Articles

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Softly, Softly Catchee Monkey

Rick Lane, CFA

The title to our review refers to an African proverb. Largely popularized by Lord Baden-Powell, the founder of the Boy Scouts, the saying means "patience gains the day." We believe investors will have to be patient and cautious over the near to medium term as the equity markets absorb rising interest rates and the ongoing trade negotiations. These two recent developments come on the heels of thirteen straight months of extremely low volatility, rising valuations, and powerful equity returns. Indeed, the 29% advance in the S&P 500 Index (January 1, 2017-January 31, 2018) was dwarfed by the returns of the collectively known FANG stocks (which we are not invested in) over the same period, led by Netflix, Inc. (NFLX) up 118%, Amazon.com, Inc. (AMZN) up 93%, Facebook, Inc. (FB) up 62% and Alphabet, Inc. (GOOGL), the parent company of Google, up 49%. Yet FANG was child's play compared to the 940% increase in the crypto-currency Bitcoin.

The two factors cited above, rising interest rates and trade negotiations, quickly pricked this speculative market bubble in early February 2018. In our minds, this was a long time in coming. Super low interest rates since 2009 had set in motion a reach for yield and drove asset valuations to high levels while feeding speculation in sectors like technology. In our view, there has also been a flywheel effect caused by so much money flowing into passive investments, like index funds, that it essentially prevented normal corrections along the way. That abnormally low level of volatility only emboldened investors to put more money into equities. Against that backdrop, the market was overdue for a correction.

Jerome Powell, the new Chair of the Federal Reserve, recently outlined three to four quarter point Fed Funds increases this year which we believe caused investors to pause. However, in our opinion, it was President Trump's strident approach to trade negotiations which really caused the sell-off in early February 2018.

So where does that leave us? We believe that rising interest rates will at some point negatively impact asset valuations through both the discounting mechanism as well as creating some competition for equities. Most studies we have seen suggest individual investors are over-weighted in equities. Given the length and magnitude of this bull market, combined with super low interest rates in fixed income, this is easy to understand. Our thinking is that if short-term rates approach three percent while intermediate-term corporate yields approach mid-five percent, investors will likely reallocate some equity exposure to fixed income.

On the other hand, earnings are likely to be very strong this year. Furthermore, we don't think the benefit from a considerably lower corporate tax rate can be overlooked. The recent correction has brought valuations down some, and yet the "pain" has not been evenly distributed.

Several other nuances are very relevant to our thinking here as well. One, growth stocks have dramatically outperformed the rest of the market for a few years now, creating solid value in many overlooked industries. Secondly, the significant flow of money into S&P 500 Index-based funds has inflated many components of that index. Markets have a way of correcting these imbalances. We think this may be unfolding as we speak. Warren Buffet likes to say that in the short run the market is a popularity contest (today's technology stocks) while in the long run the market is a weighing machine. We believe the market is likely to rebalance toward the solid growing, fairly-valued companies that comprise the firm's portfolios. Patience gains the day!

Network & Communication Infrastructure

Faraz Farzam, CFA

We recently met with the CEO of a network and communication infrastructure company that sells software and equipment to telecommunications providers. Their largest customers include AT&T Inc.

(T) and Verizon Communications, Inc. (VZ). Both AT&T and Verizon have initiatives to drive fiber closer to their customers. Once the fiber is laid, the network and communication infrastructure company's equipment is required to "light" the fiber, enabling it to carry a signal.

Additionally, AT&T has been commissioned by the Federal government to build FirstNet, a $6 billion project to build and manage America's first nationwide public safety broadband network dedicated to first responders. This could drive business for the network and communication infrastructure company.

Verizon is in the early stages of developing a 5G wireless broadband network. Their aim is to challenge cable companies' dominance in providing residential broadband internet service. Again, optical equipment suppliers, such as the network and communication infrastructure company, could benefit.

Elsewhere, India is in the throes of building out their modern communication networks. The network and communication infrastructure company is a major supplier to several major carriers in India.

Finally, the rise of large global content networks ("GCN"), like Spotify Technology (SPOT), Netflix, Facebook, and Google, has created a new and significant customer category. These GCN's are so large that they are building their own networks. The sum of all this is that we believe there are several tailwinds behind network and communication infrastructure companies.

Energy Sector: Recent Developments in the Exploration & Production (E&P) Industry

Aaron Garcia, CFA

On March 28, 2018, Concho Resources Inc. (CXO) bought RSP Permian, Inc. (RSPP) for $9.5 billion in stock, a 29% premium to the day before close. RSP Permian is a Permian basin based pure-play with high quality acreage in the oil-rich Midland and Delaware basin. While we were not invested in these companies and therefore did not benefit from this specific transaction, we were encouraged to see a realization of private market values in the Permian basin.

We are believers in the upside of this basin and Permian operators. Like RSP, many have top tier quality acreage and capable management teams. We believe that 2018 may well be the start of the recovery of the E&P sector, and that Permian names may be among the beneficiaries. Several offer high capital yields and have lower cost of extraction compared to other U.S. companies in the E&P sector. Some companies active in the Permian Basin have recently digested large acreage acquisitions and are now implementing aggressive development programs. They are using pad drilling and enhanced completion techniques to drive economics by increasing total resource recovery and decreasing costs per well drilled. Pad drilling allows for lower cost drilling of longer laterals and tighter spacing of the wells.

We are also encouraged by the progress of an E&P operator with most of its operations in the Bakken Formation. Results in the Bakken have continued to surprise. Capital spending estimates continue to move down for this E&P operator as a new management team executes against their plan.

More generally, E&P company equities have been choppy in this volatile environment. Commodity prices have held above $60 per barrel of oil all year (except for a small dip) and are up 21% over the last year (source: WTI price). Most E&P company equities have lagged this price performance.

Not only have production economics continued to improve through new methods, but there are some signs that the E&P industry is evolving into a more investible space. Historically, the smaller E&P companies have been looked at as equity plays on the commodity. They offered some differentiation based on location and management. However, the industry generated little excess return on capital and free cash flow. Management raised equity with impunity to speculate on new areas and rarely were held accountable for economic returns. We believe that is slowly changing.

Investors have begun to demand more accountability. Companies with a path to free cash flow generation are being rewarded with multiple expansion. Also, we believe the new manufacturing-like techniques that the industry is adopting have the potential to smooth out some of the volatility in quarterly results. Despite this, the industry still sells a commodity that trades around the world. A softening of global demand would be detrimental to the price of oil and could affect our outlook for these companies.