PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

After five straight quarters of outsized gains coming off the pandemic lows, in which PVP returned a net 74%, **in the most recent quarter we encountered some volatility**.

As usual, there were a combination of factors at work. Although many data points suggested a clear continuation of the economic recovery, the pace of that recovery did moderate somewhat in 3Q21. The **main culprit was the "delta variant"** of covid, which resulted in diminished economic activity, relative to expectations, around the globe. Related, the dislocated global supply chains we have discussed in recent quarters became more of a problem, causing some profit warnings from a handful of companies most directly affected.

This economic deceleration, which seemed to be confirmed by an apparent drop in inflation, was reflected in the bond market as well, with the "flight to safety" resulting in the 10-year UST falling from about 1.5% at midyear down to less than 1.2% in August. **By the end of September**, as **the market began to reassess the delta variant as more of a speed bump than a real threat to the recovery,** the 10-year UST shot back up above 1.5%.

As a result, for the stock market it was something of a tale of two very distinct periods. Although the equity market mood was mostly "risk off" through most of the quarter, with technology and other "growth sectors" outperforming, in late September equity leadership shifted to the more cyclical "value sectors", with financials and energy leading the way. Interestingly, looking at the quarter as a whole, there was **very little performance dispersion between sectors, and also between value and growth.** [1]

In recent quarters we have discussed in great detail the ever-increasing likelihood that the Fed would (over)achieve its goal of 2% inflation, and last quarter we shared how we have prepared for that possibility. While the Fed had steadfastly maintained its belief that the current high rate of inflation would be "transitory" (we just could not resist including the meme below), late in the quarter the Fed modified this view somewhat, effectively conceding that inflation was worse than expected. For this reason the market now has a consensus view that the Fed will begin its "tapering" process this quarter, the beginning of what may one day be the end of its extended "quantitative easing" (QE) program.

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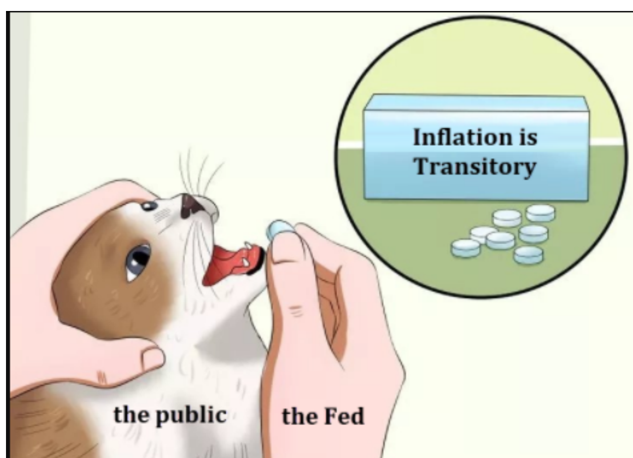
[1] In 3Q21 the Russell 3000 Growth index returned 0.7%, vs. (0.9)% for the Russell 3000 Value.



In terms of the “wall of worry”, there remains plenty out there to keep us up at night. Covid has not yet been completely conquered, and remains unpredictable, continuing to suppress economic activity. Geopolitical tensions in East Asia around the issue of Taiwan have been elevated of late, with both the US and China flexing military muscles in the region. Supply chain issues will no doubt continue to hamper certain companies’ performance. There are also serious question marks around trillions of dollars of US legislation, with a potential US default on its debt hanging in the balance. We believe this is not a likely outcome, but given the current circumstances it is more likely than it normally would be when it comes time to raise the debt ceiling. Finally, as noted above, inflation is here now, without a doubt. How bad it gets and for how long will be resolved over time. Inflation is likely to continue to make interest rates rise, and will also likely force the Fed’s hand in reversing its QE measures perhaps sooner than it had planned, which will add to upward pressure on rates. This is generally not good for stocks.

And yet we are optimistic. We expect the recovery, still in its early stages, to continue and hopefully accelerate. With rising rates, as discussed previously, we remain hopeful that the leadership shift from growth to value will have real legs. The plentiful proportion of financials in our portfolio will mostly benefit from rising rates, and the non-financials are generally leaders in their industries with some degree of pricing power to pass through the inflationary pressures. Technology remains in the regulatory cross-hairs, and we have little exposure there. And with an 8% aggregate FCF yield, we believe our stocks are cheap – especially with rates still as low as they are.

On this last point, valuation must always be considered in the context of alternatives. Our companies are generating 8 cents of FCF this year for every dollar we have invested right now. Of that 8c, almost 2c will be paid out to us as dividends, and the remaining 6c will be used to reinvest in the business, buy back shares, pay down debt, buy other companies, etc. By contrast, consider a popular “junk” bond index called the “High Yield 100”. These are lower quality companies than what we own, and that index has a current yield of just 3.7%. Whereas our 8% of FCF (and our 2% of dividends) will rise over time, *in the best case scenario* these high yield companies will pay out to bondholders the same amount each year. High Yield 100 investors only do better than 3.7% if interest rates fall farther. If rates rise, or if there are defaults, they will do worse than 3.7%. To us that seems like quite an unattractive risk/reward.

In aggregate **PVP was up 0.2% in 3Q21, and is now up 18.4% ytd in 2021, with an annualized return since accepting our first partner capital in February of 2016 of 13.6%.**[2] Looking forward, our portfolio's current Equity Risk Premium (ERP) of 5.9% (8.0% portfolio FCF yield, less 2.1% 30 yr UST) remains quite attractive. 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*.

Actions taken in 3Q21

Buys in the quarter

Our two new buys in the quarter, as well as several additions to existing holdings, reflect our view, as stated above, that we remain confident in the recovery. These stocks were discounted during the quarter due to the delta-driven market fears discussed above, fears that we expect to be more transitory than inflation fears.

Even though it is bigger and more established, **Principal Financial Group (PFG)** is a company that looks a lot like our Voya (VOYA) a few years ago – a traditional low return life insurer in the early stages of reinventing itself as a more focused "asset lite" and higher returning retirement services provider and money manager. As the company's mix shifts from more to less capital intensive businesses, PFG believes it can achieve an ROE of at least 15% by 2023. If management is able to accomplish this, PFG shares will be likely worth much more than its current 10x P/E and slight premium to BV. Principal, like most financials, also benefits from higher interest rates. PFG ended the quarter up modestly from our acquisition in August.

Booking Holdings (BKNG) is better known by most Americans for one of its small subsidiaries, Priceline.com, which of course also was formerly the name of the company. Today Booking is largely a European online lodging site, a space the company dominates. Booking is also investing heavily in the US and in airline tickets, where there are real opportunities, albeit at lower margins. Of course Europe has been slower to recover from the pandemic than the US, thus the opportunity in the stock. Booking expects to emerge from the pandemic a much stronger and more competitive company than pre covid. Based on 2019 results, which BKNG hopes to exceed by 2022, the stock trades at about a 5% FCF yield. This year the company is expected to be modestly profitable on revenues down about 1/3 from 2019. This is an extremely scalable business, of course, so when the revenues finally return profitability will quickly ramp much higher. At the end of the quarter we were up 13% from our initial purchase in August.

GXO Logistics (GXO) is the logistics company spun out to shareholders from our highly successful XPO Logistics in July. The rationale for the spin off was that separating the very attractive, fast growing and very high returning "asset lite" logistics business from the more mature legacy trucking business would create value for shareholders – and in fact GXO is up 31% since the spin. GXO and XPO both are currently benefiting greatly from the heavy demand for transporting goods.

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

Exits in the quarter

Our decision to buy any given security is never predicated on the likelihood of the company selling itself; however, sometimes the stars align for such a value-creating event even when the valuation suggests otherwise. In the case of HR software provider **Cornerstone Ondemand (CSOD),** which we acquired just last quarter, our gratification was fairly immediate when the company announced that it had agreed to be acquired by Clearlake Capital just about two months after we bought the stock, giving us a quick gain of 29%.

One way PVP tries to differentiate itself among value managers is that we always strive to "own the future…at value prices". But sometimes events unfold that lead us to question whether we are faithfully applying that aspiration. In the case of **Altria (MO),** we had a very cheap stock in a company with a very high ROIC and a great deal of pricing power, enabling it to optimize Free Cash Flow even as volumes contracted, while also investing for the future. But the company's new "risk reducing" products have faced regulatory and competitive challenges, making it relatively less attractive compared to alternative uses of capital, so we decided to re-deploy MO proceeds into what we believe are the more exciting opportunities in BKNG and PFG (described above).

Strong performers in 3Q21 [3]

Palo Alto Networks (PANW), the provider of cyber security software, has been an excellent investment for us over time. In the most recent quarter, buoyed by continued overall technology outperformance, PANW was up 29%. The company has been effectively riding a big secular wave of demand for its products, and posted quarterly results that topped even elevated expectations. Again we took some profits in the quarter.

Cheniere Energy (LNG), our top performer last quarter, had another outstanding quarter in 3Q21. In addition to a generally strong market for energy stocks, in early September -- for the first time, now that the bulk of its massive capex has been spent -- Cheniere spelled out for investors its capital allocation strategy for the plentiful FCF that results. Specifically, the company has committed to a dividend, share buybacks and also debt paydown. The market liked the plan, and so do we. LNG, now our largest position, was up 12% in the quarter.

So often it is the case that our weakest performers one quarter are among our stronger performers the following quarter. Not much has changed with **Sony (SONY)** recently, but sentiment has improved somewhat, and the stock was up 13% in 3Q21. Sony continues to trade at a discount to the market, and at a substantial discount to the competitors in its largest unit (gaming).

Insurer **American International Group (AIG)** has been a "turnaround" that has been excruciatingly slow to materialize. Recent quarters have shown real progress, however, and, aided both by an ongoing "hard" pricing environment and also a good deal of "self help", in 2Q AIG actually generated its best global commercial property/casualty profitability in 15 years! As part of its ongoing streamlining, AIG also plans to IPO its life/retirement unit sometime in the next few quarters. The stock was up 14% in the quarter, and still trades at a healthy discount to BV.

Again this quarter, as in 1Q21, **Alphabet (GOOG)** was one of our top performers. In spite of ongoing regulatory scrutiny of its business practices, Alphabet's growth was eye-popping in the

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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.*

quarter for a company valued at $1.8 TRILLION: 67% growth in revenues and 99% growth in EBITDA. Still, Google trades at just a small premium to the overall market. Again we took some profits in the quarter, and GOOG is now an average-sized position for us.

Weak performers in 3Q21

I suppose it is inevitable that our engineering/construction firm **Mastec (MTZ),** after three straight quarters as one of our top performers, would eventually give back some of those returns. In 3Q21 MTZ was by far our worst performer, off 19%. We continue to like the stock with or without the current proposed infrastructure bill, which on the recent earnings call the Mastec CEO described as sounding "like it had been written for Mastec". We had taken profits last quarter at higher prices, but MTZ remains one of our larger positions.

Financial technology provider **NCR (NCR)** has been a perplexing stock. Although the company has made tremendous strides in transforming its business model from "lumpy" hardware to annuity-like software, and is very much in the sweet spot of demand in terms of its current offerings, and also has exceeded investor expectations in recent quarters, the stock remains very inexpensive. With the stock off 16% in the quarter, we added to the position on the weakness.

Anheuser-Busch InBev (BUD) has been a challenging stock. When we initiated the position, BUD had a very impressive long term track record of both gaining share in its core brands and also successfully acquiring and integrating other beverage companies. But the global beer market is now largely consolidated, and spirits have taken share from beer in recent years. Then covid shut down so much of the bar/restaurant/event complex upon which BUD heavily relies. This has resulted in FCF declining by about 30% from 2017 through what is expected in 2021. Now a fairly small position in the portfolio, we continue to consider our options in this stock.

Fairfax (FRFHF) is an insurer/investor with a great long term track record, and is managed by a CEO (Prem Watsa) who is often described as "the Canadian Warren Buffett". The challenge with Fairfax as a public company is that it is quite complex, with dozens of private equity investments in various entities around the world. For this reason, among others, Fairfax earnings are typically "lumpy" and somewhat unpredictable. For long term shareholders like us, who are primarily interested in growing BV over time, that is fine. But the market doesn't typically appreciate unpredictability, so occasionally it presents us with bargains like Fairfax. With quite a few of these investments bearing fruit in 2021, we expect BV/share to be around $600 at yearend, and currently the stock is under $400.

Travel & Leisure (TNL), the time share vacation operator formerly known as Wyndham Destinations, has had a terrific bounce off the pandemic bottom last March, and has generally exceeded expectations since then. Still, however, as an "epicenter" stock, it suffered in the most recent quarter as fears swirled about the "delta variant". In September TNL hosted a very bullish investor day, where management suggested the company could return $3 billion (about 2/3 of the current value of the entire company) to shareholders just through 2025. If that number is anywhere close to reality, we believe the stock still has tremendous upside potential.

Setup

As discussed above, quantitatively 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 5.9% (8.0% FCF yield less 2.1% 30-year UST). At this level we believe we are quite well compensated to bear the risk of equities.

	PVP [4]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2021E)	8.0%	4.3%	5.4%
Price/Earnings (2021E)	17.6x	22.6x	16.8x
Debt/EBITDA	3.7x	3.0x	3.4x
EBITDA margin [5]	28.2%	19.2%	19.0%
Return on Equity (2021E)	16.8%	18.7%	15.2%
Return on Invested Capital [6]	11.2%	8.2%	6.8%

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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[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.*

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

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