January 2018

Dear PVP partners and friends

The **market continued its positive momentum** in the quarter, primarily bolstered both by stronger overall economic growth and also the tax bill we discussed last quarter. Meanwhile, the Fed continued in its path of slowly exiting its Quantitative Easing (QE) policy begun in the wake of the 2008 financial crisis, raising the Fed Funds rate by 0.25% in December. As we have said previously, assuming the economy continues to grow at least in line with expectations, if the Fed continues to hike rates -- slowly and methodically and in a well-communicated fashion -- we believe the stock market will be well served. Longer term, however, higher rates will mean a lower Equity Risk Premium (ERP), which will tend to depress future returns.

The **new tax law ("Tax Cuts and Jobs Act of 2017")**, signed just before Christmas, will have the overall effect of **reducing corporate taxes** and thus resulting in **higher free cash flow** for the vast majority of our holdings. By our rough math, the profits of our average holding should be about 5+% higher. Moreover, the bill creates incentives for our companies with large overseas cash deposits to "repatriate" that cash, put it to more productive use, and pay a relatively small tax. Of course, the new tax law won't benefit all companies equally. Our smaller, domestically-oriented holdings, which currently pay the highest tax rate, will benefit most. Our REITs and internationally domiciled holdings, on the other hand, will not likely be materially impacted by the new law. Our wind/solar companies will lose some of their tax benefits – though not nearly so many as the market had feared. And a few of our holdings, which for a variety of reasons pay very little tax currently, will actually see a probable tax increase. In the aggregate, though, again, very positive for the portfolio. Whether it will have the additional desired effect of accelerating GDP growth will depend on how the capital is redeployed, which remains to be seen.

While stronger economic growth, lower taxes and higher profits are obviously good for stocks, there are also currently some data points that give us pause. First is the "**flattening yield curve**". The yield curve is simply the difference between the yield offered by long duration bonds and the yield offered by short duration bonds. In a normal healthy economic environment there is a "steepness" to this curve, owing to expectations about higher future growth and some degree of resulting inflation. Historically speaking, a "flatter" curve suggests some skepticism about those optimistic assumptions, and an "inverted" curve (in which short term bonds actually yield more than long term bonds) has tended to predict a recession. Some (including outgoing Fed Chair Janet Yellen) suggest these historical relationships are no longer valid, since technological advances and the commoditization of labor from global trade flows are mitigating normal inflationary pressures in an accelerating economy. As always, time will tell.

Another area of concern, which we have highlighted previously, is the recent correction in the **"high yield"** (aka "junk") bond market. Investors around the world are seeking income, but in a world of very low interest rates, in some cases they have been **"stretching" for that income**, e.g., taking on more risk than they want, or realize, in order to capture it. Consider that very recently one prominent high yield index yielded just under 5%. That is less than PVP's FCF yield; in

lesser quality and more highly levered companies; and with a coupon that, in the best case scenario, will remain constant over time – in contrast to our portfolio's FCF, which we expect to grow over time. Subsequently high yield has backed up somewhat, and that index now yields 5.6% -- a healthy correction but still inadequate compensation for the risks assumed, in our view. One factor that has helped maintain the momentum of the current bull market is continued skepticism, or even fear. When fear capitulates to greed, this is when *we* tend to get fearful.

The strength in the quarter was relatively broad-based, as every sector showed positive returns. Technology and consumer cyclicals were the top performers, followed by financials. Utilities were the weakest sector this quarter, followed by health care, REITs and telecom. **For the year** as well, **technology was the best performing sector, by a wide margin**. We have benefited here, but as we have taken profits we remain underrepresented in technology, as we are finding fewer and fewer attractive valuations. On the other hand, we have also been underrepresented in the four *worst* performing sectors in 2017 – respectively, energy, telecom, REITs and utilities. As we have discussed previously, we build our portfolio on a "bottom up" basis, and thus our sector weightings are an output rather than an input in the process.

"Growth" stocks continued to outperform "Value" stocks in the quarter, which is an ongoing headwind for value-oriented investors like PVP. We don't have a clue as to when investors will return to value stocks (which have outperformed over the long term) but we would observe that, generally speaking, Growth has handily outperformed Value since just after the financial crisis of 2008. Although these style preferences typically move in multiyear cycles, in 2016 Value snapped out of its slumber, outperforming by 10%. In 2017, however, Growth returned to leadership, outperforming Value by 16+%. No matter what style is in favor, our goal remains to buy high quality companies selling at a discount, and to sell them when their value has been realized.

In aggregate **PVP was up 4.4% in 4Q17, up 16.5% for all of 2017, and up 38.7% since accepting our first partner assets in early February of 2016.** [1] Regardless of how strong or weak recent performance has been, **we will always caution 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.

<u>Actions taken in 4Q17</u>

Buys in the quarter

As opportunities continued to present themselves, like last quarter, we continued to be more active than usual. **Adtalem Education (ATGE),** formerly known as Devry, is one of the more established for-profit education companies, in a sector that had a very rough go of it in recent years. What makes Adtalem different is that the majority of its students are in fields in which there is more demand than supply, such as primary care medicine, veterinary and nursing. Because these skills should continue to be in demand for the foreseeable future, outcomes are better for students, and therefore also bad debts from its graduates are much lower. We also expect the political landscape to be much friendlier today to for-profit education than it has been in recent years. Adtalem, which means "empower" in Latin, has a new CEO who is quickly making positive changes, and trades at a very attractive 7+% FCF yield.

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[1] *Returns are net, and assume a 1% annual management fee.*

Altria (MO), the tobacco company formerly known as Philip Morris, much like BTI (discussed last quarter), suffered a period of weakness at the end of the Summer following the FDA's rather aggressive announcement regarding its policies in regulating tobacco. This gave us the opportunity in the stock. The industry has evolved into a very cushy global oligopoly, with tremendous pricing power and very high returns for incumbents. Moreover, the "Next Generation Products" (vapor and such) are "safer" products that are actually encouraged by regulators, and are likely to grow into a meaningful new revenue stream. By the end of the quarter MO was up 11% from our cost basis, and currently trades at just under a 5% FCF yield.

For nearly a decade we have observed the very impressive restructuring process at **Sony (SNE),** as management has steadily and diligently disposed of non-core businesses. As a result of this process, Sony's best businesses -- movies, music, and semiconductors -- now represent more than 2/3 of earnings. These business are highly profitable and growing nicely. Nor is Sony done pruning away non-core businesses, a process we expect to continue. Finally, the valuation of the remaining businesses is extremely compelling at 10x FCF. We believe Sony is poised for both a sharp increase in earnings and a material improvement in valuation in the coming years.

General Electric (GE) has been quite a laggard in recent years. A new CEO has come aboard, however, who has re-set the bar and committed to put in place new business heads, simplify financial reporting, divest noncore assets and significantly cut costs. These actions have already begun. Sentiment remains quite negative on GE, which we believe will limit the downside. If new management is able to achieve its goals, on the other hand, we believe considerable upside exists.

BankUnited (BKU) has a unique and attractive geographic footprint in south Florida and the New York City metro area, and is managed by shareholder-minded entrepreneurs rather than career bankers. Like other banks, BKU should benefit from rising rates, and currently trades at just 1.4x adjusted Tangible Book Value (BV).

Aspen Insurance (AHL) is a Bermuda-based property/casualty insurer that writes both primary and reinsurance. Aspen was hit rather hard by the major storms during the quarter, and lost about 10% of its capital. Aspen now trades at less than BV, but its future earnings should be buoyed by expected higher pricing -- especially in reinsurance.

You might recall we just sold **Nextera Energy Partners (NEP),** the clean energy project manager, last quarter. In 4Q we had the opportunity to buy it back "on sale", as the market feared the possibility of wind and solar power losing their tax advantages as part of the tax reform bill. We felt strongly, on the other hand, that it would be highly unlikely that key Midwestern senators in "wind" states would allow that to happen. Fortunately that is mostly how it played out.

TerraForm Power (TERP), like NEP, is an alternative energy "yieldco". Although, like NEP, TERP is also partnered with a blue chip sponsor in Brookfield Asset Management, it is smaller and earlier in the process of being "discovered" by investors than NEP. Terraform believes it will distribute 72c/share of dividends next year, implying an attractive 6% yield, which the company expects to grow at least 5-8% per year for the foreseeable future.

Sells in the quarter

In our 4Q16 letter we discussed a significant add to our position in outsourced government social services provider **Maximus (MMS),** on the day after the November elections. There was a good deal of market volatility at the time, including the fear that the possible dismantling of PPACA ("Obamacare") in a Trump administration would jeopardize a major Maximus contract. We were

skeptical and bought into that fear, and since then were rewarded with a 22% return. Maximus is a company we like, and we will continue to keep on the lookout for buying opportunities from its occasional volatility.

Thermo Fisher (TMO), the leading manufacturer and distributor of life science tools, was an excellent stock for us, rising 52% from our cost basis and moving past our Price Target (PT). While we still like the company a great deal, we no longer find the valuation compelling.

Becton Dickinson (BDX), the medical device manufacturer, also exceeded our expectations. During our period of ownership the stock was up 55%, as the very steady core business hummed along, and also the company agreed to acquire another device manufacturer, CR Bard. BDX is a very high quality company, but now trading at 28x earnings, we can no longer justify ownership.

We originally acquired **HealthSouth (HLS),** the leading provider of inpatient rehab facilities (IRFs), at a time of considerable uncertainty about future Medicare reimbursement rates. Those fears eventually abated, only to be replaced by new fears about reimbursement for HLS's home health care business. When those fears also proved unfounded, sentiment quickly shifted in a positive direction, the stock blew through our PT, and we took profits. Originally purchased in February 2016, our total return was almost 50% in the stock.

When we initially invested in **UPS (UPS),** a major part of our thesis was that UPS would benefit greatly from "the Amazon effect", as e-commerce grew as a percent of overall retail spend. This has in fact been the case. As we have monitored our investments in both UPS and Amazon, however, we have come to believe that there is an increasing likelihood that the UPS/Amazon relationship is evolving from one of partnership to one of competition. This would certainly not be good for UPS. Overall UPS was a profitable investment, although it was a modest detractor in the quarter.

Scotts Miracle-Gro (SMG), the ubiquitous maker of garden products, has been very strong since our initial purchase. Our thesis played out much sooner than we had anticipated, as the company's growth in hydroponics and renewed emphasis on FCF continued to surprise the market to the upside. The stock surpassed our PT and was up 52% in 2017.

Hamilton Lane (HLNE), the private equity consultant to pension funds, was a small IPO earlier in 2017 with limited liquidity and sponsorship. With two consecutive quarters of results that greatly exceeded expectations, the stock was up substantially from our original investment. While we still like the company's business model and positioning, the stock moved very quickly through our PT, so we took profits. Like many others, we would like to own this for the longer term, and will continue to monitor it for such an opportunity.

Although we generally have a longer term time horizon on our investments, our investment in **Seagate Technology (STX)** is an example of an opportunistic trade. While over time the data storage industry is becoming more attractive, it still has some commodity aspects that can lend themselves to volatility. We bought the stock on the premise that short term negative sentiment was overdone, so with the stock up 17% in our short period of ownership, we took profits.

We sold **Macquarie Investment Corporation (MIC)** because we feared there were risks to the company's earnings trajectory. Specifically, we suspect there might be increasing pricing pressures in one of the company's major businesses, Bayonne, NJ-based contracted power and energy, where we believe competitors might have overbuilt supply. MIC was a minor detractor in the quarter.

Vista Outdoor (VSTO), described in greater detail below, was a very disappointing experience for us. In early November the sporting goods manufacturer surprised investors with results and forecasts that were much worse than what had been expected. Although the stock was down significantly on the news, we felt the company had completely lost credibility, and we sold the stock.

Strong performers in 4Q17 [2]

Our patience with **Mylan (MYL)** has at last begun to pay off, as it was our top performer this quarter. Fundamentals have not changed much for Mylan in recent months, but the company has recently received FDA approvals for several new generic drugs and also "biosimilars" (generic biotech drugs), which has had a marked effect on sentiment regarding the stock. Even after the 30+% bounce in the quarter, Mylan remains quite attractively valued in our view at 7-8x earnings.

Voya Financial (VOYA), the life insurer/investment manager, has done an admirable job of improving itself since being spun out in 2013 by the Dutch financial services firm, ING. Like most financials, it also benefits from higher interest rates. In December Voya also announced the sale of its "closed block" annuity business. This is a legacy unit – contracts that had been written many years prior – which consumed a great deal of capital and generated subpar returns. Now freed of that albatross, Voya's risks are lessened and its returns will improve, which in time should further expand its valuation.

Private equity consultant **Hamilton Lane (HLNE)** continued its strong momentum this past quarter, as once again the company trounced consensus quarterly estimates. In many ways HLNE is in the right place at the right time. Although we love the business model, positioning and momentum, the stock is now up more than 60% from its March 2017 IPO, and, as discussed above, from a valuation standpoint we could not justify continuing to own it.

BankUnited (BKU), a recent purchase described above, reported a somewhat disappointing 3Q, which gave us the opportunity in the stock. With rising rates a tailwind for most banks, along with a favorable IRS settlement for the company, BKU bounced back 22% in the quarter from our cost basis, and still trades at an attractive valuation of 1.4x adjusted Tangible Book Value.

Cisco (CSCO) is another stock with which we have shown some patience. Like Oracle (ORCL) not long ago, Cisco finally expects some growth in the coming quarter as it continues to transition its business toward a higher value, annuity-based model. Cisco, with billions of overseas cash, should also benefit from the repatriation aspect of the new tax law.

Weak performers in 4Q17

Vista Outdoor (VSTO), our worst performing stock in the quarter, was a very disappointing experience for us. After extensive due diligence, we acquired the position knowing that this sporting goods maker had some current challenges, particularly in its retail channel. When the company announced its 3Q results in early November, however, they were much worse than we, and the market, had expected. Although we often try to take advantages of our stocks "going on sale", in this case our revised VSTO estimates still did not make the stock particularly

[2] *Top and Bottom Five performers in the quarter defined as the most value added or subtracted, in basis points, relative to the Russell 3000. Top and bottom stocks are presented, respectively, in descending and ascending order of value added/subtracted.*

compelling. Furthermore, we believe the company now has real credibility issues with investors. We sold the stock with a loss of 39%.

Allergan (AGN), maker of Botox and numerous eye care drugs, continued to come under pressure in 4Q (down 20%), largely on concerns around the loss of exclusivity (LOE) of Restasis, one of its major products. While quite material, we believe investors are unduly focused on this one issue, which we believe is more than reflected in the current valuation, and ignoring the company's extremely robust pipeline of potential new drugs. Even in the worst case scenario for generic competition for Restasis, AGN still trades at just over 10x earnings. We added to the position in the quarter.

InfraREIT (HIFR), like most other alternative energy-related companies, was weak in the quarter, down 17%, as confusion still reigns regarding the impact of the new tax law on its profitability. We expect it will take some time for investors to digest the details of the new law, with valuation benefiting once it is better understood.

We are not quite sure how to explain the weakness this quarter in **Post Holdings (POST)** stock, which was off 10% in spite of another strong quarter, and also strong guidance for 2018, when it expects EBITDA to grow 15-19%. Post currently trades at 9x EV/EBITDA and at about a 10% FCF yield.

We have also been somewhat perplexed by the ongoing weakness in **Dish Network (DISH),** especially since the recent FCC decision to reverse its position on "net neutrality" should have the effect of making DISH's wireless spectrum holdings – a large part of the company's overall value – even more valuable. Moreover, while the market reacted negatively to the announcement that the company's current CEO and major shareholder, Charlie Ergen, would step down as CEO in order to focus on issues of strategy, we believe the move sends the positive message that Ergen is closer to monetizing DISH's spectrum assets. DISH was down 12% in the quarter.

Setup

As discussed above, 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.** While we are normally reluctant to rely much on benchmark data in the short term, some context can occasionally be helpful. 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 and growth rates. Relative to the Russell 3000 Value index, PVP's valuation is similar (discount on FCF, premium on earnings) yet PVP's margins and returns are substantially better.

	PVP [3]	Russell 3000	Russell 3000 Value
Free Cash Flow yield (2017)	5.7%	4.1%	4.4%
Price/Earnings (2017)	18.5x	21.2x	18.0x

[3] *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 3000 Value
Debt/Total Capital	41%	43%	41%
Debt/EBITDA	2.7x	3.1x	3.4x
2017 revenue growth	9.8%	7.2%	15.4%
2017 eps growth	7.2%	9.9%	11.6%
2017 EBITDA margin	31.7%	18.9%	18.2%
2017 Return on Equity	17.6%	15.0%	11.8%
2017 Return on Invested Capital	11.2%	6.8%	5.5%

To put PVP's FCF yield of 5.7% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 2.8%. This suggests an Equity Risk Premium (ERP) of 2.9% (5.7-2.8). While admittedly this number has fallen somewhat as the market has risen rapidly in recent quarters, we still believe we are being appropriately compensated to bear the risk of equities. Since we still expect volatility to eventually increase, we will strive to position ourselves to take advantage where possible.

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

Albert Rosano

Managing Director

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