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Dear PVP partners and friends

**The recovery in the equity markets** from the late March lows created by the coronavirus pandemic, and our response to it, **continued through the first two months of the quarter. In early September, however, some volatility to the downside returned.**

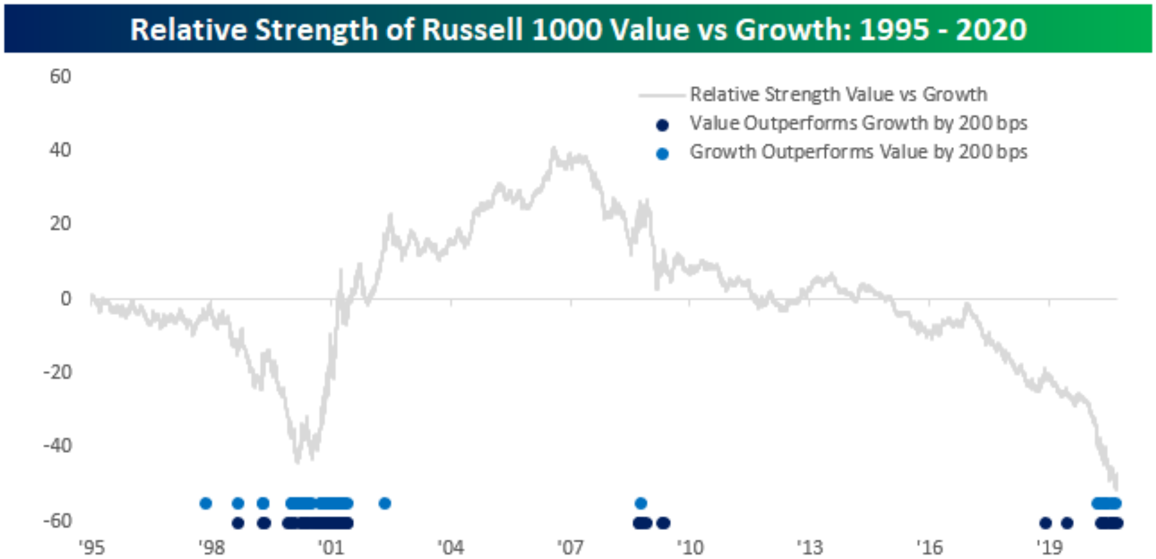
Various economic indicators, while quite positive compared to the previous quarter and still pointing to a probable "V"-shaped recovery, were not strong enough to top the very high expectations that had been set. Moreover, the additional fiscal stimulus that the market craves may be currently jeopardized by election politics. On a related note, the market has begun to focus on the increasing likelihood of a long, drawn-out election process with the potential to create lasting uncertainty, and possibly civil unrest and maybe even a Constitutional crisis. It is often impossible to say what exactly caused such a sharp reversal, but **perhaps we had simply climbed back too far too quickly** – led by a technology sector whose stocks had practically gone parabolic?

Consider the following signs of excess in technology and related sectors:

- Tesla (TSLA), the maker of electric vehicles, which has only been profitable for a few quarters and is expected to generate *revenues* of $30 billion this year, is now worth more than Walmart (WMT), the largest private sector employer in the USA, which has more than *half a trillion dollars* of annual revenues and is expected to generate nearly $20 billion of *Free Cash Flow* this year. Tesla is also worth more than almost every other automaker in the world, combined.

- In early September the US tech sector became more highly valued than the entire European stock market.


- Value stocks now trade at their lowest valuation relative to growth since early 2000.




It is said that history might not exactly repeat itself, but that it does tend to rhyme. Well, the 2020 vs. 2000 comparison is an interesting one, another quite painful time for value investors. Having invested through the period, we do take heart in the fact that, after growth trounced value by a whopping 45% in 1999, small cap value came back with a vengeance over the next several years, outperforming growth by 45%, 23% and 19%, respectively, in 2000-02. **Interestingly, while the late 1990s are generally remembered by financial markets for the mind-numbing upward moves in tech stocks, such as we have seen lately, when one considers the entire cycle, encompassing the bubble, crash and recovery, value handily outperformed growth.** [1]

**The "glass half full" take on the September downdraft is that value modestly outperformed growth for the first time in a very long while.** Will that one month of value outperformance continue? We have seen several "value tremors" that in hindsight were "head fakes" in recent years, so there is always reason to be skeptical, but we believe there are increasingly more reasons to be optimistic. Now at nearly 13 years, the current growth leadership is the longest period of outperformance on record. Cyclical value tends to lead in an economic recovery such as we are currently experiencing. Notwithstanding that recovery, the yield curve has remained stubbornly flat. But with the first discussion of potential inflation in a very long time, and the Fed not inclined to pursue a "Yield Curve Control" (YCC) policy, there are reasons to hope for a steepening curve, which would favor value.

Amidst this market turbulence, we have remained relatively cautious. As we discuss below, we have done our best to take advantage of what we believe to be excessive ebullience in certain

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[1] *In 1998, the Russell 2000 Growth (+1%) outperformed the Russell 2000 Value (-7%) by 8%. In 1999, R2KG (+43%) > R2KV (-2%) by 45%. In 2000, R2KV (+23%) > R2KG (-22%) by 45%. In 2001, R2KV (+14%) > R2KG (-9%) by 23%. In 2002, R2KV (-11%) > R2KG (-30%) by 19%. In 2003, R3KG (+49%) > R2KV (+46%) by 3%.* ***For the 1998-2003 period, R2KV average annual return was 8.9%, vs. 1.0% for R2KG.***

corners of the market, aided by the discipline of our rigorous process of establishing and updating Target Prices (TP). As we have done since the beginning of the pandemic, we have redeployed those proceeds into companies that we believe are well positioned both to ride out the current storm and also to emerge much stronger when it ultimately recedes. As we mentioned last quarter, we continue to be confident in our holdings to ride out the pandemic and its aftermath – some better than others, of course – but the timing of real economic recovery is impossible to predict with any certainty.

**Growth continued to outperform value in the quarter overall.** Along with the continuing leadership of the technology sector, the best performing sectors in the quarter were those most levered to economic recovery, such as consumer discretionary, materials and industrials. Two sectors that would ordinarily fall into that category are financials and energy, and both were up modestly but were laggards. In the case of financials, questions remain on the ongoing impact of the pandemic on credit, as well as the effect of rates/YC on margins. With respect to energy, the price of the commodities has remained stubbornly low as economic activity is down, and the secular headwinds facing carbon-based energy sources continue.

In aggregate **PVP was up 4.2% in 3Q20, and our annualized return since accepting our first partner capital in February of 2016 is now 7.8%.**[2] Looking forward, as we shall discuss below, our portfolio's current Equity Risk Premium (ERP) of almost 9% continues to be *extremely* attractive, historically speaking. As always, we encourage our partners to take a long term view. We believe we will be well compensated for this very healthy premium, we just don't know quite when.

## Actions taken in 3Q20

***Buys in the quarter***

**Seagate Technology (STX),** a stock we have owned previously, competes with Western Digital (WDC) in what has evolved into essentially a duopoly disk drive/data storage industry. Seagate, like Ciena (discussed below), represents another way to have exposure to increasing digitization and "connectedness" within the context of a value discipline. As more data flows, at greater speeds, the need for innovative storage solutions increases. While this core thesis is exciting, certain legacy markets have been severely impacted by covid, causing the company to reduce its outlook somewhat and giving us the opportunity to buy the stock at a very attractive valuation. The stock now trades at about 10x earnings, with a 9% FCF yield, and offers a 5.4% dividend yield.

**XPO Logistics (XPO)** is a very innovative, tech savvy transportation logistics provider, whose very entrepreneurial CEO has a tremendous track record for creating value in previous stints at United Rentals and United Waste Systems. XPO's businesses include both asset-based (trucking) and asset-light (logistics) operations, and the company is particularly levered to e-commerce. The company has grown quickly in recent years, both organically and through acquisitions (where it has been particularly successful), to become one of the industry leaders. Even in these covid times, XPO should generate enough cash flow this year to trade at a 6+% FCF yield.

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

***Exits in the quarter***

**Carrier (CARR)** is the HVAC spinoff from United Technologies resulting from its merger with Raytheon to form Raytheon Technologies (RTX). As we were assessing what to do with our relatively small position during the depth of the pandemic, the stock continued to climb. In late July we sold the stock, up more than 2x from the price where it had begun trading in March.

Our other sales in the quarter can be simply explained as our sell discipline meeting a relentless appetite for tech stocks, forcing us to part ways with companies we greatly admire. In the case of **Apple (AAPL),** the stock is now about 35x earnings. Even though AAPL is expected to generate a whopping $70 billion of FCF this year, at a $2+ trillion market cap the FCF yield is now just over 3%.

**Ciena (CIEN),** the networking equipment company, was not only a very profitable investment for us, but also one of our most fortuitous sales in recent years. We bought the stock in February/March around $40 and sold the bulk of it in August at about $60, as it had surpassed our TP. Subsequently, later that month, CIEN had an earnings report that seriously disappointed investors, and the stock is now again around $40 – where, in our view, the recent hiccup notwithstanding, the stock looks pretty attractive. We don't claim to have possessed any special insights with the company's quarterly report just around the corner, but it is a good example of the benefit of adhering to a rigorous sell discipline – especially in a stock that had moved up so quickly for us.

In the quarter we also trimmed our positions in **Amazon (AMZN), Alphabet (GOOG)** and **Palo Alto Networks (PANW).** These stocks have also done well this year, and our trims kept the stocks at position sizes commensurate with our conviction levels. Technology is now less than 7% of our overall portfolio. This is not because we dislike tech, but rather a function of the current opportunity set. As tech valuations rise, we will likely continue to take profits and redeploy proceeds into more attractive opportunities. On the other hand, to the extent tech continues the sell-off that we saw in September, you should expect to see us make opportunistic buys.

## Strong performers in 3Q20 [3]

It seems so often the case that our worst performers in any given quarter become our best performers in subsequent quarters. In 2Q **Berkshire Hathaway (BRKB),** now our biggest position, was our third worst performer. As we discussed last quarter, Berkshire's unrealized losses on publicly traded equity had "artificially" depressed its Book Value (BV). As the equity market has recovered, so too has Berkshire's BV and thus BRKB as well. The stock was up 19% in the quarter.

**Comcast (CMCSA),** the diversified media company, is another large position that we have long believed to be undervalued. Although the pandemic is adversely affecting the company in a variety of ways, Comcast still reported a quarter that exceeded expectations. In addition, in late September it was revealed that two major "activist" investors now agree with us, as they have taken stakes and intend to help create more shareholder value. CMCSA was up 19% in 2Q.

As discussed above, **Apple (AAPL)** was a terrific investment for us, up 178% from our initial purchase in September 2017 through our final sale in August. There is obviously much to like

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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.*

about Apple's prospects, but at current valuations we believe those bright prospects are more than appropriately reflected in the stock price.

In the depth of the equity market crash, in mid-March, as sometimes happens in panic situations, **Nextera Energy (NEP),** the wind/solar energy project manager, was the proverbial "baby thrown out with the bathwater". We added substantially to the position at the time, making it one of our larger positions, and the stock has now almost doubled since then. NEP was up 18% in 2Q.

**Nutrien (NTR),** the fertilizer company, like Berkshire, was one of our worst performers last quarter, which reversed sharply this quarter, with NTR up 24%. Like NEP, Nutrien was also a stock that we believed had been unjustifiably tainted by covid fears, so we added substantially to the position in March and April. Even as agriculture remains in a downcycle, NTR is still generating abundant FCF through the pandemic, and still has a very attractive dividend yield of just under 5%.

**<u>Weak performers in 3Q20</u>**

The recent stock moves in **Adtalem Global Education (ATGE),** the for-profit company formerly known as Devry, have been perplexing. In recent years the new CEO has fine-tuned the company's sprawling operations, divesting several units and creating a hoard of cash on the Balance Sheet, in order to focus primarily on the company's core mission of health care education (doctors, nurses and veterinarians) and, to a lesser extent, other professional education. In September Adtalem announced that it would deploy that cash, and also assume some debt, in acquiring online health care education company Walden University. The deal seems to make sense to us – an adjacent asset, at an attractive valuation, with favorable return characteristics. For now at least, though, the market disagrees, sending ATGE down 21% in the quarter.

As discussed above, the banks were relative laggards in the quarter, with some much worse than others. **Signature Bank (SBNY),** based in NYC and recently expanding on the west coast, is one of the highest performing small banks in the country, but the market remains extremely concerned about potential losses from the pandemic – especially commercial real estate. Despite the large additions to loan loss reserves in the past two quarters, and the CEO's optimistic tone on the most recent earnings call, the market is skeptical, with SBNY now trading at about 8x earnings and less than 90% of Tangible Book Value (TBV).

Although **Citigroup (C)** has taken extraordinary measures to build its loan loss reserve even as it maintains profitability through the pandemic, investors remain skeptical, sending the stock down 15% in the quarter. In addition, the Fed, the company's primary regulator, has extended its restrictions on capital returns to shareholders (share buybacks) of C and the other largest banks for at least another quarter. Citi plans to maintain its very healthy dividend (4.7% current yield) as it awaits approval to deploy its excess capital in shareholder-friendly ways.

Shipbuilder **Huntington Ingalls (HII)** was down 19% in the quarter, as the company revised downward its expectations for future margins. In addition, sentiment for the Defense sector has been generally weak as investors contemplate potential DoD spend in a Biden administration. The stock is very inexpensive in our view, trading at about 10x earnings and about a 9% FCF yield, for a company with greater visibility on future revenues, in terms of backlog/revenues, than any we have ever seen.

Like many banks, **Pinnacle Financial (PNFP),** based in the southeastern US, was weak this quarter, down 15%. Historically among the highest growth/returns performers in the country, the bank is currently focused on potential credit problems that might emerge from the pandemic. Although the company, like others, has built its loan loss reserves considerably, and has also provided highly encouraging detail on its decreasing deferrals to borrowers (granted in light of the pandemic), the stock still trades at a considerable discount to BV.

## Setup

Particularly in times of stress, such as we face today, the equity market functions more as the proverbial voting booth than the scale that is preferred by fundamentally-oriented investors like PVP. We don't know how others will vote, so we don't pretend to know what will happen to the market in the short term. But if we make the assumption that we *will* get through this period, we believe it is still helpful to look at some comparative metrics.

Since 2020 results are an aberration, we are continuing to use 2019 data as a starting point. The numbers below have changed a bit, but the story remains very much the same: PVP's portfolio is historically cheap, with superior returns. Moreover, our companies' superior margins will take a hit but will help them weather this storm. Using 2019 FCF, the Equity Risk Premium (ERP) of our portfolio remains extraordinarily high at 7.9% (9.4% FCF yield less 1.5% 30-year UST). If we look forward to 2021, which of course the market is doing already, we suspect our aggregate FCF yield will be even higher. At this level we believe we continue to be *very* well compensated to bear the risk of equities. In other words, we remain optimistic about the prospects for our portfolio as the economy continues to heal.

| | PVP [4] | Russell 3000 | Russell 1000 Value |
|---|---|---|---|
| Free Cash Flow yield (2019) | 9.4% | 4.3% | 5.1% |
| Price/Earnings (2019) | 14.5x | 19.0x | 14.4x |
| Debt/EBITDA | 3.2x | 3.5x | 3.9x |
| 2019 EBITDA margin | 31.4% | 19.2% | 19.0% |
| 2019 Return on Equity | 18.1% | 17.6% | 14.1% |
| 2019 Return on Invested Capital | 11.3% | 5.7% | 4.8% |

[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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