BAVIELLO
INVESTMENT MANAGEMENT

Selective Value Strategy

Note 2: In times like these, proceed with caution, but proceed nonetheless.

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While current economic and political uncertainties are valid causes for concern, they are not the only reasons caution is advocated. Usually, and in the past, ambiguity represents potential opportunity—especially when asset prices are low. Yet, internally generated valuations of individual companies indicate that market prices for companies, in general, are significantly higher than their values. The result? A minimized potential opportunity set.

From a long-term and value-oriented perspective, to justify the current general over valuation, one would have to assume some or all of the following when conducting company valuations:

1. The perfect execution of growth and profitability goals for many years.
2. The end of downturns—both in the general economy and specific industries.
3. A reduced accounting of risk both in probability and magnitude.
4. The use of historically low discount rates.
5. An over reliance on relative valuation approaches, which must be used carefully in both overvalued and depressed pricing environments, compared to absolute valuation approaches.

Uncertainties and risks are taking an unnecessary back seat.

At current prices, investors are discounting risks and/or rationalizing the taking of additional risk as a necessity in the increasingly difficult search for yield and/or price appreciation. There is little thought towards the preservation of capital or long-term returns. Although avoiding risk is impossible, it is preferable to buy companies when the perception of the risk is greater than its reality, rather than less. And at times, even when the potential compensation for that risk is fair.

The result? Widespread complacency.

Complacency is not limited to investors; it also extends to companies themselves. For instance, companies continue to implement a large amount of share buybacks at these high price levels - relative to fundamentals - with either excess cash or debt. This behavior, in part, results from the pressure on companies to deploy cash from short-term oriented shareholders. Furthermore, these companies continue to justify their shares as cheap, even though prices continue to rise and often, interestingly, those same management teams are usually not buying those "cheap" shares for their own accounts.

This is disturbing from a value perspective. Why? Once that cash is deployed into a buyback it's gone. When prices become depressed it can't be used later to buy back a greater number of shares at a much lower price. Likewise, it can't be used to grow the business and its productive assets, or to take advantage of opportunistic acquisitions—actions that would potentially increase a company's value. Buybacks create the most long-term value when used at cheap valuations, which seems to be when they are used the least. This was illustrated by the large drop in total buyback levels during 2008 and 2009. Consequently, companies using buybacks regularly, instead of opportunistically, trade long-term value creation for short-term performance, further decreasing their allure as an investment opportunity.

While we're talking risk, let's talk Exchange Traded Funds.

Passive exchange traded funds ("ETFs") and their burgeoning assets under management have become a relatively new concern in the current investment environment, especially when evaluating individual companies. The concern, and the potential risk, is the level of combined ownership these ETFs have in many of the companies trading on the stock market. Even in large companies, total ETF ownership of any given company can be as high as 20% to 30%—if not higher.

First: Such large ownership positions from passive investment vehicles pose governance risks, especially given these vehicles may not be as knowledgeable on each of their holdings' operations/businesses as more discerning investors would be. With greater ownership, these ETFs are gaining more influence and can possibly significantly alter or impact a company's future direction. Such influence from undiscerning passive investors presents a clear risk. While attempts are starting to be made to address this, it remains a concern.

Second: An ETF can be a source of substantial downward pressure on a company's price. This could occur in a situation where:

1. An ETF experiences substantial net outflows of funds and must significantly reduce the size of its positions across its holdings (e.g. times of market panic).
2. An ETF must reduce or eliminate its ownership in a company to continue to accurately track the target index.

Due to the nature of most ETFs as tracking instruments, such sudden and large reductions in their ownership percentages of their holdings, if substantial, would have the potential to be disorderly as well as cause and/or further exacerbate price drops in individual company prices. This downward pressure would likely be even more evident in illiquid stocks and in other securities, outside the scope of the SVS, with low liquidity like high-yield bonds.

While a scenario of large net outflows may be hard to imagine given the trend of net inflows into ETFs—which, one could argue, is another sign of investor complacency—it cannot be ruled out and should be expected. It would be a mistake to assume that investors owning ETFs are immune to herd behavior or psychological influences such as fear and panic. After all, hasn't the tremendous growth of passive ETFs been reminiscent of a herd? Incidentally, the larger passive ETFs become, the more likely markets become increasingly inefficient and susceptible to the large money flows of the ETFs.

Internally, when evaluating companies for investment, the percentage of the company held by ETFs is monitored closely and the potential downside risk is considered.

The value of Selective Value.

The focus of the Selective Value Strategy ("SVS" or "The Strategy") is on buying companies at prices significantly below their internally evaluated valuation. Additionally, if the company being evaluated is robust and has very appealing long-term economics, it may be purchased near or at its value. Value provides a relatively objective guide for most purchasing and selling decisions, while deterring the psychological influences of fear and greed.

It is imperative that companies are not purchased at overvalued prices, which could reduce the probability of long-term capital preservation and appreciation. To illustrate, if a company is overvalued and a downturn occurs, the company will likely drop in price. During a downturn, a company's fundamental operations and assets can take one of three paths:

1. They can contract.
2. They can stay about the same.
3. The company can take advantage of the downturn and emerge larger and more profitable.

Most companies will take one of the first two paths and their value will either remain within a reasonable range or contract significantly. Thus, leaving no fundamental reason for the company to return to or rise above the original inflated purchase price. Without that, there is increased uncertainty in ever recovering one's full investment, much less making a return on it. Ideally, one would back up the truck on companies positioned on the third path when they drop below value. Yet, such companies are rare. And even more rare are the ones that are attractively priced.

Additionally, the internal evaluation process does account for the risk of both general and industry specific cycles/downturns when determining value. Rather than trying to predict downturns, which is very difficult to do consistently, it's better to assume that they will occur and invest accordingly in undervalued companies.

The SVS never stops.

At present, in line with the SVS's process, companies continue to be reviewed and evaluated daily. As indicated above, it is difficult to find compelling investment opportunities, but that does not discourage the daily process. Such periods are to be expected over time. Consequently, over the past few months, only one new company has been added to The Strategy's portfolio. Although new opportunities continue to be rare, the research and evaluation process continues. This process has resulted in several new companies being added to the internal watch list for potential opportunistic purchases when prices are much more attractive. I firmly believe research done today is never wasted and can be of great use tomorrow.

Due to The Strategy's selective bent, cash levels have grown over the past year. These levels may continue and/or increase until a time when compelling, undervalued opportunities emerge and provide good reason to deploy the cash. The cash level is solely a function of not finding compelling undervalued investment opportunities, and is not a call for a market crash. If the market's price level continues to increase The Strategy's current portfolio companies still provide a level of exposure to the market.

That's why I remain active and aware, regardless of market turns.

Although I will not predict the timing of a downturn, as these risks and price levels can continue to increase for quite some time unchecked, I do think one will occur eventually. I believe The Strategy's defensive position enables it to not only withstand a downturn but also to take advantage of it in the long term to potentially deliver good results over the full cycle. Nevertheless, the SVS is not dependent on a crash, as dislocations between value and price are possible in most market environments even though the opportunity set may be significantly smaller.

As always, value remains the guide and the daily search for it continues. Patience, discipline, a risk-aware nature, and maintaining a long-term horizon are fundamental to The Strategy and continue to be of the utmost importance.

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