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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Finding Bottom-Up Opportunities in Health Care

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SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm, its history and what it's involved in?

Mr. Eveans: I would describe our firm as an active-management, value-centric investment boutique. We are an independent firm, internally owned. We manage a bit over $1.7 billion for both institutional and private clients. When you look at our philosophy and focus over these many years, what you find is that we're bottom-up, stock-by-stock value investors. We are driven by a very robust quantitative ranking process that has been in constant improvement backtesting and real-time testing for over 20 years.

We use proprietary algos to continuously rank over 6,000 securities worldwide. Long story short, the process boils down to about 200 securities at any point in time that we deem to be quantitatively attractive for purchase. From there, these ideas are bucketed into five different — and we believe diversifiable — equity strategies. They are large-cap value, large-cap growth, a unique yield-focus strategy that stresses all equity high yield, and we also have small-cap versions, which we have recently rolled out — both value and growth using our methodologies.

I would also add, to complement our quantitative process, we have a specific, specialized in-house qualitative overlay, which applies to both our current holdings and our prospective holdings. When you look at how we do it, we have an investment team of seven CFAs — with a minimum experience with Meritage of 12 years for each of our portfolio managers. Each of our specific strategies is managed by a lead portfolio manager, a senior portfolio manager from this group. So we have a highly organized and systematic way of looking at the investment world that has enabled us to achieve very solid returns over the years. Also, we have a highly professional client service operation, taking care of both wealth clients and institutions.

The last piece I would add regarding our total process of investing would be that, in the last three years, we have built our own internal top-down macro process as well. That is designed to continuously evaluate the risks and opportunities in the overall investment environment. It's strictly data-driven. There is one important goal, both in our selection processes and our macro processes, to eliminate the capricious nature of emotion that often distorts values in the marketplace. Bottom line, we're a process-driven shop, and that productivity and success enables us to compete with anybody, we think.

TWST: Would it be possible to maybe highlight one or two of the quantitative things that you look at when you're reviewing the different stocks?

Mr. Eveans: Our process uses five conceptual categories. They're growth, valuation, business momentum, investor sentiment and something we call "management IQ," which gets to the quality of management's ability to handle things internally. In those five conceptual categories, we develop what we call primary insights, and there are 15 of those. I won't list them all. But for example, in growth, they include standard earnings growth and profitability measures, plus proprietary look-ahead measures on both sales growth and earnings.

Inside each of these primary insight categories, there are anywhere from six to 12 different factors that we have optimized using our formulas. We constantly search for those independent factors that achieve high information coefficient ranks and periodically re-optimize for a total picture that gives us the best backtest to produce strong results in our highly ranked stocks. Conversely, we look for poor ranks and poor performance in the other extreme, the negative side of the bell curve of ranks. So for example, in the business momentum category, we study earnings momentum, cash flow and earnings surprise, all kinds of earnings, revision models, analysts ranking trends and so on to give you a flavor.

I should add that all this data is the same for all five of our strategies, but each strategy has a different formulaic application of our primary factors. So our value strategy contains a more rigorous valuation component that's supplied to all stock candidates. Some might question, "Well, what does that mean for your growth strategy?" Our growth ranking process uses the same data and factors but remixes and reorganizes to also include a distinct valuation focus but includes more of a growth factor tilt. This has enabled our growth strategy to basically reduce the risk of obtaining those growth results with better downside protection but still has really attractive upside also. So our growth strategy is unique in that regard.

TWST: Did you want to highlight a stock that you find interesting now?

Mr. Eveans: Sure. The first one is **WellCare** (NYSE:WCG). Most people know that company. It's a managed care services company, but its sweet spot is that it's a specialist in government-sponsored programs. That's all they do. They specialize in Medicare, Medicaid and so on.

Highlights

Mark E. Eveans discusses Meritage Portfolio Management. The firm is an investment boutique using active management. Mr. Eveans is a bottom-up value investor. He explains that the firm uses a robust quantitative ranking process to identify about 200 securities, which are then bucketed into five different equity strategies. Mr. Eveans notes that the quantitative process is complemented by a specialized in-house qualitative overlay. He believes being systematic and process-driven enables the firm to achieve solid returns. For the past few years, Mr. Eveans has found valuation opportunities in the health care sector.

Companies discussed: WellCare Health Plans (NYSE:WCG); Apple (NASDAQ:AAPL); PRA Health Sciences (NASDAQ:PRAH); Cigna Corporation (NYSE:CI); Express Scripts Holding Co. (NASDAQ:ESRX); Aetna (NYSE:AET); Anthem (NYSE:ANTM); UnitedHealth Group (NYSE:UNH) and CVS Health Corp. (NYSE:CVS).

First of all, it's got to have a qualifying process rank in our buy zone. Our ranking system uses a golf score approach. In other words, one is an optimum rank, and 100 is the worst rank. So when we look at this, all buyers have to come from the top 5% of our entire universe. It's a strict criteria for us, and all buys have to come out of that group. So each one of these that I describe is going to have an extremely strong Meritage rank first.

But how does it get that rank? We've already hinted at the components of our ranking process. For **WCG**, the growth factors here are pretty compelling. This is a 20% earnings grower. Asset growth is even higher than 20% in recent years. And then, we look hard on the valuation side, we see strong free cash flow and cash flow return on investment yields. This one has a very attractive free cash flow yield for a growth company of 10%.

This gives them all kinds of flexibility to continue to, in some cases, acquire or improve the profitability of existent assets that they're growing. So very attractive characteristics of earnings growth, sales growth and free cash flow generation. Also, a solid cyclical outlook that remains intact. It's done well, but it still ranks well.

1-Year Daily Chart of WellCare Health Plans

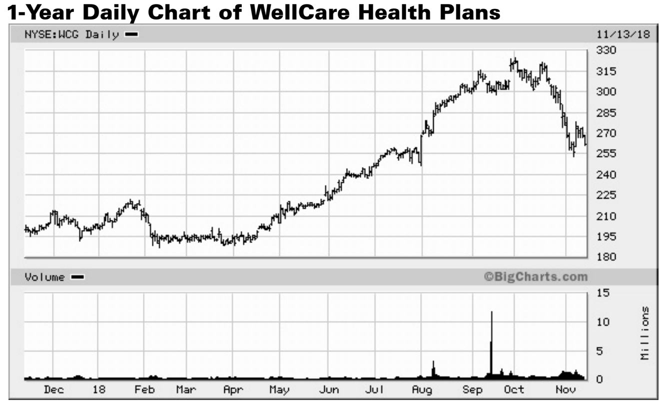

Chart provided by www.BigCharts.com

The way we run our process, we don't use price targets because everything changes every day. What we do is really pay attention to the ranks, and if a rank starts to deteriorate but the fundamentals don't, that's a sign that the stock is getting into overvalued territory and is a signal for a possible sale and rebalance. The other side of the equation is that, using a process like this, sometimes the fundamentals don't cooperate. And the inherent expectations that are in the data sets have to be dealt with on a qualitative basis and a judgment has to be made there.

I would also say one of the real values of the way we do things is where a company already has had a strong return but maintained its strong rank, we continue to own it. We have many multiyear holdings that have benefited from this approach that might otherwise have been sold prematurely. If all the fundamentals are intact and the rankings stay strong, we stay with the stock.

WellCare is a smaller, managed care company, so it also presents some opportunity for the larger ones to perhaps be interested in expanding their horizons in this world of very intense acquisition activity. That's not a big factor, but it is something that the size of the company might suggest could happen over the future. So we like that.

TWST: With WellCare, might they be helped in the future by the fact that there is an aging population and Baby Boomers are starting to age, so there are more people looking for their type of service?

Mr. Eveans: I think unquestionably the secular case for health care in general, the demand for services, is very compelling. And you're right to point that out as an overriding theme. It's one of the strongest we have in the marketplace. The key is finding those companies that can really address that demographic in ways that help the client and grow the business successfully for the shareholder. **WellCare** certainly demonstrated they can do that, as have some of the others. But you're exactly right there. The demographics are compelling.

TWST: Did you want to go to another company?

Mr. Eveans: Let's take well-known growth stock, **Apple** (NASDAQ:AAPL). Everybody knows what **Apple** does: mobile communications, phones and PCs. They do mass market stuff to individuals in addition to businesses, and for both its hardware and software.

What we have with **Apple** is somewhere around a 12% to 14% earnings grower and, of course, has a very attractive rank in our process. Specifically, we see very strong asset growth in excess of that expectation for earnings growth. When we see that, we know we have an opportunity, all things considered, to improve the profitability of those assets as we go forward, which can be very powerful in terms of earning strength. This company has achieved high levels of cash flow return on investment. It still has high returns measured this way, but they're lower than they used to be. Continued erosion of high CFROI is a negative. But if the company shows other signs of regaining higher returns, again, it's a definite plus.

One of the best correlations we have found for the success of a stock is that if you have a rising cash flow return on investment measure, the correlation with stock success is very high. This, we believe, is the case in **Apple**. It's had some ups and downs, but it is a very profitable, very well-run, margin-improvement opportunity in a fast-growing business. It ranks very well.

TWST: Within the process that you use, is there something you revealed about Apple that investors may not have realized or got confirmed based on the approaches that you use to analyze the stock?

Mr. Eveans: That's a great question. When we look at our own proprietary work here, as mentioned, we place a lot of emphasis on the cash flow return on investment, which is inflation-adjusted on both sides of the balance sheet to see what the real returns are and the trends of those returns. They have

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historically operated at a very high level. The all-industry average for CFROI is something like 7%. In their last five years, **Apple** operated at 23%; that's enormous success. Currently, their CFROI is at 17%, still a great number. As I mentioned, we're starting to see stabilization and possible growth again being associated with the CFROI.

1-Year Daily Chart of PRA Health Sciences

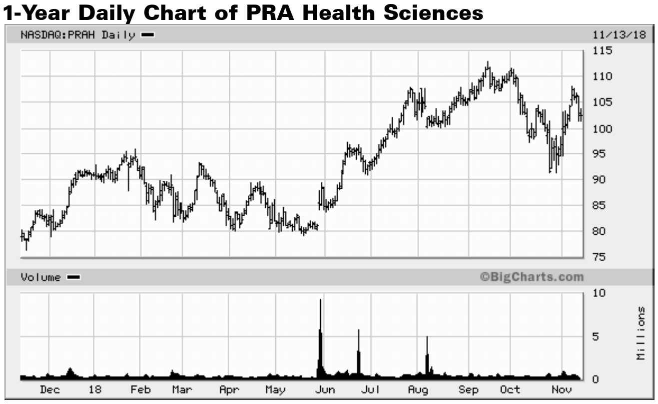

Chart provided by www.BigCharts.com

We see a company that's still very attractive with a lot of growth opportunities but a price that does not reflect it. CFROI is an insightful way our process looks inside our data on **Apple**. So our factors and the way we align them is the difference. The conventional way of looking at p/e ratios and assessing conventional research reports doesn't really delve into the kind of factor or work that we do. Our process works best on a longer-term basis. **Apple** is in a range where it seems to us, based on our ranks and our sense of the future, that it's going to be a very good further investment.

TWST: Did you want to mention another company?

Mr. Eveans: Let's move to one we follow in our value work, **PRA Health Sciences** (NASDAQ:PRAH). Roughly 17% grower in earnings, historical and prospective, and very high rank in our process. They do contract clinical research basically; they are one of three big companies that do that. They do work for biotech companies, for standard drug companies, testing the results of their prospective new drug compounds. It's a very valuable service that they provide. And all of the drug industry relies on them.

What triggers our rank here is their strong free cash flow generation, which enables management flexibility, and their sales and earnings growth factors are also very good. Our base criteria continues to be strong for them, and that's the CFROI rank and the growth of the CFROI, which is highly correlated with their success. And the demand curve gets back to that overarching demographically driven opportunity where the faster we can speed up new and inventive drugs and therapies to improve the quality of life, the better. **PRAH** is right in the middle of that.

Also in the value category, **Cigna** (NYSE:CI) is a top-ranked security right now. And as you probably know, **Cigna** is trying to buy **Express Scripts** (NASDAQ:ESRX), and that — depending on who you talk to — is either going to happen, perhaps be delayed or not happen. We don't know for sure. But **Express Scripts** also happens to be a company that we like a lot. So the fact that they're trying to combine with them as a more complete health care services company is a good thing. We like that combination a lot.

More specifically, we find with **Cigna** that they, of all major health care companies, are the cheapest. Even though their fundamentals are very similar. We're talking **Aetna** (NYSE:AET), **Anthem** (NYSE:ANTM) and **UnitedHealth** (NYSE:UNH). And when you compare them, **Cigna** stands out as a really attractive valuation opportunity should all the trends continue that we think will in health care. It will be interesting. We'd like to see a successful combination of **Express Scripts** and **Cigna**, but we think it will be OK, even if that doesn't happen.

1-Year Daily Chart of Cigna Corporation

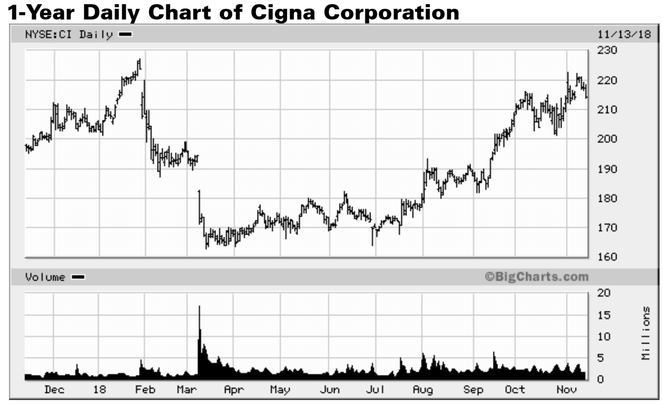

Chart provided by www.BigCharts.com

TWST: And that proposed acquisition comes soon after the merger of CVS (NYSE:CVS) and Aetna?

Mr. Eveans: Yes, correct.

TWST: So do you think it's sort of like a longer-term trend in that sector to provide that kind of approach to health care?

Mr. Eveans: My answer there would be yes. I do think it is a trend; while there may be long-term oligopoly concerns among large managed care companies, they're getting more efficient and better able to deliver their services. And there are a lot of smaller companies that are out there too. I think that trend at the level of **Cigna** and **Aetna** is probably fairly close to being over because these recent deals are transformative acquisitions. There may not be many more of those left for the big four, but there are certainly a lot of smaller companies out there that are challengers to these folks in various areas that would be available for combination to compete better against the bigs, or to round out areas for the larger ones, but are not transformative.

So it's an attractive general area to pick from in our evaluation work. And when we look at things from the bottom up, as we primarily do, we look for those areas where we're getting more valuation opportunities in an industry or a sector, compared to where we're getting less, and health care has been one of those very prolific bottom-up opportunity areas in the past few years.

TWST: And changing direction a bit, did you want to talk a little bit about, when you meet with clients, what are one or two of their concerns as they look to the rest of this year and into next year about the market and the economy?

Mr. Eveans: Sure. As a preface though, I'll point out the last piece of our process environment involves something that we resisted for many years, and that was using much top-down intelligence, if you will, in our work, because frankly, its impact on our work was not that helpful. But we decided a few years ago that it was very important for us to look at the big picture more systematically, like we do with our selection process. So we created our own macro process, and we run it as strictly as possible on objective data. We look at almost 200 time series here.

We take an approach where we look top down at the overall investment environment in a systematic, disciplined way. We want to know where the strengths are. We want to know where the weaknesses are. And we want an overall assessment, again, driven by our data of what the balance of those factors are.

So we created a matrix of attractive, neutral and unattractive, which crosses six factor sets. First, longer-term secular dynamics, like you brought up with health care. Then, cyclical trends in four ways: economic fundamentals, company fundamentals, valuation fundamentals and risk. Last, we assess three outside macro services that we respect.

As background, our macro process started pointing toward an increasingly negative upcoming environment before the 2016 election. The stakes were high; the opportunity for a market destructive recession to ensue looked like it was building momentum. And so we were cautious increasingly as we went into that fall and the election. Long story short, what happened there, we all know, changed the mindset and promoted pro-growth capitalism concepts that the market liked a lot. The good news is, our macro process picked it up pretty fast and went from a very negative reading in the fall to an increasingly positive reading after the election into the spring and has maintained that positive reading.

At one point in 2016, we had zero attractives in our attractive, neutral, negative ranks. We currently have about 40% of our factors in the attractive category. The negative went from over 70% in the fall of 2016 to the 30s and are holding at present. So to your question, not surprisingly, our clients' key priorities right now revolve around the possibility of a wealth-destroying major equity market decline and the economic fundamentals that would precipitate the same.

In addressing these concerns, we do not see a recession in our work anytime soon. That is a big tail risk that is off the board at the moment. What we do see are excessive valuation risks. Excessive valuation tends to feed the volatility on the downside. This is just a fact. We have studied and experienced that over time. Thus, we're not surprised to see the dislocations here short term. We believe and we've counseled our clients that this is a correction, not a vicious bear market — like 2008 to 2009 — but we're very diligent about how quickly that view can change because of all of the uncertainties.

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We think it's been a good time to have pulled back on some of the overall risk in portfolios over the past few months, partly because of the success that has occurred and the higher valuation risk. We, with our clients, recognize that we have short-term risk that will probably carry further, but it's survivable. It also refreshes the system for us as value investors. Opportunities start to rise, and we're certainly seeing that in our bottom-up work. So bottom line, we are less risk-committed now, but we are not in a major defensive posture.

TWST: Is there anything we didn't bring up you care to mention, either about the firm or some trends out there?

Mr. Eveans: I might comment on a couple of things just to follow along the conversation we just had. There is something that is substantial within the marketplace that adds to risk but isn't discussed much. Most analysis and discussion is about the fundamentals and how they correlate and relate to investment factors and so on. But you don't see very much commentary that addresses the structure of the market. The structure of day-to-day trading in the marketplace has shifted so dramatically away from portfolio managers, like us, making decisions, to automatic quantitatively triggered processes. Whether they're a so-called robot, commodity trading account, or CTA, various leveraged hedge fund structures, ETFs, derivative structures, option structures, flash trading or other tools.

The bottom line is that these mechanisms buy or sell in huge mass transactions, and that trading dominates day-to-day transactions in the markets today. Simply put, it is an additional risk factor in markets that is not well-understood. A lot of stocks get caught up in that wash that are very valuable, and you and I wouldn't be selling them, but it doesn't matter. They may go down a lot, and then, of course, that causes client and manager angst and uncertainty, thinking something must be wrong and so on. A lot of it is simply machine trading, and it's an area we're trying to get to understand better and assess it as a risk.

Second, I didn't discuss much here about our Yield-Focus strategy, something we've had great success with over about 15 years now. The Yield-Focus equity strategy is a different, diversifiable way to earn solid long-term equity returns. The linchpin in the whole thing is a distinguished dividend yield. Most of what you see in terms of dividend strategies are dividend growth strategies. But the actual dividend rate on these is very close to the S&P.

Our Yield-Focus equity strategy seeks to discover and own the best high-dividend-yield franchises we can find. This strategy yields approximately 5% as of October 31, 2018, while the S&P yield is under 2%. We focus on the quality and the sustainability of those high dividends. But simply put, it's a different way to look at the equity world and goes back to your demographic view of demand and so on.

This is a client-derived strategy. Many of our clients need income. They haven't been able to find safe, reasonable income in the bond market for a long, long time. So we built this all-equity approach to earn approximately two-thirds of the expected long-term equity market return from cash dividends and distributions. Over the history of the strategy, we've been able to achieve that goal with a 64% contribution from pure cash, which people can either use or reinvest. In coming years, we think this strategy option is unique and very well-positioned, especially for Baby Boomers.

TWST: Thank you. (ES)

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