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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Assessing Equities on Valuation Factors and Company-Specific Catalysts

DIANE E. JAFFEE, CFA is Group Managing Director and Senior Portfolio Manager of The TCW Group, Inc. Ms. Jaffee is the Senior Portfolio Manager for the TCW Relative Value Large Cap, TCW Relative Value Dividend Appreciation and TCW Relative Value Mid Cap strategies and funds. She joined TCW through the acquisition of SG Cowen Asset Management in 2001. She had been a senior portfolio manager at Cowen Asset Management since 1995 and continues in that role at TCW. She has more than 30 years of investment experience. Before joining Cowen, she was Vice President and Portfolio Manager at Kidder, Peabody & Co. from 1986 to 1995. Prior to that, she was Vice President at Lehman Management Company from 1985 to 1986 and an equity analyst with Prudential Insurance from 1982 to 1985. In 2007, Ms. Jaffee was named the Separately Managed Accounts Award winner in the Large Cap Equity category by Standard & Poor's and its award partners Prima Capital and *Investment Advisor* magazine. The TCW Relative Value Large Cap, Dividend Appreciation and Mid Cap mutual funds have been each awarded *The Wall Street Journal's* "Category Kings" in their respective categories, multiple times in 2012, and the TCW Dividend Appreciation Fund was ranked the number-one top-performing fund among Lipper Equity Income Funds for 2012. In 2013, the TCW Relative Value Large Cap mutual fund was ranked number-one fund for the first quarter and the number-six fund for the one-year period ending March 31, 2013, among Large Cap Value peers, while the Dividend Appreciation Fund ranked number two for the quarter and number three for the one-year period ending March 31, 2013, among Equity Income peers. Ms. Jaffee holds a B.A. in economics from Wellesley College, 1982. She has completed postgraduate work in finance and accounting at Rutgers University Graduate School of Management and is a CFA charterholder. Ms. Jaffee is also a member of the New York Society of Security Analysts, the Economic Club of New York and the CFA Society.

SECTOR — GENERAL INVESTING

TWST: Please start with an introduction to TCW and an overview of the funds you manage.

Ms. Jaffee: TCW is a quiet giant in the institutional money management world. We run over $200 billion through fixed income, equities and alternative strategies. In equities, it's not just relative value, which is what my team and I are responsible for, but also growth, artificial intelligence and ESG portfolio management as well as alternative strategies. So it's a very diversified and well-run company. In the last four years, we've also gotten four awards for being one of the best places to work for companies our size in money management.

TWST: You've also received many accolades for your leadership and acumen as a portfolio manager. Tell us a little bit about your investment philosophy and what gives you a leading edge.

Ms. Jaffee: Thank you. We call our investment philosophy "the search for value poised for growth." I started off as an analyst covering different sector specialties before I ever dreamed of becoming a portfolio manager in 1992. And when I got the chance to become a

portfolio manager, I knew that it was important to inform the process knowing that every company and every industry may be best measured by different factors. And that philosophy and process has been in place for a long time.

We have an over 20-year GIPS-compliant track record at TCW. It has gone through many market cycles, and we have not changed the process over that time frame. So I think what differentiates us is the combination of understanding the analytical side in terms of different companies and industries, having a discipline in place for this long period that has stood the test of time and, very importantly, having a quantitative framework for everything we do. We hear from clients that we are amongst the most disciplined of their investment managers.

TWST: Do you look at the cyclical nature of the market as part of your evaluation process? How important is that?

Ms. Jaffee: We have done a lot of empirical assessments of different macro environments. Our team itself has gone through many market cycles. And we believe the evidence is pointing that we are in the second phase of an equity cycle. The first phase of an equity cycle is when we go through a crisis period like 2008 and 2009 where S&P operating profits drop like a stone, and then, what has to follow afterward is cost cutting and restructuring in order for those companies to stay alive and find their right footing and eke out some profits. So profits in the first phase are mostly built on the back of cost cutting and restructuring.

The second phase is when there's more stability in the underlying economy, where employees and companies have stabilized and there is enough demand in the economy so that revenues start accelerating. And that's the phase that we have entered — officially in the second quarter of 2017. We had been at very low topline growth for the S&P 500 companies, low single digits coming out of the crisis. And then, we started accelerating to the 5% level in the second quarter of 2017, into the third quarter of 2017. And in the fourth quarter of 2017, as your readers probably know, it went over 8% year over year in terms of revenue growth.

TWST: What's your outlook going forward? How long do we remain in the second phase, and what happens in the third phase?

Ms. Jaffee: If you go back 20 years, there have been three of these full cycles in the equity markets, and historically, the second phase has lasted, at the shortest, 15 months and as long as 90 months. It's a very investable phase. So we believe we were already in this before the tax cuts came about. Tax cuts have added a tailwind to this current second phase so that most likely this phase will be toward the middle of the longer side of historical patterns.

TWST: So it sounds like your broad outlook for the second half is quite positive?

Ms. Jaffee: The S&P is 90% correlated with underlying earnings. This is important. And so earnings are driven of course by cost cutting and restructuring as in the first phase. But in the second phase, they're driven by topline sales and increased demand. And so even without tax cuts, the second half of 2018 earnings are expected to be up double digits, and tax cuts actually add to it, making it quite robust for the second half of the year.

Highlights

Diane E. Jaffee discusses The TCW Group, Inc., as well as the TCW Relative Value Large Cap, the TCW Relative Value Dividend Appreciation and the TCW Relative Value Mid Cap strategies. Ms. Jaffee refers to her investment philosophy as "the search for value poised for growth." All three strategies have a concentrated number of names but are diversified across all 11 major economic sectors. Ms. Jaffee evaluates equities on five valuation factors and also looks for company-specific catalysts, such as restructuring, new products, or strong or new management. Ms. Jaffee has three sell disciplines, two on the upside and one on the downside.

Companies discussed: JPMorgan Chase & Co. (NYSE:JPM); Textron (NYSE:TXT); Cisco Systems (NASDAQ:CSCO); American Express Company (NYSE:AXP); Microsoft Corporation (NASDAQ:MSFT) and Goldman Sachs Group (NYSE:GS).

TWST: Give us a closer look at the funds that you manage and tell us about their composition. Where are your heaviest weightings?

Ms. Jaffee: So we're responsible for the TCW Relative Value Large Cap, the TCW Relative Value Dividend Appreciation and the TCW Relative Value Mid Cap strategies. In total, our group is responsible for just about $7 billion of assets under management with the Relative Value Large Cap having the longest track record going back over 20 years, and Dividend Appreciation is over 15 years and we've just anniversaried the five-plus for Mid Cap. They all have this same underlying investment philosophy: the search for value poised for growth.

All these strategies are relatively concentrated in terms of number of names, but it is deeply embedded in our philosophy that there will be sector diversification. So in answer to your particular question, while the portfolios will always have exposure to health care, telecom, real estate, etc, right now, in absolute terms, the largest sector represented in the portfolios is financials, followed by technology, followed by health care and industrials.

TWST: Walk us through some of your guiding strategies for evaluating equities in these funds. Do they differ according to whether you are looking at Relative Value Large Cap or Mid Cap?

Ms. Jaffee: All the strategies focus on five factors: price to

cash flow, price to sales, price to book value, price to earnings ratio and dividend yield. In order to get a relative value check mark, a company gets it if its relative price to cash flow is equal to or less than the broad-based market. In the Relative Value Large Cap and Dividend Appreciation strategies, the broad-based market watermark we're using is the S&P 500, although there is a slightly higher performance correlation with the value indices. In the midcap space, we're using the Russell Midcap broad-based benchmark as a relative valuation watermark.

1-Year Daily Chart of JPMorgan Chase & Co.

Chart provided by www.BigCharts.com

A company must meet at least one of these five factors; generally speaking, they meet three or more. In Relative Value Large and Mid Cap, we're indifferent to which of the factors are meeting. But in Dividend Appreciation, the promise to our clients is that the gross yield will always be greater than the benchmark indices because we want to give our clients the comfort of that cash cushion if times get tough.

TWST: Can you share your investment thesis for one or two of your favorite names in each fund? Where do you see the most compelling opportunity for the short term and, if different, for the longer term?

Ms. Jaffee: In Relative Value Large Cap, the three largest holdings are **JPMorgan Chase** (NYSE:JPM), **Textron** (NYSE:TXT) and **Cisco** (NASDAQ:CSCO). Let's talk about **JPMorgan**, for example. In terms of the number of factors that **JPMorgan** answers are two out of the five, and most importantly is price to book at a stated book value of 1.7 times and a price to earnings ratio of 12.3 times, which are both less than the market. Generally, for financial companies, we see the highest correlation statistically speaking with price to book. And that is true in the case of **JPMorgan**. I just would say that in terms of our statistical models as well as our qualitative understanding, some financial companies — for example, **American Express** (NYSE:AXP), which is not currently held — they're best measured on price to cash flow or price to earnings, so I love looking at the correlation of the stock price to the five factors.

For **JPMorgan** to be included, they also have to have company-specific catalysts in place, such as cost cutting/restructuring, new products, new markets, or strong or new management. **JPM's** catalysts are new markets, new products and strong management. **JPMorgan** was essentially forced to purchase Washington Mutual and Bear Stearns during the depth of the crisis. With Washington Mutual, they were able to get branches and in regions where they didn't have an organic footprint. And with Bear Stearns, they were able to enter the prime brokerage business.

It took a long while with good management expertise, but you could see early in the initiation process for **JPMorgan** that their organic branches were delivering two or three times the revenue and profit growth that Washington Mutual branches did. And now, we're starting to see that come to fruition. And they're taking the smaller base in terms of the prime brokerage business that was excellent at Bear Stearns but now deploying it across their platform, and that gives them that new markets, new products catalyst buoyed by strong management.

"We don't want our analysts to fall in love with their names. And so there's an automatic sell discipline that as a name appreciates from initially coming into the portfolio, when it met four or five of the five valuation factors, and appreciates to meeting three, then two or one, if it gets too close to zero out of the five, that's an automatic sell discipline."

TWST: What are the macroeconomic, regulatory or geopolitical issues you are monitoring that could have possible impacts on your portfolio?

Ms. Jaffee: The way we use geopolitical issues or macro trends in the process is we use them as stress tests. So for example, with any health care name that is in the portfolio or even being considered, it has to be able to withstand a repeal and replace of the Affordable Care Act. Not that we're in Congress and know whether that's going to happen or not, but it is a potential macro risk. And so therefore, the names in the health care space have to be able to withstand that kind of stress test.

In the case of the energy sector, the macro stress test is utilizing an average price of $40 WTI over the next one to two years, and would we still want to own the portfolio energy names in that scenario? And even though that's not our base case, it's possible that OPEC production constraints fall to the wayside and that the Permian Basin gets even more prolific in terms of production. So stress tests are always a good idea for conviction weightings.

TWST: Where do you advise caution, and what are any related strategies you use for mitigating risk?

Ms. Jaffee: Sure. Of course, I'm speaking from our perspective in terms of being really in favor of relative value, but we're reaching close to two standard deviations where growth is more expensive than value as measured by price to book of the Russell 1000 Growth Index versus the Russell 1000 Value Index. And I've seen statistics where there is a very high correlation with growth and momentum lately, and volatility could increase where we've gotten some shots across the bow in some favorite technology names that have some of the largest market-cap weightings in benchmark indices. And I worry that clients like the glitter and the glamour of growth and momentum but that it can come back to haunt them if there is a trend change. We're at close to two standard deviations of valuation differential on price to book. I think it's only prudent for investors to have some value orientation in the portfolio.

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In terms of risk mitigation, there are three major risks that we've identified that we try to mitigate in all three strategies. And number one is never let an individual stock weighting get too big. In fact, the maximum initial weight a name can go into the portfolio is never greater than 1%, and only as the company meets the self-imposed milestones measures of cash flow, margin and earning expansion will we incrementally add to that name. On a cost basis, it's kept at 3% to 4% because an automatic risk control is that we will scale back and reduce that name as it appreciates above 5%. That is an important risk control.

The second one we touched on earlier, which is the sector diversification. Even though there are times when energy or financials may be more attractive in the market and the portfolios will have significant overweightings there, we will never become an energy fund or financial fund. We will always have exposure to all 11 major economic sectors. And even though they may sector underweights, that diversification has helped reduce, but not eliminate, the tracking error over time.

And then, the third risk control is in terms of the number of names. Well over 70% of the excess return on the large-cap portfolios has come from stock selection since inception. Because of the stock selection prowess, we want to have a relatively concentrated portfolio. But we also want to minimize market or specific risk. In the large-cap space, there is a minimum of 30 portfolio holdings. And in the midcap space, it's a minimum of 50 names.

TWST: Can you tell us a little bit about your sell strategy and where you most recently might have lightened up?

Ms. Jaffee: So we have three main sell disciplines: two on the upside, one on the downside. The first one is on the upside, where we've tested at the five valuation factors' price correlation quantitatively and have a deep understanding qualitatively of what is the best factor for each company and the industry it's in. And that's how we set the valuation target, based on the most significant factor.

For example, in the case of homebuilders, it might be a valuation target based on price to book because the stock prices are highly correlated with their net asset values or the value of their land. In cases like the managed care space, there is more significant correlation with price to cash flow. As the company gets within 10% of its defined valuation target, we will start reducing that name and be completely out when it hits its valuation target. Let's say the valuation target is two times price to book. As it hits that valuation target, we will be completely out. That's sell discipline number one on the upside.

The second one is, as I love the relative value investment philosophy and process, we never want to trespass into the growth space. We don't want our analysts to fall in love with their names. And so there's an automatic sell discipline that as a name appreciates from initially coming into the portfolio, when it met four or five of the five valuation factors, and appreciates to meeting three, then two or one, if it gets too close to zero out of the five, that's an automatic sell discipline.

A good example of that in the first quarter was **Microsoft** (NASDAQ:MSFT). It had been late to the party to be considered part of the FANG companies, but indeed, recently it became very beloved by investors. And so the stock price traipsed over the final valuation factor of dividend yield that was equal to or greater than the broad-based market. Once it met zero out of five valuation factors, it was completely sold out of the portfolio.

But the third sell discipline is the most important because we want to be ready when the market tells us we're wrong. And so we have an internal live spreadsheet that looks at the price performance for every stock in every portfolio for that day, week to date, month to date and then on a rolling 30-day basis relative to the market. If there is a negative spread in either Relative Value Large Cap or Dividend Appreciation of

10% to 15%, literally a flag pops up and says, "Hey, the market's telling us we're wrong; we need to do a fundamental review."

Then, the original analyst is joined by another member of the team or myself, and in less than five business days, the pair reassesses the correlation analysis and evaluates the company-specific catalyst. And over 60% of the time, that name is either reduced or sold in that five-day window. And less than 40% of the time, it is increased. A fundamental review means some action must be taken.

1-Year Daily Chart of Goldman Sachs Group

Chart provided by www.BigCharts.com

TWST: What's your view of the current M&A scenario? What do you see as driving most M&A currently?

Ms. Jaffee: The M&A cycle is getting at front and center with corporations now having more access to their cash. However, M&A is not one of our company-specific catalysts. In general, because names we hold tend to be the names doing the acquisitions.

TWST: What are the most recent additions to any of your portfolios, and what attracted you?

Ms. Jaffee: In the large-cap space, we did initiate in **Goldman Sachs** (NYSE:GS) during that period of volatility in the first quarter. **Goldman Sachs** has been on our interest list. They met the valuation factors that we think are most relevant, which would be price to book, trading at a stated price to book of about 1.2 times, and it also has the company-specific catalysts that we like to see. In this case, they've identified $5 billion of new markets, new product opportunities, and it's very clear cut what those milestones and benchmarks would be to measure the success of that catalyst. **Goldman** is still just an initial position. We're still making sure that they will adhere to their initiatives in terms of new revenue generation, which could be quite significant, as it constitutes at least 15% of their current revenue run rate.

TWST: Tell us about TCW's involvement with AI. Could you give us a closer look at that?

Ms. Jaffee: We have a team that's been part of that central research for a really long time that identified artificial intelligence as an area of investment focus. It's been up and running as a fund we sell in Japan to Japanese investors through a local distributor for almost two years and as a U.S. mutual fund for less than six months. It's done quite well. And I think technology, even though we've seen some shudders and shakes in their recent stock prices, it still is going to be a very important part of the economy and so of course an important part of TCW's portfolios.

TWST: Are you aware of any commonly misunderstood investment concepts or mistakes that investors typically make?

Ms. Jaffee: There are some great strategies that just really focus on the highest-quintile dividend yield or the lowest-quintile price to book. I do feel investors could miss out though just taking a one-factor approach for the universe of investable stocks. Not all companies are best measured on dividend yield or price to book. And so that's why I am a big believer in sector specialist analysts who really have a deep understanding qualitatively of their industry group to identify which factors are most relevant as well as endeavor to find meaningful company-specific catalysts.

We also support that experienced, expert qualitative knowledge with rigorous quantitative analysis using five valuation factors. And so every time I read a report that says, "Well, you know, it's very attractive on price to earnings," but yet it's a very cyclical company in a very cyclical industry, I'm like, "No, the price to earnings ratio may not necessarily be the best factor to be viewing that company with those spectacles on."

TWST: How did first-quarter earnings come in? Were there any secular trends evident that reflected strength or weakness?

Ms. Jaffee: The financial companies did display strength; they are generally the first sector out of the gate to report, and they generally demonstrated strong earnings growth. A fair amount of it came from equity trading, so the stocks didn't get the love because trading profits can be ephemeral. Additionally, tariffs and trade wars will dampen future growth. Maybe first-quarter earnings are not a repeatable experience. But we think that some financial companies displayed reasonable loan growth as well. Net interest income generally increased, and it looks like they have sown the seeds for future growth. And so we think that financial first-quarter 2018 earnings maybe should have been a little more respected by investors.

Overall, the earnings season is still in play. In fact, this is one of the heaviest weeks we're in right now, but companies are showing, even without the benefit of tax cuts, there are double-digit year-over-year earnings so far. And as I mentioned earlier, the measure for the second phase of the equity cycle is that revenue growth has accelerated from low single digits a year ago to now 7% to 8% year over year. Definitely we've not fallen back into that anemic revenue growth of 1% to 2%. It's still early, the second phase of the equity cycle.

TWST: Thank you. (VSB)

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