Large Cap Value Commentary

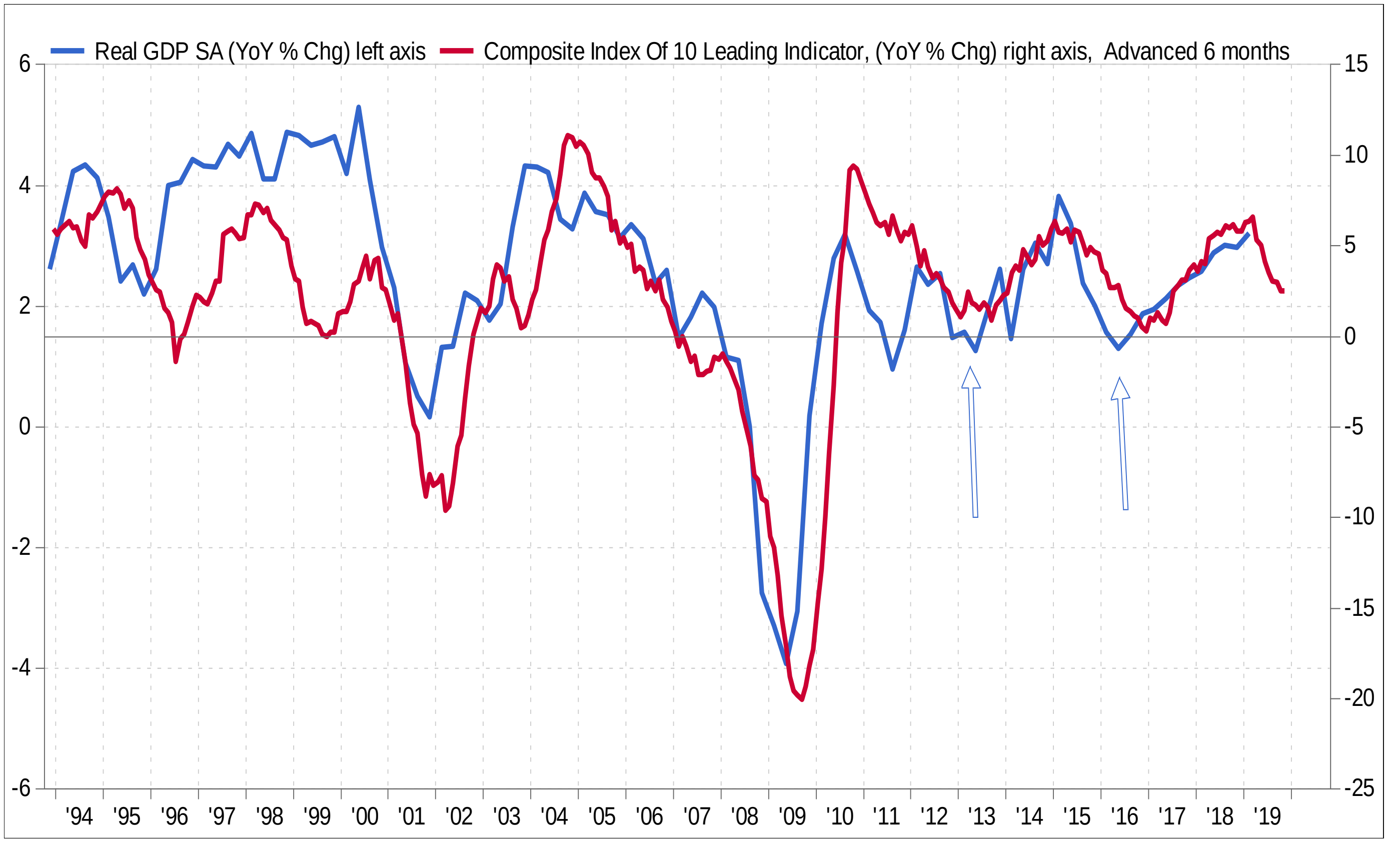
July, 2019

After a sluggish start to the quarter, hope for a trade truce between the US and China and talk of an insurance cut by the Fed triggered a record rally in equities in June, which lifted the indices into positive territory for the quarter. On a relative basis, after holding up better during the pullback in April and May, the portfolios did not keep pace in June, leaving us behind the benchmark for the quarter.

In terms of our macro or market view, not much has changed in the past three months. As a reminder, we focus on Leading Economic Indicators (LEIs) because they LEAD coincident indicators like industrial production, retail sales, corporate profits and GDP. This influences how we tilt the portfolio in terms of the types of stocks and industries we want to own. We are currently in the third cycle for LEIs for this expansion, and the recent path of the LEIs are pointing to another slowdown in growth. It could be argued that last year's stock market losses, the decline in interest rates and the equity market's leadership already discount or reflect this expected slowdown. This may be true to some degree, but the future path of the LEIs is obviously not clear yet, and that is what will dictate markets. A key difference between today and the two previous cycles is the Fed tightening that has occurred since late 2015. Historically, Fed policy has been a differentiator between a mild slow down, such as the two we have already witnessed during this expansion and a broader decline or recession. While short term rates are not high relative to past cycles, they are at or near the Fed's estimated neutral rate and that has typically not been a good thing for risk assets and the broader cycle.

This cyclical risk, coupled with expensive growth stocks, presents a challenging offering in our view. To be honest, we have had to loosen our value discipline and buy or hold some stocks that we would label as "expensive." In some cases, we have sold only to see these expensive stocks become more richly valued. To illustrate the point, consider two of our largest positions, Danaher (DHR) and ThermoFisher (TMO). We have owned these stocks for years and they have been great performers. Since year-end 2016, DHR is up 83% and TMO is up 108%. While earnings growth has been strong for many companies, including TMO and DHR, much of their appreciation has been from multiple expansion. DHR's PE multiple has expanded 39% from 20x to nearly 28x, while TMO's multiple has climbed 46% from 15.3x to 22.8x. To put that into perspective, if we go back to year-end 2016 and look at the ten largest stocks in the benchmark that we did not own, only Cisco (CSCO) appreciated by a similar percentage and it also benefited from the most significant multiple expansion of the ten. The other nine "large-cap value" stocks in the benchmark all saw much more modest multiple expansion (or contraction) and price gains. In summary, this has been a growth market, inside and out.

We made several changes to the portfolio, too many to recount in the update, but we would be happy to share our thoughts on each of them if you would like. In total, we were a net seller during the quarter, as we have maintained a relatively low portfolio beta of 0.92 and our over-weights to the more defensive or less cyclical sides of the market. The most significant new addition to the portfolio was Advanced Auto Parts (AAP), a company that we have followed for several years. The stock has traded at a steep discount to its peers O'Reilly Automotive (ORLY) and Autozone (AZO) because of its historically weaker growth and margins. Three factors have changed recently which led us to believe that the valuation gap versus its peers could narrow in AAP's favor. During the second half of 2018, after several years of concerted effort to right the ship, management at AAP began to further integrate and streamline the various franchises. This process had been halted a few years back after sales began to disappoint as a result of their aggressive integration efforts. Additionally, in the fall of 2018 AAP's sales reports began to matched or topped those of its peers. The board's confidence in the current process was demonstrated when they also resurrected their share buyback program, which had also had been placed on the shelf. The cost savings efforts, if done correctly, could help to narrow the margin gap between AAP and its peers. Importantly, these company-specific efforts will be helped by a healthier environment for the after-market auto parts market given the growth in the older population vehicles that inevitably will need maintenance.



Tyler Pullen, CFA
Portfolio Manager