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VALUE PARTNERS
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Dear PVP partners and friends

At the risk of repeating myself, **it was another volatile quarter.** This is typically the case when there is such a monumental shift in Fed monetary policy. This current cycle has encompassed the very necessary easing in the aftermath of the 2008 Financial Crisis, through QE (Quantitative Easing), QE2 and QE3, and culminating in ZIRP (zero interest rate policy). Ultimately this extreme dovishness was partially responsible for the inflation that took root in 2022 that has resulted in an about-face to a policy of extreme hawkishness on the part of the Fed.

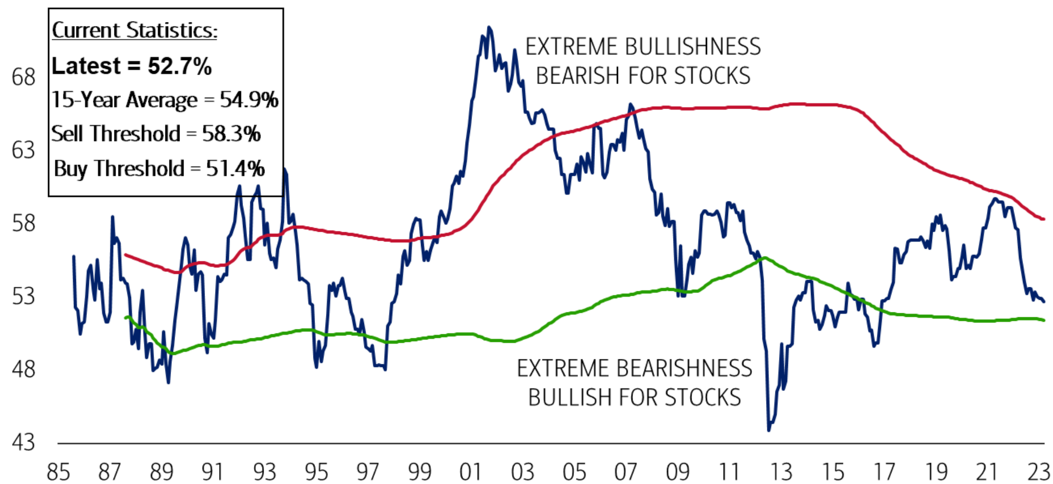
The year began with a nice continuation of the momentum from 4Q22, with value stocks continuing to massively outperform growth stocks. Then, in early March, the rapid demise of Silicon Valley Bank (discussed in greater detail below) led to **a crisis of confidence in the banking system** that quickly brought down the entire market, but especially the financial sector, leading investors to flee to the "safety" of technology and other growth stocks – even after the sector had performed so miserably in 2022. In the last week of the quarter confidence had begun to return, as the market began to appreciate that Silicon Valley was not at all a typical bank. But in the meantime a lot of damage had been done.

The Fed now believes it is in a quandary. (What else is new?) On the one hand, it has committed to conquering inflation (which very much appears to be happening). On the other hand, it would prefer to avoid a recession incited by this tightening, and moreover now it also has to contend with a shakier financial system. On March 22, with the bank crisis still raging, the Fed actually continued tightening – the opposite of what we would typically see in a time of crisis – to the tune of 0.25%, although it was tempered with some conciliatory language about future policy, which did ease some market fears about more gas being thrown on the fire. Market participants currently ascribe 60% odds of a much-awaited Fed pause next month.

Meanwhile, **we wait for the most anticipated recession I can ever recall.** Clearly the economy is slowing. Whether we get to consecutive or more quarters of negative real GDP growth -- and if so, how bad and for how long? – still remains to be seen. The bond market seems increasingly more certain of recession, as the yield curve has become quite inverted. Counterintuitive to the normal "term structure" of interest rates, whereby investors are increasingly rewarded for longer holding periods, at quarter-end the 3-month UST yielded 4.85% and the 10-year UST yielded just 3.30%. Clearly it seems the bond market expects a recession around the corner, with attendant rate cuts.

For all these reasons – recession fears, rate hikes, financial crisis -- **market sentiment is currently very negative**. In fact, the well-known Bank of America "sell side indicator" (SSI), which tracks Wall Street strategists' average recommended allocations to stocks, is now at as low a reading as it was in the Financial Crisis of 2008. This is a "contra indicator" – in other words, the more bearish Wall Street is, the more upside there is for sentiment and thus stock prices. All else being equal, the current reading predicts a 16% return in the market over the next year.

Historically, when the SSI has been this low or lower, forward 12 month returns have been positive 94% of the time, with a median return of 22%. Of course these kinds of trackers should always be consumed with a heavy dose of salt, but this does offer some support for our generally optimistic outlook.



In terms of stylistic and **sector performance**, as discussed above, there was a sharp reversal in style outperformance due to the financial crisis in March, leading **growth** to prevail **over value for the quarter overall.** Not surprisingly, given the bank panic, the "growth sectors" (technology, consumer discretionary) performed best, while the "value sectors" (financials, health care, energy) performed worst. Also not surprisingly, large caps (both growth and value) materially outperformed their small cap brethren.

In aggregate **PVP was down 0.5% in 1Q23, with an annualized return since accepting our first partner capital in February of 2016 of 10.0%.**[1] There is no denying that this was *not* a quarter in which we covered ourselves in glory. Whether the quarter was great or not, though, we always ask our partners to take a longer term view, and we do take some solace in the fact that we have still outperformed the S&P 500 and major value and growth indices for the past five years.[2]

Looking forward, as discussed above, our portfolio's current Equity Risk Premium (ERP) of 5.9% (9.5% portfolio FCF yield, less 3.6% 30 yr UST) remains *extremely* attractive in our view. Predicting future returns via the ERP can be a crude tool when it registers in the "normal" range. When it reaches levels extreme enough to flash green or red, however, its predictive power tends to be much greater. Right now, unless a severe recession impairs our aggregate FCF yield, it looks pretty green, which makes us relatively optimistic about prospects for medium term returns.

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

[2] *For the 3-year period ending 3/31/23 annualized returns are: PVP (net): 18.9%; Russell 3000 Value: 18.1%; Russell 3000 Growth: 18.2%; S&P 500: 18.1%.*

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Actions taken in 1Q23

Buys in the quarter

We always want to be humble. Humility is extremely important as an investor, as the market throws us lots of curveballs. Rarely do we get the fat pitch right down the middle, and when we do we try to jump on it. So it is with a profound sense of humility that I relate the recent saga of **Signature Bank (SBNY),** which we acquired in February. We have written previously about ill-timed purchases, but this one truly takes the cake.

First, we need to understand what happened to SVB Financial (aka "Silicon Valley Bank"). SVB was a unique bank. It catered mostly to a venture capital/technology customer base, with generally small business rather than retail depositors. In fact, more than 90% of SVB deposits were in excess of the $250,000 FDIC guarantee. Although the bank had over 35,000 corporate clients, they were largely controlled by a small group of venture capitalists. This is key.

SVB also had a balance sheet problem. As interest rates have been rising, its bond portfolio had been relatively long duration even while, as we shall see, its deposits that fund the loans and investments can sometimes be quite short duration. This is called a "duration mismatch", which resulted in losses in the bond portfolio due to rising rates, which necessitated a capital raise to cover the resulting loss. Depositors, fearing the sudden uncertainty at SVB, quickly fled and greatly exacerbated the situation. SVB's unique combination of mostly large ($250K+) depositors, controlled by a relatively small number of VCs in a rather incestuous community, quickly resulted in a "run on the bank". By March 10th, enough deposits had exited that federal and state regulators shut down the bank, in the largest bank failure since Washington Mutual in 2008.

This very rapid series of events caused investors to ask: Is this a contagion? What other banks might be vulnerable? Who else "looks like" SVB? Signature, based in New York, only "looked like" SVB insofar as it also had a very well-heeled, small business-oriented clientele, with most depositors also above the $250K threshold. But Signature had no duration mismatch issue, and no need to raise capital; however, in a general panic investors will always shoot first and ask questions later. On Thursday, March 9th, with its stock price dropping in the wake of the SVB situation, Signature issued a press release confirming its diversified deposit mix, strong capital position, abundant liquidity, and an investment grade rating from Moody's, Fitch and Kroll.

Specifically, Signature's Tier 1 common equity risk-based capital ratio at year end was 10.4%, well in excess of regulatory requirements. As of March 8th, Signature had $4.5 bn of cash, marketable liquid securities of $26.4 bn, and the capacity to borrow an additional $29 bn (vs. total deposits of $89 bn). In other words, in the event of a bank run on Signature, it was in the seemingly quite solid position to quickly cover a loss of 2/3 of its deposits. Perhaps most astonishingly, its deposit balance as of March 8th was $89.17 bn, which was *up* $576 mm since year end. In fact, Signature was so confident of its financial position that it also announced that it had bought back $55 mm of its own stock during the week.

And yet three days later, on Sunday, March 12th, New York state regulators closed Signature. We have no idea what happened between Thursday and Sunday, and we probably never will. With First Republic (FRC), which is sort of a much larger version of Signature, also teetering, and the public growing increasingly concerned about a general contagion, presumably Signature was sacrificed to "ring fence" the problem, to try to contain it. When I asked the former head of the Office of the Comptroller of the Currency what exactly happened, he said: "I have no idea. That's a great question!"

As a postscript, on March 19th, regulators sold Signature to New York Community Bank (NYCB) for $2.7 bn. As an indication of the value that investors still ascribed to Signature, and the sweetheart price paid by NYCB, NYCB's stock shot up 40% as a result of the transaction. In the end, Signature was collateral damage as a result of SVB. Humbling indeed.

Sells in the quarter

On a much happier note, **Alphabet (GOOG)** was a terrific investment for us over a long period of time. When we sell, it is generally for one of three reasons: the stock has reached our target price (TP); a fundamental change has occurred that has invalidated our investment thesis; or another more promising opportunity has emerged that is a more worthy recipient of our precious capital. If we are doing our job well, most of our exits happen as a result of the first reason. In the case of GOOG, however, we have raised our TP numerous times over the years as a result of outstanding fundamentals, but now we fear a major future fundamental change. The company's core, in terms of source of advertising revenue, is its search engine. Others have tried and failed to unseat Google from its spot as king of the search heap. But now its rival Microsoft, whose previous search engine effort called "Bing" has gained little market share over the years, appears to have an AI-based search engine that could rival or even oust Google. Moreover, Microsoft management has hinted that it would be willing to compete on price in order to accomplish this. What an effective monopolist does *not* want is a credible and aggressive competitor. So even though GOOG has taken a bit of a hit from the 2022 tech sell off, and so although we are not quite selling at the top, we have decided not to stick around to see how this plays out.

Outsourced commercial services company **Aramark (ARMK)** was acquired during the pandemic, on the premise that it possessed the financial resources to withstand the downturn, and would likely thrive when the world reopened. As this started to play out, we were unenthused by management's complacency in reaching its profitability targets. Meanwhile, inexplicably, the stock climbed toward our Price Target. ARMK turned out to be an OK investment for us, and we were pleased to be able to exit in January around $44. The stock sits today at just under $35.

During the quarter we also sold two small "stub" stocks – small positions that we inherited when these entities were spun off by their former parents. **Bell Ring Brands (BRBR),** spun out of Post Holdings, is an exciting growth story (protein shakes and the like), rare in consumer staples. But the stock very quickly achieved a valuation with which we were not comfortable. **Warner Brothers Discovery (WBD),** on the other hand, spun out from AT&T, is a cash cow entertainment business with little prospects for top line growth, but which also has grand ambitions to compete vs. the big boys in streaming video. We wish them the best, but that is a tall order, and there is strong possibility that much of its attractive FCF might be squandered in the process.

Strong performers in 1Q23 [3]

There are many overvalued stocks that are spoken of euphemistically by analysts as "growing into their valuations". In the case of wealth and retirement solutions provider **Voya Financial (VOYA),** the opposite seems to be the case. Since emerging from Dutch insurer ING in the wake of the 2008 financial crisis, the company has made terrific progress evolving its portfolio toward

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[3] *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.*

less capital intensive, more highly valued profitability. Voya has been a very positive contributor over time, and still trades at only 8-9x earnings. Voya was up 16% in a quarter that was generally quite tough on financials.

Palo Alto Networks (PANW), the cyber security software provider, is another stock that has been very strong for us over a long period of time. In the most recent quarter Palo Alto posted impressive growth in every metric – billings, revenues, profits, cash flow, you name it -- as it has emerged as the clear leader in a sector with very high demand. One of our weaker stocks last quarter, PANW was up 43% in 1Q23.

Booking (BKNG) is the online travel reservation provider that we acquired during the covid pandemic. As travel continues to return, Booking has the wind at its back. Moreover, the company, which currently makes most of its money in Europe, is now making considerable progress in the US. Even after moving up 32% in the quarter, Booking still trades at an attractive 6% FCF yield.

Vontier (VNT), the industrial technology provider, has had a rather rocky start as an independent company since being spun out of Danaher (DHR) in late 2020. In the most recent quarter, however, our patience paid off as Vontier surprised to the upside, sending the stock up 42%. Based on the FCF the company expects to generate this year, VNT still trades at a very attractive 10% yield.

One of our stronger performers in 4Q22, **Mastec (MTZ)** was once again a great performer in the most recent quarter, as investors continue to appreciate the company's tremendous growth prospects in the buildout of 5G and renewable energy, and as the details from last year's federal infrastructure bill have begun to emerge. MTZ was up 11% in the quarter, and still trades at only about 7x EV/EBITDA.

Weak performers in 1Q23

Our biggest detractors in the quarter were primarily though not exclusively financials, for the reasons discussed above. **Signature Bank (SBNY)** was obviously our biggest detractor.

CVS Health (CVS) posted a strong quarter fundamentally but was off 20% presumably due to a cut in the "STAR" rating in its Aetna HMO unit, which likely results in a $2 bn annual headwind (on $84 bn total annual revenues in 2022) in reduced reimbursement from CMS (Medicare). Investors are possibly also contemplating potential legislation that might be detrimental to CVS's pharmacy benefit management (PBM) unit. CVS is now very inexpensive, trading at about 8-9x earnings and at about a 12% FCF yield.

Johnson & Johnson (JNJ) is an amazingly consistent, and resilient, company, with many "levers to pull" in its broad range of health care businesses when it needs to pull them. But JNJ has had a huge lawsuit regarding its talc baby powder for several years, which has finally come to a head, and investors have been worried about a potentially escalating price tag to settle the matter. Just after the quarter ended, the company announced that it had agreed to pay $8.9 bn over the next 25 years, even though it still calls the claims "specious and lacking scientific merit". For perspective, JNJ is expected to generate $26 bn of FCF this year.

Providence, RI-based superregional bank **Citizens Financial Group (CFG)** posted its usual strong quarter but suffered along with most other regional banks (down 23% in 1Q23) from the scare around deposit safety in March. Citizens was so confident of its position that on March 13th

it decided to extend the hours at its branches and increase staffing to answer customer questions during the period of uncertainty. CFG now trades at just 6x earnings and at about 70% of BV.

In a continuation of its multi-year turnaround, insurer **American International Group (AIG)** once again showed nice improvement in the profitability of its core P&C unit. Like most other financials, however, AIG was dragged down in March by the fears around bank deposits. AIG is now valued at about 8x earnings and at less than BV.

Setup

As discussed above, quantitatively the story remains very much the same: PVP's portfolio generates superior returns on capital even though our stocks are cheaper than the market. While rates have risen, our Equity Risk Premium (ERP) remains quite healthy and is well above the market at 5.9% (9.5% FCF yield less 3.6% 30-year UST). At this level we believe we are being very well compensated to bear the risk of equities.

	PVP [4]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2023E)	9.5%	4.6%	5.3%
Price/Earnings (2023E)	13.0x	18.0x	14.7x
Debt/EBITDA (2022)	3.2x	2.5x	2.7x
EBITDA margin (2022E)	28.3%	19.5%	19.0%
Return on Equity (2023E)	19.2%	18.3%	15.0%
Return on Invested Capital (2022E)	11.8%	9.3%	7.9%

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

[4] *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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