March 1, 2016 Interview of Jerry Dodson, Founder and CEO of The Parnassus Funds

Wednesday, March 1, in New York City, I interviewed Master Investor Jerome Dodson, CEO and founder of The Parnassus Funds. The Parnassus Funds under the leadership of Jerry Dodson have built one of the most impressive performance records in the investment business, generating superior returns over the last one, three, five, ten and twenty-five years. According to Barron's, the Parnassus Endeavor Fund is one of only four domestic stock funds to accomplish superior returns with such consistency. The fund has a five-year annual return of 17.8% versus 14.1% for the S&P 500.

The Parnassus funds have accomplished these returns following simple investment principles: invest in companies with exceptional long term profitability during periods of temporary adversity, or when the market is negative about the prospects of an entire sector, and focus on companies that are socially responsible, in particular that are good places to work, that treat their employees well. In part, this approach evolved out of studies of the investment performance of Fortune's list of the best 100 companies in the country to work for -- they outperformed the market by one to two percent, on average, consistently, over long periods. In our interview, I explored the investment principles behind the Endeavor Fund, as well as the individual holdings in the fund -- what positions Jerry feels best about, and which ones concern him.

Rod MacIver: What do you look for in potential investments?

Jerry Dodson: There are two crucial considerations. One, we look for companies that are out of favor, that are selling at low prices compared to their five-year historic average price to earnings, price to sales, price to cash flow, price to book value. The second thing we look for are companies that are good corporate citizens and that have good environmental policies. We look at charitable contributions. Most importantly, we look at how a company treats its employees. We try to invest in undervalued companies that we think are good citizens and that are socially responsible.

Rod MacIver: Average price earnings, price sale, price book over the last, what period of time?

Jerry Dodson: Five years. If the average five-year PE ratio is 15, and now the stock is selling at 14 or below, it's a candidate. If the average PE is 21, and now it is trading at 19, it is cheap on a relative basis.

Rod MacIver: I see. If it falls further ... let's say it falls 50% from where you buy it. You have been investing long enough that that must have happened at least a few times.

Jerry Dodson: Unfortunately, it has. Just because it is out-of-favor and trading at five year lows, doesn't mean it can't go lower. We look at it again to see if the fundamentals are still intact. We look at the qualitative; what Warren Buffett calls “moat”. Of course, we exclude certain areas: tobacco, alcohol, gambling, and, in my fund, fossil fuels.

Rod MacIver: How about military suppliers?

Jerry Dodson: There's a good question. Because we don't want to give the idea that we're anti-military. The military keeps America ...

Rod MacIver: You like living in America.

Jerry Dodson: Exactly! Safe and free! We don't want to invest in weapons manufacturers, which have a lot of different problems. If they're making, say, uniforms for the military, or they're selling canned foods or something like that, that's fine.

Rod MacIver: Yes. Okay, so if it falls, you look at it again, review it, and if the fundamentals appear reasonable and it's now down 50%, you buy more, and if it's not, you sell it, and move onto the next thing.

Jerry Dodson: Exactly.

Rod MacIver: Holding period, on average?

Jerry Dodson: The average is about three years, but of course it varies from time to time. Sometimes, it'll go up in a year and we sell it. Sometimes, we should have sold sooner and we didn't. For instance, Whole Foods. We bought in the low $30s. It promptly went to $60, but we'd held it less than a year so to take a capital gains tax, not an ordinary tax, we held on. Was that a mistake. It promptly plunged back, below where we originally bought it. That was within a year. Typically, you don't have that happen.

Rod MacIver: Would you ever hold a stock for decades?

Jerry Dodson: Not that long. We sell when a stock reaches what we calculate as intrinsic value. It's rare that we hold more than three or four years.

Rod MacIver: Yes, and it appears from what you've said, that you won't pay a premium for growth unless it's reflected in the historic five-year average PE, price book, price to sales, etc. Right? You wouldn't for instance, apply the Benjamin Graham valuation formula for growth stocks as outlined in the 1962 edition of *Security Analysis,* which proposes appropriate PE ratios for companies based on historic growth rates. They range from nine to 48.4 basically. He's looking at historic growth rates, but not looking at historic PE ratios. Your approach is fascinating to me. That's why I'm re-exploring it. Of course, the most standard, widely used, difficult to use well ratio, is the PEG ratio. Price earnings to growth, so if a company is growing at 10%, the PEG ratio is ten times. If it's growing at 50%, then the appropriate PE ratio is 50, according to the theory. That doesn't enter into your analysis, correct?

Jerry Dodson: No, the PEG ratio is interesting and we do take it into consideration. It's not one of the main ones. It's a little tricky sometimes. If it's a faster growing company, it makes sense to pay a higher PE. We look at the PEG ratio in conjunction with the historical PE ratio. If you take the last five-year average PE ratio, it's implicitly taking into account the five-year growth. The PEG ratio takes it in more explicitly, so it's also useful.

Rod MacIver: Would highly-cyclical companies fit your model? They're cheapest when their PE ratio is highest. That is, when they have little or no earnings at the bottom of the cycle.

Jerry Dodson: We do consider cyclical companies. For example, two of the companies you're going to ask me about are Applied Materials and Lam Research.

Applied Materials is on your list of companies both with strong trends and that is undervalued. The reason why Applied Materials looks undervalued is because their earnings have been growing rapidly. But the company is very cyclical. We're selling Applied Materials because device manufacturers are trying to buy new equipment, driving earnings up. But it can turn very quickly. We like the company, but it's cyclical, so you've got to watch it very carefully.

Other companies that your analysis indicates are undervalued are Micron Technology and Lam Research. They are also cyclical. We like them, but you have to buy them right. It's very rare that we hold them for three years because you never know when the cycle will turn. We know, given their earnings and where the stock has come from, that they've probably reached its peak.

Rod MacIver: Lam has?

Jerry Dodson: Lam and Applied Materials, we think. Applied is selling for something like 36 dollars. We paid $16 a share in July 2015. It's now somewhere around $37, so it's more than doubled. The PE ratio looks low because the earnings are peak earnings. That's tricky. So although your analysis indicates that the company has strong trends and is undervalued, that is based on peak earnings. We think it's reached its intrinsic value.

Rod MacIver: I'm saying it's worth about forty dollars a share.

Jerry Dodson: You're probably close, but sometimes we don't want to wait with a cyclical company to get the last three or four dollars out of it.

Rod MacIver: Sure. Lam Research, I'm saying, is significantly undervalued. I'm saying it has a value of $256. What is your thought on that Jerry?

Jerry Dodson: Lamb Research is now at $118 dollars. You're saying it's worth double that?

Rod MacIver: I'm saying it's worth $256 so it's selling at 46% of my estimate of value, and you're thinking because it's cyclical and I'm using peak earnings, that I'm likely high on that.

Jerry Dodson: That's what I'm saying. You're saying 250, I'm saying maybe 140. The next twelve month earnings are going to look great because of the peak earnings, but when their customers stop ordering equipment, the cycle turns really fast. The book-to-bill ratio can swing from 1.5 which is strong, to maybe 0.7 in one or two quarters. You need to know the nature of the company. The exercise you're doing is useful, but then you've gotta look beyond that, into the company's history and the past. That's our viewpoint on that one.

Rod MacIver: How much, if any role, does current dividend yield versus long term average dividend yield play in your analysis?

Jerry Dodson: In the Endeavor Fund, it does not play a part. In the Parnassus Core Equity Fund, which is another fund of ours, actually our largest fund, dividend plays a big role. Eighty percent of the portfolio has to have a dividend. It's sometimes tricky trying to take a dividend yield and say it's fully valued and so forth, but it's an important element.

Rod MacIver: I'm interested in dividends, like anybody, but I use it as a value method as opposed to ...

Jerry Dodson: If it has a high yield, then it's more interesting to you?

Rod MacIver: If the average yield over the last 15 years is 2% and now it's yielding 3%, then that's one of four approaches to value that I use. I'm using dividend yield in a somewhat similar way to the way that you are using PE ratios.

Jerry Dodson: As a first crack, that's very useful. Sometimes though, the dividend can change. As a screening tool, I would agree with you. They do that in the Core Equity Fund. A higher-than-average dividend yield is one signal that a company is a candidate for purchase.

Rod MacIver: What do you find most challenging about investing? What's most difficult?

Jerry Dodson: When a stock goes down, you have to make a judgment on whether that decline is permanent or temporary. Right now, I'm wrestling with Whole Foods. It sold at PE ratios continuously above 18. Strong growth, great company. Now, for the first time, it's selling at a relatively low PE ratio. A lot of competition. Other companies are offering natural foods. Kroger's, even WalMart. So I'm trying to decide what to do with Whole Foods. Has the PE ratio permanently changed? Is it no longer a high growth company? If it isn't, it's overvalued.

Or, is it going to come back the way it was? That decision is the most difficult one we face.

Rod MacIver: I noticed that what I call its rate of fundamental change is actually negative 16, and it's trading at what I have as a 50% premium to net asset value. I think you and I might be in agreement on that one.

You've offered your thoughts on what's most challenging, that is what to do when a stock goes down significantly. I guess when it goes up significantly that's challenging too, right? It's all challenging. Investing is challenging!

Jerry Dodson: Do you sell because it's reached what you estimated to be a company's intrinsic value, or has the intrinsic value increased over time? For instance, Alphabet, formerly Google. With all the advantages that company has, and the moat that it has, I should have held on. That's sort of the opposite of the Whole Foods question.

We still like it. We paid about $700 a share and now it's $850. We thought the intrinsic value was about $850 but now we've changed our mind and we think the intrinsic value is about $950. It could be more, depending on the earnings.

Rod MacIver: Sure, a dominant position in a growing market.

Jerry Dodson: They have put a lot of money into things that aren't generating much in the way of earnings, but if one of them does well, it would push the value higher.

Rod MacIver: They seem to look far into the future and put a lot of money into projects that will take ten or twenty years to generate high returns, if at all. If the projects work out, it could be phenomenal ...

Jerry Dodson: Like the self-driving car, what's going to happen with that? I have no idea whether that's going to pay off or not. If it does, it could be substantial.

Rod MacIver: Absolutely.

Jerry Dodson: Now they're suing Uber because one of their engineers left and is working with Uber now, so there's a huge controversy. People think that self-driving is going to be an important aspect of Alphabet.

Rod MacIver: What do you enjoy most about investing? Why do you do it? Why is this your chosen profession?

Jerry Dodson: I like it because of the intellectual challenge. I'm fascinated by businesses, by what makes them profitable, by how they operate, by the management. For me, it's very fascinating. It's like reading good novels when you study businesses. I think that's really the biggest challenge for me. It's interesting.

Of course, from a personal standpoint, it enables me to have a very comfortable lifestyle. Making money is important, but the way of doing it is very interesting. I never get bored. Each company is its own challenge -- understanding the marketing, finance, the other aspects of the business. I think is very interesting.

Rod MacIver: Before I turned on the tape, you mentioned that you meet with management. How important is that in your analytical process? Your impression of them as people, as human beings, as executives, as businessmen or women?

Jerry Dodson: Very important. You can learn a lot just by reading the material, the 10K or the annual report or articles written in the press. You consider all that, but sometimes when you meet the CEO, you have a different impression. They're usually pretty unusual people. Meeting a CEO, gives you a good understanding. How they answer a question is important.

For example, from the social or environmental responsibility standpoint, no company is going to say, "Oh, we don't take the environment into account, or we don't treat our employees well." No one is going to say that. The way you ask questions, is important. "Is such and such a good place to work?" If they say, "Yes," you say, "Why?" If they give really concrete examples with a ring of authenticity, that's a plus. Same thing with their environmental policy or any other aspect. You can learn lot just by how they answer questions.

Rod MacIver: I've never been good at that. I tend to do better if I don't meet management. I'm too easily drawn into people, especially charismatic people.

Jerry Dodson: We all are! We all are. That's happened to me before too. CEOs are often very charismatic. They say that they're going to do everything, and it turns out they didn't do much. So you get to know the numbers and you think it through. But it's still very worthwhile to meet them.

Rod MacIver: I imagine that a lot of these companies you have researched or invested in over the last thirty years. That must help a lot. You have a history with them, you've known them and followed them either in a close or loose way for a long period of time. That must be an advantage.

Jerry Dodson: It is, because I've been doing this for 32 years. You can discount some of the charisma, let's say. Charisma is usually good as a leadership quality, but when they start to articulate ideas, do they make sense?

Rod MacIver: In Buffet's early career, he was very focused on competitive advantage. I think looking at his portfolio now, he's more trying to figure out what to do with all that money. His quality standards have gone down a little, but I wonder how important moat is to you, or what is sometimes called an unfair advantage or a competitive advantage? What percentage of the companies that are in your funds have a distinct, important advantage over their competitors?

Jerry Dodson: We have both wide moat and narrow moat companies. Sometimes the narrow moat can be cyclical. Micron Technology is a very good example. They make D-rams, Dynamic Random Access Memory Chips. They make Nand chips, which are essentially commodities. Anybody can make those. Their moat is very narrow, but they do have economies of scale. That's a very narrow advantage. You have to watch companies like that because is there is a lot of potential competition. The companies in our portfolios may have a narrow moat, or even no moat. You have to be much more careful with the narrow moat than the wide moat.

Rod MacIver: Okay, but it's not an overriding determining factor in whether you'll get in or not, into a company or not.

Jerry Dodson: We prefer all wide moats, of course, but we can't find that many. The wide moat may be selling at such a high valuation it doesn't make sense.

Rod MacIver: Where is Micron Technologies in the cycle right now?

Jerry Dodson: Okay, that's a good question.

Rod MacIver: It has the weakest trends of any company in your portfolio.

Jerry Dodson: I notice you also have ADS in there, you've got Apple in there, you've got Qualcomm and you have Auto Desk according to your email.

Rod MacIver: Those are the weakest financial trends, yes, of any of the companies in your portfolio.

Jerry Dodson: When you define weakest trends, what are you talking about?

Rod MacIver: I look at margins, capital turnover, liquidity, leverage, and growth. Sixty percent of the conclusion is from trailing 12 months versus prior 12 months. Twenty percent of the emphasis is on the latest quarter versus the same quarter a year ago. Then the final 20% is five-year trend versus the prior five years. Margins and capital turnover, which are ultimately reflected in return on capital, would be about 15% of the total calculation. So when I say these companies have weak trends, I mean they have weak return on asset trends. You had described Micron as a cyclical company, and I'm wondering where it is in the cycle right now.

Jerry Dodson: It is not as far along as the equipment companies, Lam and Applied Materials. Micron is cyclical, but it won't turn quite as fast as the equipment companies. We paid $10.80 for Micron. It's now trading at $24. Our initial stab at intrinsic value was at $24, so that would mean that it's fully valued. I'm undergoing the process now of trying to establish a new level. I'm thinking it could go into the low $30s. Both DRAM and Nand markets have changed. They used to have seven or eight major competitors but there's been a lot of consolidation in the industry, so they're not going to have a price war that you otherwise might get with a commodity product.

Samsung is still one of its main competitors, but they have some other issues going on. They're probably not going to increase their production of semiconductors. I think Micron will probably go higher now. Probably into the low 30s, so I'm hanging on.

Rod MacIver: I'm quite interested in any thoughts you'd be willing to share on ADS. Alliance Data Systems Corp.

Jerry Dodson: It's essentially a credit card outsourcing company. They serve medium size credit card companies. Companies that want to offer credit cards for marketing purposes, and want to offer premiums. They devise various programs and plans to do that. We think that most credit card companies don't know how to take advantage of the potential of their portfolio. ADS has a good formula.

ADS is somewhat similar to American Express. For ADS, we paid $212 dollars in September of 2016. It's now about $240, more or less. We've done reasonably well in it, and we think there's more upside.

Rod MacIver: The financial performance, of course, of American Express is superior to ADS. For companies in somewhat similar business, American Express is much more stable, according to my numbers.

Jerry Dodson: Yes, American Express has a superior brand. Even though it's had trouble with Costco accounts and with other competition, basically, they have a great name. It used to be a really strong moat. Now it's halfway between a strong and a narrow moat. I don't know where on this continuum it is, but it's somewhere in that range.

Rod MacIver: Jeff Ubben says, according to panels he's been on that are on YouTube, that he looks for companies with potential that are not totally lost and total basket cases, but are kind of meandering along without a clear vision or purpose. He can bring something to the table in terms of an outside perspective that management will listen to if he delivers it in a gentle as opposed to aggressive way.

He's saying, I think, by his position in ADS, unless it's totally passive, that there's potential there that he can help shape and positively influence. Do you have any thoughts on that?

Jerry Dodson: Jeff Ubben was a big investor in the pharmaceutical company Valeant. He got killed. The company tried to use financial engineering. They bought companies rather than did pharmaceutical research and a downward spiral developed. There's nothing you can do if, fundamentally, the business is not there.

Rod MacIver: You don't, for instance, say that Carl Icahn or Jeff Ubben are smart guys and they're going to shake things up a little and so I'm getting in because they're in. That's not an element one way or another in your analysis?

Jerry Dodson: Not for us, no. They are smart, I agree they've made some money, but that's not what we look for.

Rod MacIver: I believe on the phone you mentioned Charles Schwab. I can't remember exactly what you said, but my vague memory is something to the effect that you were concerned about it. Do I have that wrong Jerry?

Jerry Dodson: I think the only thing I may have mentioned is it's getting close to its intrinsic value, but we haven't sold. We still like the company. If interest rates go higher, Schwab will go higher. On the other hand, I've been wrong on interest rates for at least 18 months. We haven't had much inflation ... More of Schwab's income comes from interest than from brokerage transactions, which is interesting. It's more like a bank than it is a discount brokerage firm. They do make money from their discount brokerage business, but they're very sensitive to interest rates.

We paid about $24 a share for Schwab. We think it's worth somewhere in the low to mid 40s, which is where it is now. If interest rates go up, they could go above $50 dollars a share. Some of that is already built into the stock. It's close to its intrinsic value but we don't know exactly how close without knowing what interest rates are going to do.

Rod MacIver: How sensitive is Charles Schwab to increasing interest rates? If the ten-year T-bill went to 6%, would it double earnings? Would it triple earnings? Would the stock double? Triple?

Jerry Dodson: Probably not double. Excuse me, probably not triple. It would be somewhere between 30 to 90 percent, probably. They earn a lot in the overnight market – money on deposit from individual investors.

Rod MacIver: They're sticking it to us, are they?

Jerry Dodson: They pay you a quarter of one percent. They're not getting that much themselves. If they were to lend out at six or seven percent, and they could take money in at maybe two or three percent, that's a huge risk-free margin. But interest rates may not go to 6%. I don't know. If they do, Schwab is in the money, and we'd hang on until we thought it was fully valued.

Rod MacIver: I don't believe current rates are sustainable, especially ...

Jerry Dodson: They have to go up, but I've been saying that for two years. I've been wrong for two years. Eventually they've got to go up, right? But can they stay up?

Rod MacIver: Trump's only been there for a month, he hasn't really built any roads or any walls. He hasn't cut taxes ...

Jerry Dodson: If he starts that, you're right. I still say interest rates are going up in 2017, but I just want to point out I said that two years ago.

Rod MacIver: Okay, all right.

Rod MacIver: Of the companies in your portfolio, what are you most optimistic about? What do you think has the most investment potential and exciting future?

Jerry Dodson: Well, one you mentioned here already: Gilead Sciences. Right now, I look pretty bad. I think that's maybe one of the only positions in the portfolio that is trading below what I paid, about $76 a share. It's now slightly below $70. You say it is the most undervalued company in my portfolio. I agree with you. By far its the most undervalued. It's trading at a PE ratio of 7. A 7 PE ratio sounds incredible, right? The problem is the E is earned from two medicines. One treats HIV, the other is Hepatitis C. With HIV, there's no cure, so a patient uses it for life. They are curing people with Hepatitis C. Which is good! That's a positive! Eventually, these drugs will cure most of the people with the disease, and there will be no one left to buy the medicine. That's why the earnings will go down, and that's why the PE ratio looks so low. Why am I holding a company with earnings that are going down? When demand for Hepatitis C drugs is declining?

Gilead has a huge cash balance from all the money they've made. I think they'll make a major pharmaceutical acquisition. They also have a very good pharmaceutical research program. I know the management; I think they're going to come up with something. Maybe not a blockbuster like the HEP C or HIV drugs, but they will come up with something, or buy a drug or company and develop the acquired drugs further. I have no evidence of that, but it's in the nature of Gilead. I know the company, so I think it's going to happen. I think it is the most undervalued company in my portfolio, but for a reason. And I could be wrong. If I'm wrong, I've lost some money in this one.

Rod MacIver: At current prices, do you consider it risky?

Jerry Dodson: No. At current prices, I think it's absolutely on the bottom, on the floor. But there's no reason it can't go down even more. Even though it's undervalued, it could meander down to the mid 60s. I think people are discounting the Hepatitis C drug -- they're assuming that nothing is going to replace it. That's the only way you can come up with the current value. There will always be some demand for the Hepatitis C drugs... I think there is opportunity there or I wouldn't have 7% of my portfolio in the company. Rarely do I own more than 5% in any one company.

Rod MacIver: If that's the position that you see as having the greatest potential, and I know you're saying it has risk too, but if that has the greatest potential which one are you most worried about? Which is the one that when you wake up at three in the morning you think why the hell ...

Jerry Dodson: Oh, which company?

Rod MacIver: Yes, Which one are you most concerned about? Which one do you think has the poorest risk reward ratio? Would it be Whole Foods?

Jerry Dodson: Probably Whole Foods because their market has changed so much. Before they had a huge competitive advantage. At its current price, the stock is not as risky, but I think it may be permanently mired if their competitive advantage is lost. It's a great place to work, they give great benefits to their staff, they get profit sharing, they cover all of their employees with health insurance. Great company, so they meet all of our social and environmental requirements. But can they keep their growth premium? If you think the sales are going to basically stay where they are now with very small growth, the current price is right. In which case, not only am I not going to make any money, but I'll lose a little. I guess that's the position I'm most concerned about because I'd expected it to come back by now and start growing again. And it hasn't.

Rod MacIver: Do macro considerations or thinking or politics, someone like Trump, does any of that enter into the degree of caution or aggressiveness you have in investing?

Jerry Dodson: It's tough to get a handle on Trump, because I have no idea what he's going to do.

Rod MacIver: He doesn't know what he's going to do!

Jerry Dodson: I know!

Rod MacIver: He makes it up as he goes along.

Jerry Dodson: But some of the things he says are actually good. If you lower the corporate tax rate -- we have the highest corporate tax rate of any developed country in the world -- it’s about 36%, which is huge. If he cuts that back to 20%, that's great. That's really an A+.

If he does some of the stupid things he's talked about, like building a wall with Mexico -- I can't imagine a dumber thing to do. The Mexicans are not a major problem for us. They contribute to the economy, they're usually law-abiding people, they come and they work hard. California, our state would shut down if all of the undocumented workers were sent home. New York City would shut down, the entire state of California would shut down. Why would you chase these people away? If they have a clean criminal record, I want to legalize them. They're good law-abiding citizens.

If he goes after the Chinese or after the Mexicans it's going to be a disaster! It's going to be horrible for us. Are cooler heads going to prevail in the Trump administration, or is he going to do those dumb things he's talking about?

Rod MacIver: Don't you think that his policies are very likely to be inflationary and lead to higher interest rates? Reduce taxes, major infrastructure spending. Wages have to go up. At my local Home Depot store, in order to hire people, they have to put out a desk with balloons and things on it. Where are they going to get the people to build all these roads and hospitals and airports and where’s he going to get the money without borrowing it? Won't it increase wages substantially?

Jerry Dodson: Some of that is good though. The middle class, the working people, haven't had enough of an increase. Some of that is good ...

Rod MacIver: Good or bad, it's inflationary or do you disagree with that?

Jerry Dodson: Well, you would think so. Look, we've had low interest rates since ‘09. Rock bottom. Sometimes close to zero. Inflation hasn't taken off. Inflation is way below 2%, probably below 1% depending upon the way you calculate it. Inflation hasn't really been a problem, so that must mean that we have extra capacity to grow without inflation. At some point, you're going to be right, but we may not have hit that yet. I think more money going to the middle class would actually help, because they'd spend more and that's good. At some point if we have too much of that, you're right. Inflation will take hold. It will take a while though for that to build up.

I can't go to all cash in my portfolio.

Rod MacIver: You're paid to invest regardless of the circumstances. You have a reasonable cash position though, if my memory is correct, it's about 15%, although I may be out a little bit. I look at a lot of portfolios.

Jerry Dodson: You are right, but there are reasons for that. The money is coming into my fund so fast that I can't invest it. The stock market, by any reasonable measurement, is fully valued. The PE ratio of the market, not forward looking but the actual, is over 21. That's a high PE ratio. You gotta say that as a whole the market is fully valued. I only invest in undervalued companies, and right now I'm having a hard time finding them. That's why I only have 30 companies in the portfolio. I'd love to have 40.

Rod MacIver: Is forty the target?

Jerry Dodson: Forty is the target.

Rod MacIver: Do you ever have 60?

Jerry Dodson: Very rarely, because forty is probably all I can focus on.

Rod MacIver: How about twenty? Do you ever have twenty?

Jerry Dodson: I haven't had that low. I've been in the mid 20s when I couldn't find anything and money was coming in. Now I'm just under 30.

Rod MacIver: What would be the maximum cash position that you would have in extreme circumstances?

Jerry Dodson: Legally, I could only go to 20%. That's the SEC regulation.

Rod MacIver: Is that for all mutual funds?

Jerry Dodson: No, depends on whether you're a diversified fund or the name of the fund. There are some arcane rules. In the Parnassus Fund years ago, I went to forty or fifty percent cash. This was when the market was fully valued in '03. As the market kept going higher, and I was mostly in cash, I underperformed. Some of the worst relative performance I ever had.

Rod MacIver: Warren Buffet had the same problem.

Jerry Dodson: Yes. Now I don't try and time the market. I don't think it's possible. At least I can't do it. Some people can. I just think ...

Rod MacIver: You don't subscribe to the Elliot Wave Theory?

Jerry Dodson: I got killed and I learned my lesson. That's it, no more. That was fifteen years ago. Now, I just try to find a good company that I think is undervalued. When the money comes rushing in like it is now, though it's tough finding companies that are undervalued. The average PE of companies in our portfolio is 14. We're still low on a relative basis.

Rod MacIver: That's the long-term average of the market, isn't it, roughly 14?

Jerry Dodson: Fourteen or fifteen, yes. That's the long-term average. When the market as a whole is about 21, it makes a difference. Even the forward PE is about 18, which is high.

Rod MacIver: Is there anything that we have not talked about that you would attribute your strong long term performance to?

Jerry Dodson: One thing is emotional stability. When I buy a company that's going down, there's always a reason. You have to be able to buy when a company goes down a lot. You can't always buy at the bottom. It's hard to do. Even myself, although I've been doing this for a long time, I worry about almost every company that I buy because I think it can go down even further. I have to be completely rational, steel my emotions, and buy. That accounts for a lot of my over-performance.

It's nothing to do with intelligence. It's the ability to focus and use common sense and put your emotions aside. I think that's one of the hardest things to do. Somebody can say, "Oh yeah, I buy when it's low." It's harder to do than people think. You have to determine whether the decline is temporary or permanent. Like with my Whole Foods example.

Also, the ESG factors -- the environmental, social, corporate governance –- people used to say, "Oh yeah, that's a negative, you're not going to do well with those kinds of companies." For me, it's been very positive.

A friend of mine writes the book called *The One Hundred Best Companies to Work for in America*. He started about 30 some years ago, and then it was picked up by Fortune and Fortune now features those companies once a year. After he'd been doing this ten years for Fortune, he called me and said, "Guess who I had a call from?" I said, "Who?" He said, "Russell Associates up in Washington state. They did an analysis of every company every year that appeared in the Fortune magazine's 100 best places to work and those stocks beat the S&P 500 by one to two percent per year." Not many money managers can do that. In fact, 85% can't do that.

I said, "That's interesting. A great place to work contributes to the stock price." He suggested I start a fund focused just on companies in the Fortune 100 best places to work. I knew he was on to something, but I decided to add other companies that met the requirements, but that weren't named in the Fortune 100 because they don't want to go through the application process. He said, "No, don't do that. That will just ruin things. We know if you just stick to the Fortune 100, the publicly traded part of the Fortune 100, it's going to do well. Just do that and don't do anything else!"

Yeah, so I said, "Okay, tell you what Milton, I'm going to include other companies, not just the ones from the 100 best, and after a while we'll do a side-by-side analysis. We'll compare the Endeavor Fund -- at that time it was called the

Workplace Fund -- to the 100 best." Within three years, it was clear that quarter after quarter after quarter the fund beat the 100 best. In addition to being a great place to work, you need to do the financial analysis. You need to say, "Okay, is it overvalued? Does it have too much debt? Is there a moat?" All of these things that we talked about earlier. That makes a difference.

That's how that Endeavor Fund got started.

Rod MacIver: What percentage of the companies in your portfolio are actually in the Fortune 100?

Jerry Dodson: Right now, it's about 25%. It varies from time to time, but it's usually not the majority.

Rod MacIver: If the average PE ratio of companies in your portfolio is about two thirds of the market, and the average five-year return on equity of the companies in your portfolio is in the top 25% of all public companies, which it appears to be from my analysis, could you simplify your whole investment process just by using those two criteria, and achieve the same results. Just invest in high return-on-equity companies when they are trading at a substantial discount to their long-term average PE? You'd have some big winners and some big losers, but do you think you could achieve as good or better returns by simplifying it down to that?

Jerry Dodson: What you're saying would come close to duplicating the history and the performance of the Parnassus Endeavor Fund, it's true. We look at it in a somewhat different way, but you come out almost at the same place. To make it into our portfolio, a company has to have either 15% return on equity, or we think it could reach 15%. If it doesn't, or can't, we won't invest.

We look at the five years and we see the trend. If it earned 15% five years ago and then it goes down, let's say, it goes from 13% to 12%, to 11%, that won't work. But if it started at ten and then went to 11%, then 12%, and the trend is upward, and it looks as if it might hit 15%, then we would invest. There's judgment involved, but return on equity is very important.

But yes, you're right. If you just invested in companies that had the highest return on equity and the lowest PE, you would come close to doing what the Endeavor Fund is doing, leaving aside the social and environmental factors.

Rod MacIver: How about Perrigo? We haven't talked about that at all. When I look at these companies, it's one of the few with a very low average return on equity and capital.

Jerry Dodson: What are you getting return on equity there?

Rod MacIver: I have here five-year average of 5%. Is that inaccurate?

Jerry Dodson: It is hard to determine the real return on equity for that company because of the changes that the company has gone though. But if there's one company that I'm more concerned about than Whole Foods, it's Perrigo. You use Perrigo products all the time, I'm sure, even though you don't know what they are.

Rod MacIver: I have no idea.

Jerry Dodson: When you go into the Walgreen's or whatever drug store, and buy an antihistamine, it will have the store brand on it, it will have Walgreen's, it will have Duane Reade or something like that. Perrigo makes that, and they make many similar products.

They were trading at $200 dollars a share. Teva Pharmaceuticals tried to take them over. I didn't sell. Mistake. I liked the product, I think I paid in the 90s, and it's now in the 70s. That is one I'm concerned about. I think they have a moat because they're selling the store brands. It's a narrow moat, but nevertheless it's a moat.

I think Perrigo has hit bottom almost like Gilead Sciences. That's my take, anyway.

Rod MacIver: Ciena?

Jerry Dodson: Ciena makes equipment for use in long distance as well as domestic phones. Their customers are AT&T, Verizon, all the major telecoms. They make the equipment that sends the impulse along the phone lines, underwater a thousand miles. They're in Maryland. They're a relatively high tech company.

We've done reasonably well in the stock, but I expected that we would do better. Because they've got a very few customers, they don't have the pricing power that I would expect for such a valuable product.

I don't think it's reached a 15% return in equity. Do you have it? I don't have it.

Rod MacIver: I'm concerned that my number is incorrect here. I have a long term return on capital of only 2% and an average five-year return on equity of negative 11%. Trailing 12 months I have positive 9.

Jerry Dodson: There's some strange things about the company. ... There's a huge restructuring going on. They used to sell a lot of equipment.

Rod MacIver: So they've been writing off assets and restructuring ...

Jerry Dodson: Exactly. Some companies like Perrigo and Ciena, you can't go by the financials. Most of them you can, and so I have to adjust. That's one I've adjusted for. It still isn't hitting 15% return on equity, but what is the E? They've had mergers, they've bought a lot of Nortel's former businesses, which is a Canadian firm that went bust. You can't go by the accounting.

That happens maybe one out of every fifteen companies The accounting is a good place to start, but you have to adjust it. That's what I've done with Ciena.

Okay great. This was a good discussion and I'll look forward to your article.

Rod MacIver: Great, I'll send it to you.