April 27, 2020

Be Greedy When Others Are Fearful

Samantha McLemore, CFA and Christina Siegel, CFA

Opportunity Equity 1Q 2020 Letter

"Yes, as my swift days near their goal,
'Tis all that I implore –
In life and death, a chainless soul,
With courage to endure."
— Emily Brontë, Poems of Solitude

The first quarter of 2020 brought disastrous news of a global pandemic causing stocks, including ours, to suffer immensely. Through the market's peak on February 19th, things looked okay. The S&P 500 and our *Opportunity Equity* strategy were both up mid-single digits for the year. Then the world awakened, albeit too slowly, to the growing health risks from a novel coronavirus, which causes a disease subsequently labeled COVID-19. Political leaders around the globe attempted to slow the virus's exponential growth by limiting citizens' normal activities bringing economic activity to the most sudden halt ever experienced. And while leaders reacted too slowly, the market did the opposite. The S&P 500 plummeted 10%, then 20%, and finally 30% faster than any time in history. It ultimately lost 35% from peak to trough and ended the quarter down 20%. Opportunity, given its positioning in economically sensitive areas, fared worse, declining 39% for the quarter.

That loss ranks nearly the worst in the history of the Strategy. Only in the fourth quarter of 2008 did the Strategy decline more. On a relative performance basis, only the fourth quarter of 2008 and the third quarter of 2011 were slightly worse.

Both the 2008 and 2011 drawdowns occurred during extreme economic upheaval or a significant risk of it. During 2008, the financial crisis and the worst recession since the Great Depression crushed stocks. In 2011, fears that a European sovereign debt crisis would throw the global economy back into recession and potentially deflation had the same effect. I wouldn't have thought we'd face a similar drawdown again given the improvements we made to our process as a consequence of those events, but here we are. With an economic "sudden stop", all bets are off in the short term. Long-term prospects, on the other hand, appear quite promising.

The other noteworthy similarity between 2008 and 2011: they were great times to invest in Opportunity. Some of our strongest returns arose from those drawdowns. The average forward 1-year return coming out of those quarters was 61%! The average forward 3- and 5-year annualized returns were 25-26%, well above typical market rates of return.

Yes, a sample size of two may be too small to be reliable, but the broader data set suggests investing after a significant drawdown has the potential to pay off handsomely. There's a consistent pattern of nice returns if you invested in the Strategy after a 1- or 3-month decline of 15% or more. The average 1-year return was 36-43% while 3- and 5-year annualized returns were between 18-23%. Investors in the Strategy after one of these significant historical drawdowns earned roughly double the market's long-term average returns. (refer to chart at the end)

Looking at how cheap our Strategy is relative to our calculation of its intrinsic value shows attractive appreciation potential as well. We've tracked the upside in the portfolio since prior to the financial crisis. We have an estimate for the value of each of our holdings, so we know how much we believe we stand to make. Then we aggregate that up at the portfolio level. Historically, it's been one of the best indicators of forward returns for the Strategy. I remember that number surpassing 250% in the dark days near the bottom of the market in March of 2009 when I had to give my first pitch to prospects (who looked at me like I was insane!). Over the next 12 months, Opportunity gained well more than 200%.

It hasn't gotten close to those 2008-09 levels since… until now. As of the beginning of April, it's again approximately 200% upside. We don't update the figures daily, but I'm confident that at the lows on March 23, our estimate of fair value of the portfolio would have nicely surpassed that 200% level. If the stocks in the portfolio normalize to their February 19th prices alone (S&P 500 high), there's more than 60% upside and if they return to their 52-week highs, Opportunity would rise 110%[1]. Who knows what the future will bring, but you don't often get chances to put money to work with implied returns as high as they appear now.

Sure, the outlook contains great uncertainty. That's always the case, especially when market prices are so low relative to normalized levels. I've heard numerous people question how the market can be rising with the pandemic far from controlled. The market discounts the future so we should expect it will bottom in advance of the fundamentals. The market has already priced in a dire scenario.

From a purely biological perspective (i.e., the health threat), we've dealt with pandemics before. With the 1957 and 1968 flu pandemics, the market declined roughly 20% peak to trough. At a 35% peak-to-trough decline in the S&P 500 and a 38% decline in the Dow Jones Industrial Average (DJIA), we've well surpassed those levels, so let's take a look at the doozy of the last century's pandemics: the 1918 flu pandemic.

Before I do so, I want to acknowledge that life is precious and make clear that I do not take any loss of life lightly. My heart goes out to those suffering losses from the new coronavirus and I wish no one had to meet that fate.

But with markets, one must quantify to understand the appropriate historical and financial context. The devastating 1918 flu pandemic killed between 1-3% of the world's population! So ghastly, it's hard to even imagine. The coronavirus has taken ~167K lives at the current moment[2] (growing substantially by the day), which is .00002% of the world's ~7.8 billion people. That's a far cry from 1918.

There aren't great current estimates for how high the ultimate death toll will go globally. The Imperial College model that received significant media attention estimated that with no interventions, we'd reach 40M globally, or 0.5% of the current world's population. That's likely the worst case scenario for COVID-19, and still not even half as bad as the best case estimates of the 1918 flu pandemic.

Looking at stock losses from the 1918 flu pandemic is a little harder because the pandemic overlapped with World War I, so disentangling the effects of one versus the other is impossible. The DJIA fell 40% from its high in 1916 to its low in 1917 and actually gained throughout 1918 and 1919 as the pandemic ravaged the world. Many reference the earlier losses when discussing the 1918 flu pandemic's effect on markets. That's tough to justify since the pandemic was unknown then, but we can say that the market's 40% decline priced in enough bad news to allow the market to advance in spite of the pandemic as World War I ended.

The Dow's current 38% peak-to-trough decline actually come close to the WWI/1918 flu period losses of 40%. Obviously, governments have implemented extreme measures to curtail the ultimate death count. It's reasonable to wonder whether the reaction to the pandemic will cause the economic pain to be worse than 1918. It's impossible to know at this point. A lot will depend on the duration of the shutdowns.

We do know that there were shutdowns during the 1918 pandemic as well, although they were more locally-based. The data suggest areas with more restrictive social distancing measures improved both loss of lives and long-term economic performance (which is governments' rationale for current actions). If this turns out to be right, the ultimate economic impact should be less than 1918. As for the market, it doesn't surprise me much that it rushed to price in close to the worst case outcome (1918) and has recovered some from there as it monitors the fluid situation.

Currently, the entire world is singularly focused on prevailing over COVID-19 and getting the economy opened. Political and monetary support has been swift and sizeable, outdoing all prior precedents. Scientists around the globe have united to focus on finding solutions to this problem from understanding the disease better to figuring out treatments. Corporations have also dedicated themselves fully to the job, reworking supply chains, testing treatments, working on vaccines and creating new measures to help monitor and track the virus. It surely won't be a straight path to success, but there's good reason to be hopeful that we can figure this out.

We've been active in making changes to the portfolio in this market volatility. Typically, when prices swoon and volatility spikes, we aim to take advantage of extreme price movements to improve the risk-adjusted return in the portfolio. This time is no different. We added 8 names, and sold 8 names as well. Most, but not all, of that activity took place during the extreme market movements in March. With so much activity, I won't go into as much detail as usual, but I will cover our thinking on each.

Early in the quarter before the market mayhem began, we added a sizeable Alphabet (Google) position and a tiny SmileDirectClub position and sold Alexion. We thought Google was attractively priced given its dominant competitive position, growth prospects and new management structure and incentives. We ramped this position quickly and fortunately, it's been a relative outperformer in the decline. We also started a small position SmileDirectClub which had fallen from an IPO price of $23 to $8 when we dug into the company in more detail. We found many things about the company interesting, but this new environment raises significant questions about its future so it remains a small position as we continue to do further work. We chose to sell Alexion to fund these ideas. While it still looks like a great bargain at face value, we've owned it for three years without the investment working. When we did an exhaustive review of how to improve our process after 2011, one useful rule was to sell a name that hadn't worked after 2-3 years. The grandfather of value investing, Ben Graham, advocated this rule as well so we incorporated it into our process.

The one other significant action we took prior to the pandemic panic was exiting United Airlines. While we continued to view the airlines as attractive investments, we thought there was more upside in some other names so we exited. Sometimes it's better to be lucky than good, and exiting one of our airlines right before the pandemic hit classifies as luck. United happened to fall more than our other airlines in the panic despite it having a better balance sheet than American so we swapped our American back into United at the depths of the decline.

The airline business has been crushed by the pandemic and stay at home orders. The fact that they have withstood 95% revenue declines speaks to how much better the industry is positioned than historically. But no business, especially one with a high fixed cost base, can withstand that kind of decline for long. The government wants to support the industry given its large employment base and systemically important designation, but the duration of this decline will determine how much equity value remains in the airlines. If we start a gradual recovery in a couple months and government grants help the industry operate normally through September, there's a good chance United and Delta could be worth double the current prices. But there's a wide range of outcomes.

We also took advantage of what we believed to be attractive prices in the following names (in order of position size at quarter end): Boeing, DXC Technology, Chemours, Canada Goose and Taylor Morrison. To fund these new ideas we mostly sold names that had fared better on a relative basis and had less upside, including CVS, Qualcomm (used to fund Boeing), and Micron. We also exited two mistakes: Eventbrite and Centennial Resource Development (which we rolled into Energy Transfer).

We've known Boeing for a long time. It's always been a high quality company that's traded for a premium valuation owing to its position as a global duopoly. We'd looked at it recently after weakness due to its highly publicized Max 737 issues, but it never got cheap enough for us to pull the trigger. After the pandemic, the stock went into freefall as its customer bases' business dried up and people worried about its liquidity. The stock fell from $338 on February 19th when the S&P hit its high to a low of $89. We bought the stock after the new CEO Dave Calhoun said publicly that it would not take government capital if it required equity dilution because it had many other options. Our average price is just above $120 where it was trading for less than 7x what it earned in 2018. It will likely take a while to normalize to those earnings levels, but this business will survive and ultimately we will own a leader in a global duopoly. Even on depressed forecasts, the company currently has about a 10-15% free cash flow yield. If and when the economy normalizes, we think Boeing could be worth more than double its current price. While we liked Qualcomm, it didn't have as much upside so we swapped it into Boeing.

We'd also been considering DXC Technology prior to the panic. DXC is a global IT services business that's been pressured as its core business, IT outsourcing, declined due to the cloud. The new CEO Mik

Salvino, who previously ran Accenture's outsourcing business, is very highly regarded and has triaged accounts to stabilize the business. He's announced numerous asset sales, most recently the State and Local Health and Human Services business for $5B, which is more than the entire market cap of the company ($4B). At the current level of $15, the stock just looks too cheap at less than 3x what it is expected to earn the next couple years and with a 5.4% dividend yield. It's relatively insulated from the coronavirus economic halt. We think this name has the potential to double as conditions normalize. With any success in turning around the business, there could be additional upside from there.

Chemours is another name that we've followed for many months. It's a chemical company spun out of DuPont. It traded down from $40 a year ago to the mid-teens in February, mostly due to concerns about environmental liabilities and a down cycle in one of its businesses. A good quarter caused it to trade up to $20 before the market malaise took it to $7 at the lows. David Einhorn, the noted value investor, made great money on it after buying it at $3 and selling it at $57. He re-entered his position around $23-24 saying it baked in a good margin of safety. If it was good there, it must be fantastic at the current level of $10-11. We think it's worth somewhere in the low $20's. At 4x this year and 3x next year's earnings, with a 9.5% dividend yield, we think you are getting a great deal on a leader in its markets.

Canada Goose is a premium luxury brand focused on outerwear. It was one of the first to announce problems from the pandemic because of its Asian presence. The stock was $55 a year ago, over $30 in February and $21 today. While this one looks more expensive on today's numbers at 22x earnings, this unique kind of brand typically trades for a premium and we believe it still has nice growth potential. We think it has greater than 50% recovery potential plus the ability to compound capital over the long term.

The last new name is Taylor Morrison, a homebuilder we've owned in the past. It has great management and the stock was hit even harder than most builders due to its increased leverage from a recent acquisition. It's trading for merely 4x what it is expected to earn this year. Homebuilders have been battletested from the financial crisis when home prices declined ~30% along with a deep and long recession. As we learned then, builders can become cash machines in downturns which helps them survive until better times. After the economy normalizes, we think Taylor Morrison would likely trade for more than twice its current price.

I want to note a couple final last points. First, we've mostly gotten inflows rather than outflows during this period which makes me so proud (my mom-self shining through). It's not easy to buy into a market that immediately slaps you in the face with a loss, but over the long term it can be the best way to build wealth. I think that buying here will serve investors well. Second, I feel lucky to work with Bill and the team here most days, but particularly during these challenging times. I truly believe there's no one who can navigate these markets better than Bill, and I'm fortunate to work with him and learn from him. Finally and most importantly, we are so grateful to have your continued trust and support. Thank you! We are working hard every day to ensure that we earn that trust and deliver the financial rewards that appear possible. Take care and stay well.

Samantha McLemore, CFA

Historical Opportunity Equity Net Performance

Month over Month Return Equal or Below -15%

Total Number [illegible] | Current [illegible] Return [illegible]

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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[illegible]	[illegible]					
Average	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Median	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Ex Financial Crisis Average	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

3 Month Return Equal or Below -15%

Total Number 22 | Current 3-Month Trailing Return [illegible]

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Average	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Median	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Ex Financial Crisis Average	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

*Returns presented net of fees.**Past performance is no guarantee of future results.***

Strategy Highlights by Christina Siegel, CFA

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During the first quarter of 2020, Opportunity Equity returned -38.4% (net of fees). In comparison, the Strategy's unmanaged benchmark, the S&P 500 Index, returned -19.60%.

Using a three-factor performance attribution model selection, allocation, and interaction effects contributed to the portfolio's underperformance. United Airlines Holdings Inc., Boeing Co., Amazon.com Inc., Canada Goose Holdings, and GTY Govtech Warrants were the largest contributors to performance, while American Airlines Group Inc., OneMain Holdings Inc., Flexion Therapeutics, Delta Air Lines Inc., and ADT Inc. were the largest detractors.

Relative to the Index, Opportunity was overweight the Consumer Discretionary, Communication Services, Financials, Health Care, and Industrials on average during the quarter. With zero allocation to Real Estate and Utilities, the Strategy was dramatically underweight these groups and more moderately underweight the Information Technology, Energy, and Consumer Staples sector. In terms of sector allocation, the underweight position in the Information Technology sector, which outperformed the index, detracted the most from the portfolio's relative performance. On the other hand, the overweight in Health Care, which outperformed the index, contributed the most to relative performance.

We added eight positions and eliminated eight positions during the quarter, ending the quarter with 40 holdings where the top 10 represented 44.7% of total assets compared to 19.2% for the index, highlighting Opportunity's meaningful active share of around 102.7%.
Top Contributors

- At the end of January, we had exited our position in **United Airlines Holding Inc. (UAL)** while the stock was still trading in the ~$80s but decided to re-enter the name in March having watched the stock fall to the ~$20s amid the COVID-19 pandemic. As a result, our position in United returned 20.0% for the quarter making it our largest contributor. The name declined as travel was brought to a standstill as a result of the spread of COVID-19 and stay-at-home orders around the world. During the period, United announced that it had cut about 80% of its capacity in April with even larger cuts expected in May. The company has been losing more than $100M/day and they expect 4Q revenue to be down at least 30% YoY. The stock benefited from the passage of the Coronavirus Aid, Relief, and Economic Security Act (the CARES act) which will provide airlines with up to $33B in grants to make payroll, $29B in loans should other sources of liquidity be tapped out as well as waiving federal excise and fuel taxes.

- We built a position in **Boeing Co. (BA)** during the period which returned 23.1%. Boeing was hit from the impact on travel by COVID-19 and the belief that the government would seek equity positions in connection to any financial help. Boeing's CEO, David Calhoun, stated that Boeing will not accept government aid if it requires an equity stake noting that they have plenty of other options. The company has stated that they have ~$15B in liquidity and believes they will be able to meet its obligations through the summer (~8 months). The company suspended their regular dividend indefinitely while also pausing any share buybacks.

- **Amazon.com Inc. (AMZN)** gained 5.54% as the company benefited from increased online purchases due to stay-at-home orders but struggled to keep up with demand. During the quarter the company announced an effort to hire 100k additional employees to meet demand, a suspension of 3rd party FBA service for non-essential categories, and a temporary stoppage of deliveries in India. The company announced the delay of Prime Day until 3Q from 2Q.

Top Detractors

- We exited our position in **American Airlines Group Inc. (AAL)** leaving us with a return of -63.7% for the period. We transitioned our investment into United Airlines as we saw greater potential upside on a recovery and less balance sheet risk. American declined with the other airlines as a result of the COVID-19 pandemic. Earlier in the quarter the company had announced the extension of the 737 MAX's planned absence from their schedules until Mid-August.

- **OneMain Holding Inc. (OMF)** declined 51.7% during the period as investors worried about the potential negative economic impact from the coronavirus outbreak. The company issued a report on their current business position noting that they have $4.4B in cash which they believe is sufficient to run operations under numerous stress cases through 2021 along with $6B of unencumbered collateral and $3.6B undrawn and committed conduit lines that they can draw if needed. They reiterated that they expect to maintain profitability even in a 2008/2009 type of downturn. There has been a string of insider buying with the Chairman, Jay Levine, purchasing 30k shares and the CEO, Doug Shulman, purchasing 3.25k shares and a Director, Richard Smith, buying 2k shares. In addition, the company increased their buyback program from $100M to $200M, which represents ~8% of shares outstanding. The company reported 4Q results which beat the highest estimates. The company reported adjusted EPS of $1.96 versus $1.74 expected with net charge-offs of 5.71% versus 6.30% last year. The company increased their regular quarterly dividend to $0.33 and announced a special dividend of $2.50.

- **Flexion Therapeutics (FLXN)** fell 62.0% during the quarter as people became concerned with their ability to reach profitability without having to raise capital due to negative sales impact from COVID-19. The company reported Q4 revenue of $23.7M (+148% Year-over-Year (Y/Y)), in-line with their pre-announcement. The company announced a licensing deal with Hong Kong Tainuo Pharma for development and commercialization of Zilretta in Greater China with a $10M upfront payment and up to $32.5Min milestones. At the same time, the company withdrew its 2020 guidance and noted the suspension of certain clinical trials to maintain safety during the COVID-19 outbreak.

Related Posts

Bill Miller's *1Q 2020 Market Letter*

Christina Siegel's *1Q 2020 Market Highlights*

A *Q&A* with Samantha McLemore on market movements around COVID-19

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[1]As of April 9, 2020

[2]As of April 20, 2020

For important additional information on Opportunity Equity strategy performance, please click on the *Opportunity Equity GIPS Composite Disclosure*. This additional information applies to such performance for all time periods.

Contact Miller Value Partners to obtain information on how Top Contributors and Top Detractors were determined and/or to obtain a list showing every holding's contribution to Strategy performance.

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