Sweetbay Capital Management, LLC

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Volatility: A Source of Returns

The first half of 2016 was marked by elevated volatility in stock markets globally. Embracing the inherent volatility of stocks as opportunities to improve our expected returns is core to our strategy. We invest in companies with sustainable competitive advantages and good balance sheets - companies that we believe become more attractive investments when share prices decline.

The conventional view that volatility is risk is, in our opinion, ill-founded. A company's market price can deviate significantly from its intrinsic value, which tends to exhibit only modest variability. Eventually, the fundamental value of a business and its stock price converge. A longer investment horizon negates short-term market price fluctuations. Since 1926, the probability of experiencing losses in the S&P 500 over five-year periods was 56% lower than for quarterly periods.[1] Yet time horizons have gotten much shorter. New York Stock Exchange data shows that the average holding period for stocks traded on the NYSE has fallen from eight years in the 1960s to around one year currently.

Investing in stocks while keeping one hand on the sell button can be costly, as was illustrated vividly in a 2014 study that compared the performance of mutual funds to the returns of investors in those funds.[2] From 1994 to 2013, the average annualized return for U.S. diversified equity mutual funds was 8.7%, which compared to just 5.0% for the average fund investor. *Abandoning funds after poor performance and chasing funds following good performance led investors to receive less than 60% of the underlying mutual funds' returns.* It is our belief that those who understand the detrimental effects of short-term behavior can make better decisions and will ultimately find themselves in a much stronger financial position than if they allow themselves to be affected by swings in market prices.

Our Search for Value

We allocate capital based on our fundamental analyses of individual companies, and only when we perceive a discount to fair value that is likely to close over our three- to five-year investment horizon. In order to determine where investment opportunities may be the greatest, we begin our search by assessing valuations of various markets and asset classes on an absolute basis. A broad perspective can capture value opportunities even during times of speculative mania. For example, at the height of the U.S. technology bubble in 1999 and 2000, the S&P 500 and Nasdaq Composite indices were trading for excessive price-to-earnings multiples of more than 30x and 100x, respectively. While many U.S. stocks were swelling with speculation, the MSCI Emerging Market stock index was trading at a price-to-earnings ratio of just 10x, and commodities such as gold and

[1] nickmurraynewsletters.com, Returns 2.0
[2] *Quantitative Analysis of Investor Behavior* by Dalbar Inc (March 2014) and Lipper

oil were trading at large discounts to production costs. It was cheaper to purchase commodities than it was to produce them, as it is again today! Over the following years, shares of companies in emerging markets and those of commodity producers performed markedly better than the U.S. indices. Even within the U.S., shares of many companies not tied to the Internet mania, such as financial services and industrial companies, remained moderately priced during the tech bubble, and performed well as aggregate stock market valuations subsequently fell back to earth.

The stock market is currently bifurcated, as it was in the late '90s. While many technology, consumer staple, utility and real estate companies are trading at rich valuations, we are finding compelling opportunities in other areas. We construct the foundation of our portfolios with reasonably-valued, high quality and relatively stable businesses that we believe have enduring competitive advantages. Examples include Disney, Apple, Verizon, Pfizer and MasterCard. Each of these businesses improves as customer usage increases, which attracts still more customers. This phenomenon creates a virtuous cycle of strength. For example, MasterCard's payment network strengthens as more retailers accept MasterCard, which drives banks to issue more MasterCards, which leads to more customer usage, and more retailer acceptance. We expect these investments will be tax-efficient as long-term holdings, and the relative stability and consistency of their businesses should counteract some of the volatility from our investments in more cyclical companies.

For the balance of our portfolios, we look for quality companies with cyclically depressed earnings. Magnified reactions to variations in earnings can cause stocks to trade at large discounts to intrinsic value. Once the emotional smoke clears, a company's sound fundamentals come back into view. This dynamic can create unique opportunities to invest at bargain prices in companies with stable book values but slumping earnings.

One example can be found in the U.S. banking industry, which is trading far cheaper than historically as low rates and the flat yield curve weigh on earnings. Earlier this year we bought shares of Bank of America, which is the country's largest depository institution and an essential part of our economy. We paid 54% of book value, compared to an average pre-financial crisis multiple of 200% of book value. Over the last eight years, leverage has fallen by half as increased regulatory capital requirements have improved the strength and resilience of U.S. financial institutions. The company is now better capitalized than it has been in decades. Having just passed the most stringent stress tests conducted by the Federal Reserve, the bank increased its capital return plan by 50%. We believe Bank of America's book value per share should be relatively stable and buying shares at a large discount to stable book value should limit downside risk, even in the event of a prolonged period of low rates. If the yield curve normalizes, the bank's earnings will soar, and we believe shares will trade for a premium to book value, as they have historically. While we wait, book value will grow from even depressed earnings and accretive share repurchases at discounts to book, and we collect a dividend.

Another company in which we invested during the first half of the year is Antero Resources, a natural gas producer. The decline in energy stocks in the first quarter created opportunities for long-term investors to acquire shares of higher quality, cost-advantaged companies at discounted valuations. Shares of Antero sold off along with the rest of the industry, despite significant differences in the quality of its assets and strength of its balance sheet. Natural gas prices are depressed due to a mild winter and excess supply. The price of natural gas is now at a substantial

discount to both the marginal cost of production and the price of oil on an energy-equivalency basis. In response to depressed prices, the natural gas rig count has fallen 94% from its peak to the lowest level on record. Demand has continued to grow, driven by electric power usage. According to the U.S. Energy Information Administration, coal's share of U.S. electric power generation declined from 50% in 2005 to 33% in 2015, while natural gas increased from 19% to 33% over that time period. In time, the combination of production declines and demand growth should relieve excess supply and bring the market back in balance.

We only invest in oil and gas companies with low production costs and good balance sheets that can withstand commodity cycles. Antero has one of the largest land positions in the Marcellus shale, where the geology provides a production cost advantage over nearly all natural gas basins around the world. Antero's equity capital is also well protected by its hedge position, which is by far the largest in the industry. The company has hedges in place to provide a profitable, minimum price for the majority of production through 2022, including protection for 100% of its production over the next two years at prices about 50% higher than current spot prices. In comparison, the rest of the publicly-traded natural gas producers average hedges on just 15% of 2016 production and 7% of 2017 production. We believe the strength of the company's assets and balance sheet make Antero an ideal investment vehicle to capitalize on a depressed natural gas market.

By combining investments in cyclically depressed companies that are well-capitalized and defensible, such as Bank of America and Antero Resources, with a core foundation of more stable and predictable businesses, we build portfolios with a distinctive marriage of value and quality. We believe our long-term horizon is key to our investment process, and we are personally invested alongside clients in every security we buy on their behalf. Like the Magnolia tree we planted for which our firm is named, we expect the companies we invest in will grow stronger with time.

Please contact us with any comments or questions.

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Important Disclosures:

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