MD Sass Concentrated Value

MD SASS

Q4 2022 Commentary *January 23, 2023*

The MD Sass Concentrated Value ("CV") strategy was up +9.3%, net of fees, in the fourth quarter of 2022, vs. +12.4% and +12.2% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

For the full year 2022, CV was down -5.4%, net of fees, vs. -7.5% and -8.0% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

From inception (January 2019) through the end of 2022, CV was up +88.0% net of fees, vs. +50.5% and +49.9% for the Russell 1000 Value and Russell 3000 Value indices, respectively.

2022 was a challenging year across most financial markets and our space was no different. While we are never satisfied with negative performance, we are pleased to have outperformed our benchmark by over 200 basis points last year. Remarkably, we did so despite having zero exposure to the Energy sector, the best performing sector of the Russell 1000 Value. The Energy sector contributed 320 bps of positive return in 2022 to the Russell 1000 Value, creating a difficult hurdle for any manager with no exposure. Although sector allocation had a negative impact on Concentrated Value's performance, our stock selection was a significant positive contributor that overcame the negative sector allocation effects. This is exactly the outcome we want as a concentrated manager. We want to outperform not because of sector exposure but rather by being "right" about the idiosyncratic value drivers embedded in the stocks we own.

Without a doubt, we will not be right all the time. In fact, we expect to be wrong quite often and have long understood this. However, it occurred to us recently that our return objectives do not contemplate nor articulate what constitutes acceptable levels of error tolerance, in terms of frequency or severity. Internally, we have discussed our performance goal simply as 300+ bps per year of excess returns vs. the Russell 1000 Value. While this is indeed a worthwhile objective as it would likely place us in the top quartile of our peer group, it falls well short of explaining how to get there. How often can we be wrong while still achieving our performance objective? How bad can the damage be from being wrong before it impairs our ability to achieve our goal? It is important to answer these questions because we need to be willing to accept some level of error as an outcome and acknowledge it is part of the formula for success. It is OK to be wrong…but how wrong is OK?

To answer this question, we looked at data from eVestment on all top quartile performing managers since our inception in 2019. Based on our analysis, the batting average of this group is an eye-opening .580. If the best performing managers are right only 58% of the time, then high performing teams need to understand that being wrong is simply a part of the algorithm of success, and rather than chase the phantom prospect of always being right, they should instead focus on being good at being wrong. This quality is best captured by a fund's slugging percentage, the ratio of how much the manager earns on average on its winners compared to how much it loses on its losers. Fiducient Advisors released a white paper in October 2020 that looked at the slugging percentage of top quartile managers. Reverse engineering some of the data in that report suggests that top quartile managers within the large cap value space had an average ratio of approximately 1.4x. For us to achieve ~300 bps of excess return with a .580 batting average and gain/loss ratio of 1.4x, our winners need to generate 1100 bps of outperformance vs. the market while our losers can underperform by about 800 bps. Intuitively this seems like a reasonable goal and is very much consistent with our belief in "being wrong early" so that our losers hurt us much less than our winners benefit us.

Putting all the pieces together, we can more clearly articulate our return objective of ~300 bps of annualized outperformance into the following – *our objective is to be right at least 58% of the time and when we are right, we strive for 1100+ bps of excess return on average. We aim to be wrong no more than 42% of the time with the losers hurting by 800 bps or less on average. If we achieve these goals, we should generate 300+ bps of outperformance per year.* We believe that setting aggressive but realistic return expectations using batting average and gain/loss ratios incorporates reasonable tolerances for error into our objectives. We intend to share an analysis of Concentrated Value's batting average, slugging percentage and other metrics in a future investor letter.

Each year the team meets to reflect on the prior year's results with a focus on process. We have candid discussions about what we did well, what we got wrong and why, and how we can incorporate our learnings via enhancements to our process. We believe "process" is a dynamic concept that should evolve with our learnings over time. Below are some of the takeaways and key discussion points from that meeting.

- *With respect to idea generation, we need to devote more time to thorough discussions of non-actionable ideas.* Yes, you read that correctly – we unanimously agreed that spending more time on ideas that are not actionable at the current price is a good use of our time. Given the time needed to fully diligence a new idea, the highly uncertain environment, and the often volatile backdrop for stock prices, we believe it is beneficial to have a few thoroughly researched, well-vetted, and compelling risk-adjusted investment ideas in the queue that we can quickly put to work should we wake up one day and find that prices or estimates have come our way. In 2022, we found several investments where we liked the long-term prospects and felt we had a differentiated view of the fundamentals but had concerns about timing – either the current price represented a less than desirable risk/reward or the near term consensus estimates were perhaps a bit too high. When faced with this situation in the past, we likely would have simply focused our attention on other, more actionable opportunities. However, in 2022 we took a different approach, opting to complete our due diligence in the hope that one or more short term factors (lower price or negative earnings revisions) would ultimately create an attractive entry point. This strategy worked well for several investments during the year, including *Charles River Labs* **(CRL)** and *Rockwell Automation* **(ROK)**. To be clear, we still plan to spend much of our time working on ideas we think are immediately actionable, but we think a hybrid approach will ultimately yield better results. To crystalize this change in approach, we now carve out time every Monday as part of our daily team meeting, for each analyst to discuss in detail his or her work-in-process and the working thesis behind the idea regardless of whether it is actionable today or not. Timing matters a lot in this business and our preference is to be ready to act when the time is right.

- *Similarly, it is important that we leverage our knowledge base on important themes to act quickly when opportunities arise.* Sometimes we can find opportunities in areas where we already have exposure. Such was the case with our investment in *World Wrestling Entertainment* **(WWE)** in Q3, which benefitted from our insights regarding sports rights fees that we acquired by researching *Liberty Formula One* **(FWONK)**. We were also able to leverage our knowledge of utilities' capex trends and broadband fiber demand – themes we studied when researching *Quanta Services* **(PWR)** - to exploit an opportunity to acquire *MasTec* **(MTZ)** at a favorable price. Much like being willing to diligence a stock even when it isn't actionable, putting in the work to maintain a continuous, deep understanding of themes and trends – even when we have no direct exposure to them - can be an invaluable asset, enabling us to pounce when opportunities do arise. Such was the case with our recent investment in CRL, which leveraged our knowledge of the CRO industry gained when we owned CRL in the past. Because we put in the work to stay current on the important issues, we were able to pick up shares opportunistically when the chance arose.

- *When a secular grower operates in a cyclical end market, the end market often wins in the short term.* For obvious reasons, we are often attracted to businesses with positive secular tailwinds that are able to take market share and compound at high rates of return for years to come. But as we discussed earlier, timing matters in this business. While owning a secular growth company may provide great returns over a multi-year period of time, if it operates in a cyclical end market that is in the late innings of its growth cycle, near-term performance can be quite challenging. We owned several stocks in 2022, including *Walker & Dunlop* **(WD)** and *First Republic Bank* **(FRC)**, that significantly underperformed the market due to their cyclical end market exposure, despite their continuing to gain market share. Lesson learned – we can't get too enamored with recent growth rates of secular "winners" if they are operating in cyclical end markets operating at or near cyclical peaks. We have to think both strategically and tactically about these situations.

- *We have been quicker to react to stocks that have had a sharp move lower than those that bleed lower over time.* When a stock falls hard and fast it is usually due to a negative event or headline that provides a causal explanation. As a team, we generally have been proficient at discussing the price-moving news, assessing its validity and impact to our thesis, and making timely decisions on what to do. Where our process has not been as robust is in situations where a stock moves lower, slowly but persistently, over many weeks. Oftentimes, these slow bleed situations aren't the result of one news headline but rather a change in sentiment, factor swings, or technical pressures. We recognize that we can do a better job of addressing these scenarios. Going forward, any stock that has underperformed the market by 1000 bps over a two-week period will be re-evaluated regardless of news flow. It is our job to try to understand why a stock is underperforming and assess whether something has altered our thesis and whether the risk/reward has changed. However, we also need to be mindful that there isn't always a good explanation for stock movements. Although we'd like a succinct answer to why a stock may be underperforming, the truth is that one may not always be available. As Daniel Kahneman explained in *Thinking Fast and Slow,* "our mind is strongly biased toward causal explanations and does not deal well with 'mere statistics'…causal explanations will be evoked when regression is detected, but they will be wrong because the truth is that regression to the mean has an explanation but does not have a cause." Although it is important to discuss stock price underperformance and try to understand the cause so that we can act appropriately, we must be careful not to force fit a false narrative to rationalize past price movements.

These are only some of the topics we discussed at our year-end meeting. We spent time reviewing a variety of other topics, including new performance analysis tools, "bucketing" investment theses into more digestible categories for future reference, reviewing certain investments more frequently that may lack intra-quarter data points, and refreshing our "bear case" earnings assumptions with more frequency (we seem to have had a bias towards updating base case estimates and price targets more so than those of our bear case). Borrowing from the great cycling coach Dave Brailsford, we believe the aggregation of these marginal gains over time can potentially lead to significant outperformance.

Q4 PORTFOLIO REVIEW

The biggest contributors to performance in Q4 were *APi Group* **(APG)**, MasTec (MTZ) and *Raytheon* **(RTX)**.

Shares of APG came under heavy pressure in the first half of 2022 on concerns of a slowing economic environment. We have long believed that the market simply doesn't appreciate how resilient APG's business actually is. With approximately half of its revenues tied to service-oriented work, much of which is mandated by law, and with a differentiated, self-help story in Chubb Fire & Safety, our view has been that APG should be able to grow its business and expand margins even in a deteriorating economic environment. We believe our thesis was proven correct as APG implicitly raised adjusted EBITDA guidance (ex-FX) from $650-$700M in February to $680-$695M in November. We can't name many "cyclical" Industrial sector companies that raised core EBITDA guidance during 2022. The Investor Day held in November, in which APG raised its cost synergy guidance for Chubb and outlined a path to 13% adjusted EBITDA margins by 2025 (up from ~10.5% in 2022), went a long way to dispelling the misperceptions about the business and was largely responsible for the 42% rise in the stock in the quarter (along with better than expected Q3 results and outlook). We believe APG will generate over $2/share in free cash flow by 2025 assuming just 12% adjusted EBITDA margins, making the stock an attractive value at ~$19 today.

MTZ is a "show me" story and we believe Q3 earnings gave investors comfort that management is executing well relative to consensus expectations which supported the 34% rise in the stock in Q4. MTZ is at the epicenter of several secular growth themes including utility capex spending, fiber-optic cable deployments and renewable energy infrastructure. Furthermore, we believe their highly cyclical oil & gas infrastructure business, a headwind to earnings for the last two years, troughed in 2022 and is set for a cyclical rebound in 2023 and 2024. MTZ's valuation disparity with PWR widened substantially over the past couple of years as MTZ lowered guidance due to several factors we believe are now becoming tailwinds. With MTZ's organic growth likely to accelerate to low double-digits over the next few years, and margins expanding in the process, we believe MTZ shares are likely to re-rate from the 8.3x EV/EBITDA they currently trade at to closer to PWR's 13.5x multiple, particularly given MTZ's potential for superior organic growth and operating leverage.

RTX's stock price was up 24% in Q4 2022. A confluence of positive datapoints drove outperformance in the quarter, including favorable commercial aerospace aftermarket commentary from *MTU Aero Engines* **(MTX GY)** at their November Investor Day, optimism regarding the reopening of China and the implications for air travel, and continued strength in the defense business as evidenced by significant award activity in Q4 both in the U.S. and abroad. We believe the demand environment for defense and commercial aerospace will remain robust in 2023 and 2024 with margin upside from easing supply chain issues and labor shortages. RTX trades for 15x our 2024 EPS estimate which we think is attractive relative to its demand resiliency (much of their business is arguably countercyclical), visible pipeline of defense awards and margin upside potential.

The biggest detractors to performance in Q4 were *PayPal* **(PYPL)**, *Match Group* **(MTCH)** and Walker & Dunlop (WD).

When we originally initiated a position in PYPL we thought revenue growth would begin to reaccelerate as eCommerce payment volume normalized following the post-COVID deceleration in 2021 and 2022, and saw additional upside to consensus estimates from cost-cutting, accelerated share repurchases, higher rates impacting customer cash interest income, and easing headwinds from the loss of *eBay* **(EBAY)** business. In underwriting the investment, we felt that the biggest risk to the thesis was the potential for core PayPal Checkout to lose share to emerging alternative providers such as Apple Pay, Shopify Payments, Amazon Pay and/or the numerous "buy now pay later" upstarts. Based on our research, we believed that PayPal Checkout held market share over the past couple of years but also recognized there was a lot of noise in the data given the dramatic shifts in online demand that occurred between goods and services as well as cross-border transaction activity in the wake of the pandemic. However, recent datapoints from *Adobe* **(ADBE)**, *Amazon* **(AMZN)**, the major credit card networks, the U.S. Census bureau, *Salesforce.com* **(CRM)** and other sources led us to increasingly question the resilience of eCommerce spending in the current economic environment as well as the stability of PayPal's market share. Despite many elements of the

thesis going our way, and consensus estimates moving higher as a result, we concluded the risk/reward was no longer favorable and exited the position for a modest gain (although a loss in the quarter).

MTCH declined 13% in the quarter, largely due, in our estimate, to factor flows rather than any company-specific drivers. Sector peers such as *Interactive Corp* **(IAC)**, *Meta* **(META)**, *Roku* (ROKU) and *Google* **(GOOGL)** were all down between 7% and 20% in Q4. From a thesis perspective, we recognize that Q3 results did not support our view that Tinder will experience accelerating revenue and subscriber growth, but we did not expect this to occur until early 2023. It takes time for new senior leadership to establish goals, design and implement new innovations and drive growth (particularly during a period of difficult comps, FX headwinds and decelerating economic growth). More recent data suggests that Tinder has stabilized and Hinge growth is accelerating which we think will create a favorable setup for the stock in 2023.

As discussed earlier, WD is a secular grower operating in a cyclical industry. The cyclicality of multifamily capital markets prevailed in Q3 as WD experienced a sharp deceleration in growth as the spike in interest rates and rate volatility effectively froze capital markets. We believe that rate volatility is unlikely to remain at historic highs and any normalization toward historical levels will benefit WD's origination volumes. Furthermore, we expect GSE multifamily loan originations will grow nearly 6% in 2023 which will act as a counter-cyclical force and drive growth in WD's most profitable business. WD should continue to be a long-term share gainer in the multifamily origination market as its focus on proprietary technology enables it to drive growth in small balance lending volumes where WD has a small share today. And though we suffered losses in the position last year, we believe consensus estimates and valuation now more accurately reflect where WD is in the cycle, providing upside as fundamentals normalize.

We didn't initiate any new positions in the quarter. We certainly turned over a lot of rocks but candidly we believe consensus estimates are broadly too high for many stocks and so finding situations where we expect considerable upside to consensus has proven unusually elusive. Considering this, we have focused our attention on special situations (stocks with near term catalysts or events to unlock value) and high-quality companies that we believe are trading at or near trough multiples on trough estimates due to near-term headwinds. As a result, we have a short list of investment ideas that we believe are not actionable today but may become actionable on further weakness and/or estimate cuts.

MARKET COMMENTARY

During the second half of 2022, bad news was good news. Rising jobless claims, wage growth and lower CPI were largely met with a rally in equity markets as investors interpreted economic weakness as a positive indication that the Fed would end the pace of rate hikes sooner than later. Over the course of the quarter, market expectations of the Fed Funds Rate at July 2024 declined from around 4% at the start of October to 3.2% today, leading the S&P 500 to appreciate 7.5%. Of course, there were other factors at play, but we believe the future direction of the Fed Funds Rate dominated the market narrative. Yet while the market rallied, underlying corporate earnings deteriorated. In Q4, analysts cut their Q4 2022 estimates for the S&P 500 by about 6.5%. With prices up and earnings down, the forward P/E of the S&P 500 expanded from a trough of 15.1x on October 12, 2022, to its current level of around 17x. Put simply, corporate earnings have mattered far less than interest rate policy.

However, this appears to be changing. This week, disappointing retail sales and PPI data sent the U.S. market into a steep sell-off. Last year, such bad news would've been embraced and lauded. Today it is the opposite. Bad news now seems to actually

be bad news. With a growing consensus around the future path of interest rate policy, the market seems to be turning its focus to actual economic activity and corporate earnings. If that is the case, we think 2023 could be a bumpy ride. Leading economic indicators have broadly rolled over and with Q4 corporate earnings now underway, and many companies poised to provide guidance for 2023, we expect to see broadly negative earnings revisions. We see mounting indications of a recession on the horizon – in fact it has already arrived in some industries – yet consensus estimates currently do not reflect even a mild one. And even with the benefit of these overly optimistic expectations, the market multiple is not "cheap" relative to historical standards. We find it hard not to remain cautious when faced with these facts.

Putting aside the risk of negative earnings revisions, are we really in the clear on the inflation front? Yes, disinflation is accelerating with 59% of CPI components now in outright deflation, and yes wage gains and job growth are visibly slowing – but there are also structural issues at play which may prevent inflation from getting back to the Fed's preferred 2% level. For one, the sheer drop in the labor force is a problem. According to Jerome Powell, about 3.5M people are missing from the labor force compared with what one might have expected based on pre-2020 trends. Slower immigration and the large increase in retirements are largely to blame. Among those 65 and up, participation lags well below its pre-pandemic level. High wages and a tight labor market didn't seem to positively impact participation rates for this age cohort which suggests those that retired are simply done. With 1.7 job openings for every jobless American, and virtually no improvement in the participation rate of those 65+, we may have a structural inflation issue on our hands, particularly with respect to the Service industry. The U.S. labor force grew by 9.9M people between the end of the Great Recession and the start of the pandemic with nearly 98% of that growth coming from workers 55 and older. The removal of large swaths of this population from the workforce could have implications on wage growth and inflation for years to come.

Another structural impediment to reaching the Fed's 2% core inflation target is de-globalization resulting from declining international cooperation and commerce. A recent study by the International Monetary Fund warned that this process of "geoeconomics fragmentation" could lower global gross domestic product by up to 7% over the long-term with the impact growing to 8%-12% if technology sharing is also restricted. According to the IMF, "while fragmentation may entail strategic advantages for some countries in selected cases, it is very likely to involve significant economic costs in the aggregate." These economic costs "include higher import prices, segmented markets, diminished access to technology and to both skilled and unskilled labor, and ultimately reduced productivity which may result in lower living standards," the IMF said.

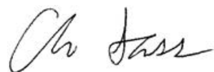
In sum, we may not be out of the inflationary woods just yet and the market does not appear to be prepared for such an outcome based on the market's outlook for the Fed Funds Rate and the current 10-year yield. At the same time, corporate earnings appear poised for negative revisions and the market is trading well off its trough multiple. While it might seem that this presents a dubious environment for stock picking, we believe it is a favorable one for our strategy. We do not invest in "the market" rather we own a concentrated portfolio of twenty or so stocks. Our process prioritizes finding ideas where we have views on earnings that are materially out of consensus. If we are doing our job well – achieving the batting average and slugging ratio we target – we believe our portfolio should materially outperform as broader market numbers reset lower. And along the way, as numbers come down, we expect plenty of names will overshoot to the downside, giving us opportunities to put new money to work.

As of January 18th, our five largest positions were *Formula One* **(FWONK)**, API Group (APG), Walker & Dunlop (WD), First Republic Bank (FRC) and *CACI International* **(CACI)**, representing just over 30% of the total portfolio. Approximately 15% of the portfolio is currently held in cash.

MD SASS

We hope everyone is safe and healthy. Thanks, as always, for your continued support and confidence.

Sincerely,



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