August 2017

To Our Friends and Fellow Investors,

During the first half of 2017, stocks continued their post-election romp. Year-to-date through August 23rd, the S&P 500 has risen 9.2%, adding to its 4.6% rise through year-end 2016 following Donald Trump's victory in the November 8th Presidential Election.

In our last letter to you, we identified the new administration's pro-business stance and commitment to tax reform as likely underpinnings of the rally. At least for the moment, meaningful regulatory and tax reform have been overtaken by political chaos in Washington, D.C., calling into question whether the administration can get anything through Congress. Yet the market has thus far performed well despite heightened political and military concerns, which raises the question, "what is driving stock prices?" (Hint – it is certainly not tweets). We want to take this opportunity to address this fundamental question.

Earnings Drive Stock Prices

Legendary mutual fund manager Peter Lynch said it best: "corporate earnings drive stock prices", and it has been surprisingly strong earnings, combined with continued low interest rates, that has been the main source of the market's strength. The Wall Street Journal reports that earnings for the second quarter ended June 30 are expected to rise 11% over the past year, marking the second consecutive quarter of double-digit profit growth, the first such period since 2011. By contrast, only a year ago, we were emerging from four consecutive quarters of shrinking earnings.

But what are earnings? Accountants measure earnings using Generally Accepted Accounting Principles (GAAP). GAAP is essential, helps create transparency, levels the playing field and reduces the opportunity for accounting mischief. Unfortunately, GAAP often requires accounting adjustments that obscure economic reality. We address this problem by recasting financial statements to produce a truer picture of the earnings power of a business. Once accomplished, like any owner of a business, we seek to determine the amount of cash that can be safely taken out of the business after provisioning for its future needs. It is this stream of future cash flows that comprises the value of the business. For example, consider a cell tower owner. Providers of wireless services pay rent on a monthly basis to the tower owner, and the cash that is left over after paying all the ongoing operating expenses which include utilities and reserving for predictable expenses, such as repairing and painting the tower, is money that the owners can take out of the business. This remaining cash is what we term "free cash flow" and in this case, due to large non-cash depreciation charges stemming from the initial investment, it is typically a much larger figure than the cell tower owner's GAAP earnings. Free cash flow is what an owner can take to the bank, and from an investor's perspective, it is the sum of the future free cash flows discounted appropriately to the present that equates to "intrinsic value."

The Valuation Conundrum

The question then becomes: "how should free cash flow be used in determining whether an investment is attractive or not?" Generally, the process starts by calculating the earnings yield, which is the inverse of the price-to-earnings ratio, the widely-used tool that compares the price of a stock to its earnings per share. For the moment, we are going to ignore the distortions introduced by GAAP as mentioned in the previous paragraph. To illustrate, if the share price is $20.00 and the earnings per share are $1.00, then the

P/E ratio is 20. The inverse of this ratio, or the earnings yield, is the percentage return, in this example, $1.00 divided by $20.00, or 5%. Focusing on the earnings yield allows investors to make a rough comparison between returns on a stock versus bonds, real estate or any other income producing asset. In an era of ultra-low interest rates, with one-year CD rates around 0.75%, an earnings yield of 5% or greater looks relatively impressive. Currently, according to Bloomberg, Wall Street analysts collectively peg 2018 S&P 500 earnings at over $143 per share. This means the S&P 500 currently trades at 17 times next year's expected earnings, or, alternatively stated, at an expected earnings yield of 5.9%. All else equal, paying $17.00 for a stock earning $1.00 is far better than paying $17.00 for the $0.13 of earnings produced by the 0.75% CD. This implied yield differential is why investors have piled into the stock market.

But the important thing to understand is that not all else is equal. The owner of a CD is guaranteed to get back 100% of his or her money within a year while the owner of a stock faces a number of unknowns that may adversely affect the stock's future stream of earnings, and thus its price. The most obvious risk is a general increase in interest rates. We have no idea when or if interest rates will rise, but the Federal Reserve has recently started tightening, gently reversing the zero-interest rate policy that it had maintained since the depths of the financial crisis in 2008. If rates rise on CDs, bonds and money market instruments, then the aggregate earnings yield on stocks will likely rise as well. Using the previous example, if the expected earnings yield of 5.9% on the S&P 500 rose by 1% to 6.9%, then the price of the S&P 500 would correspondingly decline approximately 14.5%.

The second risk is to the estimate of $1.00 in future earnings, which, in turn, depends on the economy and the reasons underlying any change in interest rates. If rates are rising due to increased economic activity, then the prospects for earnings could be better; conversely, if rates are rising simply due to Fed policy, then earnings assumptions could be at risk as corporate interest costs increase or economic activity slows. If expected earnings yields stayed constant, but expected earnings fell 3.0%, then the stock would correspondingly decline by 3.0% from $17 to $16.49 – not an awful decline but illustrative of the risk of forecasting earnings, and more important, the risk of pricing stocks off precise estimates of future earnings.

The point is that prospective returns on stocks currently look good compared to interest-bearing alternatives, but less so compared to their historic returns, or in the event of higher interest rates. Expected absolute returns are below historical averages of 9 to 10% per year. The only way for stocks to maintain historic rates of return are for earnings to accelerate materially or for interest rates to remain low. Maybe both will happen, but being capital preservation minded, we are unwilling to bet on either outcome, for the cost of being wrong is painful.

As well-known investor Howard Marks of Oaktree Capital recently said, these thoughts are "indicative, not predictive". While the near term economic outlook remains favorable, equity valuations are generally high and we must be mindful of that fact. Avenir manages elevated risks two ways. Since earnings drive stock prices, we strive to own non-cyclical businesses whose earnings have relatively little exposure to an economic downturn. Secondly, cash is riskless, and Avenir portfolios currently have more of it for two principal reasons. First, a major holding of ours, Popeye's Louisiana Kitchen, was acquired for cash at a 27% premium in March by Restaurant Brands International. Second, the prices of a couple of our businesses have approached our assessment of intrinsic value, prompting us to sell and resulting in additional cash. In fact, cash always seems to increase for us when valuations are high. As we have discussed in the past, we never target a set percentage of cash in portfolios; rather, cash holdings fall out of our investment process that is, at its essence, simply "buy low and sell high."

During periods of high valuations, we are occasionally asked if one should "get out of the market." The answer is generally "no" for several reasons. First, valuations may remain persistently high or go higher, and the unlucky investor who got out would be faced with the daunting task of reinvesting his or her capital at low rates. Second, while the market as defined by the S&P 500 is trading at a relatively generous multiple, Avenir portfolios are purposely comprised of securities in businesses trading below our estimates of intrinsic value. Third, capital gains taxes are essentially a high transaction tax that gives investors the even more difficult task of reinvesting after-tax proceeds at the same rate that was being earned prior to selling. Lastly, experience has shown that owning businesses that can compound capital on a per share basis through astute capital allocation is the surest way to achieve investment success, making us loath to part with our true compounders. The key insight for a portfolio manager is to own durable businesses run by excellent managers, and hold enough cash to take advantage of a reversion to historical valuations. That uncomplicated message is what we think is important to communicate to you today.

In Conclusion

At the outset of this letter, we noted that the stock market's post-election rocket ride was initially thought to be rooted in the belief that the new administration and Congress would act quickly to reform taxes and ease business regulations. While some progress has been made on the latter, the opportunity appears to have been squandered, at least for the moment, though animal forces appear to have been unleashed by the passing of the previous administration, which was widely regarded as hostile to commerce. While American businesses justifiably keep an eye on Washington, businesses have a life of their own. While some are yoked to the regulatory and political environment, the overwhelming majority create value through innovation, entrepreneurship, hard work, prudent risk-taking and solid capital allocation, behaviors almost completely independent of the political climate. That's how per share value is created and that's where we focus our attention. There is no substitute for owning businesses that reward owners by compounding earnings, book value and free cash flow on a per share basis for decades.

As always, we welcome your thoughts. We are pleased to serve you and your families and hope to hear from you soon.

Respectfully,

Peter C. Keefe James H. Rooney