KLCM Advisors, Inc.

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Change

After four years of low volatility in the market, the investing world changed (again) this summer. Global growth concerns, full profit margins and extended valuations in some sectors (such as biotech) reached a point where low interest rates and hope of further earnings growth could not buoy stocks. The reality of the world as it is, not as we want it, set in. While volatility is unnerving, for those who anticipate and plan for change, it spells opportunity. We use this perspective as we continue to deploy capital.

Superior long-term investors exhibit two principal characteristics. The first is based on an understanding of how successful companies are created, built and managed. The ability to identify such companies is at the core of our investment philosophy. We rely on proven processes to identify target companies and take advantage of opportunistic entry points. That has been a key to the success achieved in our client portfolios over the past twenty plus years. Please note that the operative phrase is “long term”. We have encountered time periods where our style is out of favor, including the last four quarters.

The second is the acknowledgement that change is constant. One must have the ability to recognize and adapt to change while still focusing on long term value creation. This capability requires conviction. The noise can be deafening and emotions run high at market inflection points. That is when you must do your work, form your thesis, and act.
This open minded view of change also requires having the capability to recognize mistakes and mitigate losses. While we evaluate relevant information prior to adding a security to the portfolio there are times when we miss or misinterpret data, or simply misjudge the environment. Investing is a humbling vocation.

With that backdrop, the following two examples highlight how companies we have recently purchased are adapting to changing environments.

Kohl’s

The retail world is shifting. Shoppers no longer have to visit a brick and mortar store to make a purchase and the options for where to buy these items continues to grow. While the Kohl’s shopper has been pressured in recent years from a slow jobs recovery and stagnant wages, the company continues to evolve and innovate.

Kohl’s has spent a significant amount of capital preparing for the perpetuation of online shopping (which goes much further than the internet). In the fourth quarter of 2015 Kohl’s is launching its latest omni-channel initiative, buy online pick up in store and buy online ship from store. Kohl’s has listened to consumer wants and has adapted. Shoppers will now be able to make a purchase online and within a few hours have their purchase ready for pick up in a store of their choice, thereby saving time and eliminating shipping costs. In addition, after years of investments in systems to support these omni-channel efforts, Kohl's has the ability to ship to a consumer from a local store thereby optimizing inventory in stores and at distribution centers. This will benefit profit margins, as less in store inventory will have to be sold on clearance.

These omni-channel efforts were put in motion years ago, and are just now coming to fruition. We believe Kohl's will see benefits from these initiatives in their fiscal fourth quarter. Trading with a double digit free cash flow yield and 4% dividend yield we were able to buy a position in this forward thinking retailer at only 10 times next year's earnings.

Verizon

Verizon Communications is another example of a company that understands how to create value over time while at the same time focusing on the changing landscape of communication. The company is one of two major carriers that realized early on that the quality of their network, not price would be the differentiator for mobile communication. As a result, they have continuously invested capital to develop the best network, which has allowed them to maintain price without losing a significant number of customers.

They also realized that this quality network could serve as a platform to deliver different types of video content to their subscribers. Currently, they are testing a platform called G90 that delivers content to digital devices for consumers that don't want a full cable subscription. This and other revenue streams are available to Verizon only because they continuously invested in their infrastructure. By focusing on the long term and having a vision of where the communications world was moving (digital) the company has built and maintained the network required to ensure their competitive moat remains intact.

The strategy of focusing on network quality is correct and over time the company will be able to grow earnings as customer retention increases, add new customers, and develop new revenue streams enabled by their network. We were able to purchase this best in class asset at approximately 12 times earnings with a 5% percent dividend yield. This combination provides us with significant current income while also offering reasonable upside as earnings grow and valuation potentially improves.

We are moderately optimistic about return prospects over the next twelve months. Last quarter's correction has tempered equity valuations and provided investment opportunities. However, we cannot ignore the advancing age of the economic and equity market cycle. Our response is to continue the progression up the scale of market capitalization and quality; pursuing companies that generate high levels of free cash flow and use it wisely (see above). Moving towards this lower risk approach with some of our investments and building cash positions is how we are navigating change.