January 31, 2017

"If you want to catch beasts you don't see every day,
You have to go places quite out of the way,
You have to go places no others can get to.
You have to get cold and you have to get wet, too."

- Dr. Seuss

Dear Client,

As we enter 2017 and the beginning of the Trump presidency, the US equity bull market is almost eight years old. In fact, the eight years since the "great recession" has been a bull market not just in domestic equities, but in almost every global financial asset class. This is particularly interesting given how weak actual economic growth has been over the same timeframe.

Writing in July 2016, Kevin Kliesen of the Federal Reserve Bank of St. Louis commented:

> *"Although the current expansion keeps plugging along, the U.S. economy's pace of growth during the past seven years has been extraordinarily weak. Since the second quarter of 2009 (when the Great Recession officially ended), real growth in gross domestic product (GDP) has averaged 2.1 percent per year. By contrast, growth in the previous three expansions (1982-90, 1991-2001 and 2001-2007) averaged 4.2 percent, 3.6 percent and 2.7 percent, respectively."*[1]

Despite the bull market's age and weak economic growth, the coordinated central bank interventions in February of 2016 seem to have (once again) successfully quelled any threat of a global recession that appeared possible as commodity prices collapsed and industrial production shrunk for well over a year. Further, as far as markets are concerned, President Trump's economic proposals are bullish for real growth and risk taking.[2] Credit spreads have been narrowing for almost a year now and the trend continues.

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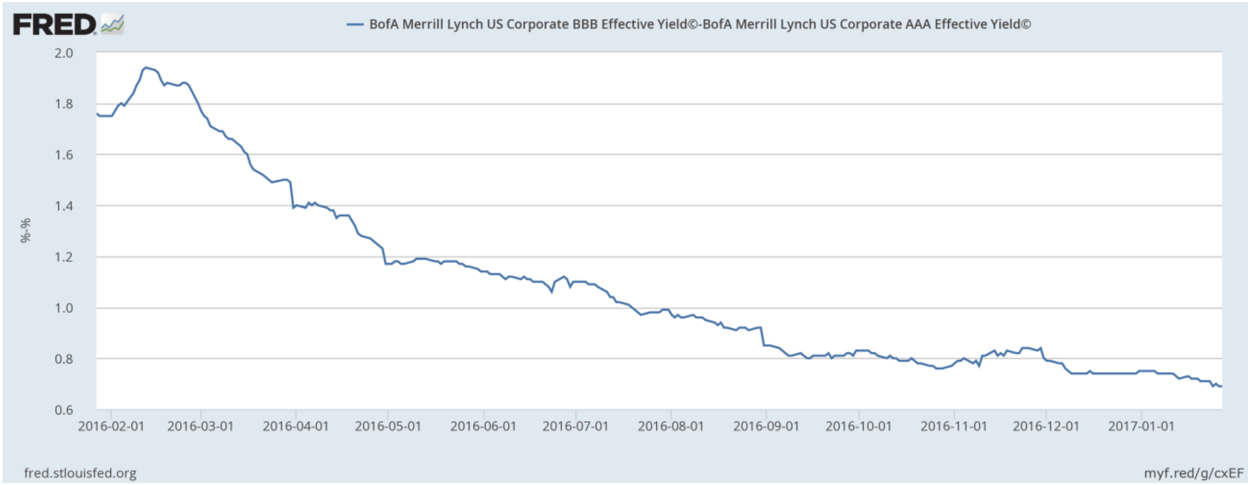
[1] https://www.stlouisfed.org/publications/regional-economist/july-2016/despite-weakness-economic-expansion-marks-seven-years

[2] Deregulation and tax cuts are certainly pro-growth. Infrastructure spending – hard to say. Trade restrictions are anti-growth.



Yet whether or not President Trump's agenda is successful at reinvigorating economic growth, financial assets and domestic equities in particular are priced to provide poor returns going forward. As of January 30, 2017 Research Affiliates projects an average annual real return over the next 10-years of just 0.8% for the S&P 500.[3] Even more pessimistic, GMO's 7-year forecast published on December 31, 2016 estimates a -3.1% annual real return for large capitalization US equities over that period.

No Real Growth? There's Always Financial Engineering

While the economic expansion has been weak, for the largest corporations, the last three years have been even worse. S&P 500 sales are up just 3.2% from 2013 to 2016. Earnings are DOWN 1%. Yet dividend distributions are up 30% and the price to earnings multiple is up 22.4% driving the S&P 500 Index up 21.1%.

S&P 500 Index Statistics[4]

	2013	2014	2015	2016
Sales	1116.81	1163.32	1127.13	1152.77
GAAP EPS	100.20	102.31	86.53	99.18
Divy	34.99	39.44	43.39	45.70
Price	1848.36	2058.90	2043.94	2238.83

Sales vs. 2013	3.22%
EPS vs. 2013	-1.02%
Divy vs. 2013	30.61%
Price vs. 2013	21.13%
P/E vs. 2013	22.37%

Sales Growth	2.24%	4.16%	-3.11%	2.27%
EPS Growth	15.82%	2.11%	-15.42%	14.62%
Divy Yield	1.89%	1.92%	2.12%	2.04%
P/E Ratio	18.45	20.12	23.62	22.57

[3] https://www.researchaffiliates.com/en_us/asset-allocation.html
[4] http://us.spindices.com/indices/equity/sp-500/

The same phenomenon is visible, in many cases, on the individual company level. This is particularly acute in "consumer staples." Prior to President Trump's election and the rally in US-centric and industrial companies, the staples sector was an investor favorite – it offered "stability" and a reasonable yield when compared to sovereign debt. Yet business fundamentals have been deteriorating and most of the growth is via financial engineering – stock buybacks and increasing dividend payouts as a percentage of earnings. Just look at two of the largest and oldest consumer staples: Coca-Cola and General Mills.

	Coca-Cola Co. (KO)		**General Mills (GIS)**	
	2013	**2016**	**2013**	**2016**
Sales	$46.9mm	$42.2mm	$17.8mm	$16.6mm
Earnings	$1.90	$1.77	$2.79	$2.77
Dividend	$1.10	$1.40	$1.30	$1.75
Yield	2.7%	3.4%	2.6%	2.8%
Dividend Payout Ratio	58%	73%	47%	63%
Stock Price	$41.31	$41.46	$49.91	$61.77
Price / Earnings Ratio	21.7	21.6	17.9	22.3

According to the most recent *Factset Dividend Quarterly* (September 22, 2016)[5], 42 of the S&P 500 companies paid out MORE in dividends than they earned over the past twelve months. This is the third highest number in the past 10 years. More shockingly, across the entire S&P 500, companies paid out 123% of the past twelve months earnings in both dividends and share buybacks combined. How long can that continue?

Two New Positions

The general environment warrants caution, but the volatility of capitalism and politics still supplies opportunities. We made two significant portfolio purchases bookending the fourth quarter of 2016. In mid-August, we purchased Hanesbrands (HBI) and then made a follow up purchase at the very end of December. In early January 2017, we purchased TripAdvisor (TRIP).

<u>Hanesbrands (HBI)</u>

Hanesbrands spun out of Sara Lee in 2006. The stock traded sideways through 2012 and then, as the company delivered on operational goals, earnings grew and the price earnings ratio began to expand from 10 to over 30 at the peak in 2015. Beginning in the middle of 2015, unusually inclement weather, few new fashion trends, a more subdued consumer, and poor inventory controls led to heavy discounting across the apparel space. The entire sector sold off

[5] https://www.factset.com/websitefiles/PDFs/dividend/dividend_9.22.16/at_download/file

and HBI's price went from a high of $35 in July 2015 to a low of $21 in January 2017. The final move from the mid-$20s to $21 occurred following the election of President Trump; presumably in anticipation of increased tariffs on overseas produced goods.

We initially bought HBI shares in mid-August 2016 at $27.24/share. We added to the position in January at $21.51 for an average cost basis of $24.78.

We believe the recent apparel industry challenges mask the long-term earnings power of HBI and its status holding #1 and #2 positions in all of its brand categories. In addition, we think the stock price overly discounts any reasonable border tax or tariff scenario.

The current price significantly understates the company's value if there are only minimal tax or tariff implications plus continued progress on operational plans (sales growth and margin expansion). With mid-single digit sales growth and several points of margin expansion as the firm continues to rationalize expenses from acquisitions and leverages fixed costs, we think the stock is worth in the high-$30s. In a draconian scenario that assumes significant tariffs *and* only minimal sales growth and margin expansion (in our analysis, a far lower probability than the base case just described), we believe the stock is worth around $20/share. The stock also provides a 2.5% dividend yield.

<u>TripAdvisor (TRIP)</u>

The TripAdvisor platform consists of a significant network of over 1 million hotel listings, 830,000 vacation rentals, 4.2 million restaurants, 730,000 attractions, and 435 million reviews. Each month, over 388 million unique visitors access this content to help make travel and leisure spending decisions.[6] Historically, TRIP generated revenue from this traffic via pop-up links to online booking agents and then via embedded references to multiple booking options within the TRIP website (i.e. "metasearch"). Both of which were essentially advertising businesses.

Recently, the increase in mobile traffic (where metasearch is less effective given smaller real estate) and a desire to capture more value led TRIP to introduce Instant Booking (IB). Rather than sell advertising to online travel agencies, TRIP aimed to book travel directly on its website. However, it has taken longer than anticipated to get visitors to use Instant Booking at the desired rate. In the meantime, this has hurt impressions and rates for the old advertising platform. Revenue is expected to be flat in 2016, but margins have deteriorated from 15% to 10%. The stock declined from a high of $111 in July 2014 to a low of $45 in December 2016.

In the fourth quarter of 2016, TRIP will lap the introduction of Instant Booking to English language countries (about 50% of revenue). The rest of the world will lap in Q2 2017. We anticipate a return to growth and margin expansion will follow. In addition, revenue per hotel

[6] Data is from TRIP filings and is as of Q3 2016.

shopper has already stabilized, and instant booking repeat usage rates (measured by the use of stored credit card numbers) continue to improve. Finally, conversion, repeat and monetization all improved in each month of last quarter. Going forward, we believe TRIP will return to positive hotel revenue growth. Our confidence is bolstered by the fact that Instant Booking provides a more streamlined user experience than metasearch and TRIP has successfully managed through multiple monetization changes in the past.

We purchased TRIP shares at an average price of $49.93 on January 6, 2017. If hotel revenue growth revives to the high single digits and margin expansion returns, we believe TRIP could be worth over $70/share. At least as important, we see minimal long-term downside. Even if there is no hotel revenue growth (but a continuation in the current trend of non-hotel revenue growth and margin expansion) we think the stock is worth $50/share.

Conclusion

While US equities in particular and most global financial assets are expensive (at least according to the historically accurate analytic processes of Research Affiliates, GMO, and the like), there are pockets of opportunity due to idiosyncratic characteristics of individual companies. Hanesbrands and TripAdvisor are the most recent examples we have uncovered.

If valuation does not matter, indices are a viable investment option. On the other hand, if valuation does matter and "you want to catch beasts you don't see every day, you have to go places quite out of the way."

Broad asset class valuations are certainly at levels that warrant caution. However, credit spreads indicate investors currently have a significant desire for risk taking. For now, it appears the bull market has more room to run.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

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Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

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