

An Interview With Broad Run Investment Management

A Motley Fool analyst interviews Broad Run's portfolio managers about quality growth investing, valuation, and more.

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([TMFEarlyRiser](#))
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Broad Run Investment Management, based in Arlington, Virginia, was founded in 2012 by Brian Macauley, David Rainey, and Ira Rothberg. The colleagues have a history of collaboration: They have worked together since 2004, applying the same investment approach Broad Run uses today. As of June 30, 2016, Broad Run had \$2.5 billion in assets under management in a sub-advised mutual fund and separately managed accounts (SMAs). The three portfolio managers' track record dates back to Sept. 1, 2009, when they assumed responsibility of the mutual fund.

Broad Run manages a concentrated investment strategy with about 20 to 30 stocks and 60% to 80% of assets in the top 10 positions. According to the firm's website, Broad Run aims to invest in high-quality, growth-oriented businesses at discount valuations. The company manages concentrated portfolios because 1) finding superior businesses at discount prices is rare, and 2) it allows the investment team to focus its resources on the most promising businesses. The firm averages about 14% portfolio turnover, implying an average holding period of about 7 years.

From its inception on Sept. 1, 2009 through June 30, 2016, Broad Run's Focus Equity Strategy has generated a gross annualized return of 16.2%, and a net (after fees) annualized return of 15.1%, compared to the Russell 3000's 13.5% return. Broad Run's outperformance is driven by its ability to pick winning stocks: It has captured 96% of the market's upside, but only about 85% of its downside.

Motley Fool analyst John Rotonti recently interviewed Broad Run's portfolio managers about quality growth investing, valuation, and more. Here's what Macauley, Rainey, and Rothberg had to say.

Can you tell us about the types of businesses you look to invest in?

We are focused on finding what some in the industry might call "compounders," or businesses with the competitive position, growth, and management to compound their "owner earnings" per share at a mid-teens annualized rate, or higher, for the next decade. There are very few businesses capable of this level of long-term compounding. By our numbers, just 8% of public companies in the U.S. have achieved this hurdle over the last decade, and of those, many started with high expectations / high valuations, so the return an investor received in the stock was quite a bit below the fundamental performance of the business.

So we are looking for these compounders at discount valuations, when they are misunderstood, underappreciated, or out of favor. These are not typically the high profile growth companies that get a lot of media attention; we do not own **Amazon**, **Salesforce.com**, **Tesla**, or **Mobileye**. We find that businesses with exciting stories and high organic revenue growth rates are usually too expensive for our approach. We usually find opportunity in somewhat less obvious growth businesses. Our sweet spot tends to be businesses with mid- or high-single digit organic revenue growth, with significant operating leverage, free cash flow, and intelligent capital allocation that can get them to mid-teens or higher bottom-line results.

Please explain your five investment criteria.

Our five investment criteria provide a roadmap, or checklist, to help keep us oriented as we evaluate businesses in search of compounders. While very few, if any, businesses meet the criteria perfectly, it is still a very good litmus test in our research process. The five criteria are: a high-quality business, a large growth opportunity, excellent management, low tail risk, and discount valuation.

What do you mean by a high-quality business?

We view a high quality business as a business possessing a unique, and hard to replicate, competitive position that allows for high returns on capital today and far into the future. A high quality business must have sustainable competitive advantages (high customer switching cost, low cost position, proprietary know-how, government license, network effects, etc.) and an ethos that seeks to enhance that advantage over time.

What do you mean by excellent management?

We look to invest with management teams skilled at both operations and capital allocation, motivated with proper economic incentives, and possessing a long-term mindset. Of these considerations, it is hard to overemphasize the importance of skilled capital allocation. Consider a new CEO hired to run a 100-year-old business. If that business earns a 12% return on equity today, and that ROE can be sustained, then in six years time the firm's equity base will have doubled. In just six years, the CEO will be responsible for investing 50% of all equity capital ever invested in a century-old business. Over time, there is significant power to create -- or destroy -- shareholder value based upon what is done with a firm's profits and balance sheet.

You mentioned low "tail risk" as one of your five criteria. Can you explain this?

In investing, the power of compound interest is the investor's best friend. With enough time, the power of compounding can carry the investor to a wonderful outcome. So our first consideration in investing is to try to avoid mistakes that could interrupt the power of compounding. This means that we are ever watchful for "tail risks" that could wipe out an investment: excess financial leverage, unsustainable levels of demand, fad or obsolescence risk, excessive valuation, etc. We attempt to avoid businesses where rapid change or complexity make it too difficult for us to have a confident opinion about what the company, and its profitability, will look like in ten years.

How do you define a discount valuation, and what valuation techniques do you use?

Our approach is business first, valuation second. We only want to own businesses we would be comfortable owning for five or ten years. If the business is not appealing, the valuation does not matter to us. If the business is appealing, then we use a two-pronged valuation approach to assess if it is trading at a discount price. We look for investments that can pass both of our valuation tests.

First, as a blunt tool, we use price to owner earnings ("P/OE"), P/E, EV/EBITDA, EV/EBIT and other traditional valuation ratios that may make sense in the given circumstances. We look at these ratios on a trailing and forward year basis, and consider their current level in relation to the long-term levels for the company and its peers. Of these metrics, for most companies, our favorite is P/OE. We have traditionally been able to pay mid teens P/OE for these high quality compounders that we think will grow bottom line results at a mid-teens rate over the long term.

Second, we create a five-year financial forecast of a business to determine a reasonable range of future values (and expected returns from today's stock price). This forecast incorporates our well-informed assumptions about revenue growth, margins / operating leverage, free cash flow

generation, balance sheet changes, and management's capital reinvestment decisions. We stress test the forecast to understand potential upside and downside variance. We are typically trying to underwrite investments to a mid-teens expected annualized return in a base case scenario, with positive returns even in a downside scenario.

In your second quarter 2016 letter to investors you write, "We attempt to purchase / own these businesses at around a market multiple so that it is primarily earnings growth that drives our returns rather than change in valuation. Dividends are typically a small contributor to our total returns because most business we own tend to retain their earnings to reinvest back into growth initiatives. Our simple logic is that if we can buy / own businesses that grow value (EPS growth + dividend yield) at nearly twice the rate of the overall market, at valuations similar to the market, then this higher growth should translate into higher absolute and relative investment returns over time." Are you willing to pay slightly higher multiples today, given that the stock market is trading at multiples above its historical average?

We are willing to pay somewhat higher multiples, but are not stretching much. We are still finding and owning businesses that, for the most part, are trading at mid teens multiples of our estimate of next twelve month owner earnings.

Do you calculate owner earnings in the same way Warren Buffett does (reported net income plus depreciation/amortization and some other non-cash expenses less maintenance capital expenditures)?

With our long-term investment horizon, we focus on what we believe to be the true underlying economics of a business, rather than EPS and GAAP accounting numbers that may or may not provide a good measure of economic reality. Our preferred metric is "owner earnings," a term coined by Warren Buffett in his 1986 Berkshire Hathaway annual shareholder letter. Owner earnings is the amount an owner of a business could take out of the business each year without diminishing the competitive position or future earnings power of that business. In some cases owner earnings are the same as GAAP net income, but in other cases adjustments are required to get to the real economics of the business. For example, in certain situations, we believe book value per share growth at a financial institution, adjusted funds from operation (AFFO) at a real estate intensive business, or amortization-adjusted earnings at an acquisitive software company are better measures of economic profits and progress than GAAP accounting earnings.

How do you narrow down your investable universe? How large is that universe?

We are primarily focused on the U.S., where we can best understand the language, legal, regulatory, and business environment, and customer motivations. In the U.S., there are about 2,300 companies with greater than a \$500 million market cap. About one-third of these companies are in industries that are clearly unattractive within our investment framework, leaving about 1,500 that could be investable.

Beyond this, there is no single computer screen or formula that can identify companies that fit our mold, so we employ an eclectic search process. We systematically sort through industries looking for interesting businesses. Some ideas are the result of continuous reading of annual reports and periodicals, some spring from our travel to meet with companies in the field, and others are a product of one investment being tangential to the next.

Over the last decade, we have accumulated several hundred businesses that are interesting to us and worth monitoring. We also maintain a more refined watch list of about 75 companies that we have studied closely, that measure well against our business criteria, and where we are waiting for attractive entry points.

Are there any industries you tend to prefer? Or avoid?

We have historically found the specialty financial, consumer, and business services areas fertile hunting ground for competitively differentiated businesses with large growth opportunities. Conversely, we do not find these traits in oil and gas, commodities, traditional banks, semiconductors, or computer and electronics hardware, so we avoid these spaces.

Do you set price targets? When do you sell?

There are four reasons we will sell a position: we find a better investment idea in which to invest the capital, we become concerned about the business's long-term prospects, valuation (our expected annual return in our five-year scenario analysis drops below 10%), or for portfolio-level risk management purposes. Of these, the vast majority of our sales occur because we find a better investment idea in which to invest the capital.

Valuation and price targets -- which are implicit in our five-year 10% expected return scenarios -- rarely become a factor, because we typically swap out an existing idea for a new idea well before that point.

How do you evaluate a company's balance sheet? Do you look for a particular coverage or debt ratios?

We do not believe that debt is intrinsically bad, and cash intrinsically good. We believe a company's balance sheet needs to be viewed in the context of where that business is in its corporate lifecycle, and the predictability of its cash flow. A high growth business with lots of acquisition opportunity would be shortsighted to carry any meaningful financial leverage except to finance a highly accretive acquisition. Conversely, a slow growth business with highly predictable cash flow, little capex, and few acquisition opportunities would optimize returns to equity holders by sustaining some financial leverage. We want management to be thoughtful about using the balance sheet, and we try to avoid management teams that use too much or too little leverage in their given circumstances.

Among other things, we consider debt-to-EBITDA, interest coverage, fixed versus floating interest obligations, and debt repayment / refinancing timelines. But again, the acceptable and appropriate level of leverage and balance sheet strength depends upon the nature of the business and the circumstances.

How do you think about position sizing and portfolio diversification?

We manage a concentrated, conviction-weighted portfolio. Typically we hold 20 to 30 total positions with 60% to 80% of assets in the top ten positions. While this is an unconventional approach -- most investment managers are much more diversified -- we believe it allows us to provide magnified exposure to our best ideas while still maintaining adequate economic diversification across the holdings.

When sizing individual positions, we take into consideration: 1) our confidence in the business's long-term financial prospects (a function of its fit with our investment criteria, the nature of the business, and our depth of knowledge) and 2) its valuation / expected long-term return profile.

At the portfolio level, we contemplate how individual businesses interact as part of the whole. We attempt to limit overall exposure to any one industry or business factor risk. Our attempt is to build a portfolio in which we have high confidence in the component businesses, while also having high long-term expected returns. We seek enough diversification so that when one or several of these businesses encounter(s) a setback, the balance of holdings can carry the overall portfolio forward.

Can you discuss the research process at Broad Run? What is the process for a stock to make it into the portfolio?

Since we typically hold an investment for many years, we conduct our research with an eye toward understanding the opportunity for a business over the next decade. Most of our research is focused on evaluating those things that can make an important difference in the long term, i.e. demand, the competitive structure of the industry, management quality, and the sustainability of pricing and margins.

To build this knowledge, we begin by conducting industry standard research by reading annual reports, SEC filings, financial statements, attending presentations, and meeting with senior management. But to really understand a business, we find it is important to dig deeper. So we often visit company facilities, meet with field level employees, talk to customers, interview former employees, attend industry trade shows, and speak with public and private competitors. While this is hard and time consuming work, we believe it gives us an understanding of a company and its industry that can build our conviction in an investment thesis, and lead to important investment insights.

In most cases, when we find a high quality growth company it is not available at an attractive price. So we place it on our watch list where we monitor the business and wait -- sometimes for years -- for the market to present an attractive entry point.

We have a small investment team and operate as generalists. We have a primary analyst assigned to each business in the portfolio and on the watch list, but we work as a team to understand those businesses and make investment decisions. We meet informally every day, and have a formal research meeting scheduled once a week. Most of the time consuming business research can be conducted in the office and over the phone, but we get out and travel several times a month for meetings with management, visits to company sites, and other due diligence efforts.

What common characteristics or patterns do you recognize in some of your biggest winners?

It has been our experience that we get the best results by paying a good price for a great business, rather than a great price for a good business.

What lessons did you learn or patterns do you recognize from some of your losers?

Most of our losers have been businesses that didn't grow their earnings as quickly as we expected, or at all. We have owned few businesses that have gone materially backwards with significant and sustained earnings declines. Since we try to buy businesses at modest valuations, our losers have underperformed the market, but have not delivered significant capital losses.

On one hand, this confirms for us that we have a pretty good valuation and business analysis discipline in place. On the other hand, we still get businesses wrong. Every losing investment teaches you a new lesson. We try to learn from these experiences, but the reality is that every business, every situation is different, and no matter how many lessons we learn from past mistakes, we will find new mistakes to make in the future.

We think our five criteria provide a good framework for not only picking winners, but also avoiding losers. If we can keep these criteria in mind -- buy well-run, quality businesses at good prices -- then we think our future mistakes can be moderated, and our losses contained.

Do you have any performance metrics that you prefer management compensation be based on?

We like to see management compensation skewed to long-term results, with an important return on capital or return on equity component.

What step(s) should investors take to try avoid "value traps"?

As long as we pay a reasonable price for a business and that business is growing its owner earnings at a nice rate, we do not worry about a stagnant stock price. In fact, some of our best purchases have been in businesses where earnings have been growing, but stock price has not.

What's your brief investment thesis on O'Reilly Automotive ([NASDAQ:ORLY](https://www.nasdaq.com/symbol/orly))? Do you think the company can maintain its current multiple?

O'Reilly is one the three largest aftermarket auto parts retailer-distributors in the U.S. We think O'Reilly has set up its business to win over the long term. Management has invested in a robust distribution network that allows the company to provide a very high level of service to retail and commercial customers. This network is unrivaled in the industry, expensive / hard to replicate, and has allowed O'Reilly to gradually gain market share and grow its geographic footprint over time. In the U.S., we think the company has 7-plus years of mid- to high-teens EPS compounding in front of it, with international growth opportunities beyond.

We do not know if the business can sustain its current low to mid 20s P/E multiple -- it is elevated compared to the company's historical mid-teens multiple range. However, with our growth outlook, we think we will get an attractive long-term return in the stock, even if the multiple contracts to its historical range over time.

What are your thoughts on stock market valuations?

We have no idea what the stock market will do in the short-term or even the next few years. But we do monitor long-term market valuation metrics to get a sense for how attractive or unattractive the overall environment is. Using long-term fundamental ratios (stock market capitalization-to-GDP, price-to-cyclically adjusted earnings [CAPE or Schiller PE], enterprise value to replacement cost [Tobins-q]) the market is modestly elevated relative to its long-term valuation history. However, we are in a very low inflation and interest rate environment, which at least partially -- and perhaps wholly -- justify this modest valuation premium.

Our view is that even if the market is somewhat overvalued, it does not mean there will be a correction (although there of course could be!). It simply means that all investors should expect somewhat lower long-term investment returns from here, as valuation levels return to the mean over time. For us, it is clearly more difficult to find cheap stocks in this environment than it was several years ago, but our concentrated strategy serves us well, as we need relatively few compelling ideas to drive performance in the portfolio.

John Rotonti owns shares of O'Reilly Automotive. The Motley Fool owns shares of and recommends Amazon.com, Salesforce.com, and Tesla Motors. The Motley Fool owns shares of O'Reilly Automotive. The Motley Fool has a disclosure policy (<http://www.fool.com/Legal/fool-disclosure-policy.aspx>).

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Past performance is no guarantee of future results. All investments involve risk and may decrease in value.



Broad Run uses a concentrated, low-turnover investment approach, and generally seeks to invest in high quality, growth-oriented companies trading at discounts to intrinsic value. Broad Run manages equity portfolios for institutional and individual investors through separate accounts and a sub-advised mutual fund.

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Focus Equity Composite Disclosure Presentation



GIPS Composite Information

Composite Name	Focus Equity Composite
Reference Index	Russell 3000 Index
Reporting Date	December 31, 2016
Composite Inception	September 1, 2009

GIPS Compliance and Verification Status. Broad Run Investment Management, LLC (Broad Run) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Broad Run has been independently verified for the periods October 27, 2012 through December 31, 2016. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request. A list of composite descriptions is available upon request.

Firm Information. Broad Run is an investment advisor registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940, as amended. Broad Run is defined as an independent investment advisor that is not affiliated with any parent organization.

Composite Description. The Focus Equity Composite contains all fee-paying, discretionary accounts that are managed according to Broad Run's Focus Equity Strategy. The Focus Equity Strategy invests primarily in U.S equity securities—regardless of capitalization—and seeks long-term capital appreciation while incurring a low risk of permanent capital loss. The strategy uses a concentrated and low turnover investment approach, and generally seeks to invest in what the firm believes are high-quality growth-oriented companies trading at discounts to Broad Run's assessment of their intrinsic value. Broad Run has determined that no appropriate benchmark for the composite exists because the Focus Equity Strategy has minimal exposure to a number of sectors and invests across the market capitalization spectrum.

The Focus Equity Composite was created in October 2012; its inception date is September 1, 2009. From September 1, 2009 to October 26, 2012, the composite is composed solely of an equity mutual fund. Broad Run's managing members served as portfolio managers for this equity mutual fund while employed at the fund's advisor. From October 27, 2012 to February 28, 2013, the composite is composed solely of the successor equity mutual fund to the aforementioned equity mutual fund. Broad Run is engaged as the sole sub-advisor of the successor equity mutual fund (managing 100% of its assets) by its new advisor, and the firm's managing members serve as portfolio managers for the successor equity mutual fund. Broad Run has met the GIPS portability requirements to link the returns of the equity mutual fund and the successor equity mutual fund. For the time period after February 28, 2013, the composite is composed of the successor equity mutual fund and separate accounts. Currently, the assets in the mutual fund comprise a significant majority of the composite's assets.

Fee Schedule. Broad Run's standard annual asset-based management fee schedule is 1% of the account's total assets on the first \$5 million and 0.85% thereafter. Gross performance results do not reflect the deduction of Broad Run's investment advisory fee, which will affect a client's total return.

Gross of fees returns are calculated gross of management and custodial fees and net of transaction costs. Net of fees returns are calculated by deducting the monthly-equivalent amount of Broad Run's highest applicable annual management fee of 1.00% ("Model Net Fee"), as described in the firm's Form ADV, Part 2A (without the benefit of breakpoints) from the monthly composite gross return.

Reference Index Disclosure. The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The index is market-value weighted. Index figures reflect the reinvestment of dividends and capital gains. Index figures do not reflect deductions for any fees, expenses, or taxes. Investors cannot invest directly in an index. The index data below is supplemental information. The index's performance returns are included to illustrate the general trend of the U.S. equity market and are not intended as a benchmark for the composite.

Other. All returns presented in the table below (including the reference index) include the reinvestment of dividends, interest income, and capital gains. Valuations are computed and performance is reported in U.S. dollars.

	Calendar								Annualized (12/31/16)				
	2016	2015	2014	2013	2012	2011	2010	Sep-Dec 2009 ¹	1 YR	3 YR	5 YR	7 YR	Since Inception
Focus Equity Composite Gross Return (%)	8.83	4.40	11.76	37.18	18.27	5.13	26.40	8.64	8.83	8.29	15.55	15.47	16.01
Focus Equity Composite Net Return (%)	7.76	3.37	10.66	35.85	17.11	4.08	25.16	8.29	7.76	7.22	14.42	14.34	14.87
Russell 3000 Return (%)	12.74	0.48	12.56	33.55	16.24	1.03	16.93	10.34	12.74	8.43	14.67	12.92	13.81
Composite Standard Deviation ²	12.06	11.30	9.44	12.52	16.80	- ³	- ³	- ³	n.m. ⁴	12.06	10.78	13.93	13.87
Russell 3000 Standard Deviation ²	10.88	10.58	9.30	12.54	15.74	- ³	- ³	- ³	n.m. ⁴	10.88	10.56	13.07	13.02
Number of Portfolios	101	52	41	30	1	1	1	1					
Internal Dispersion ⁵	0.31	0.13	0.10	n.m.	n.m.	n.m.	n.m.	n.m.					
Composite Assets (USD millions)	2,671.8	2,266.5	1,618.5	1,454.0	781.2	672.2	772.8	812.5					
Firm Assets (USD millions)	2,794.1	2,268.6	1,619.5	1,459.8	781.2	N/A	N/A	N/A					

Past performance is not indicative of future results.

1: Annual Performance Results reflect partial period performance. The returns are calculated from September 1, 2009 to December 31, 2009 for the Focus Equity Composite. 2: Standard deviation measures the variability of the gross returns of the composite and the reference index. All standard deviation figures are calculated using monthly gross performance numbers. Figures presented for calendar year and YTD periods are three-year annualized standard deviations. 3: The three-year annualized standard deviation is not shown due to having less than 36 months of composite returns. 4: n.m. - Not statistically meaningful for periods less than 3 years. 5: The annual composite dispersion presented is a dollar-weighted standard deviation of the gross returns for all accounts in the composite for the entire year, using beginning of period values; not statistically meaningful (n.m.) for periods less than one year, or when there are five or fewer accounts in the composite for the entire year.

Additional Composite Details. The Focus Equity Composite includes a mutual fund for which we charge a sub-advisory fee that is lower than the model net fee. However, the mutual fund's total operating expenses, which are not applicable to you, are in excess of the model net fee. Therefore, the actual performance of the mutual fund in the composite on a net-fee basis will be different, and will normally be lower, than the model net fee performance. However, the model net fee performance is intended to provide the most appropriate example of the impact management fees would have by applying management fees relevant to you to the gross performance of the composite. Actual fees and expenses in client accounts may differ from those reflected in this composite presentation and would cause actual performance to differ. The performance figures do not reflect the deduction of any taxes an investor might pay on distributions or redemptions.

Investing Involves Risk. Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results and client accounts may not achieve the Focus Equity Strategy's investment objective. There may be market, economic, or other conditions that affect client account performance, or the performance of the referenced market index. Therefore, it should not be assumed that the future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Broad Run) will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. The Strategy invests in small- and medium-size companies. Investments in these companies, especially smaller companies, carry greater risk than is customarily associated with larger companies for various reasons such as increased volatility of earnings and business prospects, narrower markets, limited financial resources and less liquid stock. A client account invested in the Focus Equity Strategy will hold fewer securities and have less diversification across industries and sectors than a diversified portfolio, such as a portfolio based on an index. Consequently a client account and/or the composite performance may diverge significantly from the referenced market index, positively or negatively.

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