

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Assessing the Behavioral Cycle in Terms of Value, Growth and Sentiment



**BRIAN R. BRUCE** is the CEO and Chief Investment Officer of Hillcrest Asset Management, LLC, an employee-owned institutional investment manager. Under Mr. Bruce, Hillcrest has won numerous awards for outstanding investment performance. Before founding Hillcrest, Mr. Bruce was Chief Investment Officer at PanAgora Asset Management. Previously, Mr. Bruce was Director of the Alternative Asset Management Center at the Cox School of Business at Southern Methodist University. He has also held senior investment roles at State Street Global Advisors and the Northern Trust Company. Mr. Bruce received his MBA from the University of Chicago, M.S. from DePaul University and B.S. from Illinois State University. He is a member of the Illinois State University College of Business Hall of Fame, is a recipient of the University of Chicago Graduate School of Business CEO Award and

was awarded the SMU Cox School of Business Media Expert of the Year Award. Mr. Bruce has published numerous scholarly articles and books including *Analysts, Lies, and Statistics*, which he co-authored with Harvard Business School Professor Mark Bradshaw. In addition, he co-authored the only textbook for student-managed portfolios, *Trading and Money Management*. He is also the Editor of *Journal of Investing*, the *Journal of Index Investing*, the *Journal of Trading* and the *Journal of Behavioral Finance*.

### SECTOR — GENERAL INVESTING

#### (AGW502) TWST: What prompted you to establish Hillcrest?

**Mr. Bruce:** Hillcrest's founding partners wanted to run money the best way we could for our clients using our behavioral philosophy and behavioral beliefs. It's hard at an existing firm that has a set of existing products to really create something that's unique and different. Large firms want strategies that don't overlap with each other that they can position in a product set, and we just wanted to run money the best way we could for our clients.

#### TWST: You mentioned your behavioral beliefs. Can you talk a little bit more about that and how it guides your investment decisions?

**Mr. Bruce:** Behavior is at the core of our investment philosophy. The reason behavior is important is that it addresses how assets are actually priced. If you think about what we all learn about markets in business school, we are taught the efficient market hypothesis. According to this theory, all the information that's out there is already in the price of the stock. If that is true, and most people tend to believe some form of the efficient market hypothesis, the only way you can perform better is to find information that other people don't have.

That's why you see so many managers out there, fundamental managers, that have a slogan something like, "We dig deeper," or "We do more research than other managers," and that's a really tough game. There are a lot of competitors doing it. But this approach ignores the other reason why assets don't trade at that efficient market value. We all get access to the same information: income statements, balance sheets and press releases. We now get more information than we ever have. You can go online and read every company's transcript. Everybody gets access to the same information.

So why aren't prices more efficient than they've ever been? The reason is that the information doesn't just go from a press release and have that information automatically included in the price of a stock. People ignore the mechanism of how information flow happens. It happens because investment teams get together, take that information, make buy/hold/sell decisions about stock, and that's what moves the price. So that decision-making process is the behavioral component. That's where cognitive biases and decision errors and feelings about companies come into the decision process that affects the price. So the price of a stock is the efficient market information plus the behavioral information. And that's what Hillcrest takes advantage of.

**TWST: How do you view risk?**

**Mr. Bruce:** For our current small- and mid-cap products, we are benchmark-centric. We think about it this way: If I'm a pension plan, I've got somebody looking at my assets and liabilities. They come up with an appropriate asset allocation that should allow them to cover their liabilities with their assets. They break those down into various asset classes. We manage small- and mid-cap U.S. stock portfolios. So by the time we get money to manage, we are hired to be a small-cap U.S. long-only manager.

We are given a benchmark. So if the asset allocation is done correctly, the chosen allocation can be invested in passive products that represent the asset allocation benchmarks, and the returns allow the plan to fund its liabilities. The reason people hire an active manager is to try and do better than that. What we're trying to do is perform better than the benchmark we were provided, so we use that benchmark return as the return we are trying to beat.

**TWST: What is the actual process of selecting stocks for the portfolio beyond the benchmark?**

**Mr. Bruce:** Our process is based on the philosophy that behavioral biases create a behavioral cycle. If investors are unenthusiastic due to problems at a company, they drive prices below fair value, and when things get better, the price recovers, but the price doesn't stop at fair value. It goes past that fair value because now investors are enthusiastic. We look at this behavioral cycle in terms of three things: value, growth and sentiment. You can tell where you are on this cycle based on what your valuations are relative to your peers, how you are growing relative to your peers and what the sentiment is about your stock.

Our process is twofold. The first part is a screening process. The screening process screens on three broad categories of things based on our behavioral philosophy: value, growth and sentiment. The second step is a fundamental analysis to determine the best companies from the screened list. The final step is portfolio construction.

**TWST: What is the midcap space like in general right now?**

**Mr. Bruce:** The midcap space, for several years, was a great performer. Now this year, the best performer has been small-cap value. There's currently a lot of good opportunities in midcap. The reason we started the midcap portfolio is we're very disciplined in our small-cap portfolios, but after holding a small-cap stock that performs well, it reaches \$5 billion in market cap, and the stock is too big. If you don't sell those stocks as a small-cap manager, you end up with a smid portfolio.

One of the things that we want to make sure that we don't have is that kind of style drift. So we started the midcap portfolio because there were so many names that we had in the small-cap portfolio that we had to sell because they got too big, but we still loved them. We've been able to continue to move great ideas into the midcap portfolio along with finding additional ideas. Midcap started to attract a lot of attention in the early- to mid-2000s, and it's something that everybody should have in their portfolio.

**TWST: Give us an example of a name you like.**

**Mr. Bruce:** Here's an idea that just went into the portfolio recently. It's a company that is set up as a real estate investment trust. It's **Lamar Advertising** (NASDAQ:LAMR). It reminds you of one of those classic boring Buffett names. What these guys do is they are the largest outdoor advertising company in the U.S. They do billboards.

And so what do we like about them? The business is very stable. It's an industry that does continue to grow. Spending on advertising consistently grows, and billboards have about 4% of that. And what's really interesting about the industry is there are three major players, and they have about 60% of all the business. The other 40% are mom-and-pop players. So this is an industry that is perfect for consolidation and perfect for a

company like **Lamar** to continue to grow, not just by having to get new spaces and new billboards but by taking over companies that are really too small since they have critical mass.

**TWST: Give me another name in a completely different sector.**

**Mr. Bruce:** A restaurant name that we just sold out of the portfolio is **Brinker** (NYSE:EAT). **Brinker** is namely the restaurant Chili's. We owned this in small cap for five or six years. Then, a couple of years ago, we put it into the midcap portfolio, and it continued to be strong there with a lot of same-store sales growth within the company. We liked several of the concepts that they were developing besides their main restaurant chain.

Recently though, valuations got slightly higher, and the company management came out in April and had a somewhat negative conference call. All of the estimates fell off quickly, and right about that time, the short interest rose to its current position of over 14% of the flow. That's a company that we held investment thesis on, we rode it up, it went past its fair value, and it continued to grow strongly.

The reason you hold it past the fair value is the enthusiasm in the marketplace. So as long as a company is still growing and people are enthusiastic about it and investors like it, the world

**Highlights**

*Brian R. Bruce discusses Hillcrest Asset Management, LLC. Behavior is the core of Mr. Bruce's investment philosophy. He views the price of a stock as the efficient market plus the behavioral information. In addition, he looks at the behavioral cycle that is created by behavioral biases. When investors are unenthusiastic, prices are driven below fair value, and when investors are enthusiastic, the price goes above fair value. Mr. Bruce judges where a company is in the cycle based on value, growth and sentiment. Using these three categories, Mr. Bruce runs a screening process and then performs fundamental analysis to choose the best companies.*

*Companies discussed: Lamar Advertising Company (NASDAQ:LAMR) and Brinker International (NYSE:EAT).*

doesn't suddenly open *The Wall Street Journal* every day and go, "Oh, look, **Brinker** hit fair value. We better get out of there now." That's just not how things work. So we rode **Brinker** up through the enthusiasm, but once management stated that earnings growth was starting to slow, we knew valuations would pull back as enthusiasm dropped. This is when we sell a stock.

**TWST: Tell us about your process of selling something.**

**Mr. Bruce:** We have a weekly portfolio meeting. We look at names that get flagged. If a company's score starts to deteriorate, we review it. Even if your scoring is doing well, if you've significantly underperformed your peers in the last three months, we need to look at it because maybe we missed something. So we roll through the portfolio. Every week you get together, and the analysts who are coverings stocks that are flagged bring them up, and we talk about them. Then, we decide what we are going to do with those specific names.

**TWST: How many holdings do you have?**

**Mr. Bruce:** We've got two different versions of the midcap portfolio. We've got the basic model portfolio that is just under 50 names. But we also have another version of the strategy that we have for a specific client. That client wanted a 30-stock portfolio, so we do run a 30-stock version of our strategy for this one particular client.

**TWST: How did you settle on 50 as the number of names that works for you?**

**Mr. Bruce:** That number came from a lot of years of managing portfolios and lots of backtesting and trying to figure out where we think we add the most relative value without creating too much volatility. We looked at 30 names and determined how much value we could add relative to the benchmark. We looked at 40 names and 50, and determined that around 50 there is great value added in a very consistent manner. Our goal for our active portfolios is to average 4% above the benchmark over a long period of time. We get there with different numbers of holdings, but 50 gives you a lot of consistency, and that's what we love — consistency.

We've got a much longer track record with small cap, so looking over the eight years of that, we've outperformed six of the eight years. It gives you the idea that our strategies are built to be consistent, and then, from quarter-to-quarter, we are trying to outperform about two-thirds of the quarter, which again, if you look at the small-cap example, the small cap has done that. It has outperformed approximately two-thirds of the quarters. So that's where you come up with 50 names.

It is a really nice risk profile for an investor. For value strategies, clients don't have to be fourth quartile two or three years in a row and suddenly top decile in order to get first-quartile

returns. We try and build portfolios that give you a lot of value added, but do it on a consistent basis.

**TWST: Do large events, like elections, impact your selections?**

**Mr. Bruce:** No. We are not going to, for example, put on a trade ahead of an election, guessing what we think is going to be the outcome, and therefore, this result is going to be good for the following industries. You are essentially guessing how something is going to turn out and look into the future. We, on the other hand, flip it around and say, "OK, so there's a lot of people betting on industrial names. There are a lot of folks saying, 'Well, with all the things that Trump is talking about, industrial companies are going to do well.'"

So we look at it as a risk. And we say, "Let's make sure that we have an appropriate amount of our portfolio in that sector, and no matter if the sector does well or poorly, we can outperform based on our stock selection." Our philosophy is simple. Don't make a bet if you don't ever forecast. So when we don't have a forecast, we set that equal to the benchmark, and therefore, you don't have a bet.

**TWST: How would you counsel investors to approach midcap investing at this point?**

**Mr. Bruce:** We think valuations are very fair when you look at it compared to historical averages. The advantage an investor is going to have in the midcap space will come from finding firms that can add value. There is no asset class or sector right now in the U.S. market that's screamingly cheap. What you don't want are things that are excessively expensive.

We put out a piece in the beginning of 2016, looking at some of the various asset classes and some of the style benchmarks. One of them was the Russell 2000 Growth Index. It was over two standard deviations higher than its long-term average for valuations. That's a place that you don't want to be. So midcap is in a reasonable spot. If an investor wants to get good returns, they should find a good active manager.

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

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