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MUTUAL FUNDS

Three Steps That Help Make This One Of The Best Mutual Funds

BY PAUL KATZEFF

Broad market pullbacks are tough on most diversified stock fund managers. The pullback that began in October is no exception. Colin Hudson, a manager of $1 billion Natixis U.S. Equity Opportunities Fund[NEFSX], reminds himself it's the long run that determines which portfolios are among the best mutual funds and that in the long run he's riding a winner.

The mutual fund outperformed the S&P 500 in calendar 2017 as well as in the prior three, five and 10 years on an average-annual-return basis. Just 10% of U.S. diversified stock funds managed that four-for-four feat, making the Natixis mutual fund an IBD Best Mutual Funds Awards winner.

In addition, co-managers of his sleeve of the Natixis fund include William Nygren and Kevin Grant, managers of $18.9 billion Oakmark Fund[OAKMX], another of the industry's best mutual funds. Over the 10 years ended Oct. 31, that fund's 14.31% average annual return had topped 94% of its large-cap blend rivals tracked by Morningstar Inc. and had beaten the S&P 500's 13.24%. Hudson's sleeve in the Natixis fund consists of Oakmark's best ideas, Hudson says.

Hudson, Nygren, Grant and Natixis U.S. Equity Opportunities co-manager Michael Mangan all call Harris Associates, Oakmark's parent, home base.

The Natixis fund portfolio is divided in two, each run by separate subadvisors. Half of it is run by Hudson's team, with a value-stock tilt. The other half is run by Aziz Hamzaogullari at Loomis Sayles. Morningstar categorizes the fund overall as a growth portfolio.

Both Harris and Loomis Sayles are wholly owned subsidiaries of Natixis Investment Managers.

Hudson, who is 49 years old, talked with IBD about how his team invests for this portfolio, one of the best mutual funds, from his office in Chicago.

Best Mutual Funds: Stock Picking

IBD: Your stock picking boils down to three steps, doesn't it?

Colin Hudson: Our investment philosophy revolves around three tenets. First, we buy stocks trading at a significant discount to our estimate of its intrinsic value. There's no one way to measure that. With some companies, we use the discounted-cash-flow multiple. With cable companies, our primary method is to use the enterprise multiple, which is enterprise value-to-EBITDA. We use EV-subscribers as a secondary measure.

Recent stock market volatility gave Colin Hudson's team a chance to add some names to their portfolio sleeve. (Kristan Lieb for IBD)

Then there are companies with nonearning assets. An example would be **Alphabet**[GOOGL] with YouTube, which it isn't fully monetizing yet. We spend time understanding businesses so we get a good estimate of intrinsic value.

Our second step is to invest in companies expected to grow per-share value over time.

IBD: Which means?

Hudson: We expect share price to increase (and) we believe we are buying these businesses at a big discount to our estimate of intrinsic value.

IBD: And your third step?

Hudson: Our third step is to look for management teams that think and act like owners. Every company we buy, we meet the managers. If companies generate a lot of cash flow, what do they do with it? Do they buy back stock? Do they make smart acquisitions? If we can understand what they've done in the past, it may help us understand what they may do in the future.

IBD: Why combine a value-stock team with a growth team in one fund?

Hudson: Both sides operate separately, and both have done well over time. Over time, it dampens some volatility.

IBD: Amid recent stock market volatility, have you gone bargain-hunting or taken defensive steps?

Hudson: The recent volatility has given us a chance to add to some names where we think the business fundamentals are still strong but the stock prices have declined significantly.

IBD: What does it take to outperform again and again over time the way this fund has?

Hudson: I can speak for our sleeve. It's the due diligence that we do. It's our drive to understand businesses, cash flows, competitive dynamics. Then buying at a big discount to what a business is worth.

IBD: Which members of your team decide which stocks to buy?

Hudson: The Harris domestic investment team has 12 analysts doing research, looking for new stocks that meet our criteria. They bring names to our Harris stock-selection group that meets every Tuesday. If two of the three voting members vote yes, the stock can be bought by any Harris portfolio.

It's up to each manager's discretion. This fund — our sleeve of it — is a subset of Oakmark Fund. This is the best ideas from Oakmark, typically 25 to 32 stocks.

Best Mutual Funds: Hudson's View Of Apple

IBD: Is the iPhone the key to **Apple's**[AAPL] prospects, or does the key lie in Apple's services like the App Store, Apple Music and Apple Pay?

Hudson: Apple needs the iPhone hardware for its income from services to be relevant, to have impact. And we're confident that the iPhone will be one of their main assets, that it will have a long life.

IBD: Both sleeves hold **Visa**[V] and your sleeve holds **Mastercard**[MA]. Which do you like better?

Hudson: They trade at similar discounts to value. We bought them back at the Durbin Amendment (a part of the 2010 Dodd-Frank financial reform legislation that hurt Mastercard's and Visa's share prices slightly by limiting fees that could be charged to retailers for card processing).

Now they've had huge runs in the last year. One thing we look for is a powerful network effect. Over 20,000 financial institutions are tied to them, millions of merchants globally. They take a very small cut of each transaction. There's still plenty of room for digital payments to grow. Our guess is that there's about 40% digital penetration.

We watch for competitive entry, but we don't see any meaningful threat near-term or even midterm. We see midteens earnings-per-share growth for many years. These businesses are growing quickly, but they're just modestly undervalued.

Best Mutual Funds: Holding Netflix

IBD: Netflix[NFLX], like other **FANG stocks**, has seen its share price fall in the broad market pullback. What's your thesis?

Hudson: We talk a lot about long-term value here. In mid-October, the market reacted positively to news about Netflix's 6 million new subscribers. What gets lost is that that's on a subscriber base of almost 140 million. That's a huge competitive advantage over nearly anyone else. That allows them to spread content spending over a lot of subscribers.

Longer term, those subscribers stay a long time and are worth quite a bit.

IBD: Did Netflix spend too much to attract those new subscribers?

Hudson: Short term, it looks like a big cash outflow. But the way we look at it, we value each new "sub" at $1,000 per share. So 6 million new subs created $6 billion in value, despite what they spent on content.

IBD: Netflix raised prices for two of its plans a year ago. Now its basic, standard and premium subscription plans cost $8, $11 and $14. Are those too pricey?

Hudson: We think there's a lot of pricing power there. They could raise their price to $15 a month. That would move their P-E ratio to a high-teens market multiple. And they would still have a lot of growth after that. If you look out several years, with their pricing power and subscriber growth, they're trading at a reasonable multiple.

IBD: Regeneron Pharmaceuticals'[REGN] earnings-per-share growth has slowed for two quarters. (It reports on Nov. 6.) Any concerns?

Hudson: Looking at current earnings is deceiving. They are depressed by high R&D spending and high selling, general and administrative (SG&A) expenses to launch new drugs.

Eylean and Dupixent are two of their main drugs. Both are still ramping up. So if you adjust the spending for those drugs and the high R&D and SG&A, then Regeneron trades at a mid-teens multiple, which is very reasonable. At the moment, Regeneron trades at 11 times our estimated 2020 earnings forecast. EPS would be $30 in 2020 compared to the consensus of industry analysts, who expect $21.

And that gives no credit to a proven management team and a promising pipeline of drugs being developed for oncology, pain and rare diseases, as well as internally developed technology for drug development, which are worth a premium to where this stock trades.

Best Mutual Funds: Dissecting HCA

IBD: Are you worried that hospital operator **HCA's**[HCA] annual earnings per share slowed to $6.82 last year from $6.87 the year before?

Hudson: When you look at the (nation's) aging demographic and HCA's footprint in high-growth regions, we think HCA can grow EBIT (the profit measure of earnings before interest and taxes) in the midsingle digits.

They've been fantastic capital allocators. They took the company private once. They've done highly accretive deals that have made a lot of sense. They've also just bought back a ton of stock. And they bought it at a historically low price, which has led to faster EPS growth and EBIT growth.

IBD: Do you like the prospect of **CVS Health**'s[CVS] merger with **Aetna**[AET]?

Hudson: There are worries about CVS's business being disrupted. In retail pharmacy, **Amazon**[AMZN] may be an entrant. There are worries about the role of pharmacy benefit managers (PBMs) going forward. With Aetna, they're getting into managed care.

But with Aetna, CVS could be the disruptor. There are a lot of cost synergies from combining.

CVS-Aetna will be a retail pharmacy, PBM and managed care company. Managed care companies trade all over the map, with **UnitedHealth Group**[UNH] trading at 18 times next year's earnings. **Cigna**[CI] (which acquired **Express Scripts**[ESRX]) trades at 14 times next year's earnings. At less than 10 times projected earnings and free cash flow, with cost synergies from combining, CVS-Aetna looks very cheap.

Best Mutual Funds: Comcast's Pipes

IBD: I see **Charter**[CHTR] and **Comcast**[CMCSA] in the portfolio. Comcast is much bigger. Why do you like it?

Hudson: We think cable has the winning solution for broadband. Having pipes into all the homes and having the fastest-speed broadband is hugely value accretive.

There's some worry about 5G (the fifth generation of cellular mobile communications). But we think 5G will only be effective for the most densely populated urban areas. We're not worried about it for most Comcast homes.

And Comcast not only has interesting assets on cable channels, it also just did the Sky deal (winning the auction for the big European pay-TV system). And they have a good theme-park business in Universal.

Earnings per share will be about $3. The stock trades about 12 times that. Fair value is mid- to high teens.

IBD: Value and blend (a combination of growth and value) investing as represented by iShares S&P 500 Value (IVE) and SPDR S&P 500 (SPY) have underperformed growth both year-to-date and since 2009. Under which conditions will value and/or blend outperform growth for an extended period?

Hudson: I am not certain of the exact environment that will enable value to outperform. But the big decline in many of our holdings this year seems to be correlated with worries about global growth and tariffs. We believe that any lessening of trade tensions and also an easing of fears about the global economy should be positive for many of our holdings.

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Natixis U.S. Equity Opportunities: Equity securities are volatile and can decline significantly in response to broad market and economic conditions. **Value investing** carries the risk that a security can continue to be undervalued by the market for long periods of time. **Growth stocks** may be more sensitive to market conditions than other equities, as their prices strongly reflect future expectations. Investments in **small and midsize companies** can be more volatile than those of larger companies. **Foreign and emerging market securities** may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than U.S. securities, due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.

Average Annual Total Returns (%) as of 12/31/18†	**YTD**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Natixis U.S. Equity Opportunities Fund Class Y	-6.24	-6.24	10.00	9.85	15.39
Natixis U.S. Equity Opportunities Fund Class A *at NAV*	-6.48	-6.48	9.73	9.57	15.10
Natixis U.S. Equity Opportunities Fund Class A *with 5.75% maximum sales charge*	-11.85	-11.85	7.59	8.28	14.43
S&P 500® Index[1]	-4.38	-4.38	9.26	8.49	13.12
Russell 1000® Index[2]	-4.78	-4.78	9.09	8.21	13.28

Average Annual Total Returns (%) as of 12/31/18†	**3 Months**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Oakmark Fund – Investor Class (OAKMX)	-17.30	-12.73	7.76	6.03	13.92
S&P 500® Index[1]	-13.52	-4.38	9.26	8.49	13.12
Lipper Large-Cap Value Fund Index[3]	-12.44	-7.58	7.67	5.95	11.03

Average Annual Total Returns (%) as of 10/31/18†	**3 Months**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Oakmark Fund – Investor Class (OAKMX)	-7.71	-0.55	9.90	9.51	14.31
S&P 500® Index[1]	-3.25	7.35	11.52	11.34	13.24
Lipper Large-Cap Value Fund Index[3]	-3.74	4.10	9.65	8.71	11.28

Performance data quoted represents past performance and is no guarantee of future results. Total return and value will vary, and you may have a gain or loss when shares are sold. Current performance may be lower or higher than quoted. For most recent month-end performance, visit oakmark.com. Performance for other share classes will be greater or less than shown based on differences in fees and sales charges. You may not invest directly in an index. †Performance for periods less than one year is cumulative, not annualized. Returns reflect changes in share price and reinvestment of dividends and capital gains, if any.

Natixis U.S. Equity Opportunities Fund gross expense ratio 1.19% (Class A share) / 0.93% (Class Y share); net expense ratio 1.19% (Class A share) / 0.93% (Class Y share). Oakmark Fund gross expense ratio 0.89% (Investor Class); net expense ratio 0.85% (Investor Class). As most of the recent prospectus, the investment advisor has contractually agreed to waive fees and/or reimburse expenses (with certain exceptions) once the expense cap of the fund has been exceeded. This arrangement is set to expire on 04/30/19 (Natixis U.S. Equity Opportunities Fund) and on 01/28/20 (Oakmark Fund). When an expense cap has not been exceeded, the gross and net expense ratios and/or yields may be the same.

[1] **S&P 500® Index** is a widely recognized measure of U.S. stock market performance. It is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation, among other factors. It also measures the performance of the large cap segment of the US equities market.

[2] **Russell 1000® Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the U.S. market. The Russell 1000® Index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected.

[3] **Lipper Large-Cap Value Fund Index** measures the equal-weighted performance of the 30 largest U.S. large-cap value funds as defined by Lipper.

IBD's Best Mutual Funds 2018 Awards spotlights funds that beat their benchmark indexes over the past one, three, five and 10 years. All returns as of December 31, 2017. Special recognition is given to the five best mutual funds in each of 12 categories. All the funds considered have at least $100 million in assets and 10 years of operation. For the 2018 list, 2,806 mutual funds met the criteria of having at least $100 million in assets and 10 years of operation tracked by Morningstar Direct, but only 627 funds beat their performance benchmark across all four periods evaluated. Of the 1,104 U.S. diversified stock funds, only 115 outperformed the S&P 500 benchmark in the four periods.

The top ten holdings are presented to illustrate examples of the securities that the fund has bought and the diversity of areas in which the fund may invest and may not be representative of the fund's current or future investments. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual stocks. Current and future portfolio holdings are subject to risk. To view the full list of holdings, please visit oakmark.com.

Natixis U.S. Equity Opportunities Fund
Top 10 Holdings as of 12/31/18

Security	% of Net Assets
Alphabet, Inc., Class A	4.09
Regeneron Pharmaceuticals, Inc.	3.86
Visa, Inc., Class A	3.83
Amazon.com, Inc.	3.65
Alibaba Group Holding Ltd., Sponsored ADR	2.82
Oracle Corp.	2.80
Facebook, Inc., Class A	2.54
Monster Beverage Corp.	2.38
Autodesk, Inc.	2.35
Expeditors International of Washington, Inc.	2.26

Oakmark Fund
Holdings mentioned in the article as of 12/31/18

Security	% of Net Assets
Alphabet Cl C	3.5%
Citigroup	3.0%
Regeneron Pharmaceuticals	2.9%
Bank of America	2.9%
Apple	2.7%
Netflix	2.7%
American Intl Group	2.5%
Capital One Financial	2.5%
Fiat Chrysler	2.5%
CVS Health	2.4%
Charles Schwab	2.4%
Ally Financial	2.4%
State Street	2.4%
General Electric	2.4%
Comcast Cl A	2.4%
TE Connectivity	2.3%

Before investing, consider the fund's investment objectives, risk, charges, and expenses. For the Natixis U.S. Equity Opportunities Fund, visit im.natixis.com or call 800-225-5478 for a prospectus or a summary prospectus containing this and other information. For the Oakmark Fund, please visit oakmark.com or call 800-Oakmark (800-625-6275). Read the prospectus carefully.

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