August 2021

THE PESSIMIST COMPLAINS ABOUT THE WIND; THE OPTIMIST EXPECTS IT TO CHANGE; THE REALIST ADJUSTS THE SAILS.

- William Arthur Ward

In this letter, we'll review our portfolio through the first half of the year, illustrate what happens when sensible expectations become senseless, discuss how we've adjusted our sails to weather various market conditions, share our thinking behind a new investment, and provide an update on our current investment strategies.

PORTFOLIO REVIEW

The largest contributors to performance during the first half were existing investments in tobacco and healthcare and new investments in LatAm (detailed in the appendix to this letter).

- Philip Morris (PM) and Altria (MO) shook off the prospects of a ban on menthol and a potential cap on nicotine and gained 23% and 20%, respectively. We shared our thoughts on these regulations during the quarter, which are available here.

- Analysts continued ratcheting up full-year earnings estimates for Lab Corp (LH) and McKesson (MCK), driving both stocks steadily higher. Despite strong year-to-date gains, shares of both companies are trading at lower valuations today than before the pandemic as earnings estimates have outpaced their rising stock prices. Notably, consensus estimates for Lab Corp have nearly doubled over the past year as analysts have been slow to recognize the impact of increased testing volumes on fundamentals.

- The story is similar at McKesson where vaccine distribution should continue to provide upside to consensus estimates. Although investors have been hesitant to give the company full credit for today's "temporary" profits, we think these "temporary" COVID-tailwinds may turn out to be not so temporary. If we are wrong, we believe downside is limited given recent activist involvement and management's decision to pursue a strategic review to capture the full value of the company's drug development business.

The largest detractors to performance during the first half were existing investments in Equity Commonwealth (EQC) and Dollar Tree Stores (DLTR) and a new investment in Madison Square Garden (MSGE).

- After outlining our investment in Equity Commonwealth in our last letter to investors, the company's management team promptly stuck a fork in our investment thesis, surprising their shareholder base with an all-stock deal in one of the hottest sectors in commercial real estate. We shared our thinking on the deal with investors here.

- We trimmed our investment in Dollar Tree after the stock's first-quarter gains, but the company later disappointed investors with weak guidance that fell short of expectations. Despite the recent acceleration in same store sales growth at the Family Dollar banner – which weighed on the stock for years - the consensus is now more concerned with rising cost pressures eating into margins at the moment. At some point, sentiment will be just right.

- We established a position in Madison Square Garden Entertainment (MSGE) during the first half, as shares plummeted following the announcement of the company's proposed acquisition of MSG Networks. Unfortunately, the stock has continued to decline in the interim as some investors continue to digest the merger while others simply decide to cut and run given the increasingly complexity of the story.

SENSIBLE VS SENSELESS EXPECTATIONS

Investors have good reason to be enthusiastic. Growth is booming as economies around the world re-open with plenty of capacity. Policymakers are content to keep the party going with heaps of monetary support and fiscal stimulus. Operating leverage is robust, leading to record margins and 90% earnings growth that is crushing expectations (although the market's reaction to such extraordinary earnings growth has been less than extraordinary).

But it's not all roses and rainbows. The risk-reward profile for equities has deteriorated as valuations recovered and surpassed record highs. Both interest rates and taxes have more room to go up than down. Lapping last year's record fiscal stimulus is likely to create a significant drag on growth this year. Economic growth is likely to come down, and economic surprises are no longer positive given the spike in expectations.

The market has always been good at reallocating capital from the careful to the careless. Lots of people lose lots of money when sensible expectations become senseless. It would seem that over time, investors have become increasingly senseless as return expectations have steadily increased year after year alongside rising equity markets. Seemingly, the higher equity markets go, the greater returns investors expect. That's just not how this works.[1]

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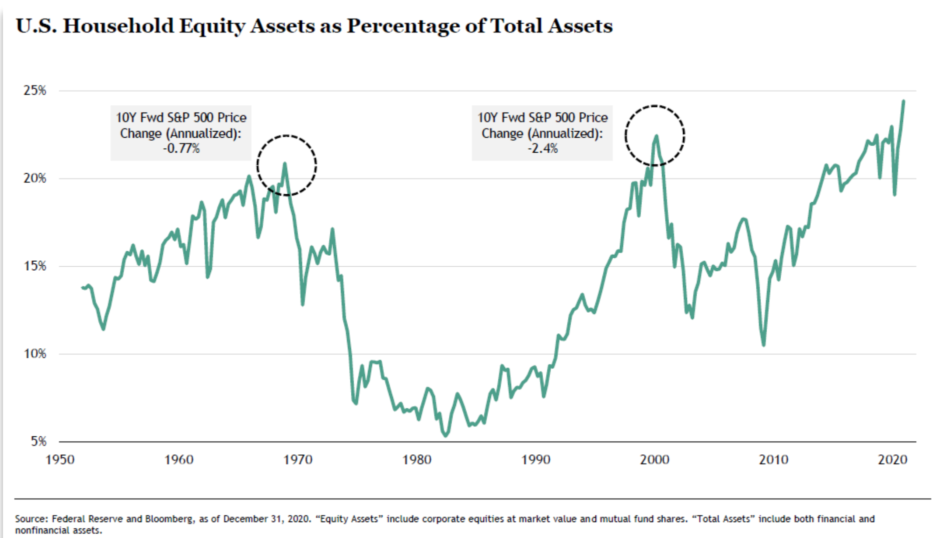
[1] Consider that today's trading volumes are 4x what they were just before the pandemic. If you're wondering who's doing all that trading, look no further than Robinhood, with $80B in AUM, which executes more trades than Schwab, with $4T in AUM. Or Wall Street Bets, which has grown from 2MM to 10MM members in six months. The five most popular stocks amongst those members all lose money. And speaking of money losers, there are 617 of them in the US with market caps over $1B. More than half of them trade at more than 10x sales.

The chart below from a recent Natixis Survey shows that individual investors expect 13% annual real returns (returns in excess of inflation) from their equity investments. A separate survey from Paine Webber and Gallup showed that the least experienced investors expect long-term annual returns of 22.6%. We'll take the under.

For better or for worse, investors appear to be putting their money where their mouths are. Household equity exposure stands at record highs today. And in contrast to elevated expectations, forward returns from these levels have not been pretty.



What does this mean for Broyhill and our investors? It means that even though the market marches steadily higher—scratch that, especially when the market marches steadily higher—we never stop thinking about risk. During times like this, we revamp, refine, and reexamine our thinking every day in order to maximize our odds of success. There is no silver bullet. We must make decisions without the comfort of perfect information. The best we can do is assess all the relevant factors through all the relevant lenses, and as always, we strive to make the best decisions for our clients that we can with the information we have.

We manage money for investors who have worked hard to build their net worth. We work equally hard to keep it by ensuring we have a deep understanding of every business we own. Sometimes we get it right. Other times we don't. But we don't buy stock because someone on the internet said we should. The work is always our own. Not a hot tip poached through a message board.

Today, the businesses we own remain attractively valued despite the recent rally. Valuation dispersion among equity sectors remains high, providing ample opportunity to construct a portfolio much cheaper than the market. Importantly, we have not sacrificed quality for value.

We believe our portfolio companies are better than the average company held in passive benchmarks. In aggregate, our portfolio generates higher returns on capital, enjoys higher margins, and does so with a similar growth profile to the overall market.

So while the market remains broadly expensive and priced to deliver lackluster returns, we take comfort in knowing that we don't own the market. Rather, we own a concentrated portfolio of good businesses trading at attractive prices, with multiple ways to win in the years ahead.

ADJUSTING OUR SAILS

The global economic recovery continues to unfold. Vaccine roll-outs are accelerating, economic growth is surging, and loose financial conditions reflect ongoing stimulus. The re-opening, however, will not follow a straight line. It will remain uneven and uncomfortable at times, with speed bumps in the form of new variants, kinks in the global supply chain, and unintended consequences.

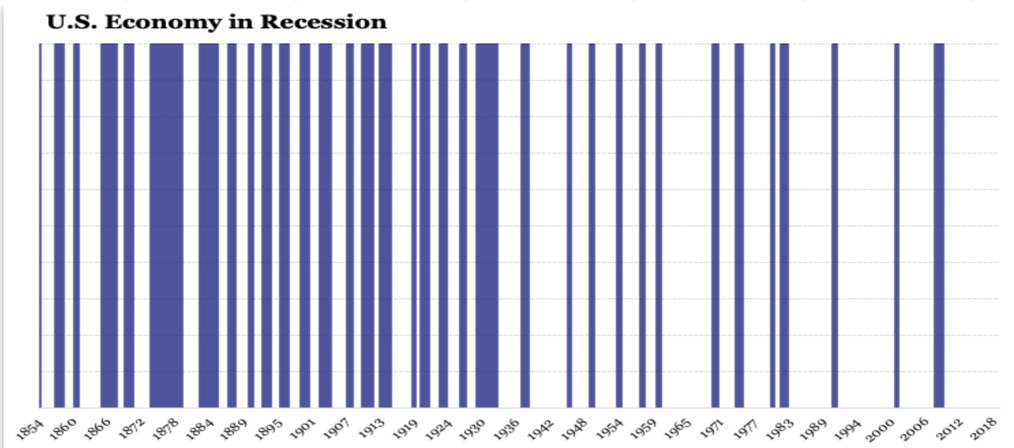
Although the economy is unlikely to follow a direct path to normalization, vaccines have proven highly effective in reducing the severity of the virus and limiting hospitalizations. So, the recovery should continue in its zig-zag fashion.

Despite favorable conditions, markets have likely pulled gains from future returns, leaving more volatility and greater dispersion ahead. This would be consistent with historical precedent. On average, valuation expansion has slowed or reversed as economic growth peaked.

The trickier question, in our opinion, is if this is the start of a new economic cycle or just the continuation of the old one, temporarily interrupted by a global pandemic. The National Bureau of Economic Research (NBER) maintains a chronology of US business cycles, identifying peaks and troughs in economic activity. NBER defines a recession as a significant decline in economic activity that is spread across the economy and that lasts "more than a few months."

The COVID recession was one of the deepest on record. It was also the shortest, lasting all of two months. Despite the brevity of the downturn, NBER's Business Cycle Dating Committee concluded that the fall in activity was so great that it should be classified as a recession.

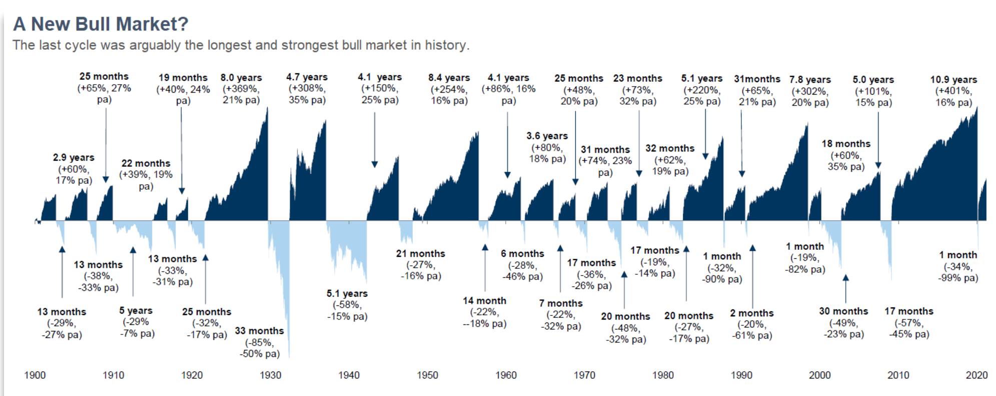
We are not particularly concerned with how recessions are documented in the economic history books. But we are interested in their impact on economic growth and asset prices. Recessions are a necessary component of the business cycle. And although they are impossible to predict with precision, we shouldn't be surprised by their arrival. In the 1800s, they occurred about every two years. During the 1900s, the length of the average cycle grew from five years to eight years. Prior to 2020, we had gone more than 13 years without a recession. What's changed?



In a garden variety recession, growth accelerates until the economy begins to overheat and inflation begins to rear its head. Higher inflation prompts the Federal Reserve to raise interest rates until economic growth slows to prevent the economy from overheating. Excesses are purged from the system, providing a clean slate and a more stable foundation for growth to continue.

The Fed's role in managing the economy is analogous to the US Forest Service managing prescribed fires. Controlled burns are an important tool for maintaining the health and safety of a forest. It's the most effective way to remove fuel from the system and protect forests. It's also the only way to restore ecological processes in the forest, such as removing debris to create opportunities for new growth.

Fires are a natural part of the environment, just as recessions are a natural part of the economic cycle. In the wild, trees depend on fire to clear out the competition and release their seeds. Recessions also clear out competition, restoring balance to the economy and reducing leverage. So, the question remains: was a sixty-day downward spiral in economic activity, followed by eighteen months of super-sized monetary and fiscal stimulus, enough to clear the decks? Or are excesses, which grew unchecked for thirteen years without a forest fire, still lurking?



Source: Datastream, Goldman Sachs Global Investment Research

We don't know the answer, and neither does anyone else. But we do know that another recession will occur at some point. And we won't be surprised when it arrives.

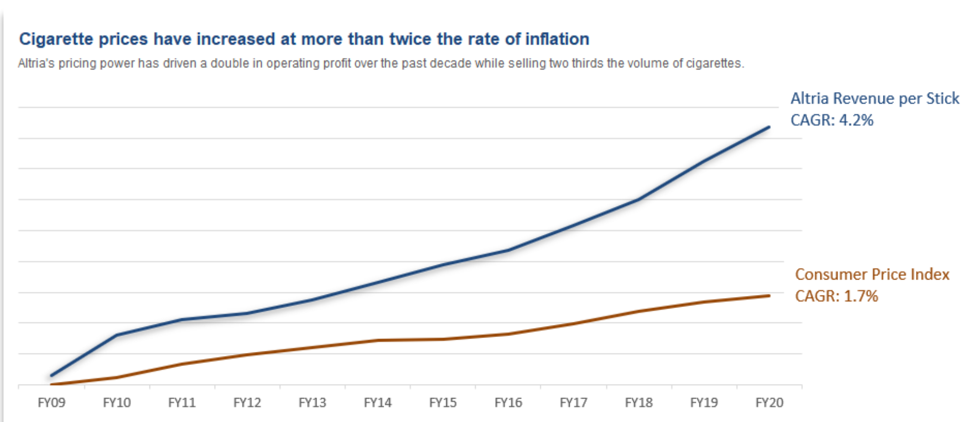
Highly leveraged, overvalued markets levitating on extreme stimulus and high expectations, are particularly susceptible to violent drawdowns. So rather than betting the farm on a continued early cycle recovery, we prefer to focus on rule number one (don't lose money) while trying to make a reasonable profit without violating that first rule.

We are likely entering a more challenging period for financial markets. Investors should prepare to embrace volatility. The dispersion of returns across and within asset classes is likely to widen creating a compelling environment for active management.

Diversification will become increasingly important as hedges remain prohibitively expensive. The majority of passive indices and investor portfolios are heavily skewed towards last decade's winners. This means markets are increasingly vulnerable to any surprises with respect to these businesses—from regulatory changes to unfavorable tax reform. Contrarians would be well served to look elsewhere for next decade's winners. To accomplish this, our current portfolio is well diversified across five themes.

Re-Opening Rally. Concerns around the Delta variant are creating opportunities in those businesses that are most exposed to the virus—and in those that have the most to win from a continued re-opening. Consumption patterns were skewed by the pandemic, but they are beginning to normalize as restrictions are lifted. In the latest quarter, international traffic at Mexico's airports (i.e., US leisure travel) was largely unchanged, compared to 2019 levels. The stocks trade on average at 11x 2019 EBITDA or about half of the 22.5x Peak EBITDA recently offered for Sydney Airport.

Pricing Power. Companies with pricing power are likely to be re-rated higher if and when inflation continues to pressure input costs. Investors are beginning to appreciate the power of price elasticity, as evidenced by the increase in Altria's multiple this year. Tobacco may be the market's poster child for pricing power as demand is almost entirely inelastic—buying habits remain largely unchanged regardless of price increases. Revenue growth generated by pricing also has a much larger impact on profitability. For reference, just have a look at recent earnings reported by Hertz and Avis.



At the other end of the spectrum, fragile supply chains, tightening labor markets, and surging input costs should squeeze profit margins and compress multiples for below-average businesses.[2]

[2] Supply chain shortages may have an additional impact on many businesses beyond increasing cost pressures. Order backlogs and related guidance may be inflated by retailers knowingly over-ordering to get enough product amidst shortages. In the past, investors were caught off guard when inventory levels normalized and the true demand turned out to be a fraction of what those orders

Dollar Diversification. We expect the recent flood of monetary and fiscal stimulus to cause a long-term devaluation of the dollar relative to other assets, creating opportunities in real assets and emerging market equities. The combination of declining currencies, declining stock markets, and increasing interest rate differentials has made emerging market cashflows very cheap. We believe LatAm markets are particularly attractive and continue to find compelling opportunities abroad.

Real Returns. Real assets, like infrastructure and commercial real estate, have performed well during inflationary periods,** and are generally under-owned today as inflation protection was not necessary amidst decades of declining rates. As a result, many are attractively valued and poised to benefit from a combination of fiscal stimulus and loose monetary policy. If inflation fears continue to escalate, we expect to see more investors looking for alternatives to the traditional 60/40 portfolio.

Cash is King. Free cash flow, not total addressable market, will likely define the next decade's winners. Low inflation and falling rates have had an outsized impact on the valuation of growth stocks. At the same time, investors have been enamored with the secular shift towards capital-light business models and the corresponding rise in intangible assets. As a result, many high quality businesses that generate strong and recurring free cash flow are trading at magnificent bargains. Defensive industries, like healthcare, trade near their lowest absolute valuations in history and at a record discount to the market.

indicated. We saw this in the RV industry a few years ago as dealerships placed huge orders far exceeding demand to secure inventory. In each case, the stocks peaked when backlogs looked most promising, then collapsed as inventory normalized. We suspect that many of today's "COVID beneficiaries" will face the same fate once the economy fully re-opens, supply chains adjust, and the current "scarcity" of product comes to an end. The emperor has no inventory.

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