In Search of Sustainable Growth

A Q&A with Chautauqua Capital Management

CHAUTAUQUA CAPITAL MANAGEMENT
A DIVISION OF BAIRD

Why should investors consider an international allocation?

Worldwide investing offers an expanded opportunity set. While the United States represents 54.4% of the MSCI ACWI Index, approximately 95% of the global population and about three-quarters of the world's economic activity (based on nominal GDP) occurs outside the United States. Second, given elevated growth rates in these non-US countries, active managers simply have more opportunity to find advantaged, high-quality growth investments—active management has had significant headwinds since the 2008 financial crisis, but we think active management continues to add value in the non-US markets. We believe a sound strategy around variables such as currency, country and sector allocation can give active managers, like us, great opportunity to diversify within a concentrated portfolio.

What is unique about Chautauqua's team approach and how are decisions finalized in the portfolios?

Brian Beitner, CFA, is the lead portfolio manager, but all members of the portfolio management team are engaged in every element of decision making as they evaluate stocks through a multi-step process. It's not until these seasoned generalists have thoroughly analyzed each company's business model and have evaluated the geographic, currency and macro implications of its business, that the company meets our quality criteria, that we actually assign the company to a team member for valuation model construction. Importantly, models at Chautauqua are stress tested by all members of the team and as a group we forecast growth and profitability. This is a more thorough approach than to rely on one analyst's projections as is the industry norm.

Any team member may propose a company for initial analysis and ideas generally spawn from discussions about trends and the listed results of screens. Through our process, most ideas are eliminated early and the multi-step, "all hands on deck" approach means the process itself is the decision maker. Names aren't added until everyone's concerns have been addressed. Even then a potential addition to the portfolio is compared on a profitability, growth and valuation-based score relative to what we already own. Those that don't score well enough typically are moved to the watch list.

Team Member	Degrees	Investment Experience
Brian Beitner, CFA **Chief Investment Officer**	MBA, University of Southern California BS, University of Southern California	39 years
Jesse Flores, CFA	MBA, Stanford University BS, Cornell University	13 years
Haicheng Li, CFA	MBA, Stanford University MMSc, Harvard Medical School MS, Harvard University BA, Rutgers University	18 years
David Lubchenco	MBA, University of Denver BA, The Colorado College	26 years
Michael Mow, CFA	MBA, University of Southern California MS, University of Iowa BA, California State University, Northridge	32 years

There are several benefits to our approach:

- We avoid the bias that results when analysts are incentivized to sell ideas to portfolio managers.
- We avoid problems brought on by an industry/sector-specific analyst's lack of full market perspective.
- We don't place too much reliance on a single "all knowing" portfolio manager.
- We have better team harmony because everyone accepts full credit and responsibility for everything.
- Continuity and succession risks are eliminated since everyone is steeped in every holding and has mastery of the process.

Our team is rightsized and capable, owing to the fact that we hold around 40 securities, have a long-time horizon and a 20% name turnover, suggesting 8 new names a year—we can develop a thorough understanding of the company and industry fundamentals while other strategies with 100 names and 100% turnover would have to trade 100 names through the portfolio each year, requiring a much larger, and arguably less effective, team.

How does a small investment team in Boulder, Colorado compete on a global stage with other global and international investment managers?

For decades Boulder has ranked at the top of lists for education status, health and even happiness. No surprise to us, Boulder is a desirable city where people want to live and work. This is incredibly important for attracting the best and brightest investment talent. Our investment team operates as an autonomous investment boutique supported, in non-investment functions, by the financially strong and stable, employee-owned, Baird. The result is an investment team whose primary focus is on generating superior risk-adjusted investment returns through stock selection while providing excellent client service.

From our offices in Boulder, Colorado, our team has access to best-in-class technology and real-time global communication, allowing us to maintain geographic distance from the distractions of crowded financial districts while still being connected. Being strategically located away from the noise and groupthink of larger markets, our investment professionals think independently and focus on a time tested investment discipline.

You manage concentrated, high-conviction portfolios with 25–35 names in the international and 35–45 names in the global. How do you make sure no one holding has a disproportionate effect?

There are two components to our risk management approach. The primary responsibility lies with our focus, with respect to investment risk, to reduce the probability of a negative outcome rather than interim volatility. We are willing to withstand price volatility for companies that meet Chautauqua's quality requirements as long as the companies' fundamentals remain intact. We emphasize cash flow as a valuation metric. Downside protection is aided by our careful business analysis, consideration of macro factors and currencies, forward-looking valuation, and an emphasis on quality.

We closely monitor portfolios on a daily basis. Conviction-weighting reviews take place at least monthly; even more frequently when considering either the addition or removal of a holding or as market conditions warrant re-evaluation.

You're a long-term sustainable growth manager with a valuation discipline. What valuation factors are critical to your stock selection process and how are they applied? Can you describe the firm's process for valuing securities?

Our valuation work is the last step in our four-step investment process. That's because the valuation work we do is labor intensive and we would rather not eliminate a great wealth-generating company because it appears expensive based on a simple current results basis. We believe that it is worthwhile to analyze the company thoroughly and, if it is too expensive, monitor it until conditions change.

We consider many valuation metrics, but all models emphasize proprietary forecasted cash profits compared to the current cost of the business. For most companies, this is our forecasted three-year forward EBITDA over current enterprise value (EV). For financials we compare our projected adjusted pre-tax profits over modified tangible book value.

Importantly, we use this valuation work, along with proprietary revenue growth and profitability projections, during the conviction-weighting process to make quantitative assessments to manage risk and to rebalance the portfolio to optimal conviction weightings. As a result, the portfolio is populated with companies that tend to be much faster growing, much more profitable and only modestly more expensive than the MSCI ACWI ex-US benchmark.

What role does top-down analysis play?

It's integral through many stages of our investment process. Given our long-term orientation, we try to glean investment trends based on economic development, political and cultural alliances, demographics, product innovation, labor mobility and numerous other factors. Upon deciding a company is well positioned and that it meets our quality criteria, we ask: Is the company doing business where it is favorable for them to do business? This requires building a geographic footprint that detail, on a country by country basis, where each company is generating revenue. In addition, we evaluate the major countries where we have exposures based on detailed analysis of such factors as: economic momentum, demographics and trade sensitivity. The complete nature of our top-down work helps us identify threats on an ex-ante basis so that we can quickly protect the portfolios while benefiting from long-term trends.

Do you hedge currency?

We take great care to understand the revenue and cost sources of each holding to reduce currency risk; currency considerations are implemented through stock selection and portfolio construction.

Currency judgements are based on relative valuation and economic factors not on predictions. We try to avoid exposure where currency movement that might negatively impact the portfolios. Alternatively, we want to be aware of situations where relative currency valuations could provide a tailwind to earnings.

Your international portfolio has historically had 15-30% exposure to emerging markets. How do you determine those percentages and how do you manage risks associated with investing in EM?

We have added value over the years by adjusting weights between emerging and developed markets. The primary drivers for us are valuation relative to our growth and profitability outlook adjusting for macro-economic risks. In all cases, we evaluate companies based on where they derive their revenue.

Chautauqua Capital Management was founded in 2009 and joined forces with Baird in 2016—talk about your experience with Baird after three years.

Baird offered us the opportunity to remain an autonomous investment boutique while providing us with the support of a privately-owned, leading financial services partner. The relationship continues to exceed our expectations and has allowed us to better focus on investing as Baird has assumed most operational and administrative responsibilities. As a privately-owned company, Baird is able to take a long-term, client-first approach towards supporting our business and driving value for our investors. It has been an excellent cultural fit for us.

IMPORTANT DISCLOSURES

For additional important information about the fees, expenses, risks and terms of investment advisory accounts at Baird, please review Baird's Form ADV Brochure, which can be obtained from your financial advisor and should be read carefully before opening an investment advisory account. You may also visit the www.bairdassetmanagement.com webpage. Please read the Form ADV Brochure carefully before investing.

Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. Investments in international and emerging markets securities and ADRs include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Portfolio characteristics may change over time.

MSCI ACWI Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed and emerging markets. The MSCI ACWI Index consists of 44 country indicies, including the United States, compromising 23 developed and 21 emerging market country indicies.

MSCI ACWI ex-U.S. Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed and emerging marketing excluding the United States.