October, 2017

Sitting

With nine months of relative tranquility and rising prices in equity markets in the rear view mirror, it would be easy to be complacent. Stocks, while expensive relative to almost any other moment in history are juxtaposed with bonds that are even more expensive. Having to "own something", investors have made the rational choice to own more equities. Within equities, investors have been increasingly choosing passive indexes to active management. Backstopping this behavior to date has been a continued steady improvement in the US and global economy, combined with very low inflation. This has allowed the Fed to remain highly accommodative for a longer period of time than we could have imagined.

However, monetary policy is beginning to change. The Fed has now raised interest rates four times and at their September meeting announced plans to begin shrinking their balance sheet. In addition, there appear to be early signs of inflation on the horizon. Rising wages are generally a prerequisite for higher inflation rates. We are starting to see signs that the tight labor market is finally manifesting itself in higher wages. Concurrently, the dollar has weakened by 8% in the past six months, which generally will prove inflationary several quarters later through the mechanism of higher import prices.

While the US economy continues on its slow and recently accelerating growth path, the complacency suggested by the market's lack of volatility is disconcerting. With uncertainty surrounding outcomes on tax reform, healthcare legislation, conflict with North Korea, and increasing trade hostility with China, the market is apparently comfortable with any outcome. In fact, despite all of this, the volatility index remains firmly planted at multi decade lows around 10!

Roaring Twenties investor Jesse Livermore once said, **"It was never my thinking that made big money for me. It was always my sitting."** While this quote would seemingly justify buy and hold passive investment strategies, we would point out that buy and hold is easy to implement in long bull markets. In light of this, we are reminded of another quote, this one from famed boxer Mike Tyson, "Everyone has a plan until they get punched in the face!" The point is, as investors we will make the most money finding good businesses run by good managers who are able to deliver an increasing stream of free cash flow to their shareholders, and then holding those shares for long periods of time allowing the returns to compound in our favor.

The following are two examples of companies where we own large positions, and why we are comfortable sitting with those positions.

Cisco Systems

Cisco is one of the premier global franchises in the technology sector, selling their products across the communications infrastructure, from provider to end user. Cisco will play a critical role in the growth of private and public cloud computing, the connected home, server virtualization, and the upgrading of data traffic infrastructures around the world.

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Recently, the company reported results that confirmed an improving mix of business. The results highlighted that the company is having continued success converting from selling individual pieces of technology hardware to selling their customers solutions to their infrastructure needs. This switch allows the company to get closer to their customers and converts more of Cisco's revenue to highly valued annuity streams.

We started investing in Cisco nearly seven years ago. At that time, the stock was $17; the company had nearly six billion shares outstanding, paid no dividend, and was expected to earn $1.20 per share. Through continued business execution and a focus on returning cash to shareholders, the company has doubled earnings, pays $1.16 a year in dividends, and has repurchased nearly one billion shares.

While the stock price has doubled over that time period, it remains an attractive investment. The shares trade hands at just thirteen times earnings and offer investors a 3.5% and growing dividend. Additionally, the company has nearly sixty billion dollars stashed overseas that would benefit from any repatriation tax holiday. Cisco's continued business execution, attractive valuation, and pristine balance sheet combined with a commitment to return cash to shareholders continues to make owning a large position a very comfortable place to sit.

Citigroup

Since the recession on 2008-2009, Citigroup has gone from the poster child of all that is wrong in banking to one of the most over capitalized money center banks in the industry. While it has not been a smooth road since its corporate restructuring in 2008, it has been worth the wait, with the company's tangible book value increasing more than 60% over that time.

At the time of our initial purchase in 2014, five years post the depths of the financial crisis, Citigroup was trading at only 85% of tangible book value. With a failed Federal Reserve stress test, minimal capital returns to shareholders ($0.04 annual dividend, zero share repurchases), and legal and repositioning costs exceeding $5 billion, there was still a long way to go.

Slowly over the past three years Citigroup has emerged as a leading global banking franchise. Citigroup's return profile has improved from earning a mid-single digit Return on Tangible Common Equity (ROTCE) in 2014 to 9.2% in the most recent 12 months. Citigroup recently laid out a path to earning 10% ROTCE in 2018 and 13% ROTCE in 2020.

In addition, Citigroup is a leading capital return story. The 2017 fed stress test process, Citigroup became one of the first banks to be approved to return in excess of 100% of annual earnings via dividends and share repurchases. This return of excess capital will be in the form of an increased dividend ($1.36/year) and a $15.6 billion share repurchase program that will reduce the shares outstanding by nearly 8% this year!

While the stock has appreciated more than 50% since we began purchasing it 3 years ago, it is still only trading at tangible book value. Given the improving ROTCE and considerable capital returns to shareholders, over time the stock should trade more in line with its peers at 1.50-2.0 times tangible book value. Therefore, we believe considerable upside remains and downside is limited by the improving return structure and the ballast of a significant share repurchase program.

While both of these stocks have appreciated significantly since we began purchasing them several years ago, we believe they continue to be undervalued. Having put in the time, energy, and thought into identifying these investment opportunities, when turmoil returns to the market, it will be easier to remain seated. **We call this conviction**.