We strongly believe that long term investing holds significant advantages, especially for tax-paying individuals. But like any relationship, reaping the benefits of a long-term time horizon means enduring challenging periods. We have been in just such a period, stretching back into 2015. Naturally this concerns us, but it does not leave us pessimistic about the future.

With one or two exceptions, healthcare and finance have been minefields over the last six to twelve months. Likewise, a small number of economically sensitive companies have dramatically underperformed. We believe that some of these underperforming stocks have intriguing potential. As always, we try to differentiate between inaccurate predictions and areas of disagreement with the market. So far this year, financial and healthcare stocks reflect concerns about the implications of two important big-picture issues: the slowing global economy and the threat of potential growing regulation of the healthcare sector.

The latter worry is relatively straightforward. The rising cost of health care is a significant problem. In an election year, drug prices are an easy target. However, the pharma companies we own produce drugs that, while expensive, save money in the long run (by curing hepatitis C for instance) or meaningfully advance the treatment of important diseases. In our view, our holdings should produce far above-average returns long into the future based, on exciting science and significantly below-average valuations.

The U.S. has been the one bright spot in the global economy. Evidence suggests that the rest of the world is still struggling. Investors are concerned that the U.S. recovery will be dampened or at least put on hold. Virtually everyone believes that global interest rates will remain at historically low levels. No one thinks the Federal Reserve will be able to raise U.S. rates as quickly as it had hoped.

First and foremost, this has had a significant impact on financial stocks. Many investors have been counting on higher interest rates to help lift the earnings of banks and other financial companies. The unexpected result of the Brexit vote seems to underscore fears that economic weakness abroad and a low interest rate environment will persist for the foreseeable future. This was the final excuse to sell the sector. Already lagging the market, banks were hit particularly hard by the news from the U.K.

We think this is a classic set up for future outperformance. Financial stocks are so cheap that it matters very little when their earnings growth accelerates. Many good quality companies are selling at or below tangible book value[1] (TBV) because investors still seem scarred by the financial crisis and have been unwilling to acknowledge the significant improvements in risk control and capital structure. We understand the emotional response, but a rational analysis

[1] **Tangible Book Value** is the total net asset value of a company (book value) minus intangible assets and goodwill.

reveals a very different industry than the one that stood at the epicenter of the financial meltdown.

Increased banking regulations since the financial crisis have had positive and negative effects. One can debate the merits from both a philosophical and pragmatic basis. Putting those arguments aside, it is clear to us that banks and insurance companies are far less risky businesses today than they were a decade ago. Under the magnifying glass of Federal Reserve stress tests and the Comprehensive Capital Analysis and Review (CCAR) financial institutions have dramatically reduced leverage, increased tangible equity and scaled back or exited risky capital intensive businesses like trading and underwriting. If anything, banks are currently over-capitalized, rather than over-leveraged.

We think this makes it appropriate to examine financial companies in the context of a normal operating environment. With proper risk control mechanisms in place, financial companies can be value-compounding machines. The job of a bank is to take a pool of shareholder capital and invest it into return-generating businesses like commercial and mortgage lending or providing investment products. A portion of the earnings are returned to shareholders in the form of dividends or share buy backs. The rest gets reinvested in the portfolio to increase the potential for future profits, thereby compounding value for shareholders. This can create attractive returns if shares are bought at the right price.

Here is a simple illustration. Company A has TBV of $100 per share on which it earns an 8% return annually. It pays half of its earnings to shareholders as dividends and reinvests the rest. Let's assume that Company A's shares trade right at TBV, or $100 per share. In a laboratory environment, the expected result would be the following:

	Starting Point	Year One	Year Two	Year Three	Year Four	Year Five
TBV Per Share	$100.00	$104.00	$108.16	$112.49	$116.99	$121.67
Earnings Per Share		$8.00	$8.32	$8.65	$9.00	$9.36
Dividends Per Share		$4.00	$4.16	$4.33	$4.50	$4.68
Cumulative Dividends	$21.67					
Cost of Investment	$100.00					
Total Ending Value	$143.33					
Annual Rate of Return	7.5%					

In the current low interest rate environment, the promise of a 7.5% annual rate of return seems more than reasonable. However, the math actually improves, given the discount valuation of many financial companies. Some of our holdings are trading as low as 70% of TBV which by itself amplifies the return of the above scenario. We feel strongly that two additional factors may come into play, making potential future returns even more attractive:

- As investors become more comfortable with the lower risk profile of financial companies, stocks will trade at a minimum of liquidation value, at least 100% of TBV.
- When interest rates rise, if even only slightly, return on TBV should increase to at least 10% and in some cases perhaps to as much as 12% - 15%.

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The table below illustrates the favorable impact of the above scenarios:

	Buy & Sell at Equal Discount	Valuation Normalizes	Valuation & Returns Normalize
TBV Per Share	$100.00	$100.00	$100.00
Price to TBV Today	70%	70%	70%
Price to TBV in Five Years	70%	100%	100%
Business Return on TBV	8%	8%	10%
Cumulative Dividends	**$21.67**	**$21.67**	**$24.62**
Total Ending Value	**$100.33**	**$143.33**	**$149.24**
Shareholder Rate of Return (Five-Year Average)	**8.8%**	**15.4%**	**16.3%**

What we find most interesting is that the biggest jump in shareholder return comes from closing the valuation discount. A move over five years from 70% to 100% of TBV nearly doubles an investor's rate of return. We do not believe that financial stocks will continue to sell for less than liquidation value. We are convinced that the discount will narrow as time passes, memories of the financial crisis fade, and banks and insurance companies demonstrate that they are far less risky than they once were. Investors who are focused on the dampening effect on earnings growth of continued low interest rates are missing the boat, in our opinion. We have paid the price for investing before others, but are highly optimistic that our patience will be rewarded.

We believe the financial sector stands in stark contrast to a current market darling, the consumer staples sector (i.e. Procter & Gamble, Coca Cola, Phillip Morris etc.). To be sure, there are many fine companies with world-renowned consumer brands in the sector. We understand the comfort of "steady" earnings. But we believe that investors have bid up prices to the point where there is more risk than safety. The consumer staples sector of the S&P 500 now fetches more than 21 times earnings according to FactSet, while the financial sector trades at 12-1/2 times earnings.

We feel confident that this strong valuation anomaly will resolve itself over time, and that our investments will benefit. However, we cannot completely ignore the headlines. Brexit has the potential to muddy the waters for some time to come. Much has and will continue to be written about the implications of the United Kingdom leaving, or maybe not leaving the European Union. We have nothing unique to add to that conversation. While a complete surprise to us, the outcome of the Brexit vote dovetails into the theme that we have been writing about for some time. Investors hate an unpredictable future, and hardly anyone in the money fields, (investors, economists, odds makers and the dedicated media that follows them) had any idea that Brits would vote to leave.

Investors react to unpredictability by seeking safety in the familiar, the perceived wisdom of others and the tried and true. The "low-risk" sectors that did best in the first half of the year may continue to attract investor flows. We will not be jumping on that bandwagon. We hardly think this is the time to throw caution to the wind. However, rather than joining the crowd, we find comfort with the misunderstood, unloved and most importantly undervalued. We see great potential in our positions in financials, healthcare and select dominant industrial companies.

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