Q2 2017 Quarterly Commentary – July 1, 2017: Amid Favorable Economic and Market News, a Scarcity of Investment Bargains

The broader US equity market, as measured by the S&P 500 total return index, finished its seventh consecutive positive quarter on June 30th, logging an increase of 3.09% including dividends. The Dow Jones Industrials rose by 3.95% during the period, and the tech-heavy NASDAQ Composite finished higher by 4.21%. Fixed income markets also posted a positive return during the quarter ended June 30th, with the Barclays Aggregate Bond Index adding 1.45%. While it is an impressive record, we find nothing irrational about the level and direction of the overall stock market, as first quarter earnings of the companies that comprise the S&P 500 advanced by nearly nine percent versus the comparable period in 2016, and estimates of future earnings remain robust. Price-to-earnings ratios now stand at 21.4x the latest four-quarters' earnings, 18.6x estimated annual earnings for 2017 and 16.6x estimated annual earnings for 2018. These levels do not give us cause for concern, particularly in an environment of low interest rates and positive economic momentum, although they do make it more difficult than we'd like to find outright bargains. If the expected earnings for 2017 and 2018 materialize, we'll look back and say that this was a good time to own stocks. If not, then the immediate future is less certain for equity investors. The estimates we referenced above are just that—estimates—made by people whose crystal balls are no clearer than anyone else's. Let us be clear, however, that regardless which path the markets take in the near term, we're convinced that the long-term future for equity investors is very bright indeed.

We of course will not ignore the real potential for short term volatility. We have been investing long enough to know that markets can move in both directions, and it's inevitable that the relative calm of equity markets this year will be disrupted at some point. Like earthquake faults, pressures build and are released without warning—those who live near them understand this, but don't live in fear of it. If they do, they move and accept that they will not be able to enjoy all that a place like California has to offer. Similarly, if investors live in fear of volatility, they should forever steer clear of equity markets and accept that their wealth will likely not grow above the rate of inflation. As investors who have lived and worked through some of the best and worst times in equity markets, we don't worry much about the bumps in our path. If we can avoid them, we will. But we'd be fools if we believed that we could invest without occasional setbacks. We think the long-term results will be worth it.

At home, the macro-economic picture looks mostly positive. The Federal Open Market Committee has seen enough economic strength to raise the Federal Funds rate by another quarter point and signal a gradual pace of continued rate increases and other measures to tighten money supply; the unemployment rate reached 4.3% in May, its lowest level since May, 2001; inflation remains tame with both core-CPI and PCE reading below 2% and growth of average hourly earnings (a measure of wage inflation) a moderate 2.4% in May; consumer and business confidence surveys remain upbeat; manufacturing activity remains in expansionary mode, with a May PMI reading of 54.9 (anything above 50 signals expansion); consumer credit is expanding moderately amid historically low short and long-term interest rates. Major financial institutions passed their government-mandated stress tests with flying colors, signaling that the underpinnings of our financial system are sound. Abroad, economic statistics across most major developed economies are generally less strong, but directionally similar to those of the US. The Chinese economy is showing recovery after a soft spell. There are pockets of weakness around the world and in certain industries, but overall the picture is good.

The markets are showing a degree of satisfaction with this economic data. Market volatility, as measured by the CBOE Volatility Index ("VIX")[1], has hovered at levels below 16.0 this entire year to date and settled at 11.2 at quarter end. For perspective, from the period beginning January 2004 to the present, the average, minimum and maximum values for VIX were 18.8, 9.8 and 80.9, respectively. We can't help thinking there is something a bit unsettling about this apparent investor complacency. Further, the current financial recovery is now the third longest on record since the beginning of America's industrialization, so despite the strong indicators, we maintain a skeptical eye when evaluating projections either by Wall Street analysts or company insiders. Consequently, in the absence of really compelling opportunities, we think that it makes sense to reduce overall portfolio risk. Please know that this is less of a "call on the market" than it is a reflection of our firm discipline to risk your capital only in opportunities that "pencil out" with a margin of safety following our intensive research.

You see the result of our thinking in the form of cash in your accounts, which we've allowed to build. We view this larger cash balance as a temporary phenomenon. We are ready to put it to work as soon as we identify compelling investment opportunities, which can come at any time. The opportunity cost of having cash on the sidelines is very high when markets are cheap, but not so great when markets are more fully priced, as they are today.

Q2 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed, and you should not assume that an investment in these securities was or will be profitable. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.

During the quarter we exited our positions in American International Group (AIG), Pepsi (PEP), and CR Bard (BCR) and initiated positions in Expedia (EXPE) and Priceline (PCLN). Explanations for these changes are provided in the following paragraphs.

<u>American International Group</u>

In January of this year AIG announced that it had entered into a reinsurance contract with Berkshire Hathaway to mitigate risks associated with the company's inadequate insurance reserves. While we were well aware of AIG's poor track record of reserving, we believed CEO Peter Hancock's initiatives to improve the company's technology systems and business practices would prevent further reserve revisions. With the announcement of the Berkshire deal, it became clear to us that management still did not have a good handle on reserves. Accordingly, we decided to exit the position given that we no longer felt the undervaluation of the stock was large enough to more than offset the risks associated with potential reserve revisions beyond what has already been disclosed by the company.

PepsiCo

Pepsi possesses many of the favorable qualities we look for in a core Golub Group holding, namely: strong brands, products that stand the test of time, and exceptional distribution. Despite these qualities, we no longer felt that a position in the company was warranted given where the stock price trades in relation to our assessment of intrinsic value.

Pepsi is a wonderful business, and we will look to reinvest in the company if the stock price declines to a level where reinvestment becomes appropriate.

CR Bard

In late April it was announced that Becton Dickinson would acquire CR Bard in a cash-and-stock transaction. After analyzing the combined entity on a pro-forma basis we determined that a position in Bard no longer represented a compelling value. Accordingly, we exited the position.

Priceline and Expedia

We initiated 2% positions in both PCLN and EXPE during the quarter. The companies operate as full service online travel agencies that provide a complete suite of travel products such as hotel bookings, flights, and car rentals. Priceline and Expedia are the two largest online travel agencies in the world and together dominate the industry with a combined market share of 85%.

While the travel industry remains highly competitive, Priceline and Expedia have garnered substantial economic moats due to their unmatched scale, dominant market share, and strong brand positions. In addition, these companies benefit from meaningful network effects which stem from their ability to offer travelers millions of hotel rooms and flights around the world. Furthermore, the growth prospects for the two companies are quite compelling. Although Expedia and Priceline dominate their industry, online travel penetration is only 55% in North America and significantly below that level in other regions. This bodes well for continuous online travel booking penetration globally. Given these companies' dominance, we expect revenue to grow at least as fast as the industry, which we estimate to be around 10% per year over the next decade.

While the companies are quite similar in many ways, they each possess some unique differences. Specifically, Expedia's core market is here in the United States while Priceline's core market is in Europe, the latter of which is more profitable given that European hotel chains are less consolidated and are, therefore, more reliant on online travel agencies to generate bookings. Another key distinction between the two companies is Expedia's larger array of assets including vacation rentals and a corporate travel agency. Expedia's assets are more difficult to manage than Priceline's assets, but if properly developed and maintained, these assets provide opportunities to create substantial shareholder value over time.

While these two names trade at higher valuation multiples than many other portfolio holdings, we believe the intrinsic value of these companies will increase significantly over time given their favorable growth prospects. Accordingly, we will look to add to our positions in these names if the stock prices decline in a meaningful way.