Income Builder through Value Investing

Valuation drives everything, according to Sean Slein and Kimball Brooker, portfolio managers of the First Eagle Global Income Builder Fund. Investing with a perceived "margin of safety" in equities and fixed income, the fund aims to provide both current and future income. With a flexible, bottom-up approach, the team can go anywhere it concludes there is value—including cash—while keeping a steady focus on avoiding the risk of capital impairment.

What is the genesis of the fund?

The origin of the fund is related to the aftermath of the financial crisis. When interest rates plunged to unprecedented levels by historical standards, we had requests from investors to help them manage through this repressed-interest-rate environment. The mutual fund was established in 2012 with the basic idea of a portfolio of bonds and equities that can seek to provide both income generation and, most importantly, wealth preservation.

In addition, we believe the fund may meet the needs of many in a particular demographic group. As investors get older and transition from the gathering phase to the harvesting phase of their investing lives, the natural demand for more income arises. This fund may help some in that group to potentially fulfill those needs.

The fund represents a combination of dividend-paying equities and fixed income. As the name suggests, the goal is to build income, so we seek to manage the equity portion to not only provide current income potential, but also to potentially grow the corpus of the fund and drive the potential for future income. The aim of the fixed-income portion is to provide most of the current income. Overall, the goal is to achieve meaningful and sustainable income today and into the future.

What core beliefs drive your investment philosophy?

Our philosophy and beliefs are influenced by value investors, in particular Benjamin Graham. His concepts are near and dear to our hearts and permeate everything we do. One of the most important concepts of Graham is the notion of investing with a so-called "margin of safety". We feel that it is important to seek to invest at what we believe is a discount to the value of both equity and fixed-income securities in an attempt to protect the fund's investors' capital.

We also look for factors that are not necessarily quantitative, like the quality of the management of the company, the position of the business within its industry, or the quality of the covenants in fixed-income securities. But the core of what we do is striving to invest with a "margin of safety," because valuation really drives everything.

How is the fund different from its peers?

Because of our focus on loss aversion, the fund would hold cash (and cash equivalents) if we fail to find suitable investments that meet the requirements of our discipline. Cash is the residual of the investment process, and when we decide to hold cash, we view it as deferred purchasing power for the future. When we do find suitable investments from the bottom-up perspective, we can take that cash and deploy it as we move forward.

Another important feature is that we are quite flexible, and we don't have a top-down view about how to allocate capital. Our process is very much driven by security selection. When we find something that meets our requirements, we are happy to invest. But if that's not the case, we are very willing to wait, and we would typically wait in cash and cash equivalents.

I think that our benchmark agnosticism, our flexibility, and the go-anywhere approach are quite unique and make us different from our peers. We deploy capital where we find value, but when investment ideas are few and far between, we'll wait for better opportunities.

Kimball Brooker, Jr.
Portfolio Manager

Kimball Brooker is deputy head of the Global Value team and a portfolio manager for the Global, Overseas, U.S. Value and Global Income Builder Funds. Kimball joined First Eagle in January 2009 as a senior research analyst covering banks, commercial services, financial services and holding companies. Previously, Kimball was the chief investment officer of Corsair Capital. He began his career in 1992 as a financial analyst at Lazard Frères. In 1994, he joined J.P. Morgan as an associate in the Investment Banking Department's Corsair private equity funds. He was named chief investment officer of Corsair Capital and managing director in 2005. Kimball earned his BA from Yale University and his MBA from Harvard University.

Sean Slein, CFA
Portfolio Manager

Sean Slein is a portfolio manager for the Global Income Builder and High Yield Funds. He joined First Eagle in October 2011. Prior to joining the firm, Sean was a portfolio manager of the Dwight High Yield strategy at Dwight Asset Management Company LLC, where he focused on high yield opportunities in the forest products/packaging, transportation and services sectors. Previously, he spent two years as a fixed income analyst in the private placement department of Allstate Insurance Company. Sean began his career on the floor of the Chicago Mercantile Exchange as an options strategist with Discount Corporation of New York Futures. Sean received his B.A. from the University of Notre Dame and his MBA from the University of Chicago. He holds the Chartered Financial Analyst (CFA) designation.

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What is your definition of value and your approach to uncovering it?

No investor would want to overpay for a security and, in a way, all investors think of themselves as value investors. Our understanding of value investing is that our primary mission is to avoid permanent impairment of capital. That notion is very important to us, but isn't necessarily shared by every investor.

Because the fund is a flexible, go-anywhere fund, we don't feel constrained by targeting investment exposure to certain sectors, geographies, asset classes or yield. We believe that when artificial constraints are imposed upon a fund, they open the door to the potential of overpaying for an asset. In an environment where prices are going up, multiples are expanding, yields are compressing and spreads are narrowing, investors targeting a particular level of yield could end up incurring more risk for the amount of return that they are receiving.

Because loss aversion is so important to us, we are not willing to tolerate investing lower in the credit spectrum for greater yield or paying a greater multiple for equity due to some artificial constraint. That discipline helps us to stay true to the investment philosophy.

The fund seeks to provide income for today and tomorrow, and there's a tradeoff between the two. If we over-rely on higher-yielding securities, we expose the fund's investors to the potential risk of capital impairment. We need to be extremely disciplined. We want to avoid exposures that other managers appear willing to tolerate in their pursuit of yield.

Would you describe your investment process? How do you search for ideas?

We make some use of quantitative screens, but we also employ other methods to come up with ideas. The investment process is very much about valuation and quality. We are bottom-up managers. We eliminate securities that we find expensive or of lower quality, because that would translate into higher risk of loss. We don't feel the need to invest in every company in an index. If there are securities that come across our desks that don't make sense to us, we don't have to own them, and we won't own them.

How do you make decisions on your geographical allocation?

We are agnostic about where a company is domiciled. There are many good companies all over the world, but we are more cautious about certain jurisdictions from a legal perspective. Otherwise, we are open-minded and willing to look anywhere.

At the moment, the bulk of our fixed-income investments are in the United States and that exposure is a function of the global interest-rate environment. In the equity portfolio, we are more skewed towards international companies, which, again, is a result of the bottom-up approach.

What is your allocation between equities and bonds?

We don't have a preset determination for the split between equities or credit, but we need exposure to both asset classes to seek to meet the objectives of the fund. We need a significant exposure to equities because our goal is to provide meaningful and sustainable current income and also to grow income into the future. We aim to provide that growth on an inflation-adjusted basis, and the portfolio would typically have between 40% and 55% equity exposure.

The aim of the fixed-income component is to provide the majority of current income and we would typically allocate between 35% and 50% to it. However, when we populate the portfolio, we evaluate fixed income on an absolute basis versus cash. The important question is if it makes sense to deploy capital in this fixed-income security with this maturity, level of duration, and credit risk, versus remaining in cash and looking to deploy the cash later. The same applies to equities.

Could you give us some examples that illustrate your research process?

The fund purchased bonds issued by the American refiner Citgo Petroleum Corporation many years ago. This example is interesting from a structural, covenant, asset quality and a general indenture perspective. It is owned by Petróleos de Venezuela, S.A. (PDVSA), the Venezuelan state-owned oil and natural gas company, but is domiciled in the US and governed by US laws. The refineries themselves are located within Illinois, Texas and Louisiana. They have 750,000 barrels per day of refining capacity.

The bonds are secured by those refineries, so we believe it would be very difficult for PDVSA to try to take value from the fund, because they are governed by US law. The fund's investment is also protected by covenants that limit PDVSA's ability to take money out of the structure. There needs to be post-dividend liquidity of $500 million either in cash, in the credit facility or in a combination of the two. Additionally, Citgo is required to maintain a ratio of total debt to total capital of 55% or less on a pro forma basis post dividend payment.

The assets themselves, the refineries, are fairly complex and can blend heavy high-sulfur crude along with the lighter crude that's produced in the United States. Historically, that's provided them a little bit more margin. The light-to-heavy spread has narrowed, but the refinery assets provide options from an input perspective.

The asset value of the refineries is covering the debt by probably a factor of two. Leverage is below three times, if we include pension liabilities. Citgo itself has generated, in our view, a significant amount of free cash flow that, if continued, could give it the potential to deleverage.

So, we feel that there's a fair amount of asset coverage and an equity cushion that provided us with a "margin of safety," in addition to the covenant structure that governs the indenture. Given the fact that cash flows can be volatile and credit spreads can ebb and flow, the asset coverage provides us with an additional comfort level.

Do you view Citgo as an income generating security?

We are not necessarily looking for credit improvement. There is the potential that PDVSA at some point will want to monetize its stake in Citgo and sell it. That provides some upside potential if it is sold to another refiner. There's the potential for spread compression, but given the goals of the fund, we are looking to clip a coupon and have the fund paid without taking excessive risk. So Citgo, with sub-three times leverage, provides the fund with the potential for the relatively stable income stream that we desire.

What is your portfolio construction process?

We don't make any top-down allocations; the process is entirely bottom-up. We are sensitive to aggregation risk and firmly believe in diversification. As long as the fund's portfolio is diverse by the number and sizing of positions, by geography and by industry, we don't have any constraints.

On the fixed-income side, we have a global, multi-asset approach and we have the flexibility to invest across different asset classes like sovereigns, agencies, investment grade, or high yield. The fund holds some European and other foreign corporates. Importantly, in terms of portfolio management, we want the fund to be adequately paid for the duration, credit or liquidity risk that is taken.

As we move through this credit cycle, we've gradually moved towards higher credit quality to seek to minimize credit risk, and we've shortened the duration in an attempt to avoid duration risk. We are not momentum players; we are absolute-value-oriented investors. As credit risk increases and duration risk remains elevated, cash and cash equivalents are useful risk management tools. As the markets become more attractive in time and prices fall, we expect

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the fund may benefit from the attractive optionality that cash and short term higher quality credit provides.

As manager of a First Eagle fund, we are patient and willing to wait. Credit markets go through cycles and investors often misprice risk. As we move through that cycle, many may be willing to tolerate greater and greater credit risk for narrower and narrower spreads. We want to be in a position to potentially take advantage of investor complacency as we move through the cycle. That is consistent with the philosophy of seeking loss avoidance and attempting to maximize risk-adjusted returns of the fund.

Although we are not top-down investors, we believe that equity and fixed-income markets around the world are quite fully valued. It isn't a particularly wise moment to take duration or credit risk or to chase equity performance. At the moment, we believe patience is warranted.

How do you define and manage risk?

For us risk is separate from volatility. Risk is the impairment of capital and the simple definition of risk is loss. Risk is often considered and measured at the portfolio level, but the front line in any risk management process is security selection. That's why security selection is of paramount importance to us.

Everyone knows that there are geographic and macroeconomic risks, but you really don't know when trouble will come and in what form. In our view, the key factor in risk management is finding businesses that are well financed, well positioned in their ecosystem and capably managed by ethical people. Combined with diversification and a discount to intrinsic value, that approach can go a long way in risk management.

Of, course, we can't completely avoid risk. We need to seek to meet the fund's investment objectives, but if we can minimize the risks that the market is mispricing and take advantage of the re-pricing of that risk through deferred purchasing power, that's truly bottom-up investing. In other words, risk management is not just about avoiding risk, but also about providing liquidity and potentially benefiting from that liquidity when the risk is re-priced or overpriced in subsequent periods.

So there's a temporal arbitrage, where our patience and longer-term perspective provides us with the flexibility to wait until the markets become a little bit more attractive in our view and to avoid risks that we are not being properly compensated to take. T

First Eagle Global Income Builder Fund

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There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. These risks may be more pronounced with respect to investments in emerging markets.

Investments in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

The Fund invests in high yield securities (commonly known as "junk bonds") are generally considered speculative because they may be subject to greater levels of interest rate, credit (including issuer default) and liquidity risk than investment grade securities and may be subject to greater volatility. High yield, lower rated securities involve greater price volatility and present greater risks than high rated fixed income securities. High yield securities are rated lower than investment grade securities because there is greater possibility that the issuer may be unable to make interest and principal payments on those securities.

Bank loans are often less liquid than other types of debt instruments. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower's obligation, or that such collateral could be liquidated.

Income generation and dividends are not guaranteed. If dividend paying stocks in the Fund's portfolio stop paying or reduce dividends, the Fund's ability to generate income will be adversely affected.

Investment in gold and gold related investments present certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. Physical gold does not produce income.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

All investments involve the risk of loss.

The Global Value team defines "margin of safety" as the difference between a company's purchase price and our estimate of its intrinsic value.

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The holdings mentioned herein represent the following percentages of the total net assets of First Eagle Global Income Builder Fund as of 12/31/2017: Jardine Matheson 1.43%, Citgo 0.97%.

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INVESTMENT MANAGEMENT

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