November 1, 2018

"We cannot choose our external circumstances, but we can always choose how we respond to them."
- Epictetus

"Learn to be indifferent to what makes no difference."
- Marcus Aurelius

Dear Client,

October brought a significant increase in market volatility and a broad equity sell-off to match the late-January through early-February move lower. From the September 21 high of 2941 to the (so far) October 26 intra-day low of 2628, the S&P 500 fell a bit more than 10%. At this point, it is still hard to know what to make of the move. Equity valuations remain very high. This is true even when one accounts for a sustainable shift in profit margins, the asset-light mix of US companies, and market structure[1] that all argue for higher-than-historical average market multiples. Valuation presents a bad setup (but, that is not new). On the other hand, like the move lower in January, signs of increasing risk aversion (e.g. significant widening of credit spreads and narrowing of market participation) that typically begin developing months before a full bear market takes root, did not precede the current move lower. A near-term rebound would not be a surprise and we have added some equity exposure near the recent lows. Yet, given valuations and recent opportunistic transactions, we still have large positions in cash and Treasuries that should mute a continuation in the sell-off.

In equity accounts, we were active this quarter. Corporate transactions allowed us to realize meaningful gains in two equity holdings: Express Scripts and Zoe's Kitchen. We also closed an index position at a loss, added to an existing holding, and purchased two new securities. In fixed income accounts, we have made zero changes this year. The core of the fixed income portfolio remains a barbell between long-duration US Treasury bonds (stability) and floating-rate bank loans (growth). A meaningful move in the price of gold (signaling a change in inflation) and/or credit spreads (signaling a change in growth and investor risk-aversion) would provoke a shift in

[1] Access to information, transaction costs, etc.

fixed income portfolio structure. Despite the equity market volatility, both of these series have remained relatively stable this year. Below we detail each of the transactions from the quarter.

Sale – Zoe's Kitchen (ZOES)

Last quarter we wrote in detail about our June 8 initial purchase of Zoe's Kitchen. On August 14, just prior to the company's second quarter earnings announcement, we added to our position. Given our conviction in the idea, we wanted to have a larger position if the "strategic initiatives" they were pursuing developed sooner rather than later. We increased the size of the position to 5% of account value.

On August 17, Zoe's announced an acquisition by privately held Cava Group, Inc. for $12.75 per share. Despite the $12.75 deal price, we were able to realize an average sale price of $13.25; our best guess as to why the stock traded at such a premium to the deal price is short covering. With an average cost basis of $9.18, our total return was approximately 44% over an average holding period of a bit more than one and a half months.

Sale – Express Scripts (ESRX)

As fast as the Zoe's investment developed, Express Scripts was the exact opposite. We first purchased shares in ESRX in November of 2012. We added to the position several times over the years, most recently increasing the position by about 70% following the March 8, 2018 announcement that Cigna would acquire ESRX for $92 per share in cash and stock. (The $92 per share price reflected Cigna's stock price at the time.) Our final purchase was at just over $69 per share, only slightly higher than the $66 per share basis we had established over the previous six years. We discussed the history of our ESRX position and the merits of the Cigna deal in our first quarter 2018 letter.

In the end, we sold the entire position on September 5 after the stock rallied following the news that the Justice Department was close to announcing approval for the merger. Our sale price was slightly above $90 per share and within 3% of the "deal price" based on the then per share value for Cigna. Our ultimate return was just over 34%, a terrific return on our April investment and an "ok" result for our overall position.

Sale – iShares MSCI Emerging Markets ETF (IEMG)

We sold the remainder of our position in the emerging markets ETF in July. Since January, emerging market equities have been in a downtrend. The downtrend began following a modest increase in credit spreads in early 2018 and a stable-to-down gold price – conditions that are hostile to emerging markets and commodities. When those signals combined with a decisive move below the 10 month moving average, we used the modest bounce in July to exit the position. Including the lot we sold in May with this lot, we lost 7% on the position.

Buy – iShares 20+ Year Treasury Bond ETF (TLT)

We used the sell-off in long US Treasury bonds to opportunistically add a position in our equity accounts. The ETF positions (including this one, the gold ETF, GLD, as well as IEMG and EFA[2], which we owned earlier this year) complement our individual security selection and provide exposure to "primary" asset classes[3] with two goals in mind. First, they enable a more balanced portfolio of securities that historically work best in different economic and market environments. Second, when signals from credit spreads and gold place us in a specific "quadrant" we tilt the portfolio to the prevailing conditions. The hope is that the tilting enhances returns and minimizes portfolio volatility. We have discussed this "all weather" or "permanent portfolio" approach in more detail in past letters, most recently in our fourth quarter 2017 letter.

Buy – Jefferies Financial Group (JEF)

The financial services sector has fared poorly this year. While the Federal Reserve has raised short-term interest rates 75 basis point this year to between 2.00%-2.25%, the longer end of the yield curve has increased only modestly. This puts pressure on a commercial bank's net interest margin. Year-to-date through October 26, the financial service sector (Spider) ETF (XLF) was down over 8%. JEF is worse – down over 22% year-to-date through October 26. Yet, JEF is a holding company and the Jefferies investment bank makes up only half of the entity. Further, an investment bank with a heavy weight toward advisory services is not impacted by the yield curve in the same way as a commercial bank.

While the current yield curve puts commercial banks under some pressure, from an operating standpoint, Jefferies has thrived recently. Through a series of transactions that monetized several of their larger investments, JEF increased tangible book value from $20.48 at the end of 2017 to $24.41 at the end of June 2018. In August, we added to our long-term position in JEF at just under $24 per share. The management team believes very strongly their stock price is undervalued. They demonstrated this by buying back 26 million plus shares (over 7%) at an

[2] EFA is the iShares MSCI EAFE (Europe, Asia, and Far East) ETF.
[3] We define "primary" assets as the four assets that align with each of four possible economic environments: domestic stocks for growth and disinflation, government bonds for recession and disinflation, gold for recession and inflation, and commodities for growth and inflation. The concept has been formalized by HCWE & Company (among others), but the basic idea dates back to at least Jakob Fugger in the 15th century (if not biblical times).

average price of $24.41 during the first nine months of the year. We have discussed this idea several times in the past in greater length, most recently in our first quarter 2018 letter. JEF is now our largest individual equity position with a weight just over 10% of our typical account.

Buy – Tencent Holdings Limited (TCEHY)

Most readers are familiar with Facebook, Spotify, Netflix, Nintendo, and PayPal. Those are all separate, multi-billion dollar enterprises. In China, Tencent is a market leader providing all of those functions. Tencent's core network is WeChat and it has over 1 billion users. The network effect from connecting all of those users creates a significant moat. Today, Tencent earns the equivalent of about $35 dollars per user. For comparison, in the US, Netflix users pay $10.99 per month for a standard package. As China's wealth grows, we believe Tencent can increase its market penetration in communications, gaming, media, and financial transactions, which will boost the $35 dollars per user sales figure. The stock has been under pressure for a variety of reasons including the Chinese government's increased focus on regulating online gaming. Regulation in this area is a concern, but apprehension regarding regulation should be balanced with the understanding that the government benefits from the ability to collect data from a single network – there is a symbiotic (though not necessarily appropriate) relationship between the Chinese government and Chinese "big-tech." We purchased a small initial position in September at just under $42 per share. At that point, the stock was already down over 30% from its January high of $61 per share. We knew we were catching a falling knife so we kept the initial position small. Subsequent to the quarter end, we added to the position, lowering our basis to $38.50.

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For sure, the Stoics (quoted at the beginning of this letter) model a useful way to live, but they are equally (perhaps even more) instructive regarding day-to-day decision-making. We have used recent individual security and overall market volatility to make opportunistic transactions in individual names. Zoe's developed about as fast as possible and Express Scripts took what seemed forever – our response, being patient when warranted, adjusting when facts changed, was all we could control.

Despite the recent market volatility, nothing that has proven useful historically is signaling we should make any major portfolio modifications. This could change quickly – even in the next few weeks. Yet, despite the headlines and noise, we work hard to be "indifferent to that which makes no difference." Thus, our overall posture remains similar to our last few quarterly updates. We are wary of equity valuations yet do not see the historical signs of an immediate market breakdown. We continue to hold a neutral posture – neither aggressively bullish nor bearish.

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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