“Management is doing things right. Leadership is doing the right things.” Peter Drucker

14th of April 2023

Dear Clients and Friends,

Our portfolios enjoyed a solid Q1 2023 as we saw meaningful gains across many of our holdings. Even with the year-to-date gains, we believe that many of our holdings remain undervalued. The underlying business fundamentals are strong and the management teams are best-in-class. Across our portfolio companies, we see an increased focus on cost management and thoughtful capital allocation, which should translate into earnings growth in 2023 and beyond.

In Q1, the S&P 500 rose 7.5%, with communications, consumer discretionary, and technology sectors performing well, and healthcare, energy, and financials lagging. In times like these, in which sectors rapidly and unpredictably fall in and out of favor and macroeconomic concerns dominate investor psyche, we believe that our bottoms-up, flexible approach to portfolio construction provides several key advantages.

First, our stock selection is not constrained by market capitalization. Great investment opportunities are agnostic to company size. By maintaining the flexibility to invest across market capitalization, we can pursue what we believe are the best investment opportunities of any size.

Second, we do not limit our portfolios to specific market sectors. By owning what we believe are the leading businesses across sectors, we gain exposure to the best companies without needing to predict which sector might be in favor next quarter.

Lastly, we benefit from our long-term orientation. Many investors are captive to short-term results, which can lead to high portfolio turnover, transaction costs, and unfavorable tax treatment. We maintain a long-term view on our investments, allowing us to tax-efficiently compound our capital with minimal transaction and trading costs.

While we maintain the flexibility to invest across market capitalization and sector over a longer-term time horizon, we remain disciplined on our standards of business and management quality. Every prospective investment, irrespective of size or industry, must meet our high standards for a competitively advantaged, durable business model and strong management team. Likewise, we remain steadfast in our pursuit of investment returns. No matter how great the business or the management, we will only invest when we believe the investment is a great value and will allow us to generate attractive potential returns.

FINANCIALS

Over the years, steady increases in book value, dividends, and buyouts have made bank stocks a good investment area for us. However, in Q1, banks were particularly weak performers, with the KRE Regional Bank ETF declining 25%. The rapid rise in interest rates sparked two primary investor concerns: 1) higher interest rates would impair the value of a bank's held-to-maturity securities portfolio, causing book value write-downs; and 2) higher interest rates would increase the rate that banks would need to pay to retain deposits, thereby eroding net interest income and bank profitability. While our bank holdings declined in Q1, we fortunately did not own any of the banks that collapsed due to losses in their bond portfolios or concentration of deposits.

We seek to invest in banks with great management, leading cultures, solid balance sheets, and strong market positions. This recipe has served us well over time. Across our portfolio, the Price/Earnings and Price/Book value ratios of our financial holdings are far below historical levels, giving us confidence that our bank holdings have meaningful upside potential.

JP Morgan ("JPM") is one of our bank holdings that meets our investment criteria. In 2022, J.P. Morgan generated $132.2B in revenue, $37.7B in net income, and an 18% Return on Tangible Common equity. JPM has grown tangible book value per share from $15.35 in 2004, to $73.12 in 2022, a 9% compound average annual growth rate. JPM is diversified across banking and asset management and maintains a fortress balance sheet. We believe that the management, led by CEO Jamie Dimon, is among the best in banking. During the recent sell-off in banks, JPM outperformed the broader bank indexes due its financial strength and conservative approach. JPM currently trades at only 10x E2023 Price/Earnings, an attractive valuation for a strong banking franchise.

We have experienced many banking crises over the years, and while each crisis looks different, the fundamental qualities that enabled banks to withstand the crises have not changed. Banks that are well-capitalized, well-managed, adequately reserved, and diversified across their credit portfolio and deposit base have survived and emerged stronger. We believe that our banks have these qualities and that our bank stocks will recover as the crisis subsides.

GREAT MANAGEMENT

During challenging economic periods, the value of great management shines brightest. Given that the quality of the management teams of our companies underpins our-long term confidence in our portfolio, we felt that it might be helpful to share a little more detail on what we think makes a great management team.

First, we look for management with a clear, demonstrated history of shareholder value creation. As public market investors with a non-control passive stake, we cede control of all major strategic and operating decisions to the management. We must be confident that the managers of the businesses have our interests at heart. A demonstrated record of shareholder value creation is a strong indicator of management competency and shareholder orientation.

Second, we look for managers with integrity and good character. This may sound trite or obvious, but it never ceases to amaze how often we see the managers of public companies operate with questionable business practices. This can range from aggressive accounting to self-interested financial dealings. We demand that management conduct their business ethically, abiding by appropriate standards of accounting, corporate governance, and financial reporting.

Third, we expect management to be transparent and forthcoming about problems and challenges. We appreciate that a key part of management's job is to sell investors on their vision of the future and maintain investor enthusiasm. However, we also know that business performance can be lumpy and difficult periods are inevitable. We want management to shoot us straight, be forthcoming about challenges, and avoid being overly promotional. We find that the management teams grounded in reality often deliver better results.

Lastly, we seek management who recognize that their responsibilities as leaders extend beyond the stock price. Great management cares about their customers, employees, and communities. They recognize that being a good corporate citizen is not only the right thing to do, it is also good business.

While we cannot predict how the economy or the market will perform over the next few quarters, we are confident that the management teams of our companies will make thoughtful, rational business decisions that aid our quest to achieve strong long-term investment returns.

Sincerely,

Ben Weiss

Tom Eidelman

Ben Weiss, JD
Chief Investment Officer

Tom Eidelman, CFA
President

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