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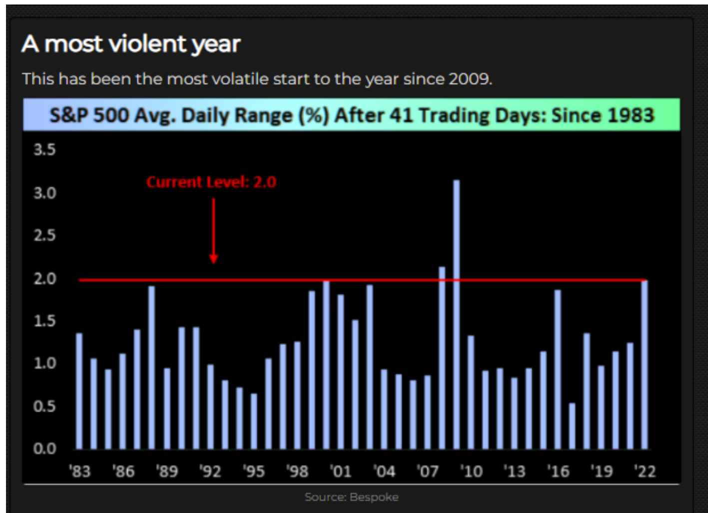
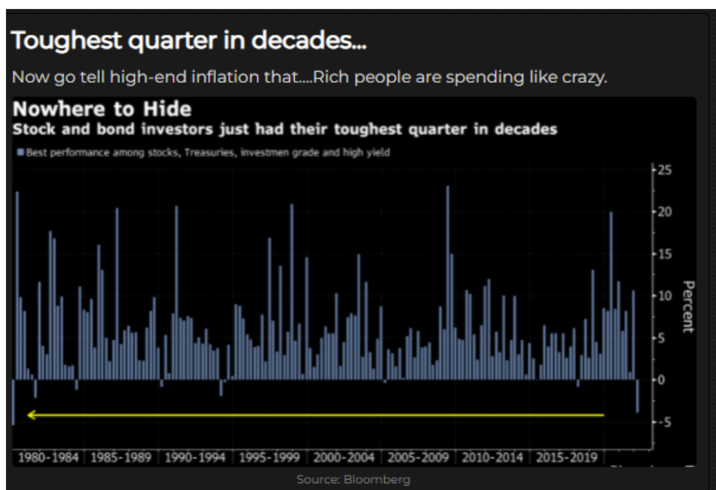
April 2022

Dear PVP partners and friends

It was quite an eventful quarter, as reflected in the stock volatility depicted in the charts below. It was also a quarter in **which there were very few hiding places, and most all major asset classes were down**.





The quarter began very positively for us. In the first week of January it felt like the tectonic shift in investor appetites we have been anticipating, **from growth stocks into value stocks,** had finally begun in earnest. The 30-year UST bond shot up from 1.90% to 2.11%, putting considerable downward pressure on technology and other expensive stocks, and upward pressure on value stocks. (And even more upward pressure on our portfolio.) This general trend continued through mid-January, when "earnings season" began. We have discussed in recent quarters the substantial upward revisions to estimates for at least the past year, as companies have materially outperformed analysts' expectations. Finally, this quarter, it quickly became apparent that analysts had "caught up" with their upward revisions – and then some, in many cases. As shown in the chart below, **there were far more "earnings misses" and or "poor guidance" than we have seen in quite some time – largely caused by covid-related supply chain disruptions.** Because expectations have been elevated by the positive reports in recent quarters, moreover, the market was also far more punitive to companies that disappointed than we have seen in quite some time.

The large financials are usually among the first to report, and their results were generally "in line". But after many consecutive quarters of outperforming expectations, "in line" was just not good enough. Financials also were not helped either by the fact that higher rates take a bit of time to flow through the income statement, or by the difficult comparisons resulting from the massive reserve releases last year after they realized covid would not result in huge losses for them. But the **market reactions to the slightest disappointments were much more draconian in technology and other high-valuation sectors**. As an example, Meta (ticker "FB" -- the company formerly known as "Facebook") saw its stock sell off 26% on the day of its earnings release, meaning the market had decided FB was now worth about a quarter of a trillion dollars less than the day prior. To my knowledge that is the biggest loss of market cap ever for one company in a

single day. And in fact FB continued to slide, with the company now valued at nearly a half a trillion dollars less than it had been at its peak last Fall.

In the midst of this torrent of micro news, **the market was also absorbing and processing some very important macro issues -- namely inflation, interest rates and the upcoming actions from the Fed**. Regarding the former, **inflation has continued to run quite "hot"**, with CPI about 8% [1] as reported both in February and March. "Too much money chasing too few goods" is of course the classic definition of inflation. While "too much money" is correcting itself as stimulus checks are spent and monetary policy tightens, the "too few goods" part is a bit trickier, with supply chains disrupted first by covid and its policy repercussions, and now exacerbated by war and geopolitics, which has led in many cases to a complete rethinking of global suppliers, outsourcing and "just in time" inventories. Our own baseline view is that inflation is likely to be more persistent than the doves anticipate, but not as bad as the most strident hawks would have us believe. Energy and the like will move up and down, and at some point the escalating price levels will induce more energy production – environmental concerns notwithstanding. On the other hand, as shown in the chart below, we are also seeing meaningful wage inflation as well, which will be much "stickier". Time will tell how bad inflation gets and for how long, but it is quite possible that CPI peaked or will peak in 1H22.

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[1] In January and February, reported one-month annualized inflation (CPI) was 8.0% and 10.0% respectively; the "year-over-year" figure was 7.5 and 7.9%, respectively.

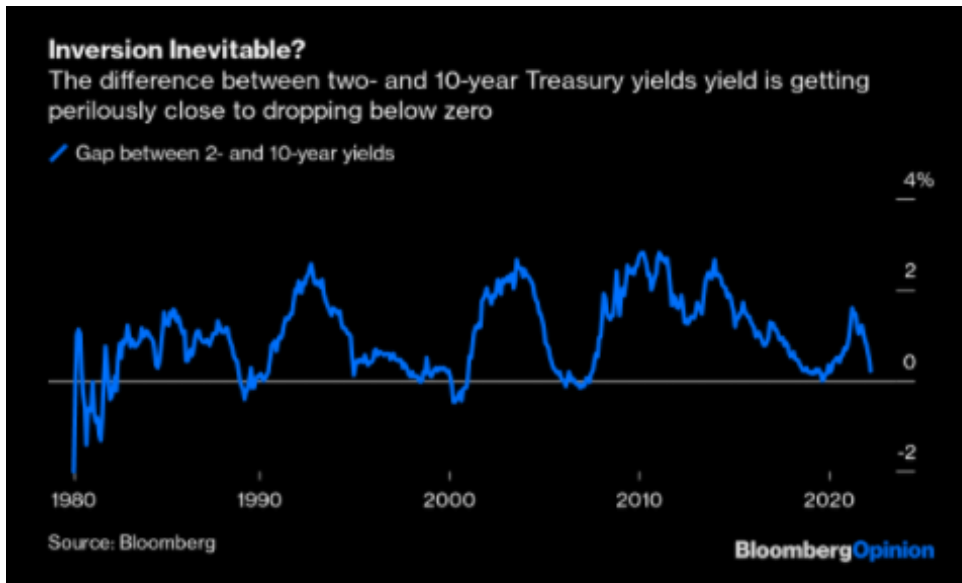
Regarding rates and the Fed, after many years of "manufacturing" inflation through quantitative easing (QE) toward a 2% goal, the Central Bank has finally acknowledged that it has succeeded beyond its wildest dreams. Coincidentally, **inflation has inevitably become a political issue,** and it so happens that Chairman Powell and other new Fed nominees are still currently up for Senate confirmation. The Fed continues to signal a number of Fed Funds rate hikes, which began with 0.25% in March, to slay the inflation beast that is in no small part its own creation.

In late February, after months of saber rattling, Russia invaded Ukraine. In addition to the horrific and pointless human suffering it has caused, from a market perspective investors quickly began to worry about the effect of **resulting shortages in so many raw materials** that come from that part of the world – oil/gas, potash (fertilizer), nickel, wheat, etc. – that would exacerbate the inflation we are already experiencing. In one scenario (to which we do not currently subscribe) that has quickly evolved from extreme to near-consensus, the war and the coordinated international responses to it to punish Russia may throw us back into a recession, with the additional complication of inflation, just as we continue to emerge from the pandemic. Thus, for the first time in a very long while, **the most bearish pundits began to speak of the prospect of "stagflation"** – the unusually noxious combination of recession and inflation that certain of our most seasoned readers might remember from the 1970s.

To make matters worse, on more than one occasion Russian President Putin reminded the world that, even while humbled in the early days of the war, Russia is still a nuclear power. This is a "black swan" existential risk that markets most likely had not contemplated in a very long time. It is unclear how much impact this not-so-thinly-veiled threat had on markets, but it certainly didn't help sentiment. Needless to say, if nuclear weapons are actually used in the Russia-Ukraine war, then all bets are off, and equities would get seriously hurt – probably to a degree that would make the early covid selloff look pleasant by comparison.

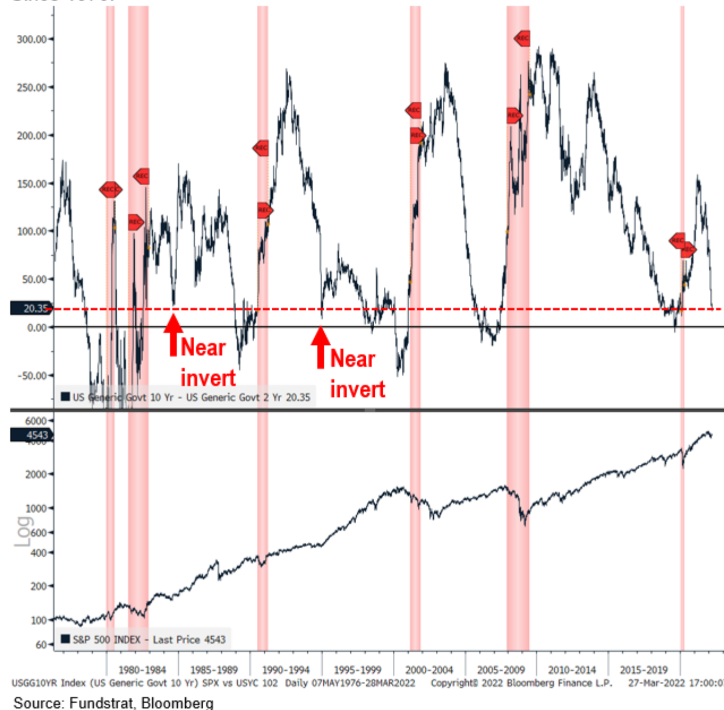
By early March sentiment had clearly become quite bearish, and investors had become so negative that one highly respected market strategist (ISI) revealed that an astonishing 100% of the investor clients it surveyed expected a recession in 2023 (even though ISI itself anticipates

growth slowing but sees an imminent recession as “unlikely”). As a “proof statement” (as shown in the chart below), bearish investors could offer up evidence of a (nearly or barely – depending on how one looks at it) **“inverted” yield curve (YC)** -- a phenomenon we have discussed frequently, in which the yield on shorter-dated bonds counterintuitively exceeds the yield on longer-dated bonds. Those predicting a recession on that basis typically assert that an inverted YC has preceded every recession for the past several decades. It is impossible to know exactly what the YC is telling us here – whether its shape is a function of technical factors, or a recession in the near/intermediate term, or a slowing of growth that will forestall future rate hikes, or perhaps a view that inflation will prove to be more transitory than permanent?



Of course, by no means does an inverted YC make an imminent recession inevitable. While we certainly would take this “signal” seriously, its appearance can be more correlation than causation. Although inversion has occurred prior to every recent recession, it seems far less appreciated that, as shown below, it also sometimes happens that a recession does not follow YC inversion – calling to mind the old joke about the economist who has predicted five of the last two recessions. Moreover, if we consider the brief covid lockdown-driven recession two years ago, it seems rather far-fetched to believe the YC inversion in 2019 was somehow predicting a global pandemic.

YIELD CURVE + S&P 500: 10 inversions, 6 recessions
Since 1976.

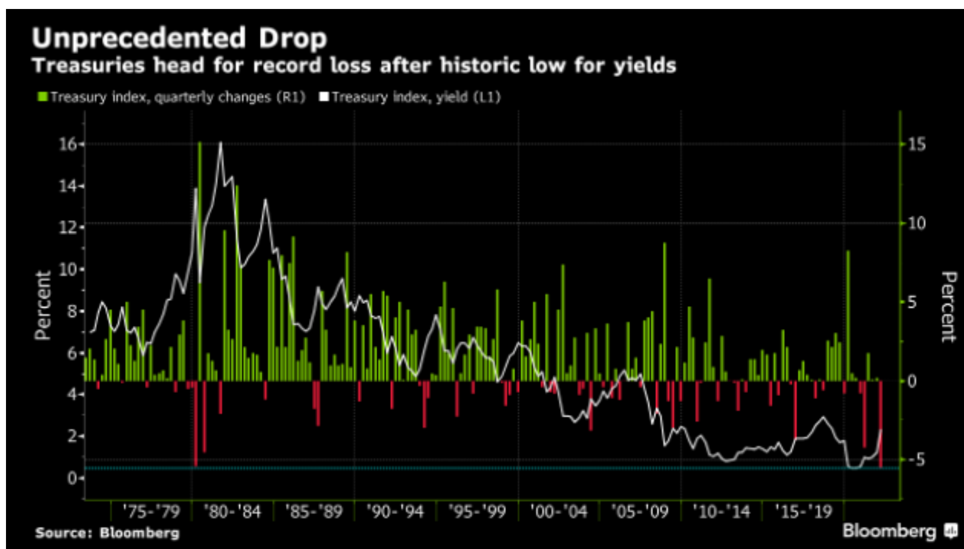


Source: Fundstrat, Bloomberg

Later in March the market began to discount a cessation of hostilities in the near term, and accordingly stocks turned back upward. Of course there is no way to know with any confidence, but diplomatic efforts to end the war already began less than two weeks after it started, and had reportedly made some progress, so that is certainly encouraging. Then in mid-March, **after Chairman Powell sounded incrementally hawkish and the Fed actually began its rate hikes, yields rose and stocks continued to generally respond positively.** As rates rise, of course, bond values drop, and in fact by some measures the quarter resulted in the worst bond performance in the past 40 years. As shown in the chart below, bonds can quickly relinquish their "safe haven" status in times of inflation and Fed hikes.

As an extreme example, a few years ago the Austrian government had the foresight to take advantage of the rate environment and lock in very cheap money (0.85% coupon) *for an entire century* with a 100-yr bond. Austria is fiscally healthy, and that bond is rated AA+. This is obviously far from a SPAC or a "meme stock". Yet from its peak value in December 2020 that bond is down a whopping 55%. When inflation rears its ugly head (and PPI in its neighbor Germany reached an astonishing 26% in February)[2], even the "safest" securities can get annihilated.

[2] *I would prefer not to discuss the last time we saw German hyper-inflation.*



On a positive note, isn't it nice not to have to discuss covid this quarter? Though we certainly cannot dismiss that about 2,000 Americans are still dying every day of it, thankfully at last — from a market perspective, at least — we are truly beginning to see the pandemic in the rear-view mirror. Although it continues to flare in parts of Asia, most governments at all levels, generally speaking, have loosened restrictions, workers are returning to offices, kids are returning to school, and the masks are even coming off.

In terms of stylistic and sector performance, the quarter was a tale of several discrete periods. Before the Russian invasion of Ukraine — as interest rates climbed — the financial and energy sectors were way out ahead, with technology severely lagging. Once that war began rates dropped as investors sought out the (perceived) relative safety of UST bills. This reversal of the trend in rates, coupled with concerns about Russian/Ukrainian exposures among the larger financial institutions, pulled the financials into negative territory. Meanwhile, energy and certain other commodities, whose supplies would be presumably constricted by the war (with positive implications for price), skyrocketed upward. Later, as the market began to anticipate an end to the war (or at least a lessened possibility of the worst case scenario mentioned above), the rising tide lifted most ships. For the quarter overall, owing to its massive early lead and buoyed by rising rates (30 yr UST ended the quarter at 2.44%), **value still handily outperformed growth.**[3] Energy was by far the best performer, and technology and consumer discretionary were the worst.

As we have discussed extensively in recent quarters, **to some extent we have been able to hedge the portfolio from inflation risk, and our numerous defense-related holdings also benefited from the geopolitical unrest.** These factors helped us to continue to comfortably outperform the value indices in the quarter. [4] Moreover, we have used the recent volatility to initiate new positions in some exciting new stocks that were formerly "too expensive" for us, and we have also added to certain of our existing positions where we have considerable conviction but the stocks have sold off – "the baby with the bathwater".

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[3] *The Russell 3000 Value index was down 0.9% in 1Q22, vs. down 9.3% for the Russell 3000 Growth index.*

[4] *The Russell 3000 Value index was down 0.9% in 1Q22. PVP annualized net returns for the 1, 3 and 5 year periods ending 3/31/22 were 12.8%, 16.2% and 11.9%, vs. 11.1%, 13.0% and 10.2% for the Russell 3000 Value.*

In aggregate **PVP was up 1.9% in 1Q22, with an annualized return since accepting our first partner capital in February of 2016 of 13.8%.**[5] Looking forward, as discussed above, our portfolio's current Equity Risk Premium (ERP) of 5.8% (8.2% portfolio FCF yield, less 2.4% 30 yr UST) remains quite attractive in our view, even in a rising rate environment that is generally a headwind for equities.

A note on performance

While net performance is ultimately what PVP does for a living, we typically ask our partners not to fixate on it in the short term – especially relative performance. In the short term, as the man in Omaha reminds us, Mr. Market is mostly a voting booth, whereas in the longer term he functions as a scale. Still, every so often it is reasonable to "check in" and see how we are doing. As you know, the market's fetish for growth and technology – often of the profitless variety, fueled by the nearly zero cost of capital courtesy of the Fed in recent years – has made the growth indices and even a "core" index like the S&P 500 (which has effectively become a growth index as well) very difficult to outperform for value managers like us.

Today I am pleased to report that, as rates have risen at long last and the profitless growth bubble has been at least punctured a bit in the quarter, **PVP has now outperformed the S&P 500 and even the Russell 3000 Growth index over the past two years** (encompassing the entire covid recovery time frame).[6] Given the very pronounced and extended period of growth outperformance in recent years, it will probably take some time to overtake them on a longer term basis – but, if the current environment persists, in which fundamentals again matter more than hopes and dreams, I believe we are very well positioned to do so. Just as we did when the dotcom bubble burst beginning in 2000.[7] We are so grateful for your patience, which has finally begun to be rewarded on a relative basis.

Actions taken in 1Q22

Buys in the quarter

Digital Turbine (APPS) is a company that has grown rapidly in recent years – both organically and through acquisitions – and is becoming a leader in facilitating the high-growth business of mobile advertising, primarily on Android phones. The company has built a unique model that is attractive to the underlying advertiser, the network provider, the phone makers (OEMs), and of course Google (Android). One astute investor recently called APPS "essentially a toll collector for phone screen real estate". We believe this stock is a good example of a very real and profitable company with tremendous growth prospects, which has been unfairly tarnished by its mere association with other "similar" companies with inferior business models, cash flow generation and future prospects. In the most recent quarter APPS grew organic revenues and EBITDA by an eye-popping 38% and 153%, respectively, and the stock currently trades at about a 6% yield on the FCF we think it can generate next year.

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

[6] *Net annualized returns for PVP, the S&P 500 and the Russell 3000 Growth index were 37.1%, 34.5% and 36.2%, respectively, for the two-year period ending 3/31/22.*

[7] *At the time I was a portfolio manager at another firm, long before PVP had been founded.*

Wesco (WCC) is a leading distributor of electrical equipment that, like our Mastec (MTZ), should benefit substantially from a renewed focus on infrastructure – especially in the datacom and power/utility verticals. Additionally, last year Wesco merged with Anixter, which is proving to be a very attractive deal as synergies are being meaningfully captured both in expense savings and the typically elusive cross-selling areas. Wesco generates abundant FCF, with which it is currently primarily paying off the debt incurred in the Anixter deal, and now trades at a very attractive 9% FCF yield.

Investing can certainly be an exasperating experience. **Adtalem Education (ATGE)**, the physical and virtual operator of schools for doctors, nurses and veterinarians, is a stock we have owned previously, and it has been a very positive experience. One Friday afternoon in late January we re-initiated a position in the stock at just over $28. The following Monday the company announced the sale of its financial services businesses (unrelated to its core health care education) for a price of $1 billion. We knew this divestiture was a strong possibility, but we did not know it would be so soon and at such a big price. For perspective, ATGE gave up about 1/4 of its profits in the sale for a price of about 2/3 of its entire current market cap, sending the stock up 13% that day. A week later, however, with our "victory lap" still fresh in mind, Adtalem announced a very weak quarter and guidance, citing mostly (you guessed it!) covid-related issues. Then, adding insult to injury, in mid-February the company was notified by the Dept. of Education that it was on the hook for $71 mm for infractions committed by a former subsidiary with a new current owner, sending the stock tumbling below $20. After a conversation with senior management, we added to the position just above $20. In early March the stock began to recover when the company announced it would use the sale proceeds to pay down debt and buy back stock (at the stock price at the time, this would represent nearly half of the total shares outstanding). This boosted the stock back up to just under $30 at quarter-end. ATGE still trades at an astonishing 17% yield on the FCF it expects to generate next year.

BellRing Brands (BRBR) was spun off during the quarter by its former parent Post Holdings. The rationale for the spin off was that BellRing operates in some faster-growth categories (shakes, powders, nutrition bars, etc.) than Post, so value could be created in a separate entity that might have been previously obscured. A small position currently, we are positively disposed and doing research to determine whether to make it a more meaningful position.

Exits in the quarter

While our turnover tends to be low, we will sell stocks occasionally for any number of reasons – most often the stock hits out Target Price (TP); or sometimes we simply see much greater potential elsewhere; or the company is acquired; or, occasionally, we lose conviction. While of course we would like all our exits to be "winners", it doesn't always work out that way. When we find ourselves contemplating a different thesis to justify continuing to own the stock, it is probably time to sell.

BankUnited (BKU) is a Miami-based bank with a healthy growth profile and an enviable geographic footprint. While we have been patient, as we usually are, over time our conviction has diminished in BKU's management team, and in particular its rather aggressive accounting practices. Moreover, unlike most banks, its balance sheet is slightly "liability sensitive" rather than "asset sensitive", meaning its margins will actually decline rather than rise with rising interest rates. We own many other banks in which we have much stronger conviction. We sold the stock in early February roughly flat on the year. BKU was a rather mediocre investment for us (up

38% from our original purchase in 11/17), and barring a sale of the company (always impossible to forecast) we don't see a clear path from here to an acceptable return for shareholders.

Our sale of **British Tobacco (BTI)**, like that of Altria (MO) two quarters ago, is a recognition of one of our basic investment tenets: We want to own the future, but at discounted prices. Although BTI has an excellent management team that is quite adept at deploying the copious FCF the company generates, and trades at a significant discount, it does not represent "the future". Rather, the future appears very challenging for BTI and its peers as they try to transition to the next generation of "reduced risk products", while negotiating with regulators and fighting off upstarts. Although we did collect a healthy dividend, the stock lost 29% in our time of ownership beginning in 8/17. Investing can also be a very humbling experience.

Well before Russia invaded Ukraine, we had been contemplating reducing our sizable exposure to the US Department of Defense. As the federal debt has exploded, with an ever-growing demand for health and social services, Democrats holding the presidency and the Senate and House, and seemingly still a "peacetime dividend", the pressure on the $800+ billion annual defense budget had been growing for some time. Specifically, the most expensive defense "hardware", such as the ships built by **Huntington Ingalls (HII)** and the fighter jets made by **Lockheed Martin (LMT)**, have arguably felt the most pressure. Over time, we believe more budget dollars will be deployed to the smaller companies that are nimble and possess superior technological capabilities. Thus we maintain positions in cyber security provider Booz Allen Hamilton (BAH – re-acquired last quarter); tech solutions provider CACI International (CACI) and outsourcer Science Applications International (SAIC). The run-up to war, which admittedly will likely be positive for defense spending, provided us the opportunity to exit LMT and HII at an opportunistic time.

Strong performers in 1Q22 [8]

We were fortunate in the quarter to benefit directly from the disruption created by Russia's invasion of Ukraine in two of our largest positions: **Cheniere (LNG)** and Nutrien. Cheniere is the leading liquefaction company, responsible for exporting US LNG around the world. Now with sanctions on Russian gas, the demand for Cheniere has grown a lot, and quickly. LNG was up 38% in the quarter, and 85% from our initial purchase, and has become our single largest position. Still, the stock trades at an extremely healthy FCF yield of 11%. We took some profits during the quarter.

Nutrien (NTR), the Canadian fertilizer company, has benefited as inflation in many commodities has taken hold. Like Cheniere, though, this positive pricing dynamic has accelerated greatly with the Russian invasion of Ukraine, since many of the fertilizer inputs come from that part of the world. NTR was up 39% in the quarter and currently trades at a P/E of just 7x and EV/EBITDA of just 5x on what are presumably peak earnings this year. Here also we took some profits during the quarter.

Like most of the energy complex, **Williams (WMB),** our natural gas pipeline company, was very strong in the quarter. Even though the company's economics are largely insulated from swings in commodity prices, in the short term the stock tends to trade with the group. In 1Q22 WMB was up 30%, and we took some profits here as well. Williams now trades at a 5% dividend yield.

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[8] *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.*

One of our top performers last quarter as well, **Berkshire Hathaway (BRKB)**, with its pristine balance sheet and wide variety of business interests, is a good stock to own during volatile times. Berkshire now trades at about 1.5x its (understated) book value. Late in the quarter Berkshire made its first significant acquisition in some time when it agreed to acquire the highly-regarded Alleghany Corp (Y) for about $11.6 billion or less than 1.3x BV.

Markel (MKL) is much like a smaller Berkshire Hathaway, a specialty property/casualty insurer and reinsurer, led by a legendary investor in his own right (Tom Gayner), with significant interests also in various non-insurance investments. With the ongoing "hard market" for P&C pricing, Markel has been thriving in recent quarters – in Gayner's words, "firing on all cylinders". Markel still trades at just about 1.3x BV.

Weak performers in 1Q22

Berry Global (BERY), the plastic packaging company that was one of our top performers last quarter, was down 21% in 1Q22. Although the company reaffirmed its expectations for the fiscal year, the quarter was a bit weaker than investors expected due to covid-related supply chain issues -- and, as mentioned above, the market was not in a particularly forgiving mood. We added to our position on the weakness. BERY currently trades at more than a 10% FCF yield.

Sony (SONY) was down 19% in the quarter, primarily on account of the $75 billion proposed acquisition of Activision Blizzard (ATVI) by Sony's much larger gaming competitor, Microsoft (MSFT). The perception is that Activision's products combined with Microsoft's very deep pockets could make things much more difficult for Sony, whose PlayStation has been a large and growing percentage of its profits. The deal has certainly attracted the attention of regulators. Interestingly, the market seems to be heavily discounting the likelihood of this acquisition being completed, with a $95 all-cash offer and ATVI now trading just above $80.

Generic drug company **Viatris (VTRS)** was also down 19% in the quarter. In addition to rather weak guidance for the year, management announced that it had reached a deal to divest its biosimilar business (which it had previously touted as key to its future growth) and is also considering a variety of other surprising strategic moves. While VTRS is an extremely cheap stock, we are currently reassessing the investment.

As discussed above, it was not a good quarter for technology companies to disappoint investors. Although disk drive maker **Western Digital (WDC)** exceeded its own recently-lowered expectations, for the second straight time the company reduced its guidance for the upcoming quarter, citing (alas) supply chain issues as the primary culprit. The stock was down 24% in the quarter. Nonetheless, management has even greater conviction in the underlying demand for its products. If current year estimates are to be believed, WDC now trades at a P/E of less than 7x, a FCF yield over 14% and an EV/EBITDA of just 5x.

Like most other housing-related stocks, shares of flooring leader **Mohawk (MHK)** were hit hard (down 32%) this quarter, as the company's solid results and guidance were overwhelmed by the expected impact of rising rates on Mohawk's business. As a result, the company expanded its share buyback program. MHK now trades at about 8x earnings and at a FCF yield of 10%.

Setup

As discussed above, quantitatively the story remains very much the same: **PVP's portfolio is cheaper than both value stocks and the market overall, with superior returns on capital**. While lower than recent quarters on account of rising rates, the Equity Risk Premium (ERP) of our portfolio remains comfortably above the market at 5.8% (8.2% FCF yield less 2.4% 30-year UST). At this level we believe we remain well compensated to bear the risk of equities.

	PVP [9]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2022E)	8.2%	4.3%	5.2%
Price/Earnings (2022E)	15.2x	20.3x	15.8x
Debt/EBITDA (2021)	3.1x	2.6x	3.0x
EBITDA margin (2022E)	27.4%	20.3%	19.4%
Return on Equity (2022E)	17.5%	19.3%	15.7%
Return on Invested Capital (2021)	10.8%	9.8%	8.4%

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

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