PROSPECTIVE
VALUE PARTNERS
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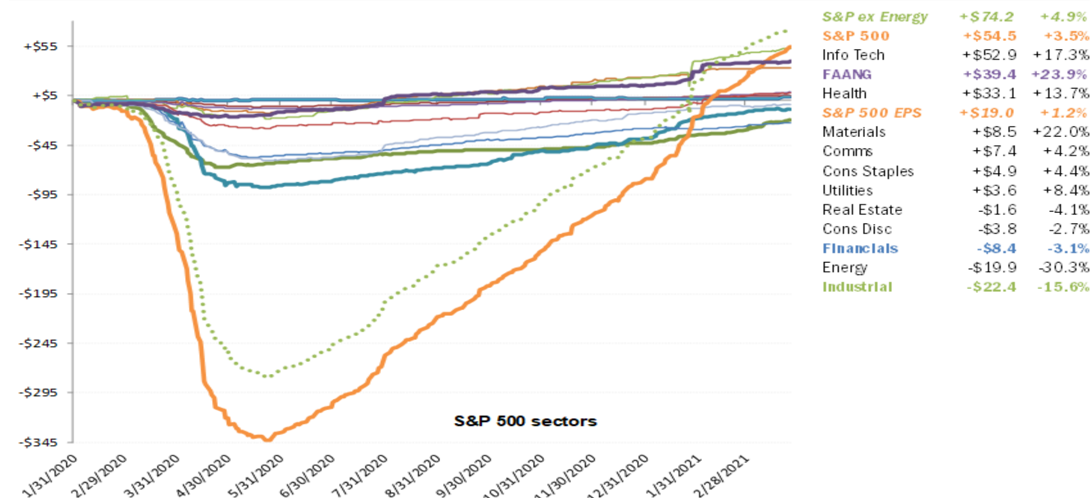
April 2021

Dear PVP partners and friends

The momentum in the equity market continued in the quarter as post pandemic "normalcy" comes closer into view, with an acceleration of the pace of vaccine rollout (and new vaccines from Johnson & Johnson and Oxford/AstraZeneca), case counts and fatalities thankfully declining, businesses everywhere reopening, and thus an increasingly "normal" economic environment. While we have not yet completely killed off covid, experts now believe we will probably achieve "herd immunity" in the US this quarter.

At the same time, another very large tranche (almost $2 trillion) of **fiscal stimulus** has arrived (making the total an astonishing $5 trillion in the past year)[1], while **monetary policy also remains extremely accommodating.** Meanwhile, corporations have generally done a surprisingly good job of adapting to the situation, so in recent quarters the **vast majority of our companies have been exceeding expectations** and also guiding future revenues and profits higher than had been expected. As shown in the chart below, Wall Street projections have followed, so whereas not long ago the market only dreamed of 2021 profits matching those of 2019 after the "dip" of 2020, today they are expected to significantly exceed 2019 – and those expectations continue to grow!

The Covid-2019 earnings dip... and now the turnaround
365-day forward consensus earnings, change from January 31, 2019, S&P 500 peak, USD billions

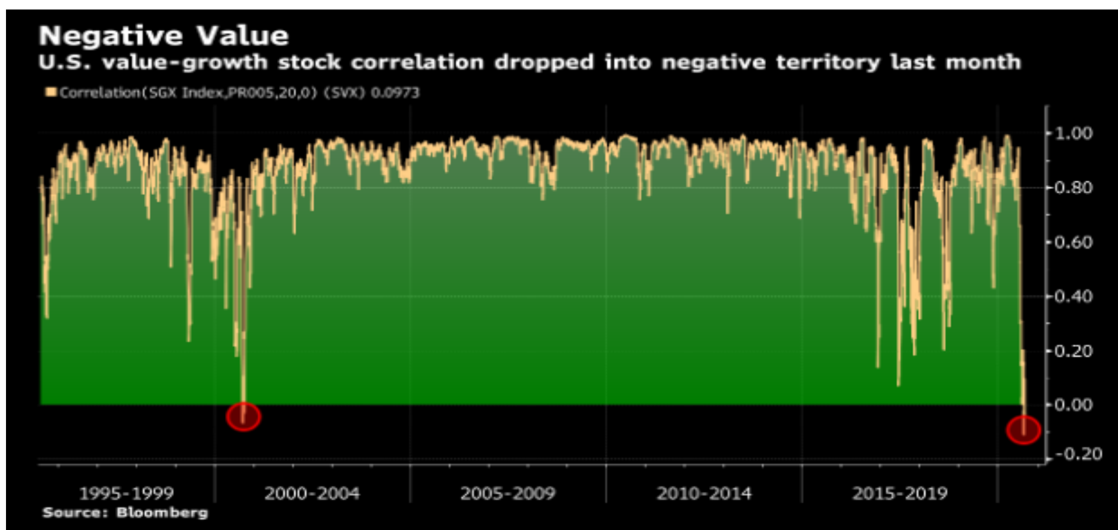


[1] *Consider that the entire cumulative US federal debt, from 1787 through 2008, was about $10 trillion. By the end of 2020 it had grown to about $27 trillion.*

Also, of particular importance to your portfolio, the **transition from growth to value leadership continued** in the quarter. [2] During the dark days of the pandemic, technology stocks were viewed not only as "safe havens" but also as beneficiaries of the pandemic as work became overwhelmingly remote. (I for one had never even heard of a Zoom call until last February, and now I seem to have several daily.) These factors served to accelerate the tech/growth leadership that had been entrenched since 2009 (the longest period of such style leadership on record).

But **in September things started to change very quickly, as the equity market began to anticipate an eventual recovery**. Since then the so-called "epicenter" stocks (the cyclical sectors hit hardest by covid -- such as financials, industrials and basic materials) have significantly outperformed technology and other sectors that were less affected by (or even benefited from) the pandemic.

In fact, not only has value begun to significantly outperform growth, but the two styles have even developed a *negative* correlation. In other words, whereas generally when growth is up a lot, value stocks are still up, and vice versa; however, recently growth has actually gone negative when value is very strong. As shown in the chart below, a negative correlation between growth and value does not happen very often, but when it does it tends to suggest major market changes, such as the bursting of the dotcom bubble in 2000.



There are multiple reasons for this "regime change". First, the cyclical (value) sectors most affected by covid starting in Spring 2020 were like a coiled spring. Profits were severely impacted in most cases, and disappeared entirely in many cases. In some cases, as in the sectors dependent on travel and entertainment, the very survival of companies and even entire industries was in jeopardy. So **naturally, as investors began to look through the end of this global nightmare these industries had the greatest potential to bounce back.** As per the graph below, the companies with the highest short interest (the most bearish bets) during the crisis have performed the best recently, while those with the lowest short interest have underperformed.

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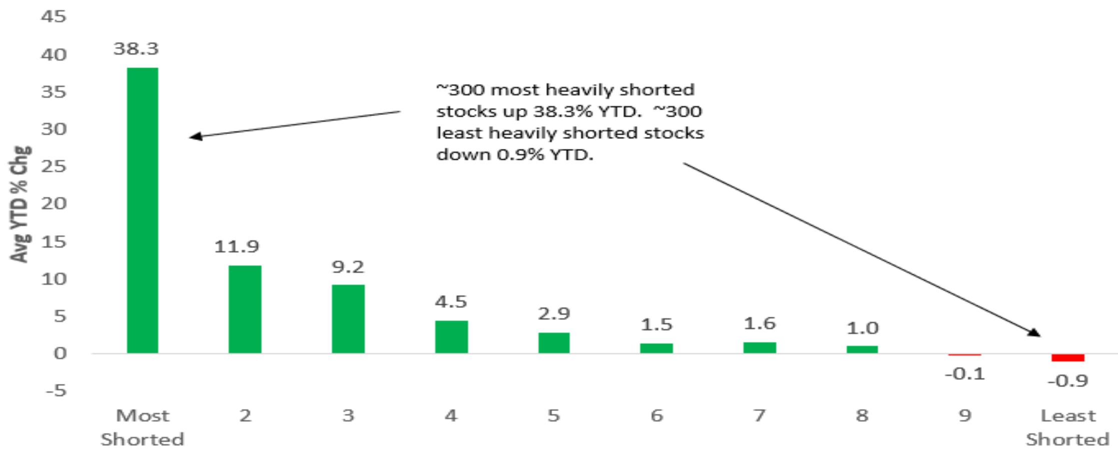
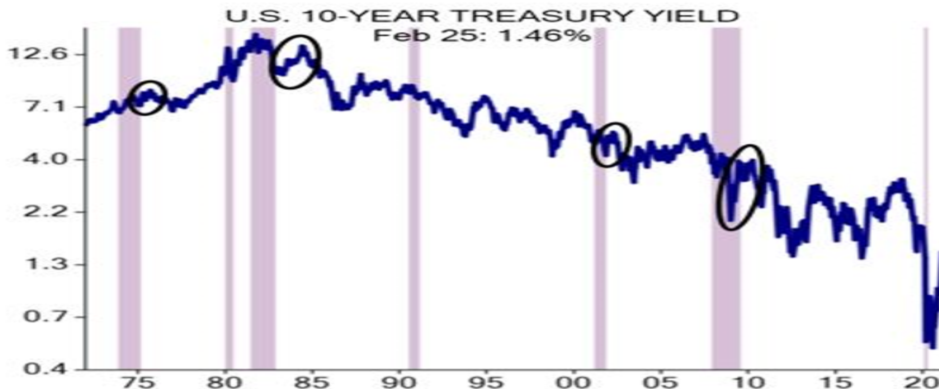
[2] *In 1Q21 the Russell 3000 Value was up 11.9%, vs. 1.2% for the Russell 3000 Growth.*



Moreover, **longer term interest rates began to rise**, not only on account of economic growth expectations but also due to inflation expectations. Higher longer term rates generally help the biggest "value" sector (financials), while at the same time rendering "growth" stocks less attractive, since their prospective cash flows must be discounted back to the present at higher rates. The cash flows of value stocks, on the other hand, are less affected by the rise in long term rates, since they tend to be generated closer to the present. The chart below shows a fifty year history of the 10 year US Treasury Bill. Since the yield peaked in 1981, until very recently it has dropped fairly consistently – *for forty years*! This is one major reason why stocks have also done quite well in this time period.

On the bottom right of the graph, however, we can see a **very sharp recent upward rise – albeit off a very low level.** In the quarter the 30 year UST rose from 1.65% to 2.41%. So holders of long term US Treasury bonds were down significantly this quarter. In the case of the broadly popular ETF "TLT", which owns 20+ year Treasuries, for instance, investors were down 14% in the quarter – a harsh reminder that even "safe havens" don't always behave that way. Since short term rates remained relatively steady, this also means the yield curve steepened significantly – an indication of expectations for both healthy economic growth and also inflation.



In terms of politics, the early January Senate runoffs in Georgia were a surprise to us and many others, with the Democratic candidates winning both of those races, creating a 50-50 split in the US Senate and effective Democratic control (with the Vice President casting the deciding ballot). The equity market response was also surprising to us in being both generally quite positive and also further accelerating the shift from growth to value leadership, on the premise that President Biden, with his fellow Democrats now in control of both the House and Senate – albeit barely – would be more likely to push through more of the fiscal stimulus/infrastructure spend/etc. that the market craves so much.

For now the market is mostly ignoring not only the rise in rates (which compresses the Equity Risk Premium) but also the medium/longer term implications for equities of Democratic control of the executive and both legislative branches, such as the possibilities of higher taxes, more regulation, etc. As one friend mentioned just after the runoffs, we might have been right on the market response but for the wrong reasons. Better that than the opposite, I suppose. Fortunately we believe we are better at stock picking than political prognosticating.

So where do we go from here? Though we are not in the business of predicting the market – especially in the short term – we will share a few thoughts. As discussed above, the **equity market is currently in a sweet spot in terms of unprecedented monetary accommodation, fiscal stimulus and accelerating corporate earnings.** The wind is, and has been, truly at our back. But how much of that good news is priced into equities now? First, we must acknowledge that **we have come back *very far, very quickly***. In the last year our portfolio is up almost 70%. Yes it was off quite a depressed base (the pandemic low was made March 23, 2020), but even if we incorporate the severe downdraft of 1Q20 we have returned almost 20% (annualized) in the past five quarters.

Certain of our holdings have doubled, tripled and even quadrupled from where we added last Spring, and some of these "epicenter" stocks are now well above their levels when the pandemic began. One year ago we discussed in detail the five stocks we own that we believed were most vulnerable. Here is their performance since then: Air Lease (AL) +121%; Wyndham Destinations (now called Travel & Leisure – TNL) +182%; MGM Resorts (MGM) +223%; EPR Holdings (EPR) +92%; and Macquarie Infrastructure (MIC) +100%.

OK, stocks have roared back, but where are valuations currently? Are stocks expensive? The chart below, courtesy of our friends at TrendMacro, provides an historical perspective on the Equity Risk Premium (ERP). Recall the ERP is one tool to assess how well investors are being compensated for assuming the risk of equities. ERP is simply the earnings yield of the market less long term interest rates. When the ERP is high, such as in 2009 (Global Financial Crisis) when there was great fear in the market, future returns tend to be strong. When the ERP is very low, such as in 1999 (peak of dotcom bubble), when there was overwhelming optimism in the market, future returns tend to be poor. (In fact, per the chart below, in the late 1990s the ERP actually went negative. In other words, investors were so confident in equities that they were *willing to pay, rather than be paid*, for the privilege of owning them.)

S&P 500 equity risk premium

Cap-weighted consensus 365 days-ahead forward earnings yield minus 30-year Treasury bond yield

— Equity risk premium, month-end *Note: means may differ slightly with chart below due to monthly v. daily computation*

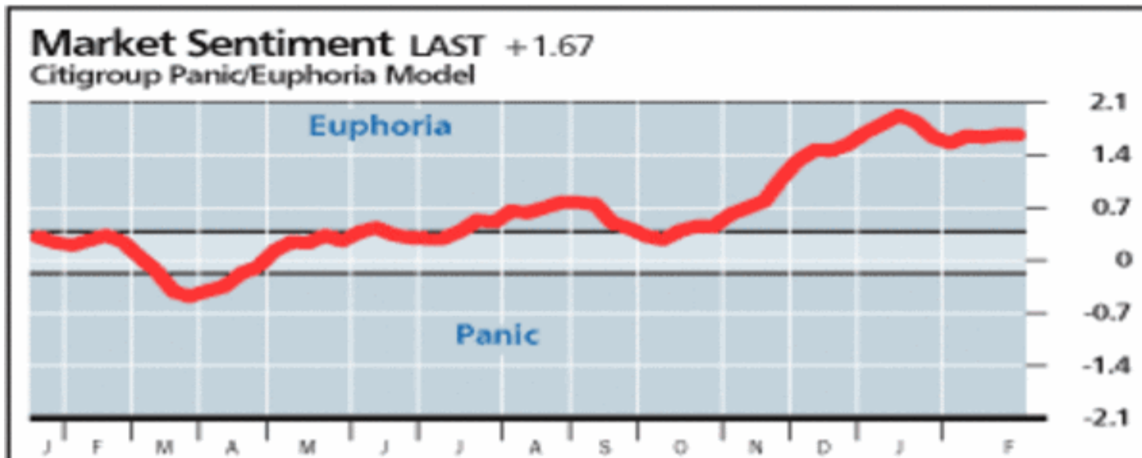
Source: I/B/E/S, Zacks, Bloomberg, Federal Reserve, TrendMacro calculations

The current *market* ERP of just over 2% is below both its recent range (since the Great Financial Crisis) and also below its very long term (going back a century) range. **While the ERP has nothing to say about short term performance, this does suggest to us that medium term returns are not likely to remain as robust as they have been in recent years.** The equity market *is* being compensated for bearing risk, but it is not quite as *well compensated* as it generally has been over time.

What might make the ERP misleading? Simply stated, if profits and or interest rates differ materially from expectations. If rates continue to climb upward, and or profits disappoint, for instance, it will have the effect of compressing the ERP, making stocks less attractive. And vice versa. If FCF growth is stronger than the market expects, which has been the recent trend, then the ERP will expand.

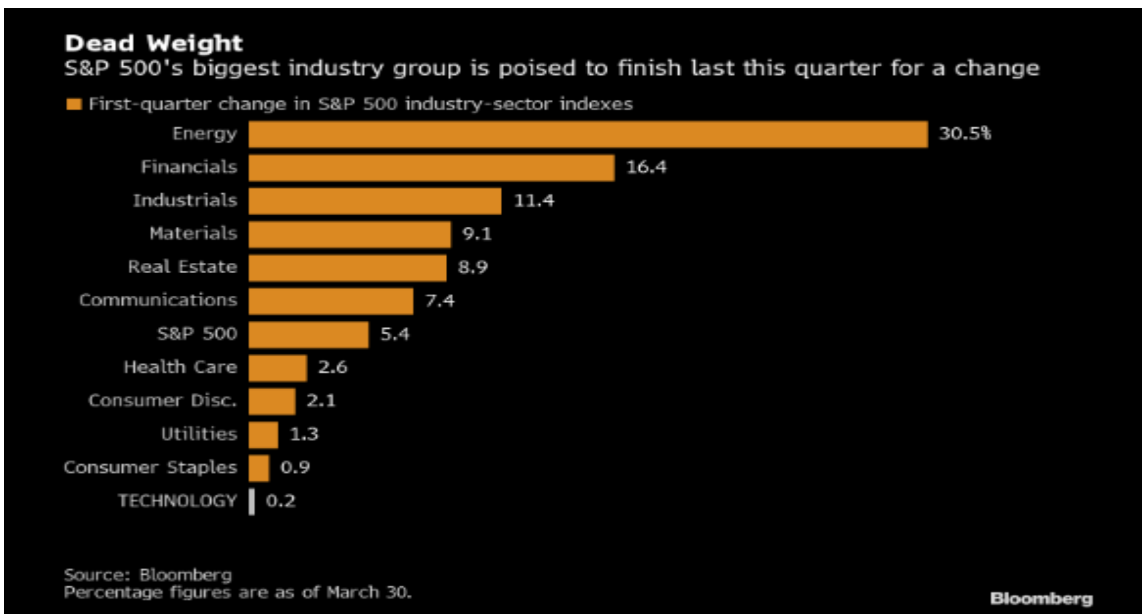
Another consideration is the style rotation from growth to value that we discussed above. **Even if the S&P 500 ("the market") takes a breather, if the style rotation continues it is not unreasonable to believe that value stocks might do just fine.** After the popping of the "dotcom bubble", for instance, the two years of 2000-01 were fairly painful for the overall market (S&P 500 down 20%), yet small cap value prospered (up 40%). Finally, as we consistently mention, because of our requirement of plentiful FCF generation from our companies, **the ERP of *our portfolio* is materially higher than that of both the market and the value indices.**

It is said that bull markets must "climb a wall of worry" in order to endure, and in our experience there is a good deal of truth in that axiom. Though we are somewhat contrarian by nature, currently we find ourselves in the unusual situation of generally residing in the consensus bullish camp, which does give us pause. Yes there is still a good deal to worry about, but, as shown in the chart below, overall sentiment remains quite strong.



Last quarter we discussed **embracing the reflationary cycle**, and **clearly we have benefited greatly**. While we expect it to continue, with the sharp moves in cyclicals in the past few quarters the very steep discounts they carried have mostly disappeared, so you should expect to see that reality reflected in our portfolio in coming quarters.

Not surprisingly, given the value leadership in the quarter, the strongest sectors were once again the major *cyclical* value sectors: energy, financials, industrials and basic materials. Given our large representation in **financials**, they **were again by far our biggest source of performance in the quarter.** The more *defensive* value sectors (health care, staples and utilities) underperformed. But every sector was up again this quarter.



In aggregate **PVP was up 13.1% in 1Q21, and our annualized return since accepting our first partner capital in February of 2016 is now 14.0%.**[3] Looking forward, our portfolio's current Equity Risk Premium (ERP) of 4.5% (6.9% portfolio FCF yield, less 2.4% 30 yr UST) remains attractive, though obviously much less so than a year ago after the combination of blistering equity appreciation and rising interest rates. As always, we encourage our partners to take a long term view. We believe we will continue to be fairly compensated for this premium, as we were again this quarter, but, as we have seen, it is always difficult to say *when*.

Actions taken in 1Q21

Buys in the quarter

As the equity market has remained so strong in 1Q21, it has become more challenging to find new ideas as a disciplined value investor. We don't like to "chase" stocks; however, one corner of the market that seems to have been neglected of late is insurance. **Markel (MKL)** is a very high quality property/casualty (p/c) insurer and reinsurer with a tremendous track record of value creation, currently trading at a slight premium to Book Value (BV). P/C insurers have been out of favor with equity investors for some time now, notwithstanding that insurance pricing began to inflect upward last year -- and that momentum shows no sign of abating anytime soon -- and also that interest rates have also begun to creep upward, making insurers' large bond portfolios much more profitable. Markel, like our Berkshire Hathaway and Fairfax, also has an unusually large equity portfolio, with a terrific long term track record.

Exits in the quarter

A very strange thing happened near the end of January. A group of online individual traders conspired to wage war against the professional "short" investors who profit when stock prices fall. Amazingly, it was the "professionals" who emerged most bloodied. As the overall market was retrenching somewhat, this dust-up resulted in a number of stocks with a significant short interest very quickly rising in spectacular fashion – more than 100% in some cases – as the shorts got "squeezed". Usually we would just observe such a spectacle from the sidelines, since the stocks in question are generally the kind of very small, highly speculative companies we tend to avoid. But in this case many "real" companies that happened to have a high short interest got swept into the frenzy. **Seagate Technology (STX),** the disk drive maker, is a company that we believe is quite misunderstood by investors -- thus the high short interest -- and one day, with no fundamental news, the stock was up more than 17%. Although we have been pleased with Seagate's progress, we couldn't resist the opportunity to sell our position at a price in excess of our Price Target, representing a 60+% return on our investment just six months prior.

Signature Bank (SBNY) is another company we like a great deal, which also found itself caught up in a bit of a frenzy, giving us an opportunity to exit earlier than expected – albeit with a handsome profit. First, Signature is based in New York City, which in many ways found itself the geographic epicenter of the pandemic in the US. So as those fears waned, SBNY's gains were magnified. Second, Wall Street has begun to get very excited about cryptocurrency, and Signature has been a leader in crypto banking. In February we made our final sale up 60% from our buy in mid 2019.

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[3] *Returns are net, and assume a 1% annual management fee. PVP defines "long term" as an entire market cycle.*

Allscripts (MDRX), the electronic medical records (EMR) provider, was one of our top performers last quarter, and with the proceeds from the large divestiture we discussed the company was very active in buying back its shares, accelerating the positive momentum in the stock and pushing it through our Price Target. While the MDRX investment did require some patience, and for most of our ownership period we did not exactly (to use a favorite expression from an investment mentor) "cover ourselves in glory", the approximate triple in the last three quarters did allow us to eke out a respectable return and exit with our heads held high.

Strong performers in 1Q21 [4]

Not surprisingly in such a strong overall quarter, our best investments were in companies in the more "offensive" sectors – financials, industrial, consumer discretionary, basic materials, energy. Just like last quarter, our strongest stock in 1Q20 was **Mastec (MTZ),** the engineering and construction (E&C) company. Not only did Mastec have a strong 4Q20, with higher 2021 earnings "guidance", but investors have also begun to attribute a higher likelihood of a Biden infrastructure plan becoming law. The stock was up 37% in the quarter and 186% in the past year. While we still like the company's prospects, and it remains a large position, we did take some profits in the quarter.

Travel & Leisure (TNL), the time-share vacation company formerly known as Wyndham Destinations (WYND), had another very strong quarter, up 36%. Although 4Q20 was a loss, as expected, for this company at the epicenter of the pandemic lockdowns, our thesis that covid had created tremendous pent-up demand for TNL's product seems to be bearing fruit for 2021. Like MTZ, we also took some TNL profits in the quarter.

Pinnacle Financial (PNFP), the high growth and high quality Tennessee-based regional bank, was once again among our top performers in the quarter, up 38%. Pinnacle benefited from both the "macro" of rising bond yields (which generally increases banks' profitability) and also the "micro" of continuing profitable growth, with the added boost of reserve releases that had been built in 2020 as the expectations for pandemic-related loan losses were much higher than what they have become. In addition, in March the Fed announced that it will begin to allow banks to resume share buybacks and also raise dividend payouts starting at the end of 2Q21.

Enstar Group (ESGR) is the specialty insurer that acquires the "runoff" and other "unwanted" lines of business from other insurers, often while the seller is under stress. With insurance transaction volume picking up significantly owing in part to the challenges of the last year, Enstar struck some favorable deals and also managed to continue to rapidly grow its Book Value (up 42% in 2020). In spite of Enstar's track record, the company remains relatively "undiscovered" on Wall Street. ESGR was up 20% in the quarter, still trades at a 15% discount to BV, and remains a large position for us.

Citizens Financial Group (CFG), the Providence, RI-based regional bank, benefited from most of the same factors that boosted PNFP and most other banks in the quarter – mostly higher rates. Citizens has done an exceptional job of improving itself since it was divested by Royal Bank of Scotland in the wake of the 2008 Financial Crisis. CFG was up 23% in the quarter, and still trades at about a 10% discount to BV.

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[4] *Top and Bottom Five performers in the quarter defined as the most value added or subtracted, in basis points. Top and bottom stocks are presented, respectively, in descending and ascending order of value added/subtracted.*

It is worth noting that we added to all five of these stocks in early/mid 2020 at quite depressed prices as the pandemic raged, so it is satisfying to see our portfolios continue to be rewarded for taking advantage of the extreme volatility that 2020 brought us.

Weak performers in 1Q21

Again this quarter, like last, with a strong overall market our weakest stocks tended to be in the more "defensive" sectors, like health care, consumer staples, and also technology. Generally speaking, our better stocks in 2020 were among our worst stocks in 2021. **Viatris (VTRS)** is the new company resulting from the combination of our legacy holding Mylan (MYL) and the generic pharmaceutical business of Pfizer. In its first quarter in the current form, the company announced goals that were less ambitious that what Wall Street had been expecting, sending the stock down 25% in the quarter. While Viatris does need to build credibility with investors, it has several years of cost savings tailwinds and is also a very cheap stock, now trading at just 4x earnings and at a remarkable 20% FCF yield.

Palo Alto Networks (PANW), the cyber security software company, had another terrific quarter in 4Q20, beating every conceivable Wall Street expectation, but as a big winner last year (up 54%) in a tech sector that finds itself out of favor so far this year for the first time in quite a while, PANW was off 9% in the quarter. Considering the company's 20+% growth, we find PANW's 4% FCF yield quite attractive.

As we have discussed in recent quarters, **WalMart (WMT)** was a beneficiary of the pandemic (stock up 23% last year). In 4Q the company continued to report growth in same-store sales (almost 9% in the US) and eCommerce (69% in the US) that is amazing for a company the size of WMT; however, the company will spend significantly more this year on labor and capital expenditures, which will constrain profit growth. WMT was down 6% in the quarter.

Amazon (AMZN) is yet another stock that performed spectacularly for us in 2020 (up 76%), and reported stellar 4Q results in January (revenues up 44%), but sold off 5% in the quarter. As with WMT, to some extent investors have begun to anticipate an inevitable deceleration of sales growth that was artificially inflated by the pandemic in 2020. Amazon also announced that its legendary founder, Jeff Bezos, would become Executive Chairman later this year, relinquishing the CEO role to Andy Jassy, who currently runs the company's highly successful Amazon Web Services (AWS).

Anheuser-Busch InBev (BUD) continued to be challenged by pandemic lockdowns around the world, and the stock was down 10% in the quarter. Because of its very global presence, BUD will lag the recovery in sales of most companies as much of the world (ex US) struggles to emerge from the pandemic.

Setup

As discussed above, with the price appreciation in recent quarters the numbers below have changed a bit, but the story remains very much the same: PVP's portfolio remains cheaper than the market, with superior returns. The Equity Risk Premium (ERP) of our portfolio remains comfortably above the market at 4.5% (6.9% FCF yield less 2.4% 30-year UST). At this level we believe we are reasonably well compensated to bear the risk of equities.

	PVP [5]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2021E)	6.9%	4.2%	4.8%
Price/Earnings (2021E)	17.4x	23.6x	19.0x
Debt/EBITDA	3.7x	3.5x	4.0x
EBITDA margin [6]	28.0%	19.2%	19.0%
Return on Equity (2021E)	14.0%	16.6%	13.3%
Return on Invested Capital [7]	9.9%	5.7%	4.4%

As always, we are so appreciative of the confidence you have shown in PVP, and we promise to continue to work tirelessly to make you pleased with that decision. As you know, we also want to be as transparent as possible. Please let us know if you have any questions, or if we can help in any way.

Sincerely,

J. Kelly Flynn

Chief Investment Officer

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[5] *Data for both PVP portfolio and Russell indices are generally via FactSet. In a few instances, we have made minor adjustments.*

[6] *Data is 2021E for PVP; 2019 for Russell indexes. Unfortunately, 2021 data unavailable.*

[7] *Data is 2021E for PVP; 2019 for Russell indexes. Unfortunately, 2021 data unavailable.*