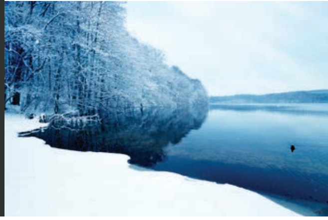

Articles

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Anatomy of a Bear Market

Rick Lane, CFA

As I write this, the markets are in the midst of a significant sell off. While painful, this has been a long time coming and we need to get it behind us before valuations return to attractive levels. The immense liquidity created by the last round of quantitative easing in 2012 ("QE3"), coupled with a zero short-term interest rate and the attendant reach for yield, drove equity prices skyward. That is, until several months ago when the markets began to fray around the edges.

There have been signs since as early as 2014 when smaller and more illiquid stocks began to decline. The high yield bond market has also been under pressure for some time. Perhaps the most telling sign has been the complete lack of breadth for most of 2015. Even while the indices were being driven higher by the likes of FANG (**F**acebook, **A**mazon, **N**etflix and **G**oogle), most stocks were in retreat from their individual highs. In our opinion, the strength of a handful of large, wildly overvalued growth stocks disguised the inherent weakness in the overall market.

It happens every cycle. Smaller, out-of-favor stocks get hit first. Investors then move into the remaining growth stocks whose charts still look healthy creating yet more overvaluation until that fateful day when "something" tips that last group of winners over and the whole market rolls over. This time, "something" was concern about China slowing along with the oil bust here in the United States. While the "something" is a different factor each cycle, every other element is similar.

Markets are difficult if not impossible to time. Our approach remains one company at a time. We have been communicating for some time our frustration finding good companies at bargain prices. As portfolio companies achieved sell targets, cash has gradually built up to its current 20% level.

As the market continues to decline, we expect we will find many opportunities! We are not sure if the market downturn portends a recession or just a necessary valuation correction, so we will be very cautious deploying cash until a clearer picture emerges. We urge investors to stay the course as much of the damage is likely done, at least in small capitalization companies. We will ultimately take advantage of upcoming opportunities to deploy our cash position.

Having said the former, demographics around the world do concern us and, in our opinion, represent the biggest risk to the usual cycle described above. In many parts of the world, such as such Japan and Europe, birth rates are so low that populations are shrinking. In China, growth rates are slowing dramatically. Unlike economic and stock market cycles which are shorter in duration, demographic changes are much longer term. Is it possible that demographic factors are behind the sluggish worldwide growth? Since demographic challenges do not lend themselves to the traditional economic tools of monetary and fiscal policy, time will tell. In the meantime, rest assured the research team at Broadview Advisors will tirelessly search for what it believes are good companies at opportunistic entry points no matter what the market environment.

Consumer Sector Review & Hibbett Sports, Inc. (HIBB)

Faraz Farzam, CFA

In our first quarter review we postulated a positive backdrop for the American consumer and consumer stocks driven by gasoline price declines, gains in employment, and the strong dollar. We were painfully wrong. Our consumer investments delivered some of our worst returns in 2015. Although no conciliation to our investors, it is worth noting that we were not alone. The consumer sector in general fared terribly. For some perspective, household names like Walmart Stores, Inc. (WMT), Kohl's Corp. (KSS), Macy's Inc.

(M), and Nordstrom, Inc. (JWN) were battered with declines of -27.4%, -17.2%, -43.1%, and -29.1% respectively. In the portfolios we manage, the biggest consumer investment, Hibbett Sports, Inc. ("Hibbett"), was down -37.3% for the year. The declines hurt our performance considerably. So what's happened? More importantly, where do we go from here?

Expectations were high for consumer stocks entering the year which, when combined with disappointing fundamentals, caused a dramatic downward rating change in valuations. But why were fundamentals disappointing against a positive backdrop of cheap gas, better jobs growth, and a strong dollar? We suspect three reasons:

1. High ticket auto sales, housing, and housing related sales drove consumer wallet share away from nondurables to durables.

2. Record warm temperatures during fall and early winter in most of the United States led to severe weakness in high ticket outerwear and high margin cold weather accessories, resulting in inventory liquidation and slashed profitability.

3. Weak top line trends were exacerbated as many retailers invested in their businesses, further damaging near-term profits. This was certainly the case with Hibbett which we will discuss in detail.

These three reasons were clearly driving factors in poor fundamentals. However, the situation was further exacerbated by sentiment surrounding e-commerce. Investors are surely aware that the internet was not invented yesterday. Online sales have taken roughly 30 basis points of marketshare away from traditional brick and mortar retailing every quarter for over 15 years. As retailers began reporting weak results, investors severely punished most consumer stocks deemed exposed to online competition. It was as if investors woke up in 2015 and noticed e-commerce.

We do not have our head in the sand. We understand that e-commerce will continue its march forward. However, we also believe that there remains a place for traditional brick and mortar retailing. We are not alone. Many emerging brands that were born online, such as Warby Parker and Bonobos, are themselves opening retail stores. This leads us to Hibbett, a fantastic business that currently has no online presence.

Hibbett is a sporting goods retailer headquartered in Alabama with a heavy store presence in the American Southeast. Currently operating 1,900 stores in 35 states, there is a long runway for growth. The company believes it can double its presence in its existing 35 states, and it just opened its first store in the state of New York. Almost the entire western half of the country, including California (the world's sixth largest economy), is still open for growth. We believe it is a fantastic business model with the potential for high returns on investment and little competition. It operates in very small rural markets where big box sporting goods retailers, like Dick's Sporting Goods, Inc. (DKS), cannot make their business model work and generally stay away. Brands such as Nike and Under Armour, that will not cheapen their best products by giving them to Walmart and Target Corp. (TGT), WILL give them to Hibbett due to the high level of customer service and the specialty nature of the stores.

Nike deems Hibbett so important that it has employees working at the Hibbett corporate offices. Therefore, in rural markets the only place you can get high-end sporting goods like Nike, Under Armour, North Face, et al is Hibbett. What makes its business model even better is the astonishingly low rents it pays for real estate at very attractive terms and durations for its leases. We believe its sustainably high profit margins, low capital costs, and lack of meaningful competition equate to industry leading returns on capital. For this reason, as it grows stores over the long term, it should eventually generate tremendous value for shareholders.

Hibbett's earnings have been under pressure largely due to necessary investments in the underlying infrastructure that will eventually lead to an e-commerce platform. It began its supply chain investments in 2014 and should conclude by the end of this year. By 2017, the company will be able to offer its goods online. It is worth noting that 70% of Hibbett's transactions are in cash. This again speaks to its geographic presence in very small markets. We also believe this fact is strong evidence that much of its business is NOT threatened by e-commerce. As we get closer to the end of this investment cycle, we believe a fairly large part of the bear case on the stock should disappear, considerably lifting the valuation. In the meantime the balance sheet is strong with no debt and nearly $90 million in cash that continues to build even as the company has been aggressively buying back stock.

Gentex Corporation (GNTX)

Aaron Garcia, CFA

Regular readers of The BroadView will remember that our portfolios have been long term shareholders in Gentex Corporation ("Gentex"). Gentex designs, manufactures, and markets electro-optic technology primarily for the automobile market. Its largest category is auto-dimming mirrors that are widely penetrated in the United States, but still growing rapidly internationally. The company has several other product categories, such as Homelink and SmartBeam that also have shown promise in the market.

Selling into the automobile industry is not easy. Customers demand annual price reductions and high quality. Auto suppliers must have a very low defect rate. Despite the tough industry, Gentex has 39% gross margins, 29% operating margins, high free-cash flow and a strong net cash position. We believe the stock is attractively valued at 12x 2016 earnings with a 2.4% dividend yield.

Despite the strong company fundamentals, Gentex is selling into an industry that is changing rapidly. Advanced Driver Assistance Systems ("ADAS"), are becoming more prevalent in high end vehicles and will trickle down into broader models. Examples of this technology include autonomous braking, lane departure warnings, adaptive cruise control, autonomous lighting, and crowd sourced traffic information. In addition, the emergence of on-demand transportation apps such as Uber and Lyft has implications for vehicle ownership, and utilization. Many see these technologies as the first step to autonomous cars. Original equipment manufacturers ("OEMs") are paying close attention to these technologies. Recently General Motors Co. (GM) and Lyft announced a partnership to create an integrated network of on demand autonomous vehicles.

The auto industry does not typically change rapidly. However, many large and well capitalized technology companies such as Google or Tesla, view this as a significant opportunity. Also, many technologically talented OEM suppliers, such as Gentex, Harman International Industries, Inc. (HAR) or Delphi Automotive (DLPH), will have to position themselves carefully so as not to become obsolete. At first pass, Gentex's core auto-dimming mirror solution appears at risk for obsolescence. After all, if there are no drivers, why would you need mirrors on a car?

While we continue to closely watch the industry, we believe this thinking is premature, if not untenable. Will ADAS provide us with a safer driving experience? Yes. However, we think it is likely that a fully autonomous driving solution would be required to have manual redundancy in case of technological failure. In the future, you may not have to drive much, but someone will have to be in the driver's seat. Further, the timeline of such a change remains very uncertain. Nonetheless, the market is a discounting mechanism, and a company's cost of capital will rise if its earnings stream is feared to be in jeopardy.

Our initial assessment is that Gentex is still well positioned in the automotive industry, and we are excited about the valuation, international growth opportunity and new product initiatives. Despite our confidence, we will be very cautious with our investment. Massive industry disruption breeds both opportunity and folly, and we want our clients' capital to be on the right side. If Gentex is not a long term winner in this industry, another company will be, and we will invest accordingly.

BMC Stock Holdings, Inc. (STCK)

Rick Whiting

We would like to update shareholders on our thoughts regarding Stock Building Supply, now BMC Stock Holdings, Inc. ("BMC Stock"). Since our last review of this position, Stock Building Supply has entered into and completed a merger of equals with BMC, and hence the new name trading under the old ticker. The merger accomplishes a number of important things in our opinion. Revenue of the combined entity will be roughly double that of Stock Building Supply. The geographical footprint is complimentary. The integrated product portfolio offers a more complete suite of materials. Finally, the combined companies should have cost synergies that over the next two years exceed $30 million.

Admittedly, this has been a laggard position in the portfolios we manage. We see four primary headwinds facing the company and view them as either more muted than the headline or transitory in nature. First, the company derives 30-35% of its revenue from Texas, and there has been much written about falling oil prices, troubles in the oil patch and the risks to the Texas economy. In 2009 Texas supplied 25% of all US oil production and that number had risen to 40% by 2014 (Bloomberg). However, having learned a hard lesson in the 1980's, Texas has been a vanguard as a "business friendly" state. Because of that urge to diversify its economy, oil and gas extraction is only 10-11% of Texas's GDP. Is there a headwind for residential home construction? Yes, but in our view, the headlines about the oil economy loom larger than the economic reality in Texas.

Secondly, El Niño has brought enormous amounts of rain to geographies that overlap much of BMC Stock's distribution. The result has been delays in the progress or start of projects as trucks and crews literally could not access job sites. Yes, there may be some small level of home cancelations on the margin, but in large part, this serves more to push revenue back as opposed to cancel opportunities.

Third, the Federal Reserve has begun the much anticipated hike in interest rates. A decision about a home purchase is, beyond question, sensitive to interest rate levels. It appears clear that the trend will be to higher rates over time. In our opinion, the key is "over time." Rates are coming off of generationally low levels and the Federal Reserve has been adamant that a return to higher rates is to be done at a measured pace. Given the low level of unemployment, the prospect of rising wages, and the benefit of lower gas prices, we believe this still nets to the benefit of household formation and housing construction verses modestly higher rates.

Finally, the revenues of BMC Stock are most levered to single family housing starts. While the trend here is positive, the slope has not been as robust as one might have hoped. The construction of multifamily rental properties has been stronger at the expense of single family homes. It is our view that many individuals in the economy have repaired their personal balance sheets. Given the level of household formation and the lack of supply in the market place for single family homes, we believe there remains a lot of runway in the form of pent up demand. Single family housing starts peaked at approximately 1.8 million units in the 2006-2007 timeframe. They have remained at the "normalized" level of 1.0-1.2 million units for eight years and have trended higher off the bottom for the last 4 years.

In sum, we recognize the headwinds and near term headline risks incumbent in this position. We further recognize that they can be exaggerated by the thin trading liquidity and volatility of the issue. Yet, we are investors that believe the value here will win out over the noise.