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HOW DOES WILLIS INVESTMENT COUNSEL RESPOND TO VOLATILITY?

Generally, if a company has sufficient liquidity, manageable debt, and reliable cash flow generation, it can usually navigate the storm. That gives us patience; and patience is everything; and few have the requisite patience to succeed with investing.

If our clients could be the proverbial "fly on the wall", would they be surprised or comforted by how we respond to, deal with, market volatility - especially days when the market is down 2-3%? This paper attempts to provide just such a look behind the scenes. There are three broad areas we re-evaluate when the thunderstorms roll in:

- Has the landscape materially changed? What does history teach us about how economic, geopolitical, and investment landscape changes affect long-term portfolio success (e.g., interest rates or inflation trends)?

- Are the balance sheets, and the overall underlying financial strength, of the companies we own for our clients reliable? Can we continue to rely on the durability and resilience of our companies' balance sheets and cash flow generation capability?

- If risk has indeed increased, do our valuation assumptions sufficiently reflect such increased risks? Do our risk/reward calculations for the companies we own reflect current trends, uncertainties, and include an adequate margin for error?

THE LANDSCAPE BALANCED WITH HISTORY

Make no mistake about it, we pay a lot of attention to the investment landscape, including to U.S. and global economic trends, political issues and policies afoot in Washington, and of course to the markets. For example, inflation affects interest rates and interest rates affect stock and bond prices. U.S. tax policy clearly plays a role. Foreign trade policy and the threat of tariffs could have a meaningful impact on the profits of selected companies.

These are just a few examples of the mosaic approach we apply in thinking about the forces that ultimately impact a company's ability to generate the level of earnings and cash flow we have based our decisions on.[1] But these landscape-forces, trends, and current news events are <u>not</u> as impactful as most believe. We certainly do not ignore the landscape, but because of these reasons we assign less weight to landscape issues than most – and far less weight than the media:

- The inherent unpredictability of the path of landscape-type issues
- The persistence of mean reversion – headwinds often turn into tailwinds
- The projected "bad outcome" is often not nearly as "bad" as expected
- The near impossibility of accurately translating a given landscape issue into an earnings or cash flow impact over the next 3-5 years
- Companies and markets usually adjust and adapt
- Attempting to adjust to the mercurial landscape becomes an enormous distraction

<u>The first and last reasons are perhaps the most important</u>. Empirical studies on the accuracy of forecasts - economic, political, foreign affairs and similar matters – comport with our 40 years of experience. Such forecasts are so often off the mark to be almost useless. They simply are insufficiently accurate to rely on for decisions. It is incredibly seductive to listen to, read, follow, think, and talk about the news story of the day; the economic statistic being released at 8:30 a.m.; and the purported reasons why the market is down, or is going to be down. Only when one realizes how little all of this *unpredictably* and *unreliability* impacts long-term portfolio success – or at least realizes if the forecast is unreliable then it becomes largely useless – does one appreciate not only is "following the news" a huge distraction, and not only can it become a poor allocation of time, it can actually become counter-productive. For all these reasons, we try not to get trapped into the harmful seduction of following and over-weighting the landscape.

<u>BALANCE SHEET RELIABILITY</u>

Another seduction we must guard against is over-weighting what is more tangible and seemingly more reliable – the balance sheets of the companies we own for our clients. Because we consider balance sheet and financial strength analysis a specialty of WIC, it is easy for us to slip into over-confidence and rely too much on balance sheet analysis. With that risk being acknowledged, we put a lot of weight – often the greatest weight – in our evaluation of the balance sheets and staying power of the companies we own.

[1] By *mosaic*, we mean a multi-faceted approach that seeks to not overly-rely on any one or two methods, metrics or models.

For example, when daily and weekly stock prices are tumbling, we re-check these type balance sheet metrics:

- Debt and leverage and what they say about staying power
- Near term debt maturities and associated liquidity risk
- Cash flow from operations versus near-term debt maturities
- Covenant headroom
- Off balance sheet debt (e.g., leases)
- Debt-to-Ebitda
- Asset and working capital turnover
- Pension funding exposure

We also compare balance sheet liquidity and debt metrics to cash flow generation (considering competitive threats thereto) for clues about the stability of those critical staying-power metrics. Generally, if a company has sufficient liquidity, manageable debt, and reliable cash flow generation, it can usually navigate the storm. That gives us patience; and patience is everything; and few have the requisite patience to succeed.

VALUATION – MEASURING WHAT WE GET FOR WHAT WE PAY

Throughout WIC's 39 years, we have calculated the *intrinsic value* of companies we own and are evaluating. *Intrinsic value* is a calculation that estimates a stock price that is rationally derived given a company's future earnings and/or free cash flow prospects; what is rational is a matter of opinion.[2] Valuation measurements and calculations have always been the foundation of our decision-making. Triangulation is central to this valuation calculation and evaluation process. We stress-test our assumptions and evaluate a range of intrinsic values and potential outcomes vis-à-vis the current stock price. The objectives of these intrinsic value calculations include:

- Theory - including a theoretically sound methodology in our process
- Discipline – working to keep emotions at bay
- Risk management – seeking to avoid over-paying for a stock
- Objectivity – a decision-making system based on rational principles

We maintain real time estimates of the intrinsic value of all the companies we own (and for companies that are candidates for portfolio ownership), and constantly evaluate the reasonableness of the inputs. When the landscape worsens, we re-evaluate our inputs with a focus on increased risks.

[2] More technically, *intrinsic value* is the present value of forecasted earnings or cash flows discounted to the present at a discounting rate that reflects the uncertainty of whether those forecasted earnings or cash flows actually materialize.

If we decide to reflect increased risks – perhaps via a higher discounting rate or a lower return on equity – and the resultant range of intrinsic values continues to be meaningfully greater than the current stock price that gives us confidence and patience to sit still. Or, if risks have increased more than our assumptions reflect, we may reduce the company's portfolio weight.

PULLING IT ALL TOGETHER – IT COMES DOWN TO JUDGEMENT

The answers cannot be calculated. What we do is math and instinct; science and art; but above all it is experienced judgment. No matter how educated and experienced we might think our collective instincts are, we understand the insidious and powerful influence of human emotion and therefore we always include a lot of math to keep our emotions under control. But alas, our emotions are never silent.

We would love to say we have a unique ability to silence our emotions and that all our portfolio decision-making thoughts are cold-blooded, dispassionate, and purely rational. But because we are human, that would be a lie. The following summarizes how we strive to balance our decision-making and make sound judgements for clients' portfolios:

- Organize our investment committee meetings to stimulate debate, not consensus
- Recognize emotional influences are unavoidable and work to contain them
- Use math to improve rational analysis and decision-making
- Accept the limitations of models
- Diversify among our team to work toward a diversity of opinion

One of our favorite quotes is a good way to close. Churchill said decades ago:

Out of intense complexities, intense simplifications emerge.

Robert T. Willis, Jr., CFA
Chief Investment Officer

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