April 10, 2014

Flushing out Momentum

Two themes are quickly emerging this year and both have been covered in these commentaries: 1) the economy needs to catch up to the stock market; and, 2) pockets of momentum have become quite irrational. There is an underlying thread that unites these two themes and that is the positive feedback loop. The simplest possible explanation of a positive feedback loop is a definition we will borrow from Wikipedia: "A produces more of B which in turn produces more of A."

Substitute "a rising stock market" for "A" and "a strengthening economy" for "B" and we have a good shorthand explanation for the relationship between the stock market and the economy. 2013 was the year of a strong stock market and a relatively tepid economy. Thus far in 2014, we have seen a strengthening economy, helped by the wealth effect and optimism derived from growing stock market valuations. Meanwhile, the stock market has largely stagnated as evidenced by the S&Ps 1.70% first quarter return. In order for markets to return to "A" (a rising state), we need the economy to do its share and strengthen, providing the impetus for continued increases in stock values.

We will revisit this relationship and the role that stock market multiples play in this bigger game, but for now we would like to focus our attention once again on these pockets of irrational momentum by way of anecdote. Craps is one of the most popular games in a casino. If you hear a raucous, joyous sound in a casino, odds are the craps table is its source. While the casino does offer nearly true odds for a bet behind the pass line, the true appeal of the game is how every participant joins forces to root in tandem for their united cause of collectively winning money. For the most part, when one person wins money at the craps table, so too does everyone else, yet not everyone wins the same amount of money in the same way.

The process of betting on craps can easily become its own feedback loop. This is something beginners are most vulnerable to, but experts are not immune from themselves. When a hot roller gets into a groove, craps players have money coming into their racks on nearly every throw of the dice. Each time more money comes in, new wagers are placed on the table or existing wagers are pressed. This effect increases the scale of winnings so long as the roller's momentum is maintained. The process of momentum is a positive feedback loop, whereby winnings lead to increased wagers, which lead to increased winnings, and on, in a virtuous cycle.

It is when that momentum is not maintained that the craps player runs into trouble. Momentum does not merely wane; rather, it halts suddenly when the dice land on seven, the dealer shouts "seven out"

and all bets remaining on the table are cleared. This is when the craps player learns how much he truly won on the hot roller, for far too many people end up with a growing arsenal of wagers on the table that get cleared off on the reset only to realize their stash barely grew, if it all, during the course of the hot streak.

The sectors prone to momentum in the stock market function very similarly to the craps table. These stocks are the domain of speculators (in contrast to those focused on fundamentals) in that people are essentially wagering that the direction of the trend will persist. As these stocks rise, traders implicitly have more money riding on each position. As traders make more money, they become less risk averse and spread their bets to other momentum situations. Soon wagers of a much larger scale are on the proverbial table. While there is no direct equivalent to "seven out" in the stock market, momentum is equally fleeting as it is in craps. There is no waning period, but rather a sharp, decisive reversal at which point these stocks collapse in spectacular fashion. Only after the wind is taken out of momentum's sails does a momentum trader know how much money was made during the full cycle.

This story is by no means a suggestion that everyone who flirts with momentum loses money. There are some spectacular traders in this arena of the market, who consistently grow their betting stash; however, it is impossible to know who really did make money until the table craps out. AQR Capital does outstanding research on market conditions and historical performance of strategies. They interestingly observed how momentum strategies tend to work; however, the average investor does not do well with momentum because they buy into these strategies far too late.[1] This is similar to how things work in craps. When a roller first picks up the dice, it is impossible to know whether they are hot or not. As they get rolling and start winning, only then can one say a roller is "hot," at which point the bettor presses his bets.

We tell this story because right now momentum is getting clipped in the stock market. It is happening swiftly and violently and it is by design that our allocation to these areas remains almost nil, for these pockets of momentum are the gambler's corner of the stock market. People do not own these companies for solid fundamental reasons, but rather for the prospect of "fast money". Further, we operate on a totally different wavelength than these types of speculators. When markets rise, rather than increase our wagers, we take chips off the table and stash them as cash. This provides us the ammo necessarily to increase our wagers when the market goes down.

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[1] http://compoundingmyinterests.com/compounding-the-blog/2013/10/16/learning-risk-and-the-limits-to-forecasting-and-prediction-w.html

This conversation we have been carrying of late about momentum begs another question: is this a repeat of 1999 all over again? We are extremely confident in our answer that it is not. We have consistently labeled this problem as "pockets of momentum[2]" and pockets is a very fair way to put it. As we went over with implied growth of the S&P, expectations on average are not low, but neither are they high. One mistake punditry often makes in discussing market valuations is that by nature of the game, one must have a position. By that, we mean that when someone appears on TV or in the press talking about the stock market, that person by nature gets backed into a corner whereby they must label the market "cheap" or "overvalued." In fact, it is those who most vocally argue one side or the other that get called upon to speak their opinions. It is very unsexy to think of the market as place with a range of possible outcomes and no one binary answer to the "cheap vs expensive" question.

If you were to ask us today where the market stands, we would tell you it is well within average ranges of valuation. In fact, the market could go higher or lower without changing our answer. Were you to ask us what we expect the market to do this year, our answer would be it "it will go up, it will go down, and ultimately it will not repeat last year." While these appear as non-answers, they are important answers nonetheless. Markets spend most of the time walking within a few steps of fair value. It is the exception to find a situation en masse where prices are extreme in either the cheap or expensive direction.

Flushing out these pockets of momentum will inject some volatility into markets, but it will not jeopardize the trajectory of outstanding businesses at cheap to fair prices, of which we think we own many. We think the key in this environment remains focusing intently on the quality of the companies we own, the risk/reward proposition of ownership, and the management teams at the helm who should be working as stewards of our capital, building long-term value all the while.

To that end, let us turn our attention to this quarter's leaders and laggards.

[2] http://www.rgaia.com/pockets-of-momentum/

What do we own?

The Leaders:

Fiat SpA (BIT: F) +40.6%

Fiat rang in the new year with some exciting news: the company agreed to pay VEBA $3.65 billion in total consideration for the ~41.5% of Chrysler it did not already own.[3] Not only was this an extremely attractive price for Chrysler, a key source of value in our Fiat thesis, but it was also paid for primarily with cash on Chrysler's balance sheet. This afforded Fiat considerable flexibility with regard to both the quantity and timing of fundraising necessary to execute its integration plan forging the new Fiat-Chrysler Automobiles. With the agreement complete, the new combined company can accelerate its focus on strategically using excess capacity in Europe to ramp its higher margin brands like Maserati and Jeep. This particular transaction affords us the opportunity to introduce an important market concept that we actively seek out: the Post Earnings Announcement Drift (PEAD).[4]

In this particular situation, the Post Earnings Announcement Drift is a misnomer, but do not be confused as it is directly related to what has happened with Fiat. On the day of the announcement, Fiat's stock rose 15.06%, a spectacular one-day return. Notice however that 15% is not even half of the total move the stock experienced during the quarter. PEAD is one of the market inefficiencies (also called anomalies) documented and agreed upon by proponents and opponents of the Efficient Market Theory alike. Efficient markets are supposed to instantly and properly incorporate new information into a stock's price; however, the PEAD suggests that the market is very slow to adjust to events that are of the extremely good (or bad) variety. To that end, when a particularly good surprise occurs, a stock's price experiences a powerful move in the direction of the event; however, the ensuing period following the event sees price continue to drift in the direction of said event.

While Fiat's positive event was not "earnings" in the literal sense, it was an extremely positive event which we felt the market clearly undervalued on the first day following the news. To that end, we used the catalyst as a reason to increase our existing position in the stock. Further, we would call the agreement with VEBA an important "de-risking event." When we look at any potential company to own, we think about the risk relative to the reward. In a de-risking event, the reward side of the equation

[3] http://www.fiatspa.com/en-US/media_center/FiatDocuments/2014/Gennaio/Fiat_to_acquire_remaining_equity_interests_in_Chrysler_Group_LLC_from_VEBA_Trust.pdf
[4] http://en.wikipedia.org/wiki/Post-earnings-announcement_drift

does not change, but the risk side decreases. Think about it mathematically. Let's say you look for investments with three units of reward per unit of risk. Then, let's say the risk in the situation is cut in half due to some catalytic event. When that happens, what formerly was 3:1 reward: risk now becomes 6:1.

All this is a roundabout way of saying our investment in Fiat remains one of our most attractive opportunities in today's market despite the already solid unrealized capital gains we have earned.

Platform Specialty Products (NYSE: PAH) +34.74%

Platform Specialty is a unique situation. The company came public on the New York Stock Exchange through a "reverse merger." Reverse mergers are typically looked at with scorn in the investment community and most of the time that is the correct way to think about such situations; however, not all of the time. This particular reverse merger was sponsored and largely owned by some parties who have exceptional records of value creation and outperformance. First and foremost, Platform Specialty is an initiative undertaken by Martin Franklin, formerly an activist investor who took over, renamed and completely revamped what is now known as Jarden Corp. We are sure you all have encountered Jarden products in your day-to-day lives. Jarden products range from mason jars, to K2 skis, to Coleman outdoor gear, Mr. Coffee makers and beyond.

Since Mr. Franklin joined Jarden in 2001, their stock has appreciated by 2,898.5% compared to 53.42% for the S&P. These are spectacular numbers and are reflective of Mr. Franklin's strategy which calls for acquiring high margin, market-leading niche products with minimal capital needs. Jarden focused primarily on household and consumer products, but Mr. Franklin today claims that a very similar set of conditions exists in the specialty chemicals sector for the deployment of such an acquisition strategy. Based on what we have learned about the sector, we completely agree, though we would be willing to settle for a return less than that of Jarden's (which is another way to say that while we like the potential here, it would be unreasonable to expect a return as spectacular as that of Jarden's). Importantly, we did not buy Platform as a shell, for Platform's initial offering on the NYSE came alongside the completion of its acquisition of MacDermid, a specialty chemicals company with a great track-record of its own and a management team that explicitly subscribes to Warren Buffett's philosophy of ownership and operation. To that end, the MacDermid management team took a decent-sized stake of its own in Platform in the acquisition.

One of the facts we like most about Platform's early rise is how it provides Mr. Franklin and his team an increasing amount of currency with which to undertake their stated acquisition strategy. While the stock

is not cheap per se, one of the great ways for a fairly valued stock to become cheap is via the acquisition of companies and pieces that are in fact cheap. Between the ample cash flow that MacDermid throws off, the recently obtained warrant proceeds, and a rising stock, Platform has plenty of dry powder for acquisitions. In today's environment, specialty chemical companies around the world are spinning off "non-core" businesses, many of which fit Platform's criteria of high margin, high-touch niche products. The combination of ample ammunition and plentiful targets play right into Mr. Franklin's hands and we are excited to watch this strategy play out over time.

Teva Pharmaceutical Industries Ltd (NASDAQ: TEVA) +32.83%

Teva was the second worst performer in our portfolio last year, and appeared in the laggards section of our quarterly commentary twice. While the stock did enjoy a positive return on an absolute basis in 2013, its return relative to the S&P was quite poor. All that changed in a flash when the calendar turned to 2014. We have spoken at length about Teva in the past, though find it worth emphasizing a key point: Teva is a textbook example of a situation where all the negatives are known, obvious and heavily discounted in the stock's price, but where the market refuses to look past them. Headlines end up on top of a story for a reason—they are designed to draw attention. Few people could look beyond the headlines at Teva for they attracted all the wrong kinds of interest.

Someone who followed the newsflow in Teva last year sees a company whose lead product (Copaxone) is losing patent protection and a management team in disarray. Those who dug deeper would see that Teva had an opportunity to protect some of its potential revenue hit from Copaxone and that even if they were not able to do so, the price of the stock reflected its entire loss anyway. Here is where the relationship between price and value is so important. Bad news is inherently implied in the price of a cheap stock. Digging even deeper, one could then realize how significant a company like Teva is in today's pharmaceutical landscape. Generics are becoming increasingly important globally and are one of the key sources of price pressure amidst rapidly escalating health care costs.

Further, as the largest generic drug company in the world, Teva not only is perfectly positioned to help drive down costs in the health care system, but they also have the capacity to sell at scale in a time when distribution and retail are consolidating in a push for more scale. Witness the Walgreen's/Alliance-Boots deal with AmerisourceBergen and the McKesson merger with Celesio. While these mergers put downward pressure on pricing at generic companies in the short-run, they create a profit opportunity for those who can trade some margin for a lot of scale on a global level. Therein lies a longer-term opportunity for Teva to continue its dominance in generic prescriptions worldwide.

The Laggards:

America Movil SAB de CV (NYSE: AMX) -14.93%

This is America Movil's second consecutive appearance in the laggards, though the stock remains largely range-bound. In the past, we have emphasized our belief that the company has been under pressure generally speaking from weakness in emerging markets, and specifically from a regulatory overhaul in Mexico's telecom sector. We maintain that these problems are fully priced in, and at today's value, America Movil is a great stock to own. Carlos Slim is a proven operator who is backing his beliefs with money from two angles: Slim continues to buy more shares in his personal capacity, and the company continues to "cannibalize" its own shares with large repurchases.

Given many of these points are redundant, we want to highlight an investment concept that attracts us to America Movil. Think of the stock market has having two kinds of waves: long waves and short waves. Long waves are the trends that take place over years to decades, while short waves are the trends that take weeks or months to play out. Towards the end of a long-wave in the upward direction, a stock becomes pretty expensive as investors assume the past trend will continue in perpetuity (which never happens in reality). When the trend inevitably breaks, the stock gets re-priced downward and then proceeds sideways for a long time. For us to be interested in the stock, one of the most important factors is that during the sideways action, the intrinsic value of the company continues to increase while the stock stagnates. This in turn leads to valuation compression.

Valuation compression is that situation where simply by moving sideways, the stock becomes "cheaper" from an owner's perspective. Stated another way, you can buy considerably more with the same amount of money. America Movil's long-wave came to a conclusion in early 2008. From then on, the company's intrinsic value has continued to increase, though the stock largely has moved sideways. Today's ~$20 America Movil earns over double the revenues and over 50% more in operating income than 2007's $20 America Movil. Clearly profit margins have not been as robust as in the past, but the fact remains that America Movil is a considerably more attractive bargain today than it was seven years ago at the same price. Back then the stock was priced for growth, while today it is priced for contraction. In reality, the company throughout this time period has delivered modest, but steady growth and we expect that to continue into the future; though we believe we are in position for a favorable investment outcome even if growth comes to an end.

Cree Inc. (NASDAQ: CREE) -9.53%

Cree is another repeat offender on the laggards list, though it also finished our 2013 Leaderboard in second place. The biggest problem facing the stock is that early last year's price appreciation went much farther than its fundamentals. Now the fundamentals need to spend some time catching back up with the stock price. In essence, Cree is like America Movil circa 2008, though with a much quicker cycle that should not see valuation compression last nearly as long. As we have pointed out in the past, we already realized considerable gains on Cree, though we have maintained an average allocation to the stock with the residual of our sales. We do this for several reasons: 1) being as large a gain as Cree has, our unrealized gains are effectively a deferred tax loan that leverages the upside of our holding; and, 2) we continue to believe that the long-term outlook holds the potential for even better performance.

In our 2013 review we said that Cree has a "modestly expensive valuation" and this fact remains true today, though to a slightly lesser extent. We continue to like the outlook for 2014 and beyond now that the incandescent bulb ban is fully in effect. Importantly, Cree's light bulbs have established themselves as the cleanest and purest "new" form of light. Light bulbs are often discussed as a textbook example of an innovative product turned into a commodity good, and certainly down the line LEDs will follow that same route. However, in the near-term, we think there is considerable opportunity to benefit from ramped utilization, which will more than offset price declines; and, longer-term we see upside from the company's leading presence in LED fixtures, and a pipeline of opportunities to use lighting in new ways.

Johnson Outdoors (NASDAQ: JOUT) -7.10%

We bought Johnson Outdoors and almost instantly the price dropped sharply. The catalyst was the company's fourth quarter earnings, though we would be hard pressed to say these earnings fell short of expectations. For one, the fourth quarter is always a slow one for Johnson considering the company specializes in warm weather outdoor goods, and second, few analysts follow the stock, rendering expectations largely a moot point. Despite the decline, we are excited to have found this stock and think the timing is largely right.

Johnson is an owner-operator, of the same family that is behind SC Johnson & Co. Johnson has several lines of business: Marine Electronics, Outdoor Equipment, Watercraft and Diving. In recent years, the vast majority of income has been earned in the Marine Electronics segment, which makes the Hummingbird line of fish/depth-finders. Over time, diving has been profitable, though it has struggled lately since much of its business has been earned from tourists in and from the most troubled European economies. The watercraft business is Johnson's oldest and most troubled. As of today, there is talk of

possibly selling that business to a purchaser and reallocating that capital. The Outdoor Equipment line is one area where the company recently made a strategic acquisition with vast potential: Jetboil. Jetboil makes a new line of camping stoves that is simpler to use than any predecessor and already is a top seller at many outdoor outlets.

Taken together, Johnson is an interesting collection of niche products, with the company's lines either the number one or two best sellers, where brand recognition is important and long-term profit margins are attractive. Johnson is reliant on leisure spending and during the crisis households cut back significantly on these purchases. On the plus side, Johnson's core earnings were largely unscathed (they did take significant goodwill write-downs, but these were non-cash expenses). On the minus side, the company experienced a liquidity crunch during the crisis, and as a result, has maintained excess capitalization ever since. That minus has since turned into an opportunity for the company, as now that economic normalization is further along, there is considerable room for balance sheet optimization to drive better returns on equity. The company's reinstatement of a dividend towards the end of 2013 was a key step in this direction.

The outlook for leisure spending looks increasingly good as the unemployment situation nationally continues to improve. With Johnson now trading at some of the lowest multiple valuations we see in the small cap space, this is a very attractive investment opportunity.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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