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MONEY MANAGER INTERVIEW

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Short-Term Concerns Create Entry Points for Long-Term Investors

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ESWAR MENON is the Founder and Chief Investment Officer of Harper Capital Management LLC. He is also a Trustee and Chairman of the Investment Committee for the San Jose Police & Fire Retirement Fund, and an Advisor to India-based Sameeksha Capital, a wealth and equity portfolio management group. Mr. Menon manages portfolio investments in three equity strategies — Global Equity, International Value and Emerging Markets. Before starting Harper Capital Management, he had more than 25 years of asset management success in prominent Wall Street firms such as Nicholas Applegate Capital Management, Loomis Sayles & Co., Denahi Global Investments, WHV Investment Management, and Geneva Advisors. He holds an undergraduate degree in electrical engineering from the Indian Institute of Technology Madras, a graduate degree in electrical and computer engineering from the University of California, Santa Barbara, and an MBA from the University of Chicago.

SECTOR — GENERAL INVESTING

(AHW500) TWST: For readers who may not be familiar with Harper Capital from past interviews, could you tell us a bit about your firm, your role within it, and your own professional background and experience?

Mr. Menon: Harper Capital was set up over seven years ago and we manage three strategies: an international value strategy, a global emerging markets and a global all country equity strategy. Two of the strategies, the international value and the emerging markets, have about seven-and-a-half-year track records now, and the global equity has a three-and-a-half-year track record.

Our process is very institutional. We emphasize a very rigorous and disciplined investment process. We talk about how we differentiate ourselves from other managers, and I'll walk you through some of those.

Our investment process is the same as it was when we talked last year. We focus on durable businesses that have long-term growth and that trade at an attractive discount to what our estimate of intrinsic value is. And so, how are we different?

First of all, we identify specific market inefficiencies, and to us those are — one is that the durable businesses that we invest in have short-term potential problems, not longer-term problems. When investors with more of a shorter-term focus exit these companies, we find them trading at a discount to our estimate of intrinsic value. So that's an opportunity to invest in them.

Second is that some of these businesses, they have much longer runway for growth than what the market estimates, that runway for growth, and therefore, again, the valuation is attractive. We are very long-term focused, what we say is a generational focus, and that again is different from many other asset managers. Our portfolio turnover is very low. It's 10% to 15% annualized.

Our definition of risk is also differentiated. We view risk as the permanent loss of capital rather than volatility. And therefore, protecting capital in all our portfolios is a very important part of what we do. And all our portfolios have excellent downside protection.

And lastly, I would say that our track records now are quite lengthy and our ex-post portfolio analytics support what we say ex-ante in terms of how we manage and how we differentiate our investment process. So the proof of what we say we do is there in the analytics if you look at our portfolios.

We are a GIPS-compliant firm, and therefore, our performance records are GIPS-compliant and they adhere to those strict industry standards.

TWST: It sounds like Harper has quite an international scope as opposed to being more domestically focused. Is Harper's overall philosophy, then, that better value opportunities can be found outside of North America?

Mr. Menon: No, what we think is the U.S. has great companies and a global portfolio has exposure to the U.S. But we think there's greater inefficiency in those external markets and therefore, we are active managers and our investors pay us a higher fee than you could do with ETFs, and we need the ability to be able to deliver, being an active manager.

Having said that, two of our strategies are exclusively focused outside the United States and the Global Strategy includes both domestic and international companies.

TWST: Given what you described as your institutional bent, it sounds as well like you favor companies that are already quite established in their fields, as opposed to being more speculative or innovative in nature.

Mr. Menon: That is correct. All of our invested companies, these are durable businesses. When we analyze these companies, a key metric we look for is to be confident that these companies survive in the long term. That to us is at least 10 years.

“I mean, we are seeing less globalization. In fact, you’re seeing what some people say is a de-globalization. You’re seeing points of conflict which I think are a much greater threat to global peace than they have been in a very long time.”

And therefore in our current strategies, yes, we invest in large-cap companies which are well-established with strong business models. So yes, we do invest in more established businesses.

TWST: How have the portfolios and investments that you manage performed in 2023 and what are your expectations going into 2024?

Mr. Menon: Right. The key for what we do is we deliver performance in the long term. That to us is five years-plus. And if you look at our performance records of all the strategies, the five-year records for both the international and emerging market is top quartile. We’ve added substantial value ahead of their respective benchmarks and the peer group.

And for the global strategy, which has a three-and-a-half year track record, over that period, again, it’s done substantially better than its peer group and the benchmarks, and has also been top quartile over that time frame. So we focus on the long-term performance.

Having said that, in 2023, our emerging market strategy — we’re not done with the year as yet, but it has been ahead of the benchmark. The global strategy has been kind of in line with the benchmark, and the international strategy has been behind the benchmark.

But to us, one year is a short time frame, and there are many reasons why we may underperform, but we try to deliver over that five-plus-year time frame, and we have done that historically through changing market cycles.

TWST: Are there any macro factors that you think could drive much of the market movement within 2024? A couple of things that came to mind were the expectations of interest rates finally going down in the later part of next year, as well as the starting-to-ramp-up U.S. presidential election campaign.

Mr. Menon: Yes. First of all, we are long-term investors, and most of what we do is bottom-up company analysis. So it’s really analyzing it company by company. And we do a quarterly investment letter where we discuss the global political and macroeconomic setup to the extent that — it’s a framework and context that we use when we analyze companies.

So I’ll give you my thoughts on that, but I have to emphasize that most of what we do is less influenced by the macro and more by the company fundamentals. In terms of macro factors, I think there are two kinds of macro factors.

One, which is more important, is the longer-term macro factors. And the second, which is less important — not unimportant, but less important — is the shorter-term, which is what happens in the next six to 12 months, perhaps.

Let me start with the longer-term, which is more important to Harper Capital Management. And I think it’s, again, an important differentiator of how we are, compared to many other asset managers.

And I think our international perspective — we talked about having an international bent and all our strategies have international exposure. Global has international, and the other two are pure international. And I think our awareness of what’s happening globally, especially outside the United States, gives us an edge in terms of what we do.

And if you look at events over the last three to five years, a lot of things have changed. I mean, you go back 25 years, you had the end of the Cold War, and people talked about maybe this is a new era, a Pax Americana, if you will, a dominant America, peace in the world, globalization.

And all of that seems to have — it’s kind of receding. I mean, we are seeing less globalization. In fact, you’re seeing what some people say is a de-globalization. You’re seeing points of conflict which I think are a much greater threat to global peace than they have been in a very long time.

We know what’s happening in Russia, Ukraine, in the European theater. People are now increasingly aware of the risk to peace in the Pacific region, particularly around Taiwan. The risk of greater conflict in the Middle East.

1-Year Daily Chart of Danaher Corporation

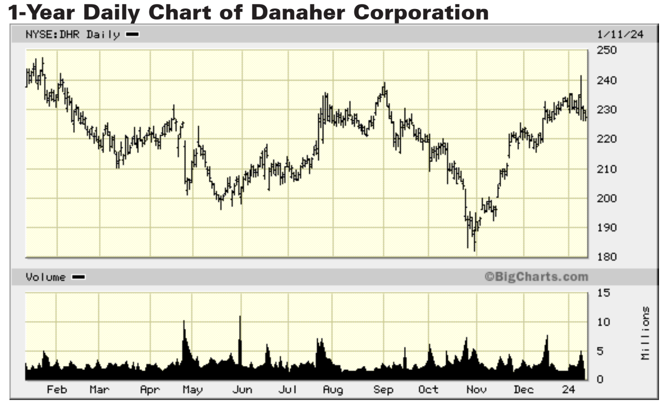

Chart provided by www.BigCharts.com

And I think we bring a perspective, just having seen the world through maybe an international perspective, that allows us to assess these risks maybe slightly differently. And we do think that all these areas are potential ones where things could escalate, where it is a risk to the global economies, right?

TWST: Absolutely.

Mr. Menon: So we are aware of that. And one of the things, if you go back and look at our investment letters over the last seven years, you will see that we have consistently highlighted the risk from China's growth, particularly since President Xi came to power, because to us that was a point at which maybe China's goals changed, if you will.

"We think that is a risk to markets, in the sense that maybe core inflation stays stickier and higher for longer, and therefore, the potential for rates to come down may not be as much as what the markets are anticipating today."

It became less about participating in global growth, being part of the global order, and more about emphasizing China's differences, i.e. going back away from the Deng Xiaoping model of growth, going back to more state control, more evocation — we just saw it in the last couple of days — of Mao.

All periods which were very bad for Chinese economic growth, and also very bad in terms of relationship between China, for most of that period, and the rest of the world.

We have highlighted the risk to investing in China for those specific reasons. And so that risk to us, underlying that is what we call the rule of law. And if the rule of law is absent where things are arbitrary, as in the case of China or in the case of Russia, often what happens, there is not a system of checks and balances. Ultimately, what happens in China really depends on one person, and what happens in Russia depends on one person.

That, to us, presents investors with a much higher degree of risk. And that's a risk that we almost always seek to avoid. So, for example, in our emerging markets portfolio, for many years now, as we became concerned about the direction of China, we've had very low to no exposure in China, despite that country being a big part of the emerging market index.

So that's the longer-term kind of risk and macro factors which we think are important and that we consider when we invest.

Now, in terms of the shorter term, the next six to 12 months, you talked about potentially inflation, interest rates, and I'll add, how will growth turn out, and the presidential elections.

So, to us, I think inflation has come down quite substantially, and not a big surprise because we always thought that there was a transitory element.

But having said that, we think that there are elements of that inflation which are a bit stickier than the market thinks right now, particularly with respect to wage inflation, because the core inflation is running higher. I mean, about 4% versus the headline inflation, which is closer to 3%.

We think that is a risk to markets, in the sense that maybe core inflation stays stickier and higher for longer, and therefore, the potential for rates to come down may not be as much as what the markets are anticipating today.

Our base case would be that inflation stays stickier, and then the markets have factored in maybe 150 basis points of rate cuts coming, and maybe those rate cuts do not at least fully materialize. And so that's a risk to markets.

In terms of economic growth, I think if you look at the different components, the cyclical aspects of economic growth are showing pressure because a lot of leading indicators, for example, have consistently shown a downtrend.

The term structure of interest rates, which is the 2 year-10 year, or the 3 month-10 year, they've been inverted for a long time. And historically, that always suggests potentially a downturn, or at least slowing economic growth ahead.

We would not be surprised if growth also surprises on the downside. So we are cautious heading into 2024, especially given that 2023 has been strong for risk assets in general and we would play it accordingly.

In terms of presidential elections, I think we talked about the rule of law, which is very important. Investors typically assume that the rule of law is not a problem in the United States. And I would say that is still largely true, but instead of being close to 100% true, maybe it is 90%, 95% true, because the partisanship between the major political parties is so deep.

And then what happened in 2020 during the election, the post-election, the change in government, etc., suggests that there are elements, particularly around one of the leading candidates, that do not view the peaceful change of power as being an important component of a democracy. We highlight that also as a potential risk.

And so, overall, we think we would take a more cautious approach to risk as we get into 2024, especially given how strong markets have been in 2023.

1-Year Daily Chart of Veralto Corp.

Chart provided by www.BigCharts.com

TWST: Now, talking to your clientele, would you say they are of a similar mind, or are you needing to convince them to be more defensive? Are they looking for profit or protection?

Mr. Menon: We get a range of views. Just like if you do a survey of people, you're going to get a range of views, often dictated by what has recently happened. If you come back to October, I think there was a lot of concern, people were very cautious. There were people saying interest rates have surged and they're going to continue to surge.

> ***"The company has what's called the Danaher business system which is kind of modeled on the Japanese concept of Kaizen, which focuses on continuous improvement and adapting to consumer needs constantly, and this speeds up innovation and reduces business risk for the company."***

Of course, things changed, and maybe the risk appetite is more today, two months later, than it was in end of October. So I would say there's a range of views, and I don't see necessarily consensus leaning one way or the other.

TWST: With regards to the structuring of your holdings in order to avoid risk in certain geographies, aside from your avoidance of China, has the Russia-Ukraine conflict caused you to shy away from European investments at all?

Mr. Menon: We would analyze each company in terms of how the Russia-Ukraine conflict is affecting them. I think the simple factor for Europe is energy prices are a risk. So for companies that used cheap Russian gas for their factories, for example, we would be a little more cautious there.

I think it's a company-by-company case, and I don't think our European exposure was affected by everything which happened there. In our case, it has not been a big deal in terms of what's happening there.

TWST: Can you tell us about some of your specific recommendations within this environment, whether they be stocks or ETFs.

Mr. Menon: Yes. I'll talk about three companies, one from each of the portfolios. And I'll start with **Danaher** (NYSE:DHR). **Danaher** is an American company which provides tools, consumables, and services to biotechnology, life sciences, and other health care segments. They're a global leader in all of their business segments.

The company has a market cap of $172 billion, an enterprise value of $182 billion. Debt is low. Free cash flow yield is about 4.3%. Operating cash flow yield is about 5%. Return on invested capital is about 12%. ROE is about 17%. Cash flow, return on invested capital and a healthy balance sheet are very key metrics in terms of how we look at companies.

They recently spun off a segment, the environmental segment, which has become a new company called **Veralto** (NYSE:VLTO). Now, with that spin-off, they have three segments left: biotechnology, which has a revenue of $8.8 billion; life sciences, which has a revenue of about $7 billion; and diagnostics, which has a revenue of about $10.8 billion.

And for these segments, a very high component, over 60% — actually, 60% to 90% of revenue — is recurring, which is, again, very important, because this means that that revenue comes back year after year, right? It's a very important metric when we look at a company.

Our measure of intrinsic value in the company suggests at least a 25% upside. We see the stock valued about $290 based on our current assessment of the company. The company did not do well in 2023, and so we've added to the position.

We think that the short-term concerns in terms of revenue, which relates to — they had a sharp spike up in revenue during COVID because they were selling more tools for COVID, and that has come off. And as that revenue goes away, growth has slowed down, but we think that's temporary and it's short-term, and the long-term prospects of the company remain very solid.

Now, the company focuses, as I said, on biotechnology, life sciences, and diagnostics. And all of these, we think, have excellent long-term growth prospects.

The company has what's called the **Danaher** business system which is kind of modeled on the Japanese concept of Kaizen, which focuses on continuous improvement and adapting to consumer needs constantly, and this speeds up innovation and reduces business risk for the company.

The other thing is, people have talked about AI recently and we think AI has a lot of potential, particularly, I think, in biotech and life sciences because we think AI can be used effectively, just given how difficult and complex developing new therapies in these areas are. But we think AI can accelerate the development and that is positive for what **Danaher** sells.

1-Year Daily Chart of HDFC Bank Ltd.

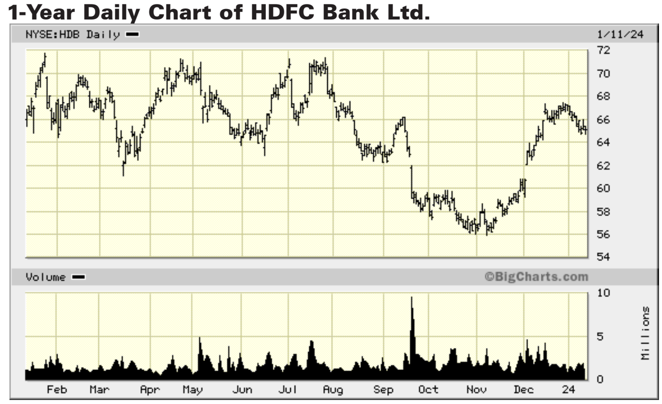

Chart provided by www.BigCharts.com

So short-term concerns in **Danaher**, but we think long-term prospects are great. It's very well-managed, the financial metrics are very strong and we see a 25% discount to intrinsic value for the company.

TWST: And certainly I would think that the currently aging demographic of the world further favors this company's business model.

Mr. Menon: Exactly. I think health care in general is going to benefit from that. Absolutely.

TWST: And what is your next company?

Mr. Menon: The second company is **HDFC Bank** (NYSE:HDB), which is in the emerging market and the global portfolios. **HDFC Bank** is an Indian bank; it's a leading private sector bank with a history of innovation, excellent execution and customer service. The company has a market cap of $155 billion, the ROE is 17%, the p/e is about 19 times and the price-to-book is about 2.8 times.

"Roche is in the international portfolio, and that's a pure value strategy, where we do look at return to shareholders in the form of both dividend yield or share buybacks and that company does have a dividend yield of about 4%."

The stock has had a recent rally but is still flat on the year. So again, it hasn't done well in general and particularly compared to what the Indian stock market has done this year. The concerns are, again, we think near-term issues.

The company has just completed a merger with its parent company, which was a company which focused on mortgages, **HDFC Corporation**. And the merger will result in a temporary slowdown in growth and a reduction in net interest margin. But we think both of these will normalize over two to three years. We think the company will come back to a trend growth and net interest margins will normalize.

There's also a change in leadership. The long-term CEO retired, and the markets always kind of test the new leader. They like to see what their vision is in terms of what's going to happen in the company. We see intrinsic value on the ADR at $83 a share, which gives us about a 24% upside.

What we like longer-term for this company, and what are the longer-term drivers? One is India is now the largest country in terms of population. It's the fifth-largest country in terms of the size of its economy, probably going to be the third-largest economy in the world in the next maybe five to 10 years.

And economic growth in India remains strong. It remains the highest among the major economies.

India is under-banked. So we think the banking sector in general will grow faster than the underlying economic growth. And we expect that **HDFC Bank**, which is a private-sector bank, will gain market share from the government-owned public-sector banks. So Indian growth, banking sector growing faster, and gain in market share are all going to drive growth for **HDFC Bank**.

This is a bank which historically has done a great job in managing its credit, meaning that the non-performing loans historically have been lower than competitors. And if you had to look at one metric to assess the quality of a bank, whether it's **JPMorgan** in the U.S. or **HDFC Bank** in India, I think how they manage credit and how they weather downturns in the economy would be a very key factor to look at. And HDFC Bank historically has done a great job in terms of that. We expect that they're going to continue to maintain those high standards.

We see synergies from the merger which can step up growth beyond this kind of one- to two-year time frame, because we think the bank can now offer mortgages which they did not before, because the parent company did that. And they can offer mortgages from their extensive branch network. And the existing customers of the mortgage company now will have access to a much wider range of banking services from **HDFC Bank**.

So, again, temporary factors which have been a headwind for the bank, I think they will go away. And we think this is a great franchise, positioned really well for the next 10 to 15 years.

TWST: It sounds like they are both growing organically within their existing range of services, as well as with those services that they'll be offering post-merger.

Mr. Menon: That's correct, yes.

TWST: And just curious about whether either of these two companies, and indeed your third recommendation, offers a dividend.

Mr. Menon: So, yes, they do. **Danaher** has a modest dividend yield, about half a percent, 0.5%. **HDFC Bank** has a modest yield, about 1.1%. **Roche** (OTCMKTS:RHHBY), the third company, has a much higher yield, and I'll walk you through that.

Roche is in the international portfolio, and that's a pure value strategy, where we do look at return to shareholders in the form of both dividend yield or share buybacks and that company does have a dividend yield of about 4%.

So, **Roche**, which is an international portfolio stock, it's a Swiss pharmaceutical and diagnostic company, they have sales all over the world. They own U.S.-based **Genentech**, and **Genentech** was a pioneer in biotechnology.

1-Year Daily Chart of Roche Holdings AG Basel ADR

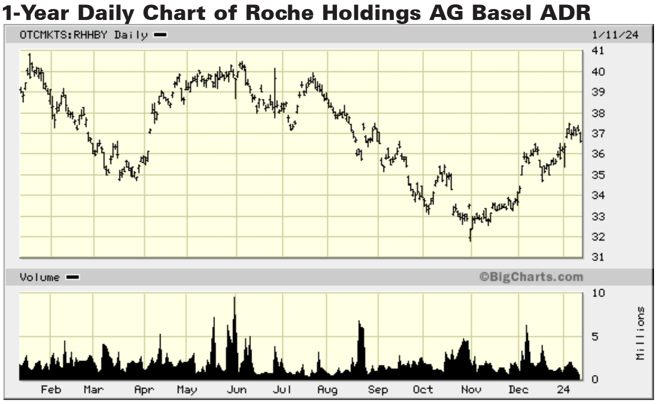

Chart provided by www.BigCharts.com

And **Roche**, they have a mix of pharma and diagnostics. Pharma is about 75% and diagnostics is about 25%. And those metrics changed slightly during COVID because diagnostics got a boost. But historically, they're kind of a 75-to-25 mix.

Roche has a market cap of $232 billion, an enterprise value of $257 billion. So modest debt. Free cash flow yield is very strong, 6.1%. Operating cash flow yield is about 8.6%. Dividend yield, as I mentioned, is 4%. Return on invested capital is 21%, and ROE is 63%.

All those measures, in terms of cash flow, in terms of return on capital, are all very strong. The short-term issues, again, just like the other two cases, there are short-term concerns which have made valuations more attractive. And that's a constant theme through all our portfolios.

We saw COVID boosted diagnostic sales, just like for **Danaher** and now that segment is seeing a decline in sales. But we think that is short-term, and things will normalize once they move away from the short-term headwinds.

And the other short-term concerns in the case of Roche, were they had an Alzheimer's drug in Phase III, which did not perform as well.

And then if you know pharma, this year, it's all about obesity drugs, **Novo Nordisk** and **Eli Lilly**, and they don't have any obesity drug in the near term. They actually did a recent acquisition of a company with such a product in the pipeline, but that's potentially a few years away. So these are the short-term concerns.

We see intrinsic value at **Roche** as substantially higher. We see about 75% upside to CHF410, or $63 per ADR. So what is our long-term thesis on **Roche**? They have a history of innovation, and we think the company will overcome the short-term problems that they face.

The combination of diagnostics and pharma, which is not very common if you look at the major pharmaceutical companies in the world, we think gives them an edge because they can speed up innovation and bring up maybe targeted therapies faster than competitors because both of those are within one firm.

We think that this company can grow its top line at high single digits, as you look beyond maybe a two- to three-year time frame, and when the diagnostic segment kind of normalizes in terms of the sales. The company has a strong cash flow and valuations are very attractive here relative to our estimate of intrinsic value.

TWST: Fascinating. The kind of growth you were describing over the COVID period for Roche, as you say, has abated, but it creates a new opportunity to buy in. Just as a closing question, do you feel that the COVID pandemic is an economic cycle that is complete? Have the effects of COVID been largely incorporated into and borne by the economy today?

Mr. Menon: Yes, I think so. And I think if you look at macro factors like inflation, for example, there's some residual impact on it because I talked about inflation being a little stickier, particularly wage inflation may take some time to kind of get away from that.

I think in terms of company sales, this year was probably the biggest negative impact for companies like **Danaher** and **Roche**. And I think you move away from that as you go into 2024.

TWST: Thank you. (RP)

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