

Second Quarter 2016 Commentary

White Brook Capital LLC's ("White Brook") first day of operation was during the 2nd calendar quarter. I believe that a single, much less a partial quarter, is not a suitable time period to evaluate the investment performance of any investment, and that is a true and appropriate sentiment when results are favorable as well as when they are unfavorable. Clients should have received their individual portfolio performance directly from their custodian, and I hope you are pleased. I will remark more fully about the performance of the portfolio and its constituents during the 3rd calendar quarter commentary and every successive quarterly commentary that follows, but this quarter I believe it's useful to review the White Brook Model Portfolio's ("Model Portfolio") construction and my view of the future.

Portfolio Construction

White Brook Capital's mandate is to be 90% invested at all times, to limit concentration in an individual stock to about 6% and to invest no more than about 1/3 of client portfolios' in a single sector. This gives White Brook wide berth to construct portfolios based on the attractiveness of the opportunities that the market presents while also preventing a misplaced thesis from irreversibly impairing the portfolio. At the same time, its concentration makes it likely that over a period of time the portfolio will not strongly correlate with the relevant index. I believe that relevant index to be defined as the next best use of investor funds, which in the case of most investors is the S&P 500. While the Model Portfolio only resembles the index in its US concentration, the index is easily invested in, with low cost, and has a history of outperforming many managers over an extended time frame. To be worthy of your confidence, White Brook's performance should exceed the returns you can achieve by investing in the S&P500 over an extended time frame by limiting investors' risks and exposure to unattractive businesses and inferior business models.

As I step back and look at how the portfolio is constructed today, I find that the theses for companies in the Model Portfolio can broadly be categorized into one of two groups.

1. **Debt heavy, great businesses:** The underlying company is a terrific business – a leader in a growing industry, with able management. The company also has a significant debt load that becomes the market's focus from time to time and creates opportunities to add to positions. In most likely states of the world, the debt is not a cause for concern. After all, it's the ability to service debt not the absolute debt level that impairs equity value. In fact, the company generates EBITDA and cash flow growth that creates additional debt capacity that can be used to enhance equity value through share repurchases, debt pay down, or acquisitions. In a world in which debt becomes relatively expensive or access to credit markets is impaired, the company's leadership position and cash flow continues to create equity value – although near term debt maturities are a significant concern worth avoiding. In general, these companies are infrequently massively undervalued or overvalued, except when the cost to borrow increases considerably and quickly. White Brook advises investment in these companies because I believe that if bought well they are able to create equity value at or above 15% compounded annual growth rate over the next three years, or 20% over one year simply by executing on their business plan.

- Debt light, good businesses:** The underlying company is a good business with a capitalization structure that could be further optimized to the benefit of the equity. I believe I understand the fundamentals of these investments better than the market - due to my approach and experience - and have an edge by investing over a long term horizon. I expect these companies to “beat” consensus earnings estimates over time, and for the Street to revise their earnings estimates higher. A significant source of upside is derived from multiple appreciation as earnings are revised higher and the Street realizes these are better businesses than they previously thought. These theses rely on the companies revealing information about themselves to change public opinion, and often the stocks trade poorly until sentiment changes. On the day of earnings release, however, the stocks can move significantly as the company reveals new information, further details its business strategy, or otherwise presents data that changes the narrative.

Two out of the twenty companies currently in the Model Portfolio have both higher than average debt loads and I believe will see significant multiple expansion, but the majority of companies currently in the Portfolio belong to one of these two groups. Clients should also be aware that companies with an above average debt load have a tendency to trade down more violently in the event of a swift market contraction when correlations between asset classes and between stocks is high. However, in the wake of a swift market correction, as the market normalizes, my expectation is that the market (re)discovers that the fundamentals of these companies are better than feared and they recover more quickly than the average company or that they outperform even in the event of a flat to slightly down overall market.

Market Outlook

I make no positive representation about my ability to be clairvoyant, especially in the realm of macroeconomics. However, I am able to analyze pervasive arguments amongst practitioners and recognize flaws. One of the most glaring flaws is in comparing the economic recovery of the past 7 years with previous economic cycles. To be sure, I don’t believe that this time is different, but I do believe that statistical analysis embeds an assumption of holding variables equal across time periods that are not in fact equal. Even multivariate analyses require bounds of normalcy of the dataset. Much like butter, eggs, flour, sugar and salt can bake a baguette or a cake, the relative levels, *the nuance*, make a difference in the outcome. I urge clients therefore to be skeptical about historical analyses drawing conclusions based on interest rate levels, oil prices, and the relative strength of the US Dollar. While these are the fundamental building blocks of the economy and the market, they don’t account for many things – including the emergence of China as an economic superpower (past 20 years), the strategies imposed by Europe and Japan to stimulate their economy (past 2 years), the shallowness of the current recovery (past 7 years), and finally, the expansion of the internet to transmit information quickly and efficiently (past 15 years). This time isn’t different – there will be an economic cycle, but leaving investment decisions to “rules” that don’t recognize nuance may result in baking a loaf of bread when what is desired is for a birthday cake. Instead, I advocate evaluating all the facts. With a wider view, I think it’s difficult to be passionate about a bear case for the overall US economy or the US equity market.

Secondly, I urge clients to be skeptical of formalist arguments. On the Street, the current popular thought is that company earnings are in decline on a GAAP basis. Unquestionably, profit margins of US companies as a whole are increasing at slower rates/declining on a GAAP basis. However, there are several headwinds that might not recur in the future such as the growth in the strength of the dollar relative to other currencies, which is a headwind for companies with foreign earnings; the volatility in the



price of oil, that benefits some, while harming others; and recent acquisitions and spending on new business activities – activities encouraged by central bank policy. One-time factors and the dissipation of current headwinds aren't considered by GAAP earnings. It's a formalist argument without consequence.

Formalist, but with consequence, is the impact of the United Kingdom referendum to leave the European Union. My preference is to view Brexit as a systematic dilemma. While there are formalist features to the crises – the referendum, triggering article 50, renegotiating treaties, and exit – the reality is that Great Britain is intertwined with Northern Ireland and the Kingdom of Scotland, and populated with French, Poles, Swedes, and other migrants of the European Union. To unwind those relationships is difficult and requires a strong leader with broad popular support. Instead, almost 50% are against the necessary actions, the leaders of the major political parties have resigned, and popular support is waning as the currency weakens and capital leaves the country (Britain's strength in the financial industry is reversible given money's ability to cross borders).

I believe it's likely that the political and economic elite understand the difficulties of growing GDP per capita while enacting policies that encourage capital flight and human capital expulsion without an offsetting ratable improvement in the productivity of the nation's infrastructure should the country enact Article 50. My expectation is that even if the next prime minister does enact Article 50, formal separation from the EU doesn't occur until renegotiations of the contracts are completed – and I don't believe they ever will be. This is like the opposite of going to war without declaring it. I expect that the UK declared its intention to leave, and will be committed to negotiations for the next decade or two, until demographic shifts make a Remain vote a certainty. After the past couple weeks, purgatory, it turns out, might be heaven for Britain.

As always, feel free to reach out by phone or email at your convenience.

Regards,

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Portfolio Manager