we do "active share." We've always called it putting our money where our mouth is.

How would you characterize the importance you put on business quality?

JD: We studiously avoid binary situations where if we're right we triple our money in short order and if we're wrong we can lose it all. So while we'll invest in restructurings, it's well after the balance sheet has been recapitalized and can absorb things not working out as well or as quickly as expected. CIT, for instance, has an $8 billion market cap but we believe is overcapitalized by about $2 billion. We're willing and regularly need to accept operating risk, but we try not to take financial risk.

HB: We also pay careful attention to the cyclicality and volatility of the industry. We highly value predictable, recurring revenue that supports our protection on the downside. As does a strong balance sheet, that baseline solidity helps us build conviction when a company or industry is otherwise out of favor.

What would you like to think distinguishes your fundamental research?

HB: It's hard to prove how unique our efforts are, but we're constantly seeking out direct input from company management and from any number of outside sources such as customers, suppliers, competitors and industry experts. I was just speaking with an executive at Anheuser-Busch InBev [BUD], which we don't own, and not only did I hear about how low gas prices seem to be helping demand for beer, I also separately asked several questions about Wal-Mart [WMT] and the changes he was seeing in its operations. All of these types of conversations are input for refining our thinking on the economy, on a particular industry or on a particular company. Some investors just want to look at the numbers and not call anyone, but that's just never been the way we've done things.

JD: With Oracle, for example, we can see from the financial statements how strongly its cloud revenue is growing and becoming more meaningful to the P&L, but more important to us is hearing from their customers and other important industry players that the company's next-generation product line is very competitive and has the potential to generate considerable new business from existing clients.

We also won't invest in a company without having a relationship with management. A main goal of our research is to identify what is truly going to matter in the thesis working out or not, and then setting benchmarks to track the relevant metrics going forward. With Oracle, again, we're watching not only the cloud business's growth, but also its margins. We're watching the R&D spend on new products. We're watching the stability of traditional license revenue. In all cases we want to be absolutely sure management is focused on the same things we are. Setting these types of triggers is a good way to hold both ourselves and management accountable.

How cheap does something have to be to make it into the portfolio?

JC: We create complete financials for the coming four quarters as well as the following year or two, incorporating fundamental improvements we see that the market doesn't seem to expect. We'll then apply what we consider to be normalized earnings multiples to our numbers, targeting at least a 30% upside from today's price over the next 12 to 24 months. We really don't think we, or the companies themselves, can predict with much confidence beyond that time horizon.

We also estimate a downside target price, reflecting ongoing depressed earnings and a low-end historical multiple. The ratio of upside to downside should be at least 2:1.

Why do you weight your positions more or less equally?

JD: We're reasonably concentrated with 35 to 40 names, so even a standard 2.5% position is going to be overweight relative to just about any stock in our benchmark index. People now call that "active share." We've always called it putting our money where our mouth is.

Given that we're set up to generate an active return, we don't push that further by varying the weights of what we own. We think our value add is more in deciding what to own than in trying to make further distinctions around position size. It takes one less decision off our hands.

We also believe the regular rebalancing required in order to maintain relatively equal weightings is a virtue. If something goes sharply against us we won't change the position without an investment-committee review, but in general, we believe regular trimming of winners and buying more of what we expect to be temporary losers is a smart way to run a portfolio.

Are you typically fully invested?

HB: That has been our practice from the beginning. If you want to win, you have to play. If you look back 30 years, you have five years the S&P 500 is down and 25 that it's up. If you haven't been invested you've probably left a lot on the table.

Describe in more detail what you think the market is missing in CIT.

David Bilik: John Thain since he took over as CEO in 2010 has made significant strides in righting the company after its 2009 bankruptcy. He's cleaned up the loan portfolio, improved regulatory compliance, and continues to restructure the balance sheet by reducing the cost of debt and by opening cheaper, more stable sources of funding such as deposits. The core business is now focused on transportation finance, where CIT is a large lessor of railcars and aircraft, and on other commercial and equipment-related lending in North America.

As mentioned earlier, the company is now materially overcapitalized and has agreed to use some of that financial firepower to buy California's OneWest Bank for $3.4 billion. OneWest was formed out of the ashes of mortgage lender IndyMac, which also went bankrupt in the financial crisis. It's now on sound financial footing and has a healthy deposit and commercial-lending franchise in Southern California, where it has nearly 75 branches. The deal, announced last July, is expected to close sometime in the first half of this year.

INVESTMENT SNAPSHOT

CIT Group
(NYSE: CIT)

Business: Provider of corporate, trade, transportation and vendor financial products and services, primarily to small and medium-sized commercial customers.

Share Information
(@1/29/15):

Price	**43.74**
52-Week Range	41.06 – 50.23
Dividend Yield	1.3%
Market Cap	$7.91 billion

Financials (TTM):

Revenue	$2.44 billion
Operating Profit Margin	28.1%
Net Profit Margin	46.3%

Valuation Metrics
(@1/29/15):

	CIT	S&P 500
P/E (TTM)	7.3	19.7
Forward P/E (Est.)	10.5	17.0
EV/EBITDA (TTM)	n/a	

Largest Institutional Owners
(@9/30/14):

Company	% Owned
Vanguard Group	6.1%
Capital Research Global	5.9%
Franklin Templeton	5.2%
Epoch Inv Partners	5.1%
Barrow, Hanley, Mewhinney & Strauss	4.3%

Short Interest (as of 1/15/15):

Shares Short/Float	3.0%

CIT PRICE HISTORY

THE BOTTOM LINE

The market appears to be underestimating the potential increase in the company's earnings power from its pending acquisition of OneWest Bank, says David Bilik. On both a current sum-of-the-parts basis and by applying a 12x multiple to his above-consensus 2016 EPS estimate, he arrives at a one-year target price for the shares of around $60.

Sources: Company reports, other publicly available information

CIT has said they expect the deal to be 20% accretive to consensus estimates, guiding to about $4.50 in pro-forma EPS for 2016. We think that's conservative. They're basically saying they'll save $20 million from integration synergies and another $20 million from cheaper funding. But the funding-cost opportunity should be much greater. CIT's average deposit cost is around 1.6%. OneWest's overall cost is half that, and its fast-growing commercial deposits pay only 27 basis points. It won't happen overnight, but as CIT's deposit costs move toward OneWest's, we estimate there's 50 cents in additional EPS for every 10 basis-point reduction in cost. Our 2016 earnings estimate is closer to $5 per share, and we believe there's considerable upside from there.

How does the overall level of interest rates impact your outlook?

DB: Low interest rates have resulted in some pressure on CIT's net finance margin, although that appears to have stabilized, in part due to strong demand in the railcar business keeping lease rates healthy. A low-interest-rate environment also provides further opportunity for the company to bring down its cost of debt. One debt issue that comes due next month has a 4.75% interest rate, for example, at a time when CIT can fund even five-year CDs at only 2.25%.

At today's $43.75, how cheap do you consider CIT's shares?

DB: The stock trades just below tangible book value, a level at which the company has been aggressively buying back stock. Share repurchases over the past four quarters have been around $800 million, around 10% of the current market cap.

Applying book-value multiples of public aircraft and rail-leasing peers to CIT's businesses in those areas and then valuing the remaining commercial businesses at 1x book, we arrive at a sum-of-the-parts value for the shares in the high-$50s. We get a similar result by assuming a 12x multiple on our $5 EPS estimate for 2016. Looking about a year out, that would give us more than 35% upside.

I'd add that our $5 earnings-power estimate still reflects a sub-10% return on equity. It's not like we're stretching and saying they're going to be earning outsized returns relative to the industry.

Describe your investment case for insurance-brokerage Aon [AON].

DB: Aon earns about two-thirds of its revenues from insurance brokerage, where it, Marsh & McLennan and Willis Group are the three strong global players. This business today earns 23% operating margins and while there's some cyclicality due to pricing, it tends to grow at GDP levels in developed countries and higher than that in emerging markets, where insurance penetration is increasing.

The remaining one-third of revenues is in Human Resources solutions, consisting of both consulting businesses and outsourcing services. This division overall earns 17% operating margins and has proven quite stable, with organic growth rates in recent years in the 3-5% range. Even in a terrible economic year like

INVESTMENT SNAPSHOT

AON
(NYSE: AON)

Business: Provider of insurance, risk-management and human-resources consulting and services, primarily to large enterprise clients, in more than 120 countries.

Share Information
(@1/29/15):

Price	**91.18**
52-Week Range	76.49 – 98.10
Dividend Yield	1.1%
Market Cap	$26.00 billion

Financials (TTM):

Revenue	$11.93 billion
Operating Profit Margin	15.1%
Net Profit Margin	10.8%

Valuation Metrics
(@1/29/15):

	AON	S&P 500
P/E (TTM)	21.4	19.7
Forward P/E (Est.)	14.9	17.0
EV/EBITDA (TTM)	12.9	

Largest Institutional Owners
(@9/30/14):

Company	% Owned
Vanguard Group	5.2%
State Street	5.2%
Eagle Capital	5.1%
BlackRock	4.0%
Harris Assoc	4.0%

Short Interest (as of 1/15/15):

Shares Short/Float	1.1%

AON PRICE HISTORY

THE BOTTOM LINE

The company – through margin improvement, a declining effective corporate tax rate, lower pension contributions and lower acquisition-related writeoffs – is significantly increasing its free cash flow generation, says David Bilik. Assuming a market-level free cash flow yield on his $7 per share 2016 FCF estimate, the shares would trade at $140.

Sources: Company reports, other publicly available information

2009, Aon's HR-related revenues were off less than 5%.

This to us is a free-cash-flow generation story that we don't believe the market fully appreciates. We expect free cash flow per share by 2016 to be at least $7, double its level in 2012. That growth has many sources, including the full effects of a tax redomicile to the U.K. – lowering the effective corporate tax rate from 26% to 18% – declining pension contributions, lower acquisition-related writeoffs and consistent margin improvement.

What's driving the margin improvement?

DB: Management over time is targeting 26% operating margins in risk solutions and 22% in HR solutions. Much of that is just smart cost control, keeping the cost base growing at only 30-40% of the organic revenue growth. The company has also been investing heavily in information systems on the brokerage side that should enhance its ability to better match insurers and clients, driving higher revenue yields at the same time the new system's costs are winding down. (The system is called GRIP, which stands for Global Risk Insight Platform.) On the HR side, margins should also get an incremental bump from the company's private-health-exchange business starting to turn a profit this year.

Are you counting on big things from the private-exchange initiative?

DB: We look at it more as an attractive option. Aon was an early mover, along with Towers Watson and Marsh & McLennan's Mercer, in setting up exchanges for its corporate clients to offer health-insurance options to their employees. The incentive for employers is to turn healthcare from a defined-benefit plan to a defined-contribution one, where they can cap the amount they pay per employee. In total there are about two million employees signed up through these exchanges, but McKinsey has estimated that number could be closer to 27 million within the next three to four years. Accenture thinks the number could hit 40 million.

More as a thought exercise, if we get to 40 million people covered through these exchanges and Aon maintains a 30% market share, we estimate that would increase EPS by around $1.30. That's a 25% increase off of 2014's earnings base – that would make a nice business, but it isn't at all the dominant element of the story.

What upside do you see in the shares from today's $91?

DB: We estimate that the S&P 500 trades at about a 5% free-cash-flow yield. While we'd argue Aon's businesses warrant a premium to the market, applying that yield to our $7 2016 free-cash-flow estimate would result in a $140 share price.

While we're waiting, cash flow is growing and the company is buying in shares. Combine the 1% dividend yield with a roughly 5% annual shrink in the share count and you're looking at an effective 6% cash return per year to shareholders.

How did lower-profile technology company Keysight Technologies [KEYS] get on your radar?

JD: Keysight is a spinoff from Agilent Technologies that started trading last November and we knew the business because we'd owned Agilent for some time. It's actually the core business from the early days of Hewlett-Packard, which had originally spun off Agilent in 2000.

INVESTMENT SNAPSHOT

Keysight Technologies
(NYSE: KEYS)

Business: Global provider of electronic-measurement instruments and systems used in the design, manufacture, testing and operation of electronics equipment.

Share Information
(@1/29/15):

Price	**33.68**
52-Week Range	27.32 – 36.33
Dividend Yield	0.0%
Market Cap	$5.65 billion

Financials (TTM):

Revenue	$2.93 billion
Operating Profit Margin	18.5%
Net Profit Margin	13.4%

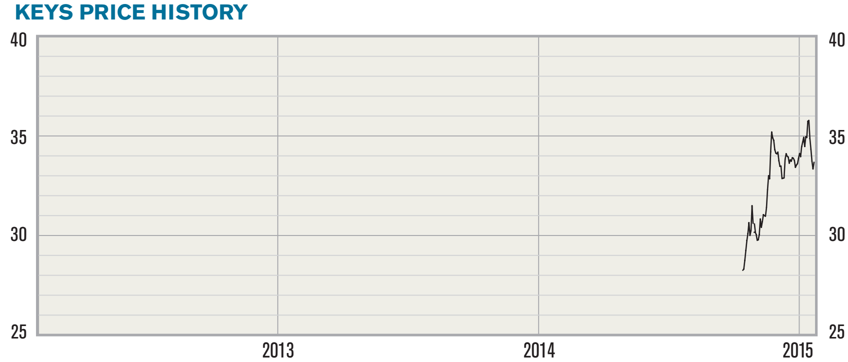
Valuation Metrics
(@1/29/15):

	KEYS	S&P 500
P/E (TTM)	14.3	19.7
Forward P/E (Est.)	11.9	17.0
EV/EBITDA (TTM)	9.4	

Short Interest (as of 1/15/15):

Shares Short/Float	0.5%

KEYS PRICE HISTORY



THE BOTTOM LINE

The company is a "classic spinoff," says John DeGulis, with upside from a rejuvenated product portfolio, significant margin expansion and balance-sheet flexibility to accelerate capital return to shareholders. Putting a market multiple on the annual $3 per share he believes the company can earn within two years, the shares would trade at closer to $50.

Sources: Company reports, other publicly available information

The company is in the electronic-measurement business, offering a variety of higher- and lower-tech instrumentation to test manufactured products in end markets like aerospace, defense, telecom and semiconductors. With cellphones, for example, nearly every phone needs to be tested to make sure the electronics and wireless connections are all fully functioning. Keysight equipment enables that. The company operates in pretty fragmented markets but tends to have leading market shares – 20% or so on average. It's a global business, with roughly twice as much business outside the U.S. than in it.

We consider this a classic spinoff situation. The company as part of Agilent produced excellent cash flow, but that money was reinvested more into the life-sciences side of the business that stayed behind. We expect a newly independent Keysight to remedy that, resulting in a picked-up product cadence that should drive new business. To give just one example, the company missed the last product cycle in one telecom networking market, but it now has a new box coming out in the next six months that, given early reports and the receptivity of the installed base, has a strong chance for success. Management also sees considerable opportunity to capitalize on an expanding wireless ecosystem and on increased connectivity driven by the "Internet of things" – it's putting product-development money behind both.

In addition to new-product upside, there's definitely a margin-improvement opportunity here as well. Keysight's EBIT margins are as much as 600 basis points lower than its most-efficient peers. We're not counting on that entire gap closing quickly, but we think closing half of it is a reasonable goal.

We also see balance-sheet optionality. The company is sitting on no net debt, and while they haven't come out with specific targets, we could imagine them adding some leverage that would help accelerate capital return to shareholders.

The shares, now $33.70, are up modestly from the $31.50 IPO price. What potential do you see from here?

JD: The free-cash-flow yield on the stock today is around 9%. Assuming 3-5% organic revenue growth and a couple hundred basis points of margin improvement, we think earnings power a year or two out is around $3 per share. With a market multiple, that gives us a target price of around $50. We also get at least to that target price if we assign to our numbers relevant price-to-sales and price-to-EBIT multiples that have been paid in recent private-market deals.

Do you think Wall Street is unimpressed, or just not paying attention?

JD: It is a classic case where both the analysts covering Agilent and the shareholders who owned it were likely much more focused on the life-sciences business than on the business that has been spun off. That's led to what we consider benign neglect when it comes to Keysight – it's not so much that Wall Street doesn't like it, they're just not looking.

The Street appears more engaged with Thermo Fisher Scientific [TMO]. Why do you consider it still underappreciated?

JD: This is a company we've owned twice

INVESTMENT SNAPSHOT

Thermo Fisher Scientific
(NYSE: TMO)

Business: Provider of scientific instruments, laboratory equipment, consumables, software and services to the healthcare, life-sciences and environmental industries.

Share Information
(@1/29/15):

Price	**127.96**
52-Week Range	107.33 – 131.12
Dividend Yield	0.5%
Market Cap	$51.19 billion

Financials (TTM):

Revenue	$15.86 billion
Operating Profit Margin	13.5%
Net Profit Margin	10.3%

Valuation Metrics
(@1/29/15):

	TMO	S&P 500
P/E (TTM)	30.8	19.7
Forward P/E (Est.)	16.8	17.0
EV/EBITDA (TTM)	17.5	

Largest Institutional Owners
(@9/30/14):

Company	% Owned
Massachusetts Fin Serv	7.6%
T. Rowe Price	5.6%
Vanguard Group	5.2%
State Street	4.0%
Capital Research Global	4.0%

Short Interest (as of 1/15/15):

Shares Short/Float	0.7%

TMO PRICE HISTORY

THE BOTTOM LINE

Given the breadth and depth of its product line, the company goes to market today with a value proposition that should continue to drive market-share gains, says John DeGulis. While he believes the growth he forecasts deserves a premium valuation, even applying a market multiple to his earnings-power estimate would yield a mid-$160s share price.

Sources: Company reports, other publicly available information

since I've been here, which through a series of acquisitions has become the dominant player in life-sciences tools, equipment and consumables. It's taken a long time, but it can now go into labs and academic centers with a value proposition that has never existed in the market – it's not quite one-stop shopping, but it's awfully close. That affords it pricing flexibility and allows it to build stronger, broader and deeper customer relationships. It's not just theoretical, they're actually gaining traction and taking market share.

Years ago Thermo was growing organically in the mid single digits but the stock traded at a premium to the market because it was such a high-quality, recurring-revenue business. Post-crisis people started to worry about growth falling sharply as a result of budget cuts and pharma-industry consolidation. Growth slowed somewhat, but has still been 3-5% per year and we believe is headed back more consistently to the high end of that range. As that happens, we expect the premium multiple to return as well.

The company's stake in next-generation genetic sequencing gets a lot of press. Do you see it as a big growth driver?

JD: There's clearly optionality in the business, which essentially uses digital technology to more quickly and cheaply sequence and analyze DNA. Thermo Fisher's business, which was acquired in the Life Technologies deal that closed a year ago, is the #2 player to Illumina, but hasn't yet had the big growth breakthrough that has been expected of it. Our view is that the business is in good hands and can benefit significantly from Thermo Fisher's distribution footprint and strong client relationships. But gene sequencing isn't the story here over the next 12 to 18 months. You're not paying for it either.

With the shares at just under $128, how are you looking at valuation?

JD: With annual top-line growth of 5%, operating leverage driving 50 basis points in annual margin improvement, some remaining cost synergies from the Life deal, and share buybacks of 2-3% per year, we think EPS can grow at least 10-12% annually over the medium term. That would result in earnings power a couple years out of around $10 per share. If that plays out as we expect, even at a market multiple the shares priced on that earnings power would be in the mid-$160s. If we return to the old days of a premium multiple, all the better.

Are there any particular commonalities among your mistakes?

JD: As you can imagine, we've made almost every kind of mistake there is, from misjudging a secular industry shift, to overestimating a company's competitive strengths, to betting on the wrong management team. Often the hardest cases are when the changes going against you are subtle and slow to evolve, making it harder to make the call on when to get out. In addition to share price, earnings and other objective triggers we set to monitor our holdings, we've also tried to build in elapsed time as well, to keep the process even more objective.

Would your long-time holding in power-generation company AES [AES] fall in the category of slow to evolve?

HB: It certainly has been slow in developing for us and one could argue it's been a pretty good example of a value trap. But in a mostly fully invested portfolio we'll at times have positions in which we think the downside is low and we can be more patient when the upside still seems attractive. That's even more likely when we haven't lost money – which is the case here. I'm not sure that's a good reason, given the poor relative performance of this over time, but that's likely a factor in our still owning it.

JC: The starting perspective on AES is still valuation. We first put it in our portfolio in 2005 when it was trading at 10-11x earnings and at a significant discount to the market and its peers. As Harry mentioned, we've made some money on the stock relative to our cost and a bit more based on rebalancing, but from a valuation standpoint it's still firmly in our wheelhouse at less than 10x forward earnings.

Management has continued to execute on its plan to simplify the company, taking it from operating in almost 30 countries down to around 15. People still find it too complex and there's an added headwind today from difficulty in some emerging markets. But the restructuring process is ongoing and we believe will eventually unlock significant value. We like in the meantime that the free-cash-flow yield is in the high single digits and that management is increasingly returning cash to shareholders. The dividend doubled last quarter, taking the yield on the current share price to about 3%.

What's a recent example in which you did pull the trigger and conclude your thesis was wrong?

JD: We had owned Teradata [TDC], which is the biggest traditional player in data warehousing. The company is good at taking what's called structured data, say from the point-of-sale system of a retailer, and then processing it into easy-to-analyze reports. But end customers are also increasingly generating unstructured data – so-called big data – that tracks all manner of captured interactions with clients that also need to be processed and analyzed. While Teradata has products to do that, it isn't the incumbent and there are a number of both established and new competitors. As its market-share numbers showed weakness and we started to better understand the changing competitive landscape, we ended up exiting our position in the latter half of last year at around our average cost.

Now isn't a particularly high time for active money managers. How are you processing that?

HB: There are so many more options for investors than there were 35 years ago. The "Look, Ma, no hands" index approach works well when there's momentum in the market and it's moving primarily in one direction. For some people that's not the worst way to go.

But the compound impact of outperformance continues to be quite attractive and is not lost on a lot of people. We've stuck to our knitting with a process we believe gives us the opportunity to outperform: Concentrate and use our knowledge of companies to take advantage when share prices move more than company values. Know when to hold, when to fold, and when to add. You don't get that with an inactive approach and we should be able to do better. There's no guarantee we will, but we certainly have that opportunity.

JD: Our contrarian instincts tell us that when everyone wants to go passive, it should make it a little easier for us to outperform. We also find it kind of ironic that at the same time you have this rush into passive, you also have a rush into so-called alternative strategies that are about as active as you can get, trying to add value with all sorts of short-term and complicated strategies and investment vehicles. A lot of that alternatives money is run by very smart people who will earn their keep, but a big chunk of it is run by people who won't. At the end of the day, we're happy with where we sit. VII