February 2019

Dear Client,

Enclosed are the return calculations for your account(s). Where applicable, three, five, ten-year and returns since inception are included as well. The S&P 500 returned -4.38% including dividends in 2018. Our composite returned -8.87% in 2018 (individual results may vary). Since inception on 01/01/2000, our composite has returned 277% vs. 146% for the S&P 500 with dividends. That represents a compound annual return of 7.24% for the composite vs. 5.14% for the S&P 500 with dividends.

The major stock market averages spent the bulk of 2018 solidly in positive territory until a late year sell-off - including a ten percent decline in December alone - pushed the averages sharply lower. Among the stocks that declined the most were the big-name tech stocks which had been the leaders of the last few years. In fact, it wouldn’t be much of an exaggeration to say that not only have they been the leaders, but they’ve been virtually the only game in town as almost all other stocks, particularly small and mid-caps, have performed poorly. Far from being a disappointing development, this bifurcation of the market into two camps: a few large cap glamour names and everything else, has created some exceptional opportunities for the patient investor.

In last year’s letter we discussed the short-term effect of algorithmic trading and the increase in passive investing on stock prices, noting, that the flow of investment dollars is often entirely mechanical with little attention paid to business value. Both trends continued and grew in 2018. In our opinion this has served to make the overall market less efficient at determining rational business value for many publicly traded companies and created a favorable environment for buyers of businesses at discounts to their intrinsic value. We took advantage of these favorable conditions and added several new names to our managed accounts in 2018.

Among the additions was Discovery Communications. Following its merger with Scripps, Discovery is a leading provider of non-scripted entertainment content including HGTV, Food Network, TLC, Travel Chanel and others. After incorporating cost synergies from the merger, we expect Discovery to generate over four dollars per share in free cash flow. Our average cost is below $25 per share, implying a free cash flow yield of 16%. This is dirt-cheap (imagine a bond yielding 16% and growing). The depressed share price is a result of the conditions outlined earlier and the concern that as customers abandon the traditional video cable TV bundle, Discovery will have trouble migrating the content to other platforms; the so-called “skinny-bundle”. Our purchase is based on the belief that the decline in video subs will be less than feared and that quality content will find willing buyers/subscribers in any environment. The current price implies a catastrophic fall-off in subscribers and earnings. We think neither are likely.

Another addition was Mohawk Industries, the world’s largest flooring company. Mohawk manufactures and sells carpets & rugs, ceramic, wood, laminate, stone and luxury vinyl tile (LVT). The company operates in 160 countries, has almost $10 billion in sales and will generate approximately $860 million in free cash flow in 2018. With about 71.5 million shares outstanding, that works out to about $12 per share implying a free cash flow yield of 9.5% at the current price of $126. The shares began 2018 at $275 and fell steadily throughout the year on a combination of production glitches, softer than expected demand and earnings disappointments. We bought our shares not on our expectations of the next quarter or even next year’s earnings, but on the probability that the production glitches would be remedied over time, demand would improve and the company would likely repurchase shares aggressively with the robust free cash flow.

Other notable additions include Evoqua Water Technologies and Stericycle. Evoqua is a Pittsburgh based company engaged in a broad variety of water treatment solutions. We became aware of the company through our research in Calgon Carbon, a competitor and earlier successful investment. Evoqua began 2018 at over $23 per share and after a series of earnings shortfalls, fell to under $9 per share. Evoqua operates in growing and attractive end markets and should be able capitalize on its broad portfolio and one-stop solutions for water treatment. With a market capitalization of about $1 billion and based on comparable multiples for similar companies, it also remains an attractive acquisition for a larger company at the current depressed valuation. Stericycle’s principal business is the treatment and disposal of medical and hazardous waste. The company is also engaged in secure information destruction and compliance services. After many years of growth and good performance, this once former high-flyer’s shares peaked at $150 per share in late 2015. Then began a series of merger challenges, pricing issues and problems with a new enterprise resource planning integration. By late 2018 the shares were trading for under $40 per share. Despite the aforementioned issues, the company was still highly profitable and is expected to generate in excess of $325 million in free cash flow, or almost $4 per share. We believe the bulk of the issues cited earlier have been resolved and that growth can resume. In the meantime, the company can employ its prodigious free cash flow in shareholder friendly ways.

Although it's never pleasant, almost all investment strategies experience periods of underperformance. Lately, the "value" style has been out of favor. Our strategy continues to be one of buying good businesses at reasonable valuations. In addition, we make sure the businesses are run by capable and honest people who are not only good managers, but skilled at making prudent capital allocation decisions. Repeating this process with a portfolio of 15-20 companies sharing those attributes will almost certainly yield good results over time. Share prices of good businesses do not stay at discounted valuations forever. Eventually, either the market recognizes the favorable economic characteristics of a company, another company offers to merge on favorable terms, or a buyout entity makes an offer. Attractive assets and cash flow will always find a buyer.

Please feel free to contact us with any questions or comments. As always, we thank you for your trust and patience.

Very truly yours,

Eckart A. Weeck
Senior Managing Director