PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

Much like last quarter, the equity market has been a bit of a roller coaster for the last three months. July was mostly a continuation of the strong second quarter, with companies generally meeting or exceeding investors' expectations in their quarterly reports. Just prior to the beginning of August, however, an apparent escalation of the US-China trade dispute again roiled the market. Beginning in late August, though, the trade rhetoric softened, the Fed soothed the market with 0.25% of further easing, and so the equity market generally headed back upward until tapering off again at the end of September and into early October.

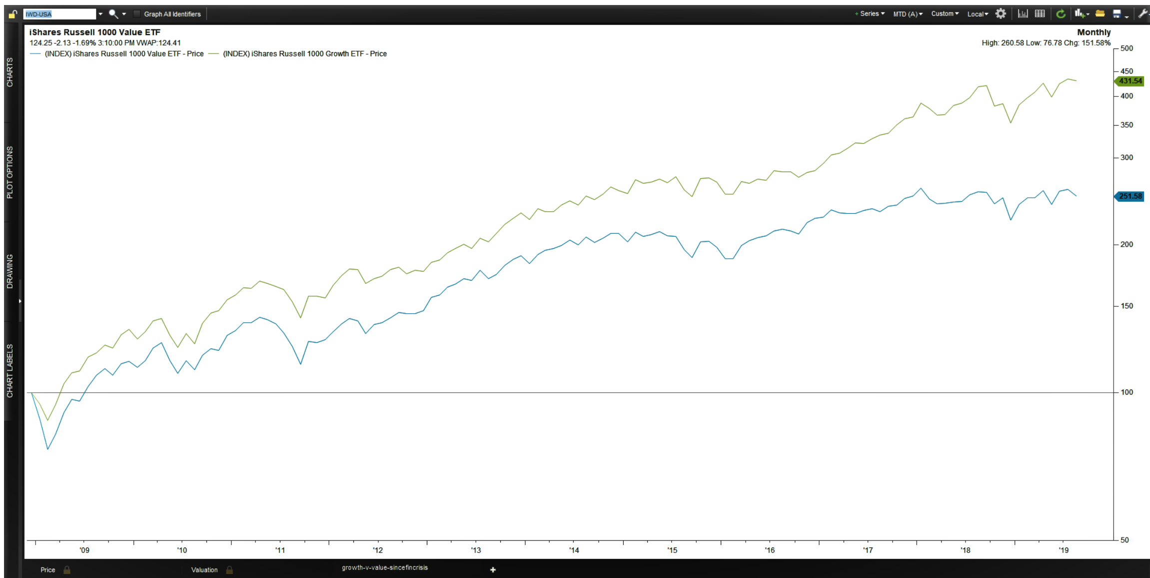
The yield curve -- which we define as the 10-year Treasury bill yield (1.7%) less the 2-month Treasury bill (1.9%) – **became *slightly* more inverted** in the quarter. Although lower rates increases the portfolio equity risk premium (ERP) and therefore makes equities more attractive overall, the lower rates and inverted curve will also continue to be headwinds for our large representation of spread-based financial holdings. The lower rates also likely reflect diminished expectations regarding economic growth and inflation, as well as elevated expectations for more Fed easing.

Is the inverted yield curve telling us that a recession is imminent? That is the question with which the market continues to grapple. For our part, **we are seeing a general deceleration of growth,** partly attributable to uncertainties around the China trade situation, but not negative growth. But we always respect the verdict of the bond market, and both ISM manufacturing and services indices were quite weak in early October, so the likelihood of a near term recession has grown. In any event, **we continue to proceed with caution.**

Two "macro" factors of note occurred in the last month – one quite positive for us, the other a bit ominous. First, the sobering event: In mid-September the normally quite stable **"repo rate"** (overnight loans between banks) **temporarily shot up to 10%** — a drying up of liquidity we haven't seen since the dark days of 2008 — until the Fed quickly stepped in to stabilize the market. The repo market now seems back to normal, and the situation has been understood as a confluence of technical factors. Nonetheless, that kind of brief "tremor" does speak to a financial system that remains vulnerable to certain shocks.

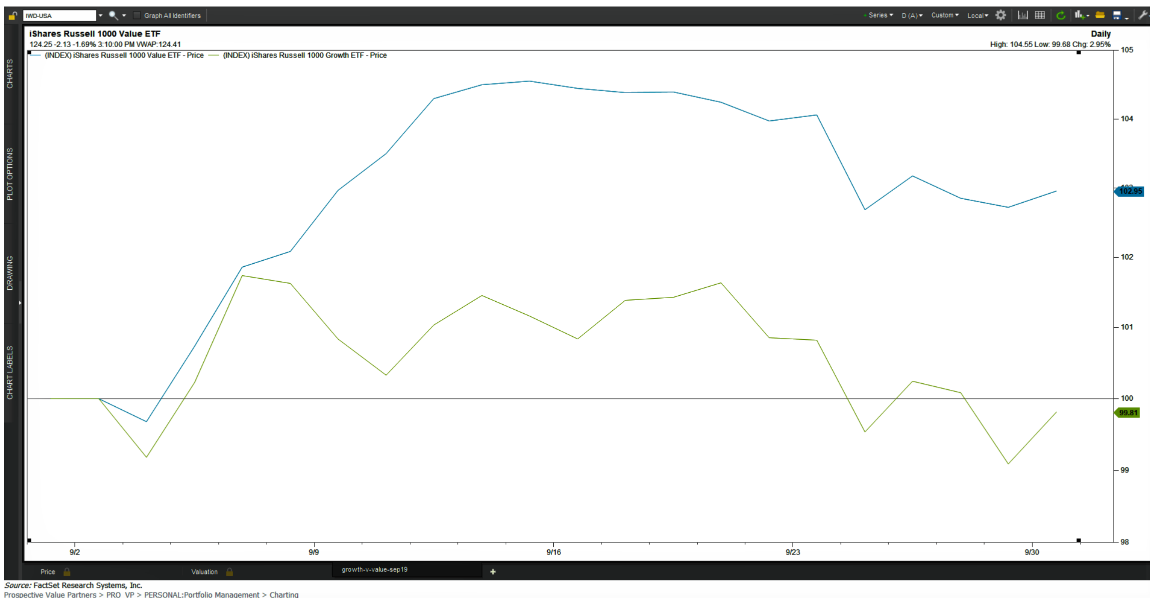
Now the encouraging news: Although growth stocks have handily outperformed value stocks since the end of the 2008 financial crisis (as seen in Exhibit A below), the performance of large "value" stocks approximately matched that of "growth" stocks during the quarter, and large **value handily outperformed growth in the most recent month** (as seen in Exhibit B below**).**

In small cap stocks the tilt to value was even more pronounced, with small value well exceeding small growth in both September and in the quarter overall. [1]



Source: FactSet Research Systems, Inc.
Prospective Value Partners > PRO_VP > PERSONAL:Portfolio Management > Charting

Exhibit A: Growth exceeds Value by 4.5% annually from beginning of 2009 through August 2019



Source: FactSet Research Systems, Inc.
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Exhibit B: Value snaps back in September 2019, outperforming Growth by 3.5%

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[1] *In 3Q19 the iShares Russell 1000 (large cap) Value ETF was up 1.3%, vs. up 1.5% for the iShares Russell 1000 (large cap) Growth ETF. In September 2019 the iShares Russell 1000 Value ETF was up 3.5% vs. up 0.0% for the iShares Russell 1000 Growth ETF. In 3Q19 the iShares Russell 2000 (small cap) Value ETF was up 0.2%, vs. down (3.9)% for the iShares Russell 2000 (small cap) Growth ETF. In September 2019 the iShares Russell 2000 Value ETF was up 3.5% vs. down (0.7)% for the iShares Russell 2000 Growth ETF.*

On September 9th there was a very *positive* tremor that seemed to kick start the trend, in which large value (up 0.8%) outperformed large growth (down 0.8%) by 1.6% in a single day. What caused this will likely remain a mystery. Our best guess would be that a large quantitative trader tweaked its program, the reaction to which possibly catalyzing others to quickly do the same. **In any event, it has been a very long time since we have seen such a pronounced shift in style leadership.** Will the "value shift" have legs? Very hard to say. But, **needless to say, if the shift to value continues it will certainly benefit PVP.**

In terms of performance at the sector level, there was a good deal of dispersion. The strongest sectors were, respectively, utilities, real estate and consumer staples. These are three traditionally defensive, "value"-oriented sectors -- although currently we do not see great value in real estate and utilities, so our exposure is minimal. We do have a healthy consumer staples exposure. The weakest sectors were energy (notwithstanding the Saudi bombings) and health care (where political rhetoric is heating up). We have little exposure to energy, and decent exposure to health care.

On the topic of politics, it now **looks like the House**, given Democrats' majority in that chamber**, is on a path to impeach the president.** Even if impeachment does happen in the House, given the hurdle would then become a 2/3 vote to convict in the Republican-controlled Senate, **the market** – rightfully in our view, based on what we know today – **is currently watching the unfolding drama with something approaching indifference.** In terms of historical precedents, when President Clinton was impeached, from January 1998 (when we first learned of Monica Lewinsky) through the Senate's acquittal in February 1999 the S&P 500 actually rallied 28%. On one hand, this was near the end of the tech bubble. On the other hand, there were also a number of *major* stressors in that time frame, including the collapse of Long Term Capital Management, the Asia crisis, etc.

Going back a few more years, the market struggled in the time leading up to the 1974 Nixon resignation, but that was quite a more challenging economy than what we have today – high inflation, high unemployment, high interest rates. Almost the opposite of the economy today. History aside, obviously **the market will become very concerned, very quickly, if it appears the current situation might evolve into a real Constitutional crisis.**

In aggregate **PVP was up 1.8% in 3Q19, up 19.2% ytd in 2019, and up 11.5% (annualized) since accepting our first partner capital in February of 2016.** [2] Looking forward, as we shall discuss below, our portfolio's current ERP of 5+% continues to be quite attractive, historically speaking. In other words, **we continue to believe we are being quite well compensated for bearing equity risk.** Of course, the ERP tends to predict returns out into the future, so **this is by no means a prediction about near term performance.** As always we encourage our partners to take a longer term view when assessing our track record. While we obviously cannot control or even predict the overall market direction in the short run, we can say that we continue to hold a diverse portfolio of free cash flow (FCF) generating companies, currently trading at a discount to the market, but with better quality characteristics.

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

Actions taken in 3Q19

Buys in the quarter

Although we did not add any new stocks to the portfolio in the quarter, as always we kicked plenty of tires, and we will likely be talking about some of them in coming quarters. We did, however, add to a number of our existing holdings in 3Q19, including the following: **Voya (VOYA),** the retirement solutions provider; **BJ's Wholesale (BJ),** the warehouse club retailer; **Adtalem (ATGE),** the for-profit education company; **AT&T (T),** the telecom and entertainment provider; and **Cheniere (LNG),** which liquefies natural gas.

It is worth noting that **we were able to take advantage of some of the volatility** during the quarter. In the case of VOYA, we added to the position in August at a level 15% below where we had trimmed the position just in July, and by the end of September the stock was back up 12% from where we added. Similarly, we added to BJ in August at a price 23% below where we had trimmed it in April, and the stock is now up 21% from our add. With ATGE, we last sold our entire position last November, and added to our new position at levels 28% lower. As we discuss in more detail below, ATGE has not yet given us immediate gratification from our add, however, and is currently down 9% from that point.

Exits in the quarter

Booz Allen Hamilton (BAH), the IT services provider to the federal government, performed very well for us during our period of ownership, with a total return of 149%. We expect the company's prospects remain bright, but we are no longer comfortable with the valuation. At current levels, we believe the stock is vulnerable to a real correction if there is any cessation of business momentum – and if that happens, we will happily re-evaluate.

Sherwin Williams (SHW), the paint company, was another investment in which our thesis (that price increases would catch up to rising input costs) played out even more quickly than we would have expected, with a 42% total return since our initial purchase just over a year ago. Like BAH, Sherwin Williams is a leader in an important business that we will continue to monitor for a more attractive re-entry point.

Strong performers in 3Q19 [3]

TerraForm Power (TERP), an alternative (wind/solar) energy provider, was our top performing stock in the quarter, up 27%. In July TerraForm announced a highly attractive acquisition, and in August the company reported strong earnings growth for the quarter and reiterated its plans to grow its dividend 5-8% annually through at least 2022. With a current dividend yield of 4.4% and high visibility on future growth, we continue to believe TERP is an attractive stock.

With the stock up 26% in 3Q19, we received some immediate gratification from infrastructure builder **MasTec (MTZ**), which we acquired just last quarter. MasTec was (and remains) a heavily shorted stock, with a "bear thesis" that there is a problem with the company's cash flow. Our due diligence strongly suggested this view is without merit, and in fact in early August the company announced a very strong quarter by any metric, as well as increased guidance. Although many

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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.*

shorts were flushed out by the quarter, the short interest remains stubbornly high, representing upside to the stock to the extent our own thesis continues to play out. Furthermore, while we are not expecting it, if major infrastructure legislation ever came to pass, we believe the upside would be significant.

The strong performance (up 13%) of long-slumbering **AT&T (T)** is a good example of the newfound respect for "value stocks" in the quarter. In addition, the company raised its FCF guidance and also commenced discussions with an activist investor who is seeking various shareholder-friendly changes. The company is committed to repaying debt from the recent Time Warner acquisition, which we applaud, and still sports a very attractive dividend (5+%) and FCF yield (10%).

Sony (SNE), one of our top performers last quarter, continued its momentum in 3Q19, with the stock up 13%. The company exceeded profit expectations for the quarter, and continues to make progress in its multi-year transformation. While many still think of Sony as a manufacturer of consumer electronics, the majority of its profits now derive from video games, music and imaging/sensors (think of the camera on your iPhone). Sony, like AT&T above and several of our other holdings, has also been engaged in discussions about further enhancing shareholder value with an activist investor.

Alphabet (GOOG) bounced back in the quarter (up 13%) after a rare "miss" in 1Q19, with the acceleration of revenue growth resulting in some degree of operating leverage. With its abundant FCF GOOG has also doubled the size of its share buyback authorization. While GOOG is generally not thought of as a traditional value stock, when we back out the enormous ($100+ bn) cash on its balance sheet, on an Enterprise Value/FCF basis the company trades at approximately a market multiple.

Weak performers in 3Q19

Adtalem (ATGE), which primarily operates medical, nursing and veterinary schools, was our most poorly performing stock (down 15%) during the quarter. The move downward has been perplexing, and so, as discussed above, we added to the position in the quarter. The company modestly exceeded expectations in the most recent quarter and affirmed its future outlook; it made continuing progress in pruning its portfolio; it upgraded its CFO (with the former CFO of Groupon); and insiders have been buying the stock. Normally these factors would have resulted in solid performance for the stock.

Johnson & Johnson (JNJ), the diversified health care and consumer products company that is the largest position in the portfolio, was down 7% in the quarter. Pharmaceuticals were generally poor performers in 3Q19, with both proposed drug pricing legislation and political rhetoric likely adding to the weakness. Although the company's fundamentals remain strong, JNJ is ensnared in two major areas of litigation: the company's role in the opioid crisis and also the allegation that the company's talcum powder contains asbestos. JNJ adamantly denies both charges, and we believe the company's case is strong. Still, while we take comfort in the ability of the company's AAA-rated balance sheet (which no doubt is also a very attractive target to any litigant) to handle any potential fallout from this litigation, these issues will still likely continue to create "noise" in the stock.

The drug maker **Pfizer (PFE),** like JNJ, suffered in the quarter (down 18%) from its inclusion in a sector that is currently out of favor. The company, which is in the process of combining its generic business with Mylan (MYL), also lowered its future earnings guidance somewhat.

Fortunately we had cut back the position substantially at levels 17% above its current price earlier this year. Nonetheless, Pfizer's new drug pipeline is quite robust, its growth will improve after divesting its slower growth business, and, now trading at 12x earnings, we find its valuation quite reasonable.

We originally acquired a position in **Mohawk (MHK),** the flooring and carpet maker, after the company's results had disappointed and the stock had been hit hard, but its turnaround now will take longer than we had hoped. The main culprits appear to be both that carpet is losing share to harder floors, and also that the consumer seems to be trading down in quality, from nylon to polyester. Moreover, there has been a flux of imports ahead of the June tariff increase, adding further competitive pressures. Mohawk, down 16% in the quarter, remains a well-managed leader in its industry, trading at a historically high FCF yield of over 8%.

Cheniere (LNG), like most of the energy sector, was somewhat weak in the quarter (down 8%), not helped by the fact that its 2Q results were somewhat "noisy" mostly owing to a swing in the valuation of some derivative contracts. Fundamentally, however, Cheniere continues to make excellent progress as the world's leading gas liquefaction company. As the company increases the number of "trains" at its existing LNG liquefaction terminals (in Louisiana), and expands into Corpus Christi, TX, Cheniere should be able to generate $8+ of cash flow by 2022, and ultimately much more. Yet the stock currently trades at just $63. As discussed above, we added to the position during the quarter.

Setup

As always, we continue to refine the positioning of the portfolio. PVP owns a diverse set of **high quality companies, operated by shareholder-friendly management teams with a proven track record in deploying capital.** Similar to previous quarters, as shown in the table below, the PVP portfolio remains cheaper than the Russell 3000, yet PVP's holdings have higher margins and greater returns than the Russell 3000, with similar leverage. Relative to the Russell 1000 Value index, PVP's valuation is cheaper on a FCF basis, yet PVP's margins and returns are substantially better.

To put PVP's FCF yield of 7.4% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 2.1%. This suggests an Equity Risk Premium (ERP) of 5.3% (7.4-2.1). At this level, as discussed above, we believe we are being well compensated to bear the risk of equities.

	PVP [4]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2019E)	7.4%	5.0%	5.5%
Price/Earnings (2019E)	16.7.x	18.8x	15.0x
Debt/Total Capital	44%	43%	41%
Debt/EBITDA	2.9x	2.9x	3.2x

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

	PVP	Russell 3000	Russell 1000 Value
2019E EBITDA margin	30.8%	19.3%	19.1%
2019E Return on Equity	18.1%	17.6%	14.1%
2019E Return on Invested Capital	12.2%	8.0%	6.6%

As always, we are so appreciative of the confidence you have shown in PVP, and we promise to work tirelessly to make you pleased with that decision. 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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