Articles

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High Anxiety
Rick Lane, CFA

Our title borrows from Mel Brooks' satirical movie, "High Anxiety." In the film—a parody of suspense classics like Vertigo—Mr. Brooks' character is taken to the Psychoneurotic Institute for the Very, Very Nervous. While the market has certainly improved during the first three quarters of 2016, election jitters may cause increased volatility and potentially a market correction. We are only three weeks from the big day and, considering how bizarre this particular race has been, it's hardly surprising that the markets appear to be skittish. Both candidates are very unpopular, but the real issue impacting the markets is the enormous gulf between the two contestants' proposed economic policies.

Until recently, most observers felt that no matter who won the White House, the Senate was up for grabs, with perhaps a bias toward the Republicans retaining it. The House looked fairly certain to remain Republican. The consensus thinking, of course, was that a divided government assured gridlock and the absence of bad legislation. However, with Donald Trump's missteps, the concern has quickly morphed into the possibility of a Democratic sweep. Though seemingly remote, we think this prospect is sufficiently tangible to frighten the markets. Given the suspicion of banks and Wall Street by outspoken critics like Senator Warren, many investors view a Democratic sweep as a "black swan" event. In such an event, we would have to seriously reevaluate our portfolio.

We will likely refrain from changing much until we see the election outcome. It is fair to assume that many businesses across our country have put capital spending plans and other important decisions on hold pending the election. This has most likely produced a negative impact on the economy as a whole. An election of a split government would likely prevent poor legislation and allow the country to get back to work.

Financials Update
Rick Lane, CFA

As outlined in previous newsletters, we have been very constructive with our financial holdings. We continue to feel an increase in interest rates is on the horizon, most likely in December of this year. In our opinion, just two or three increases would be positive for bank earnings. With this positive backdrop, two additional factors bolster enthusiasm for our financial holdings: energy exposure and bank consolidation.

Concerning energy exposure, we have previously mentioned our purchases of Legacy Texas Financial Group, Inc. (LTXB) and Hilltop Holdings Inc. (HTH) of Texas, IBERIABANK Corp. (IBKC) of Louisiana, and Zions Bancorporation (ZION) of Utah. Energy banks (banks with exposure to the energy sector) were under severe pressure following the falling energy prices. We felt the sell-off was excessive. This has proven to be the case. We believe the excellent franchises we picked up "on the cheap" still look very solid as the energy recovery is in the early stages.

As for the consolidation theme, we own CoBiz Financial Inc. (COBZ), Guaranty Bancorp (GBNK), and National Bank Holdings Corp. (NBHC), all in the booming Denver market. These three banks are essentially the last remaining locally-based publicly held banks in the very attractive Colorado market. LegacyTexas Financial Group is similarly positioned in Texas. With approximately $8 billion in assets concentrated in the economic powerhouse of Dallas, we believe that the scarcity value here is extremely lucrative.

All of these banks enjoy strong regional franchises and represent a good value on their own. Additionally, they all could be terrific buyout prospects. One never knows when lighting will strike, but that possibility adds potential upside to stock price.

We also own Renasant Corporation (RNST) in Mississippi, and Western Alliance Bancorp. (WAL) in Arizona (as Sam

Koehler dsicussed in last quarter's newsletter). These banks enjoy strong organic growth in their respective geographies. They have grown through smart acquisitions, and we feel should continue to do so in the future.

Real Estate Investment Trusts ("REITs") have had a significant effect on our relative financial sector performance due to a lack of ownership. Our investment strategy focuses on capital appreciation. Therefore, we have traditionally avoided REITs due to their focus on yield. The desire for yield in a zero-interest-rate environment has driven REITs higher and our lack of investment has detracted from our relative financial sector performance. REITs will likely continue to outperform if interest rates stay low. We believe our investments away from REITs are better positioned for interest rate increases.

Technology Update
Faraz Farzam, CFA

Technology was the best performing sector in the portfolio during the third quarter of 2016. Our largest portfolio holding, Intersil Corp. (ISIL), was acquired by Japanese semiconductor manufacturer Renesas Electronics Corp. in a $3 billion all cash deal valuing the company at $22.50 per share, a 44% premium to the pre-announcement closing price of $15.64.

In our newsletter for the period ended September 30, 2015, we wrote in depth about the investment merits of Intersil and prognosticated a takeover in the rapidly consolidating semiconductor space. Similarly, another one of our technology holdings, Infoblox Inc. (BLOX), was acquired by Vista Equity Partners, at $26.50 per share. We rolled some of our profits into existing portfolio holdings, Pandora Media, Inc. (P) and Veeco Instruments Inc. (VECO). We believe these companies have material upside potential and identifiable catalysts. We would direct investors and readers to June 30, 2016 newsletter for a detailed review of the Pandora investment case.

Although we are entering what is historically a seasonally strong period for technology stocks, we would not be surprised if tech stocks pulled back as we navigate third quarter reporting season given that tech stocks already have had a significant run to date.

Consumer Update
Faraz Farzam, CFA

Last quarter, we discussed the general rebound in Consumer Discretionary stocks and our investment in Hibbett Sports, Inc. (HIBB). Although the rebound has continued into the third quarter of 2016, the performance has been choppy. Our investment in retailers has yielded positive results, but our sole restaurant investment, Chuy's Holdings, Inc. (CHUY) has pulled back sharply after posting what we felt were good results. This speaks to what we see as a broader and rather extreme rotation that has taken place between retailers and restaurants.

Our valuation discipline has been critical here. We exploited the strength in several names like Lululemon Athletica Inc. (LULU) and Nordstrom, Inc. (JWN) by liquidating the positions entirely. Although the economic environment continues to favor Consumer Discretionary stocks, we remain steadfast and selective, investing only in companies we believe are solid durable businesses that are trading at discounts and selling our winners as they approach fair valuation.

Callaway Golf Co. (ELY)
Rick Whiting

One of the hallmarks our investment process is to know the management of a company and to understand their thought process. We do not believe that it is enough to have a static understanding of where the company is positioned today, but rather we wish to have confidence in management's view of the opportunities and challenges before them, as well as their contingency plans should things change. Most importantly, we want to share with management a common understanding of the financial and structural metrics by which we may objectively judge their performance.

It is in this light that we would like to thank Chip Brewer, CEO and President of Callaway Golf, as well as his assembled management team and their employees. Mr. Brewer took the helm of Callaway in 2012. His challenges were threefold: define a new path for an iconic brand that was adrift, rationalize the cost structure of the business, and energize the talent in-house while the world proclaimed the game of golf to be dead. Let us not forget that in 2012, while the U.S. consumer was starting to feel a shade more confident, their wallets were open only for essentials such as replacing an aging fleet of cars, getting out from under credit card and mortgage debt and doing deferred maintenance on their homes. Golf clubs were not at the top of most priority lists.

Mr. Brewer presented investors with a check list of items he felt needed to be addressed for the company to win in a stagnant environment and to blossom in a recovering economic environment. He gave of a very clear vision of how success or failure would be defined and the metrics to measure progress along the way. We believe Mr. Brewer and the team at Callaway have executed on the plan beautifully and have not let themselves be sidetracked along the way. Throughout, they have also dealt with hurdles incumbent in a bumpy recovery, foreign currency headwinds and competitors with less stable business plans.

Today we own a substantially smaller position in the company's stock. We believe Callaway continues to have a pristine balance sheet, market share opportunities and operating margin initiatives on the table. We still have a great deal of confidence in Mr. Brewer's leadership but the narrative has changed somewhat.

The restructuring and its benefits, while ongoing, are largely behind us. We do see a pathway to growth as gasoline remains inexpensive, unemployment is historically low, and consumers have already done much of the heavy lifting addressing necessities. Yet, as the company pivots from repair to growth, the metrics to measure steps along the way become more subjective. We feel there is still upside in the stock, but prudence in investing has led us to reposition the size of our investment, re-underwrite the fundamentals, enjoy some profits, and thank the team at Callaway for a job well done.