



Everyone Loves a Wonton

It was a thought for a fleeting moment. One of our Portfolio Managers (call him Howard) walked slowly out of the office he had occupied for the past 13 years. He was loyally accompanied by his partner of 22 years (call him Steve). It was mid-morning, but never too early for lunch – as a true member of the firm he left, food was always on his mind. He thought about what would be good to eat. Everyone loves a wonton, Howard thought.

“Any places to eat wontons nearby, Steve?” Howard asked.

“None that I know of; perhaps there should be!”

“Well, why not open one up?”

*“The energy of the mind
is the essence of life.”*

~ Aristotle ~

In those few moments after leaving their prior firm affiliation, the two thought up some plans. Perhaps a small store somewhere near Fashion Island, in Newport Beach, California. It could be right across the street so that they may see their old friends often. A change of career; why not?

*“No, not a **small** shop,”* said Howard. *“Let’s do it right, but meaningfully so.”*

“No arguments from me,” replied Steve.

*“We’ll bring in a designer and make it feel like a place in China. We’ll get the very best flour, make the finest wonton wrappers from scratch, filling them with fresh meats, vegetables and sauces and boil them in imported **New York** water – only the best!”*

The two partners had the entire operation planned. From financing to site location to the menu to marketing. All set.

Then Howard began to wonder what they may have missed in the planning. Always the skeptic, he wondered why it all seemed so obvious to the two partners. If all it took was a little imagination and the drive to succeed, why wasn’t there already a wonton shop nearby? Perhaps there wasn’t a need after all? Perhaps there was a need, but never the opportunity? Or maybe they couldn’t get enough of that good New York water?

The conversation continued but then seemed to turn naturally to a discussion of the stock market investment implications of opening the shop. If it succeeded would that further highlight the advantages of Chinese food? Of China? Where would we get the flour? From **Archer Daniels Midland**, a company in which we previously invested? Can we buy the fixtures for the shop at a local **Home Depot**? The glass for the shop front from **PPG**? Advertise with **Google**? Set up a bank account with Wells ... umm ... **J.P. Morgan Chase Bank**?

Soon it dawned on them both. *“What are we thinking?”* asked Howard. *“We are planning life **outside** the investment world yet still thinking of investments.”* *“It’s our passion!”* the two exclaimed almost in unison. For just a fleeting moment they pondered a different career. But borrowing from a recent Quarterly letter Howard authored ... NEVER MIND!!

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It Must Evolve

So what do wontons have in common with investments? Wontons are common in cuisines the world over. In the U.S. they are often associated with Chinese cooking as briefly described above. Within Asia there are at least a dozen varieties known in various regions as gyoza, wan tan, *chao shōu*, potsticker or, simply, dumplings. But a wonton by any other name is still as delicious. In Italian cooking, a “wonton” is commonly known as ravioli. In Polish cooking a meat-filled noodle ball is called kreplach. In Russia it can be either boiled or fried, and the filling is more typically potato – a pierogi.

As described on a cultural China website, the wonton has a long history. *“There existed numerous wonton restaurants in cities in the Tang and Song Dynasties of ancient China. Wonton was featured by clear soup and delicate stuffing at that time. Its fineness was valued by the educated, but was hard to appreciate by common people. It was a custom in some regions to eat wonton on the midwinter day, which is said to have its origins with Dr. Zhang Zhongjing. He stuffed wonton with medicinal herbs to cure villagers who suffered frostbite.”* Clearly this food has evolved and traveled over time.

We highlight this dish in our inaugural edition of *“The Essence”* as it embodies so much of what Aristotle Capital is all about. It too has evolved and traveled over time. Our investment philosophy, honed over 25 years, is straight-forward: **(i) looking globally, (ii) understanding the essence of different cultures, (iii) finding common values, and (iv) recognizing unique individual business models.** Like snowflakes, each wonton has individuality. Similarly, companies must be analyzed one by one. Our investment methodology has evolved over time to what it is today. Like the wonton, it will continue to develop and, possibly, be known by different names.

How will it evolve? Well, you must become an avid reader of *“The Essence”* to truly find out, but we’ll give one glimpse of an example here.

This year, instead of reporting on annual asset performance as we have (here, and in prior firm affiliations) for years, we’ll look back a bit further – the past 20 years. We’ll juxtapose that with some expectations for the future 20 years.

Many factors go into stock price expectations, but we do not hold ourselves out as expert asset allocators. Our investment style relies little on macro forecasts and is almost entirely based on individual security analysis. But we, unlike the false myth of the ostrich, do not bury our heads in the sand. We take notice of secular turning points and factor such views into our work. Rarely do we predict precisely how such factors will impact the companies in which we invest. But we do think about these issues and take them into consideration.

Today, for the first time in more than 25 years, we ponder if we are now entering a “secular” flat market. Unless valuation criteria change dramatically (we think unlikely), U.S. stock market returns are influenced by the following five broad factors. These factors influence economic growth, which influences corporate profits which drive equity prices.

We list each, their historic and prospective contribution to returns, and the sum of the five as follows:

1990 – 2010	
Average risk-free rate	(3% – 4%)
Inflation	(2% – 3%)
Population growth	(~1%)
Productivity growth	(>2%)
Increased leverage	(positive 1%)
EQUALS	~9% – 11% (annualized)

Note that this growth rate is approximately that of stock market returns over the 20-year period. The S&P 500 Index rose about 9% (compounded annually including dividends) while the NASDAQ rose in excess of 11%.

What about the coming 20 years?

2010 – 2030	
Average risk-free rate	(0% – 3%)
Inflation	(1% – 2½%)
Population growth	(~0.9%)
Productivity growth	(~2%)
Decreased leverage	(negative 1%)
EQUALS	~3% – 7½% (annualized)

Data Tables Sources: Bloomberg and Aristotle estimates

These are estimates and predictions and so, of course, are not guaranteed to be accurate. But some points are obvious. The first is interest rates. As can be seen by the “risk-free rate” (U.S. T-bill rates), interest rates are likely to be lower during the next 20 years than during the past – perhaps by a wide margin. Inflation is a wildcard, but we expect it may remain low, even if budget deficits remain persistent (as has occurred in Japan). Population growth may slow slightly due primarily to demographics, but also a decrease in net immigration.

The last change, less leverage, we think is certain, but the degree could vary. That is, for most of the past 20 years, individuals, corporations, municipalities and countries have

increased their use of debt serving to stoke economic growth. Even if some of these constituents did not increase their actual leverage, they did increase their use of debt (such as using credit cards for purchases but then paying off the balance each month). The extent to which this was adopted in the past is highly unlikely to be repeated.

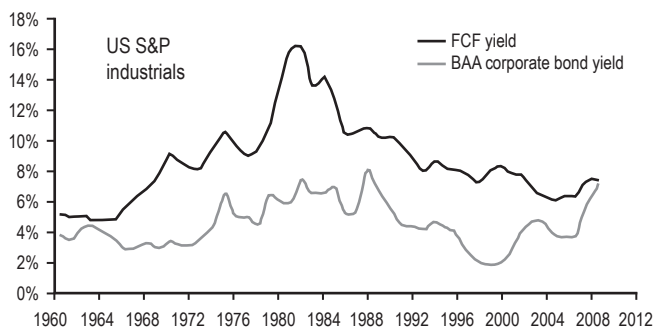
So, in summary we see the 9% – 11% growth of the past 20 years decelerating meaningfully to 3% – 7½% in the next 20. Not every quarter, nor every year, and certainly to be interrupted by recessions and rebounds, but on average over the period. The result is that U.S. economic growth, corporate profit growth and stock market returns could be subpar relative to what many investors have come to expect. It is not so much the precise numbers in the two tables above we wish to highlight. We most definitely will miss on many forecasts. It is the clear direction of diminishing returns in each category from the past to the future.

Should these results come to pass, ramifications to investing could be significant. How will pension plans meet their return assumptions? How will municipalities pay their retirees? What will happen to the trillions of dollars in “index” funds? Will “alternative” asset classes continue to gain market share? What are the investment implications of all this? What are the human implications? Stay tuned here over the coming quarters and years . . .

EQUITIES STRATEGY (U.S., International, Global)

Excluding select financial services firms, corporate America is in very good condition. Perhaps too good?

Free Cash Flow Yield



Source: Credit Suisse

This chart shows the FREE Cash Flow yield of U.S. industrial companies compared to the yield on these same companies’ debt. The solid darker line represents corporate bond yields. The lighter shaded line is the free cash flow yield. This is the net after-tax cash flows (after capital expenditures) divided by the equity market capitalization of U.S. industrial companies. Free cash flow may best be described as the difference between cash in the bank at the end of the year

versus the beginning – such cash generated from operating activities only, excluding mergers, acquisitions, divestitures and also excluding the issuance or repurchase of company stock. It is a measure that factors meaningfully into Aristotle Capital’s investment methodology as it is a measure of a business’s ability to earn returns in excess of its cost of capital. It “sees through” most accounting conventions to the true cash results of a company’s operations.

Note that for the first time in at least 50 years, corporate America is generating a free cash flow yield that equals its bond yield. There is both “good” and “bad” to this. It is admirable that businesses are well-run, becoming more efficient each year and are able to invest cash flow wisely. But companies are also very reluctant to spend their capital. Several reasons may exist for this: (i) inefficiencies in tax codes require some cash be kept overseas; (ii) uncertainty regarding the future of economic growth; (iii) some technologies evolve so quickly that waiting a little longer may result in greater “bang for one’s buck”; and (iv) a more conservative business bias in general. We will monitor these trends and attempt to better understand their long-term ramifications. For now, though, this “idle” cash may continue to constrain the progress of the ongoing economic recovery.

INVESTMENT ACTIVITY

In this section we highlight changes in the investment portfolios to any or all of Aristotle Capital’s equity strategies: Large Cap Value, International, Global or The Saul Fund, L.P. unconstrained fund. This quarter we highlight only one change, but a significant one.

- **Apple** may no longer be part of portfolios. This is a change that has been under consideration for some time, but only now at Aristotle is it being implemented. We always ask, “*what do we know that others may not?*” For years we have said that, in the case of **Apple**, we think of it as a converged media/entertainment company while others still see it as a purveyor of (excellent) hardware. **Software**, we have thought, is their key differentiating factor. Gradually, others have come to see the company as we do and so we no longer find the risk/reward tradeoff as compelling as we used to. No doubt this is still an excellent company with many years of favorable returns ahead. We are no longer unique in such views.

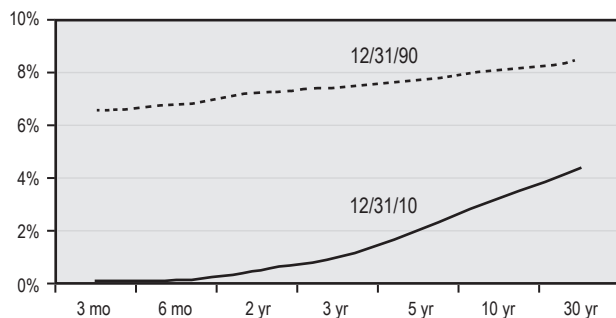
For tax considerations, if owned, the sale may occur gradually where appropriate.

FIXED INCOME STRATEGY

As discussed earlier, generating sufficient investment returns may prove challenging for an extended period of time. The following chart depicts the U.S. Treasury yield

curve as it was at the end of 1990 (dashed line) and at the end of 2010 (solid line). Note that, historically, one was able to purchase 20-year bonds and “lock in” a 7.0% annual return. This, with the only risk being the solvency of the U.S. government. Today, one may only lock in not much higher than a 4.0% yield. We believe this is not sufficient for the return assumptions prevalent throughout many retirement plans.

U.S. Treasury Yield Curve 12/31/90 versus 12/31/10



Source: www.treasury.gov

If yields do rise (something we expect may occur gradually over the coming years), it will be a two-edged sword. For as future return assumptions of bond investments could increase, the value of existing fixed income securities will fall (prices change inversely with yields), thus lowering the value of existing holdings. We are extremely cautious with regards to our outlook for the fixed income portion of Aristotle Capital balanced portfolios. We will invest accordingly.

CONCLUSION

Welcome to the inaugural edition of “*The Essence*.” Herein, on a periodic basis, Aristotle Capital Management, LLC will

share its investment views, philosophy and tidbits on the global economy and global industries. For this edition, we featured the wonton, a delicious dish that, while originating in China, is enjoyed the world over and is known by many names.

As the wonton has evolved over time, so too must investment methodologies. Aristotle, too, will evolve over time. One change possibly required sooner rather than later is our belief that future stock market gains may be more muted than the past. Ramifications of this could be significant and will no doubt impact our company analyses. But we will never “reach” for performance or attempt something without first gaining competency. If interested in how our process will evolve further, stay tuned.

Not all securities mentioned herein are necessarily owned in all Aristotle Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decisions to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable. A list of all recommendations made in the prior one-year period is available upon request.

The characters and stories told herein are often, but not always, based on true incidents. Poetic license is taken to dramatize a point about an investment topic. We strive to make these pieces as “readable” as possible not so much for the goal to entertain (we’ll leave that to our neighbors in Hollywood), but to make learning and communication a desired pastime.

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We look forward to interesting times for the coming twenty years (at least).

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