BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com OCTOBER 24, 2017

Q&A

3 Stocks That Could Outpace This Market

Aureus Asset Management's Karen Firestone explains how the firm keeps beating the S&P 500.

By LESLIE P. NORTON

Karen Firestone ran mutual funds at Fidelity Investments for more than two decades, starting out working for the legendary Peter Lynch at Magellan, then steering a variety of sector portfolios, and, eventually, the large fund known as Fidelity Destiny I. In October 2005, Firestone left to launch Aureus Asset Management, with David Scudder of Harvard Management, to offer a mixture of stock-picking and investments to their clientele of high-net-worth individuals.

It was a success: From its inception to through this past September, the Boston-based firm reports its core equity strategy returned 10.1% a year, versus 8.4% for the Standard & Poor's 500 index. Aureus has assets of $1.7 billion; its account minimum is $5 million, though clients who come through the Fidelity Wealth Advisory Services only need to invest $1 million.

The 61-year-old Firestone, an alumna of Harvard University and Harvard Business School, sat down with Barrons.com recently to discuss why she believes the stock market can keep advancing, and three companies that can outperform.

***Barrons.com:* We understand that Blackstone Group (ticker: BX) is now emulating you by offering private investments to individuals.**

Firestone: They're a great company, and we own the stock. But when David Scudder and I started the firm in 2005, we wanted to create an endowment-style model, in which we invested across many asset classes, for individuals. It was very difficult to create a portfolio that was diversified across asset classes. My background was in stock-picking. At Harvard, David had lots of experience with external managers and many contacts, and he knew about different geographies and types of offerings, including esoteric investments. Our idea was to do half U.S. and non-U.S. equities managed internally, and half through outside managers. We named our firm Aureus, which means "gold coin" in Latin.

How are you different from Blackstone?

External managers account for about 30% of our assets. We invest in U.S. and non-U.S. hedge funds that represent opportunities where we don't have expertise, such as Lucerne Capital and Varde Partners. We do a huge amount of due diligence on our external investments, and we meet with management several times and get to know their holdings. We speak to their clients, know their track records, the holdings they have, and the tax ramifications of their trading.

It takes a long time before we make an investment, whether it's in long/short European, fixed income, venture capital, real estate. We have an international sleeve, an absolute-return sleeve. Most of our assets are in individual stocks. We do primary research and create portfolios of roughly 35 names for our clients. So if Blackstone is offering a $10 billion fund in which individuals can invest $1 million, that's fine with us. We don't view Blackstone as competition since we don't use their funds, but we do own Blackstone stock in our equity portfolios.

Manager's Bio
Aureus Asset Management

Name: Karen Firestone
Title: Co-founder, chairman and CEO, Aureus Asset Management
Age: 61
Education: B.A., economics, magna cum laude, Harvard University; M.B.A., Harvard Business School
Hobbies: Tennis, golf, bridge, biking

What are your clients worried about these days?

We've had more clients than we've had in years ask us whether we're comfortable with maintaining a large exposure to the stock market. Our clients are mostly in urban areas in the Northeast or the West

(over please)

Aureus' Largest Positions

Visa (V)	4.75%
Alphabet (GOOGL)	4.13%
Constellation Brands (STZ)	4.02%
Facebook (FB)	4.01%
Blackstone Group (BX)	3.71%

Source: Aureus Asset Management

Coast. They're concerned about what they're seeing in Washington, about incendiary rhetoric related to North Korea. Are we too tied to a market that could really fall if something bad happens?

I wrote a piece recently about how markets have responded during periods of crisis going back to the Cuban missile crisis. We've had the government shut down a couple of times, crises that related to everything from suicide bombings to mass shootings to Ebola. You can look at all these discrete events separately and find the market is somehow able to push through them. Economically, if we're on solid ground, these events will ultimately not shake the stock market.

The economy is still growing. Fifteen million people have gone back to work since the recession. We see no signs that either GDP will start to decline or that the unemployment rate will move up substantially. We don't see inflation on the horizon. While interest rates are going up slightly, they're not going up a lot. They can't go up a lot until there's a lot of demand for money. There's a lot of available funding for loans. Through this recovery, we've had a very low rate of growth in capital spending. It is beginning to increase.

Let's hear some targets.

I think predictions are dangerous. We recently raised a little cash: It's now 7% to 9% of assets versus 3% to 5% six months ago. But let's be quantitative. The market responds to earnings. It has liked the fact that S&P corporate earnings in the first quarter went up 14%, earnings in the second quarter went up about 10%, and in this quarter it might be as high. But let's say it is 8% for this quarter. The S&P is around 2550, trading at 17.5 times 2018 consensus earnings. If earnings are higher, you could see how the market could trade higher.

You could have a few upside surprises. A tax cut is definitely not in the numbers for next year; I don't see anybody with lower tax rates on any model. So instead of earning $145 a share, the S&P could earn $155 a share, or 8% more. How about if oil companies earn more than expected? That sector used to account for 12% to 13% of earnings. Now it's under 5%. If the dollar stays where it is and doesn't strengthen, that's a positive going into next year, and I'm not sure that's in people's numbers. I can give you more reasons it will be business as usual rather than disaster over the next 12 months—that GDP grows in the 2% plus range and unemployment stays low.

What causes the next correction?

The market has roughly 18 months where we haven't had a 5% or greater correction. What could bring it down 10% in the next 18 months? A major shortfall in earnings from one of the big tech companies. Many investors look at the big digital companies as the bellwether for the strength of the market and consumer and corporate spending. A debt-related black-swan event out of China. But we had a big China scare two years ago, and the market came back.

What's your thesis for PayPal Holdings (PYPL), which is up sharply this year?

PayPal has an $80 billion market cap and a price of $67. Nobody recognized how much of an opportunity there was for PayPal to address. The addressable market is $100 trillion, a number that is so large, it doesn't even make sense. So PayPal, instead of competing with the other services, decided to partner with them, whether it's the telcos, the card issuers, or the networks. Its Venmo person-to-person app is popular particularly with millennials. It is growing 100% a year. That will be unsustainable, but it can persist for a while.

Venmo is processing over $20 billion in payment volume now. So PayPal has further to go. It has competition in a lot of little places. For example, JPMorgan Chase (JPM) and Bank of America (BAC) also have systems where people can pay each other, but you need to be in the same banking platform. PayPal is at 30 times next year's earnings, but it's growing that fast. This can be a $100 stock. We've had to trim it because it's gotten so big in our portfolios, but this has further to go.

What do you like about exchange operator CME Group (CME)?

This is an unappreciated financial stock, a premium operator with a lot of heavily traded products, including derivatives. In interest-rate futures and commodities, they've been able to expand their network and create more volume. Daily volume grew 9% in the most recent quarter, and that's with low volatility. So it's coming from other exchanges and from more interest in trading commodities and derivatives. As volumes grow, people gravitate towards CME because the market is more efficient, there's more liquidity, and it makes their business easier.

CME is creating silos where it's the dominant player and it becomes harder for others to compete. Last year they had 65% EBIT [earnings before interest and taxes] margins. They have huge operating leverage. They've returned a lot of capital to shareholders. Last year, earnings grew 6%. There's a 5% dividend yield, so that's 11%. They also have variable extra dividends. Then they own 27% of S&P Global (SPGI), the indexing business, which is growing fast. That's worth another $4 to $5 a share. We think the stock, which is $138 now, is worth $165 or $170. They also pay a high 37% tax rate. If there's a tax cut, the stock could be worth $200.

Finally, what is HealthEquity (HQY), and why do you like it?

This is a very interesting company. They're the leading provider of health saving accounts, which are a savings vehicle for individuals who have high-deductible insurance plans. You can contribute pretax money, and it's invested tax-free. If your insurance premiums are very high, you can create another account so you have money to pay medical bills, and while it's sitting there, you can invest the money.

These vehicles are attractive. They don't expire like flex-spending accounts, which are time-limited. And employers are starting to contribute to people's HSAs just as they do to 401(k)s. HealthEquity has $5 billion in HSA accounts. The HSA market is $37 billion. Eventually, the addressable market will grow to $1 trillion. If premiums keep going up, people will demand another way to save. HealthEquity is the only pure-play stock. It's conceivable that somebody might buy the company, though this isn't why we own it. They also get custodial fees for holding the assets.

You wrote a book called Even the Odds: Sensible Risk Taking in Business, Investing, and Life. What's the most useful takeaway for investors?

Don't invest more than you can afford to lose. Stocks are a risky asset. I tell people to not be concerned about what other people say—to think about what risk levels they can tolerate and shut out the noise. We professional investors have to shut out the noise. We do work on a company, and we make uncomfortable decisions. Uncomfortable decisions don't mean they're high-risk. It only means going against the consensus.

What are you reading now?

The Sympathizer, by Viet Thanh Nguyen. The main character is a Vietnamese soldier who is a secret agent for the Communists. I love hearing the voice of someone whose character seems real to me, articulate, perceptive, often amusing, and often intelligent.

Thanks, Kari.