PROSPECTIVE
VALUE PARTNERS
309 COURT AVENUE, SUITE 211, DES MOINES, IA 50309 · prospectiveVP.com

January 2024

Dear PVP partners and friends

The fourth quarter of 2023 was very strong for US equities, as three major (and related) macroeconomic and policy overhangs that were depressing valuations took on a more optimistic tone. First, the Fed at last all but declared "mission accomplished" in its battle with inflation, turning its "pause" in rate hikes into a likely definitive "end" to rate hikes (plus some optimism about future rate cuts). Second, interest rates reversed the upward path they have followed for the past few years, making money and stocks cheaper. Finally, and probably most surprisingly to the market, the previous consensus view that the aggressive Fed hikes will surely cause a recession have been upended by ongoing positive economic indicators, resulting in a much rosier current consensus view on the economy.

Regarding the Fed and inflation, in late December the "Personal Consumption Expenditures Price Index" (aka PCE, reputedly Chairman Powell's favored measure) was revealed to have been actually *negative* on an annualized basis for the month of November. In other words, not long after inflation has been laid to rest, *deflation* has already begun to rear its ugly head. This might well give investors agita to the extent it becomes more widespread. On the other hand, the prospect of deflation also fuels optimism about sooner and greater Fed rate cuts, possibly as early as March. Currently markets are anticipating about six rate cuts in total by the end of 2024, which would bring the Fed Funds rate to about 3.875%.

With respect to the economy, such leading indicators as job growth and unemployment claims (among many others) have defied the doomsayers and remained strong, exceeding expectations. According to GDPNow, published by the Atlanta Fed, GDP for the fourth quarter is tracking at a healthy 2.5%. Anecdotally, our companies have generally prepared for choppier seas ahead, yet remain optimistic. Interestingly, the yield curve – whose inversion presumably predicts recessions – became even more inverted in the quarter even as optimism grew about the state of the economy.

Equity markets have been through a great deal in the last few years. Honestly it feels like multiple cycles in just four years. In early 2020 we had covid, the worst pandemic since the Spanish Flu at the end of WWI, which created instant winners out of every company that could help us live virtually and losers out of most everything else. In 2Q20, after a very painful start to the year, the equity market began to "see through" the carnage and race back upwards, which continued through yearend, buoyed by an aggressive response from both monetary and fiscal policy.

The next year, 2021, continued the positive momentum as rates remained very low, the vaccines arrived, and the fiscal largesse continued. In 2022 the equity market paid the price for all the support it had received since covid, as inflation quickly spiked up more than it had in four decades, bringing interest rates up as well. It was a terrible market for virtually every asset class. Even "safe" long-dated US Treasuries were hit hard by the rise in rates, and even today after they

began to recover in 4Q23 long bonds (ETF ticker "TLT") have returned an ugly -12.3% annually for the past three years.

Moreover, as we have pointed out, with higher interest rates growth stocks are more expensive, since it is more costly to discount back their future cash flows. This led to significant outperformance of value over growth for the first time in a very long time, leading many to conclude that the outperformance baton at long last had been passed from growth to value. Late in 2022, however, the market began to conclude that the aggressive Fed response would get inflation under control, and risk assets responded quite positively. Growth stocks reversed course and outperformed value in 2023, largely led by a large cap technology cohort dubbed the "Magnificent Seven" (Alphabet/Amazon/Apple/Meta/Microsoft/Nvidia/Tesla), a slightly updated version of what were once the "FAANGs (Facebook/Apple/Amazon/Netflix/Google).

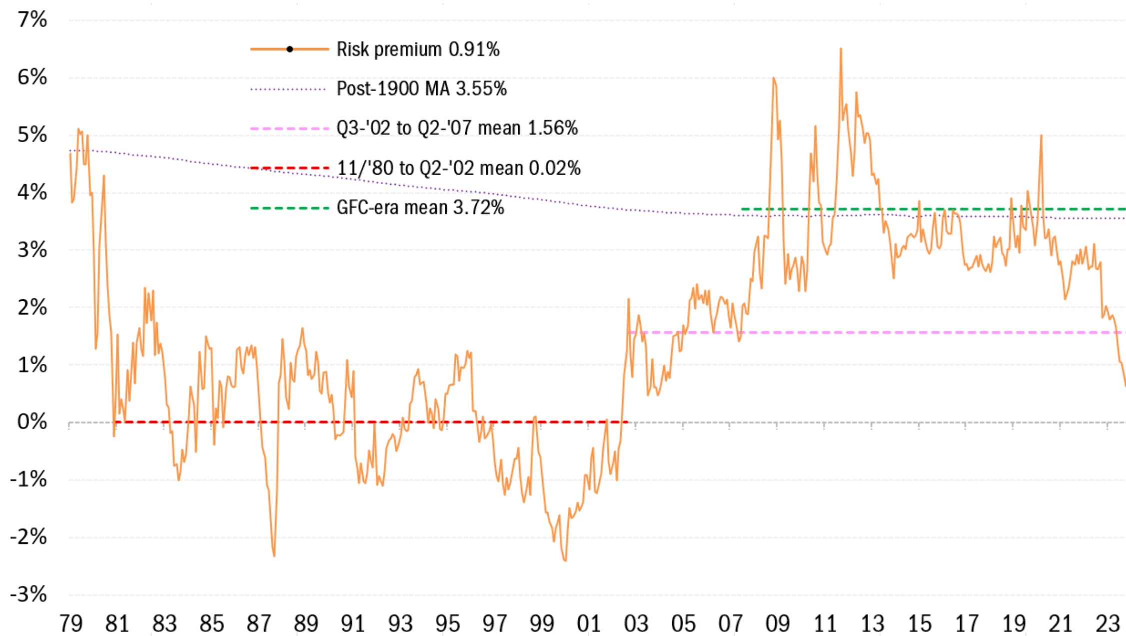
So where do we go from here? For starters, the Fed will likely be a wind at our back rather than in our face, as it has been. Having said that, as referenced above, markets now expect perhaps three more rate cuts than the Fed is signaling. Economic expectations have also quickly shifted from dreary to benign. Much is made of election year politics, but any way US elections shake out they are unlikely to result in major changes with such a divided government. Outside the US, geopolitical tensions have risen, so conflict remains a wild card. After the very strong year for the S&P 500 and technology in general, valuations have been called into question (please see below), and we tend to agree – though we also acknowledge that valuations are irrelevant in the short term. We continue to like both the financial characteristics and valuation of our portfolio. We believe we have excellent quality for which we are not paying too dear a price. But of course it is impossible to predict when we will be rewarded by the market.

Stylistic performance in 4Q23 was a mixed bag. Stocks overall were quite strong. Growth modestly outperformed value. Large cap growth (home of the "Mag 7") outperformed small cap growth. On the value side, small cap (which is quite economically cyclical) outperformed large cap. Overall, every sector except energy was positive. REITs, which are exceptionally rate-sensitive, were the best performing sector. The less economically sensitive sectors, health care and consumer staples, were the laggards, albeit still nicely up in the quarter.

In light of the incredible bounce of the "Mag 7" and their tech brethren this past year, this quarter we have begun to highlight the key metrics of the growth stocks (please see the chart on the last page). In terms of quality, there is a reason why these stocks are so popular. Owing to their software orientation and very low capital intensity, the stocks that comprise the Russell 3000 Growth index have an extremely attractive ROIC of 17.8% and an ROE of 31.5%. On the other hand, they trade at a P/E of 28.2x and a FCF yield of 3.4%. With a 4% 30 yr UST and thus a *negative* ERP, that means investors are *paying for*, rather than *being compensated for,* the privilege of assuming the risk of owning these names. When we last saw this in the S&P 500 in the late 1990s, as per the chart below[1], courtesy of our friends at TrendMacro, what followed was a very painful experience for these stocks over the next several years.

[1] *While this chart considers Earnings/Price rather than FCF yield in the ERP calculation, the concept and the result are much the same. The chart suggests the S&P 500 is more expensive than it has been in the past two decades, though it is not at the extremes it reached in the late 1990s.*

prospectiveVP.com · (515) 875-4928



We believe investing must take into account both price and prospects. While the prospects for these growth stocks appear bright, we are simply not willing to pay any price to own them. To the extent that growth ever disappoints or other risks arise – as evidenced even by the experience of 2022 -- the downside can be substantial.

In aggregate **PVP was up 8.7% in 4Q23, with an annualized return since accepting our first partner capital in February of 2016 of 10.5%.**[2] Looking forward, in spite of the rise in rates discussed above, our portfolio's current Equity Risk Premium (ERP) of 5.4% (9.4% portfolio FCF yield, less 4.0% 30 yr UST) remains *quite* attractive in our view. So with inflation seemingly in the rear view window, notwithstanding the potential for deflation in the short term and various other known and unknown risks, we believe we remain well positioned to continue to prosper.

Actions taken in 4Q23

As we have discussed previously, during the quarter our holding NCR (NCR) split itself in two, becoming two publicly traded companies, **NCR Voyix (VYX)** and **NCR Atleos (NATL)**. Voyix inherited the higher-growth software businesses, which provide solutions for customers in retail, hospitality and digital banking. If you have been in an airport and ordered food without human intervention, or if you have transferred funds online from one account to another, then you have possibly used NCR products without knowing it. Atleos, on the other hand, inherited the ATM business, for which NCR has been best known in recent decades. Although it seems like it would be primarily a hardware business, over time NCR has evolved the economic model such that today only 30% of Atleos's revenues are hardware.

---

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

As is often the case with such "orphaned" spinoffs and breakups, executed with little fanfare or Wall Street sponsorship, initially there has been a good deal of confusion and misunderstanding, providing a potential opportunity to build the positions at very attractive valuations. NATL is trading at just about 5x EV/EBITDA and at a 12% FCF yield; and VYX is trading at just 5x earnings and also at a double digit FCF yield.

Strong performers in 4Q23 [3]

Enstar Group (ESGR), the property and casualty insurer that specializes in acquiring and managing the unwanted "run off" business from other insurers, is benefiting from the drop in interest rates, which elevates bond prices and thus also the book value of insurers like Enstar, which own a lot of bonds. ESGR BV will grow substantially this quarter not only due to rates dropping coupled with normal profitability, but also because the company bought back 5% of its shares at a healthy discount to BV. I have never known Enstar to buy back stock, as it has historically deployed excess capital into acquisitions, but the stock had been compellingly inexpensive. ESGR gained 22% in the quarter.

Adtalem (ATGE), the for-profit education company focused on nurses and other health care professionals, was once again among our top performers for the quarter. Enrollment has continued to inflect positively post the covid challenges, with profits and cash flow growing nicely, and the large Walden acquisition looks increasingly prescient. As the stock has done very well for us (including up 38% this quarter), the valuation has moved from "fire sale" to something more reasonable, with a current P/E of 14x and EV/EBITDA of 8x.

Citigroup (C) has been a laggard in recent years, and we acquired the stock well aware the company is a "battleship" that would not be easy or quick to turn around, but with high hopes that its new CEO would be able to pull it off. In a quarter that was generally quite strong for banks, the market was especially pleased with Citi's progress, sending the stock up 25%. Citi's return remain subpar (6.7% ROE in the most recent quarter), which leaves considerable upside, and the stock remains quite inexpensive in our view at just under 60% of BV.

Pinnacle Financial (PNFP), like Citi, benefited in the quarter from a shift in investor expectations from "inevitable recession" to "soft landing" that was generally a boost to the most economically sensitive stocks. Unlike Citi, Pinnacle, with a footprint in the southeast, is one of the highest performing banks in the industry, yet the stock trades at only a small premium to BV. PNFP was up 30% in the quarter.

PVH (PVH), the apparel company that owns such brands as Tommy Hilfiger, Calvin Klein, and of course Philips Van Heusen, is a company we have not discussed much, as it is a relatively small position for us. Apparel has been a very tough business, but PVH management has done an excellent job for shareholders. PVH has set a goal of $1 bn of annual FCF. With a current market cap of just $7 bn, achieving that goal suggests considerable upside for the stock. PVH was up 61% in the quarter.

---

[3] *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 4Q23

Veradigm (MDRX), the health care technology provider, has been through a remarkable transformation in recent years. Once primarily the weakest among the mature electronic medical records oligopoly, the company (then known as Allscripts) noticed that a smaller unit, Veradigm, was growing like a weed. Veradigm captures and sells very granular customer information to pharmaceutical and life science companies, and also health care payors. In 2022 the company sold off its mature legacy business in order to focus on Veradigm. While Veradigm was growing quite nicely, earlier this year the company announced accounting internal control failures stemming from an earlier acquisition. Progress in resolving this issue (which is economically immaterial) has been frustratingly slow, but it is our expectation that this will be resolved very soon. If not, as fiduciaries we cannot invest in a company that cannot get its accounting in order. MDRX was down 20% in the quarter.

While fertilizer company **Nutrien (NTR)** provided us tremendous immediate gratification with our investment, in recent quarters the company has struggled to meet expectations and the stock has suffered. Most recently Nitrogen has had multiple outages in its nitrogen production, with disruptions at a handful of its plants around the world, but now seems to have the issues under control. NTR was down 9% in the quarter, and now trades at just 6x EV/EBITDA with nearly a double digit FCF yield.

Arch Capital (ACGL) is the property and casualty reinsurer that has been a terrific investment for us, as we acquired the position just as industry pricing began to positively inflect. Arch continues to print outstanding results, with a 20% ROE in this past quarter. But in a "risk on" environment for market participants, non-cyclicals like Arch that have done very well recently can become candidates for profit taking. ACGL was down 7% in the quarter.

Property and casualty insurer **Markel (MKL)** was off 3% in the quarter, and the macro story is much the same as was the case for Arch Capital; however, Markel also posted an uncharacteristically sloppy quarter, with profitability slipping in some of its excess and surplus lines. We are confident that Markel will take the necessary actions to restore profitability to appropriate levels.

Wal-Mart (WMT) revenues exceeded expectations in the quarter, with solid profitability, but it was perhaps the first major corporation to discuss deflation on its November call. While management spoke of the benefits to the company and its customers of deflation, investors were not happy, sending the stock down 8% on the day. WMT bounced back toward the end of the quarter, and ended 4Q23 down just 1%.

Setup

As discussed above, for comparative purposes we are now including a major growth index in our portfolio characteristics chart. Otherwise the story remains very much the same: PVP's portfolio is cheaper than both value stocks and the market overall, with superior returns on capital. The growth index has very attractive returns, but in our view the price is simply too high at more than double the P/E and almost 1/3 of our FCF yield. As referenced above, the FCF yield of the S&P 500 is now slightly above the current 30 yr UST yield, and the growth index FCF yield is even less.

prospectiveVP.com · (515) 875-4928

Back to our portfolio: Notwithstanding the rise in the stocks last quarter, with rates falling our Equity Risk Premium (ERP) is actually higher than it was in September. Our ERP remains quite healthy and is well above the market and also the value index at 5.4% (9.4% FCF yield less 4.0% 30-year UST). At this level we believe we are being very well compensated to bear the risk of equities.

		Russell	Russell	Russell
	PVP [4]	3000	1000 Value	3000 Growth
Free Cash Flow yield (2023E)	9.4%	3.9%	4.7%	3.4%
Price/Earnings (2023E)	13.9x	21.6x	16.3x	28.2x
Debt/EBITDA (current)	3.4x	2.6x	3.1x	1.5x
EBITDA margin (2023E)	26.3%	19.2%	18.3%	27.8%
Return on Equity (2023E)	15.6%	18.3%	14.7%	31.5%
Return on Invested Capital (2023E)	14.0%	8.8%	7.2%	17.8%

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. KellyFlynn

Chief Investment Officer

The information contained herein is proprietary to PVP and may not be copied or distributed. Past performance described in this document is not a guarantee of PVP's future results. Please be advised that both investment returns and principal can fluctuate widely, so an individual's investment could be worth more or less than its original cost, depending on market and or economic conditions.

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

prospectiveVP.com · (515) 875-4928