Q2 2020 Masonry All Cap Select Commentary **July 2020**

"You don't need any transparency. You don't need any footnotes. What were you thinking?"

Scott McNeely, CEO of Sun Microsystems

To Our Client Partners:

The aim of our quarterly updates is to provide insight into the current portfolio and how we are positioned going forward. Please reach out with any questions or comments you may have.

Overview of the Portfolio

As of June 30, 2020 we were approximately 93% in equities and 7% was in a combination of cash and fixed income. The largest exposures at the end of the quarter were the common stocks of DISH Network, ViacomCBS, and Anheuser-Busch InBev. The weighting of our top ten holdings as a percent of the total portfolio was just over 54%.

Portfolio Highlights

The portfolio is literally peppered with common stocks that trade at incredibly low price-to-earnings (PE) multiples. Many trade at PEs between 1-3x normalized earnings (pre-recession). We have discovered, researched and bought the stocks in our portfolio over a long period of time. They represent a variety of industries and sectors and each is at a different point in the life cycle of our investment thesis. Some have leverage (for those that do we have gone to great lengths to manage the inherent risk in owning a leveraged company) but many have only a modest amount. In our view, the low prices are not necessarily the result of the recent recession linked to COVID-19 but rather a function of the multi-year fascination of investors with a class of investments dubbed 'Disrupters.' These companies are subject to a narrative of unbelievable revenue and profit growth 10 years out in the future which is combined with the idea that 'this company/product/industry will change the world'. The '10 years in the future part' is important because so many of these stocks currently generate no profits. What has been left behind is a wide swath of profitable, cash generative businesses that have growing revenues. These stocks are just a poor investment fit with the current preference of the speculative crowd. That will change. It always does. In fact, now may actually be that time.

We believe that the events year-to-date in the U.S. are causing a sea change in the investing landscape. The past environment of persistently low rates, low inflation, and low economic growth is quickly changing. Rapid price increases in precious metals, in particular silver, may be telling us the inflation expectations for the future are much too low. If massive fiscal and monetary stimulus in the U.S. results in inflation, we should see a steeper yield curve (helps financials and hurts profitless companies) and an investment preference for companies with more rapid pricing power (cyclicals over growth companies). The great news is that the companies that would benefit from this environment are the ones that are currently being left on the side of the road at hard-to-believe low valuations. Remember, almost without exception, the dominant conditions of one decade are never the dominant conditions of the next decade. Every decade is different and the vast majority of the favored stocks of the 2010's will almost assuredly not be the favored stocks of the 2020's. Regardless of whether or not inflation rears its ugly head, the securities we currently own have very attractive risk / reward profiles in boring but necessary industries like shipping, commercial and residential building equipment, auto parts, life insurance and natural gas production.

While it is certainly discouraging that the market has not yet recognized the value we see in our portfolio, hence the poor returns year-to-date, it pays to remember what Thomas W. Phelps wrote in his book *100 to 1 in the Stock Market* with regard to the timing of getting paid on your investments, "[I]t is more important to be right than to be quick." If we buy a stock for $10 per share that we believe is worth $20 per share it would be great to get paid the day after our purchase, however, even if it took 5 years for the stock to trade at our $20 target price we have no right to complain. The return is still very attractive.

As the 2nd quarter progressed we were able to add exposure to both new and existing names that were seemingly left behind as the market inexplicably headed off to new heights. In doing so, we greatly expanded our portfolio of grossly mispriced securities with each having the potential to produce significant returns moving forward.

Portfolio Details

Selected Portfolio Activity from Q2 2020

We felt fortunate to be able to add to existing positions at attractive prices last quarter. The volatility in the market also presented attractive prices for a plethora of new positions as well. These include a position in the iShares Silver Trust ETC (Ticker: SLV) which was established as a potential hedge against potential inflationary pressures. We also added Ambev (Ticker: ABEV), a producer and distributor of beer based in Brazil and Corteva (Ticker: CTVA) an agricultural company that specializes in the seed and crop protection business as well as software and digital services related to agriculture. We will continue to provide more details on each new investment in the coming quarters.

Shipping Basket (Special Situation)

While we were not naïve to the volatility of our shipping stocks we have been surprised how extreme it has been. As an example of how misunderstood the economics of the shippers are, we look to comments made by Kenneth Hvid, CEO of Teekay Tankers. He highlighted in April that his company saw annualized free cash flow in their fourth quarter of $400 million and that number was bumped to over $650 million at the rates they experienced in the current quarter. The market cap of his stock was just over $800 million at the time. The stock trades at a sizeable discount to the steel value of the ships. His opinion and we share it, is that it's taking some time for the market to fully value and understand a business (marine transport) which has gone from just covering its operating and financing costs to suddenly generating a massive surplus of cash. We continue to believe in the market's ability to finally and fully realize the value in our shipping names. When and if that happens we should be compensated very well for the investments we have made in this sector.

Content and Media (Core)

Since the lockdowns began downloads of streaming apps have skyrocketed. For many of our holdings growth they thought would take two years or more to achieve happened in a matter of months. What is not widely appreciated or understood by the market is that streaming subscribers (subs) are vastly more profitable for the content producers than the subs they have that are part of a bundle. Should these content companies ultimately achieve a level of subscribers on their own platform that grow revenues and profits above their past levels their respective share prices should appreciate significantly.

Market Thoughts and Observations

As is the rest of the world, we continue to read and monitor COVID-19 and its impact on the health and well-being of the population as well as the impact on world's economy. We are encouraged by reports on the ground in China that life seems to be getting pretty much back to normal. The situation there has been described to us from a client who has boots on the ground as being 98% back to where it was from an economic perspective to where it was pre-COVID-19. In looking at Italy (another country that got hit really hard and early), there seems to be a sense of normalcy or maybe even acceptance that has appeared. Masks are worn and social distancing is in place. Additionally, the country is not anticipating the dreaded "second wave."

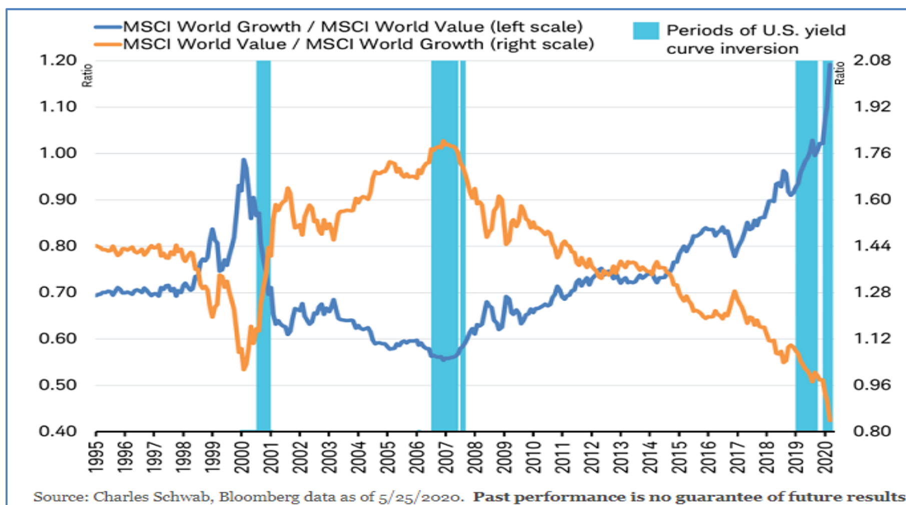
A few months ago we noticed that many of our holdings exhibited a cyclical aspect to them over long periods of time despite not being in sectors or industries generally thought of as cyclical in nature. We then broadened our scope and looked at other relationships, like that between oil prices, the S&P 500 and the marine transport companies as an example. This work, and there is more to come, has been shared with you via email over the past few months. The conclusion we have drawn is that there is a discernable and prevalent cyclicality across our holdings (both short-term and longer-term) in a variety of industries. Our findings show that we could be at a major inflection point of outperformance for our holdings if history is any guide.

Further, there is clear evidence of cycles in our investing style as we prefer stocks with proven business models with free cash flow and/or earnings and those backed by hard assets. This is generally known in investing circles as the practice of Value Investing. In Chart 1 it should be very clear that we are at historic levels with Growth beating Value on a worldwide scale. It seems reasonable to us that over time this relationship will revert, as it always has, and 'tip the scales' back in favor of Value at the expense of Growth. It wouldn't surprise us either if the reversion back to Value was historic too.

Chart 1

A reasonable question is 'what might cause this to happen?' There is ample evidence over the years that when seismic events occur in the economy or in the markets it is ripe for change. Yield curve inversions and the widely felt impact they have are one signpost. From reading our past letters it should be evident that the yield curve is something we follow closely. Chart 2 highlights the yield curve inversions that have occurred from 1995 to May of 2020. At each occurrence the leadership between Value and Growth changed and it did so throughout the world's stock markets.

Chart 2



As Q2 2020 unfolded the prices of securities we place solidly in the Disruptor Bubble camp saw huge increases. While the 'stay at home' orders permeated our country, there were companies that benefited greatly from the use of their products and services that catered to this trend. One such stock was Zoom (ticker: ZM). Zoom reported an increase from 200 million to 300 million users in a little over three weeks in April. However, as one analyst pointed out, the 300 million number does not reflect paying customers but rather users utilizing the free option and that the increased number of users may not represent high-quality, long-term sticky subscribers. Yet, the stock climbed over 73% in the 2nd quarter alone. This is the very definition of hope and hype. Should user growth not translate into the anticipated revenue and profit growth the downside of the stock is substantial as it is trading at over 70x revenues. Currently, there are an extraordinary number of stocks, some are well-known and others are not, that are trading at greater than 10x revenue. Within the S&P 500 there are 37 such stocks which are more than the 30 there were in March of 2000 at the height of the Dotcom Bubble. We would all be wise to heed the words of Scott McNeely, CEO of Sun Microsystems, who had this to say about his company trading at 10x revenues during the Dotcom Bubble:

> At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

We wrote in our previous letter that the conversation could soon shift from 'who can grow the fastest' to 'who can survive.' In fact, for some companies that is already happening. Carvana (ticker: CVNA) was highlighted in a recent Forbes article. In it, the following was written:

> ….as reported by Forbes, auditor Grant Thornton wrote that "management believes" it can meet its financial obligations through February 2021. This belief is based on "the Company's operating plan, that current working capital and expected continued inventory and capital expenditure financing is sufficient to fund operations and satisfy the Company's obligations." "Grant Thornton does not share management's confidence in that operating plan," according to Forbes, quoting Thornton as saying, "We determined the Company's ability to continue as a going concern is a critical audit matter due to the estimation and execution uncertainty regarding the Company's future cash flows and the risk of bias in management's judgments and assumptions in estimating these cash flows.

In a normal and functioning market, a ‘going concern’ mention by your auditors is close to a deathblow. Carvana’s stock did retreat from a high of around $110 per share down to around $30 per share in early March. But that retrenchment didn’t last long. The stock price at the end of the quarter was over $120 per share and the company used this price strength to do an equity raise in May. Carvana’s sales have doubled in the last 2 years while the market cap has moved from around $4bn to over $20bn and the company has never generated an annual profit.

A distinct characteristic of the day trading bonanza has been the trading, and subsequent rapid price increases, of stocks in or entering bankruptcy. As a quick refresher, as a company becomes financially distressed the trading level of the senior bonds gives a good sense of what securities in the capital structure might ultimately get paid in a restructuring (bankruptcy) and at what level. Simplistically, the most senior securities (bonds) get paid before the more junior securities (common stocks). So, if a senior security trades at $0.10 it tells you that if you bought the bonds for $1 you are most likely getting only $0.10 in return – a 90% loss. It is also a clear signal that the common stock will be deemed worthless. Prior to it declaring bankruptcy, the bonds of Chesapeake Energy with a coupon of 5.375% and maturity of June 15, 2021 traded between $0.035 and $0.04 on the dollar on June 8, 2020. That same day the common stock of Chesapeake climbed to a high of $77.50 from a close the Thursday of the week before of $14.05. So, the bonds are telling you the stock is worthless (which means a terminal value of $0), but the speculators day trading the stock were content changing hands with the greater fools. Envision it like bidding up and trading cut tulips which you know will wilt and die within the week but your plan is sell it to the next sucker to make a quick profit. Crazy stuff. CNBC chose to do a “What happens to a stock in bankruptcy” segment. It read like a Dick and Jane book. It was hard to believe what we were seeing. This isn’t hard stuff to understand but it’s clear that many of the newly minted day traders have no idea of the underlying value of what they are trading back and forth. Julian Emanual, chief equity and derivatives strategist at BTIG, called the trading of bankrupted common stocks a sign of “euphoria” he last saw before the burst of the tech bubble:

> It’s sort of this speculative behavior that we saw at the end of 1999 and the beginning of 2000. It really doesn’t make any rational sense.

These are heady times indeed. The majority of the gains in the general market are coming from just a handful of stocks and these stocks trade at very rich multiples. The human condition has us wired to extrapolate current trends into the future. Doing this gives humans comfort and settles our mind. Thinking about change is tiresome and uncomfortable for most people. Our habit of shining a light on how current trends rarely extend into the future continues with Charts 3 and 4. It seems highly likely the Nasdaq 100 outperformance over small caps will revert as will the relationship between financials and technology in the U.S. market. We are positioned for both.

Chart 3

Chart 4

We believe, and the quantitative evidence supports it, that when comparing Value to Growth, Value is the cheapest it has ever been. We own securities in various industries that trade at the lowest level to our estimate of fair value that we have ever seen – and this includes the amazing values presented in the Dotcom Bubble and the Great Financial Crisis. The current environment is truly without precedent. We are not alone in our thinking. AQR Capital Management, a firm that identified the Dotcom Bubble in 2000, wrote the following in a research piece from May 8, 2020 titled, *Is (Systematic) Value Investing Dead?*:

> Value is super cheap today and this is not coming from only the "broken" price-to-book measure (it isn't even very dependent on it) nor is it due to a group of winner-take-all monopolistic companies. It is not coming from the tech industries, it is not coming from mega-caps, and it is not coming from the most expensive stocks. Rather it is a pervasive phenomenon. ***Investors are simply paying way more than usual for the stocks they love versus the ones they hate (and measured using our most realistic implementation this is the clear maximum they've ever paid) and doing it in a highly diversified way up and down the cross-section of stocks (emphasis added*)**.**
>
> We think the medium-term odds are now, rather dramatically, on the side of value, with no "this time is different" explanation we can find (and we've tested a lot of them!) holding a drop of water and no other period in the 50+ year history matching today. It has certainly been excruciating getting here, but here we are, and it's never looked cheaper looking forward. This is where long-term investors make their bones.

At Masonry, we continue the practice of buying assets for less than we believe they are worth and while doing so we demand a margin of safety if we are wrong in our analysis. The answer to the question of when we will get paid for our work is unknowable and this can be uncomfortable. All we can say is that we think we are much closer to the end of Value's underperformance versus Growth than the beginning. Eric D. Nelson, CFA with Servo Wealth Management recently wrote the following which gives us (and hopefully you) great comfort:

> There have been 77 different 10-year periods since 1927 (out of 1,100, or just 7% of the time) where the Fama/French US Growth Index has outperformed the US Value Index. The next 10 years? **Every single one saw value beat growth**. Not some, not most. **All**. 77 for 77.

May 31, 2020 was the end of one of those rare 10-year periods when Growth outperformed Value. We think it's highly unlikely that this time, for the first time, sees a trend break that has been in place since 1927.

Finally, we write to convey our thoughts on possible implications of the extraordinary fiscal and monetary stimulus we are experiencing here in the U.S. Chart 5 shows the similarity between the 1930's and 1940's and the 2010's and potential 2020's and provides a possible roadmap for what the next decade might hold.

Might history repeat? Lyn Alden Schwartzer in her Seeking Alpha article titled "Fixing The Debt Problem" from 6/1/20 highlighted the following.

Chart 5

1930's:	**Private Debt Bubble, Banking Crisis, Disinflation**
1940's:	**Federal Debt Bubble, Wartime Finance, Inflation**
2010's:	**Private Debt Bubble, Banking Crisis, Disinflation**
2020s:	**Federal Debt Bubble (check), Pandemic Finance (check), Inflation (?)**

In examining the relationships a bit further notice in Chart 6 the similarities in the specific periods graphically with regard to the expansion of the Monetary Base and the trough and eventual increase in interest rates.

Chart 6

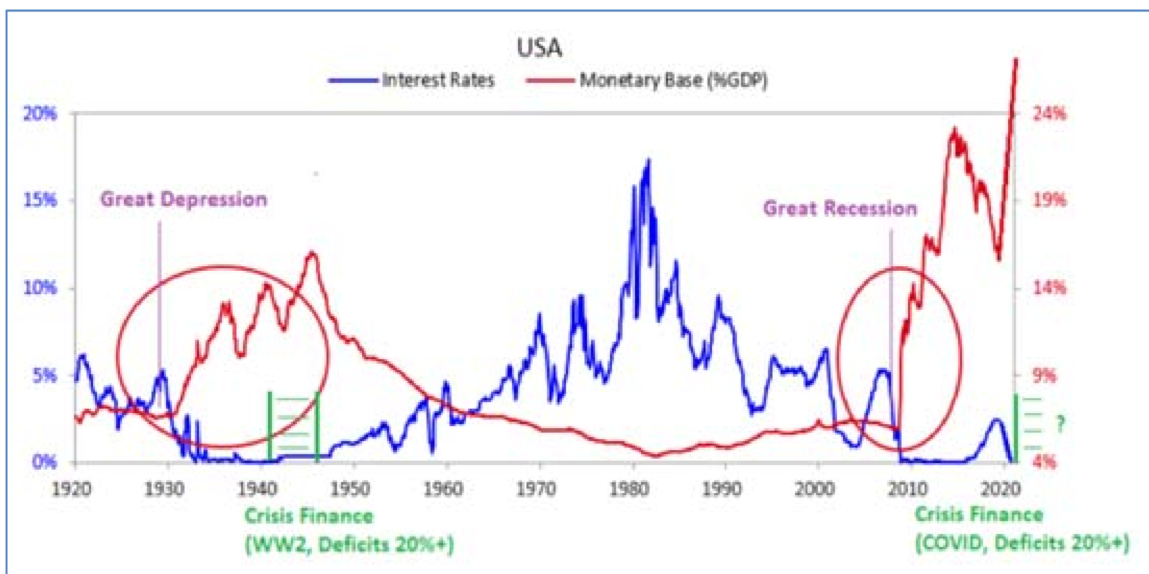
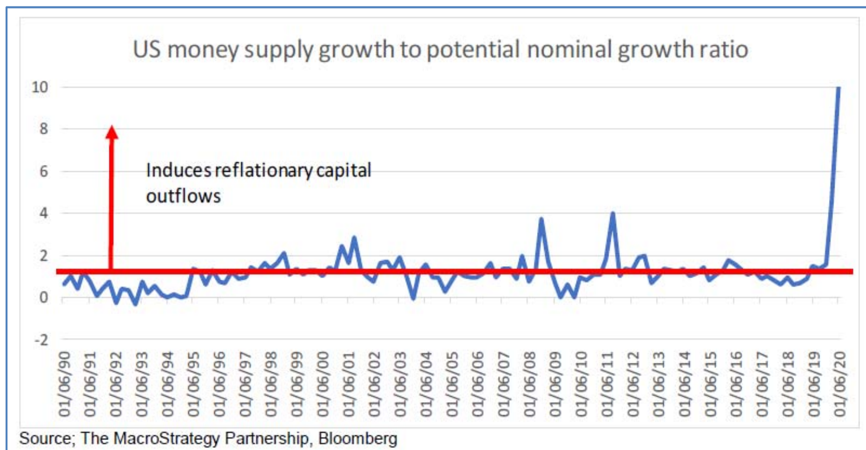


Chart Source: Bridgewater Associates, Ray Dalio, Updated/Annotated by Lyn Alden Schwartzer

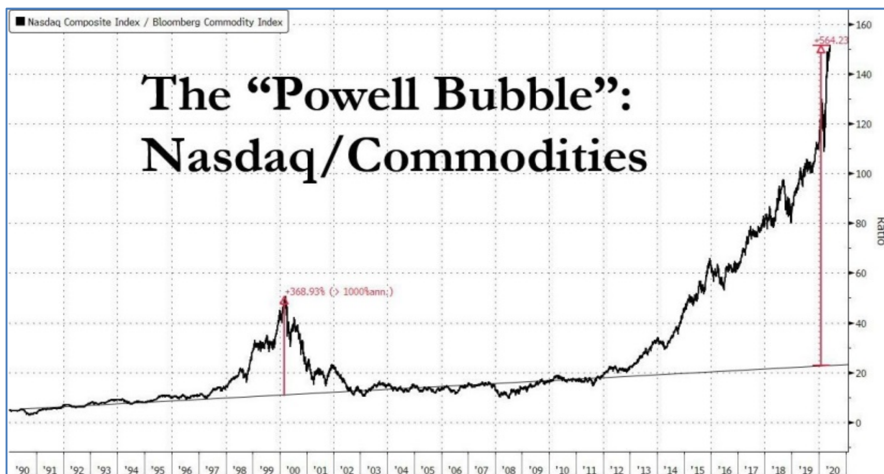
It is estimated by The MacroStrategy Partnership that the Fed's QE and the US Treasury's forthcoming fiscal spend will inject the liquidity equivalent of five QE1s and a QE2 in just one year. As seen in Chart 7, U.S. money supply growth is running well ahead of the potential nominal economic growth in the U.S. In response to the ultra-easy monetary policy and fiscal stimulus it should be no surprise that the U.S. Dollar has started to weaken and silver is rising. Both are indicative of coming inflation. After all, the least painful way to pay back our extraordinary levels of indebtedness is some combination over a long period of time of higher inflation, low interest rates, and higher taxes.

Chart 7



The unleashing of massive stimulus is reflationary in nature. This tends to benefit companies in basic resources, industrials, financials, and hard assets like gold and silver at the expense of technology (especially software) and bond proxies (slow growing, high dividend payers). As seen in Chart 8, the Nasdaq Composite Index has never been this expensive compared with raw materials. The impact of the Nasdaq/Commodities ratio reverting back to the mean will have enormous ramifications for the economy and on stock prices.

Chart 8



It also seems strange to us that while the official measure of inflation is trending down, the expectation for future inflation as measured by the University of Michigan 'Expected Change in Prices During the Next Year' is skyrocketing up and is now over 3% as of June 30, 2020. This is happening during a time when central banks around the world are artificially suppressing interest rates. It's a potentially toxic cocktail that bears watching closely.

Given all of this, it is certainly possible, perhaps even likely, that the leadership in the stock market will shift, and maybe sooner than later, from the leaders of the past decade to the now unloved, underappreciated and unfollowed. If this happens we stand to benefit. We shouldn't be surprised when and if the change occurs. It almost always happens at major inflection points like the one we are experiencing now.

Fun Factoid from Mark Meulenberg, CIO

I attended my first Berkshire Hathaway meeting in Omaha in the spring of 2000. Berkshire had been underperforming a torrid market driven by tech which we now know as the Dotcom Bubble. Buffett was skewered in the annual meeting during the Q&A session for being out of touch with the market – almost all of the people who were supposed to be asking questions were instead giving him advice on which tech stocks to buy. Looking back it was quite humorous but I didn't think it was at the time. I felt sorry for him which was funny because he was one of the world's richest people. Fast forward to today and the same general tenor is being expressed. A recent Dow Jones headline read, "Dud stock picks, bad industry bets, vast underperformance - - it's the end of the Warren Buffett era." Investors and financial writers openly question whether Warren has been passed by and maybe he has – he's almost 90 for goodness sake. However, consider this:

- The relative strength of Berkshire's stock to the S&P 500 hit a five-year low in late 1999 / early 2000. Not long after that, the bubble burst and Berkshire's stock outperformed the S&P 500 over the next 10 years.

- In 2020, the relative strength of Berkshire's stock to the S&P 500 hit a five-year low.

What are the chances that 10 years from now when we look back we might write the exact same sentence regarding this period as we did after late 1999 / 2000?

Firm Update

We are pleased to announce we have accepted our first family office as a client of Masonry Capital Management. The firm benefits greatly from the interactions and insights we have with our client partners and our conversations and idea sharing with our newest client partner has already proven to be extraordinarily helpful as we navigate through these turbulent and challenging times.

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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