Q2 2023 SUSTAINABLE VALUE STRATEGY UPDATE

By Adam Peck

Small capitalization stocks continued their weak performance in the first two months of the quarter with negative returns driven by the hangover of the regional banking crisis. Thankfully, June ended the streak of four down months with a monthly return just short of 9%, pulling the small cap index up for the quarter. The strategy underperformed in the quarter, but is still outperforming its benchmark year-to-date. True to form, the strategy has outperformed in aggregate across the down months, but has trailed in the strong up months of January and June when returns averaged 9.5% each month.

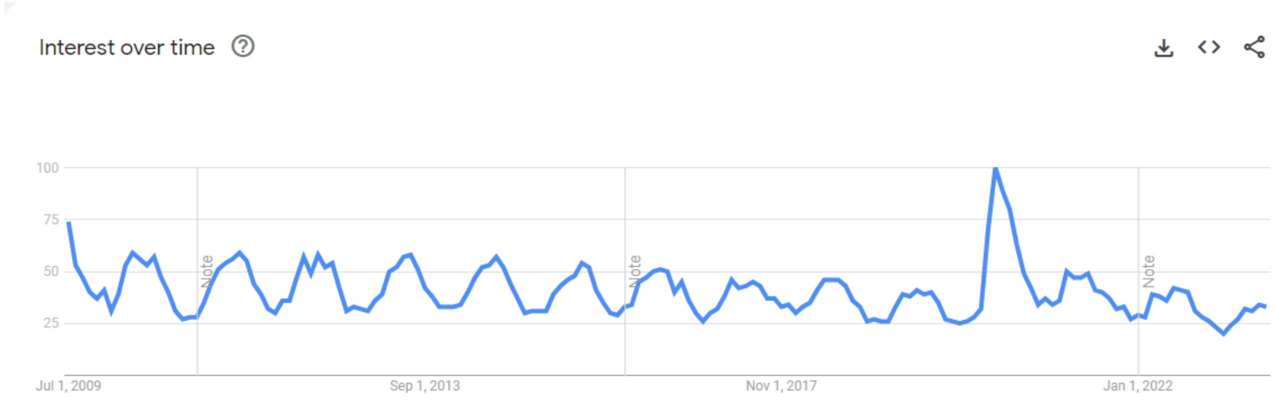
As we reviewed the factors that drove performance in the quarter, we were not surprised that the best performing factor was a high short interest ratio. A high short interest ratio is typically associated with lower quality companies that investors believe are overvalued and at great odds to decline. This factor was up 20% in the quarter and up 38.6% for the year-to-date. Investors who bet against stocks must have high confidence in their analysis as the downside potential in shorting stocks is infinite. When a highly shorted stock goes up, momentum can take over as the natural buying pressure is magnified by short sellers who end up buying back stock to exit losing positions. We generally do not have investments in highly shorted stocks; therefore, their outperformance was a headwind for our relative returns.

The number one negative factor was low beta, the standard measure of risk. This again was not in our favor as the portfolio has historically run at a beta of less than one. With the macro red flags of an inverted yield curve and declining leading economic indicators, it is not prudent to take on a lot of risk. Every company in the portfolio is profitable and we do not own any companies that we believe are at risk of breaching debt covenants nor refinancing their debt in the next 12-24 months.

Macro Landscape

The current macro landscape is one that most investors have not experienced firsthand. We still have elevated inflation levels and a Federal Reserve intent on making up for being too slow to combat inflation. So far, higher interest rates have not resulted in markedly higher unemployment rates nor have they really slowed the consumer (responsible for two thirds of economic consumption) down to any great degree.

Spending on consumer *goods* has slowed or gone negative after we all binged on “things to do when stuck at home” for about two straight years. Below is a Google Trends snapshot of “bicycles for sale”. After the spike in demand in 2020 it's unlikely that consumers will return to that level of buying for the foreseeable future. That goes for many household items.



Now travel and *services* have taken the lead for consumer spending. Below is a Google Trends snapshot for “US Passport” which as you can see is at record highs vs. the last ten years. Our guess is that revenge travel will run out of steam. Then we’ll have to see if the consumer's penchant for spending can be maintained.

Top Contributors

We currently maintain a consumer discretionary weight that is slightly higher than our benchmark. We are broadly diversified in the sector across the Auto, Home, Education and Apparel industries. Our top performing stock in the quarter was RH, the home furnishing company we profiled two quarters ago in a deep dive. We think the strong positive return was driven by the positive trends in new home sales and potentially the new RH England property.

Existing home sales are running at 50% of historical rates as homeowners are loath to move and give up record low mortgage rates. New homes built now represent two times the share of homes sold than they did in the past and 27% of new home buyers said they bought a new home because they could not find an existing one. If you are a new home buyer it's likely you need new furniture!

The second best contributor was Tecnoglass, another company we profiled last quarter in a deep dive. They recently expanded from producing commercial windows to residential windows. Just in time for the boom in new housing starts.

Bottom Contributors

Our two worst performers were StoneX and Ciena. StoneX benefits from market volatility and higher levels of trading. We have not seen either as markets have calmed since the declines in 2022. Ciena's record-high and unsustainable backlog began to return to more normal levels during the first quarter. This spooked the market and resulted in a sell off. We added to the stock on the weakness as we believe the fundamentals are solid. StoneX however, was trimmed in the quarter as we felt there was better opportunity in the beaten up bank sector.

We said we would hunt for value in the space last quarter and would look to add should we find the right opportunity. We did initiate a position in Western Alliance Bancorporation (WAL).

Company deep dive: WAL

We try to take an opportunistic approach when market disruptions occur. The recent turmoil in the banking sector resulted in significant volatility and uncertainties regarding the profit outlook, primarily driven by changing deposit mixes and deposit decline. We viewed this situation as an opportunity to invest in a high-quality banking institution that is currently undervalued. After careful analysis, we identified Western Alliance Bancorporation (WAL) as the bank best positioned to deliver substantial returns without sacrificing our quality standards.

WAL had a strong track record of impressive returns, due to their stringent underwriting practices, low-cost deposits, and consistent deposit growth. However, the bank's compounding trajectory was disrupted by the panic triggered by the collapse of Silicon Valley Bank, leading to a substantial outflow of venture capital and private equity deposits as well as uninsured deposits from WAL. Consequently, the stock experienced a significant decline.

What sets WAL apart from other banks grappling with similar deposit challenges is their recovery of deposits since the first quarter. As the current deposits remain with the bank and some previously departed depositors return, we anticipate that the Company will use these funds to pay down borrowings and bolster their reserves and capital ratios, thereby fortifying themselves against potential future shocks to the banking system. Moreover, the bank's strong credit quality in their loan portfolio positions them well to navigate any economic slowdown or decline resulting from the existing challenges in the market.

Applying our Three Pillar analysis to the stock:

Pillar One: Superior Business

WAL meets our first pillar as they have shown proper risk management through major banking challenges including the Great Financial Crisis, COVID-19, and the recent March turmoil. Credit risk has been a particularly strong datapoint for the company as they consistently show up in the top quartile in net charge-offs and non-performing loans among peers. Management has also managed interest rate risk well in the rapid rising rate environment of 2022. Additionally, in response to the uninsured deposit run seen at multiple banks, the Company has been able to increase their insured deposits from 45% at year-end 2022 to 73% as of April 14th, 2023.

Outside of risk management, the Company has consistently been an industry leader in efficiency. Cost management has been a big driver of the impressive ROE and ROA seen at the Company. Western Alliance also maintains a low footprint with around $900 million in deposits per branch/office.

Pillar Two: Exceptional Management Team

Capital allocation is the real measuring stick of management ability. CEO Kenneth Vecchione, CFO Dale Gibbons, and COO Tim Boothe have shown their skills in capital allocation through strategic acquisition, organic growth initiatives, dividend policy, and stock buybacks. In 2015 the Company acquired Bridge Bank which has established itself as a leader in banking innovative young companies. This acquisition increased the bank's low-cost deposit base and positioned itself to benefit from the continued growth of the venture and private equity world without exposing itself to increased credit risk. This acquisition grew Western Alliance's ROE and runway for organic growth. Management again showed exceptionality when the stock started to trade at a PE multiple of less than 10x. In response to this lower valuation the Company began buying back stock. This accelerated EPS growth and returned capital to shareholders.

Management has shown a long-term mindset with shareholders in mind as both Vecchione, Gibbons, and Boothe have spent 15+ years with the Company or its subsidiaries (Vecchione CEO since 2018, Gibbons CFO since 2003, Boothe COO since 2019 – COO of Bridge Bank since 2006). All three also have substantial ownership with Boothe owning roughly 5x his annual salary in stock, Gibbons 12x, and Vecchione 11x. These numbers are even after the over halving of the stock price due to recent events. With so much skin in the game, the leaders of this Company have their incentives aligned with those of shareholders.

Pillar Three: Attractive Valuation

Western Alliance stands out from other investments due to its low valuation relative to fundamentals. Despite accounting for losses from selling certain loan assets, we anticipate that the company's earnings will surpass $5 per share. As a result, the stock's price-to-earnings (PE) ratio based on 2023 earnings remains at 7x or less. Furthermore, we project that WAL will reduce its higher-cost borrowing and regain lower-cost deposits throughout 2023 and into 2024, positioning them to achieve an EPS of $8 or higher which was achieved in 2021 and 2022. Consequently, the PE ratio based on 2024 earnings falls below 4.4x, making it an attractive investment opportunity.

Moreover, the current price-to-tangible common equity ratio is less than 0.9x, which is considerably low. Typically, the Company has maintained an average ratio above 2x and has even exceeded 3x at times. The current valuation levels have not been observed since 2009, highlighting the significant value proposition of Western Alliance.

Based on the valuation metrics, we anticipate that as concerns surrounding the banking sector diminish, WAL's stock is likely to experience a rerating. However, it is important to note that for investors seeking significant returns, the stock does not necessarily rely on multiple expansion alone. By maintaining the current valuation multiples, the company has the potential to offer their attractive dividend yield of 4% while simultaneously bolstering its regulatory capital levels and growing book value quickly.

Risks

The primary risk to the Company is deposit flight. While the whole sector seems to be returning to more stable deposits, WAL will be under closer watch than the average bank given that they were one of the most affected by the panic to begin with.

The second main risk is a declining net interest margin. Profitability will be a main concern for the banking sector for the rest of the year.

The third risk is credit quality. With banks constraining lending there is additional risk for an economic downturn which could put significant downward pressure on profitability.

Throughout 2023, the company's focus will be on enhancing its equity and liquidity positions to effectively address any potential challenges that may arise. As a result, if the stock value continues to be undervalued, 2024 could present an opportunity for the company to engage in share buybacks. This strategic move would further contribute to shareholder value.

Conclusion

We again remain confident that small and mid cap stocks are positioned well to lead the market. Our confidence has not been proven right as the largest stocks in the world drive index returns, leaving all other stocks in the dust. See our main letter for more details.

Our confidence is driven by relative valuations and the high concentration of the largest stock's weight vs. the rest of the market. History has shown that small caps do well after periods of significant mega cap concentration. With attractive relative valuations added in we think the stage is set again for a turn in what the market favors.

As always thank you for your trust and confidence and please reach out with any questions.

Adam

(Disclosures and Strategy Largest Contributors and Detractors on next page).

Sustainable Value Strategy
Largest Contributors and Detractors – Q2 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
RH	RH	3.24%	111 bps
TGLS	Tecnoglass Inc	4.10%	87 bps
VECO	Veeco Instruments Inc.	3.11%	72 bps
ICFI	ICF International, Inc.	4.55%	61 bps
ATKR	Atkore Inc	5.52%	50 bps
	5 Best Total	**20.52%**	**381 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
SNEX	StoneX Group Inc.	3.68%	-89 bps
CIEN	Ciena Corporation	3.54%	-75 bps
TALO	Talos Energy, Inc.	1.11%	-51 bps
CROX	Crocs, Inc.	4.22%	-45 bps
LOPE	Grand Canyon Education, Inc.	4.02%	-43 bps
	5 Best Total	**16.57%**	**-303 bps**

Disclosures:
Reader should not assume that investments in the securities identified were or will be profitable. Timing differences of purchases and sales may have a modest impact on the actual contribution numbers presented. The holdings identified do not represent all of the securities purchased, sold, or recommended. The calculation's methodology along with details on all holding's contribution to the overall account's performance during the measurement period are available upon request. Past performance does not guarantee future results.