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Under the Radar

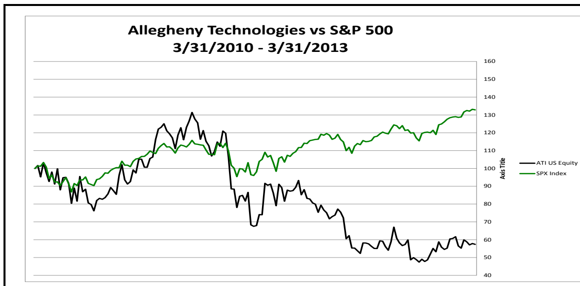
The economic recovery will mark its four year anniversary in June. Given the anemic pace of the recovery, it is reasonable to expect the up-cycle to extend for several more years. There is ongoing pent-up demand for cars and houses and plenty of slack in the economy to hold off inflationary concerns for some time. Monetary policy is extremely accommodative and fiscal tightening only a modest drag. Thus, relative to a typical economic cycle, this one still looks slower but longer.

Likewise, the equity bull market celebrated its four year anniversary on March 9th and went on to set new all-time highs later in the month by finally exceeding both the highs of 2000 (except for the NASDAQ) and 2007. With the 132% rally off the bottom, the S&P is approaching a fair valuation on what could now be characterized as normalized earnings. With slow economic growth in the US, a recession in Europe and moderating growth in the developing markets, overall corporate earnings growth has slowed to a crawl. All of this is to say, that though there is worthwhile upside for the market from further valuation expansion and earnings growth over the next several years, most of the rocket fuel that powered the early stages of the liftoff has been burned off.

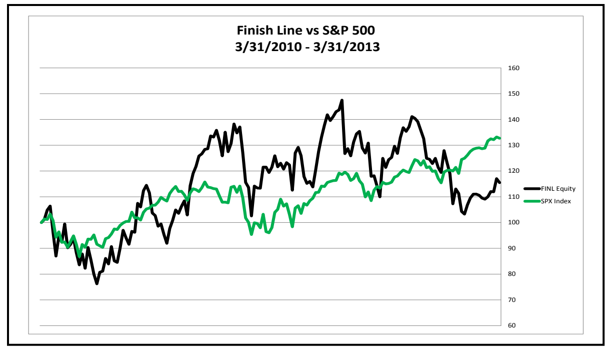
Fortunately, not every company is hitting on all cylinders with earnings at peak levels, and not every stock is hitting new highs. Thus, with the overall pace of earnings growth slowing and the market moving closer to fair value, it may no longer be enough to just “look like the market” in order to generate the returns that investors seek. In this environment, if we can find stocks flying under the radar with catalysts for improvement that have not yet played out and buy them at a discount, it can add meaningfully to portfolio returns over time. Our advantages are that we can go where the values are by buying small, medium or large-cap stocks, we get to know our companies extremely well and we are willing to live through a few messy quarters of a turnaround if our confidence and the ultimate pay-off justify it.

Our equity portfolios reflect a diverse all-cap mix of companies that we believe are undervalued and have the potential to ramp earnings much faster than the S&P 500 over the next several years. Specifically, we will highlight three very different companies in the midst of multi-year investment and turnaround situations. The upside in each case is exceptional and, if our risk assessments are correct, we do not need all of these plotlines to fully develop to add material value to equity portfolios.

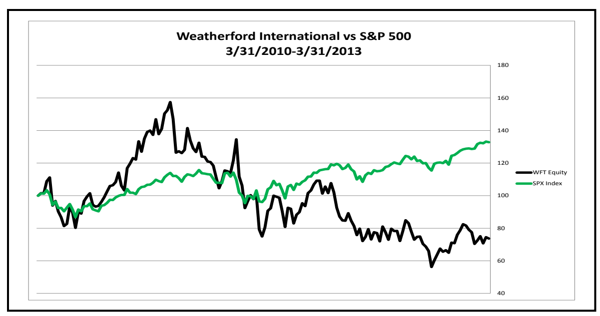
Allegheny Technologies is an integrated supplier of high value metals that has spent $33 per share since 2004 to reshape the company. The major investments include a new $500 million titanium sponge facility that will produce commercial volumes in 2014, the $800 million acquisition of Ladish and a new $1.1 billion integrated facility that will produce,roll and finish metal in 2014.



With the completion of the last facility, the company will be positioned to lower their cost of titanium, to consolidate several facilities, to reduce throughput times, energy usage and working capital while pursuing a higher margin mix of alloys. At the same time, we believe that important end markets such as aerospace and oil and gas markets will be strengthening. If we are correct, earnings per share will grow sharply from $1.49 in 2012 towards $5.00 in 2016. We would not be surprised to see the shares move from their current price near $30 to $50 by late 2014. Even at that, the shares would be $20 below their high as recently as 2011!



Finish Line is a specialty retailer of athletic shoes and accessories. The company is completing investments in new point of sale, inventory and supply chain systems that will facilitate ongoing rapid growth in on-line sales and the rollout of 450 new shops within Macy's stores. These investments will be a drag on earnings in the first half of 2013, but will become increasingly additive thereafter. With online sales growing from 11% of sales to 20% over the next three years and the Macy's stores adding 10% to overall sales, we have a growth story and a margin expansion story that we believe can drive earnings from $1.47 for calendar 2012 towards $2.50 in 2015. Success for this management team will mean a share price move from under $20 to $30 or better over the next two years. In the meantime, we are comforted by a debt-free balance sheet with over $4 per share in cash and a capital allocation policy that included buying back 8% of their shares last year.



Weatherford International is an oilfield service company that has spent three years cleaning up their financial statements and tax structure. With this now behind them, the focus shifts to paying down debt and improving operations. With a dominant position in artificial lift systems, we expect the company to be a major beneficiary of growth in oil and gas drilling in North America and internationally while proactively expanding profit margins over the next several years. We believe that this franchise can improve earnings per share from a depressed base of $.58 in 2012 towards $2.00 in 2015. If we are on target, this $12 stock can more than double over the next several years.

Clearly, these stocks are "show me" situations at this point. Managements do not have credibility yet and investors will wait to see proof of the earnings growth that we expect. The other side of that coin is that **we are not exposed to elevated share prices or elevated investor expectations,** which cushions the risk in the early stages of the turn and provides compelling upside. In each case, the cash flow has or is near turning powerfully positive and we expect managements to use that cash flow to further benefit shareholders. While we'd like to believe that each of these stocks will be major contributors in 2013, it's not the nature of turnarounds to show up on any preconceived timeline. Still, even if they truly get traction in 2014, it will be well worth the wait!