

Five Buy Ideas From Our Top Ultimate Stock-Picker

This manager's recent purchases have highlighted five stocks worth considering.

Ultimate Stock-Pickers | 06-08-11 | By Jim Ryan

With the market slipping somewhat during the month of May, several of our top managers have been able to pick up enough steam to surpass the returns of the S&P 500 Index (SPX) so far this year. As of the end of last week, eight of the 22 fund managers on our list of Ultimate Stock-Pickers are beating the benchmark, which has returned a little more than 4% since the start of January. Even more interesting, though, is that just five of our 22 top fund managers have beaten the index during the last year, with just two of these five actually beating the market year to date. This tells us that it is inherently difficult to draw any firm conclusion about our top managers' performance based on such short-term metrics.

This is why we try to focus on both near- and long-term investment performance when looking at either adding or removing managers from our list of Ultimate Stock-Pickers. This allows us to overcome periods when our managers are having a bad spell of performance, much like Bruce Berkowitz is going through with the Fairholme (FAIRX) fund this year, or just about every one of our managers went through last year, when compared with the S&P 500. That said, we do believe that there is some value in looking closely at the stock selections and strategies of those managers that are outperforming in the near term, especially if those same managers have accrued a stellar track record of long-term outperformance.

Looking at the eight fund managers that are beating the market so far this year, one group of managers stands out much more than the rest. If total domination of active mutual fund performance was on the agenda at Yacktman (YACKX), the managers at the fund would be closing in on their objective. The father and son management team of Donald and Stephen Yacktman has produced returns during the last three-, five-, and 10-year time frames that have not only surpassed the S&P 500 Index by a wide margin, but have beaten every one of the 22 fund managers on our Investment Manager Roster. Even more impressive is the fact that we can think of very few large cap value funds that have even come close to matching the level of long-term performance generated by Yacktman since the fund's inception in 1992.

Fund managers Donald and Stephen Yacktman tend to invest with a minimum time horizon of three to five years, which allows them to focus on what is truly important for long-term outperformance. A few years back, the managers talked about how committed they are to doing their own homework when researching investment ideas. They highlighted some of the types of questions they ask of each firm in which they invest, including:

"Does the business have a competitive advantage, and is it strengthening or weakening? Do the normalized operating results provide a sufficient risk adjusted return at the current price level? What is the quality of the balance sheet? Will management reinvest intelligently or squander or take your money, or make prudent capital allocation decisions?"

With more than half of the fund's stock holdings at the end of the first quarter invested in firms with wide economic moats, another third invested in companies with narrow economic moats, and almost all of their stock holdings having either low or medium uncertainty bands around their fair value estimates, it looks like the managers at Yacktman remain committed to their process.

Total Return (%) Track Record for Our Best-Performing Managers (Year-to-Date)

	YTD	1-Yr.	3-Yr.	5-Yr.	10-Yr.
Yacktman (YACKX)	7.2	19.2	14.5	10.2	11.9
Oppenheimer (OPPAX)	7	28.6	2.5	3.5	6
Dodge & Cox (DODGX)	5.4	20.5	-1.6	-0.4	4.9
Mutual Shares (TESIX)	5.4	17.2	-0.5	1.2	4.1
FMI Large Cap (FMIHX)	5.3	19	3.8	5.1	NA
FPA Crescent (FPACX)	5.1	18	4.5	6.3	9.9
Oakmark (OAKMX)	4.9	15	5.7	4.5	4.5
Vngrd PRIMECAP (VPMCX)	4.5	21.9	1.8	5	5
S&P 500 Total Return Index	4.2	20.3	0.3	2.3	2.3

Performance data as of 06-03-11.

Yacktman Fund Top Stock Holdings (as of March 31, 2011)

	Star Rating	Fair Value Uncertainty	Size of Moat	Current Price (\$)	Price/Fair Value	% of Stock Portfolio
News Corp. A (NWSA)	3	Medium	Narrow	17.18	1.01	12.7
PepsiCo (PEP)	3	Low	Wide	68.97	0.91	12
Procter&Gamble (PG)	4	Low	Wide	65.43	0.85	5.7
Microsoft (MSFT)	4	Medium	Wide	23.91	0.75	5.6
Coca-Cola (KO)	3	Low	Wide	65.53	0.96	5.4
Jhnsn&Jhnsn (JNJ)	4	Low	Wide	66.09	0.88	4.6
ConocoPhillips (COP)	3	Medium	Narrow	72.39	0.99	4.3
Viacom B (VIA.B)	3	Medium	Narrow	49.51	1.03	4.1
Pfizer (PFE)	4	Medium	Wide	20.84	0.77	3.9
Sysco Corp. (SYY)	3	Medium	Wide	31.13	0.86	3.9

Data as of 06-03-11. Fund ownership data as of funds' most recent filings.

Such a stringent focus on high-quality companies has typically led Donald and Stephen Yacktman to invest in well-capitalized firms that have dominant franchises and are run by good management teams. When talking about these types of firms in the fund's 2009 semiannual report, the managers noted:

"Generally, the market does not fully appreciate these securities as people fail to appropriately value their superior business models or simply think they are not exciting enough. Our willingness to hold these positions and watch grass grow while the world spins around us has resulted in superior returns over time. Many of these companies have held dominant positions for decades and, in some cases, for more than a century. While occasionally we may buy a clunker that can be fixed-up, we prefer to drive around in classics (like Coca Cola, PepsiCo, and Procter and Gamble), that do not go out of style. We like to own these classics when we believe that they will provide similar or better return prospects than lower quality businesses."

It should come as no surprise, then, that three of the fund's top holdings are PepsiCo (PEP), Procter & Gamble (PG), and Coca-Cola (KO), which, when combined with other consumer- defensive names, accounted for more than one third of the fund's total stock holding at the end of the first quarter. Believing that the valuations on many of these firms were still extremely attractive during the period, Yacktman bulked up on both PepsiCo and Procter & Gamble, which were two of the fund's highest conviction purchases during the first quarter, and made meaningful additions to Sysco (SYY) and Colgate-Palmolive (CL).

As much as the managers like consumer-defensive names, they do have a penchant for more cyclical firms that have largely subscription-

based businesses. This explains why one fifth of the total portfolio is invested in media names like News Corporation (NWSA), Viacom (VIA.B), and Comcast (CMCSK). Donald and Stephen Yacktman like these three names because:

"Comcast gets paid predictable monthly fees from its customers for providing cable television, Internet, and telephone services. News Corp. and Viacom receive recurring monthly fees for the cable content they provide to pay television providers. Even in a challenged economy, pay television is one of the last items to be cut by households."

Believing that all three companies were still selling at low multiples of free cash flow, the managers put more money to work in News Corp. during the first quarter, significantly adding to what was already its largest stock holding coming into 2011.

While it is probably fairly evident, it should be noted that the managers at Yacktman tend to run a more concentrated portfolio than their peers, with the fund's top 10 stock holdings accounting for more than 60% of its total commitment to equity. Even more interesting is the fact that Yacktman's top five positions accounted for more than 40% of its total stock holding at the end of the first quarter, and that just two stocks—News Corp and PepsiCo—accounted for a full quarter of the fund. This, in our view, demonstrates a significant amount of conviction in these names. That said, with so much concentrated in so few holdings, Yacktman is betting the long-term performance of the fund on just a handful of companies.

Yacktman Fund Top Stock Purchases (as of March 31, 2011)

	Star Rating	Fair Value Uncertainty	Size of Moat	Current Price (\$)	Price/Fair Value	% of Stock Portfolio
PepsiCo (PEP)	3	Low	Wide	68.97	0.91	12
News Corp. (NWSA)	3	Medium	Narrow	17.18	1.01	12.7
Sysco Corp. (SYY)	3	Medium	Wide	31.13	0.86	3.9
Microsoft (MSFT)	4	Medium	Wide	23.91	0.75	5.6
P&G (PG)	4	Low	Wide	65.43	0.85	5.7
Jhnsn&Jhnsn (JNJ)	4	Low	Wide	66.09	0.88	4.6
Cisco Syst (CSCO)	5	Medium	Wide	16.01	0.53	2.5
Clgte-Pmlive (CL)	3	Low	Wide	84.11	0.91	1.3
Intel (INTC)	3	Medium	Wide	21.73	0.94	1.1
Hewlett-Pckrd (HPQ)	5	Medium	Narrow	36.11	0.66	2.3

Data as of 06-03-11. Fund ownership data as of funds' most recent filings.

Donald and Stephen Yacktman are fond of saying that "the market provides investment opportunities," and they cannot create them. Having pulled in well over \$1 billion in net inflows during the first quarter of 2011, the managers may have felt compelled to try to create

some investment opportunities, but in the end chose to stick with the names that have gotten them where they are today. Looking at the list of top-10 purchases during the quarter, five of them—PepsiCo, News Corp., Microsoft, Procter & Gamble, and Johnson & Johnson (JNJ)—were top-10 holdings at the end of last year. The fund's most significant purchase was in PepsiCo, with Yacktman nearly doubling its stake in the snack foods giant. The fund also increased its stake in News Corp. by close to 30% during the quarter, allowing the stock to retain its top-holding status.

And in a rare twist, the managers at Yacktman continue to build up stakes in technology firms, which accounted for 12% of total stock holdings at the end of the first quarter. When looking back though past commentary, we noted that the managers have traditionally been averse to investing in Technology firms, even saying in their 2003 annual report:

"While technology certainly raises the standard of living in our society, it seems to us that the businesses that benefit the most are the ones who utilize the technology rather than the technology companies whose business and stock price in many cases looks like a shooting star or a roman candle. Thus, we rarely invest in technological capital goods companies because of the speculative nature of many of their businesses and the rich valuations given to them by investors most of the time."

Although the fund had purchased Microsoft (MSFT) several years ago, it didn't really add to that stake until after the financial crisis. Since then, Yacktman has been adding to its stake in Microsoft, and has been slowly building up positions in Hewlett-Packard (HPQ), Corning (GLW), Dell (DELL), Cisco CSCO, and Intel (INTC) since the middle of last year. As we noted in a previous article, Donald and Stephen Yacktman believe that they are getting good "old tech" businesses at "fire sale prices," with this particular group of companies trading at half the multiple of the S&P 500, despite exhibiting business characteristics that they believe are superior to the average S&P 500.

Of note is the fact that several of these firms, along with some of the fund's top holdings, continue to sell at prices that our analysts feel are attractive. Looking at the most recent purchases made by the Yacktman managers, and cross-referencing it against our own coverage universe, we feel that these five firms warrant additional research by investors looking for long-term investment ideas:

Microsoft (MSFT) ★★★★★

Not only do all eight of our best-performing managers own Microsoft, but six of them (including Yacktman) were buying shares during the

first quarter, with both FMI Large Cap (FMIHX) and Dodge & Cox Stock (DODGX) actually making new-money purchases in the software giant. While Microsoft's valuation multiples have compressed during the past three years as cloud computing has emerged as a threat to the firm's desktop-centric profit streams, our analyst, Sunit Gogia, believes that the firm will successfully navigate the transition to cloud computing and emerge with higher revenue, lower operating margins, and slightly higher operating profit dollars. He feels that the stickiness of Windows and Office guarantees that these businesses will continue generating large free cash flows to finance Microsoft's competitive responses to threats to these traditional cash cows. Despite the rise of tablets, Gogia does not believe that revenues generated by Windows are going to fall off a cliff anytime soon. Excluding acquisitions, he expects Microsoft to generate over \$23 billion in free cash flow in fiscal 2011, with the company currently sitting on about \$38 billion in net cash.

Procter & Gamble (PG) ★★★★★

While not as widely held by our top-performing managers, P&G is the seventh-largest stock holding among our top managers, and Yacktman was not alone in adding to its stake during the first quarter. Both Jensen (JENSX) and Parnassus Equity Income (PRBLX) were also making meaningful additions to their holdings in the consumer goods giant. While firms that sell consumer staples tend to be more resistant to recession than other more cyclical names, they are not recession proof. This is the lesson that has been learned by many investors in P&G during the last couple of years, and anyone looking for a quick turnaround in the firm's fortunes will likely be disappointed. That said, our analyst Lauren DeSanto believes that P&G's plans to expand its brands into new categories and markets, and to streamline its operations along the way, should yield benefits longer term. While the company is currently dealing with an adverse commodity environment, DeSanto was encouraged to see solid revenue and volume growth during P&G's most recent quarter. She continues to believe that P&G is a wide-moat firm that should be able to keep sales and earnings growing at a healthy pace longer term.

Johnson & Johnson (JNJ) ★★★★★

Johnson & Johnson is a little more popular with our top-performing managers, with four out of the eight funds holding it, and both FPA Crescent (FPACX) and Yacktman adding to their stakes during the quarter. However, it is Johnsons & Johnson's standing as a health-care stalwart that has made it a top-five holding for our Ultimate Stock-Pickers over the years. The company stands alone as a leader across the major health-care industries, maintaining a diverse revenue base, a robust research pipeline, and exceptional cash-flow generation that combine to create a wide economic moat around its operations. While our analyst Damien Conover notes that patent losses on

antipsychotic Risperdal and neuroscience drug Topamax have weighed on more recent performance at the firm, he expects the company's breadth of offerings to overcome these issues longer term. On the basis of its pipeline strength, in-line products, and patent exposure, Conover believes that Johnson & Johnson ranks as one of the best-positioned companies in the pharmaceutical industry. While the stock may not be trading at a steep discount to his fair value estimate, Damien believes that it deserves to be trading somewhere closer to \$75 per share.

Cisco Systems (CSCO) ★★★★★

Cisco has drawn plenty of attention from our top managers this year, with four of our best-performing managers holding the stock, and 11 of our 26 Ultimate Stock-Pickers with positions, at the end of the most recent period. Of note was the fact that three of our top managers—Fairholme Capital Management, Mutual Shares (TESIX), and TweedyBrowne Value (TWEBX)—made meaningful new-money purchases in the name during the first quarter, with Amana Trust Growth (AMAGX), Parnassus, and Yacktman all adding to their stakes. While market concerns over increased competition in the switches segment, slowing growth, and the potential for margin compression continue to put pressure on the stock, our analyst Grady Burkett remains bullish on Cisco. He believes that the business is still fundamentally attractive, and that the market is not appreciating Cisco's commitment to improving capital allocation and the company's management structure. With the stock currently trading at a steep discount to his fair value estimate, Burkett believes that there is a wide enough margin of safety in the shares for long-term investors to start taking a serious look at the name.

Hewlett-Packard (HPQ) ★★★★★

Hewlett-Packard is another name that has been making its way into our managers' portfolios, with five of our eight top-performing managers holding a stake in the firm, and eight of our 26 Ultimate Stock-Pickers with positions, at the end of the most recent period. Of note was the fact that FPA Crescent made a meaningful new-money purchase in the name during the first quarter, with both Dodge & Cox Stock and Yacktman adding to their holdings. While many of our Ultimate Stock-Pickers may have faith in the name, the managers at Hewlett-Packard are doing their best to undermine their own credibility with investors. Looking to stem the damage from a leaked internal memo that pointed to weaker than expected third-quarter results, the company released its third-quarter earnings earlier than scheduled last month, and lowered its full-year guidance for the second quarter

in a row. While our analyst Michael Holt feels that the firm's lowered guidance for its services operation was probably the most disconcerting, he believes that key changes in personnel, and additional investments in salesforce and software, while painful at first, should yield long-term benefits. With the stock currently trading at a steep discount to his fair value estimate, Holt believes that there is a wide enough margin of safety in the shares for long-term investors to start taking a serious look at the name.

*Jim Ryan owns shares in the following securities mentioned above:
Cisco Systems.*