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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Seeking Companies Undergoing a Positive Change

PEDRO MARCAL is the Director of International Equities and a Portfolio Manager at Foresters Investment Management Company, Inc. — FIMCO — and joined the firm in May 2018. Previously, he was a portfolio manager of global and international products at Fred Alger Management, where he worked for more than five years. Before that he was a portfolio manager at Allianz Global Investors and its predecessor, Nicholas Applegate Capital Management, for 18 years where he focused on international equities, including developed and emerging markets. Mr. Marcal has been in the investment management industry since 1994. He has a B.A. in economics from the University of California at San Diego and an MBA from UCLA.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Marcal: Since 1874, Foresters Financial has been providing socially responsible financial services to individuals and families. Today, we still embrace our purpose: We enrich family and community well-being. We continue to innovate products and services that go beyond financial planning to provide benefits that empower our clients and members. We help them help make a positive difference in the world. Giving back is not a new concept for us. It's what defines us. Because helping is who we are.

TWST: What's on the minds of investors now?

Mr. Marcal: I think probably what's on all of our minds is the trade situation between the United States and China, and potentially between the United States and the rest of the world. Anyone with investments today, including our members, has to be thinking globally. My team invests in dozens of countries around the world, and as global investors, we are keenly interested in events occurring in both developed and emerging markets. The other big issues that our members are thinking about are jobs and incomes. This is both a global and local issue.

TWST: Do you work on a specific fund at the firm?

Mr. Marcal: Yes. I am the Portfolio Manager of the First Investors Global Equity Fund.

TWST: Maybe you can talk about that fund.

Mr. Marcal: Sure. This is an equity fund that invests in companies all over the world across market-cap ranges. We seek capital appreciation by focusing on those companies undergoing positive change that isn't fully recognized by the market. We use a team of sector analysts to do in-depth fundamental research on companies. Philosophically, I would say that there are three key beliefs underlying our approach.

First is that stock prices are driven by earnings and cash flows. So the higher the earnings and cash flows, potentially the higher the stock price. This relationship is coupled with the belief that markets are inefficient, and one of those inefficiencies is how investors recognize business change. We seek to invest in companies that are undergoing a material, positive change. Second, we want to invest in firms that have a strong business model, which enables them to monetize that change into higher earnings. Lastly, we seek companies in which higher anticipated earnings are not fully reflected in the prices of their stocks by the markets.

In terms of positive change, there are actually seven specific criteria that our team considers. This list is based on my examination of the past 20-plus years of my career as a portfolio manager. After reviewing them all, I found that there really are only seven types of change. These are: a new product development cycle; an innovative new technology; changing industry dynamics, or what we call pricing/supply/demand, which basically means higher unit volume growth; a new management team; restructuring; an acquisition that has synergies; and government or regulatory changes.

But it's not enough to simply have a change in order to pass our screening because we live in a world that's very competitive. In order for a company to convert that positive change or a new product cycle or new technology into sustained higher profits, they need to construct an economic moat around it in a way so that competition can't come in and take away their products or profits.

We have identified five types of characteristics for strong business models or business characteristics that enable sustained profitability. The first is brand. An elite group of companies have strong brands that bring them pricing and market share advantages.

Other business models that have sustainable advantages include those based on unique intellectual prosperity, for example, patents or licenses, or based on dominant market position, as when the switching costs for clients are prohibitively high. If you think about some of today's technology giants, their platforms are so ubiquitous and easy to implement that their market positions are absolutely dominant.

And then, there is resource advantage, and that's a little bit more unusual because it covers anything from controlling a particular natural asset, like oil in the Permian Basin, to having a great sales force in a number of countries in the insurance business in Asia. So as you can see, a resource advantage can refer to natural resources but also to human capital or something else.

As core investors, we also care about the valuation of companies. I would say that half of our portfolio is in what we would call positive relative strength companies and the other half is in companies where we think we are early on recognizing changes, so they're underappreciated. When future growth is underappreciated, stocks are cheap. So that's kind of the investment criteria.

TWST: Did you want to give an example of a company that you find interesting now?

Mr. Marcal: Sure. We own a Polish gaming software company called **CD Projekt** (WSE:CDR) that is at the beginning of a new product cycle, as they are developing a highly anticipated new video game called Cyberpunk 2077 that will be released in 2020. We believe the game has the potential to generate hundreds of millions of dollars' worth of units of sales. We first saw an early version of the game at a gaming conference called E3, where our technology analyst met with developers. We met with the company a couple of times before initiating a position in the stock. This is just one example of a firm entering a new product development cycle that is particularly intriguing to our team.

Highlights

Pedro Marcal discusses the First Investors Global Equity Fund. The First Investors Global Equity Fund is a best-ideas fund that invests all over the world across market caps. Mr. Marcal seeks capital appreciation by investing in companies that are undergoing a positive change that isn't fully recognized by the market. His approach is based on three underlying ideas. First, he believes earnings and cash flows drive stock prices. Second, strong business models allow companies to monetize the change into higher earnings. Third, he looks for companies whose higher anticipated earnings are not reflected in their stock prices.

Companies discussed: CD Projekt SA (WSE:CDR); Microsoft Corporation (NASDAQ:MSFT); Sony Corp. (NYSE:SNE); Alphabet (NASDAQ:GOOG); ASML Holding NV (NASDAQ:ASML); Jacobs Engineering Group (NYSE:JEC); Lowe's Companies (NYSE:LOW); Home Depot (NYSE:HD) and Amazon.com (NASDAQ:AMZN).

Actually, a large part of this new product development cycle is driven by the gaming platforms. We are about to enter another gaming cycle where, by 2020 probably, you're likely going to start to see new **Microsoft** (NASDAQ:MSFT) and **Sony** (NYSE:SNE) gaming consoles. On top of that, you have **Google** (NASDAQ:GOOG) launching a cloud-based gaming initiative, for lack of a better term. So people no longer sit down at home and watch TV for a couple hours. Instead, they watch YouTube videos and play games on their phones during their commute and have a wider range of entertainment options. I think there's a big transformation that's taking place in this marketplace, and how these games are being monetized for their respective owners is particularly intriguing.

TWST: Did you want to mention another company?

Mr. Marcal: Let's talk about a different area. How about innovative new technology? We own a number of companies in this space, including an international company based in the Netherlands called **ASML** (NASDAQ:ASML) that uses photolithography.

If you're familiar with Moore's law, which in short states that the number of transistors in an integrated circuit doubles about every two years, you are aware that some of the great beneficiaries of deflation have been in electronics and computers, as these products have become incredibly cheap. As you shrink a computer circuit, there is a geometric benefit. The cost benefit of Moore's law, where the cost of computing drops by 50%, is a trend that used to play out roughly every 18 months and then shifted to every two years. That dynamic has enabled an enormous amount of innovation to take place in society.

From a technical perspective, computer chips have all been made through a process called photolithography. Every pass on each layer of an integrated circuit or chip has a level of photolithography in which they essentially take a picture and then imprint that particular circuit on a silicon wafer. As we have shrunk the thickness of the wafer to what is about 7 nanometers, the wavelength of light has become a constraint for continuing to shrink the semiconductor and for us all to continue to benefit from this ever-cheaper processing power.

"One overarching change in the world today is entertainment. I don't think people really think of gaming, television, radio, etc., as being all wrapped together in a single entertainment category. There are 24 hours in a day, and people work for a period of that time, but then everybody else is competing for a portion of that time."

TWST: Do you think that when it comes to a lot of investors, especially those who are Baby Boomers or older, that they sometimes forget about gaming as a sector to invest in because that might be something that they didn't grow up with?

Mr. Marcal: One overarching change in the world today is entertainment. I don't think people really think of gaming, television, radio, etc., as being all wrapped together in a single entertainment category. There are 24 hours in a day, and people work for a period of that time, but then everybody else is competing for a portion of that time.

ASML has a dominant position in this sector because of superior technology. Essentially, the firm takes a molten piece of tin and explodes it, thereby creating an ultraviolet light, which has a really small wavelength. This innovation will allow them to continue the process of photolithography below 7 nanometers. Their competitors cannot perform the same process because of patents and know-how.

As a result, we think that **ASML** is close to guaranteed a dominant market share in the medium and long term. Currently, they have about an 80% share in the soon-to-be trailing technology and 100% share in the new technology, which is based on extreme ultraviolet. We see 20% upside in **ASML** shares and anticipate them being able to sustain double-digit earnings growth into the future.

1-Year Daily Chart of CD Projekt SA

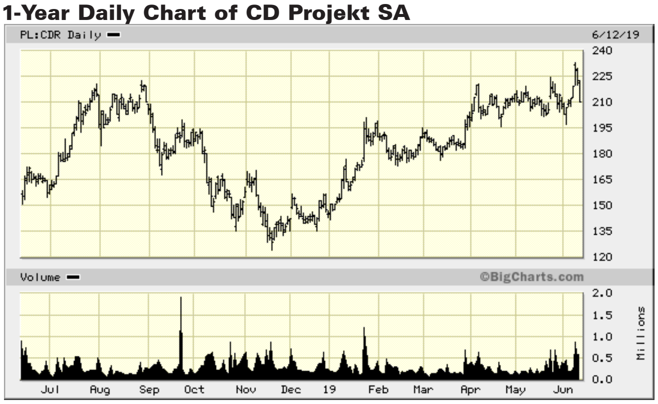

Chart provided by www.BigCharts.com

TWST: When we talk more broadly about innovation, how do you determine if a company is really innovative or its products are innovative because a lot of companies say they are, but when you really look to see what they're coming up with, it may not be? What criteria do you use?

Mr. Marcal: We break our analyst team into sector specialists who develop expertise and familiarity and can make judgment calls alongside experienced portfolio managers. For example, I have worked with John McPeake for more than five years, including our last year at Foresters as well as our time together at a predecessor firm. He is the technology specialist on our team and has more than 30 years of experience in technology as an analyst. Before that, John worked for a software company.

"I do agree with you that all companies claim to be innovative, and we typically are skeptical. I do think it's important to meet with their managements and to hear their thoughts, but the whole purpose of conducting fundamental research is to dig below and sift through all the collective information."

We think that the best way to understand change and innovation is to have a specialist on your team who has spent a lot of time digging and understanding their sector. We'll meet with companies, but we will also meet with their suppliers and their customers. Our team will examine the leading-edge products in the field and how a particular company is positioned in relation to that.

I do agree with you that all companies claim to be innovative, and we typically are skeptical. I do think it's important to meet with their managements and to hear their thoughts, but the whole purpose of conducting fundamental research is to dig below and sift through all the collective information. Every time we meet with a company, we have a model of that company. We're long-term investors, so in many cases, our model goes out five to 10 years. And the purpose of our meeting with company management is to either confirm or disprove our thesis for the company.

Frankly, in a meeting with a company, we're happy doing either, because if we disprove it, then we realize we made a mistake, and we can go and make a change to the portfolio. If we confirm the company's growth trajectory and expected valuation, then everything's on track, and we would expect our model to be fairly accurate and the company to deliver on the anticipated change.

1-Year Daily Chart of ASML Holding NV

Chart provided by www.BigCharts.com

TWST: Did you want to mention another company?

Mr. Marcal: Sure. How about a company with a new management team? **Jacobs Engineering Group** (NYSE:JEC) is an interesting company that was an idea of our industrials analyst, Ryan Kuker. **JEC** has a new management team, having several years ago changed their CEO. As an engineering business, they manage projects and construct facilities for companies in the energy, chemicals, aerospace and nuclear industries. The firm had two major businesses.

The new management team arrived with a more shareholder-friendly approach and a keen interest in transforming their portfolio. So they sold their lower-margin energy, chemicals and refinery engineering and construction businesses that are very low-margin businesses in which they had people typically bid out for fixed contracts. They sold that unit and are reinvesting that money and buying other businesses that have higher margins. For instance, they bought a company in the water business, constructing infrastructure projects for water with more environmentally friendly facilities.

By implementing this portfolio transformation, a firm typically sells off the businesses that have low margins, buys businesses with higher margins, and then it is able to raise its margin level and profitability, taking uninvested free cash flow to earn higher returns. Ultimately, shareholders are rewarded by that process because, first, the company generates higher earnings growth, and second, it obtains a higher multiple. And so that would be an example of another kind of change, where a new management team implementing a portfolio restructuring could lead to a monetization contributing to higher earnings.

1-Year Daily Chart of Jacobs Engineering Group

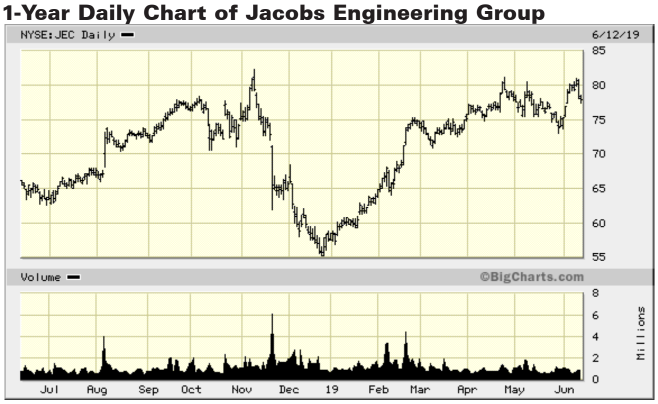

Chart provided by www.BigCharts.com

reported yesterday, they had to lower their future guidance because of an inventory accounting methodology change. This change in methodology caused the company to recognize lower margins and lower its future earnings guidance. They were changing the methodology for monitoring their inventory. The market doesn't easily forgive that type of transgression.

I think that that's a minor issue, and we are much more longer-term focused. When we look at this company in two years, it will likely have been a tremendous success, but the market can be very short-term focused. Some investors may be thinking that the company is going to fail, but I disagree. Consumers have to do well and the economic cycle has to continue on a relatively strong basis though, which is a risk, as is a big trade war with China.

TWST: Was Lowe's in a situation where they had to do something to continue to be competitive?

Mr. Marcal: Retail is interesting. We own a lot of disruptive companies in this sector. We're shareholders of **Amazon** (NASDAQ:AMZN). We're invested in a lot of companies that are disrupting the markets that they compete in. As one example, we own suppliers to companies that will benefit from the adoption of electric vehicles, but we don't own any of the electric vehicle manufacturers themselves. So the question is how are the traditional automobile companies and auto parts suppliers going to survive with huge disruptions occurring in their space?

"I've been investing for a long time, and I've been privy to owning a lot of mistakes over that roughly 30-year history. Oftentimes, the first key element is to have the right preconditions for putting companies together and changing the portfolio. And then, you need to have the right leadership team and processes."

TWST: Why do some of these changes, when new management comes in, not work as well as some others? What are the common mistakes, do you think, on a lot of companies' parts when they don't work out?

Mr. Marcal: I've been investing for a long time, and I've been privy to owning a lot of mistakes over that roughly 30-year history. Oftentimes, the first key element is to have the right preconditions for putting companies together and changing the portfolio. And then, you need to have the right leadership team and processes. Finally, the management team has to execute. And along with execution, a lot of it, believe it or not, has to do with luck and with how the economic cycle goes.

When I look at companies whose restructuring efforts haven't succeeded, they often had a CEO who did a great restructuring in another industry but fails because they're unfamiliar with the industry or because there are a host of more global issues that they can't cope with. For example, in Europe, it's usually very difficult to lay people off. If you're consolidating industries and you can't downsize a portion of the employees in your factories, you can't achieve higher margins. That's one reason why they fail.

We currently own another example in the portfolio that we could talk about, which is **Lowe's** (NYSE:LOW). They missed their earnings target recently, and their stock price was down over 10%. I think that their restructuring is going to succeed, but the jury is still out.

Lowe's announced this plan in December, with a team of people they hired coming from **Home Depot** (NYSE:HD) who are leading the different divisions of **Lowe's**. They've been doing an outstanding job restructuring, but the market doesn't have tolerance in an environment in which people don't like risk. When they

When you look at a company like **Lowe's** and you look at a company that's restructuring and bringing a new management team in with good processes, there's an enormous amount of low-hanging fruit. And I think that for **Lowe's**, in this new environment, it will work and they will do well, but I don't think that they necessarily had to do anything because you can go along as is for quite some time.

But I think the important thing is, we're looking for companies undergoing positive changes, where we think that change is sustainable and it's not fully recognized by the market. We believe that there's an opportunity to profit from a higher stock price in the future as a result of these changes. And often in these cases, companies don't make changes for many, many years, and they're fine, and then the bill comes due for those not adapting to the world that they're in. We believe that we are going to see a lot of this dynamic due to changes involving China too because there are some massive shifts that have started taking place in that country about two years ago.

TWST: Speaking of China, do you think corporate boardrooms throughout the United States are going to be addressing this issue during meetings? It's just not at the sales level, but it's important enough for corporations and their CEOs and their board members to talk about it and ask questions about it so they can prepare and respond?

Mr. Marcal: I was in Germany at the beginning of April and the interactions between the U.S. and China are being talked about by all the manufacturing companies there. Also, companies are thinking about their supply chains and making changes, many of which you can't undo. The first is that a lot of companies were simply putting their factories in China and manufacturing everything there. And now, corporate boards and corporations are thinking, "If there's potentially a 25% tariff or forced to transfer technology, then we'll be punished in order to access this market. It may now be unwise for us to have 100% of our eggs in one basket, so to speak, and manufacture everything there."

So you're actually seeing behavioral change by foreign investors in China and also among Chinese companies wanting to get closer to their European markets and to have facilities in Europe. They don't have 100% of their manufacturing there because, at the end of the day, capitalist companies are running their business for profit. And politically, people ask which countries you support. In the end, these businesses want to live in a global world and are selling global products and have global customers.

So this is definitely a topic of interest and one that comes up in a lot of our meetings. In fact, if it doesn't come up in a meeting with our companies, we typically ask it at some point along the way because we want to be aware of both the first-order and second-order conditions of how our companies are impacted by the situation in China.

TWST: Is it also possible that if some operations are relocated from China that they'll go to some of the neighboring Asian economies, maybe developing economies and those stand to benefit, maybe a country like Vietnam or some other nations near there?

Mr. Marcal: Most definitely. We have a number of small holdings in countries like that, and I would say Vietnam and Thailand are definitely places where manufacturing facilities can shift to. People are being very circumspect in the business community about what it is that they want to do.

Frankly, in many cases, they're afraid and have been afraid for quite some time, especially about intellectual property transfers. I talk to a lot of CEOs, and in some of my conversations with them, they have said that they were asked to transfer a certain core technology in order to bid for a project, and they didn't do it because they are fiduciaries — that's not in the best interests of their shareholders. And when they didn't comply with the request, they wait to see how they're going to be punished. Obviously, they won't get the project that they initially wanted, but there are other ways they could be punished in the market. Hence, nobody wants to openly support what the U.S. is doing.

At the European Chamber of Commerce in China, a very interesting report was released two or three days ago that said that in the last two years, 20% of the companies surveyed felt compelled to transfer technology, and that was up from 10% in 2017. So management teams are just very cautious. I'm cautious talking about it now because you just have to be careful.

Off the top of my head, I can't think of a single multinational company with leading technology that's manufacturing in China that wants to transfer its technology or be forced to do so. Many of them are supportive of what the U.S. is doing because it's just simple economics in their best interest, but you're not going to hear anyone say anything publicly.

TWST: More generally, when investors here in the United States are reviewing their portfolios and looking at different holdings, why would a global fund be to their advantage to have as part of that portfolio?

Mr. Marcal: So why would we invest outside of the United States?

TWST: Yes, why should investors consider that and put it as part of their portfolio?

Mr. Marcal: The main reason is we're a best-ideas fund. We own a Polish gaming software company because they are going to have a huge game, and in a year or two, we think that a lot of people will have heard about that game. If they have the best game, then that's the stock I want to own, regardless where they are located. I'm amazed they did so well.

It's a constraint optimization. We're seeking return, and we want to be able to go anywhere in the world at a reasonable market cap to find the best ideas that will get the best return on a risk-adjusted basis. When we construct our portfolio, we have a target price for one year, three years and for five years. I actually have what I expect my one-year return is going to be on every stock in the portfolio. And then, I know how much risk it puts into the portfolio because I know what the volatility of that stock is relative to my global index. I can match what my expected return is based on the level of volatility it adds or my implied alpha.

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Then, we can construct an efficient portfolio in which we have these wonderful companies that are doing amazingly well and often disrupting their landscapes, which have a great future in one, three and five years. We can construct a portfolio of those stocks to generate a diversified set of returns with the best ideas we can find anywhere in the world based on our investment process for our shareholders. I think, for investors, it is very helpful to have a diversified exposure to businesses overseas that are benefiting from all these changes that we see.

TWST: How do they prevent investing in a region where there are some regulatory concerns and some other types of concerns that could pop up and hurt the company?

Mr. Marcal: That's why you want to have a manager who's done this previously and who has people who are not only focused on the company but on the country and its regulatory environment. That is definitely something that you have to focus on. We manage mutual funds at Foresters. My first investment job was managing an emerging market fund for many years, and so I am always very focused on risk and my ability to return money to investors. That's a portfolio manager's first job.

The second job is getting a good return on that investment. A portfolio manager needs to have the risk tools and the awareness to make sure that they're not going to an unsuitable place or making an investment that is unwise.

TWST: Is there anything we didn't talk about you care to mention, either about the firm and what you can do for clients or some trends out there?

Mr. Marcal: There are a lot of things that are changing in the world. We didn't talk really about themes, but if you were to look at our portfolio, you would see our focus on some amazing things that are happening in the world both in health care and in technology that have an ability to transform the planet. We didn't talk about cloud computing, but we have a number of companies in the portfolio that perform cloud computing or machine learning or are involved in facilitating the use of electricity in trucks and cars, and in the semiconductor space.

So I would just say that there are a lot of really exciting things happening in the world and changing the way we live, and I would be focused on what's happening there and less focused on what's going on geopolitically. There are some great entrepreneurs who have access to capital and who are transforming the world with some amazing businesses.

TWST: Thank you. (ES)

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