KLCM Kitzinger, Lautmann Capital Management, Inc.

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Time Arbitrage, Part II

Large pools of equity capital are managed by highly motivated, experienced and accomplished participants. The competition for annual performance is extreme and the rewards for outperformance can be immense. The competition takes place on all levels. Macro hedge funds make calls on big picture trends in all liquid asset classes. Long/short hedge funds pick winners and losers within equity sectors and industries. Standard "long only" equity shops try to beat the relevant index for their given "style box" through security selection and varying degrees over or under weights of industry sectors. With legions of analysts combing the ranks of publicly traded stocks for an edge, how can one hope to compete, much less outperform over time?

It is clear that **"you can't take the same actions as everyone else and expect to outperform** (Howard Marks, "Dare to be Great II)." One aspect of our investment style and process that is decidedly unconventional, by today's standards, is our investment time horizon.

In October we wrote about the diminishing risk from stocks as an investor's time horizon is extended. Though very volatile over short periods of time, over long periods of time the volatility of equity returns dissipates. We called this effect ***time arbitrage*** and wrote that "In effect, equity investors can trade time, short-term volatility and patience for a high probability of superior real returns on their capital." **There is a second type of *time arbitrage* that is critical to understanding our investment style.** In this case, it applies to the selection of individual stocks.

All companies face macro and micro obstacles to earnings growth of varying degrees that they have to manage through. Today, macro issues include weakness in the global oil sector, a strong dollar that reduces the contribution from foreign earnings, economic declines in countries such as Russia, Venezuela and Brazil, and decelerating growth in China, Australia and Canada.

Company specific issues may span any aspect of the business and may be short-term in nature or structural. Whether it be for macro or micro reasons, if a company's earnings fall short of investor expectations, the stock is likely to come under pressure. At that point, we try to determine if the problem is fixable or if a shortfall in one segment is overshadowing the value of the entire firm. If we understand the business and the problem is fixable or contained, we will try to quantify the additional risk and the upside scenario. While the equity market tends to focus intensely on the outlook for earnings over the next quarter or two, if we see powerful long-term upside and tolerable near-term risk we will look out beyond the market's short time horizon and buy the stock. **We are willing to exchange time and moderate near-term risk for compelling longer term upside.** In this way, we can own some exceptional companies before the market takes their valuation beyond our comfort zone. **This type of *time arbitrage* is the normal way that we have entered stocks and we attribute most of our successes to solid research and our willingness to be early.**

One such holding in our portfolio today is Allegheny Technologies or ATI. We initially took note of ATI in 2011 when they bought Ladish Corporation, a Milwaukee-based forging company that we owned. At the time, ATI's shares were trading near $70. We got more interested when the stock declined below $30 and we came to understand the ambitious metamorphosis underway. Since 2004, ATI has spent $4.6 billion or $42 per share on capital expenditures and acquisitions. That capital spending program is now largely complete and the $500 million titanium and $1.2 billion hot-rolling and processing facility are now qualified and ramping up production of titanium and specialty metals. The company's largest end-market is aerospace

(34% of sales) which is poised for a “once-in-a-lifetime aerospace market transition from legacy to next generation airplanes and jet engines (ATI 2014 annual report).” With 22,000 large commercial jet engines in the backlogs of Boeing and Airbus, production is scheduled to grow by 33% from 2014 to 2018. In addition, ATI’s content on the new GE engines powering the Boeing 737MAX is double that of the old 737s, setting the company up for a rare level of growth over the next four years.

ATI believes that they can average a 15% after-tax return on capital over a cycle with higher peak earnings and lower trough earnings. Today, that equates to cycle average earnings per share of $5.70. We look forward to this ramp from near breakeven levels currently, but realize that there are some headwinds from currency translation for the 38% of their sales that are international and from those sales to the oil sector that may not allow a full attainment of their objectives in the next few years. Still, we expect significant earnings progress and it is rare to find a stock selling scarcely above book value, with the massive spending and operational risk basically behind the company, yet with perhaps 100% upside in the shares. To us, that is potential upside worth waiting for and we stepped up our initial positions to full sized positions in the fall.

While ATI is at the starting line in terms of its earnings ramp and investor recognition, Carnival Corporation is a stock that we initially purchased in June of 2014 that has already made good progress on what we believe will be a protracted ramp in earnings. Just nine months ago, the outlook was much less clear.

Carnival operates under nine brands with 100 cruise ships and a 48% global market share. After emerging from the recession in 2009 into a very sluggish economic expansion, Carnival suffered from disruption from the “Arab Spring” across the Middle-East and North Africa in 2011 and then from severe self-inflicted wounds the following two years. The Costa Concordia sunk off the coast of Italy in January 2012 and the Carnival Triumph caught fire and was adrift for days (without air conditioning or plumbing) in the Gulf of Mexico in February of 2013. Thus, two of the company’s major brands were impaired and bookings, pricing and earnings suffered. Management immediately implemented multi-year plans to restore their brands and profitability.

By June of 2014, we were able to observe the methodical progress the company was making with the Costa brand in improving bookings and gradually reducing discounts and improving net yields from depressed levels. With this recovery on the path forecast by management, it gave us confidence that the much larger Carnival brand would follow the same trajectory, with a lag.

At the same time, we were also gaining comfort with Arnold Donald, the new CEO who had started in July of 2013. After two generations of the founding Arison family running the company, we were encouraged that a new, disciplined focus on costs, return on invested capital and marketing could leverage Carnival’s unmatched scale and drive improved profitability. We could see the path the company was on to restore their margins, which were well below historical levels and those of their smaller competitors. As revenue growth returns, the operating leverage in this highly capital intensive business is stunning. For each incremental dollar of revenues, incremental margins can exceed 50%. With net yields now expected to increase 2% to 4% per year and capacity also growing 2.8% through 2018, the company’s earnings could grow significantly for several years. Thus, at the time of purchase, the shares appeared expensive at $38 based on the trough earnings of $1.58 in 2013. However, we were looking past near-term results and forward to more normalized earnings of $4 to $5 per share in several years. If the global economy stays on track over the next few years, we believe that this can be a $60 to $75 stock.

Six years into the equity market cycle, **it is more difficult to find stocks with the upside to justify accepting market risk. We believe that ATI and Carnival more than meet that standard for those willing to extend their horizons and exploit one of the last inefficiencies in the market - *time arbitrage*.**