Endeavour Investment Partners Presents

Q&A

With the Portfolio Manager

Jeffrey D. Lent

Portfolio Manager
Torray Resolute Equity Income Strategy

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Q & A with Jeffrey D. Lent

Q **Jeff, I'm curious how you came to Torray. What about your background makes you well qualified to manage an equity income strategy**

Jeff: I came to Torray from a small regional investment bank in Boston called Tucker Anthony where I ran the corporate services group, which was essentially made up of clients who received proceeds from an IPO or M&A transaction that our investment bankers had completed. My job was to custom tailor portfolios, both equity and fixed income, working with our equity research department and our bond desk to invest these proceeds. It was a demographic of people that had already hit their "home run", so their objective was to grow the money and preserve the capital, absolutely not lose it.

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Q **Would you say that "don't lose my money" mindset is how you manage the equity income portfolio today?**

Jeff: Yes, I fully believe in our growth strategy and I transitioned my clients into Resolute's growth approach but maintained an income focus. As you know, the 30 year fall in interest rates, especially 10, 12 years ago, started to really hurt clients' muni bond ladders. As the yields on fixed income securities hit repeated lows in 2010, 11, 12, 13, the dividend equity side was producing a far more attractive income component. The Equity Income strategy has established itself as a dialed down version of our growth strategy with an income component and capital preservation tilt. A lot of the idea generation is from our growth team's process when we're going through themes, sectors and macro views. But I've also become more involved with the Value team and utilize their research as well, because I think Value names have a natural bias toward preserving capital. A lot of this portfolio is the crossroads of those two practices.

Jeffrey D. Lent

Mr. Lent is a Principal at Torray and a Portfolio manager for the TorrayResolute Equity Income strategy, a Co-Portfolio Manager for the Torray Concentrated Value strategy, and a Research Analyst for the TorrayResolute Growth strategies. He began his investment career in 1987 with Kemper Mutual Funds in Chicago. Prior to joining Torray in 2010, he was an analyst and portfolio manager with Resolute Capital Management, and a Vice President with Tucker Anthony Inc. where he formed the Corporate Services Group. Mr. Lent received a BS from the University of New Hampshire in 1987.

Q If dividends are the key driver, does the type of company matter less than the dividends that they're paying?

Jeff: The type of company is almost paramount. While I have historically avoided utilities, there have been exceptions. There is definitely a qualitative screen, or sifting process, where I would much rather

"What I don't want is to be paid today with tomorrow's dollars"

take a lower and growing dividend than a higher levered, or challenged, high payout ratio that is just going to be a problem by not being able to grow. It is definitely qualitative, but there's a balance sheet view that dictates, in my mind, the quality of the company in the portfolio.

Q I know some of the other Torray strategies have a long-term patient investor type orientation. Would you say that's similar to the way you manage this strategy?

Jeff: Yes, in a way. When I buy something, I do it with the intention of holding it indefinitely. But that goal and the reality of a shifting yield curve, M & A transactions, management changes or shifting economic themes means that I will not just sit there and watch capital evaporate. Also, if a company that has been paying a high dividend suddenly diverts capital to start making acquisitions, I would likely sell. To me, all of those things are flashing indicators that they are not going to be growing their dividend.

Q I'd like to explore the sell discipline. If you're looking for at least 4 to 5 % yielders, is dropping below a certain level a key indicator that you need to replace the name?

Jeff: Well, as mentioned before, this strategy sits at the crossroads of our Growth and Value approaches. For example, I want to be able to participate in the technology revolution, it's hard to call it a revolution at 20 years old, but it is still a driving force of our economy and I also want to maintain the cash-flows of the portfolios. Most of the newer technology companies don't offer a high enough dividend, so I'll explore a more mature company with a stable dividend payout legacy to achieve the exposure I want. A stock may be too "growthy" for Value or not "growthy" enough for the Growth strategy, but if it's paying a higher than market dividend in a prudent way, meaning not borrowing a significant amount of debt to maintain their dividend or increase a buy-back, it may be a candidate for Equity Income.

What I don't want is to be paid today with tomorrow's dollars. It's important to understand how the company is generating the dividend. I view the dividend as a debt. If a company has a five percent dividend, they have made that commitment to shareholders. It may not be written in a bond covenant, but shareholders count on it and when it is cut, they tend to leave. So a company that borrows in the debt markets to meet their dividend obligation might seem smart right now, but when they have to pay off that debt at the expense of future dividends, it creates a future problem for me. The balance sheet, the dividend level, and the dividend payout ratio all go into my quality assessment. An ideal company for Equity Income is one with recurring stable revenue that we look for in our Growth strategy, but with a high or highly growing dividend payout to shareholders.

Q How do you assess a stock for its future sustainability of the dividend?

Jeff: Free cashflow yield is probably the cleanest metric because earnings alone doesn't get you there, as they can be manipulated by management. I focus on the balance sheet, particularly those of older, sleepier businesses with established management teams. By focusing on the balance sheet, I can see whether or not they are a "cowboy" management team, attempting an M&A strategy or a stock buyback, or engineering things with debt. The business has to cover its dividend and do it in a cashflow positive way, where management isn't then forced to take on risk to just maintain or grow it by a penny every year. Those are red flags to me when a dividend increase is a reach.

> "If we had a 7% ten-year, which is a much more historically normal level, then I could work with the yield curve to manage the equity exposures and expected dividend payments"

Q Thinking about risk and how you view it, over the next six to 18 months, what risks are you focused on for the strategy?

Jeff: Well, since day one I've viewed the biggest risk as sharply rising interest rates. In my quarterly letters, I often point out that I do expect higher interest rates and that we remain defensively positioned. I have a couple of different positions in the portfolio that are adjustable rate preferreds for that scenario. But I do not view sharply higher interest rates as a high probability. Things tend to move in fits and starts in the economy and the political and geopolitical world. The most likely potential problem for the portfolio is normalization of interest rates.

To me, the question is when will interest rates actually return back to where they have been historically. I want to look for quality, meaning a balance sheet supported by a financially strong business and a dividend supported by positive cashflow. A key risk mitigation element of this strategy is to try and stay in those names and not reach for yield or growth.

Q In your opinion, where is the tipping point from an interest rate standpoint for this product's value proposition once fixed income generates enough income that equity-income is no longer attractive?

Jeff: I think it's closer to 7% percent on the 10-year. I just think the cost of capital and historical equity returns get challenged at that level and you won't be compensated for equity risk. Shareholders are likely not being compensated for equity risk enough to not take the return from a 7% percent 10-year. And you're also going to see it in balance sheets and in term structures of the company. I think if this occurs, a lot of companies are going to be impacted early. Many have got a short-term structure with a heavy balance sheet where a 5% 10-year is likely going to be an 8% or a 9% handle for them at their credit rating. So I believe that's where you're going to see the early trouble for people that are reaching for yield or buying engineered dividends being paid today with tomorrow's dollars. Tomorrow's dollars aren't going to be there.

Q **Shifting gears just a little bit, if I recall correctly, your portfolio appears to be fairly concentrated. What are your thoughts on managing a limited number of stocks, and does that create potential risks?**

Jeff: You know, I wrestle with that. I know the optics of 20 names can be problematic for people. But in my experience, the bottom 6, 8, 10 performers in larger portfolios are typically the smallest in terms of their weight and tend to be lower conviction. I'm fishing in a pond of larger, more established names, so I don't feel the pressure to put lower conviction names into the portfolio. I do consistently have more names on a watch list, so I'm constantly monitoring to see what should come out of the portfolio and what should be added. I think with the diversification of sectors and the size and established nature of these companies I seek to own within the strategy, I don't feel the need to own any more than what I have strong conviction in.

Past performance is not indicative of future results. Historical observations are based on past market environments may not be replicated in the future. There can be no guarantee that any strategy will be successful. All investing involves risk, including the potential loss of principal.

This interview was prepared by Endeavour Investment Partners, LLC. The opinions expressed in this article by Jeff Lent who was interviewed by the authors are their own and do not necessarily reflect the view of Torray LLC, or Investment Planners, Inc (IPI) and are not intended to be investment recommendations.

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