

# Q1 2020 QUARTERLY COMMENTARY – APRIL 1, 2020



Kurt Hoefer, CFA



## COVID Crisis

Our first and most important message to you, our clients, is that we are here for you in these difficult times. We have made a concerted effort to be in touch with you by email, webinar and phone (or better yet, video meeting), and hope that you have found these enhanced communications helpful. As we have been sheltering in place at our individual homes since March 16<sup>th</sup>, even before it was decreed by San Mateo County to do so, we have been continuously refining our use of the technology that keeps us connected with you, and are accessible anytime you need us.

The early part of the first quarter was full of celebration. We officially changed the name of the firm to Summitry, with fanfare, launched a beautiful new website, added a great teammate and signed a lease for new, refreshed and expanded office space into which we would move in April. Then the world changed.

In the span of several weeks, the world was beset by a pandemic that shuttered businesses and shattered confidence, requiring unprecedented actions by governments to keep markets functioning and deliver health care and financial relief to people affected by COVID-19. For the quarter, the Dow Jones Industrial Averages, Standard & Poor's 500 and NASDAQ Composite index declined by – 22.7%, – 19.6% and – 13.9%, respectively, including dividends. Global markets declined in concert, with the MSCI EAFE Index, which measures returns in developed foreign markets, and MSCI Emerging Market Index returning – 22.8% and – 23.6%, respectively. Bonds offered no safe haven from volatility, with the Barclay's Aggregate Bond Index falling at one point when financial market selling was most acute, by – 6.3%, and ultimately finishing out the quarter up + 3.2%. Corporate bond credit spreads, which price the inherent risk of default, widened by 1.27 percentage points for 10-year single-A rated corporate paper, delivering weak performance for fixed-income investors in anything other than the safest bonds.

What is extraordinary to us was the speed of the decline. The market hit an all-time record on February 19<sup>th</sup>, at which point the S&P 500 was up for the year by + 5.0%. On that day, a New York Times cover article discussed coronavirus as a Chinese problem pitting that government against private charities that wanted to help. The Diamond Princess cruise ship, then quarantined in Yokohama, seemed an isolated outlier. On that day, the Wall Street Journal highlighted a softer line by the Trump administration on China tariffs and strong holiday sales at Walmart driving investor confidence in the US economy, but it offered no coverage of COVID-19. Only twenty-three trading sessions later, on March 23, the S&P had dropped by – 33.9% from the February 19<sup>th</sup> peak. The global economy and investor sentiment changed at a remarkable speed. Diversification among asset classes, which by design should protect portfolios from volatility, failed to do so as stocks, bonds, real estate securities and commodities fell in tandem during the most acute phase of the decline.

We've shared our thoughts in recent emails (which are also posted on [www.summitry.com/insights](http://www.summitry.com/insights)) regarding the actions taken by the Federal Reserve to provide critical liquidity to the bond markets, and by the federal government to provide support to citizens whose world was turned upside-down by the pandemic. The actions were unprecedented and necessary given the severity of the crisis. We also talked about the leadership at a local level, which appears to be flattening the curve in terms of new cases, particularly in the West. We don't know how long the crisis will persist, but it appears the country is becoming united in its determination to beat the virus and is willing to make the necessary sacrifices. We're hopeful that the news, despite the tragic loss of life, will improve over the coming weeks.

This kind of shock requires some introspection by anyone operating in markets, and whose mission—like ours—is to care for the financial wellbeing of its clients. In a March 2015 TED Talk, Bill Gates shared his concerns, based on the information gathered by the Gates Foundation in connection with the Ebola outbreak in 2014, that the world was unprepared for a global virus pandemic, and even estimated that financial losses in the event of one would top \$3 trillion dollars. In retrospect, the warning signs existed for the

potential of a COVID-19, but the experience with SARS, MERS and Ebola conditioned all of us to expect that the world was equipped to limit the tragedy and contain the financial damage caused by virus outbreaks.

Every financial crisis presents its own set of learnings, which can be applied going forward. As it relates to our approach to managing wealth, however, the health crisis and its financial ripple effects confirm the validity of our investment discipline, including our commitment to own companies with strong balance sheets to survive economic downturns, and resilient business models that provide a competitive edge in adversity. When we look at any business for investment in its stock, we understand that the first and second quarter of 2020 will be disasters, and that the results for the second half of the year, assuming the world works its way past COVID-19, will not be reliable as measures of a company's real earning power. Instead, we need to be looking at our businesses with an eye to 2021, 2022, and beyond. The "intrinsic value" of any business, and therefore its stock, is the sum of its earnings from now to infinitum, discounted back at a rate that appropriately reflects the risk that those future earnings don't materialize.

We were active in the quarter, in terms of purchases and sales of securities into client accounts. The moves on our part had nothing to do with a call on the direction of the markets. We have never claimed an ability to know where markets or individual stock prices will be the next day, week, month or year. Rather, the decisions were made based on our belief that the market price of a stock materially diverged from its intrinsic value when viewed independently and when viewed next to other stocks in our coverage universe. When stock markets are volatile, a lot of material divergence occurs, therefore we are likely to be more active as a buyer and seller. As markets declined, we put some of our surplus cash reserves, where they existed in client accounts, to work in new stocks as described below. The net result, we believe, of this opportunistic buying as selling enabled by volatile markets, was an upgrade in the overall quality of the portfolio.

## Q1 Portfolio Changes

*Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. 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 initiated new positions in Charles Schwab, Agilent, Varian Medical, Ross Stores, and Zebra Technologies and exited our positions in Flowserve and Expedia.

## Charles Schwab

Schwab is one of the largest independent investment services firms in the world. The company benefits from unmatched scale in servicing individuals and registered investment advisors such as Summitry. Schwab's scale creates an efficient operation which is being deployed to disrupt the industry and gain share from peers.

Schwab is in the process of acquiring a major competitor, TD Ameritrade, a transaction we think is likely to close later this year. We expect this deal to create substantial value for shareholders through both cost and revenue synergies.

At the current price, our analysis suggests the stock market undervalues Schwab's core franchise and completely ignores the upside from the TD Ameritrade transaction.

## Varian Medical

Varian Medical is the largest provider of radiation oncology equipment and related software solutions. The company benefits from strong competitive advantages that stem from very high barriers to entry and switching costs. The industry is an oligopoly with Varian as the largest player at 60% market share. Unsurprisingly, the business generates very high returns on invested capital.

Unfortunately, cancer is a growing problem in our society which means that demand for Varian's products is likely to stay very strong for many years. We think Varian has made several investments that could help it grow even faster than the industry. For example, the company has recently launched a new system that targets emerging markets, which are growing faster than developed markets. Another example is the software portfolio, which creates new recurring revenue streams at higher margins.

The stock sold off with the rest of the market on concerns that equipment installations will be delayed due to the current COVID-19 crisis. This is a valid concern, but we believe it will only impact the business this year and maybe next. In our view, delays today will create a pent-up demand for future periods. When we purchased the stock, the market was failing to recognize this reality, hence the discount in the price.

## Ross Stores

Ross is the second largest retailer in the off-price retail category. The company's competitive advantages stem from its brand, low-cost operating structure, and substantial scale in purchasing and distribution of off-price merchandise. Ross is also a growing business. The company is underpenetrated in large areas of the country and we believe has plenty of opportunity to open more stores in new locations.

The current crisis is hurting most retailers and Ross is no exception. Most likely, the company is going to report a sharp decline in revenue and profitability in 2020, but these headwinds are short term in nature. We believe Ross is in a terrific financial

position and has a solid balance sheet. In our estimates, the company has ample liquidity to navigate through the crisis and should return to growth, once the economy recovers. Thanks to the COVID-19 panic, we were able to scoop up the shares at a substantial discount to their intrinsic value.

### Zebra Technologies

Zebra is the leading provider of mobile computers and industrial printers that power the logistics infrastructure of retail, package delivery, warehouses, manufacturing, and healthcare. Zebra's competitive advantages stem from dominant market position and high customer switching costs, which are enhanced by customer reliance on industry-specific software packages developed by third parties for the Zebra platform.

We believe Zebra is set to benefit from the ongoing adoption of automation solutions in several industries, as more and more companies incorporate mobile computers in their operations. In addition, many customers are being forced to upgrade their existing devices to Android-based products due to Microsoft's decision to end support for Windows CE products in 2020. Not only does Zebra benefit from higher market share of Android devices, but Android devices are higher priced, have shorter replacement cycles, and drive higher software attach rates. We see all of these factors as driving strong organic revenue growth and record backlog for the company.

The stock sold off on the COVID-19 concerns, as many customers slowed or shut down their operations. We think these are short-term headwinds that are likely to abate once economic condition improve and the country goes back to work. When we purchased the stock, the price was significantly below what we consider as a reasonable estimate of intrinsic value for this unique business.

### Agilent Technologies

Agilent is a major provider of analytical instruments and consumables used in development and manufacturing of pharmaceuticals. These products also play an important role in other industries such as energy and chemicals. Agilent benefits from very high switching costs that stem from customer requirements for standardized equipment in their processes and regulatory approval of equipment for quality assurance processes.

Agilent's core products benefit from secular tailwinds including overall growth in life sciences research and development, as well as increasing spend on biotech products that require more testing on Agilent's instruments. The stock sold off with the rest of the market in recent weeks due to concerns that COVID-19 will lead to lower demand in the coming quarters. While this might true for some of Agilent's end markets, we think most of the business is very stable and not prone to economic cycle. We think that this a typical situation in which the market has thrown out the baby with the bath water.

## CarMax

We believe CarMax is a best-in-breed used car dealership with a broad national footprint. The company has been able to achieve and maintain industry-leading profits due to efficient scale in sourcing and processing used cars and a strong brand that stands for a very differentiated customer experience.

CarMax might appear to be a large business, but its share of the used car retail industry is relatively small. In our view, the company has plenty of room to gain share from smaller competitors by increasing sales in existing stores and expanding into new locations. Virtual sales is another possible growth area for CarMax, as the company has been investing heavily in recent years in its omnichannel capabilities.

The stock declined together with rest of the market on concerns that the COVID-19 crisis will lead to a major recession in the U.S. that will hit demand for used cars. While this is a reasonable scenario in the short term, we think CarMax remains well positioned to thrive once the economic pain abates. The company has a strong balance sheet and we believe will come out of the current crisis stronger relative to its peers. Our opinion is the stock price accurately reflects this year's likely pain but neglects to reflect next decade's likely market share, revenue, and earnings gains.

## Expedia Group

Expedia is one of the largest online travel agencies in the world. The company and its prime competitor, Booking.com, dominate the online travel agency space. When we first initiated the position several years ago, we thought that Expedia and Booking were both well positioned to take share from other players in the industry. We were also attracted by the opportunity that both companies had to expand into the attractive alternative accommodation space.

Both Expedia and Booking were hit hard when the COVID-19 crisis brought travel around the world to a complete halt. While we think that both Expedia and Booking will survive the current crisis and will return to growth once travel resumes, Booking is a better-managed company with a superior business model and more attractive growth opportunities than Expedia. Booking has better chances to emerge from this crisis stronger, with more market share, and higher profits than ever before. Consequently, we decided to exit our position in Expedia and reinvest part of the proceeds in Booking.

## Flowserve Corporation

Flowserve is the largest provider of pumps and valves to the oil and gas industry. We initially purchased the shares after the 2015 collapse in the energy markets, which sent the entire industry into a severe depression. Since then, Flowserve's business began to recover, and profits rebounded but the current crisis has created new near-term challenges for the business. We, therefore, decided to exit the position and reallocate

the proceeds to higher quality businesses that we believe are likely to recover faster from this crisis and grow at a higher pace, once economic conditions improve.

#### New to the Team

We are delighted to have [Anthony Piquit](#) join the Summitry team as a Client Service Specialist in our Operations department. In this role, Anthony responds to client requests and ensures that they are executed quickly and efficiently. Anthony, who holds a B.S. in Business Administration with a concentration in Finance from San Francisco State University, comes to us from Morgan Stanley, where he served as a Client Service Associate. In a few short weeks after joining us, Anthony was sent to shelter in place like the rest of the team, but he is already performing like a veteran. We thank him for his resourcefulness, and we look forward to introducing him to you in person when the world returns to normal.

Thank you for your trust and your resilience

We have been through difficult times before, and we understand the toll it can take on you to be exposed financially to volatility and uncertainty. We know from experience that the best outcomes come to those who are most resilient in the face of adversity. For us, it makes it easier to maintain conviction in times like this by understanding deeply what we own and why we own it. These days call for extra vigilance and greater communication, so our investment team, operations team and Financial Advisors will continue to work overtime in an effort to achieve the best possible outcomes for you. These are the times when having a financial plan that grounds you in your own narratives about the future are so critical.

\*\*\* The securities identified do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. The analysis and opinion expressed in this report are subject to change without notice. They do not represent a buy or sell recommendation and should not be viewed as a promise of future performance.