SEIZERT CAPITAL PARTNERS

DIRECTIONS

A PERIODIC PUBLICATION OF STOCK MARKET INSIGHTS AND OBSERVATIONS

"One of Society's most vexing problems is the relentlessly short-term orientation that manifests itself in investing, in business decision-making and in our politics" Seth Klarman, Chief Executive Officer and Portfolio Manager of the Baupost Group.

Seth Klarman, in his address to Harvard on October 1st, 2018, highlights the challenge politician's face when forced to run for reelection. They focus on a message that will keep them in office as opposed to decisions that will benefit society. Sometimes sacrifices must be made for the benefit of long-term goals. Business leaders face the same career risks when making long-term strategic decisions. Most individuals seek to avoid being uncomfortable and engage in activities that will bring happiness. It can be challenging to do something that we know is beneficial but isn't all that enjoyable. With short-term discomfort sometimes arising over a long-term investment period, it is easy to see why some investors cannot see past near-term fluctuations in the market.

Looking past current geopolitical, economic and stock specific issues when selecting investments can be difficult. This mindset takes discipline, conviction, and the ability to recognize our own behavioral biases. James Clear's book *Atomic Habits: An Easy & Proven Way to Build Good Habits & Break Bad Ones* explores an interesting subject, on the compounding nature of the long game. "…when we repeat 1 percent errors, day after day, by replicating poor decisions, duplicating tiny mistakes, and rationalizing little excuses, our small choices compound into toxic results." As we focus on taking stakes in businesses for the long term, we look to minimize these toxic mistakes that can come from focusing on day to day events.

While we as portfolio managers may make mistakes, we spend time analyzing what led to the error in an effort to avoid making the same mistake again. We seek to accomplish this through a consistent approach and an emphasis on long-term results. As many clients know, times of pain can last longer than anticipated as the market behaves irrationally. However, as we identify businesses that are trading at a discount to our fair value estimates, have stable earnings with positive free cash flow and management teams that are thinking of the shareholder, we believe that over time the intrinsic value should be recognized by the market.

Current Observations

The fourth quarter brought a shift in sentiment leaving investors to sell across a wide range of asset classes. Here are some facts and observations from the quarter.

- Equity mutual funds registered $16.905 billion of outflows for the week ending 1/2/19. This is the 9th largest weekly outflow on record (the data was first tracked by Goldman Sachs in 1992) and the 3rd largest since 12/13/17. That marks over $100 billion of outflows in a 4 week period ending 1/2/19.

- As we have highlighted in past letters the divergence of growth vs. value has been dramatic over the past two years. Through the end of the year, the outperformance of the Russell Growth indices over the Russell Value indices moderated slightly as concerns from the trade dispute with China, economic slowdown in China and fears of a government shutdown led some investors to reduce their growth equity exposure. Over the last 12 months ended 12/31/2018, the Russell 1000 Growth index outperformed the Russell 1000 Value index by 6.8%. For the same time, the Russell Midcap Growth outperformed the Russell Midcap Value by 7.5% and the Russell 2000 Growth outperformed the Russell 2000 Value by roughly 3.6%. In the long run, we believe that our style of buying quality and paying less will return to favor. We also remain mindful of Ben Graham, the patriarch of value investing who said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Ben Graham was highlighting the fickle nature of investors in the short run and the markets ability to evaluate company fundamentals in the long run.

- At the end of September, we reported that Facebook, Amazon, Apple, Netflix and Google (FAANG) had hit unprecedented market capitalizations. However, the FAANG stocks all faced headwinds during the quarter losing more than $1 trillion in combined value from recent peaks as the entire Information Technology sector slumped on trade dispute concerns. The Nasdaq returned -17.54% for the fourth quarter of 2018 and the S&P 500 Index returned -13.52% for the same period.

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- The volatility during the fourth quarter was widespread as oil prices hit multiyear highs in October, only to fall due to concerns on oversupply. U.S. crude oil prices fell around 25% for the year and about 38% for the fourth quarter of 2018.
- The debt markets also faced a turbulent year due to interest rates, growth and inflation. The Financial Times reported in December that U.S. credit markets dried up as investors had little interest in newly created loans. Bond yields continued to rise, and prices fell despite bankers continuing to finance highly leveraged loans.
- While some investors highlight the geopolitical events as part of the reason for the market behavior, this might be only part of the story. The volatility seems to also be correlated to the U.S. Federal Reserve reducing the size of their balance sheet. This coupled with rising interest rates may continue to be a driving force in the market as investors become focused on corporate balance sheets and the ability to weather difficult times.
- The world has roughly $250 trillion in debt which is the highest level in history. This amount is three times what it was two decades ago, according to a Citigroup analysis of data from the Institute of International Finance. Investors may begin to question how the new forms of borrowing that have become more accessible over the last 10 years will fare in the future. With central banks changing their direction, global lenders and borrowers may be tested.

Conclusion

Our long-term mindset remained critical in 2018 as volatility increased. We continue to look past the near-term challenges and align ourselves with like-minded management teams that are prudent allocators of capital that are focused on generating free cash flow. We understand that the market does not always appreciate this characteristic and behavioral biases can cause investors to sell at the wrong time. These emotional conflicts can cause stocks we own to sell at attractive prices. Our process, conviction and capacity to endure short-term pain allows us to focus on our mission of preserving and compounding client capital over the long run.

In times of turbulence and volatility, it is easy for investors to panic and retreat to the safety of cash. It would be wise for all investors to remember the words of Warren Buffett - "I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."

We thank you for your support and look forward to reporting on first quarter results in April.

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