Articles

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The Five C's

Faraz Farzam, CFA

The third quarter of 2015 proved to be one the worst quarters for equities in recent years. All the major averages were hit hard, with the S&P 500® Index declining 6.44% and the Russell 2000® Index declining by 11.92%. This was the worst quarter for the small cap market and the broader averages since the third quarter of 2011 when the European debt crisis hit its crescendo. In our first quarter discussion, we expressed concern at the meteoric rise in global market indices, most making 20 year highs including China's Shanghai Stock Exchange Composite Index ("SSE Index"). What made the situation fraught with risk was the rapid appreciation in the dollar along with the equally rapid collapse in commodity prices, including oil.

In our second quarter of 2015 letter, we expressed further concern over the momentum nature of the market and the excessive valuations in the healthcare sector, specifically in the biotech industry. The climax, of course came this quarter as the bubble in Chinese equities finally burst with the SSE Index correcting 43.3% by August 26, 2015 from its peak of 5,166.35 on June 12, 2015, wiping out billions in wealth. This in turn led to the correction in U.S. domestic markets headed by the sharp declines in the industrial, healthcare, and financial sectors. Our performance was most impacted by the correction in financials, especially our regional bank investments, as the expectation for a rate increase by the Fed was pushed out - yet again.

We believe the markets face five major issues as we look ahead into the fourth quarter of 2015 and beyond. We dub these the 5 C's: China, Corporate Profits, Central Banks, Congress, and Consolidation.

China

The catalyst for the correction in the SSE Index was the engineered slowdown in the Chinese economy by the Communist Party Mandarins. In our opinion, the slowdown and uncertainty in China, coupled with the unjustifiably high valuations in equities that were driven by margin debt, are the principal catalysts for the collapse of oil and other commodities. In our interconnected global economy, when China sneezed the emerging economies caught pneumonia. Today, almost every major and minor commodity economy (i.e., economies that are primarily driven by the exploitation and export of raw commodities like oil, metals, and grains) are under extreme duress. These include but are not limited to the economies of Australia, Canada, South America (including Brazil), Africa (including South Africa) and almost the whole of the Middle East, which is further embroiled in war and political turmoil driving a refugee crisis into Continental Europe.

Yes, we have just listed a large swath of the planet's economies. Further, the slowdown in China is pressuring industrial exports to China and the developing world. In a September earnings update, driven precisely by this weakness, Caterpillar Inc. (CAT) cut its outlook for fiscal 2015 by about $1 billion and nearly $3 billion in fiscal 2016. We are closely monitoring other industrial export industries. As an example, the automotive industry, a bright spot in industrials, could be impacted by Chinese weakness as well as collateral damage from besieged automaker Volkswagen AG and its emissions scandal.

Corporate Profits

As we write this, the third quarter earnings season is underway and expectations are already low. Energy profits are expected to decline substantially as are industrials and export-related materials. These low expectations are generally good for equities, as they are less likely to disappoint and may have already be accounted for in stock prices. However, there is great uncertainty in how profits will shake out in the consumer sector as the benefits of lower oil prices and improvements in employment have been uneven.

Although discretionary services like restaurants and travel and leisure have performed well on the back of good fundamentals, other discretionary goods stocks have languished or have been outright weak.

Healthcare has seen strong profit growth for several years now as the Affordable Care Act has boosted utilization and pricing, however, expectations remain relatively elevated and investors are anxious as many fear the recent decline in the stocks may be an ominous sign for reporting season. We are also cautious on financials as the global economic weakness has "stayed the hand" of the Federal Reserve which ironically spells a pushout for better bank profits in the near and intermediate term.

Central Banks

While many investors expected the Fed to finally raise interest rates in their last meeting, the challenges that we outlined earlier led the Fed to maintain its Zero Interest Rate Policy ("ZIRP") for the time being. While this portends a continuation of the easy money backdrop, it is disappointing. This policy signals continued weakness or at least uncertainty in economic growth prospects. Raising rates, in our view, would have been a clear signal by our Central Bank that it is confident in the growth outlook. In our opinion, this would have made the profit backdrop for financials much more positive. As we approach the Fed's October and December meetings, we will monitor its outlook for clues about future rate policy and, commensurately, the outlook for financials. Below, Rick Lane will discuss the idiosyncrasies of the Fed's move and how they directly impact bank profits.

Congress

Although John Boehner's surprise move stepping down as Speaker of the House averted a near-term government shutdown stemming from the political division over Planned Parenthood, the next potential crisis could arise at the beginning of November, when the debt ceiling limit is reached. Readers will recall that the last time the markets were roiled due to our elected officials' political machinations was in 2011. We believe this was a self-inflicted wound as egregious as it was inevitable. The crisis was eventually resolved, but it resulted in a downgrade of our credit rating. Some economists believed it also eroded consumer confidence with real impacts to our economy. The political landscape today is very different. Whether this is resolved judiciously or by other means will be determined by which Republican faction wins control of the House Speakership. Nonetheless, it does represent a risk to the markets.

Consolidation

The mergers and acquisitions landscape is one of the more positive developments in the marketplace. Year-to-date there has been $3.5 trillion of deal activity with the latest being the mega-deals for technology titan EMC Corporation (EMC) and global beer giant SABMiller plc (SAB), by Dell, Inc. (private) and Anheuser-Busch InBev SA Sponsored ADR (BUD) respectively. The two deals alone accounted for over $170 billion of announced deal making. We believe the Dell buyout of EMC could have significant ramifications for technology as a whole. Although the technology sector has already been active with respect to consolidation, especially in the semiconductor industry, we think it is likely that this deal forces other large players that have been on the sidelines to make consolidation moves of their own.

The core business for International Business Machines Corp. (IBM) has been under secular pressure for several years. Other tech giants, like Cisco Systems Inc. (CSCO), Oracle Corp. (ORCL), and Microsoft Corp. (MSFT), have been facing pressures from new technology architectures and paradigms. In our opinion, it is not out of the realm of possibility that, given significant cash on their balance sheets, these companies begin a wave of consolidation through mergers and acquisitions to address their issues. Consolidation may be accelerated if Congress moves on tax reform which would allow tech companies' considerable international cash to be repatriated. This would be a huge positive for sentiment and valuations in small caps as many would be likely targets.

We are now entering the sixth year of the economic recovery and seventh year of the stock market recovery. In our opinion, the global economic outlook outside of the US looks dire. Can we continue to be an oasis of relative prosperity or will it prove to be mirage? Although, we cannot and will not claim to have the prescience to answer this question, we do know that our time tested investment process of buying high-quality enduring businesses at attractive prices, while not a guarantee, has survived and prospered against several collisions with economic environments such as the one we are faced with today.

In the following paragraphs Rick Lane will discuss how the current interest rate cycle and central bank positioning has impacted our financials investments and how we are positioned moving forward. Aaron Garcia will review the recent changes in patient criteria for Long Term Acute Care Hospitals ("LTACH") and our investment opportunity in Select Medical Holdings Corp. (SEM). Finally, in the context of the tech consolidation wave we discussed earlier, I will review a recent addition to the portfolio, Intersil Corp. Cl. A (ISIL), that in our view is an outstanding business that may be a ripe takeover target.

Lower for Longer?

Rick Lane, CFA

Weak economic data subsequent to the subpar employment numbers released on September 19, 2015 have convinced market participants that a Fed hike for 2015 is now off the table. Reflecting that sentiment, 10-year Treasury bond yields have fallen back to the 2% level. The "lower-for-longer" outlook may prove somewhat challenging to our regional banks holdings in the near-term while providing a boost to our housing-related companies.

Generally speaking, regional banks are positively leveraged to rising interest rates. Earnings estimates for 2016 and 2017 embed somewhere between a quarter-of-one percent to as much as one-and-one-half percent higher interest rates. As we speak, many bank equities are modestly consolidating recent gains as investors question the rising interest rate scenario. While we are still enthusiastic about our particular holdings for idiosyncratic reasons, we concur with this market action in the bank stocks near-term.

Indeed, we have trimmed some of our winners here and have also culled some of our weaker holdings. As previously mentioned, nearly all bank stocks benefit to varying degrees from rising interest rates, and the absence of that aspect of the investment story no doubt is a negative, but many of our holdings have drivers beyond just higher interest rates. Zions Bancorporation (ZION) is a self-help story related to new management, expense cutting, and accelerating loan growth. CoBiz Financial Inc. (COBZ) is benefitting from a very strong home market in Denver and we believe is also a potential take out candidate. Renasant Corp. (RNST) in Mississippi and LegacyTexas Financial Group, Inc. (LTXB) in Dallas both enjoy strong markets and earnings boosted by recent accretive acquisitions. Anchor BanCorp Wisconsin, Inc. (ABCW) in Madison, Wisconsin is going through a very productive restructuring and repositioning and it too may be a merger and acquisition candidate.

Meanwhile, our housing-related holdings will very likely be helped by the lower-for-longer outlook. Our largest holding, Milwaukee-based private mortgage insurance company MGIC Investment Corp. (MTG) as well as Masco Corp. (MAS) (plumbing fixtures, faucets, paints and cabinets) and Stock Building Supply Holdings, Inc. (STCK) all stand to benefit from mortgage rates staying lower-for-longer. Less directly, our staffing investments: Kforce Inc. (KFRC), ManpowerGroup Inc. (MAN) and Robert Half International, Inc. (RHI), are economically sensitive. To the extent that lower interest rates for longer extend the duration of this economic cycle, we expect that they too will be advantaged.

Select Medical Holdings Corp. (SEM)

Aaron Garcia, CFA

Given the volatility in healthcare, we thought it might be helpful to discuss the current regulatory trends impacting Select Medical Holdings Corp. ("Select Medical"), which illustrates the uncertainty that many companies and investors face in the space. Select Medical is at the cusp of a significant change in its patient criteria for admissions. Admissions to Select Medical's LTACHs facilities must fit a more stringent requirement or face steep reimbursement declines. We believe this will drastically affect the facility economics in the LTACHs across the industry, resulting in closures and bed reductions. Also, many patients may find themselves discharged to home care more frequently than before. While this will be a near term-challenge for the industry, the long-term clarity on admission criteria will positively affect the best operators.

Select Medical, in our view, is one of the strongest operators and is well positioned to take share from more poorly run LTACHs. Also, the criteria will increase the eligible patient population by threefold. Currently 180 thousand patients are admitted to LTACHs each year, but there are 350-400 thousand potential patients per annum that fit the new criteria. While not all will convert to LTACH admissions, we believe this could be a significant tailwind for the industry once it is right-sized by facility closures.

The financial impact of the change is very difficult to assess, especially in the early years. We expect that the transition will be bumpy. Fortunately, in our opinion, the company has a good operating plan in place and an excellent management team to shepherd the company through the challenges. While estimates for 2016 undoubtedly face a headwind, the company has restructuring offsets and variable cost reductions that can help mitigate the financial effect of the new regulations.

We actually have reduced our position in Select Medical ahead of the 2016 phase-in, but we do believe there will be an opportunity to significantly add to the position next year at or below the currently attractive valuation of 10x earnings. In our view, the business has a high barrier to entry, an excellent and savvy management team, cost saving actions that can preserve margins, and a discounted valuation. We also note that the business has very reasonable capital requirements compared to many healthcare facility businesses.

Intersil Corp. Cl. A (ISIL)

Faraz Farzam, CFA

We are excited about the prospects for Intersil Corp. ("Intersil"), a recent addition to our investment portfolio. Intersil designs, develops, manufactures and markets a portfolio of high-performance analog and mixed-signal semiconductors for the industrial, computing, consumer and communications markets. Historically, Intersil's business was weighed down by a commoditized business servicing the desktop PC and notebook markets. However, since joining the company in 2013, CEO Necip Sayiner has either exited or deemphasized Intersil's commodity-centric, less profitable businesses in favor of their power management portfolio.

The company now commands 20% operating margins and pays a healthy dividend that amounts to nearly a 4% yield. Their dividend payout is a testament to the stability and reliability of Intersil's cash flow. An increasingly important theme in technology is the concept of power management and power efficiency. Just consider the ubiquitous smartphone and the ever present issue of battery life. This is exactly the kind of power management and power efficiency that the company's patent portfolio addresses.

Power efficiency is no longer just confined to portable computing technology. In the industrial sector as well as the high-performance computing industry, power consumption is vital to the calculus of the economics and competitiveness of products and projects. All of our online activity, including e-mail, internet use, social media and Netflix streaming is delivered through thousands of data centers across the country. From small closets to large server rooms to mammoth cloud server farms, their explosive growth is gulping huge amounts of energy.

Intersil's core competence is providing semiconductor technology to manage power consumption more efficiently in a variety of applications. There has recently been a wave of M&A in the analog semiconductor subsector. According to financial software company, Dealogic, semiconductor companies have announced just over $100 billion in M&A, well ahead of $37.7 billion total for all of 2014. That figure does not bake in recent deal speculation involving the likes of Analog Devices, Inc. (ADI), Maxim Integrated Products, Inc. (MXIM), SanDisk Corp. (SNDK) and Fairchild Semiconductor International, Inc. (FCS). We think Intersil's rich patent portfolio makes it an ideal acquisition target for an acquirer that is looking to beef up their power intellectual property. Recent transactions in the space have ranged from 20-25X earnings. We believe Intersil has earnings power of $1.00 per share. Should a similar multiple be paid for Intersil, the stock could fetch a price close to $20 per share.

Definitions

S&P 500® Index - An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors.

Russell 2000® Index - An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index which comprises the 3,000 largest U.S. companies based on total market capitalization.

Shanghai Stock Exchange Composite Index - A capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange.