

# Sound Shore on Investing Into the Headwinds

Sound Shore Management on building stakes in controversial sectors, the case for ConocoPhillips and Citi, and lessons from the market downdraft.

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**Fund Manager Q&A** | 04-02-10 | by Morningstar.com

The team behind Sound Shore (SSHFX) Fund—Harry Burn III, Gibbs Kane Jr., and John DeGulis—recently answered our questions on the fund’s health care and financials stakes, their motivation for investing in ConocoPhillips (COP) and Citigroup (C), and takeaways from the recent downdraft.

**1. Much has been written about the fact that it’s a bullish sign for equities that so much cash remains on the sidelines. However, if the increased cash is a sign of a historical shift in investors’ risk perceptions, does it undermine the overall attractiveness of the stock market?**

We approach investment opportunities from a bottom-up, stock-by-stock perspective, starting with valuation. Our disciplined valuation screens include both absolute measures and a comparison to a company’s historic norms. Although it is tough to generalize, above-normal cash holdings by investors should imply less demand for equities, greater valuation discounts, and ample investment opportunities for Sound Shore.

**2. It’s interesting to note your large stakes in two relatively controversial sectors—health care and financials. Although we understand that you’re mostly looking at things from a bottom-up angle, both of these sectors have a number of macroeconomic winds currently blowing against them that would affect the earnings prospects of firms. Can you comment on some of these factors and how they’ve affected your valuation of firms in the sector?**

Our bottom-up approach compels us to look at those stocks that are inexpensive according to our valuation work. The uncertainty created by macro headwinds in a given sector, as was the case with banks and many health-care stocks in 2009, often leads to low expectations and discount valuations. In 2009, the macro factor depressing health care was the regulatory overhang from prospective federal legislation while the post-crisis banks were faced with credit-quality issues, higher capital requirements, and increasing supervision. When we evaluated

stocks in these industries, it was at valuations that were depressed and assuming a worst-case macro outcome, and our fundamental research incorporated a range of scenarios for these factors. Importantly, each of our holdings has company-specific drivers that should create value assuming no or little help from “the macro.”

**3. Warren Buffett recently appears to have cooled on one of your top holdings—ConocoPhillips. Although that might have something to do with the price he paid, we’re curious as to what attracts you the firm’s shares and where, if at all, your views diverge from Buffett’s?**

Our investment case for ConocoPhillips starts with valuation; at 8 times forward earnings and 4 times cash flow, the stock is inexpensive both in absolute terms and versus its historic norms. Meanwhile, we see value building through the company’s significant restructuring, which was announced in 2009. First, ConocoPhillips’ stock should benefit dollar-for-dollar from the \$15-\$20 per share of debt reduction to be realized through asset sales and operating free cash flow during the next 12-24 months.

An additional \$5-\$6 per share of debt paydown could result from the potential sale of its Lukoil (LUKOY) position. Second, the sale of poor-performing assets should improve returns on capital by 200-300 basis points during the next 24-36 months, adding \$1 per share to earnings power and expanding the company’s valuation multiples. With no help from commodity prices, we believe these factors should provide ConocoPhillips’ shares with significant upside potential.

**4. You also initiated a position in Citigroup in the year’s second half, which suggests that your view differs from the vast majority of investors’ (including other prominent value investors), who outright seem to have given up on the firm. What’s your thesis for investing in the firm’s shares?**

Our investment thesis for Citibank begins with valuation as the shares trade for slightly less than tangible book value and for 6 times our

estimate of normalized earnings power. Citibank's capital base has turned the corner and should grow from here given its now-conservative loan-loss provisions, improving earnings in its capital-markets business, a favorable yield curve for lending, and the strength of its global consumer banking franchise. In addition, we estimate Citi's return on equity should rebuild during the next 24-36 months.

**5. If you had to point to one lesson from the recent downdraft what would it be? How have you taken the lesson and implemented the requisite change in the way you manage money?**

Sound Shore today is the same focused and independent value-investment firm that we started with back in 1978. Each of the six bear markets during our history, including 2008, has reminded us that adhering to a disciplined valuation and fundamental research process can provide substantial opportunity.

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