Investor Update January 2019

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

Charles Mackay (Scottish poet, journalist and song writer)

To Our Clients:

The Enhanced Core Pure Strategy (ECPS) returned (12.34%) unaudited and gross of fees in 2018 as compared to the S&P 500 return of (4.39%). As I am sure many of you noticed, December was not the kind month we have grown accustomed to but rather it was quite cruel. The entirety of the negative return for our strategy for the year was realized in the last month. December 2018 was the worst December return for the S&P 500 since 1931.

We believe now, as we did then, that this was a temporary aberration. Mitch Zacks of Zacks Investment Management summarized the results of several research reports into the behavior of institutional investors as markets fell. He wrote:

> *What they discovered is that one of the main reasons large institutional portfolio managers sell during market corrections is because stock prices are falling. Read that again:* ***institutional investors sold because prices were falling****. This active decision means institutional investors were largely reacting to price movements instead of changing fundamentals – which is the precise opposite of what long-term investors should do….*

The good news is that the ECPS was up 13.24% unaudited for the month of January to start 2019.

Other Business

If you are a reader of our past investor letters, you might recall the section titled "Other Business" usually comes near the end. This year, we felt the need to bump it to the front because of its importance.

After over a year of careful deliberations, we have decided to make significant changes in the structure of our wealth management business and, in particular, with regard to the investment management function within VNB Wealth. We began the process, as we always do with decisions like these, by putting our clients' interests and well-being front and center.

We are excited to announce that the investment strategy that has been the flagship product of the firm for over 18 years, and the investment team that currently manages it, will move from VNB Wealth into a separate company, Masonry Capital Management. This new company, a registered investment advisor, is wholly-owned by Virginia National Bankshares. By the conclusion of 2019 we expect the transition to be complete. Until that time, Mark Meulenberg, who has been involved with managing the investment strategy since 2008, will serve as the Chief Investment Officer of both entities.

As part of this structural change, the trust and estate business has been renamed and is now known as VNB Trust and Estate Services. Wendy Stone, who leads the group, and her team will move to a multi-manager investment platform, which will include Masonry Capital Management as an option, for trust accounts.

We expect 2019 to be both a year of transition and of great opportunity for our clients and our business. ***We will reach out to you in the coming weeks to personally walk you through this exciting new direction and discuss specifically how it will positively impact you.***

For now please find the contact information for Masonry Capital Management below and make sure to check out the website!

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We value and appreciate your trust in us and we look forward to continuing to serve you as we move forward in this new structure.

The view from 10,000 feet

Given that the Federal Reserve has embarked on the dual process of tightening interest rates and shrinking the balance sheet, the idea that nothing has changed or should change in the financial markets is foolish in our view. Of course things are different. We just aren't sure of the magnitude of the change at the moment. We agree with, and highlight below, Dick Bove's views when he wrote the following early in 2018 in a piece for CNBC:

- "To argue that a shift in money availability; a shift in real interest rates; and a shift in the value of the dollar; have no fundamental impact is simply folly."
- "It is not economically driven it is financially motivated. Simply stated, in the decade following the financial crisis, money availability was increased through quantitative easing and the cost of these new funds in real terms was negative. The financial crisis is now over and the aberrational financial values created by the manipulated market are ending."
- "The real cost of money, as measured by comparing the Federal Funds rate to the Consumer Price Index, has been negative 93 percent of the time since 2010."

One of the things we do know is that companies with strong and growing free cash flow generation are under-appreciated currently. Conversely, momentum stocks continue to be the darlings…until such time that they are not. To wit, the valuation gap between stocks going up the last few months (momentum stocks) and those going down (stocks losing momentum) has widened to a level not seen since the dotcom era. Importantly, the distinguishing factor is not the profitability or the valuations of these different stocks but rather the short-term movement of their share prices.

Warnings signs are flashing given that the momentum trade has faltered in the past at these valuation levels (see charts below).

EXHIBIT 4: **Within sectors the P/E of high vs. low US momentum stocks**

Source: MSCI, Factset, Bernstein analysis

There are some other eerie similarities between the overvalued market in the dotcom era and our current bull market such as the technology / utility ratio from 2010-2018 and that of 1993-2001.

We also see evidence of a probable index bubble when examining the return disparities of various indices from 2017. Witness that the largest companies in the index posted dramatically higher returns than their smaller company peers.

2017 Index Returns Distributed by Largest Members and Quintiles

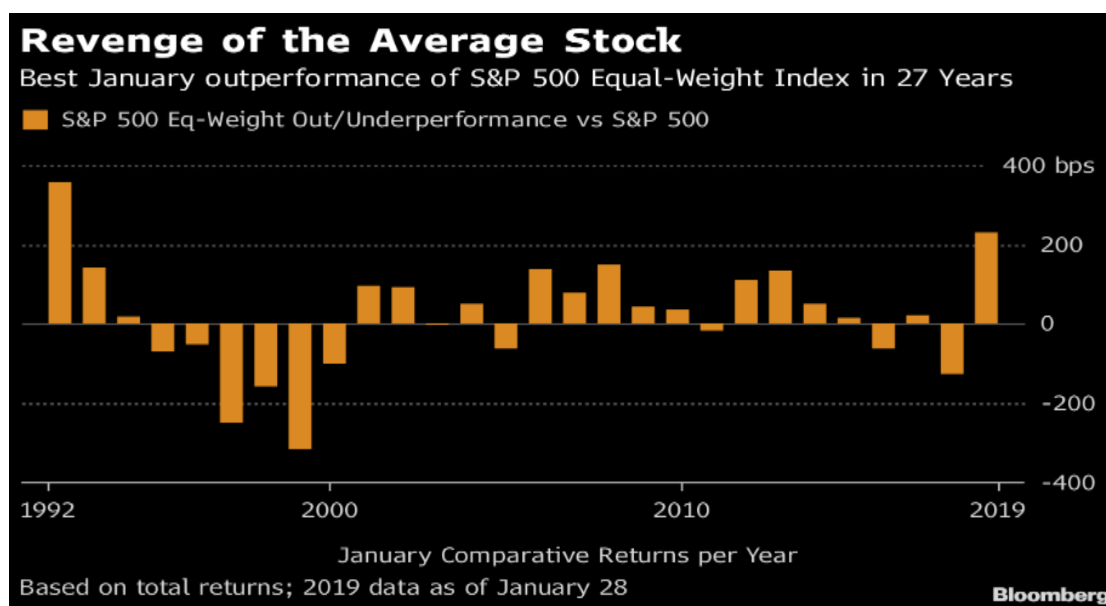
	Index Total Return	Largest 5	Largest 10	Largest 25	Largest Quintile	2nd Quintile	Middle Quintile	4th Quintile	Smallest Quintile
MSCI Emerging Market	37.3	68.0	62.5	55.9	45.0	39.1	25.1	25.0	2.5
Russell 1000 Growth	30.2	45.2	44.5	38.9	38.5	25.6	23.8	12.9	-2.0
MSCI EAFE	25.0	20.2	22.3	21.7	22.5	20.6	23.6	20.6	6.7
MSCI ACWI	24.0	49.2	46.7	34.5	26.9	25.2	22.7	21.0	10.5
Russell 2000 Growth	22.2	93.3	85.1	55.4	32.6	14.4	9.2	-7.2	-23.2
S&P 500	21.8	45.3	34.3	29.9	24.5	22.0	17.0	14.2	-1.1
Russell 1000	21.7	45.3	34.3	29.9	32.3	20.2	25.6	12.9	-18.1
Russell Midcap	18.5	42.0	35.3	29.9	24.0	20.4	14.8	8.6	-11.3
Russell 2000	14.7	76.3	73.0	54.5	36.2	19.3	4.4	-3.1	-18.6
Russell 1000 Value	13.7	26.5	19.2	14.4	16.4	14.5	19.2	7.6	-10.9
Russell 2000 Value	7.8	45.6	33.9	15.1	16.6	9.2	1.6	-0.4	-18.5

Source: Bloomberg Raw Data; SAI Calculations; Index components derived from ETF Index Holdings; Component weights using year-end 2016 weights.
Returns for the two international indices, MSCI EM and MSCI EAFE are in US Dollars. The global index, MSCI ACWI, is just under half international, and is also in US Dollars. The dollar declined against most currencies during 2017. The returns for each index in local currency terms would have been lower by the amount of the decline in the US Dollar.

Suffice it to say, this is not a description of a healthy market. The returns of these indices are being driven by the largest stocks which, in turn, drive more money to those same stocks as they become bigger and bigger members of an index as assets continue to flow into them.

We often think about the market forces that might bring about the upward revaluation of our holdings and the downward revaluation of the overvalued market darlings. The short answer is that we just don't know. But, in our experience, when it does happen it has typically done so in dramatic fashion. It brings to mind the Mackay quote at the start of this letter, which, to summarize, says that herds go crazy en masse and come to their senses one by one. For instance, how long will money losing businesses like Netflix and Wayfair with no profits in sight continue to have the favor of the investment community? If past is prologue, when the last investor finally comes to their senses, the reversal will be sharp and deep.

Might a change be in the air? By late January the return of the "average" stock in the S&P 500 as measured by the equal-weighted index had outperformed the cap-weighted version of the S&P 500 by 2.5% which is the largest gap in 27 years.



As value investors who prize cash flow generation and cheap stock prices relative to our fair value estimates, the winds of change can't come soon enough.

When someone articulates a thought better than we could ourselves, we are happy to pass their insights along and give them credit. John Hussman of Hussman Strategic Advisors offered this view in 2018:

> *The important point is this: Extreme valuations are born not of careful calculation, thoughtful estimation of long-term discounted cash flows, or evidence-based reasoning. They are born of investor psychology, self-reinforcing speculation, and verbal arguments that need not, and often do not, hold up under the weight of historical data. Once investor preferences shift from speculation toward risk-aversion, extreme valuations should not be ignored, and can suddenly matter to their full extent. It appears that the financial markets may have reached that point.*

And he also shared these thoughts regarding valuations during a bubble period:

> *One fact often lost on investors during a bubble is that a security is nothing but a claim on the very, very long-term stream of cash flows that will be delivered into the hands of investors over time. A valuation ratio is nothing more than shorthand for a proper discounted cash flow analysis. So whenever one measures valuation using the ratio of price to some fundamental, the essential requirement is that the "fundamental" one chooses must be representative of that very, very long-term stream of future cash flows.*

We couldn't agree more.

<u>Portfolio Review, Positioning and General Commentary</u>

As we moved through 2018, we held, at times, a very high cash position which was north of 20%. This is generally an undesirable development as an investment in cash yields around 2%. As previously mentioned, December was a crazy month. By mid-December we were thankful we had cash in reserve as we spent a good deal of it on very cheap securities. Additionally, you will notice that in taxable accounts we did a fair amount of tax trading in an attempt to lower the amount due to the tax man.

The dichotomy that exists in the general market between expensive stocks with high price-to-earnings (P/E) ratios and those with low P/E ratios grew even larger in the December pullback. We own or bought many companies with P/E multiples at 8x or lower with some even as low as 4x 2019 estimated earnings. To put that in perspective, simple math says that if a company trades at 5x earnings this equates to a 20% earnings yield. The 10 year US Treasury currently yields 2.73% as of this writing. It certainly

seems we are being more than adequately compensated for the risk we are taking in owning these businesses.

We continue to believe the portfolio is sufficiently diversified and has multiple and differentiated catalysts that could drive share appreciation across a number of the holdings. By many measures (low price-to-book ratio, low P/E ratio, high free cash yield, discount to our estimate of intrinsic value) we believe the portfolio could be the cheapest it has ever been. One of the equities owned in the portfolio, Discovery Inc., is expected to generate close to $3 billion of free cash flow in 2019 and management expects that number to grow each year. The current market cap is just over $18 billion. In theory, if the company used the entire amount of free cash flow to buy back shares they could retire all of their shares within 6 years. There are a plethora of these types of situations in the portfolio. They shouldn't exist but yet they do. Why is that?

As you may recall, in the mid-90's a wide swath of the U.S. stock market was ignored for many, many years. Money flowed into the large cap growth names which included the stocks of companies like Cisco Systems, AOL, MCI WorldCom, Enron, Tellabs, Home Depot, Coca-Cola, all things pharma, etc. By the end of 1999, most of these stocks traded at between 40 and 100x+ earnings. The ignored stocks kept drifting sideways-to-lower with growing earnings but lower multiples assigned to those earnings which resulted in a share price that was stagnant for a large part of the decade. Polaris Industries (ticker: PII), a decidedly unglamorous maker of off-road vehicles and snowmobiles, was one of these companies. We highlight it below as a representation of what we seem to be living through again:

Polaris Industries (PII)	**YE 1994**	**YE 1999**	**Growth in %**
Revenue	826.0	1,328.6	61%
Earnings per Share	0.58	0.88	52%

	12/30/1994 - 12/29/1999	
	Cumulative Return	**Price Change**
Polaris Industries	30.69%	3.69%
Russell 1000 Growth Index	306.18%	284.58%

Polaris Industries (PII)	YE 1999	YE 2005	Growth in %
Revenue	1,328.6	1,908.5	44%
Earnings per Share	0.88	1.58	79%

	12/29/1999 - 12/31/2005	
	Cumulative Return	**Price Change**
Polaris Industries	223.47%	185.06%
Russell 1000 Growth Index	-34.90	-38.20%

Polaris Industries (PII)	YE 1994	YE 2005	Growth in %
Revenue	826.0	1,908.5	131%
Earnings per Share	0.58	1.58	172%

	12/29/1994 - 12/31/2005	
	Cumulative Return	**Price Change**
Polaris Industries	317.76%	193.00%
Russell 1000 Growth Index	164.38%	137.61%

Highlights:

- Revenue growth of over 61% and earnings growth of approximately 52% resulted in minimal returns for PII from the end of 1994 through the end of 1999. Most of the return came from dividends and not share price appreciation (price change was 3.69% for the entire period).
- Revenue growth for the period of 2000 – 2005 was below that of the previous 5 years from 1995 – 2000 but earnings growth was higher (79% versus 52%) – there was not a huge change in the growth trajectory for either statistic **BUT the cumulative return of PII for 2000 – 2005 was 223% versus 30.69% from 1995 – 2000.**
- For the entirety of the period (1995 – 2005), revenue growth was over 130% while earnings per share grew over 172% and the cumulative return for owning the shares during the entire period was over 317% - **a very successful investment!**

Takeaways:

- Money flows during the mid-to-late 90's were largely based on hope and hype and resulted in a large segment of the general market being ignored and unloved over a long period of time.

- The operational success of PII was eventually appreciated and rewarded by the market but it took almost 10 years to be realized as such in full.
- When market excesses correct the result is not pretty – witness the 5 year cumulative return for the period of 2000 – 2005 for the Russell 1000 Growth Index which was a loss of almost 35%.
- An investor who held PII for the first 5 year period (1995 – 2000) looked very foolish versus the dominant narrative of the day but the long term result from being a disciplined and patient investor was excellent.

Once again, we feel the need to highlight the fact that successful long-term investments are not made by reading the "tea leaves" of what other investors prefer to invest in at a certain moment in time but rather they are driven by math, by facts, by industry position, and by competent and aligned management.

In a year of ups and downs that ended with mostly downs, we did have a few highlights. One of which was our late 2017 early 2018 investment in SUPERVALUE (SVU). SVU was added to the portfolio at an average price of around $18 per share. Our thesis was that although the company had substantially moved their business from being predominately an operator of retail grocery stores to that of a wholesale food distribution business, the market was still affording it the lower multiple assigned to the retail space and not the higher multiples of its wholesale food competitors which were almost 2x the multiples of the retail business. We had seen a similar situation in Spartan Stores years earlier which ultimately led to a significant gain when they were acquired by Nash Finch.

In spite of this rather simple thesis, no one really seemed to be interested or paying attention. Sell side firms came out with "sell" recommendations on the stock when it was under $20 per share with price targets in the $14 range. There was one entity that cared and that was a competitor, United Natural Foods (UNFI). In the summer of 2018, only about 6 months after we established our position in SVU, UNFI announced they were going to buy SVU in an all cash transaction for $32.50 per share. It seems to us that the dysfunction of the stock market at present was on full display with this transaction. Money flows; indexing; a preference for high revenue growth companies with only the hope of future profits; all retarded the price discovery process for SVU. Our price target of around $32-$35 per share when we initiated the position was realized because of the actions of a strategic competitor. While thrilled with a gain of over 80% in such a short time frame, we are also dismayed that this is the current state of the market.

Outlook for 2019

"Anyone can hold the helm when the sea is calm"

Publilius Syrus

It is vitally important for investors to keep their wits as those around them lose theirs. One of the ways we do this is to look toward some economic indicators as a sanity check when compared to the talking heads on CNBC and the like. The narrative for most of December was that stocks were predicting a recession that was highly likely to come in 2019. Generally, stocks don't predict recessions. In fact, historically, they seem to be the last to know we are in one!

Of note, of all of the indicators we follow that have singularly or in some combination indicated a recession is on the horizon, not one is flashing red. Some are green and some are yellow but none exist in an area that historically has signaled a recession. This is not to say one will not happen in the near term, but it is just not readily apparent from where we sit today. In fact, the better-than-expected January jobs data (non-farm payrolls) showed the US added 304,000 jobs despite the government shutdown. This statistic is not thesis confirming of a coming recession.

That said; we have highlighted below the last few Fed tightening cycles.

With the exception of the tightening cycle in the mid-90's, the Federal Reserve has seemingly overshot and caused recessions in 1990, 2001 and 2008. One has to wonder what are the odds they got it right this time? It is obviously something we are watching closely.

Respectfully submitted on behalf of VNB Wealth Management,

Mark A. Meulenberg, CFA
Chief Investment Officer

Disclosures

This Investment Review is furnished for general information purposes in order to provide some insight into the investment management process and techniques that VNB Wealth Management uses to make investment decisions. It is provided for illustrative purposes only. Opinions and information provided are as of the date indicated. This material is not intended to be a formal research report, and as such, it should not be construed as an offer or recommendation to buy or sell any security, nor should information contained herein be relied upon as investment advice. Opinions and information provided are as of the dates indicated. VNB Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. The statistics in the letter were obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed.

This letter contains commentary regarding several securities that have been purchased by VNB Wealth Management on behalf of our clients. Individual account holdings may vary, and the views expressed herein may change at any time subsequent to the date of this letter. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities referenced in this letter. The price and value of securities referenced in this letter will fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed and a loss of all of the original capital invested in a security discussed in this letter may occur.

Past performance is not indicative of future results.

No performance results presented are GIPS compliant.

Investments and Accounts at VNB Wealth Management:

- Are NOT insured or guaranteed by the FDIC or any other federal government agency
- Are NOT deposits of, or guaranteed by, a bank or any bank affiliate
- May lose value

Indexes represent securities widely held by investors. You cannot invest in an index.

Russell Indices. For more information about the FTSE Russell indices mentioned in this letter, please go to https://www.ftse.com/products/indices/russell-us.

S&P 500 Index is a capitalization-weighted index calculated on a total-return basis with dividends reinvested. The Index includes 500 of the top companies in leading industries in the U.S. market.

The MSCI EAFE Index (Europe, Australasia, Far East) is an equity index which captures large and mid-cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. With 921 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Hedge Funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 1,124 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Enhanced Core Pure Strategy represents a single account where the manager has full discretion. The inception date is December 31, 2007. Returns are reported gross of fees.

The returns have been audited and verified through 12/31/17 by qualified, independent third parties. Contact information of the audit firms is below:

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