October 9, 2014

The Great Divide

Last quarter was not your typical quarter in financial markets. While the S&P registered a flattish +0.62% on the quarter, suggestive of complacency, there was in fact considerable action beneath the hood. There were two large moves we want to highlight in particular, before doing our quarterly "What do we own?" segment.

The Euro: Down, but Not Out

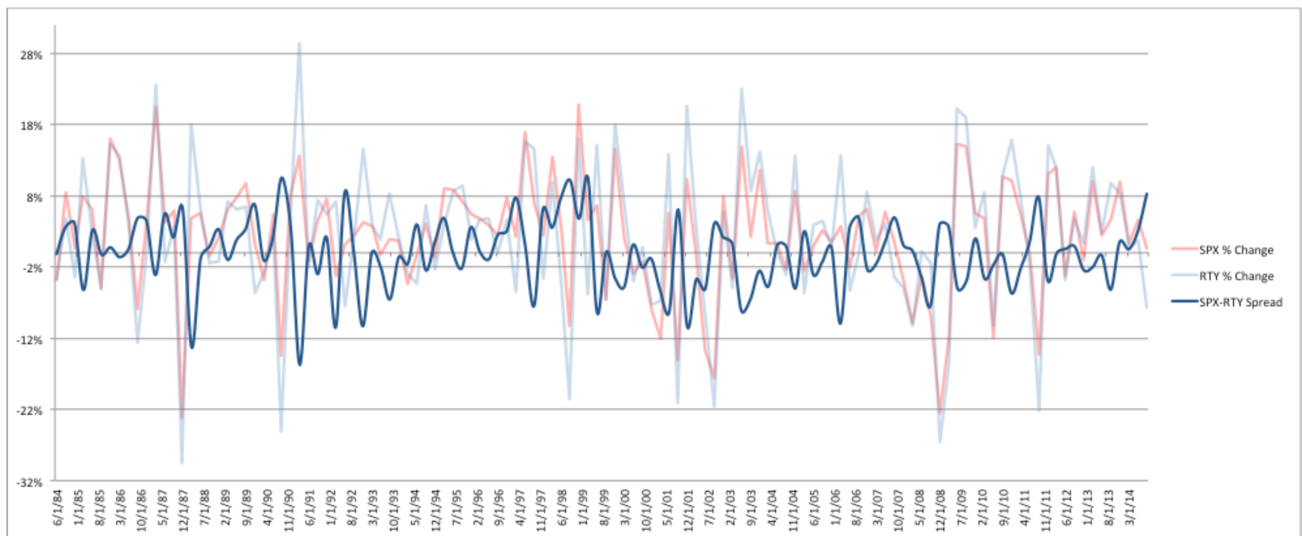
One of the most notable was the Euro's 7.9% fall relative to the dollar.

This is one of the sharpest selloffs in the euro, though this is different than prior similarly extreme contractions in price. Whereas previous selling in the euro was due to concerns about the currency's viability, this particular selloff is the result of explicit actions taken by policymakers to effect such a move. Notice the contrast: prior selloffs were borne in fear; this selloff is borne in intent. While the outcomes appear similar, the consequences are vastly different. This will actually help ease some of the problems which led the euro to the brink of collapse in the first place, by creating a natural calibrating mechanism for the particularly troubled economies to improve their export competitiveness and thus their economies.

Though we have accumulated European positions without accompanying currency hedges, we built our positions specifically in companies who do considerable business outside of Europe. Our reasoning on this was fairly simple: these companies' costs are fixed in euros, while their revenues are denominated in foreign units. This leaves their operating expenses fixed, while their revenues are variable. Thus, when the euro decreases in price, their expenses stay exactly the same, while they make more euros per sale. This is defined as operating leverage to a currency. Consequently, as time marches on, and the euro settles upon a new, lower exchange level, these companies will have considerably better profit margins and greater earnings. This should also help promote growth in companies who compete with international competitors. While the currency move translates negatively in the short-run, we believe this greatly improves the long-run outlook, and long-run return potential for our positions.

Russell 2000: The Great Divide

We noted above how the S&P 500 finished the quarter slightly positive. For those who follow the broader, small cap oriented Russell 2000, this would come as a complete surprise. On the quarter, the Russell shed 7.65%, and underperformed the S&P by 8.36%.



In the chart above we can see in visual form when past large divergences have occurred (follow the dark blue line). In the past 30 years, there have only been three quarters where the Russell had worse underperformance:

- September 1990 happened on the heels of Iraq's invasion of Kuwait. The S&P dropped 14.5%, while the Russell tanked 25.1%. The next quarter, the S&P rallied 7.9%, while the Russell tacked on 4.3%.
- September 1998 was in the thick of the Long Term Capital Management crisis. The S&P was down 10.3%, while the Russell shed 20.5%. The next quarter the S&P soared 20.9%, while the Russell surged 16.1%.
- March of 1999 was when fears of Y2K became most pronounced. The S&P was up 4.6%, though the Russell lost 5.8%. The next quarter the S&P went up 6.7% and the Russell gained 15%.

Note how each of the major divergences in the past 30 years could be explained by some kind of major market moving event; meanwhile today, if anything, people concur that there is a void of really large worries. In the past, each quarter following the occurrence of such a divergence saw markets rally substantially. What does this mean right now? We have no clue, and today's environment is considerably different than that of 1990 or 1998/99. Some might suggest that between Russia's invasion of Ukraine, the growing threat of ISIS and Ebola there are legitimately concerning geopolitical events, though we would caution holding these up to the historical significance and situational context of 1990s markets.

If we have no clue what this means today, then why mention it? We believe this is something rare enough, and large enough to warrant attention. The average spread between the S&P and the Russell over this timeframe was 0.096%, while the standard deviation of the spread is 4.86%. Further, we believe many of today's narrative-driven observations about today's markets (like excessive complacency, over-optimism, etc.) fail to hold muster in the face of this reality.

By its nature, the Russell is more volatile than the S&P given it is representative of small cap companies; however, its larger quantity of constituent holdings provides great insight into what most stocks are doing. Though it may not appear to be so from the S&P, markets have been fairly weak of late. Towards the end of the quarter, Bloomberg noted that 47% of the NASDAQ index constituents were in "Bear Market" territory (ie down more than 20% from 52-week highs)[1]. This perhaps highlights the most important takeaway in this section: there is by no means runaway euphoria in today's markets and that is a good (and healthy) thing!

[1] http://www.bloomberg.com/news/2014-09-14/record-s-p-500-masks-47-of-nasdaq-mired-in-bear-market.html

What do we own?

The Leaders:

America Movil (NYSE: AMX) +22.5%

America Movil has made its way to the laggards section in two of the past three quarters, and fortunately, this quarter's boost more than makes up for any of its past woes. Given its frequent appearances in this section, we have commented on this stock as much as any in our core portfolio. As such, there is little new to add to the thesis. We think this quarter's strength is merely a reflection of how heavily the market discounted its expectations of pressure on America Movil's bottom line as a result of regulatory woes. These woes were eased somewhat by initial signs of interest in a large international telecom purchasing some of the company's Mexican assets. It is suggested that AT&T is one such company preparing a bid, which we find this interesting given that at the close of the second quarter, Carlos Slim himself purchased AT&T's formerly large stake in AMX.[2] We will certainly be following these events closely, and expect that a formal conclusion to the mandated changes will refocus investor attention on the many positives present at AMX. Further, once this takes place, investors will realize that all the "cannibalization of shares" (aka buybacks) during the trough period will result in considerably more shareholder value than before.

Bed Bath and Beyond (NASDAQ: BBBY) +7.9%

We commenced this position during the quarter and the performance reflects not BBBY's, but rather our return during the quarter on this holding. Just above we mentioned "cannibalization of shares" and this concept is core to our thesis in BBBY. Over the past year, BBBY has shrunk their share count by 10.7%. Since five years ago, the company has repurchased a whopping 25.9% of outstanding shares. Over this time, revenues have grown at 9.8% annualized, while earnings on a normalized basis have grown by 14.0% (this is understating 5 year growth since we will overstate 2009 earnings during the financial crisis). One might ask, with these great numbers, then why is the stock down? The biggest problem at BBBY has been the contraction of their industry leading gross margins to 39.3% (TTM) from upwards of 41%. But these are still industry-leading margins mind you! Meanwhile, the perception on Wall Street holds that the company is increasingly vulnerable to the price transparency (and product mix) online competitors offer. Given the company's history of providing minimal information to Wall Street (for example, not holding a Q&A session after prepared remarks in quarterly conference calls), analysts

[2] http://www.bloomberg.com/news/2014-09-15/america-movil-said-to-seek-at-t-bid-for-17-5-billion-of-assets.html

would rather shoot first, think second about the value proposition in these shares. We think there is the potential for BBBY to turn into a great long-term holding.

Fanuc Corp (OTC: FANUY) +4.92%

Fanuc is a world class robotics and automation company based in Japan. As is typical of a Japanese company, they are overcapitalized. We have now held this position for over a year and it has quietly delivered. We started scouring Japan for interesting investment opportunities when the implementation of Abenomics became imminent. Rather than focusing on net/nets or dirt cheap, our interest was confined to quality at a fair price. The company has consistently earned double-digit returns on invested capital, while generating operating margins in excess of 30%. The business is somewhat cyclical in that it relies on investment in manufacturing capacity (or repurposing manufacturing) though it also has a secular component from the "new" replacing the "old." With many of Fanuc's products, there is a hardware and software component. The hardware makes great margins at sale, while the software comes with outstanding recurring margins over the life of the hardware. The business model, the returns and the balance sheet all are attractive here.

The Laggards

The New York Times Co (NYSE: NYT) -26.00%

This is another frequent resident in our "What do we own" section. This was a laggard last quarter, though was one of our best performers in calendar 2013. While we are still up considerably on this position since commencement, we are back to prices where the net cash + the building – pension debts is worth more than the current market cap of the equity. Though there is no clear path to the company liquidating its stake in the building, we do think once the option period ends, and NYT resumes complete control of the building, there will be more flexibility for constructive action. We are willing to wait for this day to occur. In the meantime, markets are concerned about slowing growth in online subscriptions, and the continued erosion of ad sales in print. This has been the source of pressure on the stock. We find it ironic how people are willing to pay massive dollars/eyeball on "new" online companies, while they essentially ascribe negative value to an old company's online endeavors, despite the old company being equally competent at garnering the attention of web traffickers (and more competent at generating revenues). Think of this as an investment in New York City real estate at a discount, with a $0 basis call option on an extremely popular website while also getting the runoff cash flows from what is a shrinking, albeit still profitable print newspaper.

Walgreen Company (NYSE: WAG) -19.6%

Walgreen has been one of our best performers since 2012 yet failed to once finish amongst our top three performers in a given quarter. Three separate times it was our fourth best position. The stock has been so consistently good for us that we thought about giving it a shout-out in our 2013 year-in-review. Sure enough, its first appearance in the "What do we own" section comes as a laggard. The fall this quarter was in part fundamental (lowering of 2016 estimates), and mostly due to the reversal of speculative interests in the company. When we purchased WAG, the company had been in a dispute with Express Scripts and was just purchasing a stake and an option to buy the remainder of Alliance-Boots. Many in markets perceived Boots as a negative. We did not. We were intrigued by Stefano Pessina and what he could do for the company moving forward as both an executive and its single largest shareholder (back then it was 8% now it's about 16%). Owner-operators are appealing to us for many reasons, and Pessina's long track record of value creation in pharma struck us as an obvious plus. Fast forward to today, and speculators began betting that WAG might use its ownership of Boots in order to do an "inversion" and switch its tax base to a lower-tax European domicile from the US. Regardless of the merits of an inversion, this would have hurt us as shareholders: we have a low cost basis and such an inversion would have triggered immediate capital gains. WAG is built for steady compounding of value over the long-run and we expect continued initiatives to improve distribution efficiency and margins on the pharmacy side, alongside expanded offerings of proprietary products like Boots No 7 on the front-end. This is a bump on the road in what we think will be a true long-term buy and hold.

Devon Energy (NYSE: DVN) -13.8%

Here is yet one more frequent constituent of this section. Devon is in the middle of transforming itself from a natural gas company with assets both inside and outside the US, to a domestic oil and natural gas company. All the while, the company has maintained a pristine balance sheet and has taken steps to maximize tax efficiencies in its disposal of assets. Management without a doubt has been prudent operators here. While Devon had an outstanding second quarter, the third quarter was disappointing. There is a simple fundamental fact behind why Devon fell so hard this quarter: the price of oil dropped 11.5%. We worry that oil markets have not properly accounted for a dearth of supply coming from the US and abroad, though have no true way to predict how this will impact the price of oil down the line. While we like the company and we like the management, we do not have nearly enough certainty about the future path of oil prices and are increasingly concerned that this risk may be underappreciated by markets. This is something we could write paragraphs about, so if it is a topic you are interested in, please feel free to ask us for more context.

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 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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