ValueInvestor INSIGHT
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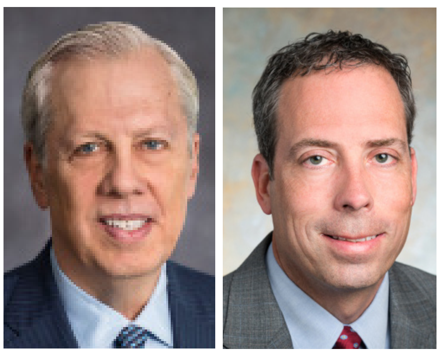
The Leading Authority on Value Investing

Great Adventure

A key goal of Clyde McGregor's balanced-fund strategy is to keep his investors from bailing at exactly the wrong time. As it turns out, that's been quite a favor.

INVESTOR INSIGHT



Oakmark Equity and Income
Clyde McGregor (*l*), Colin Hudson (*r*)

Investment Focus: Seek companies whose share prices don't adequately reflect prospective intrinsic-value growth and management's ability to deliver it.

In year 37 at employer Harris Associates and year 23 running the now-$15.8 billion (assets) Oakmark Equity and Income Fund, Clyde McGregor doesn't at all appear to have lost his enthusiasm for the game. "You hear people talk about jobs being the same old thing or drudgery," he says. "Our business is the opposite of that – every day is a new adventure."

That sunny outlook is likely aided by the fact that McGregor is as good at it as he is. Since 1995 the Equity and Income Fund has earned a net annualized 10.2%, vs. 6.9% for the Lipper Balanced Fund Index. Content with hitting singles and doubles rather than home runs, he and co-manager Colin Hudson are finding value today in such areas as passenger vehicles, auto supply, industrial products and real estate.

You've described the Equity and Income Fund you manage as "what is meant to be the least-risky, least-volatile product the firm offers." How do you deliver on that?

Clyde McGregor: It's more a function of asset allocation than security selection. The fundamental concept when starting the fund in 1995 was that a portfolio with 60% equity and 40% fixed income would capture the majority of the equity returns, but with a reduction in volatility such that clients stuck with it. That was the important thing, to craft a product that enabled people to sleep at night, while offering the potential for solid returns over time that could meet their economic needs.

We change the allocation in response to the environment, but our equity exposure is bounded by 40% on the low end and 75% on the high end. To go outside of that we'd have to go to the fund's trustees for approval. Today we're right around 60% equity, with just over 25% in fixed income and the rest in cash or cash-equivalents.

How does that basic approach inform how you pick stocks?

CM: Our research effort at Harris Associates looks for equities selling at 60% or less of intrinsic value, where intrinsic value per share is solidly growing and management teams act like owners. We as a firm generate an approved list of stocks, and from that my co-managers and I select for Equity and Income those we believe are most appropriate for the fund.

What we consider appropriate is probably best described by example. In the third quarter of last year we bought into Alphabet [GOOG], after we were able to tear apart the company into component parts and conclude we were paying a less-than-market multiple for a search advertising business that is one of best businesses in the world. That just seemed too cheap to us, and that level of cheapness for a high-quality business run by a management team that thinks like owners gave the stock a risk/reward profile fully consistent with the fund's approach.

Another excellent business whose shares we could own, but don't, would be Netflix [NFLX]. It is a rare franchise – which I obviously wish we bought at $100 – but at today's price of $315 the stock trades at 12x revenues, a valuation level that implies a riskiness I don't believe to be consonant with the needs of people who invest in this portfolio. The stock earlier this month moved up 50 points in seven or eight trading days, illustrative of the volatility present in the name, and which we try to avoid in the fund.

Colin Hudson: Netflix is an interesting example because we own its bonds but not its stock. We like to use the approved equity list to prospect for corporate fixed-income ideas. The names have been thoroughly researched, we know the management and we believe the equity is undervalued, so if the spread on the debt is attractive relative to Treasuries we typically find that interesting.

With Netflix, there's $135 billion in current equity value up against around $4 billion in net debt. We believe the company has an attractive market position, pricing power, and a long runway of growth ahead. While cash flow is negative today as they fund content development and growth, we expect the investments to pay off handsomely in the future. Given all that, we think there's a significant margin of safety in the debt – we own BB-/B+ issues maturing in 2025 and 2028 – and we can earn a yield that is 245 basis points above the 10-year Treasury. In today's market, that's attractive.

Sticking with fixed income, you discussed in a recent letter the notion that interest rates may not revert to the mean as you've expected. You didn't commit to a conclusion – what are your latest thoughts?

CM: What prompted that letter to investors was a report a client suggested I read from the National Bureau of Economic Research that made the case that the mean value for interest rates has shifted and that today's term structure is more or less the new normal. Part of the argument is that the "natural" rate of interest – the level that neither stimulates nor retards economic activity – is a function of economic productivity and population growth, and that low rates today reflect reduced levels of both. The authors made the case that while the natural interest rate was 8% 15 years ago, it's less than 3% today.

I wrote about that as a counterweight to what I'd written before, allowing for a different possible reality here that I may not have been paying enough attention to because of my own formative experience as an investor, during which interest rates were far higher than they've been in recent years. I don't necessarily accept the argument they make, but I do have to think about how to construct the portfolio in a world that at least acts like they are right for the indeterminate future.

That may simply mean that we continue our approach of having a very low duration fixed-income portfolio for some time to come. But while that does still help reduce portfolio volatility, it doesn't for the most part offer positive rates of return that are meaningful. That's a top-of-mind issue for any balanced-fund manager.

Another important aspect of this is that if we're in a secular period where the 10-year Treasury is bounded by 3% at the top, the numbers used for expected returns from endowment funds, pension plans and from people's own retirement savings are too high. It's unclear to me, if fixed income doesn't provide much support and interest rates don't go much higher, how people relying on historically derived rates of return are going to handle that. It's particularly problematic with equities at such high levels. This issue concerns me a lot more than whether I'm right tactically in terms of managing the portfolio.

ON NETFLIX:

An excellent business whose shares we could own and don't. But we do see a margin of safety in its debt.

Turning from that sobering thought back to stock picking, describe why something like recent-purchase Regeneron [REGN] got on your radar screen.

CM: This is a business we had admired from a distance, with long-tenured management that owns a lot of stock. Starting in the middle of last year it had a sharp drop in the share price [from around $515 to $325], at which point it caught our attention. The company has an unusually high percentage of sales going into research and development and an unusually broad portfolio of products in development or recently approved. In tearing apart the numbers – especially with respect to R&D and sales costs on recent drug launches, and what things would look like on a more normalized basis – we thought the stock was no longer egregiously valued and instead priced at a low-teens earnings multiple, for a company that had far greater-than-market growth potential. Above $500 we weren't paying any attention. When it got to $325 we could construct a value case for it.

We've spoken recently to bulls as well as bears on AIG [AIG]. Why did you buy its shares in the second half of last year?

CH: AIG at this point is probably best known for needing significant government support during the financial crisis. Since then it has been through a very long turnaround process that has led to improved results, but the company has continued to struggle with adverse reserve development in its general insurance business. A lot of our interest has to do with the naming last May of Brian Duperreault as CEO. He spent 20 years at AIG and then was instrumental in improving returns and growth when he served as CEO of ACE Limited and of Marsh & McLennan.

AIG's life-insurance and retirement businesses are doing fine, but to be excited about the stock – which trades at 80% of book value – you have to believe Duperreault and the impressive additions to the management team he's made can sustainably improve underwriting profitability in the general property/casualty insurance business. We're confident they can and believe the company within the next few years can earn an overall return on tangible book value – not including a large deferred tax asset – somewhere around 11%. That should then be worth closer to 1.2x our estimate of a then high-$60s per share tangible book value, which plus the big deferred tax asset would result in a share price closer to $90. From a share price in the mid-$50s today, there's quite a bit of upside.

You tend to invest further down the cap-size spectrum than most investors with the level of assets you manage. What's the rationale for that?

CM: I've always felt that we should be willing to pick up nickels off the street if it can make money for our clients. We could choose to have a 20-stock fund, but we typically have 40 to 50 equity holdings in large part so we can continue to expose the portfolio to interesting mid-cap or smaller ideas that are not large enough to be 3% positions in a $16 billion fund. Something like 20% of the names in the portfolio are less than $10 billion in total market cap, with the smallest today at just under $3 billion.

Those types of names have had a meaningful positive impact on the portfolio over the past ten years. In the market downturn of early 2016, for example, we bought a stake in Oshkosh Corp. [OSK], which makes specialty vehicles for commercial, defense and public-sector markets. We could never own it at the position size of a Bank of America or General Motors, say, but it worked out quite well for the fund as it tripled from our best purchase price.

CH: Comerica [CMA] would be another example where we were able to be opportunistic with a non-large-cap name. It's a Texas-based bank we purchased around the same time as Oshkosh, when we thought other investors were excessively worried about the company's energy loans as well as the impact of low interest rates. We only got it to about a 50-basis-point holding, but it fairly quickly doubled and we sold as it approached our estimate of fair value.

CM: Sometimes we don't get to the position size in these types of names that we could. You could ask today, for example, why we have a 30-basis-point position in LivaNova [LIVN], a medical-device company with a market cap of $4.3 billion. The company manufactures devices used to treat severe epilepsy and in various cardiology applications, and over the past 18 months has named a new CEO and CFO who are rightly focusing on exiting non-core businesses and on improving growth and margins. We bought in the third quarter of last year in the high-$60s, but the stock moved quickly enough that we weren't able to get the position size I would have wanted at that price. Now the stock is in the high-$80s and we're still happy with the shares we own.

With the U.S. market considered pricey, we could have imagined more than the current 10% of your portfolio invested in non-U.S. names.

CM: That's pretty much where it's been for some time. It's not as if international stocks haven't moved as well. When people talk about Europe being cheaper than the U.S., for example, you have to remember that Europe has a small component of technology names. If you take technology out of the U.S. and out of Europe, the valuations today are quite similar.

ON SMALLER-CAP NAMES:

I've always felt that we should be willing to pick up nickels off the street if it can make money for our clients.

When we've spoken in the past about mistakes, you mentioned as a general category counting on reversions to the mean that didn't happen. What can you do, or have you done, to try to avoid those?

CH: It sounds straightforward, but one important thing we do is closely track how our estimated intrinsic value is progressing versus original expectations. We've found that when intrinsic value growth falls materially short of our initial targets, the stock falls into what we call the "poison pond," which usually leads to lagging performance in subsequent periods. We don't sell automatically when we see that starting to happen, but our sense of urgency to make sure we understand what we might be missing is that much higher.

An example from last year would be Flowserve [FLS], which makes industrial pumps and valves. We bought into it after oil prices fell, but we didn't forecast well the impact of the energy decline and the results quickly and materially trailed our expectations. We could make the case the stock still was reasonably attractive, but sensing that the recovery would take longer than expected, we decided to utilize the tax loss and move on.

Did something similar happen with General Electric [GE], which we see you bought in the third quarter of last year and then sold in the fourth quarter?

CM: With GE, we were attracted to the fact that much of the business portfolio was composed of high-return, market-leading franchises, particularly in aviation and healthcare. We expected the new CEO to refashion the portfolio and cut costs aggressively, and that earnings could then grow favorably from the reset base. We were also attracted to the dividend yield, which isn't a primary driver of interest for us, but can support the case of a name where we see somewhat higher risk.

It was unnerving when management announced big new reserves against losses in the financial-services business, which we didn't think was going to be an issue, and when they cut the dividend sharply due to the challenges in the ongoing businesses. There's active debate here about GE, which we continue as a firm to believe trades at a significant discount to intrinsic value. For us, we decided at the time to step out – partly to offset a short-term capital gain we had on another holding that got a cash takeover offer – but we're still paying careful attention. I would say we're probably looking for a bit more clarity on the company's path forward than we believe we have at the moment.

CH: One other thing I'd mention from a process perspective that you've heard from us before: To combat value traps we build in formal devil's-advocate reviews of our holdings on a regular basis, including right off the bat when new ideas are presented. There's a natural tendency in investment research to gravitate over time to one side of the story or the other. We think it's critical to keep both sides front and center from beginning to end.

On the subject of value traps, we see you're light on retail names at the moment.

CM: As a firm, we have very little exposure to domestic retail. The only retail name we have in the portfolio today is Foot Locker [FL], which we've owned for several years. While it trades for more than we originally paid, we missed out on selling as much as we should have, which was my mistake, when the stock was in the $70s 18 months ago. Its business is under pressure from online competition, in particular the fact that Nike – which accounts for something like 70% of Foot Locker's sales – has started selling directly through Amazon.

You might ask why we still own it. At the current share price [of $44.50], the stock trades at a single-digit P/E on our 2019 estimates. You would think after a nine-year bull market there'd be nothing left trading at such a valuation. But Foot Locker is, and we believe the company can still earn reasonable money in this environment. If that's true, and it obviously depends on us being right on our earnings estimates, the stock shouldn't trade at a single-digit P/E.

From one single-digit P/E to another, describe your investment case for General Motors [GM]?

CM: GM is well-financed, nicely profitable and has a stock that is stunningly cheap and hated, making it a quintessential value play. It still carries the stigma of the old GM, but this is a different company than the 2009 version. Under Mary Barra, who took over as CEO in 2014, GM has sold off or reorganized a number of international businesses and has deemphasized low-margin sales to rental-car companies. Today it generates the majority of its earnings from strong franchises in U.S. trucks and sport-utility vehicles, where its market share is close to 40%. Also a standout is its business in China, now the world's largest auto market, where it generates close to 20% of total earnings.

Barra also deserves credit for GM's standing in two major industry growth markets, autonomous and electric. She was criticized for spending more than $1 billion in 2016 to acquire Cruise Automation, an autonomous vehicle technology startup, and for last year buying Strobe, which makes light detection and ranging (LIDAR) technology. Despite the critics, GM's autonomous-vehicle business places first in some rankings, including a recent one by consulting firm Navigant, ahead even of Alphabet's Waymo. GM is also a formidable competitor in the electric-car market, where its Chevy Bolt beat Tesla to the mass market. We don't speculate on what these emerging businesses are worth, but the option on their ultimate value is certainly free at the company's current share price.

How do you handicap the possibility that we are near a peak in the auto cycle?

CH: We recognize that vehicle sales in 2009 were just over half the current level, but that was an unusually weak economic environment and the industry has evolved quite a bit. The new and improved GM would still be profitable at a far lower rate of vehicle sales, and secular growth in China is likely to mitigate the impact to the company of industry pullbacks elsewhere. In our view, a bigger risk than declining auto sales would be a sudden move away from large vehicles to low-margin small cars, but there doesn't seem to be any momentum in that direction.

I would add that while the stock's valuation seems to reflect the herd's view that auto sales will collapse, it's interesting that the bond market doesn't seem to share those concerns. The yield today on

INVESTMENT SNAPSHOT

General Motors
(NYSE: GM)

Business: Manufacturer of passenger cars and trucks sold through subsidiaries and JVs under the Chevrolet, Cadillac, Baojun, Buick, GMC, Holden, Jiefang and Wuling brands.

Share Information (@4/27/18):

Price	**37.65**
52-Week Range	31.92 – 46.76
Dividend Yield	4.0%
Market Cap	$53.07 billion

Financials (TTM):

Revenue	$145.59 billion
Operating Profit Margin	7.3%
Net Profit Margin	(-2.6%)

Valuation Metrics
(@4/27/18):

	GM	S&P 500
P/E (TTM)	n/a	24.1
Forward P/E (Est.)	5.9	17.0

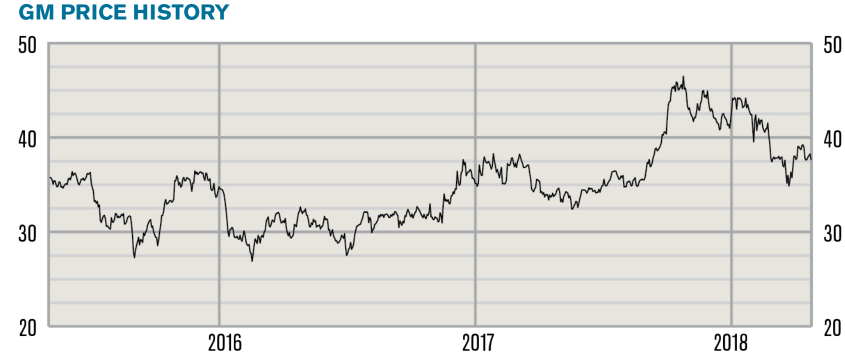
Largest Institutional Owners
(@12/31/17):

Company	% Owned
Vanguard Group	6.1%
Harris Assoc	4.3%
BlackRock	4.0%
State Street	4.0%
Berkshire Hathaway	3.6%

Short Interest (as of 4/13/18):

Shares Short/Float	2.3%

GM PRICE HISTORY



THE BOTTOM LINE

The company no longer deserves the stigma of the "old GM," says Clyde McGregor, as it has dramatically lowered its breakeven sales level and benefits from a strong position in secularly growing China. At what he considers a more reasonable 10x multiple on his 2019 EPS estimate of $6, the stock would trade at nearly 60% above its current level.

Sources: Company reports, other publicly available information

GM's seven-year bonds, for example, is still quite low, at just over 4%.

At a recent $37.65, how cheap do you consider the shares?

CH: Based on our forecasts for global auto sales in each region in which GM competes and what we believe are normalized margins in each market, we estimate 2019 EPS at $6. On that we apply a 10x multiple – reasonable given our expectations of low-single-digit revenue growth and a high-teens return on invested capital – to arrive at a fair-value estimate for the stock of $60. On top of that, we're earning $1.50 per share in annual dividends, a 4% yield on today's price.

GM's earnings haven't fully translated into free cash flow because of investments in a new truck platform that debuts with the 2019 model year. This launch could not only be a boon to sales and help offset the maturing cycle, but it also should result in significantly higher free cash flow as capital spending falls more in line with depreciation. As free cash flow improves as a percentage of earnings, the company would be in a position to repurchase a significant amount of stock, which would be accretive to per-share value.

In your last interview with us [*VII*, November 30, 2012], your colleague described auto supplier Lear [LEA] as a "mediocre cyclical company" that also happened to be extremely inexpensive. With the stock having more than quadrupled since, why do you think it's attractive today?

CH: In 2012 there were signs that global auto suppliers were becoming better businesses, but that wasn't the key then to our investment case. Since then, however, the industry has evolved in a positive way as the large global auto suppliers have continued to gain market share. Lear's revenues have grown in the high single digits annually and the company's operating margin is 50% higher than it was in 2012. It over that time has also repurchased more than 40% of its outstanding shares, while keeping net debt to EBITDA at only 0.2x. Given the changes in the industry structure, we believe the improvements in the business are sustainable.

The company's two big businesses are in seating and electrical distribution systems, which respectively make up roughly two-thirds and one-third of total operating profit. In seating, Lear has about 30% of the global market and has in recent years been taking share from its primary competitor, Adient [ADNT]. The company spent a decade moving plants from high-cost areas and also to be closer to customer manufacturing facilities, which has helped reduce production costs while also making Lear harder for competitors to displace. In electrical distribution systems it is one of four global suppliers, and the primary growth driver is the expected increasing prevalence of electric vehicles. Management expects the electrical-systems business to grow five percentage points faster than the overall industry as electric vehicles go mainstream.

CM: Lear has also had the good fortune of rising demand for more advanced seating technology, primarily in heating and cooling functionality and in passenger-safety applications. Just from personal obser-

INVESTMENT SNAPSHOT

Lear
(NYSE: LEA)

Business: Global supplier of automotive seating and electrical systems to original-equipment vehicle manufacturers; found in more than 400 vehicle nameplates worldwide.

Share Information (@4/27/18):

Price	**188.21**
52-Week Range	133.78 – 202.42
Dividend Yield	1.5%
Market Cap	$12.48 billion

Financials (TTM):

Revenue	$20.47 billion
Operating Profit Margin	8.2%
Net Profit Margin	6.4%

Valuation Metrics
(@4/27/18):

	LEA	S&P 500
P/E (TTM)	10.1	24.1
Forward P/E (Est.)	8.9	17.0

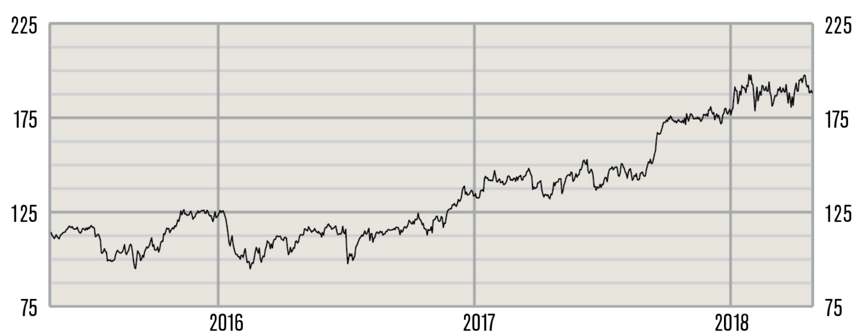
Largest Institutional Owners
(@12/31/17):

Company	% Owned
Vanguard Group	9.4%
Norges Bank Inv Mgmt	5.5%
BlackRock	4.9%
AQR Capital	3.7%
LSV Asset Mgmt	3.7%

Short Interest (as of 4/13/18):

Shares Short/Float	4.3%

LEA PRICE HISTORY



THE BOTTOM LINE

Even assuming the company's top-line growth slows, Colin Hudson believes secular car-industry trends in seating and electrical systems can drive high-single-digit EPS growth over the next few years. That plus the company's strong market positions should warrant a 15x P/E, he says, which on his 2019 estimates would result in a $315 share price.

Sources: Company reports, other publicly available information

vation, probably 80% of the vehicles at my train station now are SUVs or crossovers, which generally have higher-value seats. Not only are the seats higher value, there are also more of them in the growing number of SUVs with three rows of seats. This is illustrative of how the current state of the market plays to Lear's strengths.

Is the recent retirement of the company's CEO, Matt Simoncini, a concern?

CH: His appointment in 2011 was the catalyst for our investment. We thought he was an excellent operator and valued his conservative approach to managing the balance sheet. While we were disappointed he chose to retire, his successor, Ray Scott, has been with the company for 30 years, most recently as president of the seating business. Given Scott's long tenure and the fact that Simoncini remains at the company in an advisory role through the end of the year, we expect the transition to be smooth.

How are you looking at valuation with the shares trading at around $188?

CH: On our $21 EPS estimate for next year, the stock trades at only a 9x P/E, which we don't consider reasonable. Even if we assume slower top-line growth than the company has been generating, with share repurchases we think earnings can increase at a high-single-digit rate over the next few years. In terms of the multiple, we'd argue the company deserves a premium to OEMs because there are only a handful of firms that can supply seating and electrical systems on a global basis, and given the increasing technology and content involved for both, we expect Lear to meaningfully outgrow global auto production. There's cyclicality, but the company's global footprint protects it somewhat from the possible correction in U.S. auto sales. All in, we believe the shares deserve a 15x P/E, which on our 2019 estimate would yield a share price of $315.

Tell us about one smaller-cap holding, diversified manufacturer Carlisle [CSL].

CH: A key part of Carlisle's identity is its culture of continuous improvement, which is embodied in what it calls the "Carlisle Operating System." The basic principles focus on innovation and continuous improvement toward creating sustainable advantage, and management consistently adjusts the business portfolio to emphasize higher-return businesses. This has led to a doubling of operating margins over the past decade.

The company recently sold its lower-quality foodservice business, for example, and we expect them to sell the marginally profitable braking business within the next year. We expect the sale proceeds to be reinvested back into higher-margin businesses or used for bolt-on acquisitions. Management also believes the stock is undervalued and announced earlier this year a five-million-share repurchase plan.

Describe the more important operating business lines.

CH: The construction-materials segment is the largest business, accounting for 65% of revenue and 75% of operating income, with main products in insulation and non-residential roofing materials. In roofing,

INVESTMENT SNAPSHOT

Carlisle
(NYSE: CSL)

Business: Diversified manufacturer of niche commercial products, including roofing membranes, insulation materials, cookware, vehicle components and high-end wire and cable.

Share Information (@4/27/18):

Price	**108.09**
52-Week Range	92.09 – 119.21
Dividend Yield	1.5%
Market Cap	$6.63 billion

Financials (TTM):

Revenue	$4.09 billion
Operating Profit Margin	13.3%
Net Profit Margin	8.9%

Valuation Metrics
(@4/27/18):

	CSL	S&P 500
P/E (TTM)	18.9	24.1
Forward P/E (Est.)	15.7	17.0

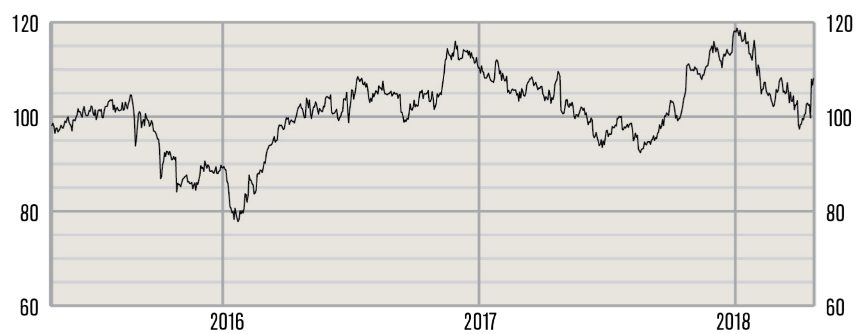
Largest Institutional Owners
(@12/31/17):

Company	% Owned
Vanguard Group	9.5%
BlackRock	7.6%
JPMorgan Inv Mgmt	5.8%
Atlanta Capital Mgmt	4.8%
Perkins Inv Mgmt	4.5%

Short Interest (as of 4/13/18):

Shares Short/Float	3.8%

CSL PRICE HISTORY



THE BOTTOM LINE

The company's entrenched businesses in the hands of highly capable management should allow it to grow at twice the rate of GDP while earning 45% returns on tangible capital, says Colin Hudson. At what he considers a warranted P/E multiple on his expectation for 2020 cash earnings, he arrives at a fair-value estimate two years out of $180.

Sources: Company reports, other publicly available information

the most-profitable business is in what's called EPDM roofing, a rubber product that commands 50% of the market and competes in a duopoly with Firestone. EPDM roofing exploded in popularity in the 1980s and the installed base provides an excellent source of replacement demand.

The second-largest business line is called interconnect technologies, which sells high-performance wire and cable products. The business accounts for about 20% of overall revenue and operating profit, and benefits from significant regulatory barriers to entry in serving its top-end market, commercial aerospace. Organic revenue growth here has averaged 9% per over the last decade.

One other division I'd mention is fluid technologies, which manufactures finishing equipment used in the coatings and auto-refinishing markets. The business was acquired in 2015 for $590 million and management has indicated that it's one with attractive expansion potential.

Carlisle's shares, now $108, were off nearly 20% from their January high before rebounding somewhat. What happened?

CH: Restructuring charges in 2017 were unusually high, at 60 cents per share, due to a renewed focus on efficiency from the new CFO, who has been on the job for about a year. Another drag on earnings has been an increase in the price of oil, a key input for roofing materials. We see that as somewhat of a timing issue, and expect the company to be able to pass on a majority of the raw-material cost increases, especially in its EPDM business. I would also point out that in 2017 there was $1.15 per share in amortization expense, so earnings would have been 20% higher if Carlisle reported cash earnings, as many of its peers do.

What upside do you see in the share price from here?

CH: Management's stated goal is to double revenues, increase operating margins by seven percentage points, and achieve $15 per share in earnings by 2025. That implies mid-teens earnings growth and is consistent with mid-single-digit annual revenue growth combined with margin expansion and a reduced share count.

For our valuation we're more or less in line with management's expectations in the near term, estimating $11 per share in cash earnings – after adding back $1 per share in amortization expense – in 2020. We think a high-teens multiple is warranted for a business with twice the revenue growth of GDP and 45% returns on tangible capital. Even using 16-17x, we arrive at a fair value for the shares two years out of $180.

Explain why you're high on the prospects for real estate developer Howard Hughes Corp. [HHC].

CM: The company has three discrete pools of assets: core master-planned residential communities in Las Vegas and Houston; a geographically diverse mix of operating commercial and retail properties; and a large pool of real estate that is undeveloped or in development. We consider the existing assets well-conceived and well-

INVESTMENT SNAPSHOT

Howard Hughes Corp.
(NYSE: HHC)

Business: Owns, manages and develops commercial, residential and mixed-use real estate in and around markets including New York City, Houston, Las Vegas and Honolulu.

Share Information (@4/27/18):

Price	**135.07**
52-Week Range	114.28 – 140.38
Dividend Yield	0.0%
Market Cap	$5.82 billion

Financials (TTM):

Revenue	$1.10 billion
Operating Profit Margin	17.4%
Net Profit Margin	15.3%

Valuation Metrics
(@4/27/18):

	HHC	S&P 500
P/E (TTM)	34.5	24.1
Forward P/E (Est.)	18.4	17.0

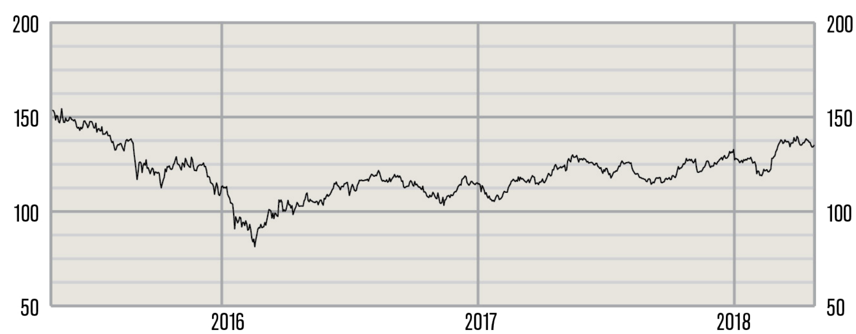
Largest Institutional Owners
(@12/31/17):

Company	% Owned
Vanguard Group	6.8%
Pershing Square Capital	5.1%
Harris Assoc	4.0%
Baillie Gifford	3.9%
Horizon Asset Mgmt	3.6%

Short Interest (as of 4/13/18):

Shares Short/Float	3.0%

HHC PRICE HISTORY



THE BOTTOM LINE

Possibly because its shares pay no dividend, Colin Hudson doesn't believe the market is giving the company full credit for the portfolio of residential and commercial operating and in-development real estate assets it commands. Based on a bottom-up property-by-property analysis, he estimates current net asset value per share at $180 to $200.

Sources: Company reports, other publicly available information

run, and almost all of the assets are irreplaceably located in densely populated and growing urban areas. Importantly, the company has enough operating assets that it can self-fund new development, so our equity shouldn't be diluted.

I've followed the real estate industry for my entire 36 years at Harris Associates and one of the things I've observed over the years is that real estate pools that have no dividend yield, like this one, often fall through the cracks of the stock market. One good example was our investment years ago in Catellus Development Corp., which was ultimately acquired by ProLogis at a wonderful premium to our initial investment. In some sense, our investment in Howard Hughes is an attempt to recreate another such victory.

As is the case with all our investments, we put a great deal of emphasis on top management's acumen and its alignment with shareholder interests. Here we believe we're well represented by CEO David Weinreb, who has been in charge since the company was spun off from General Growth Properties in 2010. Particularly impressive is his willingness to make long-term investments in the company's stock with his own capital. In 2010 he invested $15 million to purchase warrants on 2.4 million shares of common stock, exercisable in 2016 at $42.23. Last year he invested another $50 million for the right to purchase two million shares in 2022 at an exercise price of $124.64.

Tell us more about the key individual properties.

CH: The portfolio is anchored by the master-planned communities Summerlin in Las Vegas and The Woodlands in Houston, each of which is larger than the island of Manhattan. Summerlin is a 28-year-old, high-end community nine miles from the Las Vegas Strip, where lots in the most desirable areas over the last two years have sold for more than $3 million each. Hughes still owns all the remaining undeveloped land, including 3,000 residential acres and 800 commercial acres.

The Woodlands, first created in 1974, is one of the nicest communities in Houston and there is still in the original development 1,000 residential lots and 750 commercial acres remaining to be developed. There is also a future phase underway, located on 2,000 acres 13 miles to the north of the existing community. Both Summerlin and The Woodlands provide low-risk development pipelines that should be sources of shareholder value for many years to come.

Other key operating and in-development properties include a mixed-use development in New York City's South Street Seaport, a 60-acre master-planned community called Ward Village in Honolulu, and a number of retail and commercial properties in downtown Columbia, Maryland. Again, while it won't all happen tomorrow, we think these should be highly attractive sources of both existing and future shareholder value.

To that point, what do you think the company's shares, now at $135, are more reasonably worth?

CH: We've gone through property by property to assign values, dividing them up by master-planned communities, operating assets, and strategic developments. For the master-planned communities, Summerlin and The Woodlands, we arrive at a per-share net asset value of $71, which is basically our estimate of the present value of remaining acreage sales. The operating assets, which are primarily retail and office properties located in the MPCs, we believe are worth $38 per share, based on cap rates between 5.5% and 7.5% (depending on the market and property) and applied to our estimates of normalized net operating income.

For the strategic developments, we arrive at $89 in per-share net asset value, the two largest components of which – each worth more than $20 per share after accounting for remaining development costs – are Ward Village and South Street Seaport. For Ward, we base our value on a discounted cash flow analysis of future condominium sales plus a value for the retail square footage. For South Street Seaport, we imply a rent per square foot that is comparable to Manhattan retail and office properties. Overall, after subtracting about $9 per share of corporate net debt, our value estimate is in the range of $180 to $200 per share.

Did Pershing Square Capital's January sale of more than half its stake in Howard Hughes raise any red flags?

CM: No. Bill Ackman is still the Chairman of the company's board and the stock remains a meaningful investment for his fund. We don't believe the sale signals any diminished expectations about the company's prospects.

Clyde, you've made it known that you expect to retire in five years, at age 70. Why set a time limit?

CM: It's not an age thing. As a matter of fact, I'm actually getting younger all the time because I keep getting body parts replaced – two knees, one shoulder and now another shoulder on the way.

I enjoy everything about being a portfolio manager. Every day is unique. I like the competitive aspects of it and that your performance is measurable – even though you sometimes feel badly about how the measurement is turning out. I very much enjoy working with my smart and engaged colleagues.

The reason I've told people at the firm that I hope they'll let me stay until I'm 70 is primarily because I don't want to be in the way of younger people here, foreclosing them from the type of opportunity I've been able to enjoy. If that weren't the case, I'd be much harder to get rid of. VII

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Average Annual Total Returns (as of 12/31/18)					
	1 Year	3 Year	5 Year	10 Year	Inception (11/01/1995)
Oakmark Equity and Income Fund OAKBX	-8.33%	5.20%	3.50%	7.83%	9.50%
Lipper Balanced Fund Index	-4.68%	5.25%	4.48%	8.47%	6.50%

Gross Expense Ratio (as of 09/30/2018): 0.88%
Net Expense Ratio (as of 09/30/2018): 0.78%

Past performance is no guarantee of future results*. The performance data quoted represents past performance. Current performance may be lower or higher than the performance data quoted. Total return includes change in share prices and, in each case, includes reinvestment of dividends and capital gain distributions. The investment return and principal value vary so that an investor's shares, when redeemed, may be worth more or less than the original cost. To obtain most recent month-end performance data, visit Oakmark.com.*

As of December 31, 2018, the holdings mentioned above comprise the following percentages of the Fund's total net assets:

Security	OAKBX
ACE	0.0%
Adient	0.0%
Alphabet Cl C	2.2%
Amazon	0.0%
American Intl Group	1.2%
Bank of America	4.8%
Carlisle	0.6%
Catellus Development Corp.	0.0%
Comerica	0.0%
Flowserve	0.0%
Foot Locker	1.7%
GE	0.0%
General Motors	5.0%
Howard Hughes	0.5%
Lear	1.3%
LivaNova	0.4%
Marsh McLennan	0.0%
Netflix	0.0%
Nike	0.0%
Oshkosh Corp.	0.0%
ProLogis	0.0%
Regeneron Pharmaceuticals	0.8%
Tesla	0.0%

Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks. Current and future portfolio holdings are subject to risk.

Please visit Oakmark.com to view the full list of holdings for the Oakmark Equity and Income Fund as of the most recent quarter-end.

The Price-Earnings Ratio ("P/E") is the most common measure of the expensiveness of a stock.

EPS refers to Earnings Per Share and is calculated by dividing total earnings by the number of shares outstanding.

EBITDA refers to Earnings Before the deduction of payments for Interest, Taxes, Depreciation and Amortization, which is a measure of operating income.

The Lipper Balanced Fund Index measures the equal-weighted performance of the 30 largest U.S. balanced funds as defined by Lipper. This index is unmanaged and investors cannot invest directly in this index.

The Oakmark Equity and Income Fund invests in medium and lower quality debt securities that have higher yield potential but present greater investment and credit risk than higher-quality securities. These risks may result in greater share price volatility. An economic downturn could severely disrupt the market in medium or lower grade debt securities and adversely affect the value of outstanding bonds and the ability of the issuers to repay principal and interest.

The Oakmark Equity and Income Fund's portfolio tends to be invested in a relatively small number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund will have a greater impact on the Fund's net asset value than it would if the Fund invested in a larger number of securities. Although that strategy has the potential to generate attractive returns over time, it also increases the Fund's volatility.

The discussion of the Fund's investments and investment strategy (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) represents the Fund's investments and the views of the portfolio managers and Harris Associates L.P., the Fund's investment adviser, at the time of this letter, and are subject to change without notice.

Before investing in any Oakmark Fund, you should carefully consider the Fund's investment objectives, risks, management fees and other expenses. This and other important information is contained in a Fund's prospectus and summary prospectus. Please read the prospectus and summary prospectus carefully before investing. For more information, please call 1-800-OAKMARK (625-6275).