Dean: [Music] Good morning everyone, thank you for joining us. My name is Dean Papas, I'm a member of the business development team here at Pzena, and I also head up the consultant relations effort. Pzena Investment Management is a classic value investment firm. For over 29 years, we've been dedicated to a very disciplined process of identifying, researching, and investing in good businesses that are deeply undervalued, all over the world.

Two of the leaders of our firm are joining us here today, Allison Fisch and Rich Pzena. Hello, Allison.

Allison: Hello.

Dean: Hello, Rich.

Rich: Morning. Hi, everyone.

Dean: Allison joined the firm in 2001. She's our president and managing partner, and she's a portfolio manager on our International and Emerging Markets portfolios. Rich Pzena is our founder. He founded the firm in 1996. He's our chairman, co-chief investment officer, and a portfolio manager on our US strategies—large cap mostly. Allison and Rich, thank you for volunteering to share your views with us today.

Let's start by talking about what's happened in the markets over the past couple of years, and how that's impacted our portfolios and the way we research new investment ideas here at Pzena. The S&P just returned 25% for the second year in a row, approximately. At some point, it becomes unreasonable to expect this type of return from the market, but the signals from the market leaders point to continued growth in earnings, and we're constantly being told that the state of the US economy is very strong. So investors seem to be left with a binary choice from here. Are they to believe that such attractive returns are available in the market again in 2025, or should they be running for the doors? That's not a question we expect you to answer today—we're going to leave that to the strategists out there. And it also leaves out a certain third option, which we'll spend most of our time on today.

Rich, can you please share your perspective on how a value investor endures through this type of concentrated, growth-led market? Because it's being implied that value investors have not participated in this euphoria over the past couple years at all.

Rich: Well, I mean, I'll start just with a basic premise that if we look at the last two years for value, it really hasn't been so bad. In fact, our strategies across the globe over the last two years have generally returned mid-teens kinds of returns. Now, obviously that pales in comparison to 25% a year with the S&P 500, but it is very much in line with what we have done over our history and what we expect to do over the long term. And what's really interesting about our portfolios—because what is cheap is constantly changing—you can get these kinds of mid-teens returns and at the end have a portfolio that is not more expensive than you had at the beginning.

In fact, if you look at our history, and using our metric that we've always used to value companies—price to what the normal level of earnings is for the companies—we've typically bought companies between five and ten times their normal earnings. The midpoint of that range is seven and a half, and we're right at or slightly below that midpoint today. So there's nothing particularly unusually expensive about the value universe. Now, the markets—obviously, if you had your choice of making 25% a year or making 15% a year, I don't think that's a tough choice. The problem is, what are you going to believe for the long term, and what do you want your value manager to be doing?

And of course, we've—and everybody in the world talks about market concentration, so I don't want to overdo it, but the market's unusually concentrated. The top ten companies—you have to go—you didn't even get this in the internet bubble—you have to go back to the Nifty Fifty, 70-something years ago, to find a market that's as concentrated as it is today. And of course, those were all great consumer-branded stocks which were going to take over the world and have high margins and keep growing forever. And of course, when that stopped happening, the market de-concentrated—whatever, if that's really a word—over the, I'm going to say, steadily for the next 30 or 40 years.

I'm not going to sit here and tell you that it's going to be a bad year for NVIDIA next year. I have no idea. I really have no idea. But I do think that if you actually look at what drives and what's driven these companies, it's been the strong performance, the earnings growth, the excitement about the future prospects. But as you look at the way that, broadly speaking, analysts look at these companies, they are forecasting growth rates which are starting to decline simply because growing 40 and 50% a year forever is impossible. So I don't think that's a very brilliant thing to say, and that's what analysts are doing. But when you actually look at it over the next five years, to the extent you can see analysts' forecasts for five years, the earnings growth rates are starting to converge back down towards what the rest of the market is doing. And so betting on those stocks to be the winners is really something that has no real historic precedent for the long term. You're making a bet that this time is different because there's a revolutionary change going on in the world. And while that may be so, it's a long-odds bet, as history would suggest.

I would say, when you look at our—and admittedly, when I look at our two-year performance, '23 was better than '24—but over that two-year period, we performed better than, call it, 60 or 65% of the individual stocks that make up the S&P 500. So if you could do that on a regular basis, and if you would accept the reality that over long periods of time, equally weighted portfolios of the S&P 500 have outperformed cap-weighted versions of the same index, you're really making a bet that concentration not only continues or it stays, but continues to increase. And that just feels like a low-odds bet.

Allison: Yeah, I mean, I think the point, Rich, that you brought up about the growth rates of the earnings really converging with the rest of the market is pretty critical here. I mean, you can understand how we got where we are. I mean, these companies have really outstripped the other companies in the market in terms of their earnings growth, so to some extent you say, "Bravo, you know, job well done." But it's the "what comes next." And when you look at the earnings growth that's expected for all of the other companies really coming into the same zip code as these big growers, then it just looks impossible for this to continue. It's just not logical.

Dean: Okay, okay. But before we get into what comes next, because I'm sure everybody's eager to hear it, Allison, the issue of the booming, tech-driven market has certainly not been the case in international markets. Tell us a little bit about what the key issues that you've been seeing that are working for and against companies outside the US over the past couple years.

Allison: Yeah, so the landscape has looked really different outside of the US. You know, when you look to international developed as well as emerging markets, you don't have the same issue around concentration. In fact, you've had some of what were the dominant companies of emerging markets five years ago now be in the value space, as they've lost their momentum in terms of earnings. So what we see outside of the US is much more normal, I would say, in terms of a market environment.

When you look at 2024 in the realm of value versus growth, value outperformed a bit in developed markets, underperformed a bit in emerging markets. The biggest observation that people have about what's going on in global markets is really being driven by the US, you know, because of the dominance of these mega companies within global indices. The United States has become even more dominant. You know, not long ago it was sort of mid-40 percent of the global index; now it's over 60. So that's an issue that global investors have had to wrestle with in the last year as well.

Dean: We're not quite done with the issue of market leadership here in the US. Let's dig a little bit deeper into the issue of market concentration, because this "magnificent seven" phenomenon does not seem to be abating anytime soon. I think we can all agree on that. So whether this is a bubble or not, it is fairly clear what the drivers are that got us here, and that's a seemingly perpetual earnings growth—maybe not quite at the rate that it has been, but still, the estimates, the forecasts are for earnings to continue to grow a bit for these "magnificent seven"-type companies—and then the tailwind of passive flows of capital that follows these types of phenomena, call it FOMO or whatever momentum. Rich, how do investors think about what eventually happens next? What does it look like, how does something like this eventually unwind itself, or do these seven to ten companies eventually become the only seven to ten companies in the world?

Rich: I mean, I think what happens is they kind of fizzle out of their own accord rather than any big change. There could be a big change in valuation, but unlikely to be that kind of big change in what these companies do. You have to remember that when you get to a hundred billion dollars in revenue, or you're Microsoft or which is over two hundred billion in revenue, to have growth rates that are 30 and 40 percent, 20–30–40 percent, 40 percent of a hundred billion is 40 billion. That means somebody has to write those checks. And obviously, the ability to write those checks is not growing 40 percent a year. The ability to write those checks is growing at the rate of growth of the economy, so it means that you have to spend less on something else. And as you get bigger, that gets harder. That's why the growth forecasts trend down, because it's impossible to keep growing at those growth rates. And I think the companies will tell you themselves that they don't expect the 40s to be 40 forever; they expect them to deteriorate as well.

You also have competition. You have the fact that the money that's going into AI, it has to be productive in order to allocate more and more and more. So there's giant capital going into this to actually take a big bet on it. It's still not clear at what magnitude it will impact the economy—there's just dreams and guesses. You know, when you look at total growth globally in IT spend over a long period of time, it's nowhere near those numbers. It's more like GDP growth, and so this is re-allocating, and you have to get a return for it. So, when it's an idea and a concept, you can put grand expectations on it—that's good—and then it has to become a reality.

I can keep going on about this stuff, because I don't know what will make it unwind really. All I know is that when you get to unprecedented levels of concentration and valuations, it's hard. And when we look at our portfolio and look at companies that have demonstrated success, you don't have to make grand forecasts about giant growth rates. And you can buy things that are cheap, that should give you double-digit returns, and the entry point is good. It just should be part of a portfolio, right? You wouldn't want us buying these companies in our portfolio, because there's plenty of people—you can do that yourself, there are plenty of people that do that. What we do is we play a role, and as the valuation spreads widen, history suggests that that should be a bigger role, not a smaller role. I'll leave it at that.

Dean: Okay. All right, this sounds like a challenge for active management, and even growth managers can't concentrate their portfolios enough to take big enough positions in names like these, so they'll end up, by and large, underperforming as well. It's just math.

Allison, you know, following on Rich's comments, as we think about the US market eventually broadening, it sounds to me like your earlier comments on international markets—what can be expected of a scenario where performance eventually broadens?

Allison: Yeah, yeah, thanks for asking. And you know, it actually reminded me of what Rich was saying in the opening comments about the Nifty Fifty and really the broadening that happened for decades and decades after that. But we have a pretty good chart on this—would you mind pulling up that one, Dean, that shows the… okay great, you knew what I was talking about.

So what we looked at here was, what exactly happens during both concentrating as well as broadening markets, depending on your investment style? So to the far left, you can see the value investment style; the second set here is what we call "value light," which is the second quintile of valuation as opposed to the first quintile, which we think of as true, deep, deep value; and then the most expensive part of the market. And then to the far right, just looking at an equal-weight type of investment strategy, which, as previously mentioned, historically outperforms, though in periods of concentration, does not, and has not in this as well.

So you can see, you know, during the orange periods here—the periods of rising concentration—value underperforms, value light actually underperforms even more, and expensive stocks do well, which makes logical sense because those expensive stocks are becoming more and more expensive as markets are concentrating. Now, what's interesting about this chart is what happens during those falling concentration periods, as the markets are broadening out. And what you see here is a clear advantage for investors with a value investing style, where you get an average five-year annualized alpha of about 6% during those periods of falling concentration. And I think it's also worth noting that when you look at how many of these periods there are, most of the time, as investors, we're sitting in periods of markets broadening. So those periods tend to go on for much, much longer than these concentrating periods, and there's a clear advantage to having a value investment style during these periods.

Dean: All right, there goes the chart and there goes the topic of concentration. I think we've covered that enough. Let's pivot to another big issue that's been in the headlines for the last few years now: China. Allison, can you update us a bit on our perspective, as a research team, on the investing environment in China?

Allison: Absolutely. So as everyone here knows, we are valuation-led. So we read the newspaper, we see the same headlines as everyone else, and the news on China is not getting better, right? We're hearing even more about trade tensions and tariff barriers going up, the economy is weak, the real estate market is very, very weak, and so it's sort of more bad news on top of itself. Now we got a brief rally in China, you know, at the end of the third, beginning of the fourth quarter, when there was a stimulus announcement, but that has largely petered out, because the market, you know, is a little disappointed, I would say—it felt a little all show, no go in terms of what's happened since then.

But from our perspective, what this has done is it has created really a historic valuation opportunity, where we've been able to buy a number of really fabulous businesses trading at a fraction of their true value, because of the zip codes where they're sitting. And what we expect is that these companies, which are leaders in their industries and have flexible operating models, are able to continue to adapt to a weak environment. Now, weak doesn't mean weakening in a lot of places. You know, if you look at retail sales numbers, for example, they are now positive after being negative during the COVID lockdowns and that sort of thing. But by buying businesses across a number of industries, with strong business models and good positions within their competitive landscape, we're able to enjoy really high returns at very cheap valuations which just compound.

Dean: Okay, okay. Let's get into the fun part then. How about an example? Give us a Chinese company that we're so excited about, that we own, that it doesn't matter that it's in China for all the troubles that are associated there.

Allison: Yeah, yeah, let's go to the heart of the matter. You know, we do have one company that is a real estate developer in China—it's China Overseas Land and Investment, otherwise known as COLI. We are invested in this company not just because it's very cheap, but also because it's a very high-quality business and a leader in this space. You know, when you look at the land bank of this particular developer, it is more concentrated in the tier 1 and tier 2 cities, where value has held up better, and we expect that it should over time. They also have an incredibly strong balance sheet. We stress-test all of this by running scenarios of different outcomes, and you would have to see much more pain in the real estate sector beyond what we expect to happen before you would need to be raising capital in a meaningful way, which is really important because what that's enabled this company to do is to continue to build its land bank now at very low prices because of the pain that's happening.

COLI, by the way, is also partially state-owned. We get a lot of questions about owning state-owned businesses in China, as well as in other geographies, and in this case it's actually quite a benefit, because in times where liquidity is drying up, that connection to the state actually becomes a benefit in terms of getting access to liquidity.

Dean: Thank you. A little programming note for everyone here: some of you have noticed there is a Q&A tab available on the interface here, so if you'd like to send in a question as we're going along, we'll try to get to some of them at the end, as time permits. I've seen a couple come in already. So if you have something you want to ask, just go ahead and send it in.

Rich, Allison's example in the emerging markets and the case for EM is interesting, to say the least. Can you talk about some opportunities in the US that are interesting to you, that are taking a prominent position in our research and in our portfolios?

Rich: Sure. I'm going to talk about healthcare, because healthcare has become an increasing component of our portfolio. In an environment where many of the healthcare providers—service providers, more so than product providers—are assigned the blame for the ills of our system, we saw this horrendous murder of an executive, and it was cheered. We've seen the PBMs, the pharmacy benefit managers, vilified for their role in being a middleman and serving no value. And then we've seen COVID have a pretty big impact on healthcare spend, particularly during COVID when people were afraid to go seek healthcare, and post-COVID when they made up for all of that, that it threw a wrench into the actual performance.

So we've been buying companies like Humana, CVS, Baxter. And I'll use CVS, because all of their businesses are ones that you can take shots at. We all know CVS as the stores and the pharmacy. Those businesses have been very lackluster for two reasons: one is to blame the PBMs, which they actually own one of, who have been squeezing the margins at the pharmacies within these stores down to the point where the earnings growths have been negative, because there's been margin erosion, on top of the fact that you don't really have to go to the store, because e-commerce is competitive in many of the categories that exist in a drugstore. So the front of the store has been lackluster as well, so this has been a gradually eroding business over the years.

Now, what's interesting is that—I'm going to switch to PBMs for a second and then come back to the drugstores. Thirty-five years ago, I looked at the first PBM—I didn't know what a PBM was—and Merck was spinning out a company called Medco, and Medco was a PBM. They were actually a middleman between the drug companies and, really, the employers who are providing a prescription benefit for their employees. And I thought to myself, this business can never last, how—this is going to get competed away. Well, 35 years later, the business is probably five or ten times the size, earning the exact same margin it was earning back then, and now, being in the position of having run a company for almost 30 years, you sort of get it. There's no chance, as an employer, you would offer a prescription benefit to your employees unless you had somebody managing it, because you would get killed, basically. That's why managed care exists, because these guys have controlled costs, and they do something for their customers that the customers are unwilling and/or unable to do themselves, and they take a small margin. The margin has been like 4%. And my bet is that this business will go on for a long, long time to come. And if Congress tries to change things by saying—as we just saw, a Federal Trade Commission litigation coming out—cherry-picking a couple of drugs that they mark up a lot while avoiding the whole concept of what they're doing is taking a small piece of the pie in healthcare spend in exchange for controlling a very big cost that exists to companies. So that one, there isn't actually anything wrong with the business; the business is just hated.

Then you get to the third business, which is the traditional health insurance business, and this is more Medicare-related, because the Medicare Advantage, where seniors are making a choice to supplement their health plan that they get from the government because they don't want to take the risk of paying the co-pays and deductibles that exist if you have to be on Medicare and get stuck having, or be unfortunate and have, a serious illness. So Medicare Advantage simply allows you to trade off, to avoid that co-pay and deductible, in exchange for participating in their network of doctors and hospitals who have to give them a discount. Now 50% of seniors choose this, up from zero. This—Humana, for example, which is primarily this—was a growth industry, literally for decades, still a growth industry because the senior population is increasing, the medical costs are going up, and more and more people are choosing to supplement Medicare because they don't want the risk of being solely exposed to Medicare. They screwed up. The industry screwed up. Aetna, which is CVS's business, was one of the biggest error-makers, for lack of a better word, in that they got very aggressive during COVID, because during COVID, if you're a health insurer and you're collecting premiums from the government and your members don't go to the doctor because they're afraid to go to the doctor, you make a lot of money, and you want to grow the business. So you give richer benefits to your customers or to your members—that's what they did—and then the membership used those plus the ones that they weren't using during COVID, and all of a sudden, the margins got squeezed, and Aetna is losing money in this business. So there's a unique opportunity to, one, buy a hated group that's doing fine, the PBMs; buy a group that's a business that's temporarily depressed for reason and is in the process of being fixed. And if you ask the PBM today about squeezing the retail margin, they would say, there's not much more to squeeze, because we can't put these companies out of business, because we want our members to have a retail pharmacy to go to and get drugs. So we're probably at the end of that cycle. But you can buy CVS for roughly ten times its current earnings, which are depressed significantly and recovering and growing. So here's one that would be five times normal earnings when the margin structure recovers to normal and a couple of years of growth kicks in.

So I'm sorry I over-analyzed that sector, but we've rotated a big portion of our portfolio into this, and this is very interesting, because these are big, growing businesses that have dominant positions, that are available for single-digit or low double-digit multiples of their current earnings power. You cannot get this quality of businesses at that valuation.

Dean: Thanks a lot, Rich.

Allison, shifting back over to your side of the globe, there's other countries in the emerging markets besides China. Can you share with us some observation of any region or country that's particularly interesting to us, showing up in our research pipeline—where things are happening and good companies are cheap for different reasons?

Allison: Sure, sure. I mean, you know, over the last several years there's been a lot of talk about emerging markets underperforming developed markets, but when you dig into that, a lot of emerging markets have actually done very, very well during this period. Countries like India have gone up astronomically and are now, in our view, quite expensive. So when you look at sort of what has really underperformed, first on the list of course is China, which we've talked extensively about, but also I would point to Brazil, which has a pretty big concentration in our portfolio. And the fear here is also around the macro, around the government, and government activities, and the news flow there just keeps getting worse as well. Even here at the start of the year we've had some more negative news on the inflation and the rate front.

And you know, as we were talking, I noticed some questions coming in. One of them was actually about Brazil, from a client who's asking about, you know, as sort of the news flow continues to get bad, do you wait for things to stabilize, or are you catching a bunch of falling knives when you're owning and adding to this stuff in your portfolio? And I would say, if you wait for the turn, A, who knows when it's coming, and B, you'll probably miss it. You know, part of being a deep value investor is being able to go in and invest even when you're not sure when things will turn around. Now, how do you do that so that you create a skewed outcome? You make sure that you're buying businesses where you have protection on the downside in your analysis in case things do get worse. So that's where really running scenario analyses and trying to understand, you know, if things get as bad now in Brazil as they did, for example, in the Dilma Rousseff administration for Petrobras, which is a company that we hold in the portfolio, what does that look like for earnings, what does that look like for the balance sheet? And in the case of Petrobras, for example, we're quite comfortable that the company is not only still attractive—there are no balance sheet issues, there's no, you know, worry around dilution—and it's actually still cheap, even if the scenario unfolds in that negative of an environment. Well, then we're happy to be holders, and in some cases add to our positions.

But you know, as the question intimates, there is a limit to that. So part of being an investor in emerging markets and with a value philosophy overall is that you can really benefit from the diversity of emerging markets, right? You know, as excited as we might be about the value in Petrobras, it's still a relatively small position in the portfolio, because we recognize that there is a really wide range of possible outcomes for the business and its operations. And the beauty of emerging markets is, these types of controversies are all over the place, so we're able to exploit the fear in lots of different places without having an overly levered portfolio to any one particular outcome.

Dean: Great. Okay, making our way around the map then, having covered the US and the emerging markets—Allison, let's get back to talking about companies. Can you share with us an example of one of our investments outside the emerging markets that's in, say, the developed world that is a good story to share?

Allison: Absolutely, absolutely. You know, one region we haven't touched on at all is Europe, which really stands out in terms of cheapness as well. There's a lot of negativity around outcome there, and there's also a lot of negativity around businesses that are not levered to a positive outcome in the event that AI takes over the world. So let's talk about one of those that we're pretty excited about—we own it in our non-US portfolios—Teleperformance.

So Teleperformance is the traditional sort of outsourced call center business, is how it got its start. And so you can see how, in the scenario where AI takes over the world, you would say this company is out of business, they have nothing to do. But in our view, that couldn't be further from the truth, because Teleperformance itself is actually leveraging AI solutions to bring better outcomes to its customers. And if you think about it, they're really best positioned to do that, right, because they have the scale across multiple customers and many, many industries to really bring sort of best-of-breed solutions leveraging AI, as they have leveraged other burgeoning technologies in the past to continue to grow and strengthen their business.

So we're very excited about this holding. In fact, I visited them recently in Portugal, which is one of their biggest centers, and saw a lot of the work that they do. One example that really stuck with me is that they do a lot of work in content moderation, which is basically making sure that you don't see really horrible things when you're scrolling on, you know, Instagram or TikTok or whatever. And what was interesting was, most of the work in terms of the proportion of the work has been taken over by AI—so, you know, north of 95% of that sort of content moderation is done by their AI tools. That said, even though that proportion keeps going higher and higher and higher, the amount of content is growing so exponentially that this is a huge and double-digit growing business for them. So, you know, when you think about kind of the market continuing to expand for the services they provide, and then enabling their ability to provide those services with AI, up against a valuation that says this company is going out of business—I mean, I'll tell you, we do a stock-picking contest every year amongst our investment team, just for fun. I'm not sharing my long-term record, I think Rich might be happy to share his—it's a little bit better—but I digress. This is my pick for the year, so I'm pretty excited about this name.

Dean: Rich, that's a natural lead-in. Aside from healthcare, which we're clearly enthusiastic about, is there anything else in the US that either has worked, or that we're looking at right now, that you want to talk about?

Rich: Well, it's probably worth talking about some of the things that have worked out that are some of the sources of capital for what we're investing in now. And my pick in that stock-picking competition last year was Citigroup, and we still have Citigroup in our portfolio. But broadly speaking, financial banks rocked last year basically. The financials were up thirty-plus percent, the banking sector was up thirty-plus percent, it looked like the S&P 500. And we're finally getting to the point that some of the well-run banks have reached their value points, or the points at which you're not so sorry to see them go, to fund other investments. So, you know, you look at the best quality banking franchise probably in the world—JPMorgan. And what a ride, having been able to acquire that during the time of the financial crisis and hold it—it's very rare that you hold something for fifteen years, and I don't know how—what I think the general perception is, that that was a waste of holding it for fifteen years. But the reality is, these were market-beaters for fifteen years, because the valuation started so low and the earnings growth has been so good. Not via kind of AI growth, but these companies' franchises are spectacular. And now they're reaching fair value. Some are not, right—Citibank is troubled still, it's in the midst of a restructuring. They—I think the number is that they made twenty-seven acquisitions over the last twenty-five years and really never invested in a common platform and a common system, to the point where you get to be on the bad side of the Fed, because when they ask for information and it takes you four times as long to provide it as it does, let's say, JPMorgan, that, you know, you're slapped with consent decrees for operational non-excellence, let's call it. And so they're spending, you know, four or five billion dollars a year, and they have been for many years. That had been growing up until recently—stopped growing last year—and all of a sudden, the stock price had a big year, but it's still very, very cheap.

I mean, Citibank is still one of the ones that you would say is below average in valuation—cheaper than average in valuation—because it's been Citibank for so many years, and it's dragging on, and it will continue to drag on. These are major, major undertakings that literally take decades to fix. I think JPMorgan said in one meeting that I was at that it took them twenty years to get their systems to state-of-the-art, and doesn't sound like an exaggeration given the complex task. But the franchise that Citibank has, the corporate banking franchise, the multinational, multi-currency capability, is one that ought to earn good returns. They're not earning good returns, because all of the excess that they're spending on trying to make this better—they're sitting with a bunch of excess capital, which yesterday they announced they were going to start a big stock repurchase program. So what I think in Citibank is, we're going to see, over time, revenues grow, margins expand, excess costs decline, share base shrink, and here it's under seven times its normal earnings power. So there are still things in financials, but banks more broadly have—particularly the ones that have been the leaders—it's hard to call those cheap anymore, and so they become a source of cash. And so we've had an era of a very long period of exposure to financials and banks that's finally moderating and moving into other areas. And I think this is really important, because the way that you build a portfolio that's on average seven and a half times earnings for thirty years and have good performance is that the seven and a half goes to fifteen, and you replace it with something else that's seven and a half. And this was a big year for doing that for us—rotation with the biggest sectoral rotation from financial services into healthcare.

Dean: Okay, great. Thank you. Okay, that's the end of the prepared comments and the brilliant questions that I had prepared for Rich and Allison. We're going to follow through here on the directive to answer some of the questions that are being submitted by our listeners, and we'll try to go through these relatively quickly so we can get to as many of them as possible. I'll start with—it looks like a general question that, to me, looks like either Rich or Allison could answer it: "At current valuations in the various funds, is the expected long-term total return"—and that's meant to be a 10-year, okay good, long term, I like that—"is the expected long-term total return still 10% or more?"

Rich: You want to take that, Allison, or you want me to?

Allison: Go ahead.

Rich: If you look at a long-term record of a deep value investor, both quantitatively or what we've broadly achieved over our history, if you can buy stocks at seven and a half times, on average, their normal earnings power—by the way, you're not going to always get it right—but if you're going to buy it at seven and a half times, that implies a 14% return, or a 13% return, and there are times when it's more expensive than seven and a half, times when it's less expensive than seven and a half. But if you allow for some of the leakage for what you get wrong, you should be able to get 10% plus expected returns. And when we look at the universe that we're investing in, that's what we see. And when you look at a broad market, albeit I can name companies that could possibly produce higher returns than that, broadly speaking it's hard-pressed to think that you can achieve that over the long term in a cap-weighted S&P 500-type index.

Dean: Okay, okay. Here's one live question that came in a couple minutes ago from one of the listeners: "It seems that every year in January we're told how emerging markets and small caps are cheap. What's your thinking on small caps in general, but specifically free cash flow-positive small caps? Are they cheap?"

Rich: They are cheap, that's right, that's great. Look, when you compare small cap to large cap, the gap is gigantic, but a lot of that is because large cap on PE or on classic valuation metrics is overwhelmed by what's going on in the concentrated portion of the market, so I don't want to overplay this concentration theme. But relative valuation on small cap is highly, highly interesting. The absolute levels of valuation on small cap compared to large cap in the US is modestly more interesting—it's not dramatically more interesting. So part of it is that—I'm talking about large cap value and small cap value, because I don't have any knowledge about small cap growth, so you have to hear my answer to that question as a value question. Small cap plays broadly into the hands of value investors. It's always been more efficacious to be a value investor, naively, in small cap, than in large cap. I think that's true in emerging markets—Allison could go into that—but if you're going to be in small cap, value is the place to be, and if you're going to be in EM, value is the place to be, even though most people think of both of those as growth areas.

Dean: I'm taking it that Allison agrees by her head nod.

Allison: I do agree, I'm sorry, I should unmute. No, absolutely I agree. You know, it's funny when people ask the questions, "Every year you say this, every year you say that." I mean, the spreads are what they are, right? It's impossible to predict what's going to happen next, but you know, one thing that we look at constantly is how wide are valuation spreads around the world and across different market caps. And what we see very consistently is, where we're sitting today, you know, spreads have only been narrower, and it depends on the region and the market cap, you know, sort of a low double-digit percentage of the time, to single-digit in really extreme cases like the US, for example. So it's hard to argue, if you're a value investor, that it isn't a great time for small cap and for emerging markets. And I think in the case of small caps, that extends across the globe. We see the same thing in our international small cap universe as well.

Dean: All right, thank you. Looking at the question list here, looks like we have one from someone who's interested in global investing: "Is it necessary to rotate out of the US to find attractively valued stocks, or does the US market have sufficient attractive stock from sound companies to generate strong long-term returns?"

Rich: The US has tons of sound companies that are available to generate strong long-term returns. It's interesting—I mentioned the cap-weighted versus equal-weighted. Over long periods of time, the last decade being an exception, buying the cap-weighted index has always been kind of a dumb idea, because what dominates the cap weighting are the things that people are the most optimistic about, and that's what sets their valuation. Broadly speaking, people overdo things—that's what value investing is all about. We just haven't seen that in a long time because of what's gone on. We've created these big, gigantic companies that are dominating. It's hard to see how that unwinds, but you know, when you take those out, and I said if I had to build a US stock portfolio excluding those ten or Mag Seven or whatever you want to do, I think we can build a very, very credible portfolio that can produce double-digit returns or high single-digit to double-digit. The double-digit is more on the extremes of valuation.

Dean: Great. We'll go—looks like we have about five minutes left, so we're going to try to get to them all, maybe a little rapid fire here. Looks like this one's for Allison, and it is kind of asking for you a prediction: "Expectations for a policy framework in China—will it become more benign for businesses, companies, entrepreneurs? What's your guess?"

Allison: Okay, I'm going to look at my crystal ball—no, just kidding. I don't have a crystal ball, and no one does. I'm happy to share my opinions, my hopes and dreams, but the real truth is nobody knows. You know, we could wake up tomorrow and there could be news out of China that is surprising and moves markets, and that's happened over and over and over again the last few years, and I anticipate that it will continue to do so. So, from our perspective, what do we know for sure? We know that the expectations are very, very weak, and the valuations are very, very low, and that enables us to buy businesses—really good businesses—at very cheap prices. So, you know, if the situation evolves in a very negative fashion, okay, maybe we got about what we paid for. But if anything positive happens—if there's any sort of positive surprise—then the upside is really tremendous in these names. And we got a sense of that back at the end of September, early October.

I would also say, by the way, the reverse is true as well. When you look at market darlings of the moment, like India, for example, you know, we don't have really a differentiated view or a special forecast crystal ball there either, in terms of being more negative on the market. You know, we are happy to see positive developments in India's economy and in that geography. The problem for us is the valuation. If these positive developments unfold, then at best, you got what you paid for—fair value. But if there's any disappointment to the extremely rosy outlook, in that geography for example, then you're going to have a really disappointing outcome as an investor, because you paid too much on the way in.

Rich: Can I just add to that? Because broadly speaking, you can spend your time thinking about the macro environments and trying to position your portfolio according to what you think the macro is going to be. I never understood how to do that. I mean, I wouldn't know how to do it, nor do we try. Instead, we believe that company managements have a lot of ingenuity, and they deal with the hands that they're dealt, and we, as investors, want to react to the hands that they're dealt. So in China, if you're dealt an environment where people are very unsure about what the future prospects are, and therefore the prices are cheap, we're betting that the companies are going to figure out a way to prosper in those things. And by the way, they broadly do. So to me, reacting to that is a better strategy than predicting it. Now, if you're happy to be good at really predicting it, I would say that's a better strategy. I just don't know how you can be good at it, or I don't know how to be good at it. So you would hire somebody else that's good at it.

Dean: All right, getting close to finishing up here. I'll just maybe give you some quick ones here. "Is our general sector exposure to healthcare increasing across all of our strategies?" Rich's comments were very encouraging about these US large cap healthcare companies. Is Pzena increasing their sector exposure to healthcare across the board?

Allison: We actually have. I mean, to a lesser extent, because the controversies in the US are somewhat unique, but we are seeing healthcare controversies across every geography, and we have added exposure across both developed as well as emerging/international portfolios as a result.

Dean: Okay, great. And it's 11:59, I think this thing's going to cut off at 12, so a question that probably came from one of my contemporaries in the business development world in investment management: "How much longer can the embrace of passive investing last? Please tell us not much longer."

Rich: Not much longer.

Dean: Thank you, Rich. All right, at the risk of being cut off unceremoniously at noon, I want to thank everybody for joining us. Thank you, Rich and Allison, for sharing your views. We did not get to all of the questions. Some of them, we can see who they're from, and we'll try to get back to you directly. If anybody would like to continue the conversation, toss a question at us, you can email whoever you know at Pzena, and they'll get the question to Rich or Allison or anyone else who might have a good answer for you. So thank you very much for tuning in, everybody. Have a wonderful rest of your week, and hopefully we all enjoy a nice long weekend.

[Music]