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STRATEGIES

PROFILE

Following the Money

Epoch Investment Partners' Bill Priest and David Pearl beat equity benchmarks by focusing on companies that generate cash—and make good use of it.

BY BETH WILLIAMS

FOR BILL PRIEST AND DAVID PEARL, CO–CHIEF INvestment officers at Epoch Investment Partners Inc. in New York, equity investing starts with finding companies that generate a lot of free cash. Even more important, though, is how those companies use the money. "A lot of people buy companies based purely on numbers; we're saying that's not good because a company can generate a lot of cash and waste it all," says Pearl, who, with Priest, oversees more than $18 billion in global equities, mostly for institutions. "We are much more focused on the business metrics, the judgment of management and their use of the cash."

That focus explains why Epoch passed on investing in some big names in the pharmaceuticals and semiconductor industries in recent years, Pearl, 52, says. The companies, which he declined to name, were throwing off cash. Yet they were putting most of their free cash flow into new projects, he says. "We felt the projected returns would be too low or too risky," he says.

BY CONTRAST, CABLE OPERATOR COMCAST CORP., an Epoch holding since 2004, used its growing cash hoard to acquire NBC Universal Inc., raise its dividend and buy back stock. Its shares climbed 3.1 percent in 2011 through Nov. 7 compared with a 0.28 percent gain for the Standard & Poor's 500 Index.

Epoch's investment approach centers on how companies allocate their capital to what Priest and Pearl call the "five uses of cash": investing in internal projects, making acquisitions, paying dividends, buying back stock and paying down debt. "Everything we do is an application of a single methodology," Priest, 70, says.

‘WE ARE FOCUSED ON THE BUSINESS METRICS, THE JUDGMENT OF MANAGEMENT AND THEIR USE OF THE CASH,’ PEARL SAYS.

Bill Priest *(right)*

EPOCH INVESTMENT PARTNERS CEO AND CO-CIO

David Pearl

CO-CIO

- Seek companies that **generate free cash** consistently.
- Assess how well companies **allocate capital** among “five uses of cash.”
- Evaluate companies using **macro, quantitative and qualitative gauges**.

MICHAEL LEWIS

The company runs 10 separate equity strategies, with an average investment holding period of about three years for the stocks it selects. "We start with: Do we understand how the company makes its money? Is it a good business?" Priest says. One way to determine whether it's a good business, he says, is to follow the cash. That means focusing less on accounting measures, which can sometimes distort earnings in any given quarter, and concentrating more on a company's actual finances, Priest says. "Earnings and cash are two different things," he says. "Businesses run on cash; they don't run on earnings."

Epoch's approach has enabled it to outpace the broader market during the past decade. The firm's $4.47 billion U.S. Value strategy, focusing on companies the size of those in the Russell 1000 Index, returned 4.6 percent a year on average from its inception on July 31, 2001, through the end of September. That compares with an average annual return of 1.7 percent for the Russell 1000 in the same period. Epoch's strategies also include vehicles focused on small-cap stocks, global equities and dividend yield. The firm also acts as a subadviser for mutual funds.

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When Priest, Pearl and their team evaluate investments, they take into account Epoch's macro outlook for markets and the economy. They also incorporate quantitative gauges of a company's financial performance and valuation as well as more-qualitative assessments of management, including the results of face-to-face meetings and reviews of executive pay. Priest and Pearl founded Epoch in 2004 along with two other partners after each had worked decades in investment management, much of that time together. Priest led Credit Suisse Group AG's Americas investing arm and a predecessor firm, BEA Associates, where he hired Pearl, then a recent graduate of Stanford University's business school, in 1983.

Sometimes, Epoch's investments pay off quickly. In 2010, the firm bought shares of Varian Semiconductor Equipment Associates Inc., a Gloucester, Massachusetts–based maker of computer-chip-processing machines. Epoch was looking for a "late cycle" stock that would benefit amid an economic recovery, Pearl says. It chose Varian because the company dominated its niche and had continued to generate cash during the recession and because its stock price, at about $30, hadn't jumped as much as earlier-stage cyclicals. Epoch wasn't alone in finding Varian attractive. On May 4, 2011, Applied Materials Inc. agreed to buy Varian at $63 a share, a more than 50 percent premium to its stock price at the time.

ONE OF EPOCH'S LONGER-TERM HOLDINGS IS DAVITA Inc., a Denver-based provider of kidney dialysis outpatient services. DaVita gets a majority of its revenue from Medicare, so it can't set prices, and its growth is limited by the number of patients with kidney failure, Pearl says. What makes the stock a buy for Epoch, he says, is DaVita's ability to contain costs and generate free cash flow and then to use that money wisely. DaVita makes an occasional acquisition and buys back stock; it doesn't overextend itself or move into businesses that don't make sense, he says. "We keep owning it because this company is steady, they always do the right thing with the cash and the valuation seems reasonable to us," Pearl says. DaVita's shares rose more than fivefold in the decade ended on Nov. 4 compared with a 12 percent gain for the S&P 500.

Some of the companies that pass Epoch's screens take time to gain favor in the broader market. That's one reason the firm is willing to hold stocks longer than many other money managers do, Pearl says. Microsoft Corp., for example, has lagged behind peers in recent years even though it has increased cash flow, raised its dividend and even borrowed money to buy back shares. "As an investor, you can't time it," Pearl says. "You can only get the business right and the management and their actions. If you own it long enough, you'll get paid."

TIP BOX

Type **EQS <Go>** to screen for equity investments based on criteria you select.

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FOCUS ON FINANCES

EPOCH'S BILL PRIEST AND DAVID PEARL USE AN INVESTMENT STRATEGY that focuses on cash-generating corporations. They seek to analyze how a company makes its money and how management puts cash to use. You can use the Financial Analysis (FA) function to access financial data on companies and value potential investments. To chart free cash flow at cable operator Comcast Corp. in recent years, for instance, type **CMCSA US <Equity> FA A <Go>**, click on the Cash Flow tab, scroll down to Free Cash Flow and click on the chart icon. **BETH WILLIAMS**

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