PROSPECTIVE
VALUE PARTNERS
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Dear PVP partners and friends

It was a remarkable quarter, and a remarkable year, for equities. In a year in which over 300,000 Americans and 1.5+ million people globally have been killed by the coronavirus, with countless businesses destroyed and jobs lost as a result of our response to the pandemic, it seems almost obscene that equities have bounced back as strongly as they have in this *annus horribilis.* But the equity market, as we know, is a dispassionate, forward-looking discounter of future cash flows. Beginning at the end of 1Q, and taking on new urgency this quarter, this is exactly what the market has done. Specifically this quarter, in our estimation, **there were two major "macro" events that accelerated the recovery in equities that began in late March.**

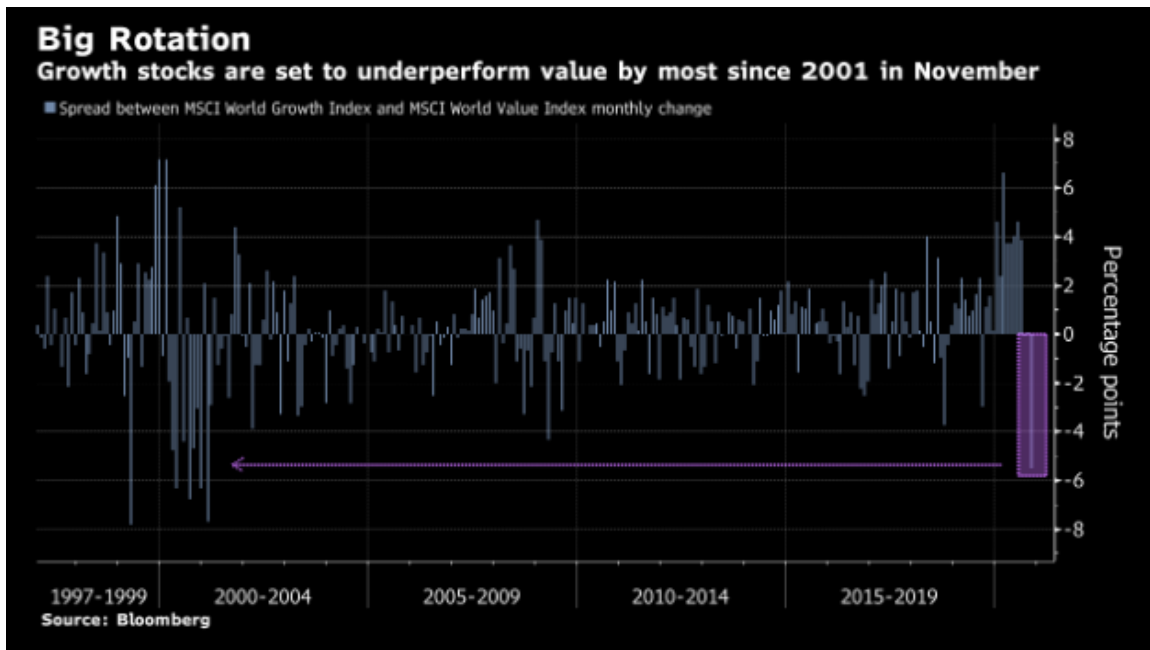
First, and most importantly both for stocks and for humanity, initially Pfizer and then Moderna and Astra Zeneca (presumably with JNJ to follow as well) announced very high levels of efficacy in their **new covid vaccines**, leading to quick approval from FDA and international regulators, with distribution recently begun – initially to those who need it most. It is impossible to overstate the remarkable speed with which this has been, and is being, conducted, from R&D through successful human clinical trials through regulatory approval through pre-arranged distribution – in months rather than years. Warp Speed, truly. Although pharma is a longstanding political whipping boy for all that ails health care in the US, this experience is a reminder that the industry is capable of some amazing things.

Second, the US elections produced equity-friendly results. Democrat Joe Biden will become the next US president, while the Senate (presumably, pending the January runoffs in Georgia) will remain in GOP hands – at least for the next couple of years. Biden is historically a moderate, and the equity market, which dislikes surprises, tends to perform best under mixed government. Moreover, the presumed GOP-majority Senate will likely not allow the most ambitious plans of left-leaning Democrats to become law. This is extremely important for entire industries, such as health care, energy, financial services, defense, etc.[1] As the year ended (at last!) the market paused to take a breath as it digested ongoing drama around more pandemic-related fiscal stimulus, and also struggled to reconcile the currently worsening short term (pandemic lockdown) news with the good (vaccine) news that is just around the corner.

Last quarter we discussed various signs of excess in technology stocks and certain other "sexy" corners of the market, as well as the extreme dichotomy that existed, in terms of both performance and valuation, between growth and value stocks, which we compared to the dotcom boom and bust of the late 1990s and early 2000s. Although the timing of these tectonic shifts is always impossible to predict with any accuracy, it did seem to us that the stars had begun to align for a shift to value leadership. And that is what happened this quarter, albeit in a modest way**. For**

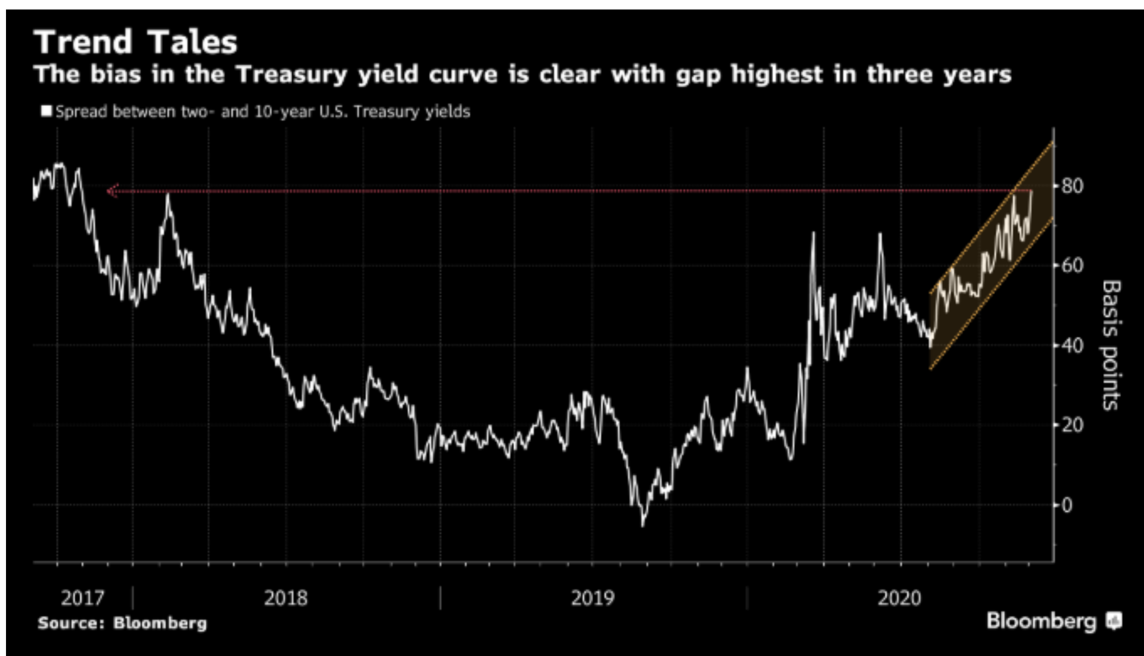
[1] *When we write about politics, needless to say, these views relate only to the impact of politics on equity markets. They may or may not reflect our personal political views.*

the first time in a *very* long time, the performance of value stocks in 4Q exceeded that of growth stocks (please see chart below).[2]



The main drivers of this shift were the emergence of evidence that vaccines will be available soon and will accelerate the still fragile global economic recovery, and the subsequent creep upward in interest rates and slight steepening of the yield curve (please see chart below). The recovery favors generally more cyclical value stocks, as opposed to the "safer" technology and other growth stocks that have outperformed for years, and especially during the darkest hours of the pandemic. Higher interest rates make growth stocks more expensive, since their cash flows are expected to occur farther out into the future, so discounting them back to the present at a higher rate lessens the present value of those cash flows.

[2] *In 4Q20 Russell 3000 Value was up 17.2%, vs. 12.4% for Russell 3000 Growth.*



With the trillions of stimulus dollars provided by governments around the world, there is also a renewed debate about the potential for inflation. This, along with the economic growth expected from the recovery, as well as bonds losing their "safe haven" status as corporate profits rebound, is placing upward pressure on interest rates as well – notwithstanding the Fed's seemingly insatiable appetite to acquire any and all risk assets. If rates climb at a steady pace it is likely a healthy sign that the bond market anticipates the recovery, and will continue to particularly boost our financial holdings; however, while rates remain quite historically low today, at some point the equity market will take notice that the higher rates are negatively impacting the Equity Risk Premium (ERP). In other words, higher rates will ultimately make stocks more expensive – but rates are so low now that it seems a fairly distant worry.

From our standpoint, the big question now is whether, and for how long, this recent value leadership will continue. **We believe there is great potential that it is still very "early innings" for value leadership.** Normally these style cycles last a few years, but the growth cycle has lasted practically since the beginning of recovery from the Global Financial Crisis – the longest period of style outperformance on record!

And we haven't yet even seen the popping of the growth/tech bubbles. Not even close. Growth and technology did not exactly lay an egg this quarter – they just underperformed. These stocks are generally still quite expensive, in our view. Thus Tesla, with its stock up over 600% this year, in early December raised $5 billion of new equity. There are numerous other signs of excess in the more speculative areas of the market, such as the renewed popularity of special purpose acquisition companies (SPACs), whose purpose is to raise capital in an initial public offering (IPO) in order to acquire assets/companies, which are unknown to the IPO investors. SPACs and other "blank check" companies tend to appear at the most frothy times, when risk appetite is very elevated, and then recede quickly (once principals and Wall Street have been paid, of course).

Finally, while we would certainly not expect to see the torrid pace of stock appreciation that we experienced in 4Q continue in subsequent quarters, **we *are* believers in the economic recovery, and if we are correct then interest rates will likely continue to climb.** Meanwhile the Fed, which for years has been working to "manufacture" inflation, may well prove "successful" in that endeavor, which will only put more upward pressure on rates.

So is the market overvalued? Maybe, maybe not, but for us the relevant question is really whether *our* holdings are overvalued, and, as we discuss below, we must answer with a resounding "no". The sage expression is that "valuations usually don't matter until they do", and in our experience that is very much the case. So **we stay away, as best we can, from those high valuations, because when that music does stop we want to be comfortably seated.** Again, the dotcom bubble/crash analogy is probably apt. While intuitively one might expect a drawdown in the most expensive and speculative equities to pull the rest of the equity universe into its wake, that was not the case in the early-mid 2000s, when value stocks performed *well* in absolute terms and *trounced* growth stocks in relative terms.

For these reasons we have become increasingly pro cyclical, and increasingly value-oriented, in the portfolio. This is reflected in our portfolio beta, which was about 0.9 at the beginning of 2020, and is now closer to 1.1.[3] While we certainly never abandon caution and always maintain our value discipline, and we never want to "chase stocks", we also have been doing much more buying than selling lately, on the premises that the successful vaccines are truly game changers, that the political setup is benign for equities, and that valuations (at least in the corner of the market where we hunt) are still relatively undemanding. As we discuss below, we have cut back on stocks that have performed heroically during the pandemic, sometimes well exceeding our Price Targets going into it, and we have redeployed those proceeds into stocks heavily discounted due to covid that we believe are very well positioned to prosper when life returns to normal.

Not surprisingly, given the value leadership in the quarter, the strongest sectors were the major *cyclical* value sectors: energy, financials, industrials and basic materials. Given our large representation in financials, they were by far our biggest source of performance in the quarter. The more *defensive* value sectors (health care, REITs, staples and utilities) underperformed. **But every sector was up this quarter, and in fact technology continued its very long string of positive performance, finishing roughly in the middle of the pack.**

In aggregate **PVP was up 22.5% in 4Q20, and our annualized return since accepting our first partner capital in February of 2016 is now 11.9%.[4]** Looking forward, as we shall discuss below, our portfolio's current Equity Risk Premium (ERP) of 6%, while down from 3Q due to the stock appreciation, continues to be *quite* attractive, historically speaking. As always, we encourage our partners to take a long term view. We believe we will be well compensated for this very healthy premium, as we were this quarter, but, as we have seen, it is always difficult to say *when*.

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[3] *Beta is a measure of how a stock has performed, in some time period, relative to an index, as a way of crudely predicting future relative performance. In our case, it is over the past year, relative to the S&P 500. In other words, if the S&P 500 is up 10% next year and our portfolio beta is 1.1, beta would predict about a 20% portfolio return. (Of course this works in reverse as well if the market is down.) Beta is a backward-looking metric and thus has its limitations, but it does give us a general sense for portfolio positioning.*

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

Actions taken in 4Q20

Buys in the quarter

CVS Health (CVS) is a diversified health care services and products company that is the parent of the managed care organization (MCO) Aetna; the pharmacy benefit manager (PBM) Caremark; and of course the ubiquitous CVS pharmacies. The company believes its integrated offering could truly be a solution in the health care industry. For instance, its in-store "Minute Clinics" show enormous promise as a way of delivering quick and inexpensive primary care. The company generates enormous FCF, with a current yield over 10%, and a dividend yield near 3%. The short term risk here, in our view, is the Senate runoff elections in Georgia, where the possibility of a Democratic sweep in that state, which would result in a 50/50 Senate and thus *de facto* Democratic control with the Vice President casting the deciding vote, could potentially call into question many prevailing assumptions about health care. Still, we very much like the current risk/reward relationship in CVS.

CACI International (CACI) is a technology company focused on the unique needs of the US defense and intelligence communities. Especially as technology plays an increasingly larger role in national security, CACI's nimbleness has enabled it to take an increasing share of defense/intel spend over time. The company believes its strong current backlog/sales of 3.8x and book/bill of 1.6x will allow it to grow revenues at least by mid single digits organically in the medium term, even in a potentially more challenging budget environment, and this growth tends to be augmented by very smart acquisitions the company makes with its plentiful FCF. CACI currently trades at an attractive 8+% FCF yield.

Lyondell Basell (LYB) is one of the world's leading producers of polyethylenes, used in a wide variety of industrial applications. Even before the pandemic the company's end markets were at cyclical lows, which spiraled lower after global lockdowns, so we believe we may be quite well levered to a rebound both in the normal cycle as well as the return to normal economic activity. Even in the midst of such a difficult period, Lyondell generates sufficient FCF to fund a current 4.6% dividend yield.

When the pandemic-induced lockdowns finally end, **Aramark (ARMK)**, which provides food, facilities and uniform services, and which has the substantial resources necessary to wait out the downturn, is an excellent candidate to rebound once normal social behavior, such as schools and sporting events, return. Even before the pandemic Aramark had committed to improve its profitability, which should benefit the company on the way out. While 2020 was obviously a very tough year, ARMK trades at about a 6% FCF yield based on 2019 results.

Exits in the quarter

Amphenol (APH) is a very high quality producer of interconnected technology products that enable communications, which we had the rare opportunity to purchase in the highly discounted days of March. Not surprisingly, given the overall pivot of the economy to virtual mode, the company continued to perform exceptionally well during the pandemic, and with the stock up 44% from our purchase price this quarter, exceeding our Price Target, we simply couldn't justify continuing to own it.

Crown (CCK), the tin can company, has also performed heroically through the pandemic as demand vastly exceeded expectations and the company scrambled to produce more to satisfy

“hoarding” customers around the world. This stock also shot through our Price Target, and is up 133% since the beginning of last year.

Strong performers in 4Q20 [5]

While financials overall were by far our biggest contributors to performance as a sector, our very top performing stocks for the quarter were a somewhat more eclectic group. It is also noteworthy that we added to four of these five stocks earlier in the year as pandemic concerns raged. **Mastec (MTZ)**, the engineering & construction (E&C) company, was our top performer in the quarter. The company announced strong results for the quarter and projected confidence about the future. In addition, rising energy commodity prices bode well for Mastec’s pipeline projects, and likewise post election the probability of a sizable infrastructure bill has likely risen. MTZ was up 60% in the quarter, and up over 2x from our add in March, and has quickly moved from what we considered an absurd valuation to a merely quite attractive valuation of 14x eps and an 8+% FCF yield.

Palo Alto Networks (PANW), the cyber security software provider, continued to march forward and rapidly grow its revenues and FCF. In addition, PANW got a boost from the well publicized and disastrous SolarWinds hack, blamed on Russian security services. These types of breeches, which are clearly not abating, continue to underscore the need for Palo Alto’s products. PANW was up 45% in the quarter, and up nearly 130% from our add in March.

Pinnacle Financial (PNFP), the Tennessee-based regional bank, one of our weakest performers in 3Q, continues to further its reputation as one of the highest quality banks in the country, with robust growth in loans and deposits leading to nearly a 16% return on tangible common equity (ROTCE) for the quarter in the middle of a pandemic. Like many other banks, assuming the vaccines lead us back into a period of economic normalcy, it will likely be the case that Pinnacle is over reserved and over capitalized from its excessive provisions earlier in the year, so that excess capital should be a source of future capital return to shareholders. PNFP, up 71% in the quarter, still trades at a modest premium to Book Value (BV).

Allscripts (MDRX), the electronic medical record (EMR) provider, is a stock with which we have been extremely patient over time – so much so, in fact, that on several occasions we have considered capitulating. What has held us back from exiting, though, is we have sensed important changes happening at the company that the market did not appreciate, and at last this quarter our instincts were borne out. Specifically, in October the company sold one of its very small businesses, called CarePort Health, which represented only 6% of the company’s overall revenues, for a price equal to about 90% of the company’s entire market value at the time of the sale, with the proceeds intended to further delever the balance sheet and buy back shares. This is the very definition of value creation, and so the stock was up 75% in the quarter.

Air Lease (AL), one of the world’s leading aircraft lessors, showed more signs of the resiliency of its business model in the quarter. While new business is obviously slow with global airlines facing such weak demand, AL continued to work with its customers to help them through the pandemic, all the while still generating respectable returns and growing BV. Losses have not materialized the way the market feared, and this sector is particularly levered to the good news the vaccines have brought. AL still trades at about a 20% discount to BV.

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[5] *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 4Q20

Our weakest stocks in the quarter, not surprisingly, were generally our more “defensive” holdings that didn’t benefit as much from the optimism brought by the vaccines. **Biogen (BIIB)**, the neuroscience-oriented biotechnology company that was our weakest performer in the quarter (down 12%), was an idiosyncratic exception. The company’s experience trying to gain the approval of aducanumab for Alzheimer’s Disease (AD), which has the potential to be one of the biggest and most important drugs in history, has been a roller coaster for investors. After years of R&D and billions invested Biogen seemingly threw in the towel in early 2019, discontinuing its most recent clinical trial. But subsequently the company reinterpreted the data from that trial and others, and with the encouragement of the FDA submitted the package for potential approval. In early November 2020 the FDA assembled an independent panel, as is its custom, to assess the drug. While the tone going into the session suggested FDA receptiveness to the drug (sending the stock up 40%), the independent panel disagreed (sending the stock straight back down). Needless to say, given the panel’s interpretation of adu’s admittedly ambiguous efficacy, there is now extreme skepticism in the market about adu’s approvability. Yet with all the encouragement FDA has provided, coupled with a benign safety profile and the enormous unmet need that is AD, as well as ample precedent of FDA ignoring the advice of its panels, there is reason to hope. With an ultimate decision likely by March we are hanging on here, and believe the enormous upside from approval more than compensates us for some degree of downside in the event of the disapproval expected by the market.

Lockheed Martin (LMT), like most other DoD contractors, has underperformed as most of the rest of the equity market has bounced back from the bottom in March. While the company delivered quarterly results that were in line with expectations, there have been growing concerns about future pressure on defense budgets – especially with trillions of dollars spent on pandemic relief and potentially “crowding out” defense investments. LMT was down 7% in the quarter.

Waste Connections (WCN), the very well managed “garbage” company, which typically serves smaller markets and generally deploys its ample FCF toward acquiring smaller competitors and improving/integrating their operations, has performed very well through the pandemic, up 12% ytd. This quarter, with “risk on” the guiding principle for investors, the stock took a bit of a breather, and was flat. In early December we actually took some profits in this stock, but maintain a medium-sized position.

Physicians Realty Trust (DOC) is a real estate investment trust (REIT) – one of only two we currently own – that is focused on acquiring and managing medical office buildings. Among the more resilient REITs, DOC has outperformed its peers through the pandemic, with a slightly negative total return for the year. This quarter, like other defensive names, the stock was down modestly and thus underperformed.

Down 26% for the year, **AT&T (T)** was a more challenging stock than we would have expected in the pandemic. Of course its financials changed materially with the acquisition of Time Warner to a somewhat more discretionary revenue profile, but still we have been impressed with the resiliency of the company’s FCF, and added to the position in November, but have yet to be rewarded with the stock flat in 4Q. T now sports a whopping 13% FCF yield and a 7+% dividend yield.

Setup

Since 2020 results remain an aberration, we are continuing to use 2019 data as a starting point. The numbers below have changed a bit, but the story remains very much the same: PVP's portfolio is historically cheap, with superior returns. Moreover, our companies' superior margins took a hit this past year but also will help them weather this storm. Using 2019 FCF, the Equity Risk Premium (ERP) of our portfolio remains historically high at 6% (7.7% FCF yield less 1.7% 30-year UST). If we look forward to 2021, which of course the market is doing already, we suspect our aggregate FCF yield will be similar to 2019, growing off the depressed base of 2020. At this level we believe we continue to be very well compensated to bear the risk of equities. In other words, we remain optimistic about the prospects for our portfolio as the economy continues to heal.

	PVP [6]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2019)	7.7%	4.3%	5.1%
Price/Earnings (2019)	16.2x	18.9x	14.3x
Debt/EBITDA	3.5x	3.5x	4.0x
2019 EBITDA margin	25.4%	19.2%	19.1%
2019 Return on Equity	16.0%	16.4%	13.1%
2019 Return on Invested Capital	11.1%	5.8%	4.6%

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

[6] *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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