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VALUE PARTNERS
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Dear PVP partners and friends

This past quarter, like other recent quarters, investors continued to be preoccupied with the big macroeconomic questions and their policy implications – namely: **Is a recession coming?** If so, when and how bad? **Is inflation conquered?** And, relatedly (and more importantly), **when will the Fed finally stop tightening** and at long last declare victory regarding inflation?

The quarter started off strong for the equity market, as economic data remained resilient, companies' quarterly earnings were generally in-line to positive surprises, and optimism developed around the idea that the Fed's rate hike "pause" in June might actually be the end of the pain. Goldman Sachs predicted a mere 20% likelihood of a recession in the next year, and 80% of investors surveyed by Evercore ISI expected either a "soft landing" or no landing at all.

But in early August -- even as inflation had basically returned to its low single digit "normalcy" -- **rates on the "long end" of the curve began to rise** (the yield on the 30 year UST rose almost 100 basis points in the quarter), which makes stocks more expensive. Since their value is determined by future free cash flows discounted back at higher rates, the present value of those cash flows is diminished. Mortgage rates are now approaching 8%, used cars 16%, and credit card rates 21%. Clearly the "free money" days are over! Yet, to make matters worse, while the Fed did "pause" again in September, the language and expectations around future policy decisions became more hawkish.

Moreover, **several leading economic indicators suggested a slowing if not an outright contraction,** even as labor strikes began in the entertainment and auto industries; gas prices increased; student loan repayments resumed (from the covid-era forbearance); and regulators proposed ever higher bank capital requirements (even though the bank crisis of the Spring was all about liquidity rather than insufficient capital).

Finally, there is also the matter of US fiscal (ir)responsibility, which is obviously not a new thing. But it is getting worse, and during the quarter the run rate federal deficit for FY 2023 was estimated to be $2 *trillion* (that's trillion with a "T"). At the same time, the influential ratings agency Fitch downgraded the USA's long term credit rating from AAA to AA+. Surely, say the bears, the spiraling debt must be "crowding out" private investment, leading to diminished economic activity? (This is a subject worthy of multiple dissertations, but out of respect for our readers' time I will postpone a rant here.)

On the other hand…as our friends at TrendMacro remind us, **perhaps there is an alternative, much more positive, interpretation of rates shooting up on the long end? Maybe they are actually a reflection of renewed expectations for economic growth?** After all, the upside of the

yield backup on the long end is that the yield curve is now less inverted, suggesting more confidence in the economy. And GDPNow, a product of the Atlanta Fed, currently estimates an extremely healthy 3Q23 GDP of 4.9%! It is also difficult to reconcile an imminent recession with a strong dollar and corresponding weak currency hedges such as gold and bitcoin. Recession? What recession?

So the short term economic forecast is far from clear to us. We remain cautiously optimistic. (In fairness, with the emphasis on "cautiously".) Our companies are generally in "belt and suspenders" mode, but frankly they do not see trouble on the horizon at this point. As we discussed last quarter, we believe we have a strong and diversified portfolio that can withstand a good deal of turmoil. If the bears win the day and we have a recession, even though we believe our stocks are already inexpensive there will still be some degree of downside for the stocks. But if we skate through this period and the economy keeps growing, we believe there is substantial upside for our stocks in coming years.

2Q23 was unusual in that there was very little difference in the performance of the value, growth and "core" indices. The Russell 3000 Value, Russell 3000 Growth and S&P 500 were all down 3.2-3.3% for the quarter. In the value indices, energy was quite strong while every other sector was down. In the growth indices energy was also strong but is a very small component. This was compensated for in the growth indices by strong performance from large components Alphabet and Meta. Similarly, there was generally little difference in performance between large cap and small cap stocks in the quarter, with the only exception being that small growth was somewhat weaker. This is consistent with a view of economic challenges ahead, as many of the small growth companies are highly speculative and must rely on ongoing funding in order to survive.

In aggregate **PVP was down 1.5% in 3Q23, with an annualized return since accepting our first partner capital in February of 2016 of 9.7%.[1] Notwithstanding that we had a major disappointment in the quarter (please see below), PVP on a net basis still has continued to comfortably outperform the major indices over the past three years.[2]** Looking forward, in spite of the rise in rates discussed above, our portfolio's current Equity Risk Premium (ERP) of 5.1% (9.8% portfolio FCF yield, less 4.7% 30 yr UST) remains *quite* attractive in our view. So with a Fed that is hopefully satisfied with the state of inflation amidst a highly uncertain economic backdrop, as always we are moving forward…with caution.

Actions taken in 3Q23

We acquired trucking company **XPO (XPO)** in the Summer of 2020, and sold it almost exactly three years later, having more than doubled our money in the stock. We had to be fairly patient in the stock, as the lion's share of our total return occurred just last quarter. In August its major competitor Yellow Corp filed Chapter 11 bankruptcy, giving XPO a final boost and providing an attractive exit point for us. During our period of ownership XPO spun off two other companies –

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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 September 30, 2023: PVP (net): 12.8%; Russell 3000 Value: 11.2%; S&P 500: 10.1%; and Russell 3000 Growth: 7.5%.*

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first **GXO (GXO),** which provides logistics services; then **RXO (RXO),** the truck broker. We have built both of XPO's progeny into significant positions for us, and in fact the majority of the XPO proceeds were redeployed into RXO.

We expected high end home furnishings retailer **RH (RH),** the company formerly known as Restoration Hardware, to be a long term position for us, but sometimes Mr. Market provides us with opportunities we just can't pass up. In the case of RH, we made more than 40% in 14 months of ownership, even as estimates for the company's profitability have come down considerably (EBITDA estimates for FY24 have been nearly cut in half from the actual FY22 EBITDA). Perhaps the market belatedly agrees, as the stock is now back to below our original cost basis. I would not be surprised to see us reacquire RH at some point, as we have been really impressed with what we have seen, but the company is highly dependent on sales of high end homes, and 8% mortgages cannot help matters.

Strong performers in 3Q23 [3]

Cheniere (LNG), the liquid natural gas infrastructure company that is our largest position, reversed last quarter's weakness in a strong period for energy generally, and was our top contributor this past quarter with a 9% gain. The company's financial results were not really remarkable, just the usual "beat and raise" quarter coupled with ongoing progress on both facility expansion and also signing up blue chip customers for long term distribution contracts. In spite of all it has going for it, LNG still boasts a 13% FCF yield.

As we have discussed previously, **Adtalem (ATGE),** the for-profit education company focused on nurses, doctors and veterinarians, has done a remarkable job in recent years of transforming and streamlining its portfolio of businesses. Although the stock was one of our weaker performers last quarter, in 3Q23 ATGE bounced back 25% on solid if unspectacular results. Like Cheniere, Adtalem seems to be in the process of slowly being "re-rated" by the market. With recession fears, the market favors defensive businesses like education. ATGE still trades at just a 10x P/E, with a 9% FCF yield.

In September the packaging company **WestRock (WRK)** agreed to be acquired by its British competitor Smurfit Kappa, sending the stock up 24% in the quarter. It is difficult to complain too much about one's portfolio companies being acquired, but in this case the price is a bit disappointing. The transaction is expected to close in 2Q24, and we would expect to hold on to WRK at least until then, and will consider owning the combined entity after the close. The industry has been consolidating over time, these companies should be able to create value out of the combination, and Smurfit stock appears to be quite inexpensive.

Booking (BKNG), the online provider of travel and reservations services, posted results that greatly surprised investors to the upside, sending the stock up 14% in the quarter. Expectations have been low, but travel has remained resilient and Booking continues to take share, expanding both in geography and in its service offering. BKNG currently trades at a 21x P/E and at a 6% FCF yield.

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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.*

Canadian insurer **Fairfax (FRFHF)** was one of our top performers for the second consecutive quarter, up 9% in 3Q23. Buoyed by a still quite strong property/casualty pricing environment, and also by the re-emergence of value stocks (Fairfax, like our Berkshire Hathaway, owns a lot of "value" equities), over time in our view the company is growing into a more appropriate valuation. The stock still trades at a modest discount to the BV we expect at the end of this quarter.

Weak performers in 3Q23

Timing can be very difficult in this business. In July the alternative energy provider **NextEra Energy Partners (NEP)**, the publicly traded subsidiary of NextEra Energy (NEE), which owns Florida Power and Light, looked quite attractive to us, like other high yielding stocks having been dragged down by rising rates. So we materially increased the size of our position, making it one of our larger holdings. Then in late September the company revised its expected dividend growth rate in half, from about 12% to about 6%, sending the stock down 50% in the quarter. The company does not expect to require equity financing to meet its growth objectives until 2027, and currently trades at an astonishing 15% dividend yield, which we believe is likely way overdone.

Fortunately our adds and trims are not always as ill-timed as they were in the case of NEP. **Mastec (MTZ)** is the engineering and construction company that has been one of our strongest contributors in recent quarters. In July we took a healthy chunk out of the position at $115-117, and today the stock sits at $68. On its quarterly call in August the company cut its earnings guidance as some of its very large projects are increasingly delayed. Investor sentiment on Mastec has obviously shifted dramatically from optimism to pessimism, and the stock now looks quite attractive at less than 8x EV/EBITDA.

Wesco (WCC), the electrical equipment maker, had been a strong performer for us in a difficult equity environment since we initiated the position five quarters ago, so in July we trimmed the position at $178. In early August, on its quarterly call, Wesco slightly lowered its revenue growth guidance for the year from 6-9% to 5-7%. With the stock up 43% ytd, as it had been, even a mild tweak of guidance can result in a violent reaction, sending the stock back down to $127 by the end of the quarter. The stock again looks quite attractive to us here, with still healthy growth prospects and a P/E of just 9x.

Voya Financial (VOYA) has been one of our stronger stocks over time, and has grown into one of our larger positions. Voya had another healthy quarter, but with the stock down 7% investors may be worried about the effect of higher interest rates on the company's sizable bond portfolio, and or outflows in Voya's investment management business stemming from the challenging current investing environment. Voya remains a very cheap stock in our view, trading at just 8x earnings and at a small premium to BV.

Johnson & Johnson (JNJ), which remains one of our largest positions, was a bit weak in the quarter, down 6%. During 3Q23 the company IPO'd its consumer health business (now called "Kenvue"), which is fairly immaterial to current financials but will result in higher margins and faster growth for "core" J&J. Most big pharma was weak in the quarter as the US Department of Health and Human Services (HHS) announced that, for the first time, under the terms of the

Inflation Reduction Act, Medicare would be able to negotiate prices on certain drugs. Included in the ten initial drugs to be negotiated were JNJ's blood thinner Xarelto and arthritis drug Stelara.

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 5.1% (9.8% FCF yield less 4.7% 30-year UST). At this level we believe we are being very well compensated to bear the risk of equities. In a more challenging economy our higher ROIC is a statement about the quality of the companies, and the higher margins provide a nice cushion.

	PVP [4]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2023E)	9.8%	4.3%	5.2%
Price/Earnings (2023E)	13.0x	19.5x	14.7x
Debt/EBITDA (current)	3.3x	2.6x	3.0x
EBITDA margin (2023E)	29.1%	19.3%	18.6%
Return on Equity (2023E)	15.4%	18.1%	14.7%
Return on Invested Capital (2022)	12.5%	8.7%	7.4%

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.*

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