WATERFRONT
ASSET MANAGEMENT

2022 1st Quarter – Quarterly Commentary

Opportunistic Equity

The Opportunistic Equity Strategy returned (3.1%) in the 1st quarter. The S&P 500 returned (4.6%)[1]. The MSCI All Country World ex US returned (5.34%) and the Russell 2000 small cap index returned (7.53%). Value indices did perform better than growth indices. The Russell 1000 Value Index returned (.74%) and the Russell 2000 Value Index returned (2.41%).

Value outperformed growth in part due to rising interest rates. Interest rates rose significantly in the 1st quarter as central banks in the US and elsewhere have started raising rates to combat very high inflation. Growth stocks tend to be more interest rate sensitive since earnings power is further out in the future. Energy is a value category and it has had a strong start to 2022.

Commodities were a good place to have money in the 1st quarter. The Bloomberg Commodity Index returned 25%. Global supply chain problems due to Covid, weather, among other items have supported commodity prices but the war in Ukraine has primarily been the reason behind strong commodity price gains this year. The war meaningfully impacts the production and flow of many commodities.

The OE benefitted from its value tilt and a couple special situation stocks, such as Dorel Industries, in 1Q. While those factors positively impacted returns, security selection was the primary determinant of returns. There was a wide variance of performance among securities held in the 1st quarter.

Some of the better performing stocks included Bayer AG, Telefonica Brasil SA, Capstone Copper and Unum Group. All were up about 30% or slightly more in the 1st quarter.

Bayer had some positive developments on the pharmaceuticals side of the business in the 1st quarter. In addition, the current Ukraine war is positively impacting agg suppliers. Also, the Supreme Court ruling on some of the litigation tied to Roundup is drawing near and investors believe that could eventually put an end to the very expensive problem Roundup has been.

Telefonica Brasil was purchased after a screening of Latin America telecoms. It has a good value, good business prospects but it also a very volatile stock due to volatility in the real. This particular telecom was purchased to have some exposure to a strengthening Brazilian economy. The war in Ukraine is a tailwind for commodity rich economies such as Brazil's in Latin America. The real has strengthened quite a bit in Q1, dropping from up around 5.6 at the end of the year to closer to 4.7 now.

Capstone Copper has benefitted from the strong pricing of copper in 2022. Copper has a bright future due to its utilization in electrification, but most of the pricing strength in copper is currently due to supply disruptions caused by a number of factors including the war.

Unum Group is an insurance company that has been trapped by its LTC exposure so it has always traded at a big discount to book value. An inflationary environment is a positive development for a company with a liability overhang. In addition, strong wage gains create a nice pricing tailwind for a lot of its benefits business that is written as a percentage of salaries.

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[1] Bloomberg is the source for all return data mentioned in this report

Some of the worst performing stocks included General Motors Co, Societe Generale SA, Tri Pointe Homes Inc and Kyndryl Holdings Inc, all down over 20% and some down closer to 30%.

The current environment is very difficult for auto stocks. Rising commodity prices and rising interest rates combined with still meaningful supply chain challenges make profitable production more difficult. Therefore, prices continue to be elevated and supply limited. Volumes look to disappoint again this year and pricing power is not very strong anymore as it is getting to the point of demand destruction. While an EV tax credit could be a big benefit to GM stock, that has not yet been put into legislation.

The rising interest environment is a headwind for homebuilders and Tri Pointe is the only one held in the strategy due to that perceived risk. The extent of the selloff has been a little surprising though. Tri Point is now below 90% of tangible book value and less than 5x historical 2021 earnings. Rising mortgages are going to stall any growth in housing but secular demand will allow the deleverage in earnings to not be as severe as many expect. If Tri Pointe's earnings power drops from above $4 to the high $2's, it still has tremendous value while it is currently buying back more than 10% of shares due to a very strong balance sheet. I am wary of homebuilders and this is not an asset class to overweight but one's trading below book with valuable assets on the balance sheet that offer some inflation protection have merit.

Kyndryl Holdings is a turnaround stock. It was spun off from IBM. It's main business line is IT Outsourcing, a business in secular decline due to cloud computing. It is a messy company. The spin off has created difficult financial numbers to analyze and there are ongoing costs associated with the separation. The current free cash flow is being used for restructuring so one needs to look out a couple years on this stock. That is too far for many investors in this market. There are some talented IT employees in this company, a company that now separate from IBM has a much larger addressable market. I believe Kyndryl with newfound freedom can stabilize the business and if revenues were to stop declining, the trading multiple of this stock to free cash flow is just so low that it will rally significantly. The risk is that a people company will continue to face rising employee costs while revenue is declining and the company can't ever break that downward cycle.

Societe Generale had a strong 4th quarter earnings report and positive business development. The stock traded up above 35 euros after reporting earnings. Then, the war came and SocGen has a Russian subsidiary. All European financials have sold off meaningfully on the war but ones with assets in Russia a lot more so. Recently, SocGen divested its Russian assets that will result in a very modest 20bps hit to CET1 ratio and a 2%-3% hit to earnings. The selloff in the stock is extremely disproportionate to the earnings impact from losing the Russian assets. I look forward to receiving the over 7% dividend and am appreciative of the company's repurchase program, to go along with the dividend.

Looking forward, I am expecting a lot of volatility in the Opportunistic Equity Strategy. Cyclical companies facing earnings cuts have good value and should produce solid returns over the next couple years but investors hate earnings cuts so these type of companies sell off pretty hard when recession fears surface. Also, there is quite a bit of exposure to Europe and those stocks are struggling with the war. Sometimes, one just needs to ride out some of the volatility. Trying to time things can get tricky and one could end up missing a quick meaningful pop in a stock, if selling a good company in anticipation of being able to buy it lower.

Despite valid concerns of an upcoming recession, cash should remain below 5% going forward. In many industries, the stock prices are already reflecting an upcoming recession so the risk vs. reward is favorable. If markets become very volatile, it is more likely than not, the strategy would add to the allocation of cyclical stocks, if they were to drop meaningfully.