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Dear PVP partners and friends

Another quarter has passed, and the recession debate continues. Most market participants wonder whether it will be a "soft landing" or "hard landing"? A few dissenters wonder whether there will be any landing at all? The classic recession playbook makes a fairly convincing case for a downturn, with a profoundly inverted yield curve, the most M2 contraction (money supply) in nine decades, and the Fed Funds rate up an astonishing 5% in just over a year. These factors led 100% of professional investors surveyed in mid-June by market strategy firm ISI to expect an imminent recession in the next year (monetary policy has a lag effect).

On the other hand, sometimes it is helpful to bear in mind Mark Twain's contrarian quip that "whenever you find yourself on the side of the majority, it is time to pause and reflect". The economy, while clearly slowing, has so far remained remarkably resilient. The bulls point to consumers continuing to spend, healthy employment, robust capital expenditures, and (perhaps most surprisingly) even a housing market that continues to march forward. Moreover, the stock market appears much more optimistic than the bond market.

In early June, at long last, the Fed either "paused" or "skipped" (depending on one's perspective) another rate rise, taking no action on interest rates for the first time since the covid-fueled inflation hit the central bank's radar about five quarters ago. Inflation has quickly receded, cooling from a brief period of quite heated levels not seen in four decades. In the end, we suspect Powell was correct in his much-pilloried -- and late -- characterization of inflation as "transitory" in 2021. (Of course, it depends how we define "transitory".) **Now, as always, all eyes are on the next move by the Fed.** Chairman Powell has not yet declared a final victory over what appears to have been a brief bout of inflation, and in fact there are various hints that the Fed may continue to raise rates. But if the Fed is not done tightening, it is certainly close.

While we certainly have our opinions, we are not macroeconomists and thus we are not "top down" investors. We are "bottom up" investors who believe we can add more value assessing the fundamentals of individual companies, as opposed to divining the next Fed move or economic data. While we are certainly cognizant of the macro, we try to build diversified portfolios that can succeed in various economic environments. Because we are value-oriented investors, though, there is some degree of economic cyclicality in our portfolio. For this reason we believe our portfolio valuations are currently weighed down by the recession expectations discussed above. To the extent the recession around the corner is milder than the market expects – or, heaven forbid, if it doesn't happen at all – we believe our portfolio is particularly poised to benefit.

This is not to say our portfolio is excessively levered to the economy. Our largest position, **Cheniere (LNG)**, which we discussed in some detail recently, is technically classified as an energy company. But really Cheniere is an LNG infrastructure/distribution company, whose revenues are largely locked in for many years to come with long term contracts, and profitability is only minimally impacted by short term swings in the price of the commodity. While the commodity will move the stock in the short term, ultimately the valuation will be determined by the cash flows the company generates – which are large and growing. Our #2 position is **Berkshire Hathaway (BRKB)**, with a variety of operating units but whose largest business is insurance. Our #3 position is **Enstar Group (ESGR)**, which acquires and manages runoff insurance portfolios.

Our fourth largest position is **Berry Group (BERY)**, which makes plastic packaging primarily for consumer and health care customers. Our #5 position is the health care company **Johnson & Johnson (JNJ)**. We need to move all the way down to our sixth largest holding, **Mastec (MTZ)**, the engineering and construction company, to find significant economic cyclicality among our top holdings. And Mastec is not really a "normal" cyclical, with the tremendous secular wind it has at its back from huge public and private infrastructure spending on things like 5G and renewable energy, and the many other projects that derive from the $550 bn Infrastructure Law of 2022.

The bank crisis of March now appears to be firmly in the rear view window. Many banks took the unusual step of updating investors at various points intra quarter on deposit levels, which are now steady; however, the much higher interest rate regime that precipitated the crisis still has resulted in certain depositors moving their funds to higher-paying instruments such as money market funds. This means banks will have to pay a bit more for their own funding, while at the same time they have taken measures to increase liquidity in the event of more deposit runs. Finally, in light of the "work from home" phenomenon, there is significant concern in the industry regarding the credit of commercial real estate (CRE) loans, and in fact some banks have already suggested that CRE losses will tick modestly upward (albeit from historic lows) in the short term. These factors will result in modestly diminished profitability for the sector. Time will tell where these CRE losses will trend, but bank valuations suggest a great deal of pessimism.

In terms of stylistic and sector performance, **2Q was a continuation of the 1Q reversal of the mini "tech crash" of 2022, leading growth stocks again to outperform their value counterparts.** And more specifically, it was large growth leading the charge, which materially outperformed small growth. The promise of AI has captivated investors, and they have charged back into the large tech names they seemingly abandoned about six quarters ago.

Year-to-date performance of the FAANGs (and their kin) has been eye-popping: NVDIA (NVDA), a chipmaker most people outside of technology and finance have never heard of, is now worth more than a trillion dollars and was up 189%; Meta (META; aka Facebook) up 147%; Amazon (AMZN) up 53%; Apple (AAPL), now worth three trillion dollars, up 44%; Microsoft (MSFT) up 38%; and Alphabet (GOOG; aka Google) up 33%. This handful of stocks has become so big in market capitalization that they have an impact on indices that is wildly disproportionate to their number of constituents. So there was large tech and then there was everything else in the quarter. Generally speaking, most other sectors were modestly up for the quarter, with the exception of energy and utilities, which were modestly down.

In aggregate PVP was up 4.3% in 2Q23, with an annualized return since accepting our first partner capital in February of 2016 of 10.3%.[1] Notwithstanding the snap back of technology and other growth stocks so far in 2023, PVP on a net basis still has continued to outperform the major indices over the past three years.[2]

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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] *Annualized 3-yr returns for the period ending June 30, 2023: PVP (net) 15.0%; S&P 500 14.6%; Russell 3000 Value 14.3%; and Russell 3000 Growth 13.0%.*

Looking forward, our portfolio's current Equity Risk Premium (ERP) of 5.4% (9.3% portfolio FCF yield, less 3.9% 30 yr UST) remains quite attractive in our view. So with a stabilizing inflation and rate environment and a highly uncertain economic backdrop, as always we are moving forward…with caution.

Actions taken in 2Q23

Our longtime readers are well aware that we are far from "day traders". We tend to enter and exit (and trim and add to) positions cautiously, guided by the target prices we set for every stock we consider. Even by these standards, however, the quarter was an unusually quiet one for us. As the market volatility was rather low, we were not presented with the usual number of opportunities to buy and sell at levels we consider exceptionally attractive. In an investment environment in which time horizons are becoming more compressed every year, we consider such patience to be a competitive advantage, a virtue rather than a vice.

Cyber security software provider **Palo Alto Networks (PANW)** was a terrific stock for us, returning nearly 5x our original investment. Palo Alto has never really been a "cheap" stock, but we have long hung our hats on the ample FCF the company generated (which grew exponentially in our period of ownership). It can be tricky to find an appropriate exit point for stocks like PANW that have acquired considerable momentum. In this case, during the quarter we learned that the cyber software market had become increasingly competitive lately, and that Palo Alto was offering its product for free for increasingly longer periods in order to take more business from competitors. While we expect the company to continue to be successful, this is the kind of "red flag" we don't like to ignore, so we sold the stock in June. The lofty current PANW valuation leaves little room for disappointment. Of course, this one mere exit does not mean we did not stay busy. Historically speaking, this time spent "sharpening the pencils" tends to plant the seeds for profitable future investments.

Strong performers in 2Q23 [3]

Engineering and construction company **Mastec (MTZ)** was again a top performer for us, up 25% this quarter, as investors' excitement continues to grow regarding future profitable opportunities for the company. This growth, as discussed briefly above, is expected both from big secular trends like 5G and alternative energy and also from last year's significant federal infrastructure legislation. As CEO Jose Mas said on a recent conference call, "it is as if the [new law] were created for us." In light of the strength we have taken some profits in MTZ, but it remains a substantial position. The stock currently trades at about 10x EV/EBITDA.

Trucking company **XPO (XPO)** in recent years has spun out two of its own companies (truck broker RXO and logistics provider GXO) to shareholders, which has made their parent XPO a smallish position for us. With low expectations, a more resilient than expected economic backdrop, and the very real potential for bankruptcy for one of XPO's major competitors (Yellow Corp), XPO was up 84% for the quarte

[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.*

Berkshire Hathaway (BRKB), as noted above, remains a large position for us. As we have discussed in recent quarters, while the company's diverse industrial and consumer businesses have continued chugging along, the rise in rates brought about by inflation and the Fed had created optical (non-economic) challenges for Berkshire (and others), which are now reversing themselves. In addition, Berkshire has an enormous position in Apple (AAPL), whose stock has performed very well lately. BRKB was up 10% in the quarter.

High end home furnishings company **RH (RH)** (aka Restoration Hardware) has benefited greatly as both the housing market and consumer spending have remained relatively resilient, and the stock was up 36% in a quarter that began with very low expectations.

By virtue of its widespread insurance holdings and very strong and value-oriented investment track record, Canadian insurer **Fairfax (FRFHF)** is sometimes called "the Berkshire Hathaway of Canada". Like Berkshire, Fairfax has also benefited optically from the reversal of negative bond marks. Up 13% in the quarter yet still trading at a discount to BV, in our view Fairfax remains a remarkably inexpensive stock.

Weak performers in 2Q23

We bought fertilizer company **Nutrien (NTR)** for about $37/share in the very early days of covid, on the premise that the agriculture cycle was probably near the bottom, that Nutrien's relatively steady retail business would buffer the company somewhat from the violent moves in the price of the commodity, and that the company would likely be a major beneficiary of the inflation to come. Then, about a year later, Russia invaded Ukraine, effectively taking more global capacity out of the industry and further raising fertilizer prices. As inflation has quickly receded, however, fertilizer pricing has adjusted accordingly, and today the stock sits at about $60. While our initial thesis was validated and NTR still has been a very profitable investment for us (and we were fortunate to trim the position in Spring 2022 at $101), unfortunately we did "overstay our welcome" somewhat. While Nutrien profits are notoriously difficult to predict, based on current 2023 consensus views NTR now trades at just 5x EV/EBITDA and at a 10% FCF yield.

AT&T (T) is obviously not a "growth stock". We have owned it because the company has done an admirable job of generating abundant FCF even in a challenging revenue environment. In the most recent quarter, however, the company's FCF was modestly disappointing, sending the stock down 17%. The company attributed the shortfall to "timing issues" of capital expenditures and working capital, and in late June reiterated its expectations for FCF for the year. FCF is particularly important at a company like AT&T in order to fund its very healthy divided (7% current yield) and pay down its sizable debt load.

Citizens Financial Group (CFG) is the Providence, RI-based regional bank that has made terrific progress during our period of ownership. Currently, however, Citizens finds itself in the bullseye of the "bear thesis" that recession is imminent and will likely result in major CRE losses for the banks – and in fact, at an investor conference during the quarter the company's CFO suggested that charge-offs for the upcoming quarter would likely tick up ever so slightly (from current historically low levels). CFG was off 14% for the quarter, and now trades at just 6x earnings and about 60% of BV.

Cheniere (LNG), our largest position, posted another very solid quarter and continued to secure long term distribution contracts, but the stock was dragged down 5% by a relatively weak energy sector. In our view the stock remains exceptionally inexpensive at about 6x EV/EBITDA and a 12% current FCF yield.

Adtalem (ATGE) is the for-profit education company focusing on health care that has been an excellent investment for us over time. In the most recent quarter the stock sold off 11% as the US Department of Education proposed tougher new "gainful employment" regulations. Given the robust demand environment for the nurses, doctors and veterinarians the company educates, we believe Adtalem is quite well-positioned for any of these regulatory changes.

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 rates have risen, our Equity Risk Premium (ERP) remains quite healthy and is well above the market at 5.4% (9.3% FCF yield less 3.9% 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)	9.3%	4.1%	5.0%
Price/Earnings (2023E)	13.4x	20.1x	15.2x
Debt/EBITDA (current)	3.4x	2.6x	2.8x
EBITDA margin (2023E)	28.6%	19.4%	18.9%
Return on Equity (2023E)	20.1%	18.2%	14.9%
Return on Invested Capital (2022)	11.6%	8.7%	7.5%

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

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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