January 2017

The Case for Active Management

Sweetbay ended 2016 on a strong note, driven by our investments in bank stocks, which constitute our largest industry exposure. We are pleased with Sweetbay's early results and continue to be excited about investment opportunities we are finding globally.

One thing we are often asked about is active versus passive management. Never has the debate been as prevalent as it is today, as evidenced by recent headlines in *The Wall Street Journal,* including "The Dying Business of Picking Stocks" and "Are Fund Managers Doomed?". The market share of equity ETFs has nearly doubled in the last eight years; about $1 trillion has flowed into passive funds, while about $700 billion has flowed out of active funds, according to the Investment Company Institute.

We recognize that a case for active management, when made by active managers, may raise a few eyebrows. But we have a choice as to how we manage our own money, and we believe a well-defined active strategy is in our family's best interest. In spite of the messenger, we hope the facts will be audible above the fever pitch surrounding passive investing.

One factor that has contributed to the criticism of active management is the rise of closet indexers, mutual funds that charge an active management fee but closely mimic an index. Closet indexing, which essentially didn't exist before 1990, has grown to more than 30% of U.S. mutual fund assets.[1] Another factor is high fees that eat into investor returns. In the past 30 years, hedge funds and private equity assets have increased from less than $100 billion to more than $6 trillion, infusing high fees across a much greater swath of the industry. In addition, the investment advisory business has become increasingly segmented, resulting in more layers of fees for investors.

In the active versus passive debate, actively managed investment strategies are typically grouped together, overlooking the many managers who beat their benchmarks over long periods of time. We believe a key factor in long-term outperformance is an investment process that is independent of the market. Actively managed strategies with high Active Share (minimal overlap with a stock index) and low portfolio turnover outperformed their benchmarks by more than two percentage points annually from 1990-2013.[2] At Sweetbay, our Active Share is over 95%, our turnover is minimal, our fee structure is transparent, and the average returns of the stocks in which we have invested since inception have significantly outperformed the broader stock market.

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[1] *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, Martin Cremers, International Center for Finance, Yale University, March 2009.

[2] *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently*, Martin Cremers, University of Notre Dame, December 2015.

It is worth noting an interesting connection between interest rates and active performance. According to Nomura Securities, active managers have historically beaten their benchmarks during periods of rising interest rates. When rates increase, correlation tends to decrease. From 2008 to 2016, correlation was high for the S&P 500. The Fed's accommodative monetary policy during that period helped lift the entire equity market, making it more difficult for stock pickers to outperform. High correlation has meant that shifts in the market valuations of certain stocks have not necessarily been tied to the underlying companies' fundamentals. As noted by Strategas Research Partners, correlation started 2017 at a ten-year low, measured on a 65-day rolling basis. This shift should continue as the Fed moves further away from its easy monetary policy.

We think the ebb of correlation will expose certain risks and opportunities. Holders of index funds and ETFs have broad market and industry exposure, resulting in investments in the most expensive and most highly levered companies in the market. The risk of broad exposure seems particularly acute now, after an eight-year bull market. Our conservative portfolio positioning will allow us to take advantage of any potential dislocations in the market. We continue to believe the stock market is bifurcated; in 2016 the spread between the cheapest and most expensive quintiles of stocks reached its second widest level in 50 years, according to Sanford Bernstein. There are currently opportunities in high quality and well-financed companies that are out of favor and therefore trading at attractive valuations. Our strategy allows us to focus on the long term prospects for these companies. We are also starting to find interesting opportunities in Europe and Japan, where markets are generally cheaper than in the U.S.

We build relatively concentrated portfolios of 25-30 stocks of our best ideas across various industries, as we don't believe our 50th best idea deserves an allocation. Such broad diversification is unnecessary and reduces the time we can otherwise spend on better understanding a smaller group of companies. We avoid companies with excessive financial leverage, as well as those that have unproven business models or are in secular decline. Importantly, we personally invest in every security that we buy for clients. Our strategy allows for multi-year holding periods, which minimize portfolio turnover and maximize tax efficiency. We believe this is the optimal method to grow wealth over the long-term.

Portfolio Activity

In the second half of the year, we initiated a new position in National Oilwell Varco (NOV), our fifth investment in the energy industry. Over the last two years, oil and gas price volatility has led to periods when the price of the commodity was materially less than its cost of production, creating opportunities to invest in well-capitalized companies at attractive prices. We believe natural decline rates for producing wells, combined with slashed investment in new wells - the global rig count declined 60% from its highs in 2014 to its lows in mid-2016 - should eventually balance the market. We believe production costs, which have experienced a recent cyclical decline due to overcapacity of drilling related services, should continue a secular rise over time due to the increasing difficulty of accessing reserves. The industry has progressed from lower cost conventional production, which peaked 40 years ago, to the exploration of reserves in deepwater, oil sands, shale, and the arctic. These new frontiers have posed greater technological challenges that have pushed costs higher.

National Oilwell Varco, an oilfield services company, exemplifies our preferred energy investment attributes: dominant and stable market share, balance sheet strength, and a cyclically depressed business that is weighing down the shares. National Oilwell's huge installed base, with technology in nearly every wellbore in the world, drives a large and recurring aftermarket business. Nine of the eleven longest wells in the world were drilled using NOV drill pipes and connections. It has 6,500 engineers, and the largest manufacturing, repair and maintenance capacity in the industry. It services clients through a global network of distribution and service facilities that help minimize costly downtime for customers. All of this adds up to a formidable competitive advantage.

None of these business characteristics would matter if National Oilwell didn't have the financial strength to survive a full commodity cycle. Its strong balance sheet is also a key consideration for customers when contracting for the construction of new drilling rigs. At the end of the third quarter of 2016, National Oilwell had $1.5 billion of cash against $3.2 billion of debt, only $500 million of which is due before 2022. The company generated $1.5 billion of free cash flow in the past seven quarters, during the worst energy recession in 30 years. An embedded defensive feature of National Oilwell's distribution business is the countercyclical nature of its working capital flows. The company extracted over $900 million from net working capital in the first nine months of 2016, leaving a balance of $4.6 billion, excluding cash. We believe the shares, currently priced around $38, offer good value relative to peak earnings of $6.07 and $4.90 in the last two oil cycles.

Other portfolio activity in the second half of 2016 included an increase in our position in Fastenal (FAST), a distributor of industrial supplies including fasteners, tools, and safety equipment for various manufacturing and construction applications. Fastenal is an entrenched, cash-generative business with a strong balance sheet. The company has generated positive free cash flow every year since 1998, and net debt to EBITDA is just 0.3x. Due to recent economic weakness, especially in areas of the U.S. economy negatively affected by weak oil prices and the strengthening dollar, the earnings multiple for its shares declined last year to 20x, its lowest level in 16 years. We seized on the opportunity to invest in a great business at a reasonable valuation.

Switching industrial suppliers is expensive and disruptive because of the number of SKUs involved. Fastenal fortifies that natural advantage through its excellent customer service and tight expense control. The remarkable consistency of its business through economic cycles highlights the strength of its franchise. Margins since 2005 have ranged from a low of 15.4% ('09) to a high of 21.5% ('13), and returns on equity have averaged 23% without the use of leverage. ROE was below 20% in only one year. The consistency holds true even looking back over the past 25 years. Gross margin was 50% in 2016 and 53% in 1989. Pre-tax margin was 20% in 2016 and 17.5% in 1989. Over that time, pre-tax earnings have grown over 100-fold, while the share count has remained constant, adjusted for splits. Co-founder Bob Kierlin was adamant that shareholders should not have their ownership diluted.

Fastenal's frugality began with Kierlin, who was CEO until 2002. He was famous for driving around the country in a company minivan because it was cheaper than flying, staying in budget hotels, wearing second-hand suits, using second-hand furniture in his office, and opting not to have a secretary. He made sure that culture filtered down to employees; even late in his career when his shares were worth more than $200 million, he and his CFO, Dan Florness, would split hotel rooms. Florness is now CEO. Bob Kierlin and former CEO Willard Oberton both attribute the company's

success to its development of people, who are empowered to make decisions at the local level. We believe Fastenal's culture, combined with a modernized inventory management and distribution infrastructure, will drive continued market share gains in an industry still dominated by mom and pop operators.

Our only sale during the period was WCI Communities (WCIC), which we exited after it was announced that the Florida home builder is being acquired by a larger rival, Lennar (LEN). WCI exemplified the excesses of the pre-2008 housing bubble. The company's reliance on speculators to absorb supply from its aggressive pace of condo tower construction ultimately led to its bankruptcy. Fresh-start accounting rules required WCI, upon exiting bankruptcy, to mark its assets at 2009 values, which were depressed. Our investment thesis was based on our belief that book value was understated. The collapsing of the credit markets eliminated the speculators, and WCI's bankruptcy cleaned up its balance sheet, so we considered this a relatively low risk way to arbitrage the difference between book and market values. Clients realized a double digit annualized return on the investment.

As always, please reach out to us if you have any questions or comments.

Sweetbay Capital Management

Important Disclosures:

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