

Resisting the Macro Urge

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Volatility returned in the first quarter as concerns about (take your pick) a global trade war, rising interest rates, selling pressure in the technology space and further turmoil in Syria were just a few of the commonly cited reasons for investor concern. Of that list, we would be most worried about the negative ramifications from further trade escalations. Of course, it is difficult to evaluate whether tweets ultimately lead to action (wouldn't our founding fathers be proud that this is the state of US politics?!)

As scary sounding as a trade war between the world's two largest economies is, would this be worse than say a possible breakup of the European Union? While this scenario feels highly unlikely now, our 2016 fourth quarter letter discussed how many market participants were worried about this exact scenario as the euro plunged following Brexit and investors anxiously eyed pending elections in France, Netherlands, Germany and Italy. Fears about the euro falling to parity versus the US dollar have now been replaced with fears that the currency's strength (up ~18% since the start of 2017) may stifle growth.

Perhaps our 2019 third quarter letter will detail investor panic over the plummeting dollar and all the reverberations this has inflicted on the global economy. We do not want to belittle the damage that a possible cascading worldwide trade war could inflict, but we have little idea just how likely this scenario may be (we suspect at least some have reviewed Smoot-Hawley's track record).

Equally problematic, even if one somehow gets the forecast correct, the prognosticator would then have to correctly anticipate the market's reaction to such an event – getting one part right is tough enough, while nailing both is nearly impossible on a consistent basis.

This unpredictability theme rings especially true after visiting China during the first quarter of this year to look at a possible investment. As part of the due diligence process, there were discussions with a syndicate of banks which had lent money to a financially challenged company. It was immediately clear that the loans, currently marked at par value, were worth far less if more conservative accounting policies were applied. It was also clear that local government is willing to provide concessions to help raise outside capital but also wants this to be achieved without requiring loan markdowns – i.e., a “win, win” solution.

A skeptic might better characterize this as a version of wanting to go to heaven without dying. Several large, well-known banks were involved in this credit. This one tiny example multiplied across millions of Chinese loans suggests that the country's banks are likely swimming in bad debt that is not fully reflected in bank reserves. An interesting insight, right? Time to short China's largest banks across the board? Perhaps US investors should move completely to cash since a financial crisis in the world's second largest economy will surely tank US markets.

While this experience was eye-opening (and we certainly will not be buyers of Chinese banks), we question the actionability. What happens if the government kicks the can down the road for 10 more years or longer (Japan extended and pretended far longer than anticipated)? If China's financial crisis erupts in 2028, would bold action today really have been a fantastic idea?

We certainly don't want to gloss over the real distortions in China's economies and these imbalances could cause problems sooner than anticipated. We would simply argue that the only certainty is that there will always be macro uncertainties, and despite considerable effort, it will likely be impossible for the vast majority of investors to successfully predict outcomes, let alone their ultimate impact on markets.

Having carried on about unpredictability, we would quickly concede that broad market valuations are not particularly attractive and could become even more unattractive should interest rates continue rising. We do not own the broader indices but instead only own a small subset of stocks generally concentrated in the telecom, financial service and consumer spaces.

Several of our largest holdings have not participated in the broader market rally or have suffered large pullbacks in the past 1-3 years, trade inexpensively relative to recurring free cash flow, have meaningful insider ownership and are often actively repurchasing shares. It is frustrating that several of our names have reported neutral or outright positive news yet continue to be neglected.

So, despite higher valuations across the broader market, we see wide gaps between intrinsic value and market price in a handful of situations. While we have no way of predicting when this gap will close, we believe value continues to be created and this coiled spring will eventually be released and allow value to be unlocked.

Following the suggestions of certain readers who noted that our quarterly letters are interesting but not necessarily 5+ pages single spaced interesting (but who's counting), we will provide a quick summary of portfolio names and actions in the next two paragraphs. Beyond that, keep reading if you are a night owl or you also happen to have a nearly four-year old who still refuses to sleep through the night (not complaining).

Leucadia (LUK) recently announced a series of transactions, including a partial sale of its stake in National Beef and increased its share repurchase program. We think the announcement is a material positive and believe that it demonstrates a commitment to narrowing the gap to its intrinsic value. Kennedy Wilson (KW) posted another strong quarter of operational results, but the stock continued to drift lower during the first quarter as the name was lumped with other REITs.

Encouragingly, the company announced a new \$250 million share repurchase program and completed just under 50 percent of the program in two weeks (retiring over 4% of outstanding shares). Few 8K releases evoke "Hallelujah" responses, but the LUK/KW releases were two of them. We added to both names during the quarter. We also began purchasing shares in another financial service company that we will detail in a future letter.

While investors started warming to our media/telecom names in January, the renewed interest quickly reversed in February and March as shares reclaimed popularity levels roughly equal to Mark Zuckerberg and Cambridge Analytica. There was selling pressure in Liberty Global (LGI), Liberty Latin America (LILA), Discovery (DISCA) and this group of unloved names welcomed previously uninvited guest Charter (CHTR) to the ostracized group (we own CHTR through GLIBA and LRBRK). Investors have firmly printed the scarlet letters "cord cutting" all over these names, even though parts of their business are insulated from the risks or the share price reflects a large number of these concerns.

Interestingly, the free cash flow story at CHTR and DISCK is far better than we initially anticipated because of the tax reform legislation. We think all four names will drive substantial free cash flow per share in the years to come. Two of the names (CHTR and LGI) are currently repurchasing large amounts of stock, while the other two will likely become significant purchasers in the next 1-2 years. Higher leverage combined with rising interest rates would seem to be problematic for the group, but

the companies have locked-in cheap long-term financing at levels generally below their growth rates. As we will detail, we think CHTR has a unique opportunity in the wireless space and its success could ultimately pave the way for an attractive acquisition opportunity. We are buyers of all four names.

Replay Patrick's [session on Liberty Global](#) at Best Ideas 2018.