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What You See Is Not Necessarily What You Get

As we hit the halfway mark on the calendar year, it's worth reflecting on the expectations we outlined in our 2014 preview. If you recall, we emphasized that "it is quite possible, almost probable that 2014 will be a better year for the economy than it will be for the stock market"[1]. Were we wrong? So far this year, reality seems like a mirror reflection of our expectation, for the stock market (as represented by the S&P) is up 6.95%, while the economy (as measured by the Gross Domestic Product (GDP) in the first quarter) appears frighteningly weak[2]. Notice however that we used the phrase "seems like" rather than "is" a mirror reflection of this expectation. Often times what you see is not necessarily what you get.

It is an exercise in futility trying to estimate stock market performance based on GDP. More broadly, the first half this year is one of the clearest signals that market participants who spend their time trying to guess which direction the broader economy will go, too often mistake the forest for the trees. While GDP is obviously a good proxy for the direction of corporate earnings, it is far from perfect. Moreover, GDP does not tell us anything about how companies are valued, and where those corresponding values will go over time. There are two implicit points here in our knock on GDP as a tool for stock market timing: 1) it is an extremely challenging task to predict what the rate of change in GDP will be one quarter out, let alone one year out; and, 2) even were one to know in advance what GDP would do the next quarter, it does not follow that one would then be able to use that information profitably in the stock market.

This is but one part of why we are strong believers in learning our companies through-and-through, familiarizing ourselves with the sectors within which they do business, and understanding the general context of the economy around them, without shifting our thesis on outstanding businesses based solely on the ebbs and flows of the macroeconomy.

So where does that leave us with regard to our seemingly very wrong assessment of the general landscape for 2014? Well, given recent stock market performance, we clearly aren't too disappointed in being wrong. However, we do think that we are still far more right than it may appear. While the S&P is off to a great start in 2014, the Russell 2000 is up half as much as the S&P, or 3.26%. This is evidence

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[1] http://www.rgaia.com/december-2013-investment-commentary-our-2014-outlook/

[2] http://www.bloomberg.com/news/2014-06-25/economy-in-u-s-shrank-in-first-quarter-by-most-in-five-years.html

that a few large cap multinationals have been pulling up the vast majority of stocks, while the average stock has been, "quite average," for lack of a better word.

Meanwhile the extremely negative Q1'14 GDP number is far less negative than it appears. Note that GDP numbers go through many revisions before they are finalized. Importantly, this particular Q1'14 GDP number was drastically impacted by the inclement weather affecting much of the country. Typically, GDP moves alongside Personal Consumption Expenditures (PCE), which measures the amount of money that households spend, and while GDP was negative, PCE remained positive All in all, we also still do not know the Q2'14 GDP, and thus cannot speak to the first half in its entirety; however, it's fairly clear from the context of an amalgamation of leading indicators such as hours worked, durable goods orders, and the Purchasing Manufacturers Index (among other reference points) that the economy has/is accelerating rather than slumping.

Taken as a whole, we think our expectation that 2014 will be a better year for the economy than the stock market remains the correct overall framework when constructing portfolios. As we discussed over recent quarters, we continue to carry a healthy cash balance, we have little to no exposure to the momentum segments of the market, and we have built a substantial allocation to global equity markets.

With that being said, let's review our leaders and laggards over this past quarter.

What do we own?

The Leaders:

Platform Specialty Products (NYSE: PAH) +47.14

This is Platform's second consecutive appearance on the leaderboard. When we covered Platform last quarter, we spent most of our dialogue discussing its CEO, Martin Franklin's history and background as well as explaining the company's emphasis on "asset-light, high-touch niche products." This alone made the investment worthwhile from our perspective. Now we think it's worth explaining why this investment remains one to hold, rather than sell after such stellar performance. We have often spoken about feedback loops, and the role positive feedback loops in particular play in economies and markets (we spent extra time on this in our March Commentary).[3]

In essence, the Platform business is an effort to create just such a positive feedback loop. As a roll-up, Platform's strategy involves purchasing high quality businesses for fair-to-cheap prices. Initially,

[3] http://www.rgaia.com/flushing-out-momentum/

Platform was financed with capital from its founders and early investors to make these purchases. As time progresses, these purchases will be financed with a combination of the cash flows from companies it owns, and either debt or equity, whichever is cheaper. As the stock moves higher, equity itself becomes cheaper. Moreover, as the stock moves higher, there is a larger equity capitalization to work with, and use as currency for future acquisitions.

The positive feedback loop works as follows: Platform makes an acquisition that makes its stock more attractive. Its stock then moves up in price reflecting the added value of this acquisition. The higher stock provides more currency with which Platform can make another acquisition. Platform makes another acquisition with its now higher stock, which the market then greets favorably, thus leading to further price increases. Rinse, wash, repeat. Now obviously this type of feedback loop cannot work in perpetuity; however, in certain industries (here we're talking about specialty chemicals), and starting from a small market cap, there is a long runway within which to operate in such a way. Mr. Franklin's track-record suggests he is quite good at this, and we are more than happy to ride his coattails as the stock marches on.

Banco Santander Brasil (NYSE: BSBR) +24.24

We spent some time earlier this year parsing through opportunities in emerging markets. We were particularly attracted to Banco Santander Brasil for its incredibly high quality balance sheet, strong track-record and sharp management team. We also felt Brazil had particularly favorable valuations relative to its peers, and for the most part, its rule of law was less risky than some other emerging markets, like Russia or China. Lastly, we liked that Banco Santander Brasil was a largely owned subsidiary (formerly wholly owned subsidiary) of Santander (NYSE: SAN), a generally well-run Spanish bank.

While we are pleased with Banco Santader Brasil's performance in our first quarter of ownership, we will chalk up the emergence of a recent catalyst to luck. Santander, the Spanish bank offered to buy out all other shareholders in the Brazilian subsidiary for a greater than 30% premium in the form of a stock for stock deal. While the premium sounds quite nice, we think this price is at a substantial discount to where the Brazilian bank could have traded two or three years down the line given a normalization in the business cycle in Brazil, a reorganization of the company's balance sheet to streamline its capital ratios, and the private sector taking an increasingly large slice of the lending market in Brazil as the government pulls back some.

We remain undecided on whether we will own Santander, the parent company in perpetuity; however, we do expect to hold our shares until this position can move to long-term capital gain status. We will do

so because a) we are quite comfortable with Santander itself for now; and b) we think the European environment right now is particularly favorable for its banks. Were these two conditions not present, we would simply sell Banco Santander Brasil and move on; however, we would like to protect as much of our gain as possible from short-term tax consequences while maintaining some potentially nice upside.

Devon Energy (NYSE: DVN) 18.63%

We have owned Devon for some time now and it has made more than one appearance in the laggards section. Consequently, we are quite pleased to see Devon in the leaderboard and comfortably above our purchase price. Devon is an extremely well-run oil and gas exploration company, which has been in the midst of an overhaul whereby the company has been selling off outside of U.S. assets and using the proceeds to purchase higher quality domestic energy sources.

Devon remains well-exposed to natural gas, and has an increasing amount of shale oil exposure. The pricing environment in its core operations continues to improve; all the while management continues to take smart steps in order to mitigate the tax consequences of its transformation and maximizing the realizable value on the disposition side.

Devon was cheap because of its ongoing transformation, but also because of the distressed environment that emerged in natural gas intensive companies following the collapse in prices of natural gas. Companies were pumping out supply and selling at prices below break-even, acting in uneconomic, irrational ways. We liked Devon's capacity to both weather the storm and emerge as an opportunistic purchaser of higher quality assets. So far the company has been delivering on our expectations, though up until this quarter the market had been treating the company as guilty until proven innocent.

The Laggards:

Fiat SpA (BIT: F) -15.25%

Fiat, a frequent leader in our previous commentaries is a laggard for the first time, thus hammering home the lesson that nothing goes up in a straight line. There is little to add to Fiat above and beyond what we have previously discussed; however, it's worth noting that Fiat, this quarter, delivered a quite ambitious 5 year plan. The market has treated the company's ambition as risk, as has been the case from the beginning with its approach towards Sergio Marchionne, though we think this is misguided. Ambition and risk are not even two sides of the same coin. As outlined, Fiat will be investing considerably in expanding some of its premium brands, and in doing so, will require some kind of

fundraising and/or increasing leverage. In this global environment where capital investment has been frustratingly anemic, those companies who do just that can build a sustainable leg up for themselves against competitors into the future with smart investment (key word here being "smart"). Fiat's leadership has proven adept through a variety of challenges, and we think the quality of management will once again shine through as opportunity is pursued.

While the market disagrees at the moment, investment is not on its face a bad thing so long as certain objectives are continuing apace, and sure enough, during this past quarter we got continued evidence that the pivot to luxury brand growth is accelerating. For three quarters running, Jeep has posted its best ever monthly car sales numbers, going back well before the financial crisis, while Maserati this May sold five times as many cars as it did in May of the prior year.[4][5] Admittedly, Maserati is growing from a small base, however its margins are better than those of higher volume Fiat brands and its runway for growth is quite large.

The New York Times Company (NYSE: NYT) -11.16%

Here's another leader turned laggard. We think this move is largely just a little reflex as to how large the gains have been over the past year. Nothing fundamentally drove this move lower, though recently NYT has been caught in the upward drift of momentum and thus was punished when momentum unwound. As with Fiat, there is little new left to be said about The New York Times. The company's transition to a more digitally domiciled revenue strategy continues apace, and there are signs that the decline in ad rates will reverse.

During the quarter, the company fired its Editor in Chief, Jill Abramson, and replaced her with Dean Baquet. While there had been rumors of Abramson's potential departure for some time, the market viewed this as an opportune to sell off and consider the consequences. Separately, though potentially relatedly, an incredibly smart and thorough document covering the company's perspective on innovation in content creation, distribution and consumption was leaked. For anyone with even a passing interest in media, we recommend giving the piece a look for it includes a well-rounded summary of both the history and the landscape today within which the company is operating. [6]

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[4] http://media.chrysler.com/newsrelease.do;jsessionid=DB87995E6A47326A95FE16036AE81A36?&id=15685&mid=1

[5] http://blogs.wsj.com/corporate-intelligence/2014/06/05/for-fiat-chrysler-maserati-is-tiny-and-booming/

[6] http://www.scribd.com/doc/224332847/NYT-Innovation-Report-2014

UCP Inc (NYSE: UCP) -9.23%

We commenced our position in UCP at the tail end of last quarter. UCP is a spin-off from a diversified holding company/insurer, PICO Holdings (NASDAQ: PICO). During the crisis, PICO/UCP bought up lands in California, around but not in the San Francisco area, and in Washington State, around but not in Seattle. Homebuilders struggled in the first half of this year as winter generally speaking is not the real estate "selling season," the particularly cold winter negatively impacted clarity on forward expectations of sales, and the spike in interest rates that started last summer and lasted into the early New Year left many questioning whether it would hurt sales moving forward. That being said, we think an improving employment situation, lower expectation for the trajectory of interest rates, softening of underwriting standards (from extremely cautious to cautious, so not concerning ease), and an expected uptick in household formation all bode well.

Specific to UCP, we think their ownership of valuable lots at low cost bases bodes well moving forward. One of the biggest problems for homebuilders has been a lack of good, developable lots as evidenced by an NAHB survey of homebuilders:

SUPPLY IN YOUR MARKET	Aug. '13	Sep. '12	Mar. '10	Apr. '09	Feb. '09	Aug. '06	Aug. '05	Jun. '03	May '01	Aug. '00	Aug. '98	Mar. '97
Very high	4%	10%	30%	26%	36%	15%	6%	3%	5%	6%	5%	5%
High	10	20	31	46	40	29	15	17	13	16	17	28
Normal	22	21	20	20	12	23	26	34	40	36	35	36
Low	39	31	12	7	5	21	33	28	-	-	19	6
Very low	20	12	4	2	2	9	20	17	39	40	22	23
Don't know/Not sure	6	6	4	-	5	4	-	1	2	2	2	2

Source: NAHB Housing Market Index: Special Questions on Supply of Lots

Given UCP owns an abundance of lots in prime areas, they have a leg up on competition and they also could have strategic value to some larger homebuilders. One factor we particularly like with UCP is that PICO, who it was spun off from, is an owner-operator with a value-driven investment philosophy. Their goal is to create value via their near 58% equity ownership, and in that sense, the incentive structure of

minority shareholders is properly aligned with management. To that end, several noted value shops have also taken substantial stakes in UCP, and we think this creates a stable, long-term investor base.

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,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-7800
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, Esq.
Managing Director
O: (516) 665-7800
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com

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