

# U.S. Quality Capital Reinvestment

THIRD QUARTER 2022



*U.S. Quality Capital Reinvestment seeks to provide superior total and risk-adjusted returns by investing in companies that reinvest in their business to grow free cash flow*

## Key Components of the U.S. Quality Capital Reinvestment Strategy

Access to a portfolio of high-quality global companies with attractive capital appreciation potential

Portfolio holdings generate strong free cash flow and use their cash to reinvest in their business through internal projects and acquisitions

Invests in companies with a persistently high spread between ROIC and weighted average cost of capital (WACC)

Active management by an experienced investment team

Risk management integrated with the investment process

## Investment Philosophy

Epoch believes that the best predictors of long-term shareholder return are growth in free cash flow and management's skill in allocating that cash.

We prefer cash flow to earnings for three reasons. First, cash flows are more reliable than reported earnings because they are harder to manipulate under accounting rules. Second, for innovative businesses which derive much of their economic value from intangible assets,

reported earnings have become increasingly less relevant as a measure of value generation compared to cash flows. Third, businesses which appear to generate reported earnings but not cash flows are more likely to run into financial distress.

Capital allocation matters because decisions on how to allocate cash flows—whether to reinvest in order to grow a company, or to return capital to shareholders—can create or destroy long-term shareholder value.

## Strategy Approach and Investment Process

The U.S. Quality Capital Reinvestment strategy seeks to invest in companies that earn a superior ROIC relative to their weighted average cost of capital (WACC), are expected to be able to maintain that return premium, and have the opportunity to grow their business. The portfolio generally holds between 75 and 100 stocks from the U.S. equity market and employs risk controls to diversify the sources of growth and reduce volatility.

The strategy first uses a quantitative screen to identify potential investments. Epoch seeks to identify companies that have ROIC greater than WACC, growth in cash flow from operations over the last five years, expected revenue growth greater than 5%, and high or expanding margins. The proprietary Epoch Core Model (ECM) is then used to rank every name that passes the screen against its peers on 22 different factors, many of which are based on Epoch's free-cash-flow investment philosophy.

On a quarterly basis, the investment team runs a portfolio optimization on the names that pass the Capital Reinvestment screen. The optimizer seeks to maximize the portfolio's information ratio—i.e., expected alpha relative to expected tracking error—with the ECM score serving as a proxy for expected alpha. Simultaneously, the optimizer seeks to maximize the screening metrics that make up the Capital Reinvestment screen described above. Risk constraints are in place to limit the contribution of any one stock

to the portfolio's aggregate ROIC - WACC premium. The optimization results in a suggested portfolio of 75 to 100 stocks, which typically includes 10 to 12 suggested new buys and 10 to 12 suggested sells.

The investment team performs rigorous fundamental research on each of the suggested names to determine whether the characteristics that allowed a company to pass the screen are likely to be maintained. The investment team performs financial statement analysis to understand the dynamics of how a company has generated a high level of ROIC. Once the source of ROIC is understood, the team looks for factors that increase the likelihood of sustaining that high ROIC. The team also looks for risks to that sustainability. Finally, they check a company's proxy statement to see what kind of long-term incentive plan management has in place. Ideally, company management should be rewarded for generating good returns on capital, rather than simply for growth in sales, earnings, or market share.

Once the team understands the source of a company's high ROIC, judges it to be sustainable, is comfortable with the risks to the ROIC, and thinks that management's incentives are reasonably aligned with the interests of the shareholders, they will approve the stock for inclusion in the portfolio. The investment team typically implements roughly one-third of the buys and sells suggested by the optimizer. The team may also purchase companies that have not been suggested by the optimizer; however, these stocks must pass the



Capital Reinvestment screen and be highly ranked by the ECM.

The investment team performs a quarterly portfolio rebalance that incorporates the results of the quantitative screen, optimization analysis, and fundamental research. Positions can also be added or removed at any time based on information from fundamental analysis or in reaction to new information. Stocks are generally held in the portfolio as long as they continue to demonstrate the sustainable growth characteristics sought by the strategy and may be sold or reduced if a company's fundamentals change, there are alternatives with a better risk-reward outcome, or if there is deterioration in the investment criteria.

## Risk Management

Risk management is integrated throughout the process with a focus on avoiding unintended risks. Portfolio risk exposures are monitored and formally communicated to portfolio managers on a regular basis and are discussed at investment meetings. The optimization process utilizes constraints to limit the contribution of any one stock to certain portfolio aggregate measures (ROIC - WACC, growth in cash flow, expected revenue growth, operating profit margin). The minimum position size is generally 0.25%, and the maximum is 2.0% (except for stocks which are greater than 2.0% of the benchmark, in which case the maximum is the benchmark weight plus 1.0%). There are no explicit limits on country, region, or sector weights, because the portfolio optimization process tends to prevent extreme overweights or underweights.

### Portfolio Management Team

#### Industry Experience

David Siino, CFA, CAIA	24 Years
Steve Bleiberg	38 years
Mike Welhoelter, CFA	36 years
Bill Priest, CFA	57 years

Supported by a team of analysts with an average of 20 years experience

## U.S. QUALITY CAPITAL REINVESTMENT



	2021	2020	2019	2018
Portfolio (Gross)	29.3	32.8	33.9	-5.2
Portfolio (Net)	28.8	32.2	33.1	-5.7
Russell 3000	25.7	20.9	31.0	-5.2

### SECTOR WEIGHTS

	Portfolio %	Russell 3000 %
Information Technology	28.6	25.2
Health Care	20.3	15.0
Consumer Discretionary	14.2	11.5
Industrials	13.6	9.0
Communication Services	10.1	7.4
Financials	8.0	11.8
Consumer Staples	3.4	6.3
Materials	0.7	2.8
Real Estate	0.4	3.4
Utilities	0.0	3.0
Energy	0.0	4.7
<b>Total</b>	<b>0.0</b>	<b>0.0</b>

### THREE YEAR RISK METRICS

Portfolio vs. Russell 3000	
Info Ratio	0.62
Alpha	3.42
Beta	1.00
R <sup>2</sup>	0.93
Upside Capture	111.2
Downside Capture	98.7

### ADDITIONAL INFORMATION

Composite Inception	December 31, 2017
Assets	\$846.5 million
<b>Availability</b>	<b>Minimum</b>
Separate account	\$25 million

### CHARACTERISTICS

	Portfolio	Russell 3000
ROIC - WACC (%)	14.0	2.0
FCF Yield (ex-financials) (%)	3.7	3.8
Standard Deviation (3yr) (%)	21.4	20.7
Sharpe Ratio	0.50	0.35
Weighted Avg Mkt Cap (\$M)	125,424	399,251
Weighted Med Mkt Cap (\$M)	27,321	104,701
Number of Equity Positions	90	2,986
12 Month Turnover (%)	32.3	

### 5 LARGEST HOLDINGS

	Portfolio %
LPL Financial Holdings Inc.	2.3
World Wrestling Entertainment,	2.0
Starbucks Corporation	1.9
Deckers Outdoor Corporation	1.8
Jack Henry & Associates, Inc.	1.8
<b>Total</b>	<b>9.7</b>

All data as of September 30, 2022 unless otherwise noted. Source: FactSet Research Systems, Inc.; Frank Russell Company ("Russell"). Totals may not add due to rounding. The inception date of the strategy is December 31, 2017. Performance for the most recent quarter is preliminary and subject to change. The risk statistics are shown for informational purposes only and are not indicative of future results. Past performance is no guarantee of future results. Valuations are computed and performance is reported in U.S. dollars. Composite returns are presented gross and net of management fees and include the reinvestment of all income. Gross-of-fees returns are presented before management fees but after all trading expenses. Net performance reflects the gross-of-fees return reduced by the investment management fee and performance-based fee (where applicable) incurred. Effective October 2012, net performance is calculated by deducting the actual investment management fee incurred by each portfolio in the composite. Prior to October 2012, net-of-fee returns reflect the deduction of the highest annual management fee, calculated on a monthly basis. Returns include the effect of foreign currency exchange rates. The statements expressed herein are informed opinions, are as of the date noted, and are subject to change at any time based on market or other conditions. International investments involve special risks including currency fluctuation, long liquidity and different accounting methods and economical and political systems. Securities of smaller companies tend to be more volatile and less liquid than that of large companies. Information about indices allows for the comparison of an investment strategy's results to that of a widely recognized broad market index. There is no representation that such index is an appropriate benchmark for such comparison. Results for an index do not reflect trading commissions and costs. Index volatility may be materially different from a strategy's volatility and portfolio holdings may differ significantly from the securities comprising an index. This information is intended to highlight issues and not to be comprehensive or to provide advice only. Any reproduction, modification, distribution, transmission or republication of the information, in part or in full, is prohibited.



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