



**Morningstar Video Transcript — December 16, 2010**  
**Interview with RS Portfolio Manager Larry Coats, RS Capital Appreciation Fund**  
**Jeremy Glaser, Morningstar, Mutual Fund Analyst**

**Jeremy Glaser:** For Morningstar.com, I'm Jeremy Glaser.

I'm very pleased today to be joined by Larry Coats. He is a co-portfolio manager of RS Capital Appreciation.

Larry, thanks so much for taking the time today.

**Larry Coats:** Absolutely.

**Glaser:** So first off, I want to talk to you little bit about how you think about risk management. I know that you run a very concentrated portfolio, a very high-conviction portfolio. How do you mitigate some of the risks of not owning a ton of different names?

**Coats:** The interesting thing about managing the high-conviction portfolio is that it requires that you have to be, as an investor, deliberate in every decision that you make. Not only the individual security selection, but the way you put those securities together in the portfolio.

So, when you look at the Capital Appreciation Fund that we manage at RS, it's interesting to note that though the portfolio is what some people might call highly concentrated, we view it as a high-conviction portfolio, it is still very diversified as we have exposure across sectors.

And more importantly, as we look at the risk management, we're focused not on the sectors or industries but the value change in the business lines themselves to make sure that we understand the risks that we're assuming in the security selection, in the price that we pay, and in the portfolio representation that we're taking in the portfolio.

**Glaser:** When you're looking at individual securities and looking at individual companies, how focused are you on the quality of the business and the competitive advantages that those businesses hold?

**Coats:** Jeremy, it's a great question. For us, it's all about advantaged businesses. Our goal is to find growing advantage businesses and then wait for the opportunity to buy them at attractive valuations.

So, our sieve, if you will, begins with this notion of advantages: competitive, structural, and economic advantages. It's interesting in that it somewhat relates to what Morningstar does on the equity side in its moat analysis, and if you look at the universe of companies that we've defined as advantaged businesses, the best of those--a 100% of them are in the moat category at Morningstar.

If you come to the good businesses, about 75% or 80% are in the moat category, and the better in the middle, they are still about 95% in that category. So, the universe that we are focused on is really, almost equivalent to the types of businesses that you are looking for at Morningstar when you look at the moat characterization. And what we find there is that there plenty of opportunities for us to buy growing advantaged businesses at very attractive valuations.

**Glaser:** One of the things that's been interesting for us in slicing the market by moats has been performance in that throughout the recovery the no-moat companies have just been beating the pants off of our narrow- and wide-moat, in performance, there has just been pretty big delta there. Is that something you've seen in the way that you slice the market?

**Coats:** We have seen some of that. If you look back in '08 and '09, interestingly enough '08 we were very fortunate in that the quality really performed well for us. In '09 we had somewhat of a separation from the pack in that the security selection we had really added value there.

So far this year, what we see is that our good businesses--in the category of good, better, best--our good businesses have actually outperformed the best businesses if you look at the universe.

In the last few weeks, we have seen some indication that perhaps there may be a shift there; ultimately it's our belief that growing advantaged businesses really will attract higher valuations, and there are plenty of opportunities right now.

**Glaser:** So, are there any specific names that you have recently picked up that you can talk to us about today?

**Coats:** In terms of names that we have recently picked up, one that you and I were talking about as we began this conversation was actually Coach.

It's not a new name to the portfolio. It's a long-standing name that we've had in the portfolio, but it's an excellent example of an advantaged business. Competitive advantage it has a brand; structural advantage in terms of its ability to segment its customers across various distribution channels. That's a brand that is both portable and scalable and it drives superior economics. We're talking about 30% operating profit margins on a business that generates in excess of 60% gross profit margins, with only 25% of its revenues outside of the U.S., but China being its fastest growth market right now, we see a significant amount of opportunity in the business, and we've been rewarded in the stock price as well.

**Glaser:** Coach is known as an aspirational brand. There's a lot of consumers who look to trade up to a Coach bag, to a Coach wallet, whatever it might be. How is that aspirational consumer been performing? Have they been maybe a little bit more hesitant to spend given all of the gloom and doom about employment and about income?

**Coats:** It's been really interesting to watch Coach, because you would have expected that to be the case. The reality is that the average ticket at Coach is about \$300. So when you consider it in the framework of affordable luxury, there's a significant amount of white space between that average \$300 ticket size and the average ticket for, say the classic European handbag companies, which are going to be around \$1,000 or \$1,200. So what we've actually found is that while you may view it as people moving up into the Coach brand, there has also been the opportunity for people to move *down* into the Coach brand as well.

When you consider that reach for the brand with also the opportunity they have to distribute through their retail stores as well as their factory stores, they have demonstrated that they can move up and down that scale and adapt with the market. And it's worked out extremely well for them, particularly over the last couple of years.

**Glaser:** You mentioned that China is one of the most important markets. How do you see the prospects of expanding into continental Europe, expanding into other international arenas?

**Coats:** They are expanding as we speak into continental Europe. They're working on a couple of joint ventures now. China is a rapidly growing market for them. They have exposure in Japan as well. Coach as a brand has demonstrated once again that it is portable in terms of its appeal, and the business model is scalable, which is a very powerful combination when you look at a relatively small platform from which they can grow. And we think that there's still a significant amount of opportunity for them to leverage that one-two punch of the brand and the scalable business model. So, you'll see in continental Europe, you'll see rapid growth in China; you'll see more measured growth in Europe. That's what we would expect.

**Glaser:** Larry, I want to thank you so much for speaking with me today.

**Coats:** It's my pleasure.

**Glaser:** For Morningstar.com, I'm Jeremy Glaser.

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