CONSUELO MACK | WEALTHTRACK

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A rare interview with Great Investor and
Morningstar's 2016 Domestic-Stock Fund Manager of the Year, David Wallack.

David Wallack
Portfolio Manager
T. Rowe Price Mid-Cap Value Fund

CONSUELO MACK: This week on WEALTHTRACK, *Morningstar's* 2016 Domestic Stock Fund Manager of the Year rarely appears on TV but David Wallack of T. Rowe Price's gold rated Mid-Cap Value Fund is joining us. Great investor David Wallack is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
In this age of rage for indexing active money managers are getting short shrift, losing assets in droves as investors opt for low cost, passive index funds and ETFs which have been outperforming the vast majority of stock mutual fund managers for 15 years or more.

Over the past two years alone, investors have pulled $574 billion from actively managed U.S. funds and plowed $924 billion into passive vehicles. As *Barron's* recently pointed out active U.S. managers oversee about $9.7 trillion in assets, but that haul hasn't grown much in four years and is just seven times the 1993 total. In contrast, the $5.4 trillion in passive funds has doubled since 2012 and has grown 158 times since 1993. Of note is the fact that 1993 was the year the first exchange traded fund was launched, the S&P 500 Depository Receipt or SPDR for short, still one of the most actively traded ones today.

There are always exceptions to every trend and we try to find them for you on WEALTHTRACK. This week's guest is one of them. He is David Wallack, long time portfolio manager of the T. Rowe Price Mid-Cap Value Fund which he has managed since the end of 2000. Wallack was named *Morningstar's* 2016 Domestic-Stock Fund Manager of the Year. As *Morningstar* put it "Wallack has successfully used a contrarian approach at this Gold-rated fund for the past 16 years" and noted its strong risk-adjusted performance."

As of year-end 2016 the fund had beaten its category peers and Russell Mid-Cap Value benchmark in multiple year periods including the last three, five, and ten years. Since inception it's nearly 11% total annualized returns has also outpaced its benchmark. And contrary to many actively managed funds the assets in T. Rowe Price's Mid-Cap Value have remained pretty stable at more than $13 billion which means the fund which has been closed to new investors since 2010 is not planning to reopen any time soon.

Wallack has been described as a contrarian value investor by *Morningstar*. Why asked him how he describes himself.

DAVID WALLACK: I think that's a pretty apt description. I tend to look for companies that are underperforming in the stock market, and they may be going through a difficult period because of the business cycle or the cycle in the particular industry in which they operate, or perhaps there have been some management decisions that have not been optimal that have caused problems in the business, but I tend to look for companies that have stood the test of time over years that are trading below what we deem to be their underlying value, their intrinsic value. So that necessarily takes you to the new low list rather than the new high list. So in that respect I'd say, yes, this is a contrarian strategy.

CONSUELO MACK: Do you ever invest in like truly distressed companies? The cigar butt approach that...

DAVID WALLACK: I would say companies that are in financial distress I would tend not to, but if you're talking about companies that may be in decline, yes. From time to time I'll do that. The fundamental principle is that you always want to focus on the price you pay versus the value you get. So I'd say it's easier to invest in companies that have a stable business or a growing business, but that hasn't kept us away from things like over the years tobacco companies where consumption of tobacco is in decline but profitability has gone up for many of these or some of the department store companies, some of which have managed to continue to prevail over the years. So I don't invest in distressed companies per se. I do invest in companies that are exiting a period of distress, for example post bankruptcy companies that have been recapitalized and written off a good deal of their debt. So an example there would be Arch Coal, a portfolio holding, a company that was in bankruptcy because of the big downturn in coal and a leveraged balance sheet, and they wrote off $5 billion of debt. They have no net debt today. So there ...

CONSUELO MACK: So you invest in it after it's gone through its ...

DAVID WALLACK: After it's gone through the wringer.

CONSUELO MACK: Are you ever tempted to go into a company that is descending into the wringer, trying to pick a bottom for instance, or how do you judge that?

DAVID WALLACK: Well, if we put aside companies that have too much debt which have the risk of bankruptcy where you can lose all of your capital as an equity investor, I do invest in companies where it's not clear where the low is in the stock so to speak, but if we're convinced that the value of the business is higher than the stock price, then we don't try to pick the bottom. I've never found it something that you can do consistently. So we tend to be incremental buyers if you will over a period of days, weeks, months, sometimes years of stocks that we like.

CONSUELO MACK: Your average holding period is? Is there any such thing?

DAVID WALLACK: Well, the average holding period is about two years, but we ...

CONSUELO MACK: Which sounds low to me.

DAVID WALLACK: Well, we have stocks in the portfolio that we've owned for 20 years, and what happens is you never really know when you're going to get paid. Sometimes you don't get paid at all, but occasionally you'll invest in an undervalued stock and, lo and behold, months later it trades at your target price. The prudent thing to do is to take money off the table. Then there are examples like what we were talking about, industries that might be experiencing trouble. Southwest Airlines would be an example. Our first purchases of Southwest Airlines were in 2004. The stock was at 15.

CONSUELO MACK: Wow.

DAVID WALLACK: We had a view that, as we do in many situations like this, there was a good business there, a good share of the market, a brand that consumers recognized and were willing to pay a premium for, but they were not allocating their capital well. They were continuing to invest in new planes, new routes, new cities and so forth which was depressing the profitability.

CONSUELO MACK: I see.

DAVID WALLACK: Over time, the market more or less meted out punishment on the company, and the stock underperformed. Most of the time people, managers behave in their own self interest, and I think in this particular case, in the crash the stock went to a price of five dollars. Now I never intended to be looking at that kind of a price when we made our first purchases, but we continued to buy because we liked the underlying assets, and we felt that they would make good business decisions, which they ultimately did. The pressures of the market caused them to do things like reduce costs, stop investing as much and focus on maintaining that good balance sheet. From there it was a great stock, but this is a long way of answering your question on the average holding period. There's quite a wide variety of holding periods. Some of them as I've mentioned can be 20 years. Southwest we owned for close to ten years before we really made that return.

CONSUELO MACK: One of the things that you told me off camera was that you were in the fine arts business. You were not in business, and that you had always been interested in investing because of your maternal grandfather.

DAVID WALLACK: That's right.

CONSUELO MACK: But there were some lessons that you learned from him as well that you've carried with you through today. So what's one of the primary lessons that you learned from him that are still with you today in running a mid cap portfolio?

DAVID WALLACK: Well, my grandfather emigrated here in 1920 at the age of 17, and he started investing almost immediately. He had two brothers who had preceded him here. They were both golf pros. My grandfather became a golf pro, and he invested through the '20s. Everybody made money in the '20s. Those were the boom years, and in 1929 his brother had amassed a considerable sum of money for those days, and my grandfather said, "Arch, you really ought to sell some stock here." He said, "No, I want to wait. I think I've got another five percent to make here."

CONSUELO MACK: From 95,000 to 100,000. Right?

DAVID WALLACK: That's right. He didn't sell. He was wiped out by it, and my grandfather would say he was a changed man after that as I think many people were including my father. My father did not believe in the stock market. So my father lived 57 years, born in 1924. When he was five years old the Dow Jones was at 400. When he died in 1982, it was at 800. So look through that lens. The stock market doubled over his life. Now I'm almost his age at that time. I'm about 57. When I came into this business, the Dow Jones was at 2,000 and it's at 20,000. So your choice of endpoints matters a lot, but what my grandfather I think, what I learned from him was one should never take for granted prosperity in stocks and recognize that there are risks and that you can lose a lot of money. So that's always in the back of my mind.

CONSUELO MACK: How are you applying that? Is that why you're a value investor and you're focusing on companies that have turnaround potential? So therefore, when I look at the FANG stocks, would you ever be in the FANG stocks?  Well, they were mid cap stocks once.

DAVID WALLACK: It's funny. We were talking at lunch today about Amazon, and there was a time when we owned Amazon in the Mid Cap Value Fund after the crash, the tech bubble crash, when you could look at it and say they've invested all this capital to improve the business and all this research. There's been tremendous research expenditure. Either they're going to stop and the profits are going to rise, or we're going to get something from all this spending which in fact is what happened, the latter. But today, no, I wouldn't invest in things like the FANG stocks. My tendency is to look for companies that have been around and stood the test of time and that have been through cycles.  So notwithstanding Amazon, we have a lot of old companies in the portfolio, and one of my mentors, George Roche, who ran the New Era Fund at T. Rowe Price and later became our chief executive and chairman, he used to tell me look at old companies because there's a DNA of success, and in addition many old companies have accumulated assets that you don't really know a lot about but which have value. So if you were to have looked at Weyerhaeuser ten years ago, Weyerhaeuser is the biggest owner of timber in the U.S., but ten years ago they had a white paper business. They had a corrugated paper business. They had a transportation business. They had a minerals business. They had a homebuilding company and there was a lot of wealth hidden in the company.

CONSUELO MACK: Why did you sell Amazon?

DAVID WALLACK: Well, Amazon ...

CONSUELO MACK: Do you ask yourself that every night?

DAVID WALLACK: Amazon reached my target price ...

CONSUELO MACK: Your target?

DAVID WALLACK: ... at that moment, and if I had to critique myself as an investor, the one thing I'd say is that I tend to sell early. I'm not comfortable when stocks become overvalued, and there are a lot of people who are able to ride their winners a long, long time, but to me when something's overvalued, I start to remember my grandfather, and so that's why I sold Amazon. You remember Bernard Baruch, the great financier, was asked once, "Why were you so successful?" and he said, "Because I sold too soon."

CONSUELO MACK: Looking at your portfolio today, what's your most contrarian investment? What's the one that maybe you and your team are saying, "Do we really want to own this?" or "Are you nuts?"

DAVID WALLACK: We often ask that question. That's the right question to ask because if a company is out of favor, if a stock has underperformed, often there are good and legitimate reasons for that. It didn't happen by accident, and what you really must get comfortable with is how much money you can lose. It's very difficult to recover from a loss. We all know that if you lose half your money, you have to double your money to get back to where you were.

CONSUELO MACK: To get back.

DAVID WALLACK: So there's a tremendous focus around what could go wrong. So yes, I'd say we're always focused on the problems. How much worse can it get? I'd say one contrarian investment that we have purchased recently is Equitable Resources which is a natural gas producer in the Marcellus Basin in Pennsylvania, Ohio and West Virginia. So Equitable has been around for over 100 years. It was originally a utility and pipeline company that happened to have assets and a tremendous land position where you want to be today. So they say better to be lucky than smart. In any event, they've managed that position very well. As a result of the fracking boom, from which they've benefited, natural gas prices have stayed low, and it's been a very difficult period for natural gas producers. What's happening now in the Marcellus Basin is that there's a consolidation taking place. If you go back seven years, there was a land rush so to speak. People were coming in and acquiring acreage in the Marcellus for huge prices. Some of them were foreign companies. Today those same companies are exiting because it's been so discouraging for them. Gas prices have stayed low, and gas prices in that particular part of the country in that basin are lower still than average because there's been a dearth of pipeline capacity to take the gas out of the market. But Equitable is well financed. They've got an investment grade balance sheet. They're acquiring assets cheaply. We're comfortable that if gas prices stay low, that they are in a position to prosper. They continue to grow their production, and they are acquiring assets cheaply now, consolidating their position and building wealth that way. If gas prices go up from here, then I think we have a free option if you will. So even within my firm it's a controversial stock. We don't all agree that this is a stock one should own, but I think if you do your work, you can come to the conclusion that this could be quite a good performer over a period of years. I never know when, but I focus much more on the value, not the timing.

CONSUELO MACK: So you set a price of when you're going to exit a company.

DAVID WALLACK: That's right.

CONSUELO MACK: For every position that you own.

DAVID WALLACK: For every investment that we have.

CONSUELO MACK: So Textron which is a conglomerate is your top holding or one of your top holdings. So explain what's the rationale in buying and owning Textron.

DAVID WALLACK: Well Textron, believe it or not, started as a manufacturer of synthetic yarn in Providence, Rhode Island; hence, the name Textron in the 1920s.

CONSUELO MACK: Old established.

DAVID WALLACK: Old established company that diversified quite a bit and over-levered itself and got into trouble in the financial crisis.

CONSUELO MACK: In this past financial crisis. Right?

DAVID WALLACK: Yes.

CONSUELO MACK: Because I seem to remember Textron from the go-go years too.

DAVID WALLACK: Yes, in the '60s.

CONSUELO MACK: It went through various iterations.

DAVID WALLACK: It would have been one of those go-go conglomerate stocks.

CONSUELO MACK: Exactly.

DAVID WALLACK: Which were very popular at the time. What happened to Textron was that they had a very big consumer finance business that required borrowings. The stock plunged from 50 or 60 dollars to five or six, and they needed to do an equity financing to shore up the balance sheet. Well, those are things we naturally find interesting because it's a little bit like holding a balloon under water. Your lenders are holding a gun to your head, and you have to finance yourself, and it's very diluted for the existing shareholders, but a new shareholder can often buy stocks very cheaply. So we made our first purchases after the crash. What was appealing about it? Well, they're in a bunch of different businesses where they have a big market share. They're one of the biggest players in business jets. They own Bell Helicopters which is a leader in its business. They have a diversified manufacturing company. They have an aerospace company, aerospace and defense company, and we looked at it and said the sum of the parts is greater than the whole here. We think there's an opportunity to reduce costs. We think there's an opportunity for them to de-lever the balance sheet and, with some focus and discipline, they'll get there. That's really what the management led by Scott Donnelly at Textron has done over the last eight years. So it has done pretty well I'll say. It's probably done a bit better than the market since then, a bit better than the average mid cap stock. However, what's intriguing to me about that stock today is the pent-up earnings power in the business jet asset. Business jets have been in their own bear market for a decade.

CONSUELO MACK: I had no idea because you hear about them flying, all these celebrities and everything, all over the place so you assume it's booming. It's not? It hasn't been.

DAVID WALLACK: It was booming ten years ago. It's half the size that it was.

CONSUELO MACK: Wow.

DAVID WALLACK: But as one often sees in a difficult period, there has been a Darwinian period here for the business jet manufacturers, so Textron bought one of its biggest competitors, Hawker Beechcraft when it exited bankruptcy a few years ago. Other competitors – Embraer from Brazil, Bombardier from Canada and Dassault from France – are all withdrawing capacity from the market, and so the incumbents are gaining share.
Now the business is profitable, but together these two companies – Cessna, the Textron subsidiary, and Hawker Beechcraft – made over a billion dollars profit in 2008, and they're making $400 million today. We think that they could make at least a billion, a billion and a half dollars perhaps at the next cyclical peak. When that is I couldn't tell you, but jets age. There is a replacement cycle. The demand is there and, in my view, Textron's earnings which are around three dollars a share today could be five dollars a share in the next three or four years, and I believe the stock could be at least 50 percent higher than where it trades.

CONSUELO MACK: David what would your recommendation be for the one investment for a long-term diversified portfolio?

DAVID WALLACK: It's hard to choose one, and I believe in diversification but, having said that, Rayonier I think would be a stock that I would highlight, again an old company. Rayonier, which started out as a pulp and paper manufacturer in the '20s which later acquired a lot of timber, was involved in the manufacture of rayon with DuPont in the 1930s.
They're out of that business today. They are one of the biggest owners of timber in the U.S. We talked about Weyerhaeuser earlier. Rayonier has 2.7 million acres of timber. The great thing about this asset class is that the trees mature and become more valuable, and the land underneath the trees grows in value over time. So most timber manufacturers are able to sell a certain amount of their land as developable land to realtors. So the wind is at your back so to

speak when you invest in this industry.
Rayonier itself is a Real Estate Investment Trust, so they pay no tax. The stock yields over three percent. I think it's trading below the asset value. This is one asset class where interestingly the private market value in my view is still meaningfully above the public market value, and if they continue to manage the business as they have, I think that this will be a stock to own for a number of years, three, four, five, ten years.

CONSUELO MACK: We're talking about analyzing individual companies. And you're in an environment right now, a macro environment where the rest of the investment world is going the other way, and they're investing in index funds. How do you view that movement?

DAVID WALLACK: I think you need to go back a bit before that, and I think you need to look at the other periods in time when indexing has been popular. The biggest one probably in recent memory would be the tech bubble. You recall in the tech bubble that 30 percent of the S&P 500 was invested in tech stocks. Well, lo and behold, if you measure the return of the S&P 500 from the top in February of '00 to three years later it was minus 45 percent. That interval was a wonderful period for active management. If you go back prior to that, a decade before that, in Japan the Japanese stock market had a tremendous move.

CONSUELO MACK: And it's never really recovered.

DAVID WALLACK: It's not recovered. So in my view it's a cyclical thing. Usually when something becomes very popular on Wall Street, one should be very careful, and passive indexing is really all the rage these days. Many stocks in my view have more or less taken flight from their underlying value, and that can happen for a period of time. It certainly happened back in the '80s in Japan and in tech stocks in the '90s.

CONSUELO MACK: Good reminders for us.

DAVID WALLACK: But if you believe as I do that over time if markets work and capitalism is effective, I would submit that indexing will likely be less popular a few years from now, and if that's because the indexes have underperformed active managers, that wouldn't surprise me in the least.

CONSUELO MACK: All right. We'll leave it there. David Wallack, thank you so much for joining us on WEALTHTRACK.

DAVID WALLACK: Thank you, Consuelo.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: **Make sure your stock portfolio is diversified among different asset classes**.
Most of us are heavily invested in large company stocks. They dominate U.S. stock index funds.

Wallack on the other hand specializes in mid-cap stocks. Small cap stocks are even more under-owned. Internationally we might have some exposure to large multinational companies but few of us own any mid or small cap foreign companies and emerging market stocks have been shunned in recent years. Consider adding a smattering of each category to your mix through active or passive funds.

Next week, are index funds actually expensive and high risk ? Global value investor David Winters says they are and that he has the research to prove it.

To see this program again and other WEALTHTRACK interviews please go to our website WEALTHTRACK.com. Also feel free to reach out to us on Facebook and Twitter.

Thank you for watching.Have a great weekend and make the week ahead a profitable and a productive one.