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Articles

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Economic and Market Overview
Rick Lane, CFA

The market decline of early October (time of this writing) was a clear reaction to rising interest rates. One never knows the exact tipping point as interest rates have been on the rise for some time. Is this the tipping point? Higher interest rates will create competition for equities and will eventually slow the economy. The latter has already been felt in interest-sensitive industries like housing and automotive and the fear is that it will spread.

The counter to this line of thinking is that rates are going up BECAUSE the economy is so strong. Our thinking is that the Federal Reserve (the Fed) is simply normalizing interest rates after almost eight years of super low rates. Most economists feel the so-called neutral rate for short-term interest rates should be around 2.5%-3.0% based on today's roughly 2.0% inflation rate. We believe the Fed feels that the U.S. economy is on strong enough legs that it needs to move to a neutral policy stance. In fact, we feel the Fed should have moved to neutral several years ago when the economy was in the early growth stage of the cycle.

The problem with doing it now is that while the economy is indeed quite strong overall, early-cycle industries, like housing and automotive, are slowing so investors are already on high alert for the next economic downturn. Rising interest rates exacerbate these fears. Our position, as we have outlined in previously, is that we are indeed late in the current economic cycle. While the next recession is likely sometime in the next several years, barring an exogenous event, it is not imminent.

What is imminent, however, is a revaluation of equities based on higher rates, and a heightened sense of where we are in the cycle. We would guess, highlighting the word guess, that following a digestion period, the market will stabilize and move somewhat higher until the next economic downturn, whenever that is. Again, this is a guess based on years of equity investing experience on the part of the Broadview team. We believe investors should be careful about risk from here on, recognizing the risk-reward late in the economic and market cycle is no longer as favorable. Our strategy is to continue to look for companies that meet our five pillar criteria while being very careful around valuation and economic sensitivity in the event the next downturn occurs sooner than expected.

Upscale Retailer Review
Faraz Farzam, CFA

Overall, our consumer names delivered positive relative and absolute performance in the third calendar quarter. Last quarter we wrote about our opportunistic position increase in an upscale retailer. We are pleased to report the company delivered. The company's second quarter results exceeded expectations across the board.

We continue to like the outlook for this retailer's fundamentals and believe they are not only a best-in-class retailer, but also a best-in-class e-commerce vendor reporting 35% of their sales online. Inventories are lean, which bodes well for merchandise margins. The investment cycle that we wrote about last quarter is behind them. We believe this bodes well for the company's overall earnings growth going forward. Although continued sales outperformance is not a given, we think this is one of the best merchandising and management teams in the business and we like the outlook for the fourth quarter with the critical holiday season.

Technology Sector Overview
Faraz Farzam, CFA

We continued outperforming in the technology sector this quarter as investors rotated out of semiconductor-related stocks due to peak cycle concerns. We were well positioned for this rotation as we previously sold all but one semiconductor stock while continuing to hold software and IT service stocks.

This quarter, the management of one of our software companies announced the sale of its legacy business. The company will maintain its strategic marketing database and business intelligence development business which is growing at a better than 25% rate and boasts already strong profitability for a company of its size and growth profile. We believe management will use proceeds from the sale of the division for share repurchases. While the stock price has gone up, we believe it remains undervalued relative to its software peers, especially when considering the company's solid profitability and growth profile. Conglomerate companies generally tend to trade at a discount, but now we believe this company can shine on its own as a standalone entity. We believe the stock's valuation should continue to expand and shed its discount.

Our largest technology investment, a network and communication gear maker, delivered strong results for the second quarter and a positive outlook. Recently, the stock has been trading at 10-year highs. Japanese telecommunications service providers, long captive to domestic equipment makers, have begun opening up their networks to international equipment providers. The company's dominant competitive position has gained them a place inside these large and capital-intensive networks. Like their recent success in India and Europe, these markets could provide a multi-year investment for equipment.

Looking forward, we will keep an eye on the valuations of our software holdings. We expect technology investors may now crowd into "working" software companies since they abandoned semiconductor and semiconductor capital equipment stocks. We have already seen evidence of this with a cloud software service holding, which we sold as it reached our valuation target. We will also look for opportunities in the aftermath of the selloff of semiconductor-related companies while being cognizant of the duration of the economic cycle.

Healthcare Sector Overview
Aaron Garcia, CFA

Healthcare stocks have broadly outperformed the market in 2018, with the third calendar quarter being no different. However, throughout 2018, we have continued to be underweight in healthcare. Thus, our call appears to be incorrect. But as we have written in the past, the regulatory backdrop is very uncertain. We expect further volatility through the November midterm elections, regardless of the outcome.

While our thinking has not changed, we will continue to look for names that are more insulated from regulatory risk and offer compelling growth stories at a palatable valuation. Valuations in healthcare appear expensive overall. We think that medical device companies will face less scrutiny than pharmaceutical and pharmaceutical supply chain companies in the coming quarters. We also think that the continued move of care outside the hospital and into alternative sites, including the home, is a theme that will persist for some time. Finally, we remain enthused with the diagnostic sector. Specifically, there are many technological advancements in the molecular diagnostic industry that we believe can drive outsized revenue growth. As the medical community grows its understanding of the genetic component of pharmaceutical treatment, we believe these diagnostic companies will have increased value to pharmaceutical drug development.

Despite our underweight in healthcare, we have benefited from a few strong names. One of our larger positions, was acquired in the third quarter by a larger medical device company. The acquisition was strategic as the company has built up a large market share position in medical implants to treat scoliosis and has an exciting new class of products that are utilized in vivo during spine surgeries. While we were happy with the premium associated with the buyout, we felt the company had strong growth prospects over the next several years. We have reallocated some capital to another company in this industry, as we believe small capitalization medical device companies have significant private market value in a growing space.

Unfortunately, several of our healthcare names detracted from performance in the third quarter. An imaging component company had weak quarterly results that drove a re-rating of the stock's valuation. We think the international opportunity for this company is appealing. Developing countries are at the beginning of a long upgrade cycle to digital imaging technology, following the adoption curve that the United States and Europe have already experienced. However, a more concerning tariff environment and global trade jitters caused many of their customers to delay purchase. We continue to like the opportunity, but we need to see better near-term execution from management before getting more positive on the name.

We also suffered from poor performance in a medical waste company that is undergoing a large restructuring and IT deployment. This company previously engaged in an aggressive acquisition campaign and now needs to better integrate many of the companies it has purchased over the last 20 years. We believe this process, while painful, will drive future margin growth and improve return on invested capital. We view the near-term underperformance here as less critical given the longer-term opportunity, while acknowledging that this investment may take some time to bear fruit. We also saw poor performance from a company in the specialty pharmacy sub-industry. We have reduced the size of the position, due to the increased rhetoric on the drug supply chain rebates. Although we were broadly concerned about this very issue, we felt the company's strategy of targeting small and mid-sized clients in the pharmacy benefit management (PBM) business was very well conceived, as the larger PBMs do not provide a high level of service to smaller customers.

In this current environment, we believe it is prudent to wait for more government clarity.