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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Protecting in Down Markets Through Compounding

J. JEFFREY AUXIER is President of Auxier Asset Management LLC and Founder of the Auxier Focus Fund. Prior to forming Auxier Asset Management in 1998, Mr. Auxier spent 16 years at Smith Barney — formerly Foster Marshall American Express, then Shearson — where he was on the Portfolio Management Advisory Board and the Chairman's Council and was Senior Vice President of Investments and Senior Portfolio Management Director. Mr. Auxier graduated with honors from the University of Oregon with a degree in finance and an emphasis on accounting. Mr. Auxier and his family choose to live far from the influence of Wall Street, on a hazelnut farm just outside of Portland, Oregon.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Auxier: Yes. We're a small boutique firm, about $800 million in assets, and founded in 1998. And I've been doing portfolio management since 1983. Actually, I have a pretty broad experience in separate account management as well as fund management.

TWST: And is there a unique investment philosophy within the firm?

Mr. Auxier: Yes. What we really try to be are business analysts, and we are trying to focus on not only business models but also enduring companies that we can hopefully buy. And we're kind of looking for the compounding machines that we can buy when they're hopelessly out of favor and get a double and triple play over a number of years — and deferring tax — and then continuing to build cumulative knowledge on each holding.

TWST: And did you want to tell me about the Auxier Focus Fund?

Mr. Auxier: We started the Focus Fund in 1999, right at the top of the market — July of 1999. I've put 100% of my retirement in the fund since inception. And basically, $10,000 in the fund back when we started roughly after December 31 is worth approximately $38,000 — versus about $27,000 for the fully invested S&P. So we've outperformed over the real long term with about 80% exposure to stocks in the fund. The stocks in the Fund are up 501% (7/9/99 to 12/31/2018) vs. the S&P 500 which is up 160% for the same period.

TWST: And what kinds of investments do you have in there? Is it a mixture? Is it certain types?

Mr. Auxier: No, we wanted a wide latitude in our perspective. So our focus is, number one, compounding. We want to be able to protect in down markets. So the problem with being in a style box is you can't necessarily protect; you have to restrict. So our mandate is to continue to compound through the most difficult periods. So we tend to do far better in bad markets. From 1999 to 2009, that was the worst 10-year period in U.S. stock market history, and that's when we went to the top 2% (Morningstar Large Cap Value Category 12/31/2009).

But our belief is compounding is the most underappreciated investment concept, and we want to maintain that compounding. And that means, if you're down 50%, you have to go up 100%; if you're down 90%, you have to go up 1,000%. So the fund has a very wide latitude to be able to buy any size company, large and small. We're just looking for really good businesses, high-return businesses, that have low capital intensity that drown in free cash flow generally.

TWST: And did you want to highlight a company that you find interesting now?

Mr. Auxier: Since 2010 one of our biggest positions has been **UnitedHealth** (NYSE:UNH). Our average basis is just over $45, today UNH is $271. But we really like **CVS** (NYSE:CVS). We actually had **Aetna**, and then it was bought by **CVS**, and then with **Express Scripts**, that was bought out by **Cigna** (NYSE:CI). So we know that space fairly well.

And right now, if you look at **CVS**, it's basically trading about nine times earnings for arguably one of the leading health care service providers. And we think they have a good shot with their MinuteClinics at being a one-stop health care provider with the new merger. So here's a company that typically has traded between 14 and 20 times earnings the last seven or eight years, and it's compressed down to nine times. Their shares outstanding in 2008 were 1.4 billion — 1.438 billion. This next year they could shrink it down to 975 million. So enormous free cash flow. They have over $7 billion in free cash. So very high free cash flow yield.

And then, there are a lot of concerns about disruption from **Amazon** (NASDAQ:AMZN) and what have you, but their vision is to actually provide health care cheaper through these MinuteClinics, and most of the U.S. population is within 30 minutes of a **CVS**. So it's one of those things where you've had tremendous multiple compression. The stock was $113 back in 2015. And recently, we've been buying it in the $60 to $64 range.

So we like these kinds of businesses that have high free cash flow. We've been kind of in a market growth at any price when interest rates hit 5,000-year lows two years ago. And so cash flow and balance sheets kind of went to the back as far as investor focus, but now with the Federal Reserve shrinking the balance sheet and interest rates ticking up, we think there'll be a regained appreciation for free cash flow, and we like their strategy in terms of health care. People can know more about what they're paying for in health care. In a lot of the data analytics, once people have the data, they can go to their local **CVS**. A lot of the routine things can be handled there.

TWST: And do you think more of the CVS locations will start to see the MinuteClinics? I know it's not in all of them.

Mr. Auxier: Yeah. And I think that's the vision. It just makes sense. People, they don't have a lot of time, but once they get their data — now the data is kind of the new oil and data analytics and predictive data analytics and also the medical wearables and what have you. So I think that's the way we'll get health care under control in terms of cost. At least that's their vision, and we've actually been a shareholder in this company I think over 10 years.

TWST: And do you think some of the other big pharmacy chains might start doing something like the MinuteClinics too, because as you said, it's certainly like a one-stop shop for your health care?

Mr. Auxier: Yeah. I would think so. You've got obviously **Walmart** (NYSE:WMT). Actually, Optum, the health services platform of **UnitedHealth Group**, they've been kind of the model as far as health care services. But yes, it's like, if you want to lower health care costs, you've got to get that data in front of people, not only their own data but also the transparency in what they're paying.

Highlights

J. Jeffrey Auxier discusses Auxier Asset Management LLC and the Auxier Focus Fund. Mr. Auxier approaches investing as a business analyst. He wants to dig down on each individual name and gain cumulative knowledge. He says this knowledge provides greater safety. The Auxier Focus Fund aims to compound and protect in down markets. For this reason, the fund has a wide latitude and is not confined to a style box. Mr. Auxier looks for good, high-return businesses with low capital intensity and high free cash flow.

Companies discussed: UnitedHealth Group (NYSE:UNH); CVS Health Corp. (NYSE:CVS); Cigna Holding Co. (NYSE:CI); Amazon.com (NASDAQ:AMZN); Walmart (NYSE:WMT); Costco Wholesale Corporation (NASDAQ:COST); Alphabet (NASDAQ:GOOG); Apple (NASDAQ:AAPL); Tilray (NASDAQ:TLRY); SoftBank Group Corp. (OTCMKTS:SFTBF); Snap (NYSE:SNAP); Blue Apron Holdings (NYSE:APRN); General Electric Company (NYSE:GE); American International Group (NYSE:AIG); Federal National Mortgage Association (OTCMKTS:FNMA) and Federal Home Loan Mortgage Corp. (OTCMKTS:FMCC).

Alphabet (NASDAQ:GOOG), they're working toward that data solution, and I think **Alphabet** is another one that has tremendous potential, as has **Apple** (NASDAQ:AAPL). I think they all have that same vision as far as data analytics.

TWST: And do you think that as investors think about the data analytics side, are these companies like Alphabet and Apple going to start to get more investor attention as analytics and artificial intelligence and Big Data become more prevalent in corporations and different types of businesses?

Mr. Auxier: Yes, for sure, because we're transforming; you see the Apple Watch, and **Alphabet's** just bought the Fossil Watch. And I think as we go into 5G — I think **Alphabet** is really the leader in AI right now domestically, artificial intelligence. So we're getting so much data in terms of opening up the internet and the sharing of data. We're looking at cancer cures by 2022 according to top firms in Seattle, Washington. That's why we do like the companies that are focusing on data analytics, knowing more about each customer or each client and knowing that cumulative data.

So it's like cumulative data, compounded data and the algorithms kick in, and that's why I think **Alphabet** is going to be another big one in that area too. But as far as physically servicing all these customers, **CVS** has the platform on the ground, and **Alphabet** and **Apple** probably have more of the wearables, where you can actually get the data by having a watch or whatever to check your EKG.

TWST: And that's going to help shape medicine in the next decade, just this data analysis, where each person's data is collected, and health care providers can watch it and analyze it?

Mr. Auxier: Yes, for sure. And again, the more transparency, the cost will come down with greater transparency, greater competition, greater data. And yes, it's an exciting time: the cancer cures through the immune system and the developments there, and then just the immune system, that focus, and then also, throwing in medical cannabis is a huge game changer for opioid addiction. I mean, the medical cannabis is going to be a major game changer. I mean, if you look at these populations and look at Oregon's population of 4.5 million, and maybe 31,000 people are using medical cannabis for acute pain, that's going to be, I think, a huge game changer.

"And so cash flow and balance sheets kind of went to the back as far as investor focus, but now with the Federal Reserve shrinking the balance sheet and interest rates ticking up, we think there'll be a regained appreciation for free cash flow."

So it's kind of like going to **Costco** (NASDAQ:COST). I mean, people know exactly what they're paying and what they're getting. In health care, they don't know what they're paying, and they don't know what they're getting. So I think **Amazon** and **Google**, or

We're seeing reversals of terminal cancer, bone, skin cancer, stomach cancer, autoimmune disorders, allergies. We're seeing that on the ground firsthand, and we did all the work on **Privateer**, which became **Tilray** (NASDAQ:TLRY) early, and unfortunately, we didn't invest, but that $100 million valuation went to $15 billion. So they're the most focused firm on the health side. The CBD, the hemp side, is really used for health. The THC, the drug side, has the drugs, but CBD is more for inflammation, anti-inflammation and what have you.

1-Year Daily Chart of UnitedHealth Group

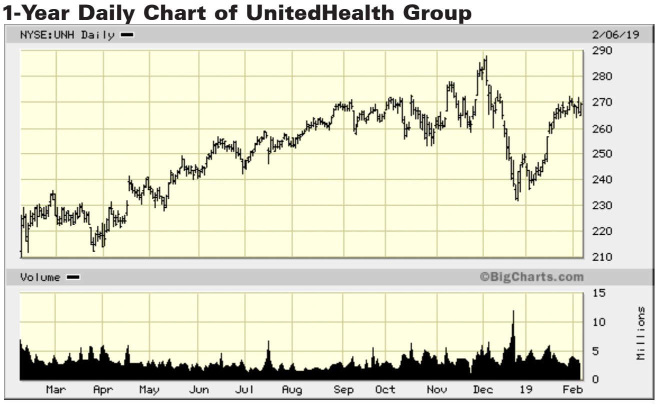

Chart provided by www.BigCharts.com

1-Year Daily Chart of CVS Health Corp.

Chart provided by www.BigCharts.com

TWST: So this is all medical-marijuana-related?

Mr. Auxier: Right. So CBD is like — there are two parts of the plant. The female part has THC. That's the drug. And then, the CBD side, which is the hemp, is the nondrug. But it actually plays a bigger part in inflammation, anti-inflammation. So that is totally different. So you're going to see that in drinks. They're going to add CBD for health because the CBD receptors in your body, and those are part of this whole immune system. That's kind of the refocus.

It used to be you went in for cancer treatment and they destroyed your immune system through chemotherapy. Well now, you're going in through KEYTRUDA and those drugs. They're boosting the immune system, and CBD does the same thing. They reduce inflammation and help boost your immune system, and that's just at the beginning — that'll impact health care. It's just starting.

TWST: And anything outside of health care that's of interest to you right now?

Mr. Auxier: Things have kind of run up. On real weakness, we like **Alphabet** — just their focus if you look at YouTube and the potential monetization in YouTube. The Millennial usage of YouTube has really been outperforming everything else, with average watch time at two, two and a half hours a day, and then just Google, and just we're in a knowledge economy with the things that people are able to do obviously.

And so overall, we're in for a major tech blow-off because the venture funding has been so extreme, and we're I think $136 billion this last year out of Silicon Valley, and you've got **SoftBank** (OTCMKTS:SFTBF) out of Japan with over $100 billion and then the Chinese. So because of their performance, tech has done really well, but we're kind of at a point where we're over-investing in the space, just like 1999, 2000. We had internet hosting and fiber optic; we just overdid it back then. Eighty-three percent of the IPOs were losing money; now 85% are losing money. The cash burn again in the top 200 Silicon Valley companies now is five to 10 times worse than the cash burn back then.

"So my fear is that the cloud has been over-invested in right now. I think too much money has already gone into that. The capital spending in that space has been running now $40 billion, $50 billion, $60 billion over the last couple of years. So I think it could end up like fiber optic. It's a great thing, but we tend to overdo it."

So with all this easy money, there are 140 delivery models, and so we see with all of the new IPOs in 2019, a lot of new supply. You've got **Uber** and **Lyft**, and you've got probably **Airbnb**. So a lot of supply and then a lot of IPO supply. So whenever you see that much supply — we de-regulated telecom in 1996. And Lucent dropped 99%. So Wall Street doesn't do a good job of determining supply. They have great forecasts, but they don't. We ended up only using 17% of the fiber optic back in 1999 that everyone was excited about.

So my fear is that the cloud has been over-invested in right now. I think too much money has already gone into that. The capital spending in that space has been running now $40 billion, $50 billion, $60 billion over the last couple of years. So I think it could end up like fiber optic. It's a great thing, but we tend to overdo it, especially when the money has been as cheap as it's been. It's been kind of like an open bar. The people have overindulged in easy money, and that's the big area of risk — oversupply in a lot of these industries.

TWST: And given that some of these bigger companies in certain sectors within technology might be in for something of a correction, is it an interesting time for some of the younger startups or things that recently IPO-ed in the technology sector, something with a promising idea behind it?

Mr. Auxier: I think as the industry washes out, there will be, but the problem is now these companies, the prices are set by the venture firms, and they're not necessarily what the market would set. So you have **Snap** (NYSE:SNAP) come out at $15 to $20, and then they dropped to $6, and **Blue Apron** (NYSE:APRN) was the same thing.

Those came out $15 to $20 — $1 to $2. Yeah, that was the big delivery. So the problem with Silicon Valley, that's an opaque pricing structure. There's no free market pricing there. They'll price whatever they feel they will get away with.

1-Year Daily Chart of Alphabet

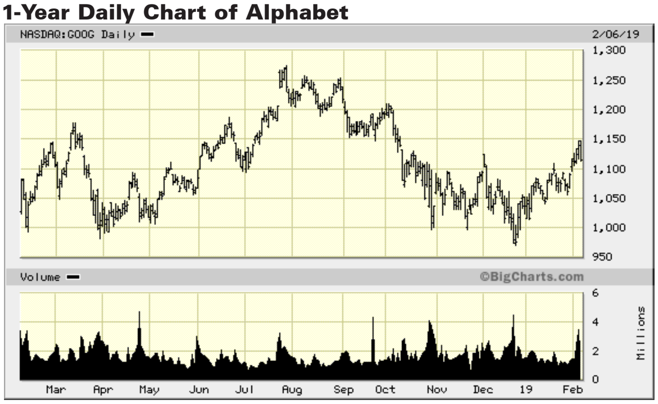

Chart provided by www.BigCharts.com

So normally when you normalize, your normal volatility picks up. So 2017, we had the lowest volatility in over 20 years I think. In 2018, we were returning to more normal volatility. We had in February 2018 that big correction, and that was really the market mechanism. There were a lot of firms shorting the volatility index, which is the VIX index, and then they were buying S&P futures. So a lot of the market mechanisms we are seeing — to me, the market is pretty virtuous. It's going to purge the bad behavior. So you saw bitcoin climb all the way up to $20,000 (12/17/2017), and then it dropped down to a low of $3400 (12/7/18). So bitcoin may go down as the biggest digital bubble in history.

And so as rates tighten, having price discipline becomes more important. And so over 80% of the trading, like in the fourth quarter, was these mathematical algorithms, and they're typically momentum-based. So if the momentum is going up, they buy, and if it's going down, they sell. And then, we've done away with a lot of the specialists, and then a lot of the bank trading has been really diminished over the last 10, 15, 20 years. So that volatility, which is normal — but the other thing is you don't have stabilizers in there like you used to. So there's no uptick rule in the short. So in other words, it used to be you could short, but you had to wait for an uptick; now the shorts can pile on.

"So the thing is, that's why it's so important to know what you own. We have a saying, investing is the craft of the specific, and the problem is, if you're all pooled up and you don't know what you own, it's really tough to buy unless you know or have a pretty good idea."

So then, once they go public, then you've got 250,000 CFAs worldwide looking at this to rip it apart. And it just does not survive; a lot of these companies they don't survive the scrutiny. It's just really brutal being under the scrutiny. So you look at the IPO volume, back in 1999, we had over 400, and back then in 1999, if you took the S&P, like the Russell 3000, I think back then it was roughly I think 380 to 400 companies were over 10 times sales, and we're about the same pricing there too. So back then, what happened was, all these companies were losing money, and in 2018 we have 140 food delivery companies, and they're all struggling to reach profitability.

So it's great if money is zero, but when all of a sudden there's a cost to that money of 2.5% on your 30-day or 2.2% on your 30-day Treasuries, that price of money all of a sudden. So all of these growth-at-any-price models, they go to get money, and it shuts off, that's what happens. The last 10 years have favored growth at really any price. I mean, it's ridiculous some of these prices, and yet people get into indexes, and they don't really look at the price. It's kind of like health care. No one knows what they're paying, so it just kind of keeps escalating up. It's like, when you do individual analysis, you look at these companies and you just know they're going to run into trouble.

TWST: Changing direction, did you want to talk about what's happened with the market, the volatility since the fall into December, and now what's going on and what investors might be looking at in terms of 2019?

Mr. Auxier: We went from euphoria at the end of September and then that whole dynamic changed. We saw again as money gets tighter, and we had quantitative easing, and then we kind of went to quantitative tightening, which is the Fed balance sheet, went from roughly $800 billion up to over $4.25 trillion. And then, they've been basically reducing the balance sheet by $50 billion a month.

So the thing is, that's why it's so important to know what you own. We have a saying, investing is the craft of the specific, and the problem is, if you're all pooled up and you don't know what you own, it's really tough to buy unless you know or have a pretty good idea. So if you go back historically over 200 years, the number-one cause of panics has been a semi-informed public, according to *The Economist* magazine. The semi-informed public that doesn't really know what they own, and they're pooled up.

It goes all the way back to Issac Newton in 1720, South Sea Company. It's great on the way up. Indexing peaked in 1999, and then from 1999 to 2009, that was the worst 10-year period in U.S. history. It is like 1973/1974. Back in 1972, all the bank trust departments were saying, "Well, you can buy these 50 companies." They became known as the Nifty Fifty, and they climbed all the way up to 80 times earnings. It was one decision; all you have to do is make one decision. And then, they dropped over 80%. The problem is, if the public sells on the down, they realize the drop.

And so in 1999, there were like low-cost index funds when the index is 30 times earnings. Well, you can see what's happened; the index over 18 years hasn't done anything. So price value does matter, and when money is easy — and obviously when you go to 5,000-year lows, which we hit two years ago, underscoring the history of interest rates, the book history of interest rates — yeah, it doesn't really matter what price you pay, right? Because easy money.

And now, when money reverses, balance sheets matter, price matters and just look at what happened to **GE** (NYSE:GE) — on a AAA rating, they went crazy on the borrowing, and that happened in 2008/2009. We had these banks — you had **AIG** (NYSE:AIG) at 100 times earnings, **Fannie Mae** (OTCMKTS:FNMA), **Freddie Mac** (OTCMKTS:FMCC) at 100 times earnings.

And so the extreme leverage, that's the other thing. We're seeing China with their extreme leverage, which is kind of mirroring Japan in the 1990s. So all of that — when you see the sharp drops, usually that's a forced liquidation, either a hedge fund selling or margin selling or a derivative trade, so that's why it's so important to be unlevered in the markets and to really know what you own, and then you can take advantage of that folly or the fear, so that's why we think it's great.

If you're in businesses that you know over long periods and you have cumulative knowledge, so you know when they get hit if that's a temporary reason or a permanent reason. And that's why we think it's a great time if you're really a business analyst, not so much a market player, but a business analyst who can really dig down on each individual business, and then if you have cumulative knowledge, I mean, you have greater safety in knowledge because like Buffett says, risk is not knowing what you're in or what you're doing.

TWST: And in a sector that doesn't always get some attention, what about a lot of the people that haven't been saving that much, and with the improved economy, they might want to get into the market? There are a lot of people who are past 35 years of age, maybe past 45 even, that have very little saved for retirement or for other things. Do you think that group is going to start to get more involved and try and catch up so that they can fund their retirement?

Mr. Auxier: You would hope so, but the problem is we found, unless they can see a systematic low-risk approach, it's almost like Las Vegas, kind of like a casino. We found for people to get hooked on an industry, they need to see a systematic low-risk approach, where you can quantify the risk. But our industry has kind of evolved; everyone's just trying to raise money. Like I say, no one is mastering the craft of investing. There's a great book on Bill Belichick, the coach of the New England Patriots. And I mean, he started watching film at age 6, and he's there to master the craft of coaching, right? He's not in it for the money.

Well, the financial industry is just raising all this money to go into all these pools. It's not about knowing specifically what you own, as everything is opaque. And so I think it's really broken. Everyone wants to be put into a box instead of knowing a business and knowing what industries have performed over 10, 20, 30, 40, 50, 60 years — that kind of thing — and that turnover is so high. The cumulative knowledge in a lot of these funds — you just don't know who knows what or who's going to trigger.

I've run our fund since 1999. We've got numbers back actually to 1989 or even back to 1983, but we can show every decision by one brain. Well, now everything is committees. Look at the great investors over time, like Henry Singleton, they're just not group thinkers, and we've kind of collectively put everything in pools, and then when it goes down, everyone panics. And so it doesn't do you any good. If you're 50% year one, 50% year two, and you're down 50% in year three, a steady 7% beats that, but that's kind of these markets we get — we go along, and then we just take these huge corrections, and then people lose all confidence in investing.

And we've found just you want to keep people in; you've got to mitigate. That's why our fund only really averages about 80% exposure over the period because the pain on the downside takes them out of the game, out of the compounding. Our industry isn't really focused on it. It's all focused on big market or whatever, but it's not about compounding as the number-one focus, which we think is the most important thing.

TWST: Is there anything else that we haven't talked about you care to mention, either about the firm or some trends out there?

Mr. Auxier: Look at great coaches or whatever, it's about data, data analytics. And for some reason, when it comes to investing, people think you don't have to think or do homework or work harder, and it's remiss. There are no shortcuts, and one out of five firms in America make it 15 years, and now more than ever, knowing what you own and especially the balance sheets — we have just an enormous debt overhang globally, and it's really important now to know the balance sheets in order to endure, especially through the next downturn.

TWST: Thank you. (ES)

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