PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

Since we started PVP in early 2016 we have been commenting regularly on the lack of normal volatility in the equity market. As the ancient Chinese proverb says: Be careful what you wish for. In fairness, we have not exactly been *wishing for* an extreme bout of volatility. Rather, just reminding our partners and friends that such an extended period of low volatility is quite unusual, historically speaking.

As such, we have been disciplined in taking profits when stocks have reached their target prices (TP), we have focused on quality companies trading at compelling valuations, we have continued to take risk out of the portfolio, and we have kept a growing stash of cash as dry powder. Nonetheless, we were still quite impacted by the severe volatility that began in October and accelerated in December. *In the short term, at least*, correlations have been very high – in other words, markets have made few distinctions between riskier and less risky equities, and between higher quality and lesser quality assets.

Market sentiment obviously shifted quite negatively in the quarter, in our view driven primarily by concerns around the economy and the direction of the Fed. With respect to the former, the global economy has been relatively weak in recent times while the US has been resilient, but there are signs that the US will not be able to "walk between the raindrops" forever, that the global slowing is catching up to the US. This has been exacerbated somewhat by the current trade tensions with China. Regarding the Fed, its communications with the market have been somewhat challenged. One major negative factor in the quarter was the market's suspicion that the Fed would stubbornly continue to hike rates notwithstanding the slowing economy. Fortunately, the Fed's language has subsequently softened somewhat, which has so quickly eased those fears that currently some expect not more tightening but rather an *easin*g in 2019.

Toward the end of December a consensus began to emerge that the US was on the precipice of a recession, and equity valuations began to reflect that view. For our part, we believe the GDP slowdown is certainly real, and probably inevitable from a recent peak of 4.2% earlier in 2018. But we do not believe a recession is likely in the near term.

In light of these views, how have we responded to the volatility? While we will continue, as always, to "proceed with caution", **we believe equities have heavily overcorrected.** As we will discuss in more detail, the Equity Risk Premium (ERP) is now more attractive than it has been since shortly after the 2008 financial crisis, which tends to bode well for future returns. We saw no reason to sell into the weakness. Rather, **we were, and continue to be, buyers**. As you will see below, we did sell two stocks during the quarter – one hit our price target and one is in the process of being acquired. We also bought two new stocks. But **we like our portfolio, so mostly we added to existing holdings at depressed valuations.**

One very positive development in the quarter for PVP, and other value investors, is that **"Value" outperformed "Growth" – albeit modestly -- for the first time in quite a while.** Time will tell, of course, whether this is a temporary "head fake" or whether it represents a real change in leadership firmly held by "growth" since 2009. But it is encouraging. Every sector showed negative performance for the quarter. Energy, where fortunately we have had small exposure, was the worst performer; followed by industrials and technology, where our exposures are also relatively small. On the other hand, utilities and REITs fared the best in 4Q18, where our exposures were also small. Our own worst performing sector was financials, where the volatility created such compelling opportunities that we added to several positions in this already well represented sector.

In aggregate **PVP was down 14.4% in 4Q18, and was down 10.2% in 2018, and up 24.6% (8.0% annualized) since accepting our first partner capital in February of 2016.** [1] We repeat ourselves ad nauseam every quarter with the following point, *perhaps never so vehemently as right now*: Regardless of how strong or weak recent performance has been, we will always encourage 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.

Actions taken in 4Q18

As mentioned above, while we were not as active as usual in establishing new positions amidst the wild volatility, we did add to a number of our existing holdings on weakness.

New buys in the quarter

We did establish two new positions in the quarter. **Hamilton Lane (HLNE),** the private equity consultant/fund of funds manager, is a stock we have owned previously. In early November an erroneous and highly sensational research report emerged that suggested the company might have sizable exposure to Abraaj, a private equity fund currently being liquidated after allegations of fraud. Some quick due diligence suggested minimal exposure and that the severe drop in the stock was an overreaction, which was confirmed by the company's subsequent 8-K filing with the SEC that less than 0.1% of its client assets were invested in Abraaj funds. HLNE was up in the quarter 5% from our re-entry price, even amidst the December market turmoil.

In December we also initiated a position in **BJ's Wholesale Club (BJ),** which went public earlier in 2018 and which one might think of as a "poor man's Costco". In fairness, Costco is a great company, but that quality comes at a big price. BJ has a similar membership-based model, with a lot of runway in front of it beyond its foothold in the northeast, and a thoughtful management team that has been impressive in its relatively short tenure, at a valuation that we find attractive. While we don't foresee BJ completely closing the gap with Costco anytime soon, there are numerous opportunities for improvement in the works. For the quarter BJ was up 7% from our initial purchase price.

With currently depressed valuations and cash available to deploy, we continue to seek out new opportunities.

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

Exits in the quarter

As **Aspen Insurance (AHL)** drew closer to completing its deal to be acquired by Apollo Management, the stock approached its takeout price, so we sold it. Aspen was up less than 1% during the quarter through the time of our sale.

Adtalem Global Education (ATGE), the for-profit education company formerly known as Devry, rose very quickly from our purchase just last quarter to meet our price target, so we sold the stock for a 20% gain in 4Q18.

Strong performers in 4Q18 [2]

For the most part, fundamentals did not drive performance in the quarter**. Adtalem (ATGE)** was our strongest performer in 4Q18, up 20%. There is no company-specific explanation for the strength – just a timely purchase after a weak recent quarter, and a timely sale before the overall market collapsed in December.

Investors have been quite skeptical about **Starbucks (SBUX)** in recent quarters, so when the company modestly exceeded sales expectations in early November the stock reacted well. In addition, still relatively new CEO Kevin Johnson, who succeeded the legendary Howard Schultz, appears far more concerned with cash flows than his predecessor, which is music to our ears.

BJ's Wholesale Club (BJ), referenced above, was also a timely purchase, up 7% from our cost basis even in December.

Hamilton Lane (HLNE) quickly recovered from the misleading research report referenced above, and was up 5% from our recent cost basis.

As we have previously discussed, **Coca Cola (KO)** has been restructuring in recent years to achieve higher growth rates and become more profitable. In the quarter KO benefited as a relative safe haven in a turbulent market.

Weak performers in 4Q18

Unfortunately there were far too many contenders for weakest performers this quarter. **Allergan (AGN),** maker of Botox and many other drugs, which has been out of favor with investors for some time, was our weakest performer. The market seems to have lost confidence in the company's ability to innovate as its more mature products start to lose their exclusivity. To the extent the company is able to translate its pipeline into revenues, and unlock the value of its well performing franchises, at 9x earnings we believe AGN is a very cheap stock. As a reminder, just over three years ago AGN agreed to be acquired by Pfizer at 2.5x its current price, but the deal was terminated due to regulatory objections. At the time of the proposed transaction Allergan generated significantly less EPS, EBITDA and FCF, with more shares outstanding, than it does currently.

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[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.*

After a very strong 3Q18, the market began to anticipate upcoming weakness in iPhone sales for **Apple (AAPL)**, which was confirmed by the company in early January, citing a soft China market. Down 30% in the quarter and now trading at just 12x revised earnings estimates, AAPL is a very cheap stock in our view.

We added to **Mylan (MYL)** shortly before it posted 3Q18 results that exceeded expectations, which provided a short term lift to the stock in November, but ultimately the stock was dragged down by the overall market malaise. As we mentioned last quarter, the MYL board is still undergoing a strategic review designed to unlock the value of the company.

Allscripts (MDRX) had a relatively weak quarter, missing expectations on several fronts. After a violent reaction in the stock, we added to the position. Subsequently the company announced the long-awaited sale of a non-core subsidiary, with after-tax proceeds exceeding 25% of the value of the entire company. In January the company also released ambitious new revenue goals.

We have not seen any fundamental changes at **Amazon (AMZN),** and in fact the company stated publicly that it had strong holiday sales, but the stock sold off 25% in the quarter. Amazon is one of the so-called "FAANG" stocks and is also not a "traditional" value stock, and neither of these categories fared particularly well this 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. Relative to the Russell 3000 Value index, PVP's valuation is cheaper on a FCF basis, yet PVP's margins and returns are substantially better.

	PVP [3]	Russell 3000	Russell 3000 Value
Free Cash Flow yield (2018)	6.7%	5.0%	5.4%
Price/Earnings (2018)	13.8.x	16.2x	13.4x
Debt/Total Capital	44%	43%	41%
Debt/EBITDA	2.6x	2.9x	3.2x
2018 EBITDA margin	31.2%	18.9%	18.2%
2018 Return on Equity	18.1%	17.4%	14.1%
2018 Return on Invested Capital	13.1%	8.2%	7.0%

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

To put PVP's FCF yield of 6.7% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 3.0%. This suggests an Equity Risk Premium (ERP) of 3.7% (6.7-3.0). At this level we believe we are being well compensated to bear the risk of equities.

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. Especially in turbulent times like this past quarter, 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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