Channing Capital Management
Quality Companies: More Than Just Shock Absorbers in Volatile Markets

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Richard: Greetings. I am Richard Turnley, director of sales and marketing at Channing Capital Management. I am thrilled to be joined today by Mr. Wendell Mackey, our co-CEO and chief investment officer, as well as our lead portfolio manager of both our small cap value and SMID value investment strategies, as well as Mr. Matthew Betourney, who's the co-lead portfolio manager of our SMID value investment strategy. Thank you both for taking time away from your PM duties to discuss our firm's view on quality investing. Let's talk a little bit about quality investing. It's gotten a lot of press lately with one recent article even [00:01:00] asking the question, is it a golden era of quality investing that we have upon us right now?

Richard: Wendell, 20 years ago, why did you decide to center our investment philosophy around investing in quality companies?

Wendell: Richard, thank you for the introduction and pleased to be here and to be here with Matt as well. 20 years ago, and I can't lay claim to this totally. Three founders, three original founders of Channing Capital, Eric McKissak, Rodney Herenton, my current business partner, and myself.

Wendell: And Eric and I had always been sort of friendly competitors, and we always talked about intrinsic value as a discipline. We were both disciples and steep in intrinsic value. My view, though, had always been that intrinsic value had been narrowly defined by most practitioners. You know, back then it was really focused on high quality [00:02:00] consumer companies mainly.

Wendell: So if you think about Coke, Pepsi, Gillette, you know, that was the world in which intrinsic value primarily lived in. It was always my view, though, that other industries should be included because you had characteristics of companies that fit intrinsic value. Sometimes they may be a little bit more cyclical or volatile, but there was no reason in my mind to exempt areas such as technology, industrials, health care, certain areas out of there.

Wendell: And I thought that if you blended that approach together with respect to a wider lens of the opportunity set, number one, that gives you a greater playing field. Number two, though, is the fact that I always was a proponent of you have to let the managements of these companies feel you and know what's on your mind.

Wendell: And so we've always been a strategic partner with our companies. We're not [00:03:00] scared to get behind closed doors with them and tell them exactly what we think. And so, if you think about intrinsic value as we laid it out, we wanted a wider lens, to more of a private equity or activist mindset in our ownership of the companies, and I'll put alongside that a member mentality of a board member. That's how we've always approached intrinsic value here at Channing, and that approach has served us well over 20 years. Still, though, at the end of the day, it's company by company selection. High quality with the motivated management team and, in Buffett parlance, that still exists.

Wendell: And so that's what we brought to bear in the marketplace. It's been greatly accepted, and we feel like we're just getting started.

Richard: Thank you for that background and that history.

Richard: How does Channing, how do we define quality companies? What goes into that definition?

Wendell: Sure. And some of the tenets that I'll cite to you, you know, various other managers may see it a little different, but that's the beauty of the marketplace.

Wendell: For us, you know, the central tenet, I think we could all agree upon, is that you have a company with a protected niche. And when I say protected, I mean, it's fully competitive out here. So we don't expect to have companies that are monopolies, but you can tell by looking at a company, when you look at a couple of different things, if it has something special. On the financial side, you see margins that are of a highest nature.

Wendell: And so what I mean by that, you know, operating margins are still the old-fashioned way. Or EBITDA margins. It's still an old-fashioned way to tell if a company has something unique and special, but then the steadiness of those margins, that's a first sort of, you know, smell test that a company is a very profitable and sustained company, but then almighty revenue growth matters too, and that's the misnomer.

Wendell: I think sometimes in value, that's not paid attention to [00:05:00]. You see this more out of guys like Bill Miller, Bill Miller looking at intrinsic value as, are you getting the appropriate discount for cash flows in the future of what a company can produce? What that number might be in terms of pure valuation can be higher than what others stomach.

Wendell: I don't say we would go that far, but I would say that we are very heightened to the fact that what is the value of a company today when we look over the next three to five years and discount that back. And then also, too, what kind of protected niche does our company have? And again, uniqueness. Small-cap companies are tied into their customers and clients such that they not only can't get rid of you, but have to work with you in terms of supply chain management, in terms of the product that you can produce. And so small-cap companies, a lot of small-cap companies are about making great big-cap companies look good. If it's sustainable, you can find a company that is a niche, you can do pretty [00:06:00] well for yourself over time. Sure, trading might go up and down because of macro, that matters to us, but it doesn't really matter over the long run. We're focused on the value that you can drive.

Richard: That's great. Wendell, we know that historically quality companies perform very well during economic downturns, but they also provide stability during market periods where we see a lot of exuberance.

Richard: Can you talk a little bit about how you expect our type of companies or the quality companies we invest in to perform in this current market environment as well as over the next, say, 3, 5, 7, 10 years?

Wendell: That's a great question. And Richard, we've had these discussions before. Clients are going to have to get used to the fact that the market of today is a lot more volatile than the market of the past.

Wendell: There are many more participants in the market. There are a lot of fancy and exotic vehicles that [00:07:00] people employ for short-term returns. There's a lot of trading on just news. And so the noise factor of markets is sort of all over the place these days. In today's times, the Fed is the central figure. What are they going to do? Are they saving us from recession? Is it going to be a soft landing? And there's trading that goes on all the time around that. And you see the sort of hopscotching around asset classes. One's in favor one day, another one's in favor, you know, three months from now. And I would say to you that quality can get swung around in the short term, but in the long term, it's always going to dominate.

Wendell: If a company can produce on the top line and produce for you profitability that is continually growing over time. And then also just a business model where it's in a niche, where you can see from a thematic standpoint, that they have a call out here on a trend [00:08:00] that will benefit all investors. That kind of company can work for you over time.

Wendell: And so your question though was when will it work in the early days coming out of a recession or coming out of an economic tougher time? Or in periods now of sort of, you know, where are we going? You can see a lot of performance in some of these lower-quality issues, companies with balance sheets that are poor, no real moat, they're more cyclical, and they can fly by, you know, depending upon where we are in a cycle that can have a period of investment where those companies can do very well. Those are quote-unquote trades.

Wendell: It usually happens again, coming out of a bottom or coming out of a lot of malaise in the market. And so if you think about a five-year market cycle, that first year could be dominated by low quality, maybe even a year and a half. You can't ignore that for the long term because [00:09:00] once you exhaust the returns that can be made out of those lower-quality issues, you're going to have quality dominate the rest of the cycle.

Wendell: And so again, in my 5-year example, maybe year 1 to 1.5 is low quality, while the rest will pick up in that 1.5 and carry it for the rest of the cycle, because then results will matter—who can put up the results. And that's when we win. And so the dominating part of the cycle would be dominated by a Channing-type of product. But you could struggle in some of these sort of waves.

Wendell: Great. Thank you for providing that color on the history of how long we've been investing in quality companies.

Richard: This is something we've been doing for over 20 years. As well as giving us a good feel for how we define quality companies and how we expect them to perform in the future. Matt, let's get you into this conversation a little bit.

Richard: And first, let me congratulate you on your recent promotion to co-lead portfolio manager of our SMID value [00:10:00] strategy. Congratulations. If you could take a second, Matt, and talk about what type of research our team does to identify quality companies, or should I say Channing-type companies? What does that research look like? And how do you go about doing it?

Matt: Yes, obviously, first and foremost, thank you for the kind words and the opportunity that Wendell and Rodney have given me with the SMID product. When you think about the type of research that the Channing Investment Team does, it really starts with a rigorous, bottoms-up, fundamental research process based on quality.

Matt: Like Wendell said, the quality as we define it, you know, there's quality from a quantitative perspective and a qualitative perspective. And what we try to do is we look for companies from a quantitative perspective, like Wendell said, high gross margins, predictable free cash flow generation, balance sheet leverage, to give optionality to an inorganic growth path. But then qualitatively is really where we start understanding these conversations with management and how these metrics from quantitative really lay into corporate strategy, into management decision-making on capital allocation, sustainable competitive advantage, barriers to entry, and improving culture, really focused around what a quality business is that can be sustainable over numerous years.

Richard: That's awesome. Appreciate that. Matt, Wendell referenced Warren Buffett a second ago. And in a letter that he wrote to his shareholders many years ago, Warren said that it's far better to buy a wonderful company at a fair price than a fair mediocre company at a wonderful, wonderful price.

Richard: Could you share an example of a wonderful company that your research identified and what made this company a quality company or a Channing-type company, in your view?

Matt: Definitely. And just to kind of marry the whole process together, you know, the investment team where the rubber hits the road is really [00:12:00] attending investment conferences, trade shows, company-hosted events, but then also looking at competitors, suppliers, customers, and understanding the whole kind of mantra of what this company is and whether it actually defines that quality aspect of it. But then we also leaned upon, you know, I think I might be the youngest guy on the investment team with 20 years of experience and the Rolodex of executives and other investors and street contacts that help us marry this down into these little, you know, 40 to 35 to 45 companies is really how we start our process.

Matt: And I think one good example of this is really taking some of that bedrock of investment research inside an industry that's high barriers to entry, which is less-than-truckload transportation. This is pretty much dominated by 10 players over the past, call it, 25 years, which relates into a rational pricing environment. Barriers to entry are really what would give this pricing inelasticity. The way to shine and really grow margins both in an expanding [00:13:00] freight environment, but also in a contracted rate environment where things are priced for performance, priced on customer service, priced on quality.

Matt: Through this research, we identified XPO. XPO was really a transportation conglomerate started by an entrepreneur named Brad Jacobs. What we thought, what we felt after numerous conversations with this company, is that inside this company, we had a small-cap company, LTL, that had the aspirational goals, had the capital, had the balance sheet, had the people to really become a next-level, maybe even the best-in-class LTL provider at a time when we were in a freight recession, coming out of COVID and post-COVID, call it 2022.

Matt: You know, Wendell and I sat down with this management team, really understanding what they were trying to do: bring technology to the terminals, understand the asset structure, understand what they needed. And one thing that we walked away with, and Wendell actually called this out, was that we have an IT gentleman running this firm. I said, yes, he's an IT gentleman, but also he built the IT infrastructure of what a transportation company should have. Other people don't have this technology. Numerous conversations occurred between myself, Wendell, and the company, and lo and behold, they go out and hire essentially the number one operator in the business from the biggest, most prestigious LTL provider in Old Dominion and bring him into XPO.

Matt: This is a game changer in our asset because not only do we have the technological advantage, i.e. competitive advantage, we have the barriers to entry. Now we have the best operator in the business that will help us drive that network density, customer service, and claim ratio, which is everything that relates to pricing and margins into a forward story.

Matt: Lo and behold, we also had a competitor go bankrupt in Yellow Trucking. He was essentially feet on the street, understanding exactly the terminal [00:15:00] structure that XPO needed to have. Without this gentleman in our management cadre, I'm not really sure

XPO could be the actual success that it has been both from a short-term perspective, but also what we believe in a longer-term perspective from a quality basis.

Matt: So initially, what we saw in XPO was a quality company that could become a top performer. Were there different checkmarks that we needed to occur? Yes, there were. But the high barriers to entry, combined with a few internal improvements and that technological competitive advantage, really make us believe that we're just getting started with this company. We're still in the middle of a freight recession, so come 2024, through 2025 and 2026, we believe the best is yet to come. We have the management team, again, based on all the research we've done over the past two and a half, three years, to really see a wonderful improvement here in operating performance, both from a stock price perspective, as well as earnings and cash flow.

Richard: Matt, that's a great example. And I appreciate you [00:16:00] highlighting the quality nature of XPO and how that company became a part of our portfolio and a part of what we consider Channing-type companies. I want to thank you both, Wendell and Matt, for taking time again away from your portfolio management duties to share your thoughts, your experiences, and really give a good, concise overview of what we do here at Channing from an investment philosophy standpoint, as far as investing in quality companies.

Richard: For our audience, I want to thank you for tuning in and invite you to follow us on LinkedIn, as well as visit our website for more information on what we do here at Channing Capital Management. That website is channingcapital.com. Also, feel free to subscribe to our newsletter, which you can do on the website as well.

Richard: So again, thank you so much. We'll talk to you soon.

Richard: Yes, obviously, first and foremost, thank you for the kind words and [00:17:00] the opportunity that Wendell and Rodney have given me with the SMID product. When you think about the type of research that the Channing Investment Team does, it really starts with a rigorous, bottoms-up, fundamental research process based on quality.

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