PROSPECTIVE
VALUE PARTNERS
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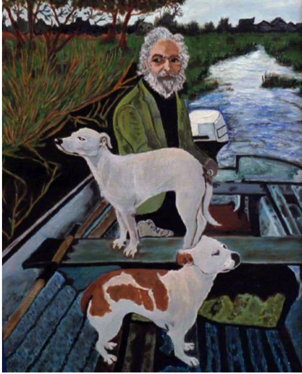
January 2022

Dear PVP partners and friends

At the end of last quarter, as the threat of the covid "delta variant" had begun to wane, notwithstanding a host of other concerns, we discussed our **reasons to continue to be optimistic**. The fourth quarter in fact did get off to a great start for the equity market, and it seemed "off to the races" again. But in mid-November a new variant ("omicron") had been identified, and market ebullience quickly reverted back to fear. In a near repeat of the delta variant experience of 3Q, though, by mid-December, as we learned more about omicron the market reassessed this variant as less of a threat to the ongoing recovery, and **the quarter finished strong.** While covid has been a terrible human tragedy for the past two years, killing millions of people worldwide and wreaking havoc on the global economy, with the miracle of vaccines we are now at last hearing experts speak of "endemic"' rather than "pandemic".

It seems perverse to consider the "positive aspects" of the awful experience of the past two years, but the way companies quickly adapted to the situation has been generally quite impressive. Of course not every company has prospered, and in fact there have clearly been market share gains by larger companies, with better technology and greater resources, from smaller companies. Whether or not this is a net social good is beyond the scope of this note, but it does help to explain the strength of the stock market since the lows of late March 2020. Of **course lingering economic uncertainties remain from the covid experience** – *What does the future workplace look like? Why am I stuck at O'Hare airport when those Zoom calls seemed to work so well? If office workers continue to work from home, what happens to the value of that pricey commercial real estate?*

The Fed's communications and actions are always watched closely, and especially now as the central bank finds itself in the unusual position of continuing to prop up the economy (and markets) through asset purchases and very low rates, even as inflation is now at its highest levels in four decades. And in fact, in his recent testimony before the Senate Banking Committee, Fed Chairman Powell finally formally "retired" the word "transitory" as it relates to his expectations regarding inflation. In what some have dubbed **the "Powell Pivot",** the Fed's communications and actions have taken a modestly more "hawkish" tone (or should we say "less dovish?") with respect to fighting inflation.



Two Fed Officials at Odds Over How to Deal With Inflation [1]

Late in the quarter **the Fed began "tapering" its supportive asset purchases.** This is not really "tightening" policy, but rather "slightly less loose" policy. At this rate the Fed will cease its bond buying in early 2022, ahead of previous expectations. In terms of actual Fed tightening (rate hikes), to combat inflation, the Fed is now signaling perhaps three hikes (0.25% each) in 2022, beginning mid-year, and two more hikes in 2023. **Curiously, while short term rates have understandably moved up post the "pivot", they have been quite static on the long end, perhaps suggesting some market skepticism regarding inflation and or future Fed actions. This results in a flatter yield curve, an unusual situation in a booming economy.**

The recent pivot notwithstanding, we would still characterize current Fed policy as rather dovish. To baldly appropriate the famous quip of former Fed chairman William McChesney Martin, the Fed has no apparent desire to take away the punch bowl from the party that is the equity market. Of course, if inflation stays "hot" (and CPI was 6.8% in December) the Fed may be forced to pivot in a more forceful manner. **Higher interest rates generally translates as lower valuations for equities. But** if the market is forewarned, as the Fed has done, the damage should be minimized. Moreover**, for value investors like us, value stocks tend to thrive *vis-a-vis* growth stocks in higher interest rate environments.**

On the political front, the long-anticipated $1.2 trillion Infrastructure bill became law, on a bipartisan basis, in the middle of the quarter. This is effectively more economic stimulus, albeit in a more targeted fashion, which of course the market applauds. On the other hand, the Biden Administration was unable to get the much more contentious "social infrastructure" Build Back Better Act over the finish line. With its various tax increases, from a market perspective this was also an outcome the market applauded. There are plans to revisit negotiations on this bill in early 2022, but midterm elections will be fast-approaching and will likely have the effect either of terminating or at least materially diluting the legislation. [2]

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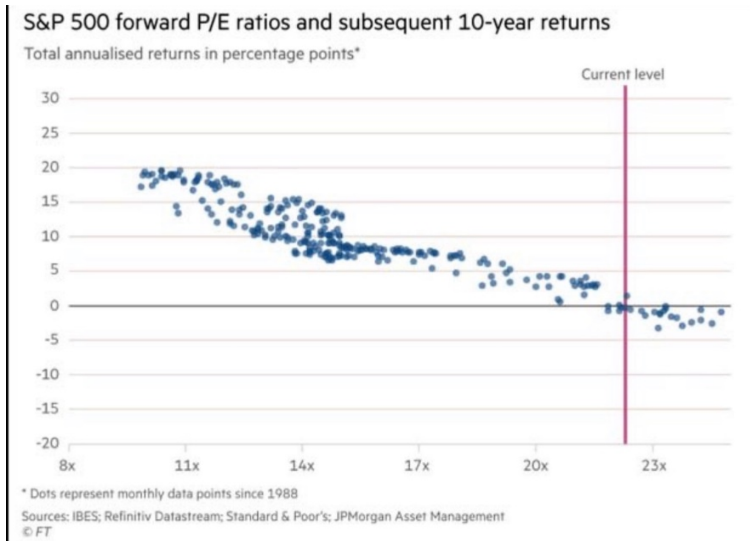
[1] *Again I cannot resist including a gratuitous meme, and I also must admit that I had forgotten it was painted by the Mother of the Joe Pesci character in "Goodfellas" – I thought it might be a Manet. Better that I am an MBA rather than an MFA, I suppose.*

[2]*As always, when we write of politics we do so from a market perspective. What is good or bad for the market may or may not reflect our own personal views.*

After another strong year, what are the prospects for the market and for our portfolio? On the one hand, charts like the following might give us pause – though as we shall see, there are important caveats and qualifications in each of them. **The chart directly below is a version of the Shiller Cyclically Adjusted P/E (CAPE) Ratio,** which considers earnings over a longer time period, and on an inflation-adjusted basis. As you can see, the CAPE ratio makes the market look awfully "toppy". While the idea of "smoothing out" economic cycles to arrive at an appropriate valuation makes sense intuitively, the problem here is that we are not in a normal economic cycle. With the exception of a severe but very brief covid-related downturn in 2020, it has been "up and to the right" since 2009. Moreover, while the CAPE ratio does take inflation into account as a proxy for interest rates, which are essential in evaluating relative valuations, as we discuss below they have recently become somewhat decoupled. And finally, frankly, we don't believe the market really cares what earnings were ten years ago.

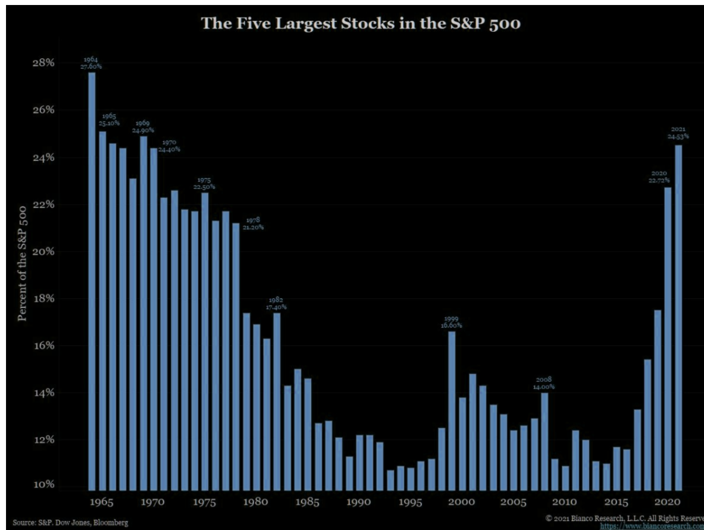
The next chart is also quite bearish, suggesting that, based on regressing historical returns vs. equity valuations, future S&P 500 returns are predicted to be *0% annually for the next decade*. While it is true that the market Price/Earnings (P/E) ratio is currently historically elevated, like the previous chart, the most important factor this chart ignores is the level of interest rates, which of course are now historically quite low. To the extent rates rise faster and higher than expectations, the chart will likely appear more accurate. There is also the issue of: What is the "E"? As earnings expectations continue to rise, the P/E decreases and stocks appear less expensive. In fact, one highly respected strategist now expects the S&P 500 to earn $250 in aggregate in 2022. If that is the case, then the forward P/E for the S&P 500 is actually 19x rather than 23x.

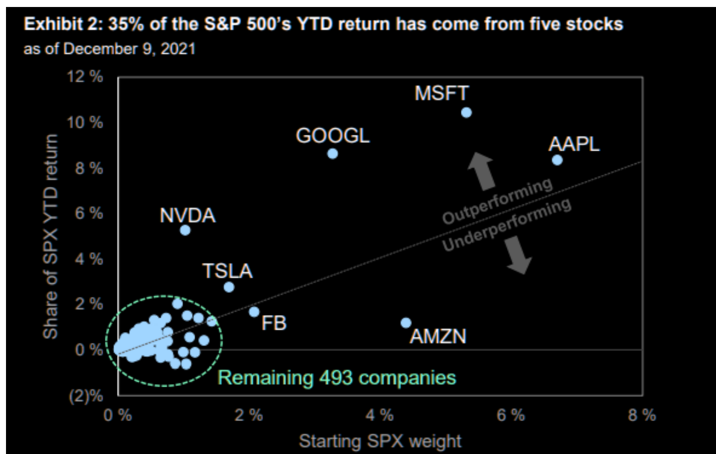


The following chart is somewhat more sobering to us. I would liken this one to the Equity Risk Premium (ERP) we discuss each quarter, but here rather than adjusting for long term rates we are adjusting for inflation. With a market P/E between 20-25x, the market "earnings yield" is therefore the inverse, or 4-5%. If we subtract the very high *current* inflation of 6.8%, we are left with a *real* earnings yield of about *negative* 2%. The problem with this analysis is that inflation is not likely to stay at this elevated level for very long. The questions are: Where does it go? And when? **Needless to say, if inflation persists at or near current levels for any length of time, it will not be good for stocks.**

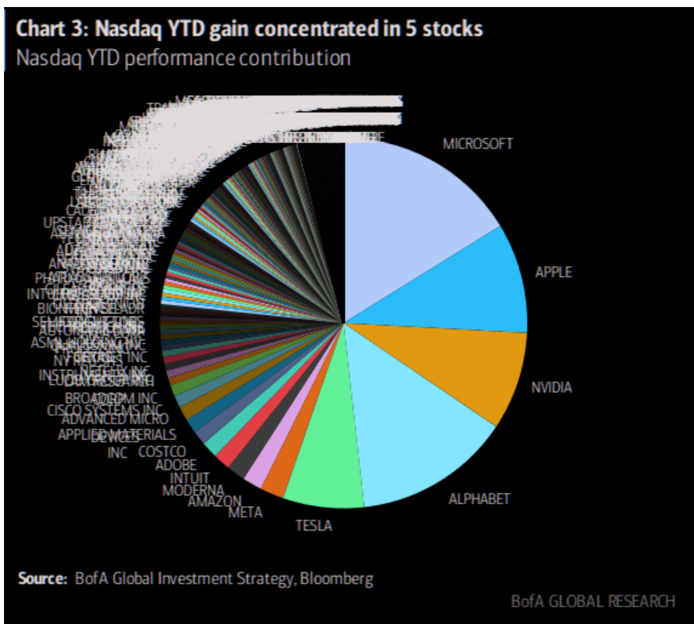
Here is another important question to ask: With several of its largest constituents now valued at more than a trillion dollars, is the S&P 500 really the same thing as "the market" anymore? Unlike the Russell indices, the S&P 500 is not regularly rebalanced, so its "winners" become an ever-larger component of the index. As we can see below, **the S&P is currently**

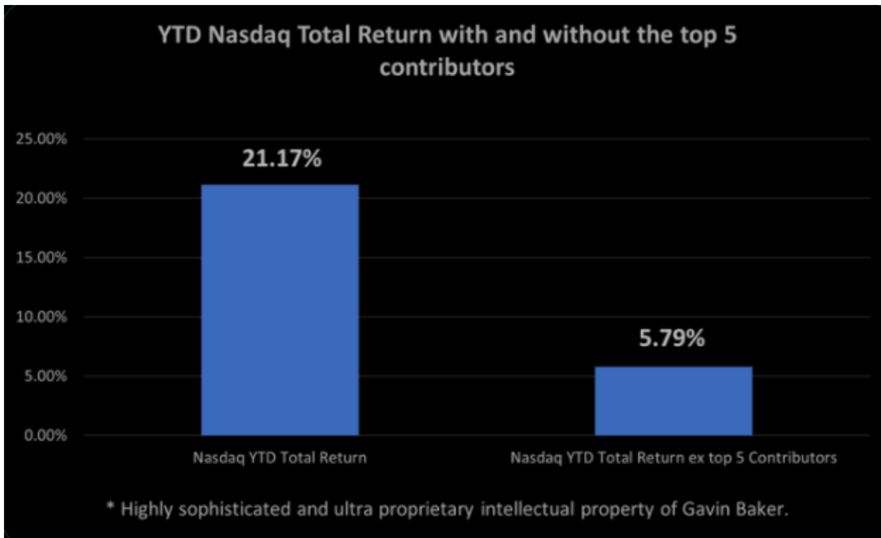
historically concentrated, and with its winners increasingly residing in the tech sector, it has effectively become a Big Tech Index.





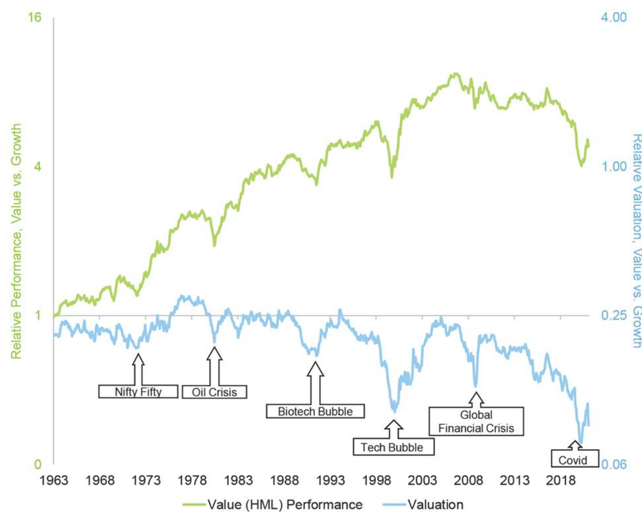
Furthermore, per the charts below, this "tech effect" is even more pronounced in the popular Nasdaq and other growth-oriented indices.





These charts, and the one below, are obviously a reflection of the outperformance of growth stocks in particular, and tech stocks specifically, in recent years. Below is a slightly different twist on a theme we have discussed often recently: **By many measures, the valuation and performance discrepancy between growth stocks and value stocks is as big as it was at the peak of the "dotcom bubble" in 1999/early 2000.**

The chart below is particularly interesting, because it **portrays a longer term view of the growth vs. value dynamic.** (While this data covers only the past 58 years, the famous Fama/French study arrived at the same conclusion based on more than a century of data.) What this chart shows is that, even through such market fixations as the "Nifty Fifty" of the 1960s, the Dotcom bubble of the late 1990s and the more recent manias, **value has handily outperformed growth over time.** Moreover, the greatest periods of value outperformance have started when it was historically cheapest relative to growth – at the risk of "boy who cried wolf" (something I tell my kids never to do), a situation such as we see today.



Note: Value is defined using the classic Fama–French price-to-book value-based definition. The relative valuation of value stocks versus growth stocks is also based on the long and short portfolios' price-to-book value ratios.
Source: Research Affiliates, LLC, based on data from Compustat and CRSP.

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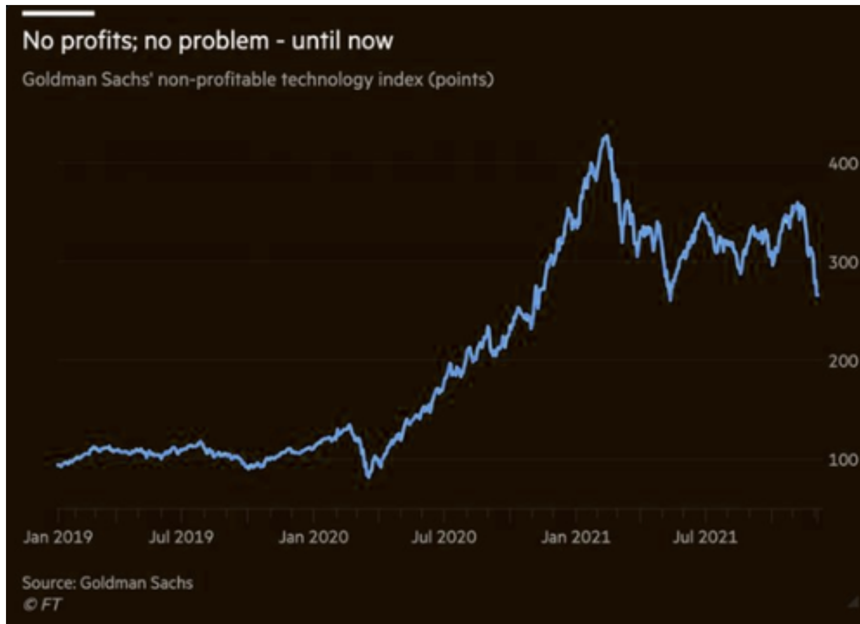
Finally, might the very poor recent performance of unprofitable technology companies, SPACs, Meme stocks, and various and sundry other indications of speculative froth be the proverbial canaries in the coal mine?



So what to make of all these charts? They are all instructive in their own way, and they all have limitations. As our partners and friends know, **we tend to fall back on the Equity Risk Premium (ERP)** as our most useful tool of gauging medium term market returns. **By this measure "the market" (S&P 500) is relatively – though not outrageously – expensive, historically speaking. But, as we have seen, this observation obfuscates the fact that some very big and quite expensive stocks now occupy a vastly disproportionate share of "the market". If we back these out, a rather different picture emerges, a somewhat Dickensian picture of growth/tech and then everything else.**

We try to concern ourselves more with our own portfolio than with the overall market, so with our portfolio generating a very healthy estimated 8.5% FCF yield this year, and a 30-year UST of just 1.9%, and thus **an ERP of 6.6%, we believe we are being quite well compensated for the risk we are taking.** As always, we have no idea exactly *when* we will receive that compensation, and we also have no idea *when* value investing will return to favor. We felt similarly in 1999, after a long and quite painful stretch of value underperformance vs. growth. But we take solace that in 2000, after a year of value underperformance by a whopping 45%, value actually *outperformed* growth by 45%. And the next year by 23%. And the next year by 19%. When we combine the bubble of that period with the subsequent crash, value handily outperformed over the entire period. Of course, as Mark Twain reminds us, history doesn't repeat itself, but it often rhymes. Honestly, it doesn't feel to us quite as stretched as it did then, but it is getting closer. We know that excess breeds excess. Just because we see blinking red lights does not mean the train is going to stop right away.

Shifting from macro to micro, **our companies generally continued to exceed expectations** for the quarter -- although there also seemed to be more "misses", mostly owing to the **ongoing supply chain issues** that continue to linger as a result of constrained supply (covid) and excess demand (stimulus). This factor continues to be a major contributor to the inflation we currently face. As we discuss below, in a few cases these supply chain issues hurt us, and in a few cases they provided opportunities for new investments at discounted prices.

Among the **large caps, growth** stocks reverted to **outperforming value** stocks. Interestingly, though, this was not the case among the **small caps**, where **value outperformed growth** by a similar margin. Presumably this was largely about some of the froth coming out of the most speculative names in the quarter, as referenced in the previous chart. Overall, **large companies handily outperformed small ones** in the quarter. In terms of sector performance, technology (by far the biggest S&P sector) drove the gains, and the cyclical "value sectors" (financials, industrials, energy) were the relative laggards. All sectors were positive in the quarter.

In aggregate **PVP was up 5.8% in 4Q21, and finished the year up 25.3% in 2021, with an annualized return since accepting our first partner capital in February of 2016 of 14.0%.**[3] Looking forward, as discussed above, our portfolio's current Equity Risk Premium (ERP) of 6.6% (8.5% portfolio FCF yield, less 1.9% 30 yr UST) remains quite attractive. As always, we encourage our partners to take a long term view.

Actions taken in 3Q21

Buys in the quarter

A pickup in volatility created an opportunity for us to be more active than usual in the quarter. As always, securities are selected on their own merits. Though with the new names below it might appear we have suddenly become enamored of technology, in reality we were simply presented with a number of high quality companies at discounted valuations, and several of them happened to be in technology, broadly defined.

Global Payments (GPN) is a leading provider of financial technology that makes possible billions of transactions each year. Until recently the stock has had a miserable year, and even after a bit of a bounce GPN was off 37% in 2021. In our view the stock was probably too expensive a year ago, which rendered it vulnerable to a downdraft, and now it is much too cheap. Earnings estimates have been cut ever-so-slightly, and the market is also now concerned about possible new entrants. We believe both these issues are overblown, and that at a very attractive current valuation of 15x earnings and a 7.5% FCF yield we are being well compensated for the risk.

Booz Allen Hamilton (BAH), as you might recall, is a stock we have owned previously, and was a very pleasant experience for us. Since we sold this leading provider of cyber security and other IT services to the federal government, the stock has taken a pause even as the company has continued to grow its earnings at a nice clip and also set some ambitious future financial targets. BAH currently trades at an attractive 6+% FCF yield.

Rackspace Technology (RXT) is a provider of technology solutions that enables its clients to access the "cloud". The company had been previously LBO'd by Apollo, which then took it public in mid-2020 with very high growth expectations, which took the stock from about $17 at its open to $26 in April 2021. In recent months, however, those lofty growth expectations have

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

been tempered, sending the stock back down to less than $14. In the most recent quarter RXT posted core revenue growth of 15%, which we think is pretty impressive for a stock trading at just 12x earnings, with an eye-popping 13% FCF yield.

Qualcomm (QCOM) should be one of the biggest beneficiaries of 5G, and connectivity in general. We acquired the position in mid-October, as uncertainties surrounded the company's supply chain and also its significant relationship with Apple (AAPL). At the time we felt the supply chain issues would prove to be transitory, and that the stock was already discounting a hit from the Apple situation. We have been rewarded fairly quickly in QCOM, with the stock now up about 40% from our initial purchase, and now trading at a still attractive 5.6% FCF yield.

Western Digital (WDC) is a leader in hard drives and flash drives, for data storage. These can be quite volatile, cyclical businesses, and on its October call the company announced a very disappointing quarter and near term forecast, blaming a variety of factors, such as supply chains, for the miss. As we strive to do, we stepped into what we consider to be the near term noise to participate in an increasingly consolidated secular growth industry. WDC has also rewarded us fairly quickly, with the stock now up about 27% since our purchase in late October, and still trades at nearly a 10% FCF yield.

Perrigo (PRGO) is a leader in making "store brand" OTC "consumer self-care" products, a business that continues to find favor with value-oriented consumers. Perrigo has recently accomplished three important goals that should make it a simpler, more profitable and more attractive investment: the company has divested its generic drug business; it has acquired a UK consumer self-care business to complement its US core business; and it has resolved some lingering tax issues, at a price far below what investors had feared. Like WDC, however, PRGO had a disappointing recent quarter. The company suffered not only from supply chain issues, but also very weak cough/cold product sales – with all the social distancing, there have been far fewer colds lately. As these issues recede PRGO believes it can earn $4.00 of eps in 2023, suggesting a very cheap 10x current valuation.

Exits in the quarter

GXO Logistics (GXO) is the "asset-lite" logistics business that was spun out to shareholders by its former parent, XPO Logistics (which we still own). The spin was tremendously value-creating for shareholders, and in mid-November we sold it at about $102, for a 70% profit in about 3 ½ months. While the company is very exciting, the valuation had quickly become stretched. At year end GXO was back down to about $90.

Amazon (AMZN) was a terrific investment for us over time, and with our sale in December we realized a gain of nearly 7x our initial investment in February 2016. Honestly I'm not sure when AMZN has ever been a "cheap stock", but it has been exceeding expectations and proving naysayers wrong since its IPO in 1997 (when it was a mere online book seller) and is now worth almost $2 trillion. We bought the stock when it finally had begun to convert all those revenues into lots of Free Cash Flow. It was not easy to part with such an amazing company, but we do believe Amazon will face challenging post pandemic comps, its compensation costs are likely to grow faster than revenues, it faces various regulatory challenges, and it is an expensive stock.

MGM Resorts (MGM) was in a very fortunate financial position going into the pandemic, when its entire operations effectively ceased for quite a long period of time. This has allowed the company to return to an offensive mode as the pandemic has abated, sending the stock to an all-time high. We sold near the high in mid-October, around $49, and at yearend the stock had traded

back down to about $45. All in, MGM was a profitable but rather mediocre investment for us, though we were pleased to benefit from its sharply upward move from the pandemic low of about $9 in March 2000.

Pfizer (PFE) was another modestly profitable investment for us that we sold in mid-November near an all-time high. Pfizer, as you surely know, is currently hugely benefiting (as is the world!) from its covid vaccines. Unlike MGM, though, PFE continued to rise after our sale at $50+, and closed the year at $59+.

Strong performers in 4Q21 [4]

CVS Health (CVS), which owns the HMO Aetna, the PBM Caremark and also of course the ubiquitous chain of drug stores, has been in the process of a "re-rating" by investors. The stock has been very cheap for quite some time, but in the wake of some impressive recent quarters, and a very well-received recent investment day, in which the company put some meat on the bones of its vision for the future, investor skepticism has begun to abate. CVS was up 22% in the quarter and 52% for the year, and still trades in our view at a quite reasonable valuation of 13x earnings with a 8% FCF yield.

Berry Global (BERY), which makes plastic packaging materials for a wide variety of health and consumer applications, is a very well-managed and remarkably consistent company. In November we felt the stock had gotten too cheap, and added to the position, making it one of our largest holdings. Shortly thereafter, an activist investor took a position in BERY with various ideas for the company to accelerate its value creation. BERY was up 21% in the quarter, and still trades at a very attractive 10x earnings with a 9% FCF yield.

Qualcomm (QCOM), discussed above, was a very opportunistic purchase in the quarter, already up 40% from our purchase price. In our experience it is rare to be presented with such a discount in such a well-known, high quality and widely-followed company.

Berkshire Hathaway (BRKB), the uniquely decentralized insurance and industrial conglomerate run by the legendary Warren Buffett and Charlie Munger, remains one of our largest holdings. The company's insurance operations are benefiting from the "hard" P&C market; its non-insurance operating companies showed nice profit growth; and the company aggressively bought back shares in 2021. After a long stretch of (stock) underperformance, Berkshire was up 10% in the quarter and 29% for the year. BRKB currently trades at a quite reasonable 1.4x its (understated) Book Value.

Continuing our streak of "worst to best", **Fairfax Financial (FRFHF)**, our fourth worst contributor last quarter, was our fifth best contributor this quarter, with the stock up 22%. In response to the quite discounted stock price, Fairfax repurchased about 8% of the company's stock during the quarter and also announced several anticipated large gains on investments. Taking into account these gains, Fairfax still trades at a healthy discount to its BV.

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[4] *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 4Q21

While **Comcast (CMCSA),** the media and entertainment company, did exceed expectations for the quarter, a few Wall Street analysts soured a bit on the stock, sending it down 10% in the quarter. Skepticism abounds about Comcast's ability to compete as video streaming commands a bigger share of household media spend. CMCSA now trades at just 14x earnings with almost a 7% FCF yield. Already a large position for us, we are considering adding more to it.

Westrock (WRK), the paper and packaging company, has been a challenging and frustrating stock lately, down 11% in the quarter even after posting an excellent quarter, even as most other commodity-oriented stocks are booming. The dominant bearish narrative seems to be that more industry capacity is imminent, driving down prices. But this has been the case for a very long time, even as the industry has become more consolidated and capital-disciplined. WRK currently trades at under 10x earnings and at a 12% FCF yield.

Citigroup (C), down 14% in the quarter, has long been the big bank that everyone loves to hate. But Citi has a new CEO who seems determined to right the ship by divesting and or shuttering some of its far-flung operations and making the company much more profitable. It will take time though. C now trades at about 70% of BV, even though it is generating an ROE of about 10% -- well in excess of its cost of capital. And bear in mind these current returns face the headwind of very low interest rates. When rates rise, margins and returns will expand, and so too presumably will valuation.

AT&T (T), down 9% in the quarter, has gone from being a cheap stock to a very cheap stock as the company has effectively turned tail on its foray into media via agreeing to sell a portion of its Warner Media assets to Discovery. While the transaction looks like a capitulation, an admission of failure of a deal completed just in 2018, it will also allow the company to materially reduce its debt load, focus on its core telecom operations, and maintain an interest in the new Discovery/ Warner entity. AT&T now trades at under 8x earnings, with a whopping 8.4% dividend yield.

Vontier (VNT), the 2020 industrial technology spin-off from highly-respected Danaher, posted a very solid quarterly results in early November, but also tweaked down its 4Q20 expectations (again -- mostly supply chain issues), and the stock was off 8% in the quarter. Notwithstanding the quarter, we are excited by what this new company's management is doing, and the stock is quite cheap at 11x earnings and a 9% FCF yield.

Setup

As discussed above, quantitatively the story remains very much the same: PVP's portfolio remains cheaper than both value stocks and the market overall, with superior returns on capital. The Equity Risk Premium (ERP) of our portfolio remains comfortably above the market at 6.6% (8.5% FCF yield less 1.9% 30-year UST). At this level we believe we are quite well compensated to bear the risk of equities.

	PVP [5]	Russell 3000	Russell 1000 Value
Free Cash Flow yield (2022E)	8.5%	4.1%	5.3%
Price/Earnings (2022E)	15.0x	23.5x	15.8x
Debt/EBITDA (2021)	3.1x	2.8x	3.2x
EBITDA margin (2021)	28.3%	20.0%	19.1%
Return on Equity (2021)	16.9%	19.5%	16.1%
Return on Invested Capital (2021)	10.8%	9.1%	7.6%

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

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