Value Investing in Intangible Assets

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GAUTAM DHINGRA is the Founder and CEO of High Pointe Capital Management, LLC. He is also a Lecturer of Finance at Northwestern University's Kellogg School of Management. Gautam founded High Pointe in 1998 to implement a new approach to stock selection. Gautam has 24 years of experience as portfolio manager, director of investment research, and investment advisor. Prior to starting High Pointe, Gautam was a partner in Hewitt Investment Group, a leading investment advisory firm. Gautam joined Hewitt in 1986 as Director of Investment Research and became a Partner in the firm in 1993. In his research and product development role, he developed the firm's quantitative investment models and led the team that developed its defined contribution plan investment consulting practice. Gautam hold a Ph.D. in finance, with a specialization in investments, from the University of Florida. He has taught courses in Securities Analysis and Derivatives at the same university. He is a CFA charterholder having earned his charter in 1987. He is a member of the Board of Directors of the CFA Society of Chicago.

SECTOR – GENERAL INVESTING

(ABK501) TWST: If you could bring us up to date with a brief overview of High Pointe Capital Management and your investment philosophy.

Mr. Dhingra: High Pointe's investment strategy evaluates the intangible assets of companies and industries and incorporates that evaluation into our stock selection model. What differentiates our investment strategy from other investment approaches is that we believe we are the only firm to take a systematic and comprehensive approach to valuing intangible assets.

TWST: The selection of these intangibles, this applies to all of your products, regardless of capitalization of the companies?

Mr. Dhingra: Yes, that is correct.

TWST: Would you explain a bit more about what you consider to be companies that have these intangible assets?

Mr. Dhingra: Intangibles refer to assets that cannot be seen, felt or touched. They are non-physical assets such as patents, brand names, etc. For example, a company like **QUALCOMM** (QCOM) has more than 9,000 patents. Its products are used worldwide and its customers give it royalty for the use of these patents. Patents do not show up as inventory on the balance sheet, but nevertheless they are highly valuable and it is the best asset that **QUALCOMM** has.

Another example is a company such as **Pepsi** (PEP), which has 18 brands which generate sales of more than $1 billion each. One of the reasons **Pepsi** is able to generate revenue from these brands is that the name **Pepsi** and its snack brand Frito Lay are widely recognized in a large number of countries. This universal recognition is a result of billions of dollars of advertising over many decades. That advertising expense has been written off every year in which it was incurred. But the asset built on the advertising expense never shows up on the balance sheet of **Pepsi**, even though it is in our opinion the biggest asset that the company has. Those are two examples of intangible assets that are very significant, but they do not show up on the financial statements of companies.

TWST: Intangibles by their nature are still hard to put into concrete terms, when you actually are looking at a company. What metrics do you use in your investment decision-making process to select potential holdings?

Mr. Dhingra: You are absolutely correct. Intangibles by their definition defy an easy metric. We realized from the very beginning that intangibles differed so much across industries that it would not be feasible to come up with a direct metric. For example, we could not compare **QUALCOMM's** patents to **Pepsi's** brand equity using a direct metric which would tell us whether the patents were more valuable or the brand was more valuable. Instead we developed an indirect metric, which we call Competitiveness Score.

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You can think of Competitiveness Score as a score for business quality. This metric is designed and based on the indirect benefits that flow from intangibles.

For example, when a company has patents, it gives that company the right to be the sole user of the underlying product. That means barriers to entry for everyone else instantly become insurmountable. While patents are not common to every industry, the degree to which barriers to entry are high or low is something that we can indeed evaluate for every industry. What we've done is taken a direct intangible, which is patent and looked through to its benefit, i.e., barrier to entry. By focusing on the benefits derived from patents we are now able to apply it to every industry regardless of whether patents exist in those industries or not. Along the same lines, we look to evaluate the benefit of having brands. The most logical benefit is that a company with a strong brand is able to charge more for its product than a generic can, even though the generic satisfies the same need. For example, **Pepsi** can charge a higher price for its cola than Sam's Cola sold at **Wal-Mart** (WMT) even though both drinks have carbonation, caffeine, and sweetness. They are meant to satisfy the same need, but only one of these products has pricing power. Thus, we focus not on the brand itself, but on its benefit, i.e., the pricing power. By making this transition, we are able to compare companies across multiple industries even though some of these industries do not have brands per se, but they can all be evaluated for the degree of pricing power. This method of focusing on the benefits of intangibles has allowed us to create a metric focused on factors such as barriers to entry, barriers to exit, pricing power, etcetera and that allows us to capture the intangibles even though it is, as you said, difficult if not impossible to capture the intangibles directly.

Highlights

Gautam Dhingra takes a systematic and comprehensive approach to valuing intangible assets. These are non-physical assets such as patents, brand names etc. He has developed an indirect valuation metric called the Competitiveness Score, which examines business quality and the indirect benefits that flow from a company's intangibles. Companies with strong intangible assets generally perform better when higher quality stocks are doing better, but they are not completely correlated. Intangibles are more prevalent among service-oriented companies rather than manufacturing or commodity type businesses, but intangibles are not the sole domain of consumer companies. He invests in healthcare, select technology and select industrial companies as well because of their strong intangibles. He defies traditional definitions of industries and sector by focusing on fundamental blocks that make some businesses better than others and it is clearly the differentiating feature of his approach compared to virtually every other investment approach out there.

Companies Include: Qualcomm (QCOM); Electronic Arts (ERTS); FTI Consulting (FTI); Philip Morris International (PM).

TWST: How did the companies with the intangible assets perform during a severe downturn of the market? Do your portfolios do better in up markets or down markets?

Mr. Dhingra: Generally speaking, companies with strong intangible assets do better during times when higher quality stocks are doing better. But I must say that there is not a one-to-one correlation. Because higher quality and high intangible scores, while they do have some positive correlation, they're not perfectly correlated.

Let's focus on higher quality first and then we'll talk about intangibles. Higher quality companies did extremely well during the turmoil from 2007 to early March 2009. Since the recovery started in equity markets on March 9th, 2009, higher quality companies have, generally speaking, underperformed while lower quality and somewhat speculative companies have performed better from 2009 March to May 2010. When we think about the kinds of companies that we have owned, which are companies with either strong intangibles selling at reasonable multiples or companies with average intangibles selling at cheap multiples, what we find is that in 2009 we were able to overcome the negative impact of a high quality bias and, as a result, our products had a very good year in 2009 despite having somewhat higher quality bias.

TWST: What shifts in emphasis have you made over the last 12 months or so? Since your companies don't have the same attributes as other money managers, do you need to make shifts in emphasis to reflect market conditions?

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Mr. Dhingra: Our shifts are a result of the opportunities presented by the marketplace. To give you an example, in late 2008, we noticed that all financials were beaten up, even though some financial stocks did not have the same risks as others. Specifically one industry in the financial sector that did not have the risk that banks had was the money management industry. Most money management stocks or companies do not have significant debt on their balance sheet. Their businesses are high margin, their costs are flexible and variable in nature and their businesses have a mean-reverting nature to them. When in late 2008 we noticed that money

management stocks were down as much as banks, we realized that this was a business with high quality, but it was selling as if it was a commodity business like a bank. We bought money management stocks across all of our products and that paid off handsomely when the markets recovered starting in 2009 March. Starting in the fall of 2009, we have been selling money management stocks to the point that at this time we only have one money management stock left in our portfolio.

"Competitiveness Score is designed to capture the quality of a business. We are essentially checking to see if a business has a franchise quality to it, and if it does, what is the likelihood that the franchise is going to sustain over a long period of time. We want to know whether it's a franchise that can be encroached upon or not, we want to know whether the franchise has pricing power or not."

1-Year Daily Chart of QUALCOMM

Chart provided by www.BigCharts.com

Buying these high quality companies that were being treated as if they were low quality is something that paid off very well in 2009. Now what we find is that the opportunities lie across the blue-chip segment of the stock market. Companies with high profitability, stable profitability are selling at multiples that are similar, if not cheaper than the broad market even though logic would tell us that higher quality stocks should command a premium valuation. But that is not the case at this point. Our emphasis has been shifting slowly but surely to the blue-chip end of the spectrum.

TWST: Am I right in believing that your type of intangible companies don't do well when commodities are strong?

Mr. Dhingra: Yes, generally speaking, that is correct. When commodity prices go up, commodity companies experience windfall profits. Given the fact that most of these companies have high operating leverage, they make money during times when demand shoots up during a cyclical upturn. Later on the same companies go on to lose significant money when demand turns down and supply exceeds demand. Our view is that these types of companies do not control their own destiny and therefore their businesses are somewhat lower quality and that's what gives them low intangible scores. Even a company that doesn't control its destiny can make lots of money when commodity prices go up. It implies that during periods when commodity prices are going up, we are likely to see companies with strong intangibles, in other words, companies that control their own destiny through patents, brands, distribution system etcetera, are likely to lag the market during commodities run-up. On the other side, companies with high fixed costs, high operating leverage are temporarily going to be in an environment where they are earning lots of money thus attracting more attention in the marketplace.

TWST: When we last talked, you mentioned that your competitive score is similar to what Warren Buffett refers to as an economic moat, can you talk a bit more about the competitive score?

Mr. Dhingra: Competitiveness Score is designed to capture the quality of a business. We are essentially checking to see if a business has a franchise quality to it, and if it does, what is the likelihood that the franchise is going to sustain over a long period of time. We want to know whether it's a franchise that can be encroached upon or not, we want to know whether the franchise has pricing power or not, because our view is that a business that has franchise power, the one that can increase pricing to maintain profitability, the one that's likely to last a long period of time instead of a short period of time is likely to be more valuable in the long run. Our Competitiveness Score metric is based on exactly this type of evaluation. If you see Warren Buffett's writings over the years and if you look at his holdings over the years, you will notice that he has made a significant investment in companies that had franchises with pricing power that lasted a long time.

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One example is **American Express** (AXP). **American Express** is a business that charges almost twice as much to merchants as **MasterCard** (MA) and **Visa** (V) even though it on the surface it seems to provide the same service, i.e., convenience for the customer and higher unit sales for the merchant. It's a phenomenal business in that even though **American Express** charges twice as much as its competitors, nevertheless, its growth has not suffered because it can deliver a richer, higher spending consumer to the customer. Warren Buffett must have realized this franchise quality it many years ago when he bought **American Express** and

it is the same type of quality that we try to capture through our scoring system.

"Philip Morris International is a brand-oriented company where people demand the product by their brand, they don't go up to the counter and say I want cigarettes, they specifically say which brand and which variation of that brand they want and they are willing to pay a higher price every year to get the same brand."

1-Year Daily Chart of Philip Morris International

Chart provided by www.BigCharts.com

TWST: Are the intangible asset companies more heavily weighted towards consumer-oriented stocks in service industries?

Mr. Dhingra: The latter observation is correct, the former is not. Intangibles are more prevalent among service-oriented companies rather than manufacturing or commodity-oriented companies. However it is not true that intangibles are the sole domain of consumer companies. Other examples of companies with strong intangibles that are not in the consumer sectors would be healthcare companies, selected technology companies and selected industrial companies as well.

TWST: Would you be able to tell us about some companies that you feel are representative of your investment approach and the reasons why you were attracted to them?

Mr. Dhingra: Let's focus on the technology side. **QUALCOMM** is a company that we believe is very attractively priced. I mentioned earlier that **QUALCOMM's** value is driven by its more than 9,000 patents. The company earns royalty from every wireless telephone that is sold anywhere in the world if it's based on the CDMA technology. So the company does not own physical assets. In fact many years ago it even outsourced its chip manufacturing business to focus solely on technology innovation and royalties from its patents. The company's business is to develop new technology, patent it and promote its use among telecommunication carriers. It so happens that the average selling prices for handsets and the royalties to **QUALCOMM** have declined over the last year or so. Nevertheless the basic franchise of having patents on the technology and earning a toll on every handset that's sold gives this franchise a tremendous pricing power and growth opportunities in the coming years.

We are attracted to **QUALCOMM** because given the recent decline in average selling price this company now gets valued no higher than the market when you adjust for its cash even though it is a business that's substantially above average in its quality and competitiveness score.

TWST: That's a company with a specific patent that does well, what about a company with a brand that has the pricing power and barriers to entry that you talked about?

Mr. Dhingra: If you look at it from the brand perspective, the company that comes to mind is **Philip Morris International** (PM)**. Philip Morris** sells cigarettes and about a year ago, its two businesses were separated, the US business became **Altria** (MO) and the international business became **Philip Morris International**. Cigarettes cost virtually nothing to make. Tobacco farmers earn very little for their produce as they have no pricing power relative to the giant tobacco companies. Tobacco business has become concentrated to the point that there are just a handful of companies that control the entire brand name segment of the cigarette market. Cigarettes, as we all know, are addictive and therefore lead to repetitive purchases by the consumer. It's a business that has extraordinary pricing power and you've seen evidence of that over the last ten plus years as governments have imposed higher and higher taxes on cigarettes. Cigarette companies simply transfer that higher tax to their consumers and despite the higher pricing, the demand for the product essentially stays flat - small declines in US offset by increases in consumption in emerging markets. This is one of the few products where you can observe the phenomenon that higher pricing has little impact on demand whereas traditional Microeconomics 101 would tell us that higher prices lead to lower demand for most products but that is not the case for a brand name company like **Philip Morris International**. It's a brand-oriented company where people demand the product by their brand, they don't go up to the counter and say I want cigarettes, they specifically say which brand and which variation of that brand they want and they are willing to pay a higher price every year to get the same brand.

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TWST: What about a company with a smaller capitalization that you have found attractive recently?

Mr. Dhingra: In the small cap space, one of the companies that we have bought in recent times is a company that's in the consulting business. It is called **FTI Consulting** (FCN). **FTI** has multiple businesses, advising companies about how to run their

business, a portion of its practice relates to restructuring, but it also has other businesses such as forensic accounting services, litigation services, reputation management services, etc. For example when **Toyota** (TM) recently had to do a major recall of its vehicles, **it** hired **FTI** to manage its reputation in the aftermath of the recall. This company provides a unique combination of services and it has enjoyed strong secular growth over the last several years. The stock market cap is currently under two billion and it recently showed up on our screens because its stock price failed to participate in the rally that occurred from March 9, 2009 onwards. The reason it failed to rally was partly because it is a higher quality, lower beta stock and the rally has been dominated by a lower quality, higher beta stock. Equally importantly the company's restructuring practice experienced a revenue decline creating negative sentiment towards the stock. From our standpoint, it is perfectly understandable that during a time when economic growth picks up, which is what we've seen over the last 12 months, need for restructuring goes down. In the year prior, especially in 2008, restructuring needs were significant, but in 2009, these needs declined, and investors who are used to experiencing strong growth from this company gave up on the company. But from our perspective, the franchise of the company hasn't gone away. Now we are beginning to see signs that the rest of the Company's businesses are picking up and slack. We are able to buy this company at valuations that are, once again, similar to that of the market, whereas we think of it as an above average franchise business.

TWST: What does trigger an exit from your portfolio? What is the sell process?

Mr. Dhingra: Ideally, the sell signal is achievement of the price target. Occasionally, however, it can mean that a new risk comes up that was not fully anticipated at the time of the purchase. Those are two possible reasons to make the change. The third and last reason would be, if a new idea comes up that has a higher return potential than one of the existing ideas then we would likely make the switch. But it's really in that order, meaning the price target is the number one reason to sell. Number two is reassessment of the risk, and number three is to make room for a new idea.

1-Year Daily Chart of FTI Consulting

Chart provided by www.BigCharts.com

TWST: You mentioned risk. Perhaps you can tell us a little more about how you incorporate risk management at the portfolio and at the individual stock level?

Mr. Dhingra: For us, risk measurement is directly related to our Competitiveness Score metric. As I mentioned, Competitiveness Score is essentially a measure of business quality, and quality and risk are two names for the same dimension. The higher the quality, the lower is the risk of a business. In viewing the world in this fashion, we define risk very differently than how other investors define it. Traditional definitions of risk are often times related to either beta measure or other volatility measure. But our view is that risk is just a mirror image of quality and our measurement of risk therefore is embodied in our Competitiveness Score metric at the company level. When it comes to portfolio level risk measurement, we do look at factors such as industry and sector concentration, price momentum, exposure to foreign revenue, or balance sheet oriented metrics such as debt level or net cash level.

"Competitiveness Score is essentially a measure of business quality, and quality and risk are two names for the same dimension. The higher the quality, the lower is the risk of a business. Our view is that risk is just a mirror image of quality and our measurement of risk therefore is embodied in our Competitiveness Score metric at the company level."

TWST: What is fascinating about your investment approach is that you compare companies that are in completely different industries and quite different from the way most money managers select individual companies from particular sectors? Tell us about your process and the way that it's differentiated from peer companies?

Mr. Dhingra: You have hit the nail on the head in making the observation that our process cuts across all sectors and industries. We defy traditional definitions of industries and sectors by making our focus fundamental blocks that make some businesses better than others. It is clearly the main differentiating feature of our approach compared to virtually every other approach out there. In using this approach, we are not saying that the other approaches are not useful. We are simply saying that other approaches can be enhanced by incorporating this additional insight that comes from evaluating the intangibles across

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sectors. By incorporating this additional insight, we are able to come up with a more complete stock selection model than traditional models. Over time this approach has served us very well, and in particular in 2009, this approach's strength was fully at display.

TWST: What is the performance record of your portfolios, and last time I remember you mentioned that, do you want to include that in this interview?

Mr. Dhingra: I can give you both the short-term and the long-term records. For the full-year 2009, our small-cap product had a return, net of fees, of 52.5% and that compares to 27.2% for Russell 2000 Index. Our large-cap value product had a return of 33% compared to 19.7% for the Russell 1000 value benchmark. Our large cap growth products had a return of 39.4% versus 37.2% for the large cap growth benchmark, which is Russell 1000 Growth Index.

If you look at it over a long period of time, i.e., the inception of the firm on January 1, 1998, and compare our performance since inception through end of first quarter of 2010, you will find that our small cap product's return is 8.6% compared to 5.0% for the benchmark. Our large cap value product's performance is 8.7% compared to 4.4% for the Russell 1000 Value Index. Our large cap growth product's performance is 6.7% compared to minus 1.3% for the Russell 1000 Growth Index, and all of the performance numbers are net of fees.

TWST: What is your outlook for the rest of this year, and for your type of investing?

Mr. Dhingra: In relative terms, we are very optimistic, because it's rare for us to be able to buy high quality businesses without having to pay a premium multiple for them. In absolute terms, I must admit we are cautious, because we do see valuations as being quite stretched. We are concerned about absolute returns, but excited about our ability to outperform the broad market benchmarks.

TWST: Is there anything that we didn't touch on that you wish to add?

Mr. Dhingra: I think you have brought out the essence of our investing quite well. I would simply say that we intentionally designed an approach that was clearly going to be distinguished from others in the marketplace. This product and style of investing has withstood the test of time and performed well over long periods of time. We are somewhat surprised, but happy about the fact that we still don't see systematic competition in the space. In other words, we don't see any of our competitors making systematic efforts to incorporate intangibles. But, we will take the gift horse and not look in its mouth.

TWST: Yes, you have a pretty unique company there, and it's like one of your intangible assets.

Mr. Dhingra: We hope so, and we hope it would get more recognized as time goes on.

TWST: Thank you. (PS)

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