



August 7, 2017

For the six months ending June 30, 2017, Broyhill generated mid-to-high single digit returns across the majority of our separately managed accounts. Detailed quarterly reports, including portfolio allocations, individual account performance, portfolio holdings, and transaction history, have been posted to our investor portal.¹

A Stock Market Lullaby

The market lulled investors to sleep in the first half of the year, with an unusually consistent climb higher. The S&P posted positive returns in each of the first six months. The second quarter saw only a single daily gain and loss larger than one percent. The last time the market declined by even 5% was over one year ago, making this the longest stretch without even a minor correction in two decades.



¹ Since we construct each client's portfolio from the bottom up, the performance of individual accounts will vary based on the opportunities then available in the market. A fundamental truth of value investing is that the higher the price one pays for a given set of cash flows, the lower the future return one can expect. Consequently, we work hard to preserve the integrity of our initial purchase decisions, rather than blindly chasing previous purchases higher as new accounts are funded. While this makes a discussion of our "portfolio" more difficult, we believe this discipline is ultimately in the best interest of our clients and that any performance dispersion will narrow over time.

From time to time, it is normal for markets to experience periods of low volatility and high complacency. However, it is dangerous to come to expect them. It is even more dangerous to rely on them.

Temporary lows in volatility have historically concluded with exploding volatility and lower prices.

In the interim, investors tell themselves elegant stories to justify their aggressive decision making amidst subdued volatility. Every cycle comes along with its own convincing narrative. Recent examples include Greenspan's ability to eliminate the economic cycle during the 1990s; Bernanke's Great Moderation; and today's relentless inflow of capital into passive investments. No matter how great the story, the conclusion is always the same.

Stories and Storytellers

Master storytellers capture everyone's attention. We gravitate toward experts able to spin compelling narratives with conviction. We take comfort in hearing strongly held opinions. The simpler the story and the more confident the storyteller, the better.

Good stories put us at ease, connect with our emotions, and invite us to let down our guards. The best stories even alter how we process information, making us less likely to seek out inconsistencies. We become seduced by the narrative. We accept arguments without questioning the assumptions.

At the moment, the most popular story amongst market participants lies at the intersection of supply and demand, where the marginal buyer sets the price for risk assets. Today, the marginal buyer is a machine with no regard for price. When markets go straight up, the machines are given the green light to increase risk exposure. More buying drives up prices, and higher prices trigger more buying. What could possibly go wrong?

For one, machines do what the algorithms tell them to do. Nothing more.

Fundamental analysis plays no part in this narrative. Price doesn't matter to a machine. It's all about supply and demand. And demand is ultimately driven by the narrative. But narratives can change.

A Very Strange Thing to Do

If you can't beat 'em, join 'em. In its simplest form, this is the argument driving the machines and the record inflows into passive investments. It's a very strange thing to do at this point in the cycle.

It seems that investors have blindly accepted another compelling narrative. They've let their guard down at a very inopportune time without questioning the assumptions behind the story they are being sold.

Passive investors are buying the S&P 500 today for 30x normalized earnings. The implicit assumption they are making is that price doesn't matter. Yet a century of historical data clearly shows that price is the most important determinant of long-term returns.

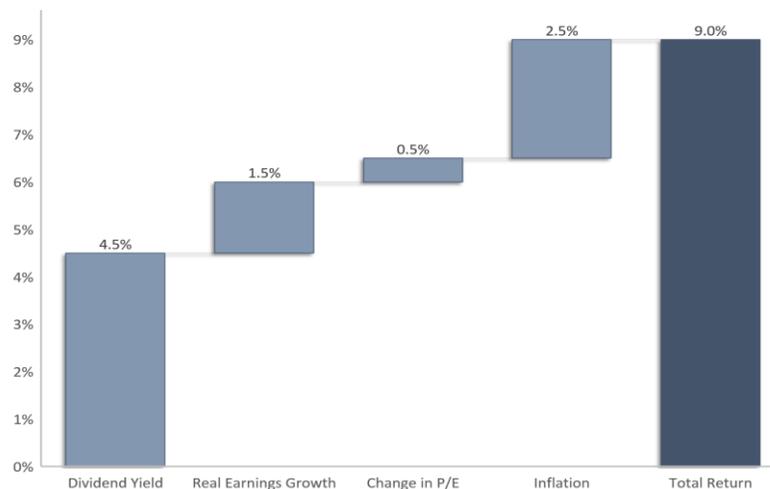
In the long run, price follows value no matter how compelling the prevailing narrative of the day. We know today's price. Value is a more uncertain concept, but it can be estimated with a dash of reason and a dollop of logic.



Forecasting a range of long-term returns lacks the sex appeal of a good story, but it is likely to prove far more accurate than a blind-folded chimp chucking darts at market pundits.

Numbers Don't Lie

Over the last century, the US stock market has generated average returns of about 9% annually. Historical returns can be broken down into the building blocks illustrated in the graph below.²



Source: Broyhill Asset Management

To forecast a reasonable range of future returns, we'll examine each of these building blocks – dividend yield, earnings growth, and changes in valuation - in turn, beginning with the market's current yield.

The beginning dividend yield is a known quantity and hence the easiest "forecast" - no room for story telling here. While the long-term average dividend yield on the stock market has been about 4.5%, Today's dividend yield is below 2%.

So right out of the gate, we should knock 2.5% off the top.

Bottom line: best case scenario for future stock market returns is 6.5% ($9\% - 2.5\% = 6.5\%$).

Real earnings growth varies widely from year to year, but the long-term trend is robust. While every cycle is accompanied by colorful stories of accelerating earnings growth, real earnings per share have continued to compound at 1.5% annually over the past century. This rate of growth is far lower than typical Wall Street forecasts for a simple reason. One is fact. The other is opinion.

² Historical data on each component of market returns is publicly available. No Bloomberg terminal required. Equity prices, earnings, dividends and inflation from 1871 to present can be downloaded from Robert Shiller's website. Rates of economic growth and levels of inflation can be accessed via the Federal Reserve. Astute readers may note that we have rounded these figures for simplicity. One can quibble with 10 basis points here or 20 basis points there, but in the words of John Maynard Keynes, "It is better to be roughly right than precisely wrong." Our intent here is to illustrate the magnitude of the shift at hand, rather than attempt to accurately forecast ten-year expected returns down to two decimal points.



With a starting dividend yield below 2% and long-term average earnings growth of 1.5%, a reasonable estimate of long-term real returns around 3.5% seems like a decent starting point.

That’s a good bit lower than the equity market’s historical 6.5% real return, but it’s a more realistic forecast than the typical, “past is prologue.” And we haven’t even considered the fact that current profits are far above trend and profit margins are hovering near all-time highs. Both variables point to lower future earnings growth, but we’ll give the market the benefit of the doubt for now.

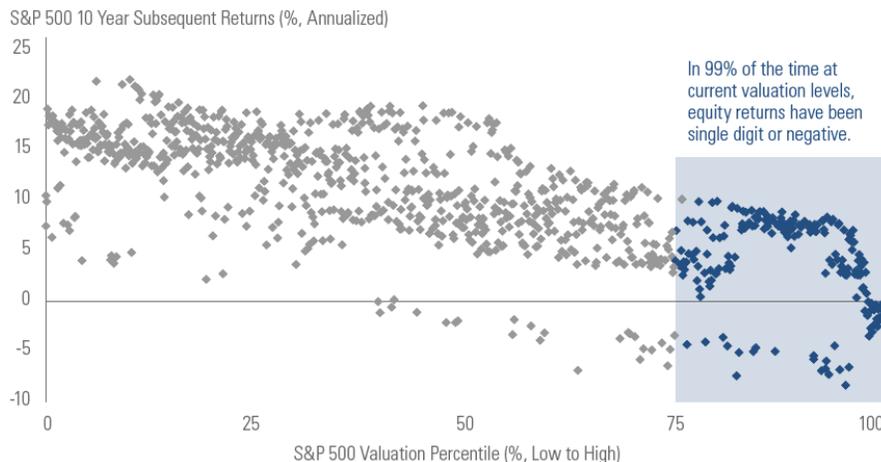
To get from real returns to nominal returns, we need to consider inflation. Over the past century, US inflation has averaged about 2.5% per year. However, sluggish, debt-fueled economic growth since the financial crisis has resulted in sluggish inflation as well. Over the past ten years, average annual gains in the CPI have been closer to 1% -1.5%. We’ll take the high end of that range and tack it onto our 3.5% real return estimate. This gets us into the neighborhood of 5% nominal expected returns.

	Historical Average	Expected Return
Dividend Yield	4.5%	2.0%
Real Earnings Growth	1.5%	1.5%
Change in P/E Multiple	0.5%	0.0%
Inflation	2.5%	1.5%
Total Return	9.0%	5.0%

Source: Broyhill Asset Management

That doesn’t sound awful relative to current yields on cash, but it’s not the whole story. Over the past century, changes in valuation have added about 0.5% to the average return on the market as PE ratios have gradually increased. Suffice it to say that a further increase from today’s levels is unlikely.

Historically, investors have paid about 15x for a dollar of earnings. Today, passive investors in the S&P have bid up that price to 30x earnings – roughly double the historical average and a level only exceeded twice in market history. Research from Goldman Sachs Asset Management illustrates that at current valuation levels, the S&P has delivered single-digit or negative returns 99% of the time.



High valuations can persist for years, but investors must recognize that they are betting the house on inflated prices to achieve, at best, single digit returns.

Even a minor reversion in valuation from today's levels would more than offset the most optimistic assumptions for earnings growth. For perspective, the table below depicts a range of outcomes for ten-year expected annual returns assuming various levels of earnings growth and ending valuation. Note that the highlighted range encompasses ending valuations in line with or greater than the historical average. Still, nearly two-thirds of the expected outcomes in this range are negative.

Range of Ten-Year Expected Returns for S&P

		<i>Ending Shiller P/E Multiple</i>				
		10x	15x	20x	25x	30x
<i>Earnings Growth</i>	0%	(8.6%)	(4.9%)	(2.2%)	(0.0%)	1.8%
	1%	(7.7%)	(4.0%)	(1.2%)	1.0%	2.8%
	2%	(6.8%)	(3.0%)	(0.2%)	2.0%	3.8%
	3%	(5.9%)	(2.1%)	0.7%	2.9%	4.8%
	4%	(5.0%)	(1.2%)	1.7%	3.9%	5.8%

Source: Broyhill Asset Management

Our Story

This isn't a comforting story. But it's a story that must be told if investors are to avoid the dangers of allocating capital on the basis of historical average returns. For prudent investors, not yet seduced by the consensus narrative, we offer the following suggestions.

Keep your powder dry. Cash balances across our accounts range from 25% to 50% of assets today. We recognize cash is a drag on returns when markets go one way, yet we've managed to generate satisfactory performance despite this drag. We know it doesn't feel good. A few clients are getting antsy. In our experience, that's generally a good sign we are doing the right thing.

Invest anti-passive. The valuation gap between stocks widely owned by passive products, and those far removed from indices, is stretching further with each day. The good news: despite richly priced passive indices, there is a growing opportunity in the stocks left behind the tidal wave of passive flows.

Remain patient. These index stragglers, overlooked by passive investors, may remain cheap until flows reverse (meaning continued challenges for contrarian investors), so patience is a virtue. But price ultimately follows value. The rubber band can only stretch so far before it snaps back. Old, stodgy brick and mortar businesses have been left for dead in favor of high flying stories out of Silicon Valley. We've heard this story before.

Stay focused. The more investments you own, the more you look like the index. The more you look like the index, the more your returns will look like index returns. Better to hold a concentrated portfolio of undervalued, under-owned businesses and sit on our hands (and on your cash) until the crowd comes to its senses.



Generally speaking, our sweet spot tends to range from ten to twenty names in the portfolio. Below ten, we begin to worry about concentration risk. North of twenty, we begin to worry about missing something.

Our top ten holdings at quarter end represented roughly 60% of our equity exposure. The combined weighting of those stocks make up less than 1% of the S&P.

Portfolio Update

One of the most difficult things to do as an investor is to sell your winners.

Perhaps the only downside to rising prices is a diminishing margin of safety. As price approaches and ultimately exceeds fair value, we've made some difficult decisions along the way.

We sold most of our Time Warner position, too low and too early. As of quarter-end, we still held a smaller position in the stock given the attractive deal spread and increased likelihood of regulatory approval.

IRSA Inversiones y Representaciones S.A. (IRS) rallied 25% in the first six months of the year after a 50% gain in 2016. We established our initial position in the single-digits at a significant discount to net asset value. As sentiment around Argentina improved rapidly alongside of political regime change, that discount narrowed. We exited our last tranche of stock at \$26 per share.

We liquidated our investment in Dell Technologies Inc. (DVMT) as the stock tacked on an additional 16% in the first half of this year. At our cost, we were buying the VMWare (VMW) tracking stock at a substantial discount to already depressed VMW shares. Over the past twelve months the discount has narrowed and the multiple investors have been willing to pay for a dollar of VMW earnings has surged from 10x to 20x. We exited the position at a nice gain as our thesis played out.

Investors re-rated shares of eBay significantly higher in the first half. As such, we've trimmed our position with the stock gaining 23% during this period. Our investment in eBay pre-dates the PayPal split and demonstrates the potential benefits of holding a non-consensus view and giving the market time to catch up to that view.

When we established our position, the stock was trading at a single-digit multiple of depressed earnings as consensus was overly focused on eBay's shrinking share of eCommerce. Our thesis rested on the assumption that eBay's potentially smaller slice of the pie still had plenty of room to grow given how big the pie was getting. Shares now trade at a more reasonable multiple for the second largest retail website in the country.

Over the years, we've done very well picking up the pieces of broken tech stocks left for dead by investors chasing momentum. The eBay situation was a wonderful opportunity as we profited from the core business as well as the spin-off of PayPal. Other examples that come to mind are investments in Microsoft post Balmer, and two separate bites of the Apple, post Jobs. We hope to have equal success with two new investments in the sector, described below.



New Positions

Ideas are abundant in today's information age. Yet, truly good ideas remain rare. We maintain a high hurdle for new investments to keep mediocre ideas from cluttering the portfolio. As a friend recently observed, "you spend all your time on the maybes." **We prefer to focus on clearing the one-foot hurdles and have managed to find more than a few this year, which might be considered a break-neck pace by our standards of inactivity.**

Starting in December of 2016, we began building a basket of closed-end municipal bond funds. As primarily equity investors, we are somewhat embarrassed to admit that this was as excited as we've been about a new investment in years. In other words, municipal bonds were as good as it gets! We even put together a deck to highlight this opportunity to investors. The response. Crickets.



As rates spiked higher following the election of President Trump, most investors reacted like the proverbial deer in the headlights. This was our takeaway at the time:

- Since the financial crisis, we've seen three major corrections in bond prices;
- Each sell-off was accompanied by consensus calls for higher rates and higher inflation;
- Each spike in rates created a panic in bond markets, marked by large capital outflows;
- Each panic created excellent buying opportunities for investors as rates retreated to new lows;

Bottom line: the spike in rates created the best buying opportunity that we'd seen in years. That was our story. Simple, straight-forward and offering what we considered to be a safe, double-digit taxable equivalent yield. If we were wrong, we believed we had downside protection in the form of high coupons, wide discounts to NAV and wide spreads to Treasuries. If right, we were well positioned to earn double-digit returns on capital with minimal downside risk. Perhaps we needed a more compelling narrative.

The average fund in our muni basket gained 6% year-to-date through June, with much of that performance generated by tax-free income to our investors. While discounts have narrowed on most holdings, others remain quite wide, with ample opportunities on offer.

Feel free to give us a call if you'd like to review our original thesis and learn more about the current opportunity set. Supplies won't last long!



IT Services

We established two core positions in the IT Services industry during the first half.

The first is a leader in the industry and one of the largest firms in the sector. However, increased size has not translated into increased returns. Despite generating revenue growth north of 20% over the past five years, shares of Cognizant (CTSH) lagged peers by over 100% as the stock's multiple was cut in half.

While Cognizant earns gross margins in line with the best of its peer group, operating margins are a full ten points lower than the smallest players in the space. The business generates substantial cash flow, but net cash has remained stagnant on the balance sheet even as shares traded at their lowest valuation since the financial crisis.

The good news is that there is plenty of room for improvement, and management has announced plans to address both the margin deficiency and capital structure in recent quarters. We think there is more to come. Shares of Cognizant have gained 19% year-to-date through June.

In contrast to the lackluster capital allocation at Cognizant, the owner operators at Syntel (SYNT) recently paid out a \$15 special dividend to shareholders last year, largely refuting the bear case for the stock.

When a controlling shareholder calls the shots, incentives are easy to understand. They are a function of shared economic interests rather than suboptimal targets laid out in a proxy statement.

While management at Cognizant has reinvested every dollar back into the business to fuel top line growth, penny-pinching at Syntel has resulted in best-in-class operating margins.

Managers follow the incentives. Owners pinch pennies.

In comparison to an institutional "revenue at all cost" approach, management at Syntel has prioritized more measured growth with a focus on high margin business. The business is far more concentrated as a result, with Syntel's top three clients accounting for nearly half of sales. While this level of customer concentration has helped margins, it has clearly increased risk (particularly when your largest customer is aggressively cutting costs).

Risk is often shunned by the investment industry, but risk in itself is not a negative so long as investors are being compensated for it.

In the case of Syntel, we believe we are being very well compensated. At 10x earnings, roughly half the average multiple of peers, we own a high-quality, owner-operated business, which has compounded sales at 13% annually for the past two decades, while the big players in the space seek out small, tuck-in acquisitions to inflate stagnating top line growth.



The Dollar Parlor

Many of my favorite childhood memories were formed on Long Beach Island. The highlight of any weekend on the island consisted of a trip to Bay Village, where if the kids were lucky, concluded with a trip to The Dollar Parlor. At the time, the economics of the business were shadowed by the endless piles of squirt guns, magnets, playing cards, and whoopee cushions. Thirty years later, the financials are far more exciting than squirt guns (although whoopee cushions still represent strong competition for my attention, even today).

Consider that your average retailer has two levers to drive sales – price and volume. They can sell more stuff or they can increase the price on the stuff they sell. A true dollar store takes price out of the equation. If everything you sell is a dollar, the only way to increase sales is to sell more stuff.

Dollar Tree (DLTR) is perhaps the best in the industry at selling more stuff. Even with one hand tied behind its back, management has generated average annual same store sales gains of 4% for the past decade. This is easier said than done in the dollar business, as even the most formidable of competitors (and childhood memories) have given up on the dollar price point. Et tu Dollar Parlor?



We believe same store sales growth plus new store openings at Dollar Tree should translate into double-digit top line growth for the next several years. Earnings growth should outpace sales growth as management squeezes synergies from the recent acquisition of Family Dollar. Margins have plenty of room to run considering that EBITDA margins at Dollar Tree stores were nearly twice the level of Family Dollar stores prior to acquisition.

A summary of our Dollar General (DG) investment thesis is included in the appendix to this letter. We aim to publish our research on both DG and DLTR in the coming months. If you'd like to receive these reports, and you are not already on our distribution list, you can [click here](#) to subscribe or to update your existing profile.

Sincerely,



*"There are no brave old people in finance."
- Steve Schwarzman*



The Death of Retail

The death of retail has been greatly exaggerated. Amazon is invading every corner of the industry and investors are reacting according to plan: sell first; ask questions later.

The Retail Sector (XRT) has underperformed the S&P by nearly 40% in the past two years. And for good reason – most of these businesses are melting ice cubes. The only question is how fast Bezos will turn up the heat.

There are few businesses models insulated from global warming in the retail sector. Consequently, we believe those with the strongest competitive positions are likely to trade at a scarcity premium. We think the dollar stores fall into this select group despite currently depressed sentiment.

Long term investors in shares of Dollar General have been well rewarded by the company's high growth and high margin operation. Since it was taken public (again) by KKR in November 2009, the shares have compounded at 17% annually even after underperforming the S&P by 35% during the past year.

Consequently, many investors were surprised by the recent pause in same store sales. After posting average comps north of 4.5% for the past decade, same store sales growth declined to 0.9% in FY17. The consensus points to the increasingly competitive landscape as cause for concern. Amazon is clearly stepping up its pressure on retail and grocery markets. This in turn, has driven Wal-Mart to step up its game and price more competitively. At the same time, the industry is staring at new competition from European discounters Aldi and Lidl.

Dollar General has faced a lollapalooza of headwinds over the past year. Food price deflation has pressured comps. Core customers have struggled with declining benefits from the Supplemental Nutrition Assistance Program (SNAP). And the prospect of import tariffs and rising labor costs threatens to reduce margins.

Good businesses rarely trade at good prices. But occasionally the market mistakes a cyclical lull for a structural shift. The threats facing Dollar General today are well known and should be discounted in today's price. We believe downside risk is limited as sentiment is washed out. Traditional growth investors have already given up on the name. At its recent peak of \$95 in July 2016, 86% of Wall Street analysts rated the stock a buy. Less than a year later, with shares around \$70, buy ratings have dropped to 40% while the price-to-earnings multiple on the stock has fallen to historical lows.

As stores lap weak comps in the coming years, we think the stock can rerate sharply higher as investors realize that even Jeff Bezos can only juggle so many balls without dropping a few. And if you're looking for a more compelling narrative, consider that same store sales at Dollar General grew on average more than 6% in the four quarters following the failure of Lehman Brothers. Defense wins ball games. At least that's what the vintage signs in the dollar stores say. Given the extreme complacency in the market in conjunction with some of the highest equity valuations in history, we suggest giving the defense some playing time. The offense is getting exhausted.



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