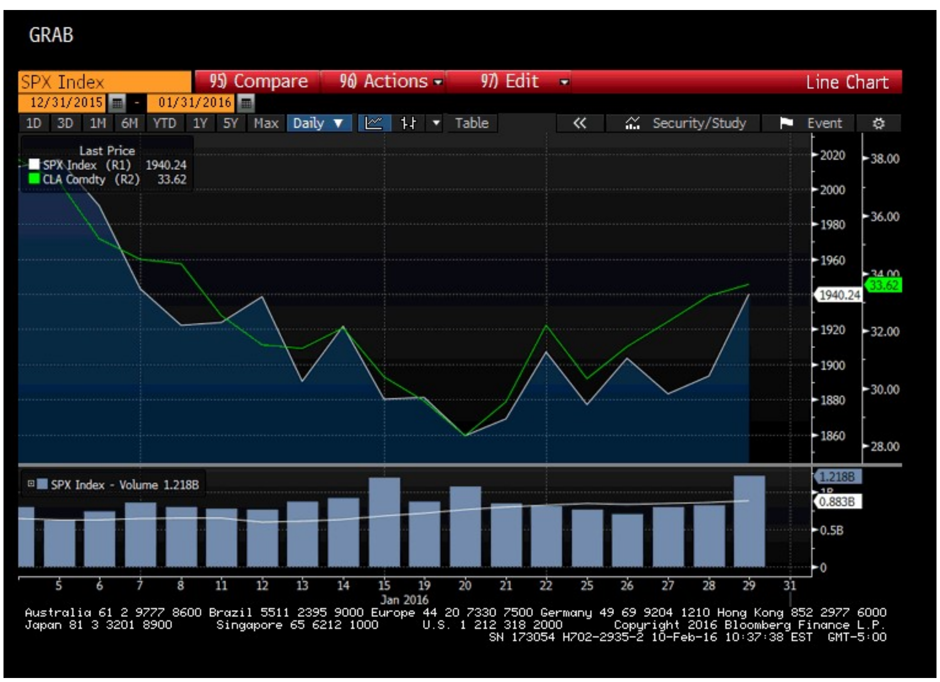
February 11, 2016

Robust Networks for the Long Term

January 2016 got off to a fast start in the wrong direction. The first trading day of the year saw the S&P fall 1.4% and the selling continued from there. The S&P ended the month down 5.0%, though halfway through the month the index was down over 10% year-to-date. In the last 30 years, for the first month of trading, only January of 1990 and January of 2009 fared worse. Meanwhile the S&P 500 in many respects masked a lot of the stock-specific carnage. The Russell 2000 was down 8.5% on the month, with many stocks down in excess of 20%. The performance of a handful of Consumer Staples and the Utility sector helped the S&P appear better than the performance of its constituents.

As the month pressed on, the S&P essentially traded in lockstep with crude oil:



In effect, the fortunes of the market thus far in 2016 have been tied directly to the price of oil. One of the points we have emphasized with regard to oil for some time now is that the benefits of the pronounced drop in price happen in a nuanced way over time: people don't immediately spend their "oil dividend" but they do receive it, and either save it (which is supportive of longer-term investment), or eventually spend it on extra discretionary items. Meanwhile, the negatives are immediate and pronounced: investment in new oil capacity and from industrial companies servicing the sector drops quickly and precipitously.

We think the timing of the selloff this year is suggestive of a force we first referenced in our September commentary entitled "A Liquidation Move."[1] With the turn of the calendar comes a new budget year for countries. Oil wealth nations in need of maintaining their expenditures thus had to come up with a way to patch the hole in their budget deficit created by the sharp drop in oil prices and the rolling off of existing hedges. These states are filling widening budget deficits with the proceeds from the sale of global assets. These flows overwhelm the balance between supply and demand across markets in the short-run.

As markets kept declining, concerns evolved from the oil effect to China and now the banking sector, particularly in Europe. We are hyper-alert to broader economic risks, but maintain our case from the 2016 Preview that strength in the consumer and financial sector balance sheets and the employment situation create a strong buffer against the downside risks in the economy and are supportive of continued growth.[2] We are reminded of renowned economist Paul Samuelson's following quote: "Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties."

Where are the market's mistakes?

Over the past few months we have given a certain kind of company a central role in our portfolios. While as of now we appear early to these investments, we think they are some of the most unique long-term opportunities in the market today. Collectively, we think of them as dominant business and commerce platforms for the future, with proven business models, robust cash flows and large growth runways. We subscribe to the philosophy of buying "Growth at a Reasonable Price" (GARP) and to that end, we think we have found some extremely compelling growth at prices that over the next three to five years should prove very reasonable.

Before listing the companies, let us introduce the traits that they each have in common:

- **Two-sided networks**—these companies all unite sellers of goods or services with consumers, at a scale that is on the one hand, large and defensible, and on the other, very lucrative.

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[1] http://www.rgaia.com/a-liquidation-move/
[2] http://www.rgaia.com/mixedmessages/

- **Capital lean**—these networks require very little incremental capital investment. There is little CAPEX needed for either maintenance or growth. Most of the actual investment flows through the operating line (R&D in some cases, marketing in others), thus actually suppressing what we believe to be the true long-term earnings power of each of these businesses.
- **High margin businesses**—despite investment flowing through the operating line, these companies generate substantial operating profit margins and/or have the capacity to ramp these margins as the businesses further scales top line growth. Further, each incremental customer who buys or a good or is serviced on these platforms has very little incremental cost to the platform itself. As such, revenue growth has two effects: 1) the ramp of growth itself; and, 2) an upward pull on margins.

Here are the companies in alphabetic order:

- eBay (NASDAQ: EBAY)
- Envestnet (NYSE: ENV)
- Grubhub (NASDAQ: GRUB)
- Priceline (NASDAQ: PCLN)
- PayPal (NASDAQ: PYPL)

Three of these are large cap companies, while two of them are small cap companies. Notice that while these businesses have the aforementioned similarities, all are very different and serve unique end markets with little overlap in the drivers of demand and thus macroeconomic risk. The end products are general goods and services, asset management, food delivery, travel and payments.

The most sensitive of this batch to the economic and market actions of January is Envestnet since it generates a material portion of its revenues from asset-based fees. Declining asset prices puts downward pressure on investment manager's billings, which is a near-term concern; however, the secular growth driver of brokers and their assets shifting to Registered Investment Advisors offsets these short-run market declines. Plus, licensing revenues with very sticky, recurring relationships (upwards of 95% renewal rates) have been growing as a share of the business, cushioning the reliance on asset prices. eBay, Priceline and PayPal are global companies with exposure to currency fluctuations. While these moves are a headwind to growth in the near-term, currency effects have a strong tendency to balance out over the long-term.

Importantly, all of these companies benefit from secular trends that will persist regardless of what happens to markets or the economy in the short-run. In fact, certain kinds of economic disruption could further advance the businesses of the two with financial exposure (Envestnet and PayPal) as people look to new solutions for old problems that are not being solved by the legacy players. All have relatively low multiples and are cheap using conservative assumptions within an appropriate timeframe in our Discounted Cash Flow (DCF) analysis. Each has multiple drivers of growth (typically users and activity per user) which compound on each other and offer extra leverage to revenues moving higher.

In markets like these, people sell what they can, not what they want to. In our November 2014 commentary, we first warned of "the oil investors who don't even know it."[3] While recognizing this reality was a helpful lens through which to view potential troubles in High Yield in particular, we did not anticipate the extent to which everyone would effectively be an "oil investor" at the behest of Sovereign Wealth Fund sell orders. Needless to say, it has created some unique opportunities where investors are throwing out some precious babies with the dirty bathwater.

In our October 2013 Investment Commentary[4], we referenced Benjamin Graham's observation that "in the short run the market is a voting machine, but in the long run it is a weighing machine." We noted that, this game of arbitrage is reflective of an important market reality: the short-term is the arena of randomness, while the long-run is the home of the investor. During these days of uncertainty, fear, and randomness, one must focus on the long-term, with an emphasis on the fundamental values of businesses that are best positioned for tomorrow.

[3] http://www.rgaia.com/the-oil-investors-who-dont-even-know-it/
[4] http://www.rgaia.com/october-2013-investment-commentary-our-actively-passive-investment-strategy/

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 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

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