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Large Cap Value Commentary

January, 2019

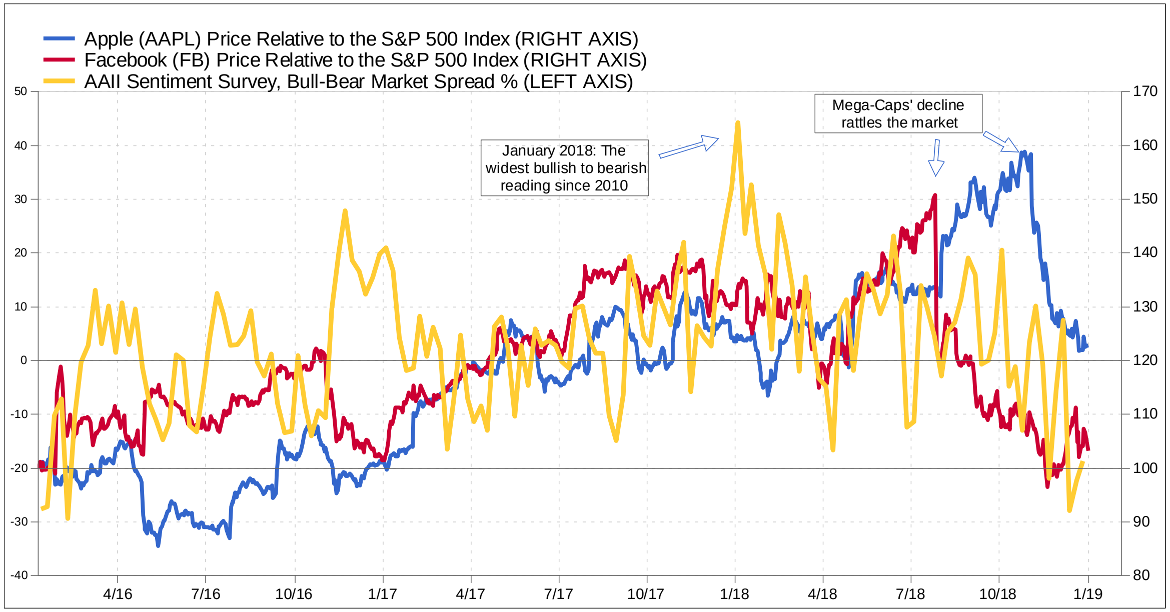
2018 was an even more challenging year in the market than what was indicated by the headline declines in the indices. Sentiment began the year at elevated levels, only to be rattled in February by a sudden storm of volatility, leaving most unable to assign a cause. That drop was eventually recovered by most of the major market averages, but after such a long stretch of a rising market with very few wobbles, the sudden drop in February was a helpful reminder that markets do not always go up. From our seats, there were fewer ways to win or keep pace as the indices recovered through the 2nd and 3rd quarters. The largest and the growthiest stocks had led the market for the past two years, but after Facebook (FB) fumbled in July the market began to feel different. Finally, in the 4th quarter, the market took most everyone lower, and while there were serval factors at play, again part of the drop can be pinned on another giant taking a fall; this time the Goliath was Apple (AAPL). We sold our position in AAPL back in July partly on the view that their presence in the Chinese market would become a worry given the slowing economy and the increasing trade tensions, and both headwinds have now become more evident. While the 4th quarter's selloff was significant, we are surprised by the sudden swing in expectations for future Fed policy given the solid corporate profit reports and the great labor data. Just a few months ago the idea of another hike in late 2018 and the Fed's projection of three more in 2019 was not hotly debated; however, now market futures and a number of commentators have concluded that the Fed will not raise rates again!

Large Cap Value Comments:

We eked out slightly better performance than the benchmark during the 4th quarter, but given our relatively more defensive positioning and our lack of exposure to the growthy mega-caps, which finally stumbled, we were disappointed that we did not hold up better.

The largest detractor to our returns by a factor of two times the next closest was our largest holding, LabCorp (LH), which dropped 27% in the quarter. In late November, the company reduced their revenue guidance. We had been encouraged by their recent decision to move into some Walgreens (WBA) stores and their Covance drug development business continues to post solid growth. With the stock trading cheaper than its peer Quest Diagnostics (DGX), despite having better lab results and the benefit of the higher valued Covance business, we were very comfortable sticking with this winner. Unfortunately, the timing of a change to their contract with the insurer United Health Group (UNH), occurred at a time at which the market was not displaying much grace. The additional pricing pressure felt by the entire lab industry should eventually lead to more volume directed to this leader, so this looks like a case of a little pain for more long term gains. While one top holding fell on hard times, Dollar Tree (DLTR) rose by 10% in the quarter and has added to that in early January. The situation with DLTR has been frustrating, as they have been unable to fully turn around the acquired Family Dollar stores. It would seem reasonable to expect that one of the best "dollar" store operators could improve performance at another dollar store, but the differences between the two stores have proven to be too great so far. Given the stability of their core franchise, it looks to us that very little value is being assigned to the struggling Family Dollar side of the company, which prompted us to add to the position during the summer. Recently, the successful activists at Starboard Value have come public with their position and their recommendations for Dollar Tree. The proposals presented by Starboard are actions that have been openly discussed with the management team on previous earnings calls, however, they have either disagreed with the recommendations or have concluded that they will not be effective. Favorably, this public campaign by Starboard will likely force the existing board's hand to more thoroughly vet these recommendations or shareholders will be given a chance to vote for a replacement of the board in the next proxy vote. We are hopeful that this development will lead the market to more appropriately value the total company's assets, which should be a good thing for shareholders.

The portfolio did benefit from our early addition of Virtu Financial (VIRT), which we had owned successfully in early 2018. As the selling took hold in early October, we saw the potential for market activity to increase at the same time VIRT's stock was trading at a lower valuation, and the thesis has played out very quickly. Value plus a catalyst! We did choose to sell our position in McCormick (MKC), which was also one of our few positive stocks during the quarter. McCormick's strong stock price and its consistently positive revenue growth have been two unique characteristics within the food and consumer staples sector, but with it trading at unchartered levels relative to its peers, we felt it was time to take our gains and move on.



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