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Deja Vu

The S&P spent the entire second quarter locked in a tight range, ending essentially flat. Markets would have registered modest gains were it not for the pronounced selloff on the last day of the quarter. It might sound "like deja vu all over again," but Greece once again was the catalyst. June marks the fifth consecutive summer in which headlines from the so-called "Cradle of Democracy" created volatility for global markets.

Many of us remember the first really big Greek-driven market event when split-screens showed the *Flash Crash* juxtaposed against dramatic riots in Greece (for full effect, watch the CNBC broadcast from that day):[1]

[1] https://www.youtube.com/watch?v=IJae0zw0iyU&feature=iv&src_vid=Wpx5gBvHNGk&annotation_id=annotation_271975

At its worst, the S&P was down just shy of 9%. A quick snapback helped markets close a mere 3.3% lower. While Greece was not the only catalyst behind the *Flash Crash*, it's safe to say that each subsequent year has seen less volatility than the prior on account of Greek worries. Today's volatility pales in comparison to 2010. This is a poignant reminder that this market, which many call "an uninterrupted bull market" has been anything but. Before we continue further with the topic of Greece, it is important to emphasize that despite anything we say about the country, the humanitarian situation on the ground is terrible and the hardships felt by the Greek people are very real. On a human level, this is a terrifying crisis. For the purposes of this commentary, it's important to speak in terms of how Greece impacts your portfolios and not from the perspective of policy analysts seeking the best possible outcome for all stakeholders. We do have strong opinions on this matter and welcome that conversation, but we will absolve from doing so through this medium. Feel free to reach out to either of us should the topic intrigue you.

There are a few reasons behind the declining volatility in today's Greek drama that are worth discussing.

First: markets are a discounting mechanism. They take all known information and try to fairly price the balance between risk and reward. In essence, this is the efficient market theory in action. We have often invoked the distinction between risk and uncertainty in markets (most recently in our January 2015 Commentary pertaining to Howard Hughes Corp).[2] When a situation like Greece first arises, people do not know the extent to which other market participants are exposed to trouble. Some don't even know the extent of their own exposure. As traders learn more about Greece, what formerly was uncertain can become quantified as risk. For example, many banks formerly had exposure to Greek sovereign debt. This debt has since been written off to zero. Were a default to have happened five years ago, there would have been severe losses recorded on balance sheets. These losses have effectively been taken gradually over the course of five years, such that in today's default scenario, these banks will not in fact realize further haircuts. Once the extent of risk is understood, the potential negative outcomes become much more manageable. You might hear talking heads on the news reference the ECB's capacity to "firewall Greece" and what they are referring to are policy measures taking since Greece first arose as an issue to prevent contagion from spreading beyond Greece's borders. It remains to be seen whether all of this will "work" in preventing any rippling negativity, but it does help take many of the worst case scenarios off the table.

Second: developed world economies are in far better shape today than when Greece first stoked global fears. Most significantly, the USA is in as good an economic position as it has been in years. While this does not mean economic momentum is immune from getting derailed, it does mean that the economy

[2] http://www.rgaia.com/value_opportunities_in_energy/

is more resilient to exogenous shocks. In our 2014 Outlook we made the following point that remains as strong today as it did then:

> As of today, the economy is moving faster and in the continued process of acceleration. As we know from Newton's Second Law of Motion, the greater the mass, the greater the force needed to change its direction. When an economy the size of the U.S. is accelerating to the upside, it would take an extremely massive force to first, derail its momentum and second, change its course 180 degrees. While such a force is not an impossibility, it is extremely unlikely in the coming months.

The acceleration in the economy has not stopped. It surely will at some point, though momentum will persist beyond the end of the acceleration. Can Greece be the kind of "massive force" which can derail the economy? Not in and of itself. It would take far greater vulnerabilities and we just do not see that on the horizon today. One related point worth emphasizing: the "event" which people often attribute as the cause of harm (for example, Lehman Brothers' collapse) is far more often a symptom than a cause of much deeper problems. It is no different with Greece. There are some potential deeper vulnerabilities in Europe, but not for the US economy and the firewall constructed over these past five years designed to maintain contagion is far more robust now than it ever has been.

Driving Profitability at Auto Dealers:

We got interested in the auto dealers during the sector as the economy accelerates and consumer confidence expands alongside it. Formerly, dealers made much more of their bottom line on the hair-thin margins they earned on actual auto sales. As such, these were not necessarily outstanding businesses. Several things have changed over time. First, dealers have consolidated steadily over the past two decades as small family businesses cashed out to better capitalized public players. Second, cars became increasingly complex where less of the parts and service (P&S) work could be done economically at local repair shops. This has started a trend whereby dealers are doing increasing amounts of the high margin work, cultivating long-term relationships with their customers. While P&S accounts for a mid-teens percentage of the revenue at the publicly traded dealers, it generates over half the bottom line private. This is what really intrigued us.

Since the past five years saw sluggish car sales, dealer parts and service income was even understated compared to the potential revenue generation once five year sales trends normalize and move upward. We are now near that positive inflection point. The particular dealer we find most interesting is Sonic Automotive (NYSE: SAH) and this is the one purchase we made over the past quarter. SAH has the highest concentration of luxury—a sub-sector where P&S spend is especially high—and its dealerships are primarily in the rapidly growing Sunbelt states. With its luxury and geographic footprint, SAH has historically traded at a premium valuation to the sector, yet today it trades at a discount. This is a closely held company with the founding family and one outside investor (Paul Rusnak) collectively owning over half the stock. Rusnak built his own wealth through a network of privately held dealers and bought into Sonic during the crisis. Collectively, ownership and management have an outstanding track record, but investors today are concerned with two big undertakings at the company: 1) SAH is investing heavily in the technological infrastructure to simplify pricing via the One Sonic, One Experience platform; and, 2) SAH is building EchoPark, a used car dealership platform using simplified pricing and a hub-and-spoke model to cover each target region. These two initiatives have dampened profitability, though the company continues to earn copious amounts of cash and the P/E multiple has more than fully priced in these concerns.

Rather than fearing these initiatives like much of Wall Street does, we love them! Tom Russo introduced the idea of owning companies with "the capacity to suffer."[3] By that he means companies with a stable ownership structure and the ability to make decisions based on the very long-term interests in mind rather than the need to meet analysts' quarterly expectations. This is exactly what SAH is doing here. In introducing a simplified pricing structure, removing the annoying hassling that many associate with car dealers they are taking a business risk that sure has quarterly earnings weakening in the short-run, but also introducing the potential for significant long-term benefits. Sonic should be able to take share from their competitors, because after all, no one likes the negotiation process inherent to buy a car.

As for EchoPark, SAH is launching an initiative to compete with CarMax (NYSE: KMX). It's hard to say anything negative about KMX from an investor's perspective, but it is also clear from a consumer perspective that more competition on both the buy and sell side in the used car market would be a positive. This is what happens when a company creates too good a profit opportunity for itself, as KMX has done. SAH is perfectly positioned to compete here given its large geographical reach, access to used cars from its dealer network, and investments in price discovery and transparency.

It will take some time to see the results from these new initiatives, but we see the worst case scenario being the company stops them, leaving us with the cheapest, but highest quality car dealer. If these initiatives succeed, then not only do we have the cheapest car dealer in our portfolio, but we'd also have the fastest growing one. In either case, Sonic deserves a higher multiple moving forward.

What do we own?

The Leaders:

Groupe SEB (EPA: SK) +26.8%

[3] http://www8.gsb.columbia.edu/rtfiles/Heilbrunn/17d1d82c-3701-0000-0080-9870cef8a602.pdf

IMAX Corporation (NYSE: IMAX) +19.46%

ING Groep (NYSE: ING) +14.42%

The Laggards:

Johnson Outdoors Inc. (NASDAQ: JOUT) -28.72%

Corning Inc. (NYSE: GLW) -12.51%

Fiat Chrysler Automobiles (NYSE: FCAU) -10.91%

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-1945
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, CFA
Managing Director
O: (516) 665-1945
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com

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