PROSPECTIVE
VALUE PARTNERS
309 COURT AVENUE, SUITE 211, DES MOINES, IA 50309 · prospectiveVP.com

July 2021

Dear PVP partners and friends,

The equity market continued its generally upward trend in the quarter (albeit at a decelerating pace, especially toward the end of the quarter). The positives we have discussed in recent quarters— widespread vaccinations, ending of shutdowns, enormous monetary and fiscal support, and corporate outperformance — overcame a handful of impediments to full recovery, such as vaccine manufacturing challenges, new covid strains, the ongoing shortage of both semiconductors and service employees, the clear emergence of inflation (more below), fears of higher taxes, and even cyber attacks on major corporations.

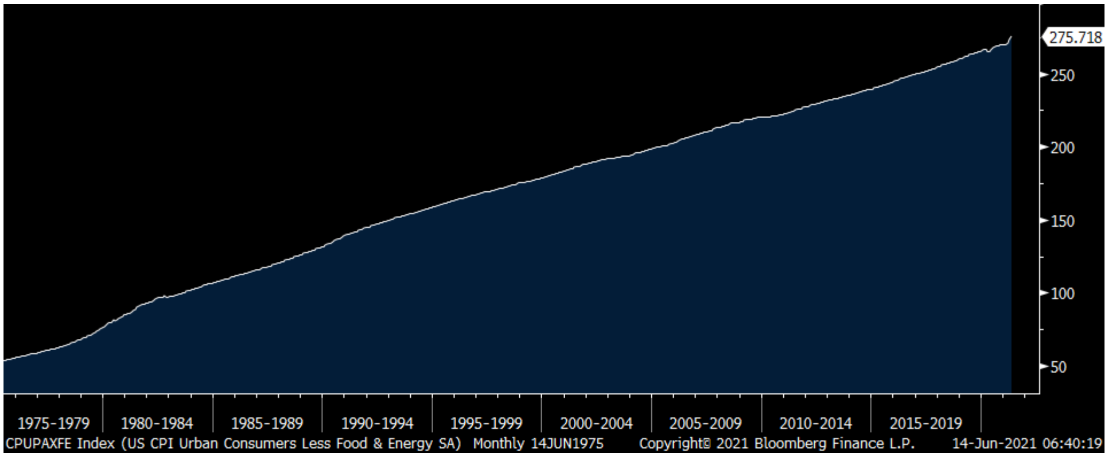
In May the Colonial Pipeline, responsible for transporting much of the Eastern US with fuel, was a victim of a Ransomware attack, allegedly perpetrated by an Eastern European gang called “DarkSide”. This resulted briefly in something unthinkable to any American not old enough to remember the 1970s – gas lines. Shortly thereafter, JBS, the Brazilian company that is the biggest meat producer in the world, with significant US operations, experienced a similar situation. More important than the obvious short term impact on fuel and meat prices and economic output, these attacks, on the heels of various other similar cyber attacks in recent years, expose ongoing vulnerability in our infrastructure. As an investment implication, we would expect these types of incidents to reduce risk appetite and thus expand the Equity Risk Premium (ERP) – the compensation that investors demand for bearing equity risks.

About halfway through the quarter the market was also briefly rattled by **the monthly CPI report, which indicated price pressures considerably beyond market expectations**. We have written in recent quarters about the rising odds of inflation, and now we believe the verdict is in. The classic definition of inflation is “too much money chasing too few goods”. In hindsight, with the unprecedented monetary and fiscal support and quite speedy recovery from the pandemic we have seen in the past year, coupled with an inability to meet that demand due to factors such as difficulty finding workers, a semiconductor shortage, global shipping challenges, etc., inflation to some extent seems to have been inevitable.

Various markets had already begun to reflect this likelihood, such as the commodity costs that tend to be precursors of inflation, as shown in the chart below. But the April CPI figures -- in which “core” (ex the more volatile food and energy) inflation spiked almost a full 1% in just a month, vs. a 0.3% expectation -- makes a strong case that inflation is here in a meaningful way. One major contributor to the CPI jump was used cars and trucks, which, presumably on account of a scarcity of new vehicles due to the global semiconductor shortage, increased an astonishing 10% in just a month – the highest monthly price increase in recorded history! Anecdotally, moreover, many of our companies discussed inflation on their quarterly calls, and several high profile companies that employ low paying service labor have recently announced wage hikes in order to attract more workers.

The related questions at this point in our view are not whether inflation has arrived, but rather: How bad will it get and for how long? The Fed’s official posture is that inflation will likely be transitory in nature, and it has given no indications that inflation will cause it to reverse its various “easy money” policies any time soon. Markets are obviously not quite so sure. Consider also that since former Fed Chairman Paul Voelker last snuffed out inflation about four decades ago, most investors today have never seen real inflation in their professional lifetimes.

Inflation is of course a tax on all of us, and is generally bad for most investments. Especially bonds. While we don’t claim any special insights on where inflation might go from here, and for how long, lest we get too agitated by the seemingly sudden appearance of inflation, we must also maintain a perspective. Per the chart below, it is certainly not new, especially on the services side. If you’ve paid college tuition or a health insurance premium in the past several decades, then you know what I mean. What *is* new is that it has quickly emerged in *goods*. In the chart you can see a higher slope in the late 1970s, and a very small spike to account for recent history, but overall inflation has been consistently "up and to the right" over the entire time period.



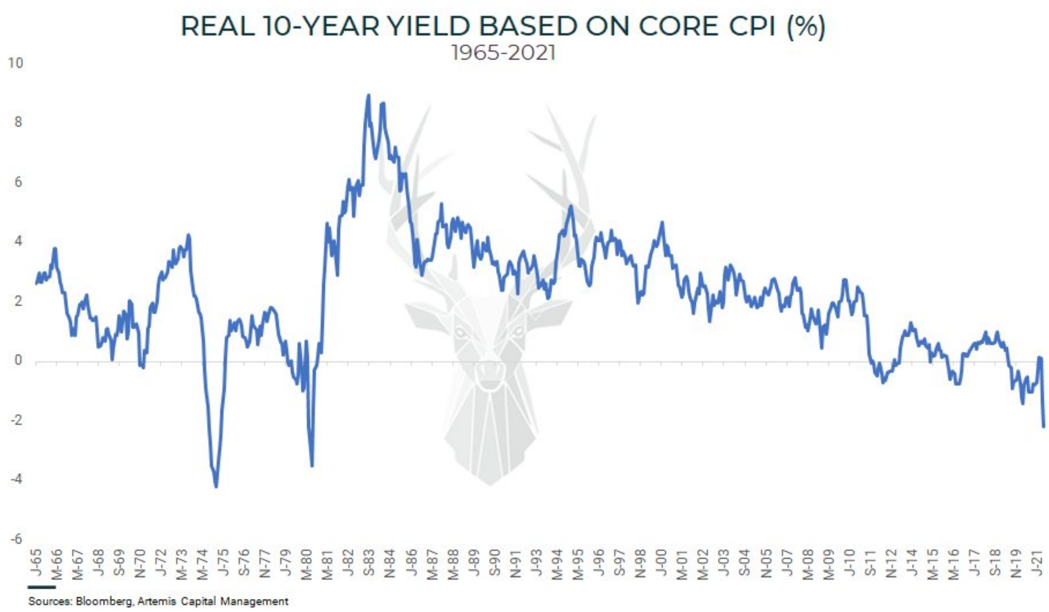
We should also point out that there are some countervailing factors as well. First, almost 1/3 of our portfolio is invested in financials, and most of these companies' margins will benefit from the continued rise in interest rates that inflation will presumably bring about. Second, partly in anticipation of the possibility of inflation, we also have invested a material portion of the portfolio in commodity-oriented companies such as **Westrock (WRK)** (paper), **Nutrien (NTR)** (fertilizer) and **Lyondell Basell (LYB)** (chemicals), which are all already benefiting from current and prospective price increases in the underlying commodities. Various other of our holdings, such as energy infrastructure players **Williams (WMB)** (pipelines) and **Cheniere (LNG)** (liquefaction), and **Berry (BERY)** (plastics), are also indirect beneficiaries.

Third, as we discuss *ad nauseam*, ours is a relatively *high quality* portfolio, as demonstrated by our fairly high portfolio ROIC (Return on Invested Capital). High ROIC companies tend to be leaders in their industries that possess pricing power, the ability to pass on higher input costs to their own customers. Fourth, the inflation discussion invariably invites the "recency bias", since the 1970s/very early 80s was our last experience with significant inflation, and of course this was generally a terrible time for stocks. But recall that period was a countercyclical *stagflation*, in which inflation is accompanied by very slow or even negative economic growth. In contrast, in the current situation the *pro cyclical* inflation we have seen so far has been accompanied by very robust growth.

And finally, as we have also discussed above and in recent quarters, higher inflation means higher interest rates, which tends to favor value stocks over growth stocks, since the cash flows generated by value stocks are realized closer to the present, as opposed to the projected cash flows of growth stocks, which happen farther off in the future and must be discounted back to the present at higher rates, making them less valuable.

This inflation uptick, concurrent with a surprisingly weak employment report, is also another nail in the coffin of the Phillips Curve, which postulates an inverse relationship between inflation and unemployment, and was once firmly ensconced in economic orthodoxy. With an increasingly technological and globalized workforce, that relationship has clearly been debunked.

Interestingly, with a heightened awareness of the threat of inflation, along with the ongoing very strong economic growth, **we would have expected bond yields to rise, but they didn't. In fact, the yield on the 30-year Treasury bond dropped from 2.41% to 2.06% in the quarter.** We suspect this primarily has to do with anticipated future Fed actions, and perhaps also with certain technical factors. While we frequently discuss the ERP as a valuation tool for equity investors, we can examine *real* returns (nominal yield less inflation) for bond investors in an analogous way. As demonstrated in the chart below, with higher inflation yet lower yields, bond investors are now increasingly accepting *negative real returns.*



In our view the Fed is now in a bind. After many years of "Quantitative Easing" (QE) in the wake of the Global Financial crisis, and then another massive QE during the pandemic, we now have artificially compressed interest rates, and the Fed has a bloated balance sheet from buying risk assets, at a time when inflation appears to be taking off. The Fed's "official" position at this point is that they expect inflation to be "transitory", and so QE has continued even as the economy has boomed post pandemic. We shall see. If the Fed is wrong, and inflation is stickier than it expects, it will be put in a position where it must not only "taper" QE but possibly even reverse it entirely, in order to address rising inflation. We are reminded of the so-called "taper tantrum" of 2013, in which equity markets reacted fairly violently to the downside when then-Fed Chairman Bernanke announced a similar cessation of QE in response to increasingly favorable economic conditions. QE has become a drug that the stock market likes quite a lot, and ending it – no matter how artfully communicated – is not likely to make it happy.

Last quarter, given the ongoing very positive trifecta of easy monetary policy, fiscal stimulus and corporate outperformance, and the resulting extremely outsized equity returns in the past five quarters, we discussed the question of "how much is priced in at this point?" In early May we came across this little nugget: At that point in time 88% of public companies had exceeded consensus expectations for 1Q, yet shares of these outperformers gained only 0.1% the day of the announcements – a reaction that Bloomberg calls the most muted on record. We don't believe this means the recovery in equities is necessarily out of gas, but clearly anecdotes like this strongly suggest the "easy money" has been made, and that future returns will be predicated on the normal "grind" of growing free cash flow over time.

So where does this leave us? How are we positioned? We believe our portfolio still has plenty of pro cyclical "juice", primarily in financials, where we continue to generally find valuations quite attractive. Yet (as we shall discuss below) we have also taken this opportunity to trim some of our cyclical "winners" and to buy some high quality steady non-cyclical businesses "on sale". Whereas we have embraced the cyclical recovery with arms wide open in recent quarters, as the stocks have increasingly caught up with the improving fundamentals we believe more caution is warranted.

As long term interest rates dropped in the quarter, a funny thing happened on the way to the return of value stock leadership. While value performance has stormed back vs. growth since last September through the end of May, in June this outperformance reversed to such an extent that **growth actually handily bested value for the quarter.**[1] It is not easy to say what exactly caused this rapid change in sentiment. We have heard a wide variety of theories, and we suspect it was mostly about interpreting the Fed's tea leaves, along with some suggestions of a deceleration in the global recovery, with the rapid drop in price of certain commodities a poster

[1] *In 2Q21 the Russell 3000 Growth index returned 11.4%, vs. 4.8% for the Russell 3000 Value.*

child for that point of view. For our part, we believe the recovery is continuing full steam ahead, and we never expected it to be completely linear.

In terms of sector performance, the first two months of the quarter were a continuation of the same trends we have seen since last September, with the most cyclical industries (financials, energy and basic materials) leading the way. In June, however, technology regained its leadership, with financials and basic materials in retreat. For the entire quarter, then, it was a mixed bag. Technology was at or near the top in what some consider to be a "flight to safety", but the cyclical energy sector was also among the best performers. Meanwhile, the traditionally defensive consumer staples and utilities sectors were at the bottom. Overall every sector showed positive performance in the quarter other than utilities.

In aggregate **PVP was up 4.4% in 2Q21, and is now up 18.2% ytd in 2021, with an annualized return since accepting our first partner capital in February of 2016 of 14.2%.**[2] Looking forward, our portfolio's current Equity Risk Premium (ERP) of 5.1% (7.2% portfolio FCF yield, less 2.1% 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, but, as we have seen, it is always difficult to say *when*.

<u>Actions taken in 2Q21</u>

Buys in the quarter

We were relatively active in the quarter. While we have benefited greatly in recent quarters from our large representation of "old economy" cyclicals (especially financials), we believe the big shift in investor focus has left behind a number of very attractive tech-oriented or tech-enabled stocks with all the cash flow and other characteristics we always require, providing us the opportunity to continue to "own the future – but at value prices".

Vontier (VNT) is a relatively new entity, having gone public in September 2020, but the underlying business has been around for quite some time housed inside the venerable Danaher (DHR). Vontier provides a wide array of solutions in the broad category of "industrial technology", with diverse offerings for retail, environmental, auto repair and even "smart cities" customers. Currently trading at a FCF yield in excess of 10%, the stock is not yet well known by

---

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

investors, and where it is known there is great skepticism around the company's ability to transition its large fuel retailer unit to an EV future. Our VNT investment is in large part a contrarian bet on a very seasoned management team at a very cheap valuation.

SS&C Technologies (SSNC) is a provider of software that enables a variety of transactions, primarily in finance but also in health care. SSNC has a very impressive track record in a very steady business, and over time it has deployed its ample FCF into acquiring adjacent businesses. With the pandemic thankfully subsiding, the company's investment management customers are seeing fewer redemptions, which is causing SSNC's top line to inflect positively. SSNC trades at an attractive 7% FCF yield.

NCR (NCR) has a very long history, starting as National Cash Register in the late 19th Century. Today most investors know NCR for its duopolist position, with Diebold, in the ATM industry. But in recent years, under new leadership, NCR has leveraged its position in payments to become more broadly a "fintech" solutions provider, as the engine in digital banking, point of sale retail and hospitality transactions, etc. NCR has also taken on more of the appearance of a software rather than hardware provider, with recurring rather than lumpy revenues that tend to be more highly valued in the marketplace. Even on somewhat depressed 2020 results, NCR trades at almost a 10% FCF yield.

Science Applications International (SAIC), much like our CACI (CACI) holding, is both a defense contractor and also a provider of outsourced technology solutions to the US Department of Defense and certain intelligence agencies. Technology is becoming an increasing "share of wallet" in the budgets of the DoD and other federal agencies. SAIC trades at a very healthy 9% FCF yield.

Cornerstone OnDemand (CSOD) provides "human capital" software to companies around the world, with offerings ranging from compliance to technical training and even general education. The workforce of the future seems increasingly comfortable in learning this way, and the "virtual office" created by the pandemic probably only enhances the attractiveness of this software. CSOD has lagged behind its peers somewhat, both in financial metrics and stock performance, and as a result an "activist" investor has recently acquired a significant stake in the company, with the goal of maximizing shareholder value. CSOD has healthy growth prospects, and trades at about a 5% FCF yield.

Exits in the quarter

The experience of **Biogen (BIIB)** seeking approval for its Alzheimer's drug, aducanumab, is a multi-year saga we have previously discussed at great length. And at last, on June 7th, notwithstanding the fact that the FDA's own panel had recommended denying approval several months ago, the FDA approved adu! Because we knew many were betting against approval and thus were "short" the stock and now forced to "cover" (buy), and because we also realize how controversial both the approval and suggested pricing were, we sold the stock a few minutes after the announcement. We sold at $424, which was about 10% off the high that day ($469), but also well above the close for the day ($396). Our last buy of BIIB was 18 months ago, at $245. By the end of the quarter BIIB had traded down to $346.

Macquarie Infrastructure (MIC) is a holding company with three major business units: IMTT (energy storage); Atlantic Aviation (private jet housing/maintenance); and MIC Hawaii (utility). Fortunately during the pandemic IMTT prospered (energy storage costs soared) even as Atlantic struggled, which we highlighted five quarters ago when we discussed our portfolio companies most vulnerable to covid. A few months prior to the pandemic MIC, frustrated with its stock price, announced that it would seek "strategic alternatives" for each of its units, and perhaps even sell the entire company itself. Amazingly, even during the pandemic MIC has been able to come to terms on the sale of each of its three units, so the holding company is effectively liquidating. In December 2020 MIC sold IMTT, and this June MIC agreed to sell both Atlantic and MIC Hawaii. Fortunately we held on to MIC during the dark days of last Spring, as we were confident in the value of the underlying businesses, and we sold the stock in June at a price up 175% from that pandemic bottom.

Raytheon Technologies (RTX) is the result of the merger of Raytheon with our former holding, United Technologies. That transaction also resulted in the spinoff of Carrier Global (CARR), the HVAC company, and also Otis Worldwide (OTIS), the elevator company. Both of these spinoffs have been spectacularly successful, and, as previously discussed, we sold them both – alas probably too soon. The remaining entity (RTX) has also done reasonably well since the merger, even with substantial aerospace exposure (Collins Aerospace and Pratt & Whitney) that has suffered through the pandemic. The remainder of RTX is defense (Raytheon), and in light of our already heavy defense exposure (LMT, HII, CACI and now SAIC), as well as a valuation that is not so compelling, we sold the position.

Unfortunately not all of our exits are predicated on stocks achieving their PTs. In the case of **Adtalem Global Education (ATGE),** the company announced the resignation of its CFO –

always a red flag, at the very least. We dug a little and learned that the departure was likely about him moving on to another very compelling opportunity rather than anything amiss with the company's financials. But this was followed two weeks later by the resignations of Adtalem's General Counsel and also a Board member. In this case we quickly sold the stock before we were able to learn more. Recall Adtalem is in the process of a highly contentious acquisition of Walden University from Laureate Education, and we believed discretion is the better part of valor here. Subsequently we learned these resignations were also likely benign and coincidental events, but still we are left with some questions. We exited with a relatively small profit from our recent buys from August through November last year, and at a price well below what we believe ATGE might be worth in the event Walden is a successful acquisition. We will continue to monitor the situation.

Strong performers in 2Q21[3]

Whereas in the past several quarters since the March 2020 low it has been mostly our outsized weighting in financials doing the heavy lifting for us, with long term interest rates declining and the yield curve flattening in 2Q21 more recently the outperformance has been more idiosyncratic. In the case of **Cheniere (LNG),** the company continues to make tremendous progress in both its current operations and its future LNG liquefaction facilities. Even though the company's economics are barely impacted by movements in commodity prices, in the short term the stock does tend to be, and so with gas prices continuing to rise as the world reopens LNG was up 21% in the quarter.

As discussed above, **Biogen (BIIB)** received the great (and highly controversial) news of the FDA approval of its aducanumab for Alzheimer's Disease in June, and we sold the stock immediately at a price 51% above where it was at the beginning of the quarter. We will continue to monitor the situation. If Biogen is able to convince neurologists that adu is beneficial to patients and also convince payors that it is worth the steep price tag, BIIB is likely worth a lot more.

Although relatively dormant in recent quarters as cyclicals moved to the fore, in the most recent quarter, even with multiple reports of increased regulatory scrutiny, **Alphabet (GOOG)** and its

[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.*

"Big Tech" brethren were outperformers. GOOG grew revenues an eye-popping 35% year over year, with profitability growing even faster, and the stock was up 17% in the quarter.

For the third straight quarter, engineering and construction company **Mastec (MTZ)** was among our top five performers. In addition to another outstanding "beat and raise" quarter, the likelihood of a major federal infrastructure bill has probably increased since it appears now to have received bipartisan support. Mastec was up 12% in the quarter, and once again we took some profits.

Pipeline operator **Williams (WMB),** like Cheniere, has more of a "toll booth" energy infrastructure-like business model than one heavily dependent on commodity prices, yet in the short term its stock also tends to trade in line with movements in the underlying commodity. In addition, Williams reported a strong quarter and raised guidance for the year, sending its stock up 11% in 2Q21.

<u>Weak performers in 2Q21</u>

As discussed above, **Adtalem Global Education (ATGE)** was overall a profitable investment for us, but most of that appreciation occurred in the prior two quarters. In the most recent quarter ATGE sold off 14% before we made the decision to sell, after the very unusual circumstance of two members of senior management, and one board member, resigning almost at the same time.

Leading aircraft lessor **Air Lease (AL),** whose clientele is overwhelmingly international, had a bit of a messy quarter as it worked with its lessee clients to get through the pandemic, sending the stock down 16% in 2Q21. Nonetheless, we have a great deal of confidence in this management team, and believe the company is making certain short term sacrifices that will be quite beneficial longer term. We remain convinced that AL will emerge from the pandemic stronger than ever, so we added to the position during the quarter. AL currently trades at a quite attractive discount to BV.

As we have discussed previously, **SONY (SONY)** has done an admirable job in recent years of transforming its portfolio of businesses and becoming more shareholder-friendly. Although the company reported another outstanding financial performance, sales in its largest unit (games) were negatively impacted by the inability to procure certain components, such as semiconductors. Still, growth in that segment was 34% in the last fiscal year, and is expected to be 9% this year. SONY was down 9% in the quarter.

In an environment that continues to be generally “risk on”, consumer staples such as **Altria (MO)** have generally been underperformers. MO, down 7% in the quarter, trades at just 10x earnings and generates a lot of FCF, with a very attractive 7.3% dividend yield.

Enstar Group (ESGR) is a specialty insurer which acquires “runoff” and other “unwanted” businesses from other insurers, and then very skillfully manages the ongoing liabilities. Considering its $5 billion market cap, ESGR is an extremely illiquid stock, so short term price movements are often impossible to correlate with fundamentals. Not much has changed for Enstar since last quarter, other than nice growth in BV, when it was one of our top performers. Already a large position for us, we took advantage of the weakness and added to our ESGR holdings in the quarter. ESGR has grown its BV at a 15+% CAGR for the past decade, yet trades at about a 15% discount to BV (which itself is likely understated).

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 both value stocks and the market overall, with superior returns on capital. The Equity Risk Premium (ERP) of our portfolio remains comfortably above the market at 5.1% (7.2% FCF yield less 2.1% 30-year UST). At this level we believe we are reasonably well compensated to bear the risk of equities.

	PVP[4]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2021E)	7.2%	4.1%	5.1%
Price/Earnings (2021E)	15.9x	23.7x	17.9x
Debt/EBITDA	3.7x	3.3x	3.8x
EBITDA margin[5]	28.0%	19.2%	19.0%

[4] *Data for both PVP portfolio and Russell indices are generally via FactSet. In a few instances, we have made minor adjustments.*
[5] *Data is 2021E for PVP; 2019 for Russell indexes. Unfortunately, 2021 data unavailable.*

	PVP	Russell 3000	Russell 1000 Value
Return on Equity (2021E)	16.0%	18.0%	14.5%
Return on Invested Capital[6]	10.5%	6.8%	5.6%

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

The information contained herein is proprietary to PVP and may not be copied or distributed. Past performance described in this document is not a guarantee of PVP's future results. Please be advised that both investment returns and principal can fluctuate widely, so an individual's investment could be worth more or less than its original cost, depending on market and or economic conditions.

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