In Search of Catalysts

At Aristotle Capital Management (Aristotle), we have three core tenets to our investment process: we seek to invest in **high-quality businesses**, trading at **attractive valuations**, where there are company-specific **catalysts** underway to unlock this often-hidden value. While the concept of an investment "catalyst" is, *generally*, well understood by the marketplace, Aristotle's *specific* definition of investment catalysts is often misunderstood.

> ***cat·a·lyst****: an agent that provokes or speeds significant change or action*[1].

When applied to the Aristotle investment process, a catalyst is an action or event both currently underway and within management's control that, we believe, will fundamentally improve the business and propel a company closer to meeting its potential. The Aristotle investment process is to identify good or great companies in good or great businesses that, for some reason, are not yet meeting their full potential.

The below table lists examples of what *are* and *are not* investment catalysts:

Aristotle Catalysts

Are	Are Not
• Increasing market share	• Economic cycle rebound
• New leadership	• Terminated management
• Marketed new products	• Expectation for new products
• Increasing FREE Cash Flow	• Hope of being acquired
• Changes in output volumes	• Changes in input costs
• Restructuring ongoing	• Ability to restructure
• Industry consolidation	• Growth industry
• Business mix shift	• Valuation

It can be instructive when discussing our approach to clearly articulate some things we do NOT consider investment catalysts. Valuation, though a critical part of our investment process, is not an investment catalyst. External macroeconomic or geopolitical events, albeit keenly watched and analyzed by many market participants, are not investment catalysts. Commodity price movements, interest rate changes and foreign exchange rates also do not meet our stringent definition of catalyst. Finally, it should also be noted that rumors, hopes or expectations are not viewed by Aristotle as catalysts. Simply put, external factors—those that are not within a company's control—cannot and do not serve as catalysts in our investment process.

"Years of penny-pinching really paid off. The price of copper just went up again."
CartoonStock.com

As the above cartoon suggests, sometimes exogenous events lead to positive outcomes. The intended action of the fictionalized client did not lead to the intended outcome. The humor lies in the notion that the client is now in a good financial position because of movement in commodity prices, not the act of penny-pinching. In effect, the client got lucky and has benefited from an event beyond his control. This concept is something we at Aristotle do not want to rely on.

The three criteria strictly necessary for consideration as an Aristotle catalyst are that the actions or events be:

1. Within the control of the company's management;
2. Currently underway; and
3. Capable of being observed and tracked by our analyst team.

The analyst team at Aristotle makes every attempt to discern *intended* corporate consequences from those results beyond

corporate control. When studying businesses, we are looking for company-controlled causes, in the form of catalysts, that lead to anticipated effects. The "possibility" of change—no matter how likely—requires tempered enthusiasm. In our opinion, one of the biggest traps of value investing is "jumping the gun" on a good idea. Just because there is potential, it does not mean such will be realized. To help avoid this trap, it is imperative that our anticipation of change be rooted in evidence. Examples of such evidence could include a company's *already* increasing market share, a new management team's strategy *beginning to bear fruit* through productivity gains, or *clear signs* of enhanced profitability from an ongoing mix shift toward higher-margin lines of business. Catalysts, as a result, are often found at the very intersection of potential becoming reality and where additional runway lies to further improve the business—conditions we believe to be underappreciated by the market.

Admittedly, our insistence that proof of concept already exists, rather than rely on rumor or hope, may lead us to miss a "bottom" or "early move" in a stock price. After all, there are a great many market participants whose investment strategy involves anticipation based solely on prediction or, said differently, making "bets."

Catalysts are necessary components of our disciplined investment process. Simply put, if no catalysts are present, we will not invest in a business. Likewise, if catalysts are complete, we will sell. Catalysts must also be expected to show results within our 3-5 year investment horizon. If we expect longer, we wait to invest. If a catalyst comes to fruition in a shorter timeframe, well that is just a bonus. Importantly, as is often the case, a company may create new catalysts during our ownership. This has allowed us to remain invested in certain businesses for periods longer than 5 years as the firm continues to find new ways to improve.

Indeed, it is our identification of catalysts that sometimes helps inform our iterative study of both quality and valuation. Catalysts may come in the form of a corporate divestiture that might allow a company to exit an underperforming business or market. This catalyst may then serve to allow management to reallocate resources to other, more successful, areas of the business, thereby strengthening the company's position in the market. Hence, a company with "seemingly average" returns may actually be a true "standout" among its peers—a fact that is only evidenced via a company-controlled catalyst. It should also be noted that this example helps elucidate why we do not employ quantitative screens in our pursuit of quality or valuation.

Not all catalysts are as obvious as a corporate divestiture. From time to time, companies may employ catalysts such as empowering local managers, changing compensation systems, or altering their product mix or pricing strategy. Though potentially powerful, these types of catalysts may take time to be fully reflected in a company's financial statements. Equally important, these seemingly subtle changes can be witnessed by our analyst team prior to their (then obvious) impact on a company's results.

While many investors attempt to predict and then "trade" on events such as elections, commodity prices or interest rates—and point to such events as catalysts—at Aristotle, we do no such thing. We claim no expertise at predicting these macro-related events, nor do we have any insight into how the market will react. It is prudent to remain macro-aware; however, we fervently believe undue time spent attempting to predict such short-term oriented events to be a fool's errand for long-term investors.

Aristotle seeks to identify high-quality companies that are taking actions to improve their position in the market. If we are correct in our assessment of these businesses, it is our belief that market participants will also recognize these improvements and reward these companies with improved valuations. A core belief at Aristotle is that the value of an investment is a function of its future cash flows; we will remain steadfast in our approach to finding companies that are taking concrete steps—which we refer to as catalysts—to improve their financial position and future cash flows.

Sources:

[1] Catalyst Definition & Meaning - Merriam-Webster

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FOR MORE INFORMATION, PLEASE CONTACT

Phone: (310) 478-4005 | **Email:** info@aristotlecap.com | **Web:** www.aristotlecap.com