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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 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? Our base-case scenario is 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!

Ciena Corp. (CIEN)
Faraz Farzam, CFA

Our technology investments delivered solid gains on both an absolute and relative basis this quarter led by telecommunication equipment maker Ciena

Corp. Following strong calendar fourth quarter 2017 results, we met with Ciena's CEO Gary Smith. Based on our due diligence, we believe Ciena's competitive position is stronger than ever due to favorable industry consolidation.

Ciena sells critical software and equipment to telecommunications providers. Their largest customers include AT&T Inc. (T) and Verizon Communications, Inc. (VZ). Both companies have initiatives to drive fiber closer to their customers. Once the fiber is laid, Ciena'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 the FirstNet, a $6 billion project to build and manage America's first nationwide public safety broadband network dedicated to first responders. Ciena is AT&T's primary optical equipment supplier.

Their second largest customer, 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. Ciena is also Verizon's primary optical equipment supplier.

Elsewhere, India is in the throes of building out their modern communication networks. Ciena is the optical supplier to all the major carriers including Reliance Communications Ltd. (532712-IN), Vodafone Group Plc (VOD-GB), and TATA Communications Ltd. (500483-IN).

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 for Ciena. These GCN's are so large that they are building their own networks and buying gear from Ciena. The sum of all this is that we believe there are several tailwinds behind Ciena's business. Ciena's balance sheet is improving as they will generate $150 million of free cash flow this year while retiring $300 million of debt. We continue to like the prospects for Ciena and its stock price.

Boston Beer Company, Inc. (SAM)
Faraz Farzam, CFA

While our consumer discretionary investments broadly delivered positive performance this quarter, our more defensive consumer staples investments retreated. The net result was a neutral impact to Broadview's strategy performance relative to the Russell 2000 Index for the quarter. Our largest consumer position, Boston Beer Company, Inc., reported fourth quarter results that were largely as expected. The pullback in the shares came after a stellar run in the fourth quarter. Boston Beer continues to see improvement in its core lager and seasonal business while delivering solid gains in its Cider and Fermented Malt Beverage (FMB) brands. Boston Beer also announced it has completed its yearlong CEO search. Long-time board member Dave Burwick will replace Martin Roper who will be retiring in May. Mr. Burwick has two decades of experience in beverage and retail operations, including senior roles at PepsiCo, Inc. (PEP).

We believe the opportunity for Boston Beer is significant. They have a solid brand with only one percent market share in the beer category. They are category leaders in the growing Cider and FMB space. Finally, we believe Boston Beer may be an attractive acquisition target for larger beverage operators.

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 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 have investments in Permian operators Parsley Energy, Inc. (PE) and WPX Energy, Inc. (WPX). Like RSP, they 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 will be among the largest beneficiaries. They offer the highest capital yields and have the lowest cost of extraction among all U.S. plays. Both these companies have recently digested large acreage acquisitions and are now implementing aggressive development programs. They are using pad drilling and enhanced completion techniques to drive superior 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 Whiting Petroleum Corp. (WLL), an operator with most of its operations in the Bakken Formation. The new management team has done a solid job in refocusing the company's drilling program. Results in the Bakken have continued to surprise to the upside, and Whiting's new CEO has laid out a conservative plan for 2018 that should drive positive free cash flow. We had long suspected there was some slack in the previous regime's capital budget, and that appears to be the case. Capital spending estimates continue to move down as the new management team executes against their plan. While the stock has been a standout performer in the beginning of 2018, we see continued upside as it de-levers and its multiple continues to move higher.

More generally, the E&P equities have been choppy in this volatile environment. The commodity has held above $60 per barrel of oil all year (except for a small dip) and is up 21% over the last year (WTI price). The equities have lagged this price performance. WPX is flat over this time frame and PE is slightly down. Concern over both weather volatility and service cost inflation have weighed on the stocks this quarter, but we think the equities have been over looked.

Not only have production economics continued to improve through new methods, but there are some signs that the 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.