



**Q3 2019 Masonry All Cap Select Commentary**

**November 2019**

*“If you wake up on a Casper mattress, work out with a Peloton before breakfast, Uber to your desk at WeWork, order DoorDash for lunch, take a Lyft home, and get dinner through Postmates, you’ve interacted with seven companies that will collectively lose nearly \$14 billion this year.”*

*Bill Blain of Shard Capital*

To Our Client Partners:

Although it is now fall, a season that winds down the work done by spring and summer, we have begun to see the green shoots of value investing start to generate meaningful outperformance. Thank you for partnering with us to manage your investments. We hope this letter gives insight into our current thinking, the positioning of the portfolio and also some highlights of a few individual investments.

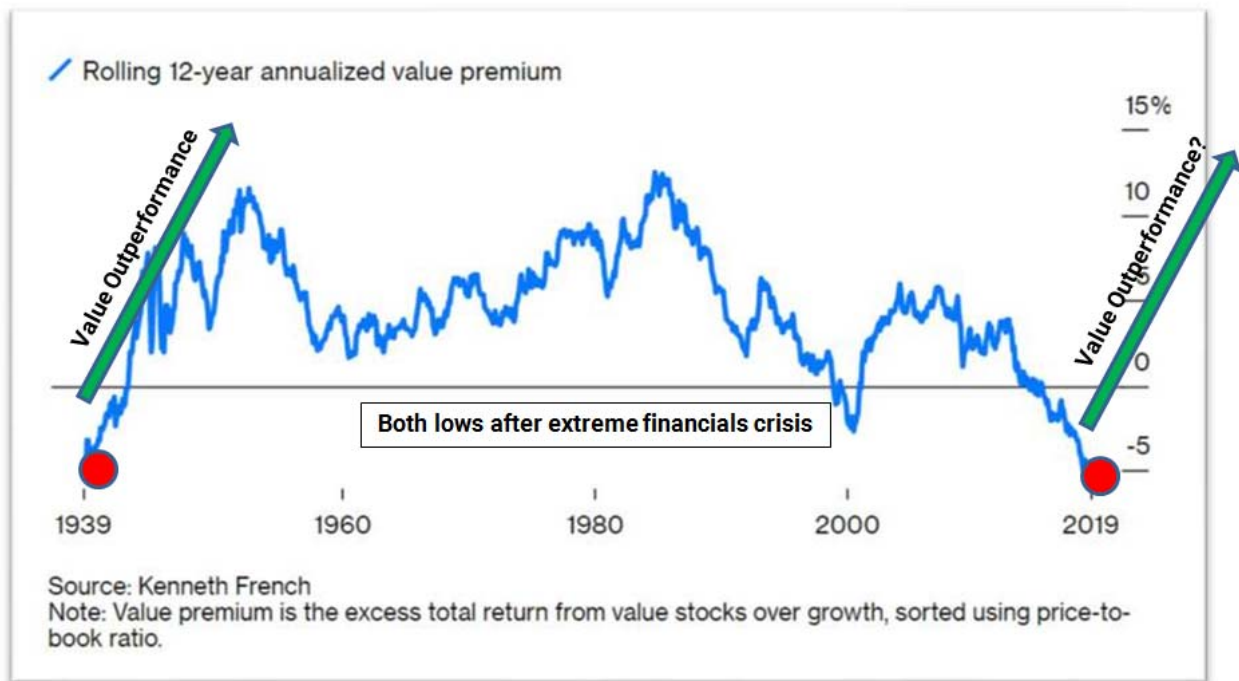
### **Overview of the Portfolio**

As of September 30, 2019 we were approximately 92% long with the remaining 8%, in cash. The largest exposures were the common stocks of Discovery Inc., Liberty Sirius, DISH Network and Viasat Inc. The largest positive contributors to performance for the quarter were BlueLinx Holdings, Liberty Sirius and Echostar. The largest negative contributors were Discovery Inc., Lions Gate, and Viacom B Shares.

### **Portfolio Positioning Highlights**

- The portfolio retained a sizeable overall position in content and media stocks most of which have free cash flow yields in the mid-teens or higher.
- The special situations section of the portfolio includes positions in small and mid-cap stocks in various industries including shipping, building products, small and regional banks, natural gas, and oil services.
- We believe the portfolio remains extraordinarily undervalued with respect to our estimate of its overall intrinsic value. This is most likely appropriately viewed through the backdrop of Value dramatically underperforming Growth over the last 10 years but, particularly, over

the last 2+ years where the Value discount has been pushed to extremes not seen since the 1930's. We are also witness to an anomaly we have never experienced in our investing careers - companies with increasing revenues and earnings (and insiders purchasing shares in many cases) have seen their valuations contract over a multiple year period which is the exact opposite of what logic, common sense and past history tells us should have happened.



## Portfolio Positioning Details

### *Shipping*

We consider our shipping investments as a great example of catalyst-driven investing within our special situations portfolio.

Historically, the shipping industry has been shown to be highly cyclical with frequent periods of boom and bust. Generally speaking, an investment in the shipping industry held over the last 20 years has basically been flat but with a few very high peaks and low troughs along the way. A few years ago, we started to notice that the industry's attitude towards, and acceptance of, the exhilaration and suffering of these cycles was changing. After all, shipping rates have been stuck in an over 10-year range of low rates which makes this particular cycle extraordinarily long and painful. It has given the shipping companies a lot of time to reimagine the future of their respective businesses and the overall industry. We generally found they were taking a more conservative approach to running their shipping businesses in a concerted effort to smooth out

the boom and bust nature of the past – they have expressed a desire for better balance sheets, more efficient operations, viewed consolidation favorably to gain scale, and began being more disciplined with their ship building.

Over the past few months in particular shipping rates have begun to increase and we believe it's probable that we are near the bottom of this very long cycle. Dry bulk shipping rates reached a thirty-year low as recently as 2016—and have since rebounded significantly from this level. Today's rates are at moderately profitable levels for the shippers. Additionally, and very importantly, a new set of emissions standards designed to reduce pollution by the world's shipping fleet, called IMO 2020, will go into effect on January 1, 2020. We expect these new regulations to tighten the supply of vessels and contribute to above-average shipping rates in the near to medium term, leading to above-average profits and capital returns via dividends and/or buybacks, which should all lead to an upward revaluation of the stock prices. We fully anticipate the companies benefiting the most will be the ones best prepared for IMO 2020 which is the most important development in the shipping industry in decades. The financial effects will be seen in fuel prices and shipping rates (due to supply issues, miles traveled and fuel availability).

We have established two positions in the shipping industry with shippers that we believe are best positioned to benefit from this new cycle. Because we are still accumulating the positions to our desired size as well as looking at other investments in this space, we are not publicizing the names until a full position has been established.

### ***Media and Content***

We have exposure to a variety of media and content companies in areas such as radio broadcasting, content creation, and sports delivered through direct-to-consumer offerings, over the internet, and through the traditional delivery mechanisms of cable, satellite and radio.

One such holding in the special situations portion of the portfolio is Entercom Communications Corp. (ticker: ETM), a radio broadcasting company. The company has made great strides in moving from a traditional broadcast company to the new world which includes high-definition radio, radio over the internet and podcasting. They have a fast growing digital app, Radio.com, and are actively participating in an emerging renaissance for radio. The company should earn close to a \$1 per share in 2020 which puts the current multiple at close to 3.5x earnings per share. Additionally, the company is on track to generate close to \$150 million in free cash flow in 2020 which represents a 30% free cash flow yield to the current market cap. The company has stated they believe the stock valuation is completely disconnected from the value of the business and the strength of their platforms and assets and capabilities. We believe, as they do, that the market is substantially discounting their opportunities for growth and value creation. We are risking very little to get exposure to this company's promising future.

Discovery Inc., Lions Gate, Corus Entertainment and Viacom (soon to be ViacomCBS) are all part of a content and media bucket that we believe is grossly misunderstood and subsequently substantially undervalued.

For starters, most of the companies in this group trade at free cash flow yields between 15-30% with corresponding price-to-earnings ratios of 3-7x next year's estimated earnings. We believe they trade at these levels almost solely due to the well-known and highly anticipated changing TV ecosystem. In essence, the negatively disposed narrative reads that as people leave the cable bundle they may actually forego the traditional channels all together and the valuable content these companies have created and own will be virtually worthless as they will find no other profitable way to deliver their content.

There are more than a few ways these companies are countering this potential threat:

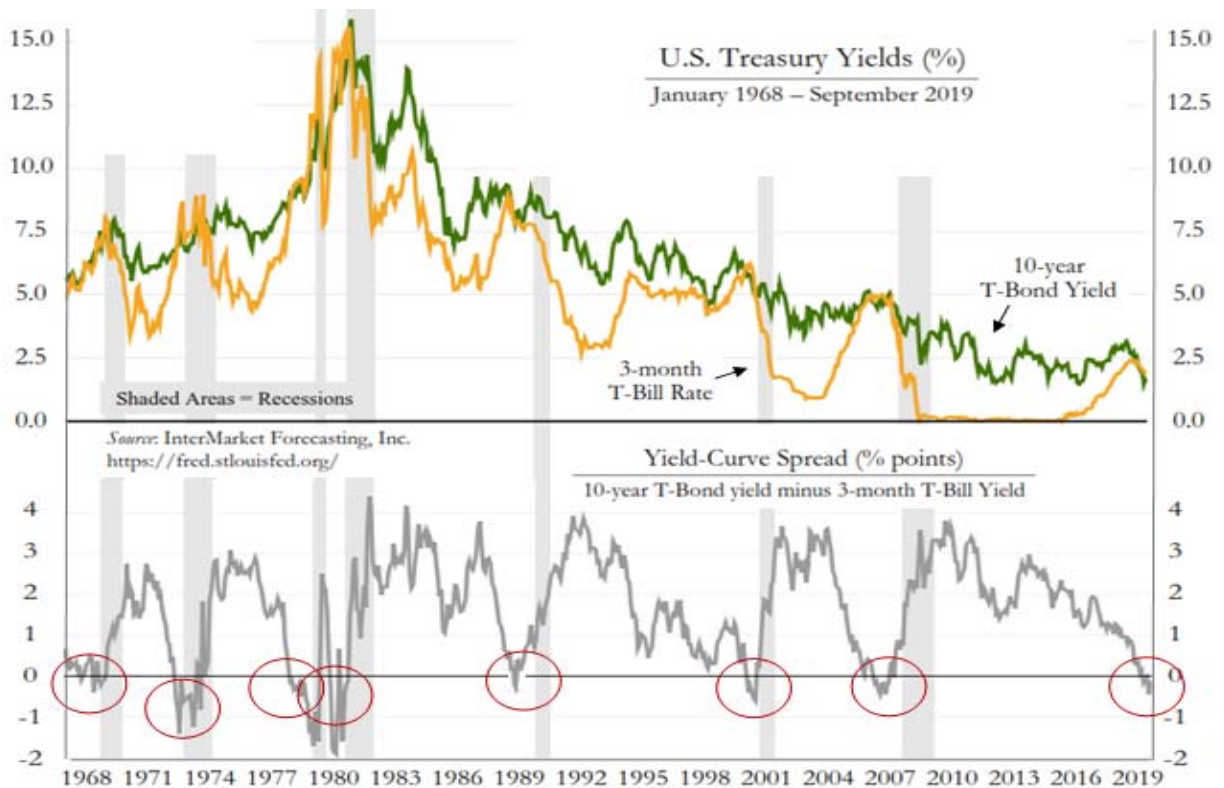
- Great strides are being made with regard to how “viewership” is measured as the traditional way (think Nielsen and cable) has not captured critical elements such as ‘on demand’ engagement, direct-to-consumer and other forms of delivery.
- There has been consolidation in the industry with Discovery buying Scripps and, most recently, the Viacom merger with CBS schedule to close later this year. This has served to give the companies more leverage over the traditional distributors while allowing the companies to gain significant scale and operational efficiencies – for instance, Discovery, post-merger with Scripps, now has over 20% of total cable viewership and has increased free cash flow generation to over \$3 billion post-merger from the combined \$2.1 billion that was being generated by each company pre-merger.
- “Content is King” and even though the delivery ecosystem is changing it hasn't changed this fact. If you own the content and have maintained the distribution rights you can deliver it however and wherever you choose. Discovery anticipates their Discovery GO app will be their 2<sup>nd</sup> or 3<sup>rd</sup> largest channel over the next few years. Viacom and CBS expect very rapid growth of their direct-to-consumer products, CBS All Access and Showtime, from around 8 million subscribers in 2019 to over 25 million by 2022.

The strategy for these companies is to deliver content to consumers in a targeted way through a new suite of platforms. They are all making the transformation from being a ‘cable channel’ by using their valuable content and IP to maximize long-term value. In the meantime, they are generating copious amounts of free cash flow and have growing revenues and earnings. We are, in a very real sense, getting paid very well to wait for them to finish this transition in anticipation of them thriving in the new world.

Viacom’s Bob Bakish recently commented on his company’s stock and anticipated combination with CBS in Barron’s, “I think people don’t truly appreciate the formidable combination of assets that this deal creates. I think they underestimate our ability to execute. But the thing they’re really missing is how this deal creates a company for today and tomorrow. For savvy investors, this is an opportunity to buy an extremely high-quality asset at an extremely low multiple.” We believe we are in the camp of savvy investors.

### Market Thoughts and Observations

Perhaps the most significant market development in the last 10 years occurred this past July when the 3-month T-Bill yield fell below that of the 10-year T-Bond yield for a full quarter. The historical significance is that an inversion such as this is a perfect 7 for 7 recession indicator going back to 1968.



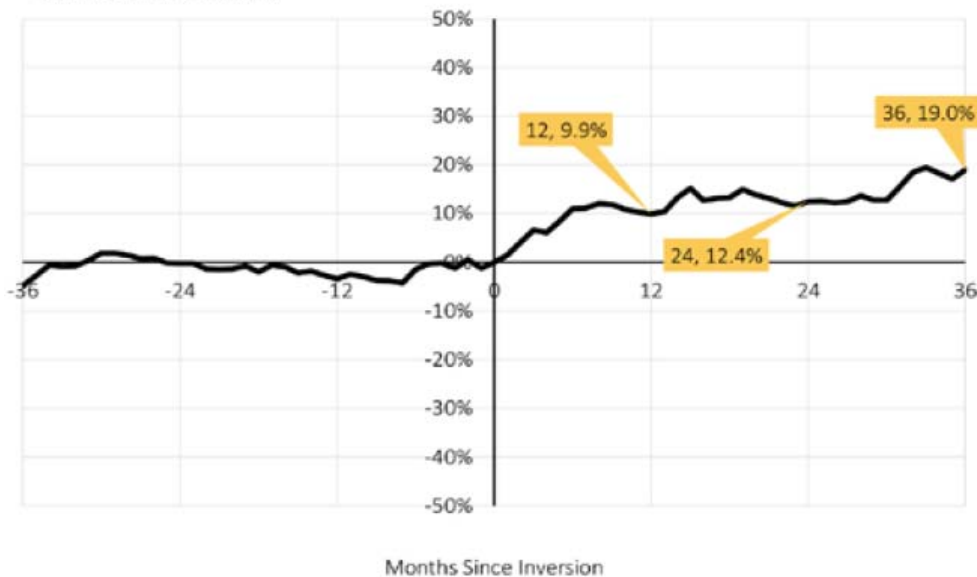
*\*This chart is reflective of the work of Campbell Harvey, PhD at Duke University who wrote his thesis on the subject. His dissertation showed that when the yield curve inverts (3-month higher than the 10-year) for a full quarter a recession has always followed. The 8<sup>th</sup> confirming event occurred for the quarter-ended, June 30, 2019.*

The following is a chart that looks at the past 7 of these inversions and the timing of the subsequent recessions.

<u>YC Inversion</u>	<u>Beginning of Recession</u>	<u>Lag in terms of</u>	
		<u>Days</u>	<u>Months</u>
6/18/69	<b>1969.12</b>	166	5.5
6/1/73	<b>1973.11</b>	153	5.1
11/1/78	<b>1980.01</b>	426	14.2
10/27/80	<b>1981.07</b>	247	8.2
5/24/89	<b>1990.07</b>	403	13.4
7/7/00	<b>2001.03</b>	237	7.9
7/17/06	<b>2007.12</b>	502	16.7
5/22/19			
<b>averages (pre-1985)</b>		<b>248</b>	<b>8.3</b>
<b>averages: ALL YEARS</b>		<b>305</b>	<b>10.2</b>
<b>averages (post-1985)</b>		<b>381</b>	<b>12.7</b>








If the past holds true regarding inversion what does this mean for stocks? According to Dr. Campbell Harvey at Duke University, if one looks at a Value portfolio as an example of a factor portfolio, the results are the opposite of the overall market in the years pre and post inversion. Three years before a yield curve inversion, Value does very poorly (and we note that Growth does extraordinarily well). Then, after the inversion, Value does very well. We do not believe it is a coincidence that a basket of highly valued software stocks compiled by Goldman Sachs peaked in valuation in late July and was down more than 20% by the end of September.

**Cumulative Return of Value Factor: Average of Seven Yield Curve Inversions**



Source: Research Affiliates, LLC, based on data from Kenneth French website and the Federal Reserve Bank, St. Louis.

There are many economic indicators we follow that provide us a lens through which we view the portfolio and the exposures across individual names and industries. We are wary that “this time is different” (meaning that an inversion won’t cause a recession) but we have yet to see confirmation of the other factors that have, in the past, indicated that a recession is nigh.

Indicator	How to Read	Current	Trend
3-month T-bill vs. 10 Year US Treasury	7 for 7 on predicting recessions	Inverted	
Leading Economic Indicators (LEI)	Recession imminent when it rolls over	Moderating	
Oil Prices	Stock market declines when oil up 100% in any 12 month period	All Clear	
US Unemployment Rate	Recession 100% of time when goes up by 0.5 pts from low	Warning Signs	
ISM Manufacturing	Below 45 is a problem - Currently at 47.8	Trending Lower	
ISM Manufacturing New Orders	Below 40 is a problem – Currently at 47.3	Trending Lower	
Housing Starts	Has rolled over before every recession	Trending Higher	

We remain vigilant and cautious in our portfolio positioning as a result while remembering that every recession the U.S. experiences is not extreme in nature. The recession in 2008 was called the Great Recession for a very good reason. Point of fact, the 2001 recession that followed the inversion didn’t even produce a year-over-year negative GDP growth rate. With that in mind, it would not be surprising to us so see a similar scenario play out as that which happened from 2000 – 2007, where Value rallied and Growth disappointed greatly while the dotcom bubble burst. The events post the peak in March of 2000 took down not only internet startups but also frauds like Enron, WorldCom, as well as many other high-flying tech stocks with real businesses and profits.

In a ‘Back to the Future’ moment, we might substitute Tesla for Enron, and the cloud and security software (Slack, New Relic, CrowdStrike, etc.) and ecommerce stocks (GrubHub, Wayfair, Pinterest, Etsy) for the dotcom stocks and history could easily be seen rhyming with an outside chance of eerily repeating.

To wit, the three worst months for Value since 1996 were February 2000, February 2009 and May of 2019. Prior to the May 2019 occurrence, the other two provided large payoffs for Value. For comparison and confirmation, we looked at our track record for the time period February 28, 2009 through February 28, 2010 for reference. The gross return for the strategy was over 93% with a net return of over 78% during that 12 month time period versus a return of just over 53% for the S&P 500.

### **Firm Update**

We continue to believe the opportunity at hand is extraordinary – we own a portfolio of securities that are as deeply discounted from our estimates of fair value as we have ever experienced. Importantly, a substantial portion of our net worth is invested in these securities alongside of you, so we are putting our money where our mouth (or pen) is.

Our search for like-minded client partners continues and we are working hard to make access to our firm and products as easy as we possibly can.

Please feel free to contact members of our team with any comments, questions or potential investment ideas.

Best Regards,

Masonry Capital Management, LLC



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**DISCLOSURES:**

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