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Extreme Times Call for Nothing Extreme at All

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Opportunity Equity 2Q 2020 Letter

Darling I don't know why I go to extremes
Too high or too low there ain't no in-betweens
And if I stand or I fall
It's all or nothing at all
Darling I don't know why I go to extremes
Sometimes I'm tired, sometimes I'm shot
Sometimes I don't know how much more I've got
Maybe I'm headed over the hill
Maybe I've set myself up for the kill
Tell me how much do you think you can take
Until the heart in you is starting to break?
Sometimes it feels like it will

— "I Go to Extremes," Billy Joel

"It was the best of times, it was the worst of times…" I'm pleased to report we just had our very best quarter of performance in the history of the *Miller Opportunity Equity*, returning +47.0% (net of fees). We've come nearly full circle (we still have some ground to make up) since last quarter when I wrote about one of our worst quarters on record. As I *wrote then*, significant drawdowns have historically been great buying opportunities. Poor returns often lead to better performance because mean

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reversion is a real thing in markets. Market values tend to move much more than underlying business values. But the reversal rarely happens so quickly and intensely.

While I'm glad it did, these extreme market moves leave lasting wounds, both psychologically and financially. A few weeks ago, the WSJ ran an *article($)* about the large number of investors who moved to cash during February and March. The article noted that those who did the same during the 2009 financial crisis often never got back in and missed the entire decade-long bull market. This time around, the S&P 500 has already recouped all of March's losses,[1] and 82% of total losses. When will those sellers re-enter?

In markets as elsewhere, sins of omission (not investing) can cost you as much as sins of commission (buying/selling at the wrong time), but worst of all is when you compound your error by doing both (selling at the wrong time and then never getting back in). Buying or selling systematically (a little every month) makes the most sense and avoids trying fruitlessly to time the market. During tumultuous times, being disciplined about adhering to your investment philosophy helps you avoid expensive mistakes, and also helps keep you sane!

Here's a reminder of our beliefs.

Markets are complex adaptive systems, always evolving. A mix of art and science. Markets are pragmatically efficient, meaning they are very difficult to beat because they reflect all available information at any given time. Given how "adaptive" they are, change is a defining feature of the system. This means there aren't many "defining truths" or constants. But a few features have withstood the test of time. We always come back to these principles.

First, the value of any investment is the present value of the future free cash flow. Most things you encounter in investing are opinions (GAAP accounting, research reports, predictions), but cash flow is fact. You can spend and invest cash, which is why it's deemed king. The entire premise of investing involves giving up cash today in exchange for greater amounts of cash in the future. That cash can

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come from the income an investment generates or from what a willing buyer will pay you for that asset in the future. But cash is the name of the game.

While the concept might seem abstract at the market level, it's quite clear at the company level. This is one reason we aim to think like owners of entire businesses. Companies generate cash, or are expected to, in the future. As owners, we are entitled to a share of that cash. If a crystal ball could tell me only a single thing about every company's future prospects, I would certainly choose to know the cash flows each would generate far into the future. While opinions and narratives surely influence market prices, cash flow ultimately drives business values. With perfect cash foresight and a sufficiently long time horizon, anyone could do quite well.

This brings me to the second constant in markets: they reflect long-term business prospects. There's great confusion around this point as critics constantly bemoan the market for being short-term oriented. While many participants in markets do exhibit short-term behavioral tendencies (e.g., companies' managements sacrifice long-term economics for short-term earnings per share, and investors hold stocks for well less than a year), the market decidedly does not.

Over its entire history, the S&P 500's price-to-earnings multiple has *averaged 17.2x*[2], which means only roughly 5.8% (1/17.2) of the market value reflects current year prospects. Data on market earnings are most readily available, but you can guess from my former comments that cash flow numbers would be more useful. Regardless, the conclusion remains the same. The market places the greatest emphasis on the future prospects of businesses rather than what's going on today.

Pop quiz: If some event were to wipe out one year of market earnings/cash flow, roughly how much would you expect the market to sell off? Ding, ding ding: The answer rounds to 6%. Guess how much the S&P 500 is off its highs as I write this?[3] The answer rounds to 6%! So the market is telling us that the pandemic will cause a loss of roughly 12 months of earnings/cash flow. The National Bureau of Economic Research said a recession started in February 2020. The US Government's "Operation Warp Speed" aims for 300M doses of vaccine (almost covers the US population) by January 2021. That might be too optimistic, but first half of 2021 seems reasonable. So that's roughly 12 months (or a little more)

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of malaise before a normalization. Obviously, the pandemic hasn't entirely wiped out earnings even during this period, and it will take additional time beyond a vaccine to heal. But overall, it still seems logical. You might hear pundits screaming about how unjustified current market prices are relative to the economy; the math suggests quite the opposite.

The market believes the pandemic's impact will be similar to a natural disaster: severe but temporary, with nearly a full recovery once the risk has passed. Fiscal and monetary stimulus are big reasons why this is the case, but that doesn't make it any less true or "real." The market can always be wrong, and it will adapt to new information as it comes out. But whenever you hear commentators obsessing about how markets don't make sense, it's likely the commentator who's missing something, not the market.

The other reason focusing on the long term is important: It's easier to make money over the long term than the short term. The market has historically risen on a little over half of days, 62% of months, 68% of quarters, and 73% of years. On a rolling 5-year basis, its posted gains 88% of the time and for rolling 10-year periods, you've made money 93% of the time.

If you can remain invested over the long term, short-term market gyrations provide opportunities rather than dangers. This is why the wise father of value investing, Benjamin Graham, said: "Price fluctuations have only one significant meaning – an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. (The) investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage."

If used wisely, volatility can help you make money by giving you the chance to buy low during market weakness and sell high during market strength. Just this year, the S&P 500 posted the fastest 35% decline in the history of markets and the largest quarterly gain (20%) in the last 20 years. For many structural reasons, volatility seems likely to stick around.

You can try to avoid it, but it will cost you dearly. Cash yields zero, and 10-year government bonds yield 0.6% in the US and even less in Europe and Japan. People pay high fees for absolute return strategies

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designed to deliver consistent returns with low volatility. But really, they pay a lot for a little. The weighted Hedge Fund Research Index (HFRI) gained 3.4% per year over the past decade severely lagging the S&P 500's 13.1% annual gain.[4] If you invested $1M in the HFRI 10 years ago, you'd have $1.4M. If you'd invested in the market, on the other hand, you'd have $3.4M! So enduring a little market volatility would have made you more than twice as rich! That speaks volumes to how volatility phobic folks are. In my view, you are paid handsomely to assume the "risk" of volatility, especially relative to the alternatives. That's why we say: volatility is the price you pay for returns in this market.

There are many reasons why people focus more on the short term and tend to sell into weakness, both institutionally and individually. At the institutional level, there's an imperative to manage risk. Entire structures (consisting of groups of people, which by their very definition are conventional) exist to ensure long-term objectives are met. Any negative deviance presents a risk so the negative consequences for losing money are much more severe than rewards for making significant amounts of money.

Even institutions with assumedly infinite institutional lives (i.e., very long time horizons where short-term drawdowns matter little to long-term outcomes) are managed by people whose careers are much shorter and tenure at any given institution even shorter still. Professionals' skills are assessed on very short-term performance – annually and many times even quarterly or monthly! As a result, it's very difficult to ignore the risk of short-term drawdowns.

At the individual level, losses inflict great pain. It's now widely known the pain of losses feels 2x as strong as the pleasure from gains. A great new book, *The Power of Bad* by John Tierney and Roy Baumeister, details just how pervasive this phenomenon is – there are literally no exceptions to the rule, from finances to marital experiences: Negative things HURT much more than positive things feel good. There's good reason for this: our survival instinct. As they say in the book, "To survive, life has to win every day. Death has to win just once."

This applies to making money as well: You only need to be wiped out once to impair your long-term wealth. The human brain is wired to react quickly to protect against threats, but these circuits sacrifice

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accuracy for speed. Much better to run from a squirrel in the bushes than to investigate and find a lion. But in markets where typically the very fact that we perceive a risk means the risk is lower (because the market is pricing it in) means our natural instincts tend to be counterproductive.

To do well in markets over the long term, it's crucial to understand how our emotions and institutions can cause us to act sub-optimally because then we can take counteractive measures. This is why Buffett has said "a keen understanding of institutional and individual behavior" is one of the three key traits for long-term market success (the other two are emotional stability and independent thinking).

A third enduring feature of markets results from being complex systems driven by human behavior. Markets go to extremes due to persistent behaviors like fear and greed. Long market cycles arise from underlying economic drivers, but there's a powerful behavioral element that operates one level up. Together they dictate which investments do best. A new unknown opportunity offers excess returns, attracts more interest and capital, and ultimately drives down the return opportunity. Mathematical models and convincing narratives built upon the past draw ever more interest but ultimately they don't reflect the future. Thus reward becomes risk. Understanding the powerful driving force of human behavior and where it can go wrong, leads to one of the few lasting ways to derive an edge against markets. This drives us to always try to identify why the market might be wrong on a given opportunity because it's mostly correct.

Diversity breakdowns increase the likelihood a security or market is mispriced. Going against the crowd can offer fertile hunting ground for profitable investments (but doing so blindly is perilous). Buying during extreme market weakness has a very strong history of success, but also produces significant pain (and fear) because you typically suffer immediate losses (no one can time the market bottom perfectly). Buying low and selling high seems simple, but it's not easy. We spend significant time learning about market dynamics, behavioral finance and where there might be opportunities.

Sir John Templeton's fabulous quote might capture this phenomenon better than anything: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." You hardly ever hear anyone bullish on TV during significant bear markets (except our own Bill Miller who

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went on CNBC near the lows to say that this was one of the great buying opportunities of his life), or for months, quarters and even years afterwards. Most people remained cautious for years after the financial crisis. Most remain nervous today. When you can't find anyone with a positive view that's a good thing! It means markets price in a dire, or at least muted, outlook. Predictions about how fundamentals will evolve are opinions, prices well off their highs are facts.

Market gains and losses result from how fundamentals develop relative to the expectations priced in. People spend nearly all their time focused on the former, while the latter merits equal attention. A great company can be a terrible investment if it's priced to achieve more than it's able to accomplish and a mediocre company can be a solid investment if expectations are low enough.

With one of the largest market caps ever, attained in the shortest time since its birth, Amazon could arguably be the best company that ever existed. If you invested in Amazon at the end of 1999 during the height of the tech bubble, you'd have done fabulously BUT it took almost 8 years just to make money and to outperform the index. Few likely held through that pain. Fundamentals were ultimately strong enough to offset very elevated beginning expectations. The same wasn't true for many other names priced for perfection at that time. Cisco and Intel, for instance, still haven't surpassed those highs. But at least they survived, unlike many. This is why we believe that Shopify, despite its great fundamentals, warrants much caution at over 2000x earnings!

Noise is another huge issue in markets and life. In today's 24-hour news cycle, social media frenzy and big data environment, it's a problem that only seems to be getting worse. Nobel Prize winner and one of the creators of behavioral finance, Daniel Kahneman, has said it's a bigger issue than the behavioral shortcomings he spent his career on. He's releasing a book on the topic in April 2021, which I'm eagerly awaiting. Until then, it's important to understand that most of what you see is noise, rather than signal. Anything that can help amplify the signal relative to the noise merits significant attention.

I've spent much more time than anticipated covering the core tenets of our investment philosophy. It's more important than ever to stick to your knitting and remain disciplined during turbulent times like these. Now I will turn to the really good stuff, the portfolio.

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The overall level of activity in Opportunity Equity dropped significantly from last quarter. This shouldn't be surprising as our activity typically spikes when prices plummet. This quarter prices rose significantly. In the second quarter, we added three new names and eliminated one. We bought Capital One Financial, Workday and Vroom on the IPO. We sold SmileDirectClub.

Capital One is a company we've admired for a long time. Bill used to own it in Value Equity. CEO and Founder Rich Fairbanks built an admirable technology-enabled franchise that started in credit cards and subsequently expanded broadly into other financial services. Superior technology is core to everything the company does (*check out their great annual shareholder letter for details*). Since the IPO in 1994, Capital One has compounded capital at 11.1% per year,[5] vastly outperforming the S&P 500 Financial Index (7.6% per year) and the broad S&P 500 (9.9% per year), even in a challenging market for financials. The company ended 2019 with tangible book value per share of $84 and earned $11 per share. In the short-term, the recession will hit earnings. But the strong balance sheet ensures it can not only survive, but continue to invest in improving the business for the long term. We think the stock is quite attractive in the high $50s, where it trades for less than 70% of tangible book value, 5x trailing earnings (good "normalized level" off which it can grow) and a 2.8% dividend yield.

Workday is one of the "software as a service" (SAAS) leaders. We looked at it last year as we did work to understand the space. At the time, we didn't think it offered enough upside, but in the market selloff, it went from $200 to $107. While we didn't catch it at the lows, we bought it in the $150s where we thought it still offered 50% upside. For a name this kind of market loves, we thought this was quite attractive. Many of its peers had already recovered all of their lost ground but the market was worried about near-term weakness from customers pushing out tech projects. This created a great buying opportunity for us. Workday leads human resource management cloud solutions and is nicely growing its newer financial services offering. It has a sizeable total addressable market, especially relative to its current market cap and revenues. At 9x EV/Revs and 40x EV/EBITDA on next year's numbers, it's not cheap on the surface, but we think it's reasonably priced for a leader with good growth prospects that should be able to compound capital for a long time.

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Lastly, we bought Vroom on the IPO, which is a name we are excited about. It's a direct online used auto platform entirely focused on a great user experience. The total addressable market (TAM) is huge ($840B) and the industry has one of the lowest online penetration rates of any. Carvana has demonstrated just how successful a company can be pursuing a similar opportunity. We think there's plenty of room for two players. Vroom has a great management team that formerly grew Bookings.com to be the leader in the travel industry competing head-to-head with Expedia. Even after huge gains from the IPO price, Vroom still trades at a discount to Carvana and we believe it will be a long-term winner.

We sold SmileDirect to fund our other ideas. We didn't end up holding the name long. While there are many interesting things about the business, we think the business is significantly challenged by the pandemic. Their product is highly discretionary with a high price point and certain distribution outlets closed down. The company loses money and had a challenged balance sheet. Given the risks, we preferred to deploy the capital elsewhere.

Overall, we think the portfolio remains attractively positioned. We have a nice mix of secularly advantaged companies that this current market loves and hated classic value names with great recovery potential. While we've recovered most of the losses that presented such an excellent buying opportunity, we still calculate the securities in the portfolio to be worth almost 90% more than where they're trading now.

We thank our investors for sticking with us through the volatility. We will work hard to deliver attractive returns to you in the future.

Samantha McLemore, CFA

Strategy Highlights by Christina Siegel, CFA

During the second quarter of 2020, Miller Opportunity Equity returned 47.02% (net of fees) compared to the unmanaged benchmark, the S&P 500 Index, return of 20.54%.

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Using a three-factor performance attribution model selection, allocation, and interaction effects contributed to the portfolio's outperformance. Farfetch, ADT Inc., Medifast, Inc., RH and StitchFix were the largest contributors to performance, while Genworth Financial, Delta Air Lines, Endo International plc, PTON C55 7/20, and United Airlines Holdings were the largest detractors.

Relative to the index, the Strategy was overweight the Consumer Discretionary, 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 Communication Services, Information Technology, Energy, Materials 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 Consumer Discretionary, which outperformed the index, contributed the most to relative performance.

We added three positions and eliminated one positions during the quarter, ending the quarter with 42 holdings where the top 10 represented 42.4% of total assets compared to 27.8% for the index, highlighting Opportunity's meaningful active share of around 88.8%.

Top Contributors

- **Farfetch Ltd (FTCH)** gained 118.6% over the quarter as the company saw better than expected demand on their luxury platform. The company reported 1Q gross merchandise value (GMV) growth of 46% on the high-end of their prior guidance of 43-46% with revenue of $331M beating consensus of $313M with Earnings before income, taxes, depreciation and amortization (EBITDA) of -$22.3M ahead of consensus of -$27M. The company reported active customer growth of 27% to 2.15M, but they saw a lower average order size of $571. The company removed full-year guidance but noted that they expect to see year-over-year (YoY) growth in 2Q. Later in the period, the company moved higher after releasing new guidance that was above expectations. The company guided for GMV in 2Q of $605-630M versus consensus at $488M, representing 25-30% YoY growth with adjusted EBITDA

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improving YoY (2Q19 EBITDA was -$38M) versus consensus estimating -$46M. The company reiterated that they plan to be EBITDA profitable for the full year 2021.

- **ADT Inc. (ADT)** returned 85.5% over the period. The company reported 1Q revenue of $1.37B ahead of consensus of $1.23B with adjusted EBITDA of $539M ahead of consensus of $509M with Free Cash Flow (FCF) of $173M ahead of consensus of $139M. For the full year, the company reiterated their topline guidance (revenue of $5-5.3B) but lowered EBITDA guidance to $2.075-2.175B down from $2.175-2.25B with a wider FCF range of $600-700M from $630-670M. The company saw positive net new subscribers for the first time in 5 years.

- **Medifast Inc. (MED)** climbed 123.5% over the period after reporting 1Q results. The company reported revenue of $178.5M beating consensus of $166M with Earnings per Share (EPS) of $1.93 ahead of the $1.32 expected. The company had their highest coach count ever of 32,600, but average revenue per coach was still down to $5,333 compared to $5,817 seen 1Q last year, but was up 2% quarter-over-quarter (QoQ) with 4Q revenue per coach of $5,229. They noted that 85% of revenue is reoccurring with 80% of expenses being variable, but the company still pulled full-year guidance due to uncertainty around COVID. The company maintained their dividend at $1.13, 4.7% yield.

Top Detractors

- **Genworth Financial Inc. (GNW)** declined -30.5% during the quarter as investors grew concerned on the potential closing of the acquisition by China Oceanwide. The company noted on their 1Q call that China Oceanwide's financing plans were "progressing well," but also noted that China Oceanwide was having discussions with third parties beyond their primary lender creating concern that the primary lender might not follow through on its commitment. Management noted that they expect the deal to close by June 30th, but noted that the buyer had allowed Genworth to explore alternatives it could pursue if the deal fell through. The company reported 1Q revenue of $1.84B below consensus of $1.99B with EPS of $0.07 below consensus of $0.27. After the quarter ended, the company announced

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another extension of the acquisition agreement with China Oceanwide. The new agreement extends the merger deadline to September 30th with an interim update on financing by August 31th. The company held a call to discuss the extension as well as "Plan B" options available to it if the deal fails.

- **Delta Air Lines Inc. (DAL)** declined -1.38% over the period after the initial hit to the stock in 1Q following the outbreak of the COVID-19 pandemic. The company reported 1Q results with EPS of -$0.51, in-line with consensus. The company guided for June revenue to be down 90% YoY and announced another $1B cut to capital expenditures (CAPEX) for a total cut of $3B so far this year. The company ended the quarter with $6B in liquidity and they expect to end the June quarter with $10B in liquidity. Delta held its annual shareholders' meeting where it noted that it expects to finish the 2nd quarter with over $15B in liquidity with a daily cash burn of $30M getting to breakeven by the end of the year.

- **Endo International (ENDP)** fell -7.4% on continued concerns of opioid and price fixing liabilities. The company reported 1Q revenue of $820M ahead of consensus of $726M with EBITDA of $421M vs the Street at $319M, leading to EPS of $0.95 ahead of expectations of $0.55. The company withdrew full year guidance due to uncertainties around COVID and they have pushed back the launch of CCH for cellulite to 1Q21 from 4Q20 originally. The company expects revenue decline in the low 20's percentage range for 2Q compared to 1Q with adjusted operating expenses at 25% of sales and gross margins of 60%. The stock fell further when the New York State Department of Financial Services alleged that Endo misrepresented the safety and efficacy of its opioid products which helped drive over-prescription of opioids.

Related Posts

Bill Miller's *2Q 2020 Market Letter*

Christina Siegel's *2Q 2020 Market Highlights*

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2Q 2020 Market Infographic

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[1]As of July 6, 2020

[2]Source: *www.macrotrends.net* Dates: Dec 1927 – Dec 2019

[3]As of July 9, 2020

[4]Source: Bloomberg. Returns 5/31/10- 5/31/20.

[5]November 1994 – July 8, 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.

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