

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Integrating a Bottom-Up Approach with ESG Analysis in a Midcap Strategy



**FRANCES E. TUITE, CFA**, is a Portfolio Manager at Fairpointe Capital, LLC. She is part of the Investment Team, co-Portfolio Manager for the ESG Equity Strategy, and is responsible for investment research for both the ESG Equity and Mid-Cap Equity Strategies. In addition, she manages the 1837 LP long/short equity fund, which she founded in 2000. Earlier, Ms. Tuite managed the 1837 Fund at RMB Capital and at Talon Asset Management — under the name Talon Opportunity Partners. Previously, she worked at Sirius Partners and Harris Associates as an analyst and portfolio manager, as a sellside research analyst at William Blair & Company, and as analyst and Director of Research at Johnson Investment Counsel. Earlier, she was employed at Procter & Gamble in their financial management training program. Ms. Tuite received a BBA from the University of Cincinnati in finance and accounting and an MBA in finance and accountancy from Miami University in Oxford,

Ohio. She passed the Certified Public Accountant examination. She is a member of the Chicago Finance Exchange, an organization for senior women leaders in finance, and a member of International Women Associates, which pursues global understanding and universal human rights. She is Chairman of the Steppenwolf's Directors Circle and Board Chair for Recovery on Water, a nonprofit focused on breast cancer survivors.

### SECTOR — GENERAL INVESTING

**TWST:** Could you please identify yourself?

**Ms. Tuite:** My name is Fran Tuite. I am a portfolio manager and analyst at Fairpointe Capital. My primary responsibility is portfolio manager for the ESG Equity Strategy. I am also a research analyst for the firm's two strategies that we manage: ESG and Mid-Cap Core.

**TWST:** Did you want to talk a little bit about the firm?

**Ms. Tuite:** I joined the firm a year ago, but it's been around since 2011, and the midcap strategy was initiated in 1999 by Thyra Zerhusen. And actually, Thyra and I worked together back then at another firm. After a couple of years, we went our separate ways. When she had an interest in starting the ESG strategy, it was a great opportunity for me to rejoin Thyra and a number of her colleagues that I had also worked with previously. The firm has always focused on midcap stocks, and it has had a very good track record over the years.

**TWST:** And is there a unique investment philosophy either with the ESG fund or just the firm in general?

**Ms. Tuite:** Yes, the firm employs a bottom-up, valuation-based approach to investing. The ESG strategy that I'd like to focus on today really integrates that philosophy with analysis regarding ESG factors. ESG stands for environmental, social and governance. We integrate our investment process by evaluating companies on those criteria as well as looking at fundamentals. We have an internally focused research process that we use in the ESG strategy that combines the two.

**TWST:** And who is interested in ESG as an option for their investments? Is it Millennials, is it institutions, or does it vary greatly depending on the investor?

**Ms. Tuite:** We see a lot of interest from both groups. We think that especially with all the headline news about climate change and global warming that these issues are now mainstream. There has been headline news too, about plastics in the ocean, the actual impact of climate change, with hurricanes, floods and fires, and rising temperatures and how the temperatures rise, and how these issues cost companies and become a risk. We are finding that people are more aware and want to integrate their investment opportunities with how they feel about the planet. And so we are finding that family offices, institutions, pension funds and retail investors are all interested in ESG.

I think the biggest issue is that there are so many different ways to approach ESG that people are sometimes confused with whether it's a socially responsible investment or impact investing or whether it's activist investing and trying to make companies better. There is a lot of interest but not a lot of clarity about the offerings and how they are different.

**TWST:** And how does your firm approach it?

**Ms. Tuite:** Our approach is to evaluate each company based on ESG criteria. We do our own work and are trying to find companies that are not contributing to global warming. Their environmental footprint is really important to us. So we look at energy usage, how they are dealing with waste and water usage, and what the company does. We avoid

companies that are using oil-based resins and plastics, and are not serving the greater good. One of our companies, **Wabtec** (NYSE:WAB), is focused on safety in the rail and transit business. Transit and freight are a more efficient way of moving goods and people.

We also look at the social issues and evaluate how they treat their employees, benefits, training and development, and then governance issues. Diversity is really important to us for the board of directors. We have also been actively voting proxies for 15 years in our midcap strategy. We have continuing dialogue with companies in terms of compensation and board diversity. We engage with management teams and try to get improvements on the governance issues; whether it's comp or diversity, those are key factors for us.

**TWST: Getting more gender diversity on those boards is a concern too?**

**Ms. Tuite:** Gender is certainly important. Diversity in terms of age and ethnic background is also important. We are a majority female-owned firm at Fairpointe, and we think that is quite unusual. We have a great opportunity to help companies find eligible female directors and have made some introductions.

A lot of times, companies will say that they cannot find any female candidates. I was at a responsible investor conference in New York recently, and the Chairman of the SEC spoke about this topic, and he said, "That excuse is just unacceptable today. There is no excuse that

company called **Agilent Technologies** (NYSE:A). They are in the health care sector and provide diagnostic and chemical analysis to life sciences and industrial companies. They also provide test equipment and consumables that help companies diagnose chemistries, whether it is an industrial, health care, academic or government agency.

**Agilent** has been around since 1999 and is headquartered in California. California has adopted a new law requiring at least one woman on the board. **Agilent** has done a good job with their board. However, their executives are all men, and we would like to see some improvement. But it is a good business and good management team.

The CEO has been there 35 years and has really transformed the company to be more focused and improve operating margins. They were already high, but they have gone higher, and we see significant upside. It is a very good business in terms of the operating metrics and the cash flow, and it has a clean balance sheet.

The company has great ESG characteristics. They recently made a big push to decrease their energy use.

They have designed their products so they are more environmentally friendly and have diverted most of their waste from landfills. They have improved their water usage, and they have managed their hazardous chemicals that they use in their processes very safely and efficiently. On the social side, they have a strong record of training and development and benefits for employees, and they are very active in their community.

### Highlights

*Frances E. Tuite discusses Fairpointe Capital, LLC and the ESG Equity Strategy. Ms. Tuite points out that many ESG strategies are large-cap-focused and very diversified. Fairpointe, however, offers a concentrated portfolio that focuses on midcap names. Ms. Tuite uses a bottom-up, valuation-based approach that integrates analysis of ESG factors. She considers a company's environmental footprint, how they treat their employees, and diversity at the board and executive level. Ms. Tuite notes that diversity includes gender, age and ethnic background.*

*Companies discussed: Westinghouse Air Brake Technologies Corp. (NYSE:WAB); Agilent Technologies (NYSE:A); Quest Diagnostics (NYSE:DGX); Laboratory Corp. of America Holdings (NYSE:LH); General Electric Company (NYSE:GE); Facebook (NASDAQ:FB); Amazon.com (NASDAQ:AMZN) and Alphabet (NASDAQ:GOOG).*

***"On the social side, they get a high rating in our book. They donate a lot of testing to people who either can't afford it or countries that can't afford it, and they also are very charitable and offer strong wellness programs for their employees. They have a very diverse work force, almost 50% is diverse and female."***

you can't find candidates for boards." And it is not just the board level; it is also the corporate executive team. We look at the diversity companies have within their executive teams, and that makes a statement.

When we look at the board, we also look at the committees. We want diversity on key committees, like nominating and pay committees. I think, at Fairpointe, we are unique that we do focus on midcap companies. We have engagement at the top level with company management and board of directors, and so we have a good opportunity to make our opinions known to the team.

**TWST: And do you want to highlight a stock that you find interesting now?**

**Ms. Tuite:** A name that we added at the end of Q4 2018 is a

Regarding governance, they do have diversity on their board. We use MSCI's database as an input to collect ESG data. It was interesting that they flagged **Agilent** for having some material related transactions from board members. As a result, they flagged their corporate governance. But these directors represented companies that are customers of **Agilent**. They are buying products, and in our opinion, we don't view that as a conflict of interest. We rate their corporate governance high.

**TWST: Do you want to move to the next company?**

**Ms. Tuite:** Sure. The next company is another health care name, **Quest Diagnostics** (NYSE:DGX). **Quest** is the world leader in laboratory testing. Basically, hospitals have labs internally, and some hospitals also

outsource lab work. There has been a lot of consolidation in the industry. **Quest** was number two, and they surpassed **LabCorp** (NYSE:LH) as the number-one player. They have grown through adding new products, becoming more efficient, and they also do data analytics.

We are finding that hospitals charge their patients two to three times what **Quest** charges. We believe that **Quest** has an opportunity to take a lot of share from the hospitals because of the huge pricing differential. If you look at the social impact, that can save a lot of health care dollars going forward. We also think that the valuation is attractive. It's a pretty steadily growing company, but not a high growth company, and pays a dividend.

#### 1-Year Daily Chart of Agilent Technologies



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

Regarding the ESG criteria, the environmental work has been a big effort. As you look at their lab business, a big part of what they do is collect blood and samples. They are making a lot of stops around the country with either trucks, courier vehicles or aircraft. As a result, they utilize a fair amount of energy, but they have really worked very hard to minimize their footprint. The company is recycling most of their waste, and they've reduced their greenhouse gas emissions, but they still have to reduce them further.

On the social side, they get a high rating in our book. They donate a lot of testing to people who either can't afford it or countries that can't afford it, and they also are very charitable and offer strong wellness programs for their employees. They have a very diverse work force, almost 50% is diverse and female.

And on the governance side, they have 14 key executives. Four are women, and one of them is African-American. So this is a pretty good ratio in terms of numbers. They also have 40% women on their board and a woman on each of the three key committees. And while they do have a combined Chairman and CEO, they do have an outside Lead Director. Overall, we give them a very high rating for their ESG criteria. We see it as a great opportunity for the portfolio going forward.

**TWST: And did you want to mention a third company?**

**Ms. Tuite:** The third company is kind of interesting because, on the surface, it does not get a high rating from MSCI for ESG. The company is **Wabtec**. But when we did our homework, we thought that MSCI had underscored it for a couple of reasons. One, the company had not done a good job of reporting some of their ESG data in the past. They are fully committed to improving their reporting, and we expect their rating to go up in the future.

**Wabtec** offers brake systems and safety systems for locomotives, freight cars and passenger transit vehicles. It is much more energy-efficient for people to use rail for transportation versus trucks and to use transit systems instead of cars. I believe the greenhouse gas emissions from rail transportation are 20 times lower than car or air travel per passenger kilometer. That is pretty significant in terms of their environmental impact.

There has been backlog building in the freight market. As purchases start to improve, it's also a higher-margin segment. So that's going to improve their margins longer term. They are in the process of buying assets from **GE** (NYSE:GE). **GE** is very big in the transit side.

They have a very nice aftermarket parts and service business with very high margins — stable in terms of a predictable revenue stream. And they're adding a lot of technology offerings to their customers, which is again an even higher margin and higher growth opportunity.

We gave **Wabtec** a much better ESG rating than MSCI. On the social issues, a big focus for them is safety, and that's important. And the company believes in internal promotions. So there are opportunities for employees to move upward.

The governance side needs improvement. They only have one female board member, and their executive management team of 12 has no women or diversity. We've had some conversations with them, and they are working to improve. They have a number of programs in place for mentorship and STEM programs. We will have follow-up conversations with them on this topic in the near future. We believe that this is a really attractive company for the portfolio, and we're excited about owning it.

**TWST: And maybe you could get into a little more detail on the transit acquisition from GE?**

**Ms. Tuite:** Sure. This was a very good asset for **GE**. However, **GE** needed to improve their balance sheet, so it was good to separate and monetize this division. I don't know that **GE** would have sold it if they didn't have some capital structure challenges, but **Wabtec** was excited to buy it. Several years ago, they bought **Faiveley**, which is a big transit operation in Europe. So they also had the appetite to take on the **GE** transit business, which has a very strong European footprint and very high margins. That deal should close early this year, but it's still not finalized at this point.

**TWST: And changing direction a little bit, when we talk about ESG, there are a lot of Millennials out there, and many of them will at some point be inheriting wealth from their parents as heirs to estates. Do you think that they're going to be looking more to ESG as a place to put their investments as they get those resources and start earning money on their own?**

**Ms. Tuite:** Yes, absolutely. We are already seeing that. Plastic straws, plastic bottles or fast fashion are all topics that are at the top of Millennials' minds. They're thinking about the environment and their footprint. We think that what we are doing in terms of ESG is really appealing.

If you look at some of the offerings for ESG strategies, a lot of them are large-cap-focused and very diversified portfolios. Some of the companies we don't really think are great ESG companies. If you look at a **Facebook** (NASDAQ:FB) or **Amazon** (NASDAQ:AMZN) that are part of these portfolios, they have some real issues. You have probably read the headlines regarding **Facebook**, but also look at **Amazon**. Its

treatment of employees has caused a lot of unrest. Even **Google** (NASDAQ:GOOG) had some issues on the social side.

So these portfolio offerings are not the best ESG options. What we're doing at Fairpointe is focusing on midcap names and offering a more concentrated portfolio. We provide an ESG investment option for people who are really thinking about investing in companies that are trying to do the right thing.

**TWST: In 2019, do you also see that more women investors are working on and asking questions about the role of women in a company, whether there is representation in the C-suite or about different boards and board committees?**

**Ms. Tuite:** Absolutely. Recently, there was an article in *Bloomberg* about that topic. Whether it's in the media sector, the film sector, etc., women are finally making progress. If you look at the averages of board of directors and CEOs of companies, we have so much room to improve, and I think there is a lot of focus on this. The 30% target we think is great, but you know the female population is actually 51%. And so in our opinion, that is a very conservative target.

**TWST: Is there anything we didn't talk about you care to bring up, either about the firm or some trends out there?**

**Ms. Tuite:** I just would say that we are long-term investors, which is important for an ESG strategy. We have a concentrated portfolio, 40 to 45 holdings. So we're really focused on understanding and knowing our companies. We focus on the midcap area, which provides us with access to management. We think the midcap space

offers liquidity and also growth opportunities. We have actively voted proxies for many years and always had a focus on the mission statement of a company and the company's culture.

I joined Thyra, as I mentioned, a year ago, but I have always been passionate about the ESG space. I have been thinking about this all my life. I grew up in a household where we were recycling and using solar panels in the 1970s, long before it was popular. My dad was a scientist and focused on agriculture and soil replenishment. So thinking about our food production and our carbon footprint has always been kind of near and dear to my heart. My carbon footprint is low. I bike to work every day, year-round in Chicago. I'm composting, and I'm recycling. Managing an ESG strategy is a great opportunity for me to align my personal passions with what I do professionally.

**TWST: Thank you. (ES)**

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