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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

# Finding Opportunities in Large-Cap Financials and Tech

**RAFAEL RESENDES** is the Co-founder of The Applied Finance, and a Founding Managing Director of Toreador Research and Trading. Founded in 1995, The Applied Finance Group (AFG) specializes in understanding the expectations embedded in market prices, and constructing portfolios from that information to outperform stock market indices around the world. Founded in 2006, Toreador Research and Trading applies AFG's research through its domestic and international funds. Mr. Resendes is the Portfolio Manager of Toreador's Domestic Large Cap Core and International Large Cap Core mutual funds. Prior to cofounding AFG, Mr. Resendes was a member of the Chicago Board of Trade, where he traded Treasury Note Options. He later served as Director of research for HOLT Value Associates. Mr. Resendes graduated Phi Beta Kappa from The University of California at Berkeley, with a B.S. degree in finance and economic analysis, and he obtained his MBA from the University of Chicago. Mr. Resendes is a frequent contributor to leading financial publications and investment programs, such as *The Wall Street Journal*, *Forbes*, CNBC Squawk Box and Forbes on Fox, among others. For over six years, Mr. Resendes has served on the CFA Institute's Speaker Retainer program, speaking to more than 35 Financial Analyst Societies in 14 countries. Mr. Resendes is a guest lecturer at The University of California at Berkeley, and he served as an Adjunct Professor at DePaul University in Chicago.

**SECTOR — GENERAL INVESTING**

**TWST: Would you begin with a recap of your investment philosophy and some characteristics that make it unique?**

**Mr. Resendes:** First and foremost, with everything we do is a profound respect and bias toward valuation. And as opposed to defining valuation in terms of traditional — it's trading at a discount to book value or a static metric such as a p/e — we really tend to view valuation in terms of what level of performance the company can deliver today and what are reasonable expectations of the cash it can deliver into the future. And we compare that against where its stock is trading today. So what we're always trying to do, first and foremost, is get a handle on the expectations embedded in the stock price and be able to compare that against where or what the company is likely to deliver in terms of performance. Unlike traditional performance metrics, we tend to focus more on a firm's economic rather than its accounting performance. In other words, we want to unscramble its accounting statement from a debit and credit perspective to an overarching look at how well a firm is truly performing — as though we owned the entire company.

For example, if you look at companies that are in technology, GAAP requires them to immediately write off R&D. Very few firms engaged in high stakes R&D are making investments that will pay off in the year the R&D is incurred, yet this year, which is what GAAP requires, which is silly and unrealistic. These are more multistaged, multiyear investments, and one of the cleanest examples of this effect is with one of our larger holdings, which is **Intel** (INTC). They've been gearing up their foundry operations, spending billions on R&D and new product processes to enter into the mobile space. There is no way they could justify such expenditures if they expected to recoup the expenditure in one year. These are longer-term investments, and the accounting statements do not properly reflect that. So we spend a lot of time cleaning up the accounting data to understand a firm's true economic performance. Once we do that, then we value it.

And lastly, we look very critically at company investment strategies to ensure firms are creating value, as opposed to pursuing investments that are wealth destructive. In other words, if we assess a company's risk as being 10% — that's the company's required rate of return — and management can't deliver investments that exceed that hurdle, we do not want to own the firm. So the three core tenets we build our portfolios from are: one, understand the firm's true economic performance; two, translate that performance into an objective measure of a firm's value, both as a point estimate and as a range of parameters that a firm needs to deliver in terms of sales growth and margin objectives; and then three, evaluate management with a critical eye toward ensuring shareholders and managers are properly aligned in terms of a company that's creating wealth. So we implement that into the fund a couple of different ways.

Our fund is unique in the sense that it has a very systematic component that allows us to have exposure to these very factors that we just discussed. So quantitatively, we're constantly screening for firms that meet those criteria, and we're able to put a large core position at work across 75 to 100 firms. And then we have a second component to the fund that is very opportunistic in the sense that it seeks out companies that are particularly mispriced at a point in time.

I think the last time we spoke we had just underwritten a relatively large position in the financial space. We'd noticed that financials had been unduly sold off. And we saw firms such as **Bank of America** (BAC) trading down around $5 a share at end of 2011, and essentially, we made financials the largest concentrated portion of our fund, not so much from the quantitative side, though it definitely showed up there, but on the opportunistic side. I think at the time **Bank of America** probably constituted about a 6% investment for our fund. Today, it's now up to close to 16% through appreciation, and it's almost triple. That, I think, is an aspect of our fund that's really unique. Some managers are constantly having to force investments because so much of their fund is qualitative. We have the luxury of really having a systematic process that's consistently worked, and at the same time, we have the flexibility and the expertise to be able to take advantage of what I think are really unique opportunities in the marketplace.

**Highlights**

*Rafael Resendes discusses investing at Toreador Research and Trading. He says there is hidden value in financials and the large-cap technology space, and he provides examples of key stock holdings. Mr. Resendes also highlights his sell discipline, a recently launched international fund and the ideal investor match for Toreador.*
*Companies include: Intel (INTC); Bank of America (BAC); Apple (AAPL); Hewlett-Packard Company (HPQ); Microsoft (MSFT) and Morgan Stanley (MS).*

A year and a half, two years ago, as I mentioned, that was happening in the financial space. What we've been noticing recently is that the same phenomenon is starting to take place in the large-cap technology space. A lot of these firms are unloved because they're not delivering crazy topline growth, and the market is really starting to misunderstand the story in terms of what type of value is hidden in these firms' ability to generate cash flow and the sustainability of those cash flows.

From a larger perspective, we believe the macro factors at work are very constructive for the market in the following sense. If the Fed chooses to taper, we think it will be a function of a much stronger economic condition in which case history has shown that as the Fed increased interest rates into a strengthening economy, the market tends to do OK. So as long as you own stocks that are priced to give investors an edge, we really don't fear that type of a condition. Further, we find it difficult to believe the Fed would begin raising rates in the absence of a very strong set of economic circumstances. We have Bernanke, whose tenure is going to end at the end of this year, and then be replaced by hand-chosen successor from Obama, and we'd find it very difficult that Obama would put someone in place that would in any way jeopardize an already tepid economy. So we feel, regardless of what happens over the coming months, the economy will strengthen, in which case that would be good news for equities. Or if doesn't, the Fed is unlikely to taper, in which case this low interest rate environment provides some pretty amazing opportunities in terms of dividend yields on the large-cap equity side. Again, that plays particularly well into the theme that we have of large-cap tech becoming a more important portion of the portfolio as we're moving forward right now.

**TWST: You mentioned Intel. Would you provide us with three other examples of your current stock holdings and tell us what attracted you to each name?**

**Mr. Resendes:** So with **Intel**, one of the themes that we often play on, and it stems from our discipline and understanding value, is we believe strongly in the concept of an emotional arbitrage. And by that, I mean crowds tend to overreact, and the financial media tends to overhype. And it is the combination of those two factors that tends to lead to a compounding effect that overall trends tend to over- and under-value stocks consistently. We see that now in the large-cap tech space. We saw **Apple** (AAPL) slide from $700 down into the high $300s, and we began buying in the low $400s to high $300s. We did not buy in to the extreme pessimism or impatience driving the "piling on" effect of **Apple** not having any products, and the extreme pessimism that went along with **Apple** not having the newest, greatest flash bang innovation of the hour. We were happy to see weak hands out of the stock. So when we tend to buy a stock, we tend to buy it with a relatively longer-term view. We're not a fund that trades a lot. We tend to do our research and have a fair set of stringent requirements to purchase a stock. And we tend to have a lot of conviction when we buy — and it's not driven by emotion, it's driven by an understanding of expectations. So **Apple** is a stock that its sell-off qualified for us to buy it, so we established a decent position there.

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**TWST: Do you have other views about the market or economy right now that are informing your investment strategy?**

**Mr. Resendes:** With respect to the market, earlier in the year, we came out with a position that we believed the market was just "blah." It wasn't really expensive, it wasn't really cheap, it was plus or minus priced just right. In my mind, saying "priced just right" is within 10% of its intrinsic value, being much more precise than that given the inherent noise in financial data is just silly, in our minds at least. So while we had a lot of fear mongers talking about the market being overvalued and it was due for a selloff, and how the market can't keep going up, we were very comfortable with our fully invested position. We had very little in cash, and we had no interest in moving defensive because we thought the market was fairly priced; however there were and are many individual stocks presenting interesting upside opportunities. With that as our backdrop through most of the year we were able to stay with our relatively aggressive stance with stocks that we felt were particularly undervalued. And to this day, we hold predominantly the same view, though a tad more cautious.

Staying in the large-cap tech space, we had a large portion in **Hewlett-Packard** (HPQ), and we've done very well with that this year, watching it almost double. I think our third largest position in the fund at the moment is in **Microsoft** (MSFT), and again, it's very, very similar type of thesis to what we have with **Intel**. We see everybody is focusing on the news that the PC market is shrinking, and certainly that's true, but it tends to be concentrated in the area of the PC market that has been least profitable, the netbook space, which are essentially poorly designed products.

**1-Year Daily Chart of Hewlett-Packard Company**

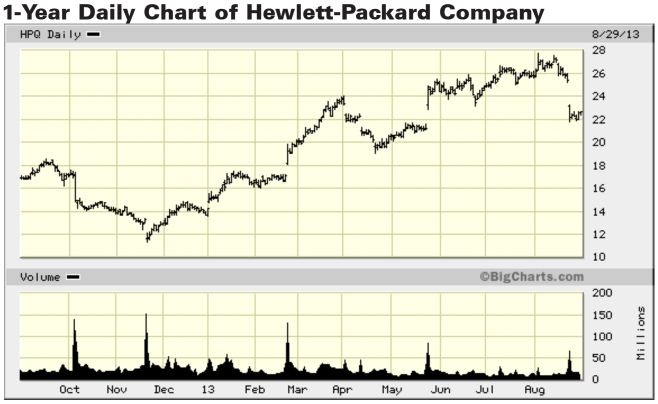


**Chart provided by www.BigCharts.com**

But if you go out five years, the PC market essentially is going to remain unchanged if you look at estimates from Gartner and so on. While the PC market is likely to shrink a little in the short term, in the long run, that shrinkage in sales will be made up and the market will roughly stay intact. So essentially, you're looking at perpetuity on the existing PC markets, and then you have areas of business for **Microsoft** that are all growing. You have the cloud aspect of the business, you have Enterprise, you have Xbox, all those pieces of the business are growing. And essentially, we are buying **Microsoft** for zero growth, and to the extent that they and **Intel** are able to come up with a Windows Mobile platform or a form factor, which we think has a very high chance of happening this year or early next year, then all of a sudden we are looking at a position where, in addition to obtaining a nice dividend that's well-covered, we have a stock that generates significant and attractive upside. And those are the two defining themes that I would say would be the case for **Microsoft** and **Intel**.

And with **Apple**, it's a simple case that we have a stock that has a great franchise, continues to have great growth opportunities going forward, but there's just a lot of emotional distress in terms of unrealistic expectations that were priced in — and a lot of bitter people or bitter investors that bought in at $700 that were buying in unrealistic set of expectations that became disgruntled and precipitated that fast sell-off that made **Apple** an attractive purchase for us.

**TWST: What is your sell discipline and would you give us an example of a stock you recently sold and tell us what triggered the sale?**

**Mr. Resendes:** Staying within the context of large-cap tech, I mentioned earlier that at the beginning of the year we held and owned a fairly substantial position in **Hewlett-Packard**. I believe at the beginning of the year, the stock was trading approximately $15. We began exiting that position in the last month and a half as the stock was trading in at $25. And the predominant driver of the sell discipline for us is first valuation; secondly would be if a stock is no longer meeting the criteria of what made it attractive. In other words, within the context of the opportunistic part of the fund, valuation drives an initial decision to explore a stock and purchase it because it gives us a margin of error that we're just very happy with, and usually a valuation mismatch occurs because of an emotional mispricing in the stock, so that's what brings it to our attention.

Then we have to have a set of themes or catalysts that make the valuation attractive, so that there will be an opportunity to realize that value. With **Hewlett-Packard**, we began buying it after a sharp sell-off. Once management made the decision to purchase **Autonomy**, immediately there was $10 billion reduction in **Hewlett's** price, and we started looking at the stock then. We were unhappy with the current CEO and as he was released, we became much more interested in the stock. The stock subsequently sold off into the high teens, and we purchased a substantial position there with the notion that Meg Whitman as a manager was going to come in and essentially streamline and make operations more efficient, which she started to do. And we started to realize the value and the price. As the stock has approached our target price goal, we started to lighten up on the stock.

**1-Year Daily Chart of Microsoft**

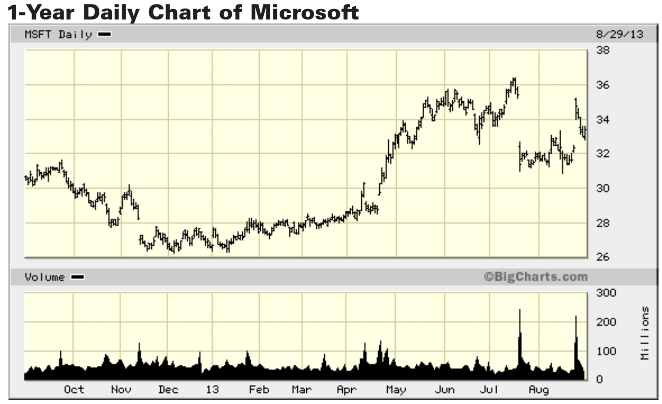


**Chart provided by www.BigCharts.com**

The same thing has taken place with **Morgan Stanley** (MS). We put on the large **Morgan** position at the end of 2011. We watched it sell off, and we endured a lot of pain throughout the early parts of 2012. Again, we thought the sell-off was unwarranted so we continued to hold it even as it dropped into the teens. And recently, we started eliminating our position at $24, and we finished selling it off around $27, plus or minus. We continue to hold a very large position in **Bank of America**, as I mentioned. We haven't reduced our position in that stock at all yet, even though it's almost tripled. We still don't see a reason to sell it, the value is still there, the company is still rationalizing its asset base and had not yet begun to demonstrate its earnings power. We think the next couple of years for that stock are very promising going forward. So even though it's a large position in the fund, we still think it warrants our full investment in it. And if it starts to approach our exit target, we certainly would begin lightening up on the stock, and ultimately, if it exceeds all of our targets, we would completely eliminate the position.

So if I were to just summarize in terms of what our sell discipline is, it starts with valuation, and in the case of a losing stock, it has to be buffeted with a realization that we made a mistake and it's not a stock that continues to fit the guidelines under which the valuation was attractive. You can have situations where companies are value traps and it's cheap for a season. For us, we tend to mitigate those risks by focusing on the economics of a firm and really understanding if a firm is able to create economic value or not through its operations. And when it's able to do that, typically the value trap aspect of a company tends to be really minimized from our empirical work. And so we're very comfortable making valuation decisions, as they tend to pay out and pay out profitably for our shareholders.

furthermore, I think one of the interesting aspects of that time period was, that gave us a live example to demonstrate that we are true to our process, we don't closet index, we don't attempt to window-dress any of our holdings at quarter end.

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**TWST: Last time you spoke to us, you were planning to launch an international fund. Has that fund launched and would you tell us a bit about it?**

**Mr. Resendes:** Indeed we did. We launched The Toreador International Fund, ticker TMRFX, on December 27, 2012. And the fund is a large-cap fund ex-U.S., so it basically invests anywhere in the world outside the U.S. For the most part, it's focused on EFA companies, so our benchmark is the MSCI EFA Index, and it has been a great success so far. Our performance has been really strong, beating our Morningstar category by over 350 bps year to date. When you look at what vehicles are available to shareholders to make investments outside the U.S., when they put up the performance of the Toreador International Fund, it's been a great vehicle not just this year, but when we've looked at our process historically, our approach has the basis for product that consistently captures alpha globally. Unlike the U.S. fund, this is a completely quantitatively driven fund, and it basically runs off of four key tenets — again, economic performance, valuation, management quality and, in addition, we're looking at earnings quality, ensuring that firms are actually delivering on the performance stated on their published financials.

For each firm in our universe, we decompose every firm's financial statements and break them down into cash component and see exactly where the accounting earnings are coming from. And then we have an economic momentum component or the firm's underlying economic operations improving. So year to date, when you look at us relative to its appropriate Morningstar category, we're beating the category by approximately 350 basis points. So in terms of the fund getting off to a good start and our investors benefiting from our process, it has been an absolute home run.

**TWST: How would you describe the client who is an ideal match for your firm and your funds?**

**Mr. Resendes:** Describing the ideal investor matches is sort of a difficult thing. Obviously, from our perspective we are very interested in the relationships that we're building with the advisers that are investing in our fund, are advisers that we tend to think of as generally on the more thoughtful side of the ledger. They are not really interested in just picking by the numbers; they are interested in understanding our story. So the majority of the money in our funds have come from advisers that we've gotten to know us really well over the last five years that we've been able to explain what we're doing and why we're doing this or that, and we're able to have a very meaningful discussions with them.

For instance, when we invested in **Bank of America**, there was a lot of popular press ramblings about how the stock was in jeopardy, how investors are fleeing the scene. And we were able to take that as an opportunity to have real meaningful discussions with advisers about why this is the right time to invest; the time to invest is not after it's tripled right now. And that was exactly what we're able to do and

Our investors are buying the products we put together with specific goal in mind, and that is we're an active manager with a very focused charter in terms of what we're looking to buy. We are going to buy — for us, growth versus values is a little bit misleading, but we are going to buy stocks that are trading well below their intrinsic value that have the ability to create economic profits, and that have management teams that understand how to create those economic profits. And so, when you have investors that sign off on that, that's the ideal type of client for us, because they understand there may be some bumps in the road, but the bumps are really creating the opportunities for outsized returns into the future.

I think there was an article that came out in *Kiplinger's* yesterday or last week that basically showed Toreador was literally the number nine fund in the U.S. in the large-cap category. I think in the last year we've been up 31% or something like that, and at the end of the day, that really is a testament to sticking to a process and replicating the process. I think that's the other part that's really exciting for investors in our fund is since we have a systematic process, we view building portfolios — the same way a **Mercedes** goes building cars — it's a consistent process to generate alpha. Over the past few years, as we have grown our investment management business, we have shown our process works domestically and internationally, and that is really exciting and profitable for our investors.

So the other thing about it that's nice is everybody involved in the Toreador process loves to do research or has really bought into the approach we take. So when you do business with us, you're buying into a group of people that A, we are an employee-owned company, and B, it's a group of people that are very enthusiastic, passionate and laser-focused on our goal to deliver portfolio alpha. Lastly, we view our advisers as partners, and actively communicate research ideas and to help them increase their market IQ and grow their businesses. It has worked very well, and we are excited about what the future brings.

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

**RAFAEL RESENDES**
**Managing Director**
**Toreador Research And Trading**
**7493 North Ingram**
**Suite 104**
**Fresno, CA 93711**
**(559) 942-6170**
**www.trtadvisors.com**