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VALUE PARTNERS
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Dear PVP partners and friends

Unlike the last two quarters, which were roller coasters**, the US equity market was mostly "straight up and to the right" in the last three months.** The most important macro factors driving the strong equity performance, in our estimation, were the related matters of the easing of trade tensions with China and the "normalization" of the yield curve (YC). As we have all read**, the US and China have apparently come to a preliminary ("Phase One") understanding in this trade dispute**, and an initial formal deal is expected to be announced in mid January. The situation remains fluid, but the market currently seems to expect that the US-China trade dispute is in the rear view mirror.

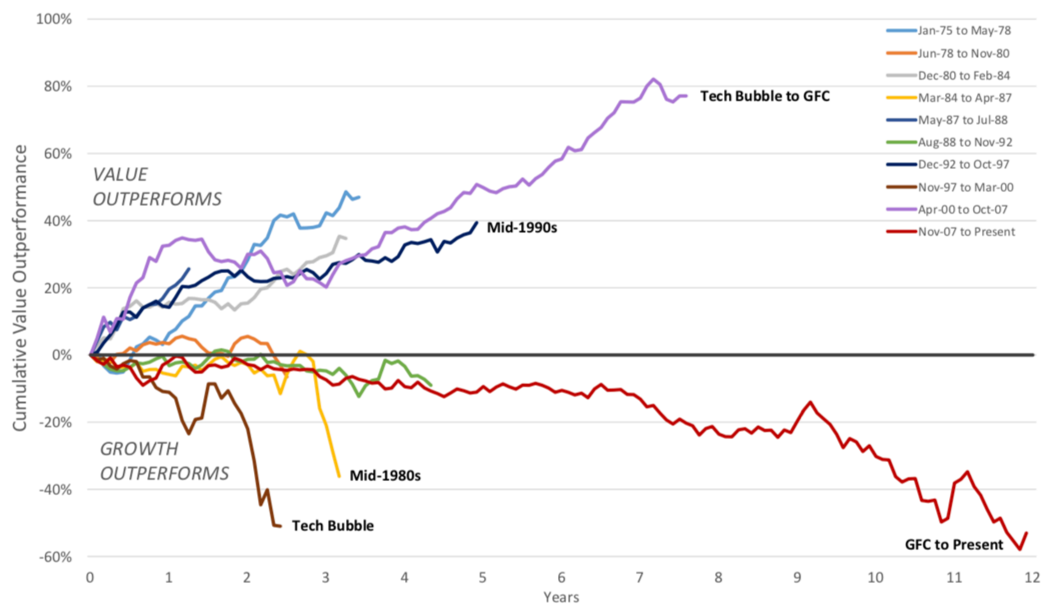
In terms of the YC, yields fell on the "short end" even as they rose on the "long end". Whereas the bond market had been flirting with "inversion" (in which short term rates exceed long rates) for some time -- and in fact the YC did actually briefly invert in 3Q19 – **now the YC is sending us healthier signals about its expectations for future growth and also inflation.** The market seems firmly to believe now that a much-discussed and much-feared recession has been averted – at least for the time being.

While higher long term rates are healthy, they also lower the Equity Risk Premium (ERP) and thus make stocks modestly less attractive. For our large representation of spread-based financial stocks, however, they are a needed relief.

Last quarter we discussed the sudden resurgence in September of value stocks relative to growth stocks. **4Q19, however, reverted back to the decade-plus pattern of growth outperformance.** The graph below highlights other "style cycles" in recent decades. The "tech bubble" (shown in brown) of the late 1990s was indeed quite painful for value investors, but was actually relatively short-lived. And when that bubble popped it was followed by a period of value leadership (shown in purple) that extended until the financial crisis of 2008, and more than compensated for the value underperformance of the late 1990s. Finally, the current cycle of growth leadership is shown in red.

We don't pretend to know when value will return to favor, but we would observe that these style preferences tend to be cyclical, and the current cycle has lasted for a very long time (as depicted in red below). Moreover, as we discussed last quarter, there have been some value "tremors" lately. There are plenty of theories about how and when value might again consistently outperform growth, but one that seems plausible to us is an environment of higher interest rates. Stocks are valued based on the market's assessment of their future cash flows, discounted back to the present. In recent years, with very low rates, cash flows in the distant future – a characteristic of growth stocks -- have been "cheaper", since they were discounted back at lower rates. If rates rise, as they have recently begun to do, those future cash flows are discounted back at higher rates, making growth stocks more "expensive".

Value Cycle Of Underperformance Appears To Be Extended



Note: Lines represent the cumulative total USD return differentials between the MSCI World Value Index and the MSCI World Growth Index for each respective period from December 31, 1974 –September 30, 2019. The MSCI World Value Index and MSCI World Growth Index launched in 1997, however data for these indices is available from MSCI beginning December 31, 1974. Accordingly, the chart depicts all periods beginning from when data is available. Data prior to the launch of the indices is backfilled by MSCI.
Source: MSCI, FactSet, Causeway Analytics

Every sector was up for the quarter, as "offense" generally worked better than "defense" in 4Q19 – a reversal from last quarter. The strongest sectors were, respectively, health care, technology and financials. In technology we maintain some representation but continue to take profits as the sector continues to outperform. Health care, where we have decent representation, has struggled in recent quarters. Financials, where we have substantial holdings, capped off a very solid 2019 with another strong quarter. The weakest sectors in 4Q19 were, not surprisingly, the defensives: utilities, REITs and staples. Of these three sectors, staples are the only group where we have material exposure.

There was great concern going into the recent quarter about a lack of overall profit growth, with a flat/inverted YC and an elevated risk of imminent recession. But on a weighted average basis our portfolio grew eps 7+% year over year in 4Q19. Of the major sectors, in fact, our financials had the best profit growth (10+%) even though their valuations were among the lowest. On a micro level, this ongoing profit growth in the face of skepticism also explains the strong equity performance in the quarter.

On the topic of politics, President Trump has now been impeached. Or has he? A merely semantic distinction perhaps -- but, more importantly, the equity market more or less ignored the proceedings in the House. Assuming impeachment does ultimately reach the Senate, we would expect the market to behave similarly, on the assumption that acquittal is a foregone conclusion given the very high 2/3 hurdle required. On the other hand, to repeat what we wrote last quarter, obviously the market will become very concerned, very quickly, if it appears the current situation might evolve *into a real Constitutional crisis.* Moreover, with the 2020 election now in full swing, given the vast differences in policy prescriptions between Trump and most of the Democratic candidates, **we suspect politics will be much more important to the equity market this year**, and we will be monitoring the situation closely for implications for our holdings.

In aggregate **PVP was up 6.8% in 4Q19, up 27.2% in 2019, and up 12.6% (annualized) since accepting our first partner capital in February of 2016.** [1] Looking forward, as we shall discuss below, our portfolio's current ERP of almost 5% continues to be quite attractive, historically speaking. In other words, **we continue to believe we are being quite well compensated for bearing equity risk.** Of course, the ERP tends to predict returns out into the future, so this is by no means a prediction about near term performance. As always, we 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 4Q19

Buys in the quarter

Entertainment Properties Trust (EPR) is a Real Estate Investment Trust (REIT) that is focused on acquiring and managing "experiential" assets, such as movie theaters. EPR, a stock we have owned in the past, recently divested most of its educational assets at a very healthy IRR, making its asset mix more focused and less dependent on exogenous factors. We like the countercyclical elements of the company's profile, certainly relative to REITs that own malls and office

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

buildings. In spite of great skepticism through the years, movie theaters have thrived through the Great Depression, various wars, the Financial Crisis, the VHS and Betamax (remember that one?) and later the DVR, and we suspect they will survive the Streaming Wars as well. EPR trades at a very attractive 13x Funds from Operations (FFO) and with a healthy 6.5% dividend yield.

While there was very little volatility in this strong quarter, we were able to take advantage of certain idiosyncratic market movements and add to certain positions, such as "earnings disappointments" in the case of cyber security software provider **Palo Alto Networks (PANW),** for-profit education company **Adtalem (ATGE),** energy pipeline company **Williams (WMB)** and warehouse club operator **BJ's Wholesale (BJ).** In the case of the adds to cable company **Comcast (CMCSA),** telecom **AT&T (T),** French bank **BNP Paribas (BNP)** and alternative energy provider **Nextera (NEP),** our conviction has increased and or the valuation has become more compelling.

Exits in the quarter

Recall that in the past year **DuPont (DD)** "de-consolidated", effectively creating three new companies: Corteva (CTVA), which develops seed and crop protection products; Dow (DOW), which is the former Dow Chemical; and the "legacy" DuPont (DD). We held on to Corteva and sold DOW last quarter. This quarter we sold DD, which, with its now substantial commodity exposure, we consider not quite as attractive as alternative uses of our capital.

In early November alternative energy provide **Pattern Energy (PEGI)** agreed to be acquired by Canada Pension Plan Investment Board (CPPIB). Because the deal included a "go shop" provision, the market speculated that additional suitors would emerge at a higher price, so we were actually able to exit the position in December at a price above the stated deal price.

With a global footprint and one of the strongest balance sheets (Aaa/AA+) in the world, **Exxon Mobil (XOM)** has a lot going for it; however, as the relatively low price of oil has hindered profits and cash flow, XOM has been paying out more in dividends (very generous current 5% yield) than it has generated in FCF -- which Exxon could undoubtedly continue for quite a long time, but it is a financial profile that makes us uncomfortable. Moreover, in recent months our conviction has grown that the relatively "cleaner" natural gas is likely to continue to gain share relative to oil, so we have consolidated our energy positions in the infrastructure and distribution companies Williams (WMB) and Cheniere (LNG).

We also trimmed without completely exiting our positions in a handful of stocks, for a variety of reasons. **Crown (CCK),** the tin can company, for instance, was up over 70% in 2019. While we still like the stock, the valuation is not nearly as compelling as it had been, so we have cut the position roughly in half. Likewise **Apple (AAPL)**, which we shall discuss in more detail below, was up almost 90% in 2019, so we trimmed about 1/3 of our position. We also trimmed our stake in the biotechnology company **Biogen (BIIB)** after its exciting Alzheimer's drug news (discussed below); and defense contractor **Lockheed Martin (LMT),** industrial conglomerate **United Technologies (UTX)** and carpet/flooring company **Mohawk (MHK)** as the stocks approached their respective Target Prices (TP).

Strong performers in 4Q19 [2]

There is a lot to like about **Apple (AAPL),** which was up 31% in 4Q19. While the iPhone still represents the majority of revenues and profits, the company's services and "wearables" are growing faster, and now eclipse the Mac and the iPad in size. Meanwhile anticipation grows for new 5G iPhones sometime in 2020. AAPL intends to use much of its nearly $100 bn of cash, and its abundant FCF, to repurchase shares. At about 22x earnings Apple is far from the cheapest stock in our portfolio. Still, for such a unique company, which actually trades at a discount to the market on an EV/FCF basis (backing out the cash on Balance Sheet), we continue to believe AAPL is an attractive holding.

Last quarter we discussed the weakness in 3Q19 in **Johnson & Johnson (JNJ),** which remains our largest position in the portfolio, as primarily relating to the various litigations facing the company. In 4Q19 the market took a more optimistic view of these challenges, based on a handful of data points that were positive relative to expectations, and concluded that the worst case scenario is likely off the table. Meanwhile the company continues to perform well fundamentally, with modest eps growth and an impressive pipeline of potential drug candidates. JNJ, one of only two US corporations with AAA credit, was up 13% in the quarter, and trades at a slight discount to the market.

Financial stocks were by far our biggest contributors to overall performance in the quarter. **Bank of America (BAC)** posted solid 3Q19 results relative to expectations, with core eps up 13% in the quarter. Moreover, as interest rates rose and the yield curve steepened modestly during the quarter, the company's Net Interest Margin will benefit, giving the market greater confidence in future earnings. BAC, which has been a terrific stock for us over time, was up 21% in the quarter, and still trades at under 12x earnings and at a modest premium to Book Value (BV).

Citizens Financial Group (CFG), the Providence, RI-based regional bank that was sold to the public by the Royal Bank of Scotland in the wake of the 2008 financial crisis, has also been a great stock for us over time. Like BAC, in 3Q19 the company exceeded expectations (8% core eps growth), and also benefits from rising rates and a steeper yield curve, sending the stock up 16%. CFG still trades at just 10x earnings and at a slight discount to BV.

Biogen (BIIB) rose 27% in the quarter, mostly on the very surprising news that the company had re-analyzed the results from its clinical trials of aducanumab, for Alzheimher's Disease. Previously the company had basically declared the drug a failure. Now, with the encouragement of the FDA, Biogen plans to submit the drug for approval in early 2020. While this is extremely exciting news for patients and also BIIB shareholders, this will not be a "slam dunk" approval. The results are mixed, and quite complicated. We took some profits on the news, but maintain a position in the stock.

Weak performers in 4Q19

The market has become increasingly intolerant of even the slightest "earnings misses". **TerraForm Power (TERP),** the alternative (wind/solar) energy provider that was our top performer last quarter, had a modest miss relative to expectations in the most recent quarter

[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.*

primarily due to the underperformance of certain of its wind assets. Moreover, in October, the company issued more common shares to bolster liquidity and fund ongoing growth initiatives. While we applaud the company raising equity at a more attractive price in order to strengthen the Balance Sheet, this does dilute shareholders in the short term. TERP was off 15% in 4Q19, and currently trades at an attractive 5.3% dividend yield.

BJ's Wholesale (BJ), the Northeast-based warehouse club, exceeded market expectations for the quarter but guided more cautiously for the next quarter. Nonetheless, in our view BJ is doing an admirable job of continuing to improve operations and profitability and expand its geographical footprint. With the stock down 12% in the quarter and now trading at a healthy 7% FCF yield, we added to our existing position on the weakness.

While we believe **Allscripts (MDRX),** the healthcare IT provider, has transformed itself nicely in recent years, in terms of optimizing its portfolio and making revenues more predictable, the market has been generally unimpressed. The stock tends to trade on growth in bookings, a non-GAAP metric, but even with healthy bookings growth in 3Q19 the market remains skeptical. With the stock down 10% in the quarter, MDRX now trades at 14x eps and 8x EV/EBITDA.

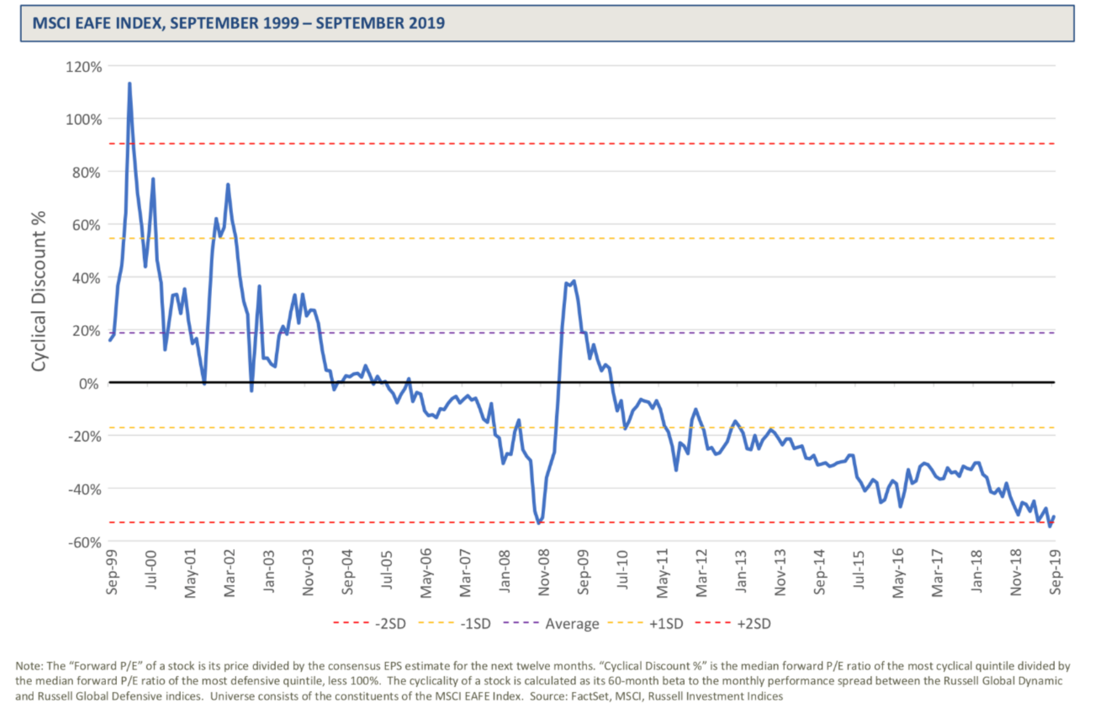
Anheuser-Busch Inbev (BUD) cut its earnings "guidance" as organic growth in several of its key markets failed to meet expectations, sending the stock down 13% in the quarter. The management team has an excellent long term track record, but the major global beer brands have struggled with competition from craft beers and also spirits. The company is responding with a variety of new initiatives in different markets. BUD now trades at a 7% FCF yield.

While **eBay (EBAY)** met expectations for the quarter, and also announced the sale of its StubHub subsidiary for a healthy price, growth has slowed in its core auction business. On the positive side, EBAY generates abundant FCF (8% FCF yield) and has shown a generally shareholder-friendly disposition. EBAY has been a very positive stock for us over time, but it was off 8% in 4Q19.

Current portfolio positioning

While both the stock market (given the very strong year end for equities) and the bond market (given the modestly steepening yield curve) seem to be telling us that a recession has been averted in the near term, we continue to proceed with caution. Although our portfolio beta has crept up a bit (0.96 currently), we believe we are positioned relatively defensively. But we are certainly not positioned as if we believe a recession is imminent. If that were the case, we would own much more of the defensive sectors, such as utilities.

The reason our positioning does not *appear* quite so defensive is that, as shown in the chart below, the traditionally defensive sectors have gotten relatively expensive as the current economic cycle has continued longer than most anticipated. For this reason we have not found very many compelling opportunities in these sectors.



International Value Equity
September 30, 2019

Investment Outlook 3

Looking below the surface, however, we believe some of our biggest holdings are in companies with quite defensible business models. In the financials, a generally cyclical sector where we have the most exposure, our largest holding is **Berkshire Hathaway (BRKB),** with an AA balance sheet and nearly $130 bn of cash on the balance sheet. One of our other larger financials is **Enstar Group (ESGR),** which acquires "runoff" businesses from other insurers, and tends to shine when the industry is weak and needs to raise capital. In the cyclical industrials our biggest position is the garbage company, **Waste Connections (WCN);** and we also have a good deal of defense exposure in **Lockheed Martin (LMT), Huntington Ingalls (HII) and United Technologies (UTX)** – which is in the process of acquiring Raytheon (RTN).

In consumer cyclicals our biggest positions are **Comcast (CMCSA),** the cable/entertainment giant; and **Adtalem (ATGE),** which manages schools for doctors, nurses and veterinarians. Finally, in energy our two holdings are the pipeline company, **Williams (WMB),** and the LNG liquefaction company, **Cheniere (LNG).** These companies are more like "energy toll booths" than the exploration and production or services companies whose prospects are very closely linked to the price of the commodity.

Needless to say*, when the market corrects we are still going to feel it.* We certainly haven't eliminated all economic cyclicality from the portfolio. But this relatively defensive positioning, coupled with the cheaper valuation of our portfolio (as shown below), should give us a margin of safety.

Setup

As always, 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.** 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 1000 Value index, PVP's valuation is cheaper on a FCF basis, yet PVP's margins and returns are substantially better.

To put PVP's FCF yield of 7.3% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 2.4%. This suggests an Equity Risk Premium (ERP) of 4.9% (7.3-2.4). At this level we believe we are being well compensated to bear the risk of equities.

	PVP [3]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2019)	7.3%	3.8%	4.2%
Price/Earnings (2019)	16.2x	21.0x	16.4x
Debt/Total Capital	48%	43%	41%
Debt/EBITDA	2.9x	3.0x	3.4x
2019 EBITDA margin	31.4%	19.3%	19.1%
2019 Return on Equity	17.2%	17.6%	14.1%
2019 Return on Invested Capital	12.1%	7.6%	6.3%

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

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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.*

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