

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Looking for Strong Businesses That Are Utilizing Platforms and Data Analytics



**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. In 1997 and 1998, he was named one of the top-10 brokers in the country by *Money* magazine, winning two consecutive stock-picking contests.

### SECTOR — GENERAL INVESTING

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

**Mr. Auxier:** We're about \$800 million. We're primarily focused on individual businesses. I started in the industry back in 1983 and started the firm in 1998. And we're very research-intensive. We try to be exceptional business analysts versus experts on the market.

**TWST: Why is research important, especially now with the way the market is?**

**Mr. Auxier:** There is so much money that's gone passive. We started the fund — just for a comparison — at the top of the market in July of 1999. And \$10,000 in the Auxier Focus Fund has grown to about \$40,198 versus \$10,000 in S&P of \$29,172. And that's with about 78% exposure to stocks.

Coming back to the research, the key why we've outperformed from that market top is just the ability to quantify risk and mitigate risk. Warren Buffett says risk is not knowing what you're in or what you're doing. The last few years there has been more speculation versus investing. Investing is the craft of the specific, and you really have to aggressively research daily to know what you're in and to be able to determine favorable odds.

So we start with the power of compounding as the number-one focus. And in order to compound, it is necessary to remember those two Buffett investment rules: The first is don't lose your capital, and the second rule is don't violate the first rule. So we really focus daily on a grinding research effort to be prepared because we know that the markets are normally very volatile. We want to be prepared when extreme emotions of the market take over. We want to know more than the market in the businesses we are buying.

The past few years, momentum strategies have dominated in an environment where interest rates dropped to 5,000-year lows. The popular trade has been to short volatility and go long passive indexes. The

problem with passive: You don't know what to buy and when to buy it on the way down. The Nikkei Index in Japan traded over 38,000 in 1989. It dropped all the way to 7,500 over the next 20 years. If you don't really know what you're in, you don't have the conviction to buy and accurately quantify the true risk.

**TWST: Do you think there is a difference between volatility and risk?**

**Mr. Auxier:** Absolutely. The average New York Stock Exchange stock will fluctuate 50%. And so that's just normal. We want to pull the company out of the market, do the work and value it. There are all kinds of company-specific risks that need to be uncovered. Look at what **General Electric** (NYSE:GE) has done since 1999. A \$10,000 investment in **GE** when we started our fund is roughly \$6,500 versus \$40,198 in the Auxier Focus Fund.

Types of managerial risk include overpaying, overborrowing, ignoring technological disruption, losing focus and general misallocation of capital. Those are examples of quantifiable business risks that can negatively impact intrinsic value. Volatility and corrections are a normal part of auction markets. The markets are pretty virtuous. They are going to correct really bad behavior. But long-term volatility is not the risk part of the equation.

**TWST: Did you want to talk a little bit about the Auxier Focus Fund?**

**Mr. Auxier:** We started the fund at the very top of the market as measured by market cap to GDP. From 1999 through 2009 were the worst 10 years in U.S. market history. I committed 100% of my retirement to the fund. It has outperformed a number of indexes, including the S&P 500, with about 78% exposure since inception. We believe strongly in having material skin in the game, and that's really important to endure and reduce risk. In fact, there is a new book called *Skin in the Game* by Nassim Taleb, the author of *The Black Swan*, which highlights the importance of ownership to enhance risk management.

We believe it's a privilege to be able to manage someone's life savings. And at the very least, we should lock in our own money; it's a lot different when your money is on the line. Many of the major brokerage firms didn't survive 2008. As private partnerships, many survived the Great Depression, but once they went public and their own money was not locked up, they applied crazy leverage to the balance sheets. It was other people's money. So we're committed with our own funds with a priority to keep compounding going through thick and thin.

**TWST: Do you want to highlight a company that you find interesting now?**

**Mr. Auxier:** Sure. We're looking for strong business franchises that are utilizing platforms and data analytics. For instance, companies along the lines of an **Alphabet** (NASDAQ:GOOG). It's not quite a buy right here, but it's one that, longer term, we would like to own in a bigger way. They're a leader in predictive data analytics and artificial intelligence.

YouTube is growing twice as fast as **Facebook** (NASDAQ:FB) and has over 1.8 billion users. It achieved 20% revenue growth this past year. And they've got Waymo, the industry leader in self-driving cars. It took six years to test the first 1 million miles. This year, they went from 7 million to 8 million miles in one month. This model represents a powerful platform that has exponential possibilities in a linear world.

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The balance sheet is solid, with \$100 billion in short-term securities or cash. It's very disruptive. In total, advertising in the U.S. right now is running at the lowest rate since 1946. So digital advertising still has huge potential. Companies that have the best data can help the customer better target their market.

In today's world of data analytics, our big winners have been companies like **UnitedHealth** (NYSE:UNH) — through Optum — which have successfully used data analytics to separate themselves from the competition in a knowledge-based economy. We also see that in other health care companies like **Merck** (NYSE:MRK) with the development of the immunotherapy cancer-fighting drugs like Keytruda. At the Fred Hutchinson Cancer Research Institute in Seattle, they think the cure for cancer could be within five or six years — through immunotherapies,

where the body's own immune system is utilized to attack cancer cells. And this is the result of connecting data. That's why we like businesses that value a culture of serious research.

**TWST: How important do you think artificial intelligence is going to be over the next five years? Is it going to touch pretty much every industry and sector?**

**Mr. Auxier:** Yes, we think artificial intelligence and predictive data analytics may be the next big disruptors in technology in combination with 5G. The smartphone dominated as we progressed from 3G to 4G. Android and **Apple** (NASDAQ:AAPL) platforms wiped out **Nokia** (NYSE:NOK), **Motorola** (NYSE:MSI) and **BlackBerry** (NYSE:BB). We're seeing companies like **Microsoft** (NASDAQ:MSFT) teaming with industry leaders in mundane industries like oil and gas to digitize through cloud applications.

The use of data analytics and artificial intelligence will enable the rapid transformation into the digital realm. And with 5G, you are going to accelerate the connectivity. The leaders will be those that can incorporate 5G with platforms that can unleash machine learning algorithms.

In addition, we need to monitor advances in blockchain technology. These are decentralized digital ledgers. Blockchain is already being used around the world to track property transactions. We want to understand how technology will disrupt our portfolio companies.

### Highlights

*J. Jeffrey Auxier discusses Auxier Asset Management LLC and the Auxier Focus Fund. Mr. Auxier is very research-intensive and focuses on individual businesses. He believes the firm's ability to quantify and mitigate risk is the key to its outperformance. Mr. Auxier notes that volatility and risk are different, and he aims to uncover company-specific risks in his research. These risks can include overpaying, overborrowing, ignoring technological disruption, losing focus and general misallocation of capital. Right now, Mr. Auxier is looking for businesses that are utilizing platforms, data analytics or artificial intelligence.*

*Companies discussed: General Electric Company (NYSE:GE); Alphabet (NASDAQ:GOOG); Facebook (NASDAQ:FB); UnitedHealth Group (NYSE:UNH); Merck & Co. (NYSE:MRK); Apple (NASDAQ:AAPL); Nokia Oyj (NYSE:NOK); Motorola Solutions (NYSE:MSI); BlackBerry Ltd. (NYSE:BB); Microsoft Corporation (NASDAQ:MSFT); Cerner Corporation (NASDAQ:CERN); BP plc (NYSE:BP); Biogen (NASDAQ:BIIB); Sally Beauty Holdings (NYSE:SBH); Discovery Communications (NASDAQ:DISCA); Walt Disney Co. (NYSE:DIS); Viacom (NASDAQ:VIA); CBS Corporation (NYSE:CBS); Netflix (NASDAQ:NFLX); Amazon.com (NASDAQ:AMZN); Wells Fargo & Co. (NYSE:WFC); Kroger Co. (NYSE:KR); Walmart (NYSE:WMT); Costco Wholesale Corporation (NASDAQ:COST) and SoftBank Group Corp. (OTCMKTS:SFTBF).*

Take a company like **Cerner** (NASDAQ:CERN), for example. They're digitizing the entire Veterans Administration. We want to be on the right side of the digital analytics.

**TWST: Do you think Alphabet and companies like YouTube are models for other sectors and industries that if you don't get involved with these things, your competition might, and you're going to be on the short end?**

**Mr. Auxier:** In our portfolio, companies like **UnitedHealth** have appreciated from \$41 to \$263 in large part due to data analytics. Data is kind of like the new oil. I'm on a board of a company called **eLynx**, and they're teaming with **Microsoft** to help digitize the oil and gas industry. If **BP** (NYSE:BP) could have used predictive data analytics, they could have potentially avoided that huge oil spill disaster. We see

that in our biotech companies like **Biogen** (NASDAQ:BIIB); it is the most focused on the brain in terms of Alzheimer’s and MS and Parkinson’s. Those companies that value research are really driving material gains in intrinsic value.

**1-Year Daily Chart of UnitedHealth Group**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

***“The use of data analytics and artificial intelligence will enable the rapid transformation into the digital realm. And with 5G, you are going to accelerate the connectivity. The leaders will be those that can incorporate 5G with platforms that can unleash machine learning algorithms.”***

**1-Year Daily Chart of Sally Beauty Holdings**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Do you think with Biogen their commitment to research really distinguishes them from some of the other companies in the sector?**

**Mr. Auxier:** Yes. So we’re all thinking in linear terms, but it has really become an exponential environment where these platforms using data are really improving their competitive position.

**TWST: Did you want to mention another company?**

**Mr. Auxier:** Yes. One that is a little bit more aggressive is **Sally Beauty** (NYSE:SBH). With only 120 million shares outstanding, it is the world’s largest retailer of salon-quality hair color, hair care, nails, salon and beauty supplies. They should earn over \$2 a share this next year. The stock at \$16 trades at a mere 8 times earnings. The market is worried about the “**Amazon** effect,” but the company is taking aggressive strides to defend their franchise.

This stock has typically traded in the midteens price/earnings ratio over the past five years in a retail environment not nearly as robust as the current environment. If it reached a 12 multiple it would give you

a 50% gain. There is huge insider buying by CEO Christian Brickman. Historically, our biggest gains have come from small companies bought at distressed prices that have improved operating efficiency. Now we have to work much harder to find good businesses that are cheap.

We think there is value in companies like **Discovery** (NASDAQ:DISCA), which has been hopelessly out of favor as media has turned to streaming. We have had great success investing with John Malone over the years. He has been picking up more shares in the past six months. Here is a stock that trades at 9 times earnings and has a free cash flow yield north of 15%. **Discovery** owns its own content; they have the number-one women’s network and is a leader in European sports broadcasting.

The traditional media stocks like **Disney** (NYSE:DIS) and **Discovery**, **Viacom** (NASDAQ:VIA) and **CBS** (NYSE:CBS) are priced at meaningful discounts to the market. Streaming is growing rapidly in popularity, with **Netflix** (NASDAQ:NFLX) and **Amazon** (NASDAQ:AMZN) leading. However, traditional media seems too cheap and priced for extinction. If you can go from 8 times earnings to 12, it’s easier to make 50% than if you have to go from 30 to 45 times earnings. We’re trying to get the double, triple play. And obviously, it’s harder with the market higher. If you can get the companies at the right price and the operating side kicks in, that’s what we’re trying to do.

Another one that’s really out of favor and is struggling is **Wells Fargo** (NYSE:WFC), which has been working hard to earn back their customers’ trust with customer-friendly initiatives such as Overdraft Reward and minimizing standard monthly service fees. Now you’re kind of forced to buy bad news. Either you have to pay a higher price or deal with controversy. That’s another company that’s really cheap, although they’ve got some pretty serious problems, but we think those problems are fixable.

**TWST: I noticed among your top equity holdings is Kroger, the grocery store. Did you want to maybe talk a little bit about why you include that one in there?**

**Mr. Auxier:** We really like **Kroger** (NYSE:KR). We were an investor in **Kroger** at \$10. **Amazon’s** shipping costs are up 35% this past year, but no one seems to care. **Amazon** is trying to centralize their **Whole Foods** operation down in Austin. The workers are looking to potentially unionize. And yet, **Kroger** trades at 13 times earnings versus **Amazon**, which is north of 100 times. I have visited numerous **Kroger** stores in three states. They are just great operators, focused on grocery. It’s phenomenal. They are exceptional in the use of data analytics and reward programs.

The competition is fierce, but **Kroger** went head to head against **Walmart** (NYSE:WMT) several years ago and came out a winner. We do see a risk in foreigners like **Aldi** and **Lidl**. However, if you look at the cost to eat food from the grocery store versus eating out, it’s one of the widest spreads in the last 40 years. It’s a much better value to source your food from **Kroger**. **Amazon** has many more businesses than just grocery. It’s just very tough to compete on a margin basis with **Kroger** and **Walmart**.

The good thing about grocery store operators is that if inflation picks up, they reprice their inventories frequently, over 14 times a year. If you go back to the inflationary 1970s, the supermarkets were attractive inflation hedges because of their high inventory turns. **Costco** (NASDAQ:COST) turns inventories over 19 times a year. **Kroger** tends to suffer in a market that’s very short term because they aggressively invest in their business for the long run, often to the detriment of short-term profits.

Other threats include some of the startup food delivery companies out of Silicon Valley. I think there are over 120 new money-losing food delivery companies. Right now, if you look at the top 200 startups in Silicon Valley, they've got a cash burn of five to 10 times worse than in 1999. Yet, valuations are absurd. **Kroger** is a very solid company with a low valuation.

1-Year Daily Chart of Kroger Co.



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

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**TWST:** As we look at 2019, what do you think is going to be on investors’ minds as they start the year and as they continue to want to do well with the market?

**Mr. Auxier:** We think there are too many people that have been speculating and who really don’t thoroughly understand what they own. There is a tremendous opportunity for the educated, rational investor buying stakes in individual businesses. Historically, the trend in passive capital allocation has been most popular in market peaks, like in 1999.

Our experience is that when clients are down 30%, they sour on investing for the long term. People are OK investing blindly on the way up, but not on the way down. In the 1920s, during a very strong market, investment trusts were the rage, but few held on during the crash of 1929. Markets can be flat for years. From 1921 until October of 1929, the market had a huge run, up over 400%. But from 1900 to 1921, the market went up only 10%. From 1964 to 1981, the Dow went up one point.

Technology has been the star performer the last few years, but we see that area as late cycle and fraught with risk. It is a magnet for torrents of new capital. **SoftBank** (OTCMKTS:SFTBF), the Japanese venture firm, has been investing \$100 billion at very high prices. The Chinese, Saudis and others are enthusiastically following. It’s very similar to 1999. Back then, the euphoria over internet hosting and fiber optic led to a massive over-investment. The main customers were losing money, then as rates started up, failures escalated. Many of the over 400 initial public offerings failed. Only 17% to 20% of the capacity was utilized.

We track and price companies and industries to assess where we are in the cycle. The last big boom was the commodity cycle that

peaked in 2012 after a 118-month run. We constantly monitor supply and demand. You can have good companies crushed due to a plethora of capital coming into a space.

Currently, technology companies represent close to one-third of the S&P 500. We’ve learned over 35-plus years of investing that the only constant is change and that generally everything cycles. Back in 1983, I remember living through over 30 initial public offerings for personal computers. Today, few have survived. We think that critical to surviving and compounding is a dedication to an intense research effort, one that prices assets daily, monitors technological disruption and anticipates changing industry dynamics.

Recently, cryptocurrencies have crashed 80%. This was probably the biggest bubble in history. You can categorize it as the first big digital crash. That’s what we see in the pre-public IPO unicorn market — companies valued over \$1 billion. Extreme examples include companies like **WeWork**, which was recently valued at \$20 billion. **WeWork** basically transforms buildings into collaborative workspaces. It doesn’t make a lot of sense.

**TWST:** Is there anything we didn’t talk about you care to mention, either about your approach at the firm or just some trends out there?

**Mr. Auxier:** The critical thing as an investor is to be rational and do thorough homework. To enjoy the fruits of compounding, it is

necessary to understand, quantify and avoid the risk. Just look at what is happening in Venezuela. Over the next year, inflation rates are projected to rise from 41,000% to potentially 1 million percent. If you owned bonds, you were wiped out. This is why it is necessary to monitor government policies and understand the rule of law. In Argentina, interest rates are up to 60% as their currency crashes.

We are coming off powerful tailwinds of easy central bank policies that have led to declining interest rates over the past 32 years. But like all cycles, we think this is changing, and as money tightens up, investors will have to work harder. I think it’s going to be a lot tougher but will favor the true investor who values a rigorous research effort.

**TWST:** Thank you. (ES)

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