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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Creating Alpha Through Market Inefficiencies

JIM GOLAN, CFA, is a Partner and Equity Portfolio Manager on the William Blair Large Cap Growth Strategy. He was also a research analyst covering U.S. large-cap technology and resources, with a focus on energy and materials stocks. Previous to William Blair, he worked at Citigroup Global Asset Management where he focused on the telecom sector. He has an undergraduate degree from DePauw University and an MBA from Northwestern University's Kellogg Graduate School of Management.

SECTOR — GENERAL INVESTING

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

Mr. Golan: William Blair is a global investment banking and asset management firm that was founded in 1935. We are a privately owned partnership, and as of December 31, 2016, our asset management business has nearly $65 billion in assets across a wide range of strategies, including U.S. equities, non-U.S. equities, fixed income, multi-asset and alternatives. Our investment teams are solely focused on active management and employ disciplined, analytical research processes.

TWST: And do you work on any specific investment strategy there?

Mr. Golan: I am a co-manager of the William Blair Large Cap Growth Strategy. I work with David Ricci, who is also a co-manager on the strategy.

TWST: And could you tell me a little bit about that strategy?

Mr. Golan: The Large Cap Growth Strategy is a high-conviction, concentrated portfolio that focuses on high-quality companies that show what we view as superior long-term earnings growth. We are looking for companies that are structurally advantaged, and by that I mean, we are looking for companies where the industry profit pool is growing at least as fast as the overall economy, but preferably faster. In addition, we want to own companies that are taking share of the overall industry profit pool.

Our investment horizon is three years to five years, so we take a long-term perspective on our companies and the overall market. We generally feel that a lot of investors have become too short-term-oriented over the years due to performance pressures. In our opinion, there is just a lot of short-term money chasing the market and chasing the latest investment trends. It is our belief that this creates opportunities for investors like us who take a longer-term view and treat companies as investments rather than renting a stock for a short-term trade. By taking this approach, we create value for our clients on a longer-term basis — again, three years to five years.

So what is required for us to succeed? It requires a very deep and intensive research effort by our eight research analysts, who are covering six major economic sectors. We spend a lot of time vetting potential ideas for the portfolio. It could be weeks or even months before a stock actually gets into the portfolio. We run a concentrated portfolio of 30 to 40 companies, and generally, it's closer to under 35 companies.

The market inefficiencies that we seek to exploit fall into two different categories. First is what we call traditional quality growth, and these are companies that are structurally advantaged, but the market is mispricing the durability of growth and, hence, the long-term earnings power of the company. The second category is what we call fallen quality growth. Again, these are the same structurally advantaged companies, but there might be a short-term issue that reduces visibility on the company's earnings power. Given the market's short-term orientation, the first reaction is to sell the stock and walk away.

In certain select cases, we see this as an opportunity, particularly where our research analysts have done a lot of work on the company and have high conviction in their investment thesis. In those cases, the portfolio managers will take a look at the company as a possible addition to the portfolio. It's our belief that this is where we create a lot of alpha for our clients. Again, the advantages we have in the case of a fallen quality growth company are time and the high-level confidence we have based on the strength of our research team.

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TWST: And given some of the macro trends that have been going on with the election of a new President, and his priorities and his administration's priorities, and also the Brexit vote and similar things going on in Europe, are the strategies and philosophies changing at all? Are you looking at some other trends that are out there?

Mr. Golan: Generally, we don't get overly focused on the macro. We do pay attention to it because it is important overall, but if you look at our overall philosophy and our process, it's focused on the long term, three to five years. Macro issues, like Brexit and the new administration, generally resolve themselves over time. It may create short-term trades for macro traders, but we do best by remaining consistent to our strategy.

Interestingly, it does create volatility in the marketplace, and that volatility creates opportunities for us to find companies that might have been oversold based on investors' perceptions of the company not being well-positioned due to some macro event. We think about things like a new administration in Washington, but it does not drive the overall process. At the end of the day, we are bottom-up fundamental investors, and we expect to create value for our clients through stock selection.

TWST: Sure, and even if it's not changing your portfolio around that much, as a group, do large-cap stocks stand to benefit if there were fairer tax laws and less regulation on some of these big companies?

Mr. Golan: I think what the market is looking at now with the new administration in there is the lessening of regulation. It's generally believed that over the past eight years or so, we have seen an increase in regulation, which has made it more difficult for companies — not only large ones but also smaller companies — to compete. Just recently, we saw the Small Business Optimism Index soar, most likely due to the election. I think if you talk to small-business owners, they are feeling a little better about the overall economy.

If you talk to the larger companies, there are a couple crosscurrents going on. One, regulations are probably reduced, but we also have to look at what's going to be happening on the trade side. There has been a lot of rhetoric coming out of the new administration about being tougher on trade, and that potentially could have some impact on some of the larger multinational companies, which have built out supply chains across the globe and have been beneficiaries of globalization. A tougher trading environment along with retaliatory measures by other countries could have an impact on their overall business. It's still early in the process, and we will have to see how this shakes out.

I think investors generally believe there is going to be less regulation. There is going to be a lower tax rate, but there might be some offsets that make up for some of the revenue that might be lost with a lower tax rate. In addition, for most

Highlights

Jim Golan discusses William Blair & Company, LLC and the William Blair Large Cap Growth Strategy. The strategy is a high-conviction, concentrated portfolio with a three- to five-year investment horizon. Mr. Golan wants high-quality companies for the portfolio that show superior long-term earnings growth. He is looking for companies that are structurally advantaged and are taking market share. Mr. Golan defines a structurally advantaged company as one whose industry profit pool is growing as fast or faster than the overall economy. In order to create alpha, Mr. Golan buys mispriced securities that fall into one of two categories of market inefficiency: traditional quality growth or fallen quality growth.

Companies discussed: Union Pacific Corporation (NYSE:UNP); Home Depot (NYSE:HD); Sears Holdings Corp. (NASDAQ:SHLD); Schlumberger Limited (NYSE:SLB) and Adobe Systems Incorporated (NASDAQ:ADBE).

Americans, wages just have not kept up with inflation over the past several years, and I think we are starting to see some signs of that starting to change, and if that does happen, that would likely have a beneficial impact for the overall economy and for companies generally in terms of higher revenues. In summary, I think people are feeling better about the overall economy in terms of growing faster than what we have experienced over the past few years, driven by less regulation, potentially lower tax rates and higher wages.

TWST: And did you want to mention a company that you own in the portfolio?

Mr. Golan: One of the companies that has been in our portfolio for many years now, and may actually be a beneficiary of some of the things potentially happening with the new administration, is called **Union Pacific** (NYSE:UNP). They are a leading railroad company servicing parts of the Western U.S., Gulf Coast and the Midwest. We bought this several years ago on three basic tenets.

One, it would be a beneficiary of a shift to intermodal — basically taking freight off the roads from trucks and putting them on railcars and then hauling the freight across the country. There is a lot of energy savings, and just getting trucks off the road is a good thing in terms of safety. Secondly, there was going to be a major repricing of legacy contracts, which we are still going through right now. The third tenet is based on how **Union Pacific** can improve operating efficiencies by doing things better and investing in infrastructure.

What makes this stock interesting today is that we expect freight volumes to improve fairly significantly in 2017. They were negatively impacted with the drop in oil prices back in late 2014 and 2015 because part of their traffic is hauling crude by rail and then also hauling sand, which is used for the production of shale oil. When the price of oil fell, that really hit their business hard, and they were also negatively impacted by the coal industry, primarily because of warmer winters and the reduced demand for coal, along with some of the regulations that impacted the coal industry. It's our expectation that coal volumes will start to pick up, particularly during February and onward. **Union Pacific** should have very easy comps going forward.

We are also going to see some major improvement on the energy side this year, so that should help volumes. The company will also benefit if industrial activity in the United States picks up, which has been at low levels for many years.

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1-Year Daily Chart of Union Pacific Corporation

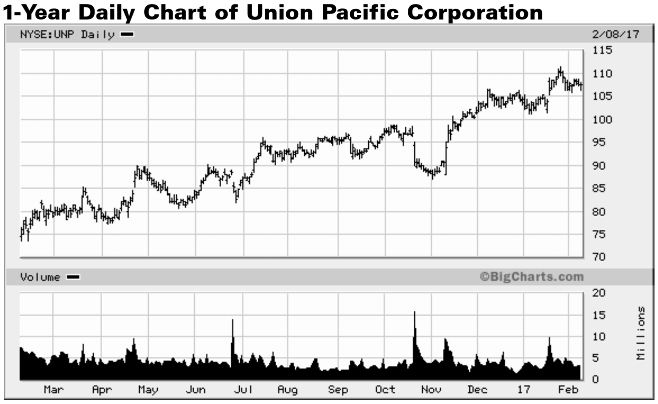

Chart provided by www.BigCharts.com

All these factors should help **Union Pacific's** volumes and earnings over the course of 2017 and 2018. But what's really interesting we think — on a longer-term basis — is that they are going to be a major beneficiary of the growth of the Gulf Coast petrochemical industry driven by cheap natural gas that we have here in the U.S. Our petrochemical industry will continue to see pretty significant growth over the next few years, and **Union Pacific**, as I mentioned earlier, services the Gulf Coast, and so they will be a major beneficiary of that growth.

Union Pacific would be something we put in our traditional quality growth category. We believe the company is structurally advantaged, has good growth opportunities ahead, and we think the market is mispricing their sustainability of growth. With the overall economy starting to improve, we think it's going to be a good stock for our investors over the coming year.

TWST: And do they stand to benefit, too, if the government decides to improve the rail infrastructure in the states that they serve?

Mr. Golan: What you have seen is **Union Pacific** has actually been investing in their infrastructure and improving it on their own. They are not relying on the government to give them money to do that. They have been doing infrastructure improvements themselves, which has helped improve the overall efficiencies of their operations over the past several years. **Union Pacific**, however, will be a beneficiary if there is acceleration in the U.S. economy, particularly on the industrial side.

TWST: Did you want to mention another company?

Mr. Golan: Another company that has been in the portfolio for many years is **Home Depot** (NYSE:HD), the leading home improvement retailer. We purchased the company several years ago, coming off of the housing bust of 2008/2009, when we viewed it as a fallen growth company. We thought the market at that time had an overly negative view of the ultimate earnings power of **Home Depot**.

Single-family construction, which is a major thing people look at, was down significantly, and home improvement spending on existing homes was also down fairly significantly because home values were down. If we get some reversion to the mean, **Home Depot** could potentially benefit at some point down the road. That has occurred over the past several years as single-family home construction has accelerated, home prices have

1-Year Daily Chart of Home Depot

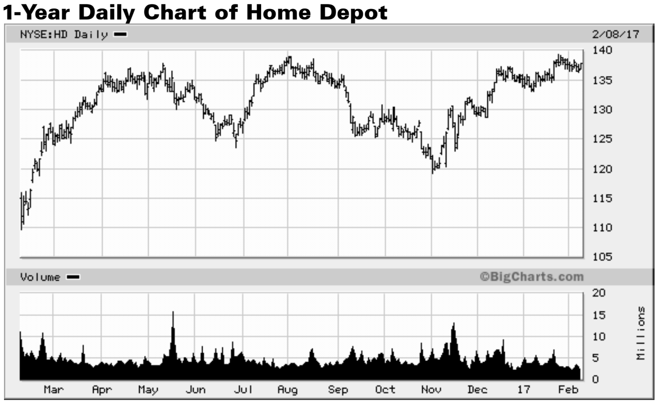

Chart provided by www.BigCharts.com

improved, and people are spending money again.

The other thing we found interesting was the opportunity to gain market share from weaker retailers, most notably **Sears** (NASDAQ:SHLD), which has been struggling for the past several years, particularly in the home-appliance side, and that created an opportunity for **Home Depot** to take share, which they have been doing successfully. We still believe that we are below prior peak levels in terms of new home construction and also in terms of overall spending on existing homes. We think the outlook is actually fairly positive for **Home Depot** as we move forward.

What gives us more confidence is job growth and wages are priorities for the new administration. Jobs and growing wages are really important drivers for **Home Depot**. If people have jobs and their wages are growing, they are most likely going to spend money on their homes. If they do that, that's going to help **Home Depot** in terms of their topline revenue growth.

We still see some opportunities to improve overall operating margins, and **Home Depot** throws off a lot of cash, which means they can increase the dividend and buy back stock. We have a company here in a potentially strengthening economic environment that can grow earnings over the next few years and selling at slight premium to the market on a p/e basis. We still think **Home Depot** has a long runway of growth and remains a fairly significant holding within our portfolio.

TWST: And as you talk about job growth and how it could benefit Home Depot, could the Millennial generation be part of that? Is that one of their target markets?

Mr. Golan: Yes, Millennials have been slow in terms of buying houses. They have been more focused on renting. We think that will change over time as they get older and start to form families — that having a house will be a good thing. Secondly, **Home Depot** has been focused on various green initiatives, in terms of helping the overall environment, and Millennials are focused on the environment. Some of the things that **Home Depot** is doing in terms of energy-efficient products, whether it's appliances or lightbulbs, is aimed and marketed toward the Millennial generation. In addition, online ordering and pickup at the store is something Millennials like because it saves time and allows them to do other things. We think they are well-positioned, assuming Millennials start to buy homes.

TWST: And did you want to mention another company?

Mr. Golan: I'll talk about another one, **Schlumberger** (NYSE:SLB), a dominant oilfield services company with leading-edge technology, generally recognized as the best in the industry. They are very well-managed and well-positioned for the long term. The company was negatively impacted by the collapse in oil prices in late 2014. However, **Schlumberger** launched a major business transformation program a few years earlier in 2011, where it aimed to improve the overall efficiency of operations. In essence, what they wanted to do was improve asset turnover or utilization of assets.

Schlumberger had a lot of equipment sitting idle with its old business structure. By focusing on improving asset utilization, it has been able to reduce capex and improve cash generation by its various businesses. Streamlining operations allowed for additional cost reductions. This transformation program paid dividends when the oil cycle went through a downturn in late 2014, as the company's margins held up better than the average company in the business, and their cash flow also held up better relative to peers.

So during this time frame, 2015 to 2016, **Schlumberger** actually produced free cash flow, which was unusual for the oil industry because the price of oil collapsed, and there was no activity, and basically everyone was trying to conserve cash to survive. **Schlumberger** generated free cash flow, which was used to repurchase stock and pay a dividend at market lows. It's our expectation with the rise in oil prices, oil capital spending will improve, and **Schlumberger** will be a beneficiary of that, particularly in 2018 and beyond, as the international markets start to improve. The company's profitability should also improve faster than what has been experienced in prior rebounds, given its transformation program.

Right now, we are seeing improved activity here in the United States driven by the shale oil producers, but increased activity will start to flow through to international markets, most likely beginning next year. That's where **Schlumberger** has the majority of its exposure; about 60% of revenues come from international markets. We feel good about **Schlumberger**. It's a company that we have owned for many years, and goes back to our long-term investment horizon and investing in companies rather than renting stocks.

TWST: And in terms of OPEC, what impact could that have on the company, depending on what they do in the next few years?

Mr. Golan: We think OPEC will most likely stick to the new OPEC agreement. There probably will be some cheating here and there. If you assume that the global economy continues to improve, the amount of activity reduction that we saw across the globe in terms of oil over the past several years means that it's going to take a long time to bring back oil from other parts of the world. Activity basically just stopped for several years. We think right now, assuming we continue to see growth in oil demand, that the oil supply/demand environment will get close to being balanced, probably late this year or early next year. In which case, everyone probably should be happy, including OPEC members.

For **Adobe**, the benefit is having a more recurring revenue model. Now, clients are paying **Adobe** every month to get access to, what they call, the Creative Cloud. Having a more recurring revenue model is something we like because it leads to more predictability in the overall business model, and it's our belief it should lead to higher valuations over time because you have greater recurring revenues.

The downside was, during this transition period of 2012 through 2015, revenues and earnings were negatively impacted because of the loss of high-ticket software sales toward a lower-priced monthly charge. Instead of getting the upfront software sale revenue, **Adobe** receives its revenue on a monthly basis at a much lower price. The model had to go through this transition period, but in 2016, we saw the inflection upward in terms of

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revenues and earnings. Most of those one-time license sales are out of the business model, and now it's basically a monthly recurring revenue stream.

It's our belief that we should now see earnings-per-share growth for the next several years, driven by above-average revenue growth and margin improvement. In addition, the company will continue to throw off a lot of free cash flow, which will be used to make small niche acquisitions and also buy back stock. We view **Adobe** as a traditional quality growth company. It's right in the sweet spot of what's going on with the need for creative content, growth of the cloud and having the best products for its customers.

TWST: And did you want to mention a final company?

Mr. Golan: Yes, the final company that I will mention is **Adobe Systems** (NASDAQ:ADBE). It's a leading software company that serves the creative industry. **Adobe's** software is used by the advertising market to create ads and web designers to create web pages, so anyone focused on developing creative content. **Adobe** has a very wide and deep moat, driven by its high market share and dominant franchise, and to a certain extent, they're almost like a monopoly. Generally, most of their clients do not leave **Adobe** given the importance of the software to their business and the high costs for switching.

About five years ago, the company undertook a major business model change, moving from a perpetual license model to a software-as-a-service — SaaS — model. Under the perpetual model, a client would pay a licensing fee for the latest software package and might buy a new software package every three to five years. **Adobe** would introduce software updates every couple years, and the existing client may or may not update. This produced more lumpiness in the business model, which impeded the valuation of the stock, in our opinion.

In 2012, **Adobe** shifted to a software-as-a-service model. With this model, a client pays a monthly fee to **Adobe**, and no longer buying a one-time software license but paying a monthly fee to access the software via the cloud. The benefit to the client is the software is constantly up-to-date, so they immediately receive **Adobe's** latest improvements and innovations. With the new model, **Adobe** can update the software as often as it likes, which has deepened its competitive moat but has also helped clients by providing the most up-to-date software version without additional costs. I think customers have grown to appreciate this given how fast the environment is changing in the creative world.

TWST: And as far as the companies they have acquired recently and the ones they might be looking at, are there some common threads to those companies?

Mr. Golan: I'd say the common thread is building out the overall Creative Cloud platform. A couple years ago, **Adobe** acquired a company called **Fotolia**, which is a stock photo site that contained over 30 million images and videos. This acquisition helped the company integrate more closely with some of its important customers, such as photographers and designers. It also helped improve the depth of its platform and, at the same time, upsell new services to its clients, increasing the monthly revenue from its client base. The acquisitions **Adobe** is doing are more niche, more platform building, rather than transformational-type acquisitions, with the ultimate goal of increasing wallet share from its client base.

TWST: And changing direction a little bit, did you want to give some advice to institutional investors about what they might expect in 2017 and any concerns that they might have looking forward?

Mr. Golan: Investors should focus on what comes out of Washington. It's going to be important to watch what happens on the trade side, as a lot of multinational companies have built out significant supply chains, and if we go in there and start to change things dramatically, that could create some potential problems down the road. We feel fairly confident that there will be some sort of corporate tax change and also some individual tax changes, but most notably, on the corporate side, to make our corporate tax rates more competitive with the rest of the world. However, the area we are really focused on right now is what happens on the trade side. After that, it's remaining focused on what we do best, which is picking companies and great stocks.

TWST: Thank you. (ES)

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About Investment Management at William Blair

William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with Taft-Hartley clients, private and public pension funds, insurance companies, endowments, foundations, sovereign wealth funds, high-net worth individuals and families, as well as financial advisors. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies, including U.S. equity, non-U.S. equity, fixed income, multi-asset, and alternatives.

As of December 31, 2016, William Blair manages approximately $64.9 billion in assets. William Blair is based in Chicago with an investment management office in London and service offices in Zurich and Sydney. William Blair Investment Management, LLC and the investment management division of William Blair & Company, L.L.C. are collectively referred to as “William Blair.”

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