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> *"You must be sure that you don't listen too much to your competitors…you have to be prepared with the independence of viewpoint to be able to go against the crowd, to do the opposite of what almost all people are doing, including the experts. Otherwise you don't get in at a bargain price."* - Sir John Templeton

Joel Greenblatt, founder of Gotham Capital and professor at Columbia Business School, tells the story of a lecture he gave to a group of 9th graders. Greenblatt passed around a jar full of jelly beans and had each student take time to study the jar and estimate the number of beans. After collecting the written responses, he went around the room and asked each student to publicly state an estimate. The written responses averaged 1,771, and there were 1,776 beans in the jar. The verbal guesses averaged 850. He explained to the kids that the written estimate was fundamental work, while the verbal estimate was akin to the stock market, where prices are influenced by the opinions of other investors.

We are seeing that phenomenon play out as investors are currently more worried about missing the next rally in stock prices than they are about the bulging mound of risks they've swept under the rug. Examples are everywhere; here are just a few:

- Duke Energy (DUK), one of the biggest utilities in the country, has largely grown through aggressive acquisitions at the expense of its balance sheet. Over the last decade, its leverage has more than doubled from 3.1x EBITDA to 6.6x EBITDA. Little benefit has fallen to the bottom line; per-share earnings haven't grown in eight years. In a particularly stark case of market distortion from easy monetary policy, investors in search of dividend yield are paying a multiple of earnings at the high end of its historical range. The shares trade near an all-time high price based on an analysis that ignores the weight of debt and the potential fall in wholesale power prices from a growing supply of renewable power, as has occurred in Europe.

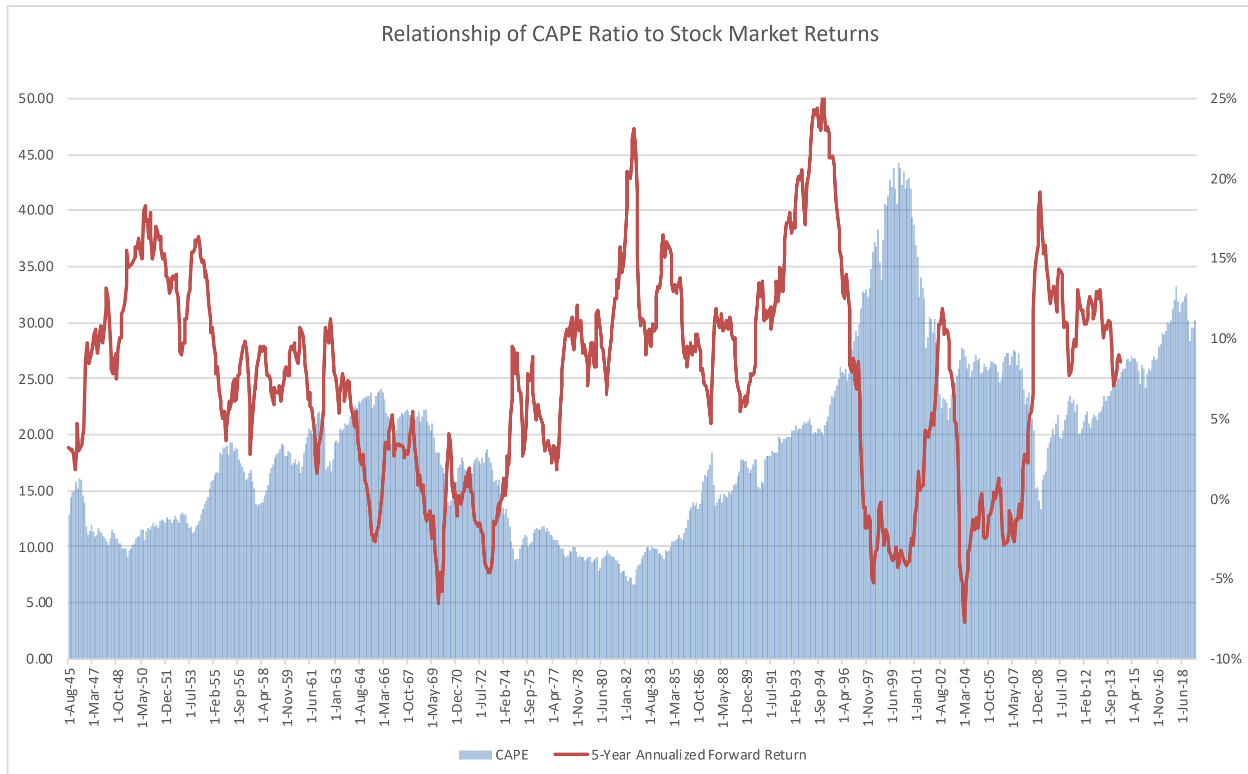
- Netflix (NFLX), the popular video streaming service, trades for a market value of $164 billion, or 137x its 2018 net earnings of $1.2 billion, which are overstated. On an operating basis (before capital expenditures), Netflix burned $2.7 billion of cash last year, and just shy of $6 billion over the last three years, compared to $2 billion in reported earnings over that time period. Any forensic accountant will raise a red flag if a company's operating cash flow trends lower than net earnings. Netflix owes its predicament to heavy spending on content to compete with its competitors'

libraries. Disney, Time Warner, Discovery, AMC Networks, and Lionsgate all produce content and all generate operating cash flow that is comfortably higher than net income. For Netflix, guidance of increased cash burn to $3.5 billion this year, net debt of $7 billion, and $19 billion of content obligations, including $10 billion off-balance sheet, are inadequately supported by run-rate EBITDA of $2 billion. That should not be an acceptable trade-off for the company's 22% revenue growth that investors covet. With the shares trading at nearly 10x sales, it seems an awful lot has to go right for investors to realize an attractive return from the current price. Instead, what if things get a little more challenging? Netflix may have been first to the streaming game, but competition is rapidly accelerating, including from behemoths such as Amazon, Disney, and NBC. In starting their own streaming services, the latter two competitors are removing their most popular content from the Netflix platform.

- Carmax (KMX), the nation's largest retailer of used vehicles, is essentially a monoline consumer finance company. US consumer credit as a percent of disposable personal income has increased from 18% to 25% in the last 20 years, according to the Federal Reserve Bank of St. Louis. Low interest rates have helped to counteract the effect of higher debt levels, enabling Carmax to triple the size of its loan portfolio since 2009. But consumers' stretched state has begun to reveal itself. Loan delinquencies for Carmax customers have been rising for five years and, despite lower interest rates and unemployment, are currently higher than at the peak of the last recession when its earnings per share and stock price both declined by 70%. Investors, ignoring the severe cyclicality of auto finance, have bid up the share price to an all-time high.

These sorts of mispricings have become widespread due to an extended period of transient volatility in stocks, thanks to coddling from the Federal Reserve. But that acts to fuel further market distortions, on which Jim Grant, publisher of Grant's Interest Rate Observer, has challenged the Fed. "I think this is becoming less about Keynes and more about Pavlov. The market has been conditioned to demand a rate cut when it feels a little weak in the knees, and the Fed has been inclined to so grant." He recently asked John Williams, president and chief executive officer of the Federal Reserve Bank of New York, "given the well-known tendency of very low rates to insight speculation and the misallocation of resources, and given the well-observed tendency of the Fed to intervene to quash difficulties in the market, is not the Fed now operating on the de facto dual mandate of arsonist and fireman?"

This dynamic has contributed to speculative stock prices. Even companies that are popular with their customers, like Netflix and Carmax, are not good investments at any price. When prices are bid up, future returns are lower, as illustrated in the following chart, which shows an inverse correlation between the Cyclically Adjusted Price to Earnings (CAPE) ratio and forward stock returns. When the CAPE ratio has been at or above the current level of 30x, US stocks have posted negative returns on average over the subsequent five-year periods. Investors who bought stocks at lower than average CAPE ratios would have had 50% greater cumulative returns over five years than investors who bought stocks at or higher than the current CAPE ratio.



Source: Professor Robert Shiller, http://www.econ.yale.edu/~shiller/data.htm

That investment returns are acutely impacted by the price paid in relation to the value received is unlikely to come as a surprise to anyone, but it begs the question: where can investors find good value today? While the overall US market is richly valued, select opportunities remain, as we've detailed in prior letters. Additionally, in certain countries in Europe and Asia, average share prices are half those in the US, as measured by multiples of book value, sales, cyclically-adjusted earnings, and dividend yield. From one of those markets came our only new investment in the first half of the year, described below. BNP Paribas is the ideal combination of enduring business and shunned stock, presenting an opportunity to invest at what we consider a bargain price.

New Investment

BNP Paribas

BNP Paribas (BNPQY) is Europe's second largest bank, with the leading corporate banking and cash management franchises in Europe, and the top private bank in both France and Belgium. Banking is a business we favor because the layering of additional services acts to tighten customer relationships. That's exactly how Yann Gérardin, head of BNP's corporate and institutional banking division, approaches market share. He onboards new clients through a simple offering, such as cash management, and "if we are clever enough, next year you'll use us for foreign exchange, and then maybe an interest rate hedging product, and a bond issue after that," he says.

European banks are terribly out of favor with investors, mostly due to sluggish economic growth in Europe, low or negative interest rates in many countries across the continent, and a doubling of

regulatory compliance costs and capital strengthening in the wake of the 2008 financial crisis. BNP Paribas weathered that period better than most, with only a 10% decline in book value in 2008. Since then, it has fortified its balance sheet, carrying half the ratio of assets to equity as in 2008. It has also become less reliant on short-term wholesale funding; stickier deposits have doubled as a percent of liabilities from before the recession. It easily passed the 2018 stress test conducted by the European Central Bank, which concluded that the bank would maintain excess capital in a severe recession, and that its capital ratios would be significantly less impacted than the average of the 48 banks tested. Despite retaining earnings to strengthen its balance sheet, BNP Paribas has still managed steady growth in book value per share, totaling 60% over the last ten years.

Jean-Laurent Bonnafé, CEO since 2011, does not have an aggressive approach to growth that can be toxic in banking. He is not tempted by industry chatter that Commerzbank, Germany's #2 player, is vulnerable to a takeover. His discipline was evident from comments he made during an interview last year. "This is not about becoming a champion. This is not the Olympic Games. This is banking. Banking is about history and numbers. It's an industry in which you have to survive the cycle. You have to have the ability to go through cycles and deliver a full scope of services in a number of geographies. Anything else is just funny, it's just being 'brilliant'. It's not banking."

Rather than undertaking a complex acquisition integration, Bonnafé is focused on efficiency improvements of the bank's existing footprint. He is overseeing a cost reduction program from streamlining IT, optimizing the company's real estate footprint, reducing the use of outside contractors, and automating certain compliance and risk functions. The company has realized €1.1 billion of an expected €3.3 billion of recurring cost savings in 2020, a material outcome in relation to 2018 pre-tax income of €10.2 billion.

None of these initiatives have yet improved sentiment toward the shares, which trade for about half of book value, compared to on average 1.5x before the last recession. BNP Paribas' €2.2 trillion of assets are on par with Bank of America, which has a market value more than four times greater. BNP trades for about 7x estimates for 2019 earnings, and pays a dividend that currently yields a whopping 7%. The dividend appears safe as it represents only 50% of earnings.

It may be that investors will not assign higher multiples to the stocks of French banks until the country's economic conditions improve. We cannot predict the effect of President Macron's efforts to reform the nation's generous rules around job security and benefits that have ironically led to stubbornly high unemployment. It is much easier to look backwards and note that the best times to invest were not when economic activity was buoyant and stocks were popular, but when securities prices reflected fear. The former characterizes the US today; the latter depicts France. For BNP Paribas, continued low- to mid-single digit growth in book value and a return to its historical average multiple over the next decade would produce a total return of over 20% annually. We believe the steep discount to a stable and growing book value, and the 7% dividend, will combine to protect our capital in the absence of improving sentiment toward the shares.

As always, please reach out to us with any questions or comments.

Sweetbay Capital Management

Important Disclosures:

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Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. The New Investments section describes each new security in which we initiated a position during the referenced six-month period. Every security may not have been purchased for each client based on the timing of a particular account opening, or based on assessed needs of a particular account.

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended by the adviser) will be profitable or equal to past performance levels.