VILLERE & Co.
SELECTIVE INVESTING SINCE 1911


Lamar Villere, CFA, Partner & Portfolio Manager

A Concentrated Portfolio Strategy

Using a selective investment approach in a volatile market

"We invest selectively and independently–taking a long-term perspective."

VILLERE INVESTMENT PORTFOLIOS

Q. Why do you prefer small- and mid-cap stocks versus large caps?

We have the ability to invest in companies of all market capitalizations, but we focus primarily on small- to mid-sized companies. While large-cap stocks are generally more liquid and stable, they are well known, often pay a higher dividend, and as a result tend to be more expensive. You tend to pay a higher price for the more mature companies.

We are long-term investors. Our approach is to uncover stocks with sustainable growth and reasonable valuations. We usually find better values in small and mid caps, as there are inefficiencies for active managers to exploit through fundamental analysis and stock selection. We look for stocks that may be out of favor, overlooked or relatively unknown.

Q. Passive investing and index funds are getting a lot of attention. Why does active management matter when investing in small- and mid-cap stocks?

As I mentioned, it is in small and mid caps where we find more attractive values. With that said, we believe that you don't want to buy a basket of all stocks. Inefficiency works both ways. When investors buy a passively-managed index fund or ETF, regardless of market-cap or style focus, they are blindly buying the whole index and are not discriminating among stocks. It is twice as important to do your homework in the small- and mid-cap space in order to buy the right names for your portfolio. As an active manager, we are not limited to the stocks in the indexes, but have a broader set of companies to invest in. We are also able to add value by being more selective in our investment choices.

We believe it is important invest in high quality stocks in the small- and mid-cap space as well, and in companies that are profitable businesses that display profit growth and have a strong outlook. Over time, this has generated higher returns than investing in large-cap stocks, compensating investors for the increased volatility.

"Our active, concentrated portfolio strategy allows us to pursue our most compelling investment ideas."

Q. By design, concentrated portfolios facilitate investing in the highest conviction ideas and therefore limit overlap with an index. Why do you use a concentrated equity portfolio approach?

We think it is important to focus your holdings. We limit our portfolios to our 20-25 best ideas and use a concentrated portfolio approach as we seek to generate attractive returns. If you have 100-130 stocks in your portfolio, it is difficult to know all the companies well. One of the benefits of having a concentrated portfolio is that we believe we know the companies in our portfolios better. We have more time to research our holdings, get to know the management teams, and so on. If you have a large number of holdings you also run the potential risk of becoming a "closet-indexer" and mirroring the benchmark index too closely.

Q. How do you decide what position size to take?

When we initiate a position we generally lean toward about a 3.5% portfolio target position, between $75 million and $90 million, depending on the bond allocation in each separately managed account. If it is a less liquid stock, we may start with a smaller position and then add to it. We find this allocation to be more meaningful. If a stock works, it can have an actual impact on the whole portfolio. Many funds take such a small position in each company that one individual stock doesn't really move the needle. We are also conscious about being too overweight in a holding. If it reaches twice the target, we will likely reduce our position.

Q. What are a couple of examples of stocks you hold in the portfolio that represent your investment approach? Why do you like them?

Axon Enterprise

Axon Enterprise (formerly Taser Intl.) makes some of the most indispensable products in law enforcement, providing Taser non-lethal weapons and Axon body cameras around the world.

We bought the stock soon after the fatal shooting by a police officer and the resulting riots in Ferguson, Missouri in 2014. At the time, the company was Taser Intl. and it dominated the non-lethal weapons market. It was valued like a mature stock and the valuation was reflecting the stable Taser business. We saw a lot of upside potential due to the nascent camera business. We spoke with a number of municipalities and learned that they planned to use more Taser devices and body cameras, which would benefit both sides of the badge. Axon rolled out a trial program that gave away body cameras to police for a year, making the revenue from subscription services with integrated cloud data storage. We believe that Axon is well positioned for the long term as its transformation continues, its market share continues to grow, and the data subscriptions have provided a solid, steady cash flow.

2U, Inc.

2U works with major universities to create online graduate degree programs, providing systems and logistical support. 2U is at the forefront of this growing business, partnering with universities such as Yale, Harvard, New York University, Georgetown, and USC.

We added 2U to the portfolio a few years ago. At the time, analysts were bearish about the company's stock for a variety of reasons, and it had dropped in value significantly. We met with management and discussed the issues to determine what was real and what wasn't. We also talked with clients about their relationship with the firm and they were overwhelmingly positive. We like the company's consistent revenue stream from its 15-year contracts with schools around the country, and now also internationally, to offer online graduate degree programs. 2U keeps around 60% of the tuition.

Q. For the balanced portfolio, how is the asset allocation between stock, bonds, and cash determined?

The asset allocation is generally a byproduct of the valuations we see on the equity side through our bottom up research efforts. If the market is rich and it is hard to find reasonably priced stocks, we increase the fixed income and cash components. We use fixed income allocations to balance the risk in the portfolios. The fixed income component usually ranges from 20-30% of assets, depending on market conditions. We have kept it near the low end of the range for a while now as we have not seen a good opportunity in bonds with the Fed increasing interest rates.

Q. What are your investment guidelines for the fixed income component?

The fixed income allocation is primarily designed to help temper potential downside risk and provide some cushion during market declines. We buy primarily investment-grade corporate debt. 90% of the fixed income portfolio is invested in investment-grade bonds and up to 10% in below investment-grade bonds to add potential for additional yield and return. The holdings in high-yield bonds are mainly in securities where we know the company and management team well from our equity research. Since we mainly use the fixed income component for income and stability, we have kept duration short to reduce risk. We focus on adding alpha[1] on the equity side by picking stocks.

> "We consistently apply a disciplined, proven investment process, refined over decades and tested in virtually every market environment."

Q. How do you manage risk?

We only buy stocks that we have researched and understand well. Although we have a concentrated portfolio, we are diversified by sectors and conscious of sector over/under weights. As mentioned, we are mindful of the position size of our holdings to make sure that none of the holdings is too large. We focus on quality companies with solid fundamentals and strong cash flow that supports the balance sheet. We may decrease the exposure to more volatile stocks based on the market environment. As pointed out, we can increase cash or fixed income allocation as needed, and diversify bond maturities to minimize volatility.

MARKET OUTLOOK

Q. Interest rates and the trade talks with China have made a lot of news headlines. The Federal Reserve changed its tune and took a more dovish turn in January. Do you believe the Fed is done raising interest rates?

The Federal Reserve tends to raise rates to slow the economy if they worry that the economy is overheating and there is a danger of an increase in inflation. On the other hand, the Fed keeps rates low to spur investment and consumer spending to drive economic expansion. Due to the strong economy, the Fed has raised rates nine times since December 2015. This came after keeping rates at nearly zero since 2009.

We believe that, while the Fed may have taken a break from raising interest rates, it is not finished with the rate hikes. Investors reacted negatively in December when the Fed signaled two rate increases for 2019. The markets calmed when Fed reassured nervous investors that they would be patient and flexible in their approach to additional rate hikes. Once we get back to a more normal environment, we will likely see further rate hikes. We are more concerned about how the Fed will go about raising interest rates.

"The overall market outlook does not significantly affect our investment strategy."

Q. A resolution to the U.S.-China trade deal would remove a major headwind for the market. Has a resolution already been priced into the market?

The market seems to reflect some optimism that a trade deal with China will happen. However, we believe that if the trade talks get resolved with an agreement in place, we will likely see an uptick in the stock market since it will take away some uncertainty. The risk could potentially be more on the downside if we don't get an agreement.

Q. We saw relatively good earnings news in the fourth quarter for U.S. companies. What are your thoughts on corporate earnings in 2019?

The good news is that the economy continues to do well. While companies don't have the benefits of a tailwind with tax cuts as they did in 2018, U.S. companies are beating analysts' expectations this earnings season, but to a smaller degree than last year. There may potentially be a decline in earnings growth this year. However, we don't see a recession coming in the short or medium term.

Q. How does your overall market outlook affect your investment strategy?

The overall market outlook does not significantly affect our investment strategy. We are long-term investors and are focused on rigorous security selection. We do pay close attention to the economy, interest rates, trade talks, and the regulatory environment, etc. However, that is not where we spend the bulk of our time. We spend more time on researching and valuating stocks, reviewing our existing holdings and considering whether we should add, trim or sell, as well as considering entry points for new potential holdings.

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[1]**Alpha** is typically used to represent the value added or subtracted by active investment management strategies. It shows how an actively managed investment portfolio performed compared with the expected portfolio returns produced simply by benchmark volatility (beta) and market changes. A positive alpha shows that an investment manager has been able to capture more of the upside movement in the benchmark while softening the downswings. A negative alpha means that the manager's strategies have caught more benchmark downside than upside.

Cash Flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

As of March 6, 2019, Villere Balanced Fund held 161,592 shares of Axon Enterprise and 103,196 shares of 2U, Inc. Villere Equity Fund held 28,590 shares of Axon Enterprise and 18,250 shares of 2U, Inc.