

# Russell Research / Ranks and Commentary

## HARRIS ASSOCIATES L.P.

PRODUCT: GLOBAL LARGE CAP VALUE

ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Equity	Global	Value	-

  

ACTIVITY DATE	LOCATION	ACTIVITY TYPE	PURPOSE
06Apr2011	Seattle	Phone Call	Product Review

### OVERALL EVALUATION



**We recommend that clients consider this manager for new placements and additional cash flow where appropriate.**

**Target Excess Return:** 175 bp  
**Target Tracking Error:** 600 bp  
**Time Period:** 5 Years  
**Russell Assigned BenchMark:** R DEV LRG CAPV

### Expected Performance Pattern

This strategy will perform best in value led market environments. The strategy emphasizes large capitalization stocks and will do well when this segment of the market leads. The strategy has historically favored cyclical sectors and stocks and performs well in this type of environment.

Harris offers a more concentrated version of this strategy which roughly 30 holdings. Our "Hire" rank applies to this strategy as well. The more concentrated strategy will have a slightly larger market capitalization. Thus some excess return may be given up due to this but made up for in concentration. Similar rationale for tracking error. Accordingly we are assigning the same target excess return and tracking error for this strategy.

### Manager Update

On April 6, 2011 James Carpenter and other Russell professionals met with Bob Levy and Dave Herro to discuss a more concentrated version of the Global Large Cap Value strategy. The more concentrated strategy will consist of roughly 30 names selected from the Global Large Cap Value strategy. This strategy will not be as concentrated as the Global Large Cap Value Concentrated strategy already being offered. As a result of this meeting we are comfortable with Bob and Dave's approach in running a more concentrated strategy and are extending our "Hire" rank on the Global Large Cap Value strategy to include this more concentrated version.



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Stocks selected for the more concentrated strategy will be above \$5 billion in market capitalization. Companies above this market cap level with the highest upside return potential will be targeted. Bob and Dave are conscious of the risks associated by concentrating the portfolio and will look to diversify the strategy across region, sector and company end markets. They expect the portfolio to be dominated by a few sectors and can differ meaningfully from the stated benchmark. These bets will be a magnification of existing bets in the Global Large Cap Value strategy.

We expect the more concentrated strategy to have more volatile performance relative to the Global Large Cap Value strategy but should be directionally consistent.

If you have any questions please contact James Carpenter at 206-505-3454 or [jcarpenter@russell.com](mailto:jcarpenter@russell.com).

**Investment Staff** ① ② ③ ④ ⑤

David Herro, Robert Levy, and Robert Taylor are the key decision makers on the Global Large Cap Value product. Bob took over from Ed Loeb in 2005. Bob has been managing portfolios for 25+ years. He is focused and passionate about investing and very driven to provide strong returns for his clients. He has a good understanding of the market environment and his years of experience allow him to synthesize the research into a compelling portfolio.

We have a high degree of confidence in David who heads the International team, which consists of six additional professionals structured as portfolio managers/analysts. Taylor is a recent addition to the PM team and our view of him is positive. David and the other professionals work very closely and effectively as a team. The dynamics of the team encourage high quality research from each member and appropriately adversarial communication.

**Organizational Environment** ① ② ③ ④ ⑤

Harris Associates, L.P. is a wholly-owned, though independently operated, subsidiary of Natixis Asset Management. Harris has a significant incentive-based compensation scheme which should maintain a high level of motivation towards performance. Also encouraging is the significant level of personal wealth the Harris professionals each have in the firm's products.

We have noted above average turnover at Harris compared to other boutique firms. We have spoken with Harris about the departures through time, and most have appeared to be for personal reasons and not related to the organizational/incentive structure. That said, there have been some departures such as David Samra and Dan O'Keefe which were related to the organizational structure and the recent departures of Pierre Py and Eric Bokota were partially related to compensation issues. Russell does not believe Harris' compensation structure is uncompetitive. We will continue to monitor things going forward, but recognize that the Harris competitive environment may not be suitable for some professionals.

**Security Selection** ① ② ③ ④ ⑤

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Harris focuses on stocks selling at significant discounts to intrinsic value. The professionals are aware of major accounting differences across countries and factor these differences directly into their analysis. Furthermore, the professionals are particularly focused on management's historical record of profitably investing cash that is in excess of maintenance capital. Harris' deep understanding of the key business drivers of their holdings provides a competitive advantage.

Harris' use of investment models to determine fair value of companies provides for an effective buy and sell signal to the portfolio managers. In addition, the portfolio managers are closely involved with the research and thus investment ideas are communicated in a timely manner. The investable universe is narrower than that of standard Global and International products but remains sufficiently robust for this concentrated product.

**Country Selection** ① ② ③ ④ ⑤

Harris' country selection process is less systematic than many favorably ranked competitors. The country weights are a residual of an attractive bottom-up stock selection process, which will, from time to time, result in significant deviations from the benchmark.

**Research** ① ② ③ ④ ⑤

The international investment team is comparatively small relative to the US. However, the international teams effective use of screens to narrow the universe and the professionals' systematic approach to establishing fair value models mitigate this being a problem. In addition, the international analysts are organized by country thus allowing them to be familiar with the names and nuances of their specific area of coverage. The US analysts act as generalists.

In addition to stocks that screen well on value characteristics (such as low P/NAV, EV/EBITA, and ROCE or ROIC), the professionals conduct ongoing research on high quality companies they would like to own should the valuation discount ever breach the minimum 30% threshold. Although this expands the universe of covered stocks, it also provides a larger base of good investment ideas. The professionals actively, and effectively, scrutinize each other's valuation model assumptions and overall purchase rationales.

We view the professionals' insight in establishing terminal values and multiples to be a competitive advantage. They focus on evaluating, from an owner's perspective, the growth trend of a firm's economic value and the difference from the implied fair value. The attention paid to management track records and quality is also a distinctive strength of the research process.

The recent departures of Matt Pickering, Pierre Py, and Eric Bokota weakens the international research proposition but Dave and Rob's increased involvement on research helps mitigate this loss of experience. We expect Harris to bolster their research experience through a near term hire and will monitor this closely.



**HARRIS ASSOCIATES L.P.****Asset Allocation** ① ② ③ ④ ⑤

Portfolios are generally fully invested, so this category is purposely not ranked.

**Sell Decision** ① ② ③ ④ ⑤

The professionals actively keep the portfolio invested in those names selling at the greatest discounts from intrinsic value. The sell discipline and security weighting schemes are, thus, directly intertwined and function dynamically. Sales are scaled as prices approach 100% of intrinsic value, whereupon the remainder is sold. The exception would be cases where fundamentals support the analyst to adjust a target price upwards (which is done only occasionally).

There have been a few examples of Harris being overly patient in the time they are willing to allow for fundamentals of a company to be reflected in the share price. However, as soon as it is realized that assumptions used to derive a stock's discount to fair value are erroneous, or no longer applicable, resulting in a much smaller discount (if any), the stock is sold.

**Portfolio Construction** ① ② ③ ④ ⑤

The portfolio construction process is effective as the portfolio managers will weight individual holdings based on the stocks upside potential, downside risk, and degree of conviction. The communication across key decision makers and analysts is robust. The portfolio managers are mindful of the risks associated with the portfolio positioning and the large factor exposures (e.g., country, sector, capitalization) though they do not control for these risks in a systematic manner.

**Currency Management** ① ② ③ ④ ⑤

Though currency risk is taken into account in the professionals' fundamental stock research, David Herro has the final say in the decision to actively manage currency exposure at the portfolio level. Although hedging is infrequent, Harris' skill at currency management is questionable.

Some clients may thus prefer to request that hedging activities not be undertaken. However, it is important to note that hedged and unhedged portfolios may not have the same names. Harris will not invest in a security, no matter how attractive, if it cannot hedge the currency exposure when they believe it is necessary. This last statement also applies to portfolios that allow hedging if such activities are not cost effective.

**Implementation** ① ② ③ ④ ⑤

Assets under management have decreased from a peak of \$26 billion across the Global and Non-US products. This has afforded Harris some additional flexibility in managing names in the smaller capitalization range. Harris is judicious in closing strategies to maintain investment flexibility.



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We have spoken with the traders and it appears that they are capable of continuing to be able to source liquidity for their holdings and for those with which they wish to purchase.

The professionals strike an appropriate balance between providing the other team members with autonomy in researching companies and directing their efforts towards those names with the highest potential. New ideas are thoroughly discussed by the entire team though only Levy and Herro may approve names to the portfolio. Implementation is thus streamlined and effective.



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