After a tough start to the year, our second quarter performance was much better. Some of our largest positions performed well and thus we were able to more than keep pace in a rising market. While it remains difficult to find dozens of great companies trading at large discounts, we really like the companies we own; and during the quarter we actually added a few stocks to the portfolio. From our vantage point, many investors appear to be wearing rose-colored, Federal-Reserve-distorted glasses. And, given our contrarian streak, that makes us a little nervous; especially when we see people extrapolating what we believe are market anomalies so far into the future.

On that note, we have recently read a few very well-articulated thought pieces—written by seemingly erudite investment managers—in which the authors covered a couple of timely topics. The first one can be categorized under the heading of "is value investing dead?" The second has to do with whether or not mean reversion is still a permanent fixture of a modern form of capitalism that is increasingly dominated by a handful of uber-powerful "platform" companies. After reflecting on the various arguments, it occurred to us that other people (most importantly our clients) might be having some of the same thoughts. This shouldn't be a surprise. We are ten years into a bull market and value-oriented strategies, many of which rely on eventual mean reversion, have not performed as they had in the past—on a relative basis. It is inevitable that very smart sounding people will start to argue "this time is different." As such, we thought it would be valuable to address these two topics in the context of why we believe it will always make sense to invest with conservative, long-term-focused value investors.

Let's start this journey by going back to December of 1999. It was right before the ball was about to drop on the new millennium. Y2K was all the rage. Britney Spears and Christina Aguilera were the co-queens of pop. And technology stocks were rocking. In fact, the Nasdaq Composite had climbed from 750 in late 1994 to just over 4,000. These were dark days for value investors, at least on a relative basis. Within that period, shares of Berkshire Hathaway had MERELY doubled but had suffered a significant drop during the second half of 1999. This prompted the famous Barron's article entitled "*What's Wrong, Warren?"* The suggestion made in the article was that Buffett had lost his touch, and there were plenty of people who were openly saying that value investing was dead. Investing in dot-coms was the future, valuation be damned. We all know how this ended, so we won't rehash the gory details. But briefly, since January 1, 2001, the Nasdaq is up about 100% and Berkshire's A shares have increased close to 500%.

If your first response to the abovementioned facts is that it is old news, you would be correct. As such, we are not going to try to draw parallels between the late-90s and today. Plenty of other people have done so. And although we are seeing companies go public at insane valuations (Zoom, Beyond Meat, etc.) and are witnessing stocks receive the IPO-day pops from the good ole days, we are not going to speculate about the sustainability or legitimacy of the current euphoria. We are simply going to make the following argument: none of what we are seeing now—including the recent relative underperformance of value-oriented strategies—suggests in any way that value investing is no longer a valid approach. This time is unequivocally not different. The reason for that is value investing is not one static thing. Buying low and selling high (or preferably holding forever) remains the core tenet of the philosophy but exactly what that entails can depend on the time period.

Yes, it may be true that Ben Graham's tactical manifestations of value investing that included looking for net-nets and buying stocks based on a low price-to-book ratio are no longer strategies that make a lot of sense. Markets have changed and the world has unquestionably changed. What hasn't changed is human beings' propensity to swing somewhat predictably from greed (1999) to fear (2009)—and eventually back to greed (2019?). What people tend to forget is that successful value investing is not only about religiously following the philosophy or the ability to recite the classics. It is about developing the right temperament and having the intestinal fortitude to be a contrarian, both of which are really hard, especially in rapidly rising—or falling—markets. The broader point is to not think of value investing as a "style" or a box that you check when

choosing where to put your 401k money. In actuality, opportunities to buy assets at less than their intrinsic value are evergreen but doing so requires a murky combination of beliefs, actions, and bias mitigation that may not work immediately but by definition will be effective as long as humans are involved in markets. Good value investors will adapt. It just might take another market downturn to remind people of that reality—sort of like how Buffett was quickly vindicated when the NASDAQ was down 39% in 2000 and then fell again in 2001 and 2002. Just don't ask us to opine on when that will happen.

The above is a nice segue into the next topic: mean reversion. The idea behind mean reversion is that many things in financial markets—including stock returns and corporate profitability—have a long-term average around which they periodically fluctuate, but eventually come back to over time. For example, let's say, hypothetically, that over the recorded history of the U.S. stock market, during an average ten-year period, growth stocks outperform during five years and value stocks outperform the other five years. Mean reversion suggests that if growth stocks outperformed for ten consecutive years (sound familiar?), then the next ten years would likely favor value, assuming the long-term average was still relevant.

This concept is also relevant when it comes to corporate margins and returns on capital. The history of capitalism and creative destruction is that most businesses that earn above industry average returns eventually see those returns competed or regulated away. On the flip side, when an industry earns subpar returns for long enough, eventually competitors leave and the remaining companies once again have the opportunity to earn returns commensurate with the industry's multi-year average.

Now, returning to the aforementioned thought papers that inspired this diatribe. One overarching idea is that there is a group of companies operating today that no longer are bound by these rules. In fact, certain people postulate that certain companies have amassed such powerful networks and platforms that they will see *increasing* returns to scale. In other words, not only will their returns not be competed away, but they also will increase as the companies get even larger. If it is indeed true that today's already massive technology companies, which the authors cite as examples of this paradigm shift, have completely transcended mean reversion, then we will have to revisit much of what economists and businesspeople hold dear.

Call us skeptical. We would argue that these are the exact arguments you would expect to hear after a decade-long bull market in technology stocks. Let's not mistake what this is: it is an argument that this time *is* different and that these companies *are* different. People who have uttered such words have often been proven completely wrong. Let's also remember that these companies compete in the technology sector, one that is notoriously prone to disruption. Just ask IBM how easy it was to maintain the top spot within the S&P 500, a position it maintained during the 1980s and early 1990s.

We fully recognize that IBM and Google, for example, are very different companies with different moats. Our point is that no company is immune to competition, even if it takes regulators stepping in to castigate anti-competitive behavior. It remains true to this day that no tree has ever grown to the sky. These stocks may turn out to be great investments, even from today's levels. However, we find it very hard to believe that their returns will accelerate from here or that their dominance has a major impact on the rest of the companies we come across. If there are a handful of companies that can defy the laws of creative destruction and trade at ever-higher valuations, then consider them the outliers. The other thousands of stocks that trade on public exchanges will still be susceptible to the vicissitudes of Mr. Market and at some point could end up in our portfolio—assuming there are still some value investors left standing.

In closing, we continue to follow the path we outlined in last quarter's letter, namely one of patience. We remain perplexed by much of what we see in the world, especially as it relates to the multiples at which the companies we want to own currently trade. We firmly believe that our conservatism will benefit investors over the long-run but we recognize that, at times, our caution will seem a little silly in the context of quickly rising markets.

Best Regards,

Ben Claremon | Principal, Portfolio Manager, Research Analyst

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