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

October 2022

Dear PVP partners and friends

"Annus horribiblis" is how Queen Elizabeth II (RIP) described a particularly difficult year for the royal family thirty years ago. While my Latin is a bit rusty, it seems appropriate to recall that quip in the wake of her passing, as I think it also fairly accurately describes equity markets so far in 2022. **Volatility continued to be elevated**, driven by macroeconomic data and the Fed, in the equity markets in the most recent quarter. In July the market bounced nicely from the extreme levels of negativity toward the end of the previous quarter, only to be brought back down in mid-August by reports of weakening economies in various parts of the world, and the fears of economic contagion.

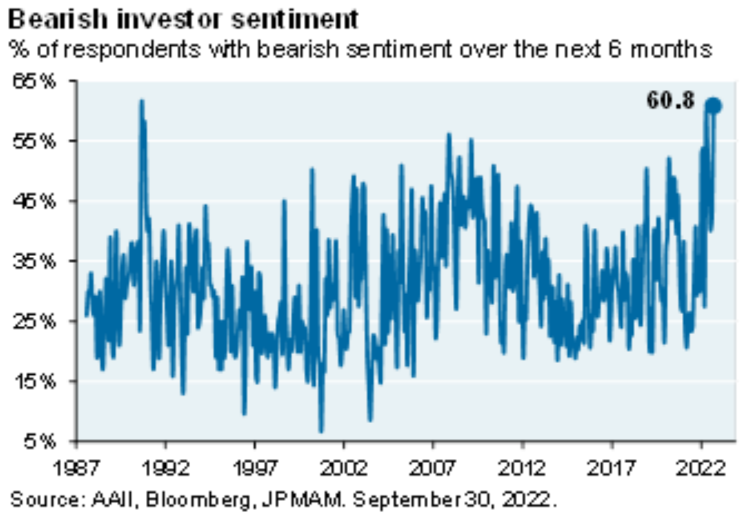
Then in mid-September, with elevated hopes that the market had made progress in doing its job of restoring supply/demand equilibrium post covid, and thus taming inflation, the monthly CPI report showed **inflation** to be **surprisingly persistent.** Not only is inflation generally bad for markets, but it also increases the likelihood that Fed policy would be more restrictive and for a longer time.

With now a second consecutive quarter of negative growth in real GDP (-0.90% in 2Q), **we are technically already in a recession**. For the past four decades this has generally been the time when the Fed injects liquidity into the economy by lowering rates. But now, on account of inflation, **the Fed is** going the opposite way and **aggressively raising rates**, which of course has the effect of further depressing economic activity.

Therefore, somewhat counterintuitively, good economic news has become bad news for the market, and vice versa, as investors assume strong economic indicators, such as job gains, will be interpreted by the Fed as inflationary and will result in "higher for longer" rates. (This is in spite of the fact that the "Phillips Curve", once economic orthodoxy positing an inverse relationship between inflation and unemployment, has been thoroughly debunked in recent decades.) Arguing for the more "transitory" view of inflation (as Fed Chairman Powell himself did for quite some time) and against the validity of the Phillips Curve, our friends at strategy firm TrendMacro refer to "the death race between receding inflation and the contractionary costs of an unnecessary Fed hiking cycle".

With an unprecedented third consecutive 0.75% rate hike from the Fed in late September and rising expectations for continuing hikes, and economic data pouring in from Europe and Asia suggesting a rapidly weakening global economy, the macro narrative seemed to shift from "inflation and rising rates" to "easy landing or hard landing?", reflecting an acknowledgement of recession in the US. This catalyzed another leg down for the stock market at the end of the quarter.

According to JP Morgan, per the chart below, **investor sentiment has become as negative as it has ever been in the 35 years** it has been surveying clients. Since we had front row seats at the bursting of the dotcom bubble in 2000, the great financial crisis of 2008 and various other major bumps along the road in recent decades, this seems astonishing, and is **quite possibly a very positive contra indicator.**



Earnings season was really not so bad this quarter, with both market-wide revenues and profits growing nicely and generally exceeding expectations. But as we know, the market is a mechanism that discounts the future, and at this point in time analyst expectations for profits and cash flow for major indices for the full year 2022 are modestly below actual 2021 results. Interestingly, current profit and cash flow expectations *for our portfolio* are almost exactly the same for 2022 as the actual results in 2021. If accurate, whether this speaks to the resiliency of our portfolio companies -- which we would certainly like to believe – or rather the tardiness of analysts in updating their estimates remains to be seen.

In terms of stylistic and sector performance, surprisingly, even in the face of rising rates (10 yr UST now above 4%), **growth modestly reversed its recent trend of underperformance vs. value.** Most likely this reversal reflected the shift in the economic narrative discussed above – from higher inflation/higher rates to recession. Notwithstanding the relative benefit of rising rates for value, value indices hold more cyclical stocks than growth indices**. Nonetheless, technology continued to be among the weakest sectors** during the quarter, along with communication services and REITs. **Energy was again the major positive sector** in most all indices. **Again, small stocks outperformed large stocks** in the quarter. All being equal in a recession, we would generally expect the better capitalized large companies to outperform their smaller brethren, but the dollar continued to strengthen this quarter, which disproportionately hurts the exports of the larger companies.

It is always a fool's errand to try to predict where the market might go in the short term. **We try to stay focused on the fundamentals, which ultimately determine stock prices. Although a recession impacts most of our holdings**, as we have discussed in recent quarters**, the higher rate environment actually increases the profits of our financial holdings (a sizable 30% of the portfolio).** The net interest margin (difference between lending yields and funding yields) for most banks will increase, largely because in a very low rate environment (such as we have seen in recent years) the zero interest checking accounts are virtually worthless when any funding is virtually free. When rates pick up it is much more valuable to have free money to fund lending activities. Likewise, the “float” earned by property/casualty insurers and the “spread” earned by life insurers also increases as rates rise (even though, as we have seen, insurer book values can be temporarily impaired due to accounting rules by unrealized losses in bonds).

So we are comfortable overall with our large financials overweight, and we expect it will augment future outperformance. The one major caveat to this optimism would be that, if the recession is long and quite painful, credit losses will accumulate as companies and consumers are unable to repay their loans. One mitigating factor, though, is that lending standards have generally remained quite high since the aftermath of the Financial Crisis of 2008.

Our sizable commodity exposure is also fundamentally benefiting from the current environment. Cheniere (LNG), our largest position, is the liquefaction company that is discussed in some detail below. Related, our large holding in Nutrien (NTR), the fertilizer company, benefits from some of the same dynamics, since natural gas is a key ingredient in the process used to make nitrogen-based fertilizers.

Like last quarter, while we certainly are not happy with 2022 performance so far, we do take some consolation that we have done less badly than most every major equity index – although we modestly lagged our index, the Russell 3000 Value, in this most recent quarter. As our longtime readers know, we try very hard to think of our investments as partial ownerships of businesses rather than mere blips on a computer screen which may or may not accurately reflect the value of those businesses. In time our experience has been that fundamentals (“the scale”) trump short term price movements (“the voting booth”).

Looking forward, we believe our portfolio of very high quality companies will hold us in relatively good stead during these difficult times, and at this point we don’t expect any of our companies to become overly distressed -- though of course profits and FCF will come down for at least some of them in a recession. **When we ultimately emerge from the current economic challenges**, **we believe our portfolio has a great deal of “juice” that will benefit from that environment, and we continue to be on the lookout for other investments to snag opportunistically.** So we believe we have enough defense to withstand the recession, and we are looking for more opportunities to outperform when it becomes time again to play offense.

In aggregate **PVP was down 6.3% in 2Q22 and down 17.4% year-to-date in 2022, with an annualized return since accepting our first partner capital in February of 2016 of 9.1%.**[1] Looking forward, as discussed above, our portfolio’s current Equity Risk Premium (ERP) of 5.7% (9.5% portfolio FCF yield, less 3.8% 30 yr UST) remains extremely attractive in our view, even in a rising rate environment that is generally a headwind for equities.

<u>Holding Profile – Cheniere Energy (LNG)</u>

We tell our partners and prospects that we would rarely hold more than 5% of the portfolio in a single security and that doing so would require truly special circumstances. This quarter, with LNG now about 6% of our portfolio, offers us the opportunity to discuss Cheniere in some more detail.

---

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

Cheniere, you will recall, is the US leader in liquefaction. By liquefying natural gas, of which the US is blessed with an abundance, the company is able to reduce its volume by 600 times, making it economically efficient to export it throughout the world from its terminals in Texas and Louisiana. As climate change and other environmental concerns push the world toward "cleaner" energy sources than coal and oil, LNG is the obvious solution. `

Moreover, in light of the Russian invasion of Ukraine, and the related energy implications for a Europe that had become far too reliant on Russian energy, Cheniere's mission has never been more critical than right now. With reports of Poland deforesting for wood to burn and Germany warning its citizens about a potential cold winter without enough energy, it is fair to say that Cheniere may play a very important role in keeping the lights and heat on in Europe in the next few months.

It has taken Cheniere a number of years and about $39 billion of invested capital to get to this place, but just last year we began to see the fruits of these efforts, as revenues and cash flows inflected explosively upward, and are expected to do so again next year. This year analysts expect Cheniere to generate $7.4 billion of FCF, and this is a company currently worth $41 billion – a whopping 18% FCF yield. Longer term, as the commodity price "normalizes" from its current elevated levels, management now believes its annual distributable cash flows will be just over $4 billion, suggesting about a 10% yield.

What does Cheniere do with all this FCF? Fortunately there should be enough cash to deploy for multiple purposes, and so far the company has initiated a small dividend ($1.58 annualized, with a 1% current yield); it has paid down $4 billion of debt, with a goal of reaching investment grade status in 2023; it has bought back just under $1 billion of its stock, with plans to buy back about 10% of total shares in the next three years; and it plans to expand both its Corpus Christi (TX) and Sabine Pass (LA) facilities.

All these positives notwithstanding, Cheniere is obviously not without risks. Although Cheniere and its construction partner Bechtel have done a remarkable job so far in building out the facilities, future cost increases and or delays are certainly possible. Moreover, although about 95% of Cheniere revenues are "locked in" at pre-negotiated prices, the company is still modestly susceptible to liquid natural gas price fluctuations. Cheniere also faces a variety of regulatory risks, and in fact in this most recent quarter the company had a minor dispute with the EPA around emission limits. Over time we would also expect Cheniere to face more competition, but we would point out that $39 billion it has invested in its facilities is quite a big "barrier to entry". Finally, in the fear-mongering Summer of 2020, when we added meaningfully to the position, one of the major concerns was that the company's customers would simply back out of their contracts – which did not happen. Of course, although the vast majority of Cheniere's customers are large, creditworthy international companies, this is always a possibility – though this is not without recourse.

Cheniere possesses so many of the characteristics we seek in successful investments, and also plays both an offensive and defensive role in the portfolio. The shift away from coal and oil toward cleaner LNG is a secular growth trend that is likely to have very long legs. At the same time, Cheniere is currently something of a portfolio hedge to the havoc wrought by the Russian invasion of Ukraine – even as the war has the potential to be more destructive to the global economy, Cheniere actually benefits from the situation.

LNG has been a very strong stock for us over time, and we obviously remain excited about its prospects. Simply stated, over time we believe Cheniere is becoming perhaps the world's most expensive toll booth – a growing annuity rather than just another energy company beholden to the price of the commodity -- and it seems the market is just now beginning to appreciate it.

Actions taken in 3Q22

In terms of trading, we were uncharacteristically quiet this quarter. Rest assured, this was not on account of a lack of effort. On the buy side, we always maintain a "short list" of companies we are closely monitoring fundamentally and awaiting an attractive entry point. On the sell side, there were a handful of stocks that got close to our Price Target to sell, but then dropped materially. But we want to sell into strength, not weakness, so we held on. Although this was not the case this quarter, in general we strive to make volatility our friend. The Covid Spring and Summer of 2020 is a good example of a time when we made some of our most profitable investments. To the extent volatility persists, we would expect to be much more active in coming quarters.

Strong performers in 3Q22 [2]

Our strong performers this quarter were an eclectic group. Normally in such a challenging quarter our strongest performers would be "defensive" in nature; in this quarter, however, most of our best stocks were pro cyclical.

Cheniere (LNG), our largest position, was by far our strongest performer in the quarter. Even in a very hot energy market LNG outperformed by a wide margin, and was up 25% in the quarter for the reasons discussed above.

Before we acquired transaction processor **PayPal (PYPL)** in May, the stock suffered not only from being a formerly quite expensive "technology darling", but it also had several of its own miscues in recent quarters. This set the bar low for PayPal – which is how we like it – and the company posted a respectable quarterly performance this time, sending the stock up 23%.

Pinnacle Financial Partners (PNFP), our Tennessee-based regional bank, continues to produce very impressive and consistent results. In the most recent quarter Pinnacle showed a whopping 32% loan growth even as its credit quality improved – pretty much the opposite of what we might expect in a recession – sending the stock up 12% in the quarter.

As we discussed last quarter, **Principal Financial Group (PFG)** has been transforming itself in recent years from an old fashioned, capital intensive life insurer to a "capital lite", higher return money manager and retirement solutions provider. Investors are beginning to take notice, and with healthy quarterly results to boot the stock was up 8% in the quarter.

It is a testament to the resiliency of **Walmart (WMT)** that, even while the company materially brought down its expectations for the year in July, the stock was still up 7% for the quarter. While Walmart is benefiting on the top line from the "trade down" effect of inflation, it is also challenged by its own margin issues resulting from markdown pressures, supply chain costs, etc.

---

[2] *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.*

Weak performers in 3Q22

Like our "winners" this quarter, our more challenged stocks were also a fairly eclectic group – both cyclical and defensive, and weak due to both idiosyncratic factors and sector-specific shifts in investor preferences.

Much like last quarter, **Enstar (ESGR),** the company that acquires and manages "unwanted" blocks of business from other insurers, suffered from unrealized losses in its bond portfolio in 3Q22 as rates continued to rise. It is important to note again that these are "paper" losses, not economic losses. In theory troubled times should be good for Enstar, since historically troubled times have created the best opportunities for the company's acquisitions. ESGR was down 21% in the quarter, and now trades at a significant discount to BV.

As expectations had grown in recent months that transaction processor **NCR (NCR)** would sell itself, the market was extremely disappointed to learn in September that the board had instead opted to split NCR into two companies – one focused on digital commerce, the other in the legacy ATM business. NCR was down a whopping 39% in the quarter, and now trades at just 7x earnings.

Entertainment company **Comcast (CMCSA)** met top and bottom line expectations for the quarter, but investors remain fixated on broadband adds, where the company's performance was somewhat underwhelming, owing to an increasingly competitive marketplace. Comcast was down 25% in the quarter, and now trades at an 11% FCF yield.

In recent years **AT&T (T)** has not shown much growth but has been very reliable in terms of generating FCF, which supports the very healthy (8%) dividend. This quarter, however, FCF disappointed as the company opted to invest more to support higher growth. AT&T was down 27% in the quarter, and now trades at just 6x earnings.

Cloud service provider Rackspace **(RXT)** is growing its business and generating lots of FCF, but the company has done a very poor job of managing investors' expectations. This quarter was no exception. RXT dropped 43% in the quarter, and now trades at just 7x earnings.

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 5.7% (9.5% FCF yield less 3.8% 30-year UST). At this level we believe we are being very well compensated to bear the risk of equities.

	PVP [3]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2022E)	9.5%	5.1%	6.1%
Price/Earnings (2022E)	13.1x	16.4x	12.6x
Debt/EBITDA (2022)	3.2x	2.5x	2.7x
EBITDA margin (2022E)	28.2%	19.9%	19.6%
Return on Equity (2022E)	18.3%	19.5%	16.2%
Return on Invested Capital [4]	11.5%	9.8%	8.5%

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.

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

[4] *PVP data is 2022; index data is 2021 (2022 unavailable).*