Manole
Capital Management

3rd Quarter 2017 Newsletter
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Manole Capital Management
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Amazon [a]

So, everybody you know (including you) is on Amazon Prime. You get "free" shipping on all your online purchases and you get shows, movies and music too. Amazon just celebrated the 20th anniversary of its IPO, when it launched with a market capitalization of $660 million. It has since grown into the world's fourth largest company with a market capitalization of $460 billion. On a split-adjusted basis of $2 per share, AMZN has increased 36% per year and just eclipsed the $1,000 per share mark. A modest $10,000 investment in AMZN is now worth $4.9 million. This is a return that is 155 times better than investing in the S&P 500. At Berkshire Hathaway's annual meeting in May, Warren Buffett proclaimed he "underestimated the brilliance of Jeff Bezos."

So, you knew this was going to happen and you were invested in AMZN from day one, right? Don't feel too bad—we do not believe many people had the fortitude to withstand AMZN's massive price swings along the way. What do we mean? To go along for this ride in AMZN, an investor would have had to display enormous patience and a willingness to withstand large declines along the way. Since its IPO 20 years ago, AMZN has experienced daily declines of 6% or more a whopping 199 times. A mere 107 times, AMZN had a 3-day fall of more than 15%. In 16 of its 20 years as a public company, AMZN has declined over 20%. In half of these years, AMZN declined by more than 40%. During the Financial Crisis of 2008, AMZN fell by 68%. During the Tech Bubble collapse (from December 1999 to October of 2001), AMZN fell 95%. Being able to absorb these volatile swings and "ignore the noise" would have been a herculean challenge.

If anybody stuck with AMZN from 20 years ago and continued to have confidence in this business that failed to generate positive free cash flow, they truly are a long-term investor. Not only did we not see this, but we could never quite get comfortable with the valuation (over 150x 2017 earnings). While AMZN has clearly been a home run for certain investors, its quarters and years of terrible slumps were horrible for others. At Manole, we prefer to hit a lot of singles or even bunt to get on base, while limiting the strikeouts. The cyclical nature of certain industries tends to be too volatile for our investment style and philosophy.

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Cyclical vs Secular - The Energy Sector:

Our kids love the craziness of SheiKra, Cobra's Curse and Montu at Tampa Bay's Busch Gardens and we certainly appreciate the endorphin rush of these rides. But sadly, as we get older, we tend to become less and less enthusiastic about roller coasters.

The energy sector represents roughly 7% of the S&P 500 index. After a dramatic move higher in 2013, the energy sector fell significantly in 2014 and 2015. In 2016, it was the single best performing sector, up an impressive 24%. So far in 2017, energy is down 14%, making it this year's worst performing sector. Last year, OPEC (the Organization of Petroleum Exporting Countries) introduced production cuts, which boosted oil prices. OPEC recently met again and decided to extend this agreement to limit its production. Where we are on this cyclical roller coaster is unknown. We prefer to avoid parts of the market rife with uncertainty and geopolitical dangers—the only prediction we are confident making about the energy market is that prices should be volatile. There are simply too many factors that determine price, outside of our area of expertise or knowledge base. We do not profess to have any true understanding about the inner workings of Saudi Arabia or their Middle Eastern foe Iran. Here's a quick example of the uncertainties involved: Saudi Arabia is looking to IPO its crown jewel – Saudi Aramco – late this year or early next year and would love to see higher prices to boost that valuation. Speculation is that it could generate $2 trillion for them, which will help sustain their expensive welfare state (and fight their nemesis Iran). Iran and Russia are somewhat strange bedfellows, but both continue to pump record amounts of oil to boost current revenues. In addition to this murky outlook, the US is reporting varying levels / stockpiles of oil, while China is experiencing less demand for many commodities ranging from steel, iron and oil.

These uncertainties perfectly highlight why we avoid investing in commodities and cyclical industries. The energy business is not only a capital-intensive business, subject to costly maintenance, but it also has multiple geopolitical factors that tend to wildly swing prices. We just don't see the advantage of investing in cyclical markets, where there is limited ability to add value.

How We Invest in "Energy":

We focus our attention on secular, predictable and recurring revenue business models. In this regard, we prefer to gain our "energy exposure" through the derivative exchanges. While these companies are classified as ***financials***, one could easily label these exchanges ***technology*** companies. CME Group (ticker CME) and Intercontinental Exchange (ticker ICE) are the two dominant exchanges where energy is globally traded. Both specialize in a key energy product, with CME dominating WTI crude and ICE controlling the Brent crude market. 15% of CME's total trading volumes and 19% of its total revenue are generated in the energy sector, while the same sector represents 23% of ICE's total revenue. Both generate transaction-based revenue, based on the amount of hedging companies decide to employ. Whether you are a user of energy (e.g. Southwest Airlines) or a producer of energy (e.g. Exxon), volatility in energy prices can endanger your business. Being able to hedge and lock-in key components of costs can be critical for future results.

Going back to our roller coaster ride analogy, think of these derivative exchanges as the ticket collector, ride operator or toll-keeper. We prefer these types of predictable franchises, as opposed to the wild up's and down's of cyclical businesses. As shareholders, we prefer to benefit from higher volatility and inflation, regardless of whether prices increase or decrease. In the cyclical energy sector, since we really have no idea where oil prices are headed, we prefer not to bet on whether prices go up or down, but rather on whether they will simply be more volatile in the future.

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Volatility:

The VIX is a measure of implied volatility derived from S&P 500 option prices. Often referred to as Wall Street's "fear gauge", the VIX typically goes up when the market goes down. The VIX is a proprietary product that is only traded on the Chicago Board Options Exchange (ticker CBOE). Unlike traditional options or equities, which can trade on multiple exchanges, there is a "protected moat" when it comes to proprietary products like CBOE's VIX. There is a great saying in the exchange industry that "volume begets volume". When an exchange creates *the* de-facto location to trade any product (equities, interest rates, commodities, energy, foreign exchange), a long-term and nearly impregnable moat is created. As more volumes come, this exchange will have the best liquidity. The tightest bid / ask spread attracts both existing and new buyers and sellers. Whether somebody is a natural hedger or a speculator, it will always seek the location of best execution. With proprietary products, like the CBOE's VIX, a wonderful, virtuous cycle can be created. Volume begets volume. Liquidity begets liquidity. This continuously builds upon itself and is a perfect example of what we look for in an investment.

With the VIX recently below 10, at its lowest level since 1993, many market "experts" were saying that some investors are being too complacent. Some fear that there is not enough fear, considering all the world's worries.
But then crack! We experienced a massive swing in volatility on Wednesday May 17th. Up till then, the market was ignoring many of the crises and controversies emanating from Washington D.C., and also globally—we believe the market was not reflecting these worries, because it is more focused on the positives occurring in our economy. We have seen a rise in global populism, potential Russian interference in our election, multiple European debt crises, a near hard landing in China, a commodity-driven emerging market currency issue, de-stabilization and riots in Venezuela, continued Middle Eastern instability (especially in Syria) and escalating tensions on the Korean peninsula. All of these issues the market seemingly shrugged off, climbing to all-time highs. In our opinion, the market was not reflecting these global worries, because it is more focused on the positives occurring in our economy.

Numbers, not News:

Paraphrasing the Democratic strategist James Carville, "It's the economy stupid". Research has proven that the stock market best correlates with the direction of earnings. Examining 1st quarter 2017 results proves this point. 492 of the S&P 500 members have reported 1st quarter results. So far, year-over-year earnings for these companies are up +13.5% on 7.2% higher revenues. Sentiment remains positive, with 73% of these companies having beaten earnings estimates and 65% exceeding revenue expectations.

We are steadily improving our growth rates, inflation is tame, unemployment is at record lows, balance sheets are flush with cash and there is a strong possibility for tax reform in 2017. Year to date, the stock market is up ~ 10% because it reflects the improving global fundamentals, as well as expectations for easing regulation and earnings boosting tax cuts.

Conclusion:

While there is the potential negative fallout from the political issues emanating from Washington DC, we continue to focus on the positive earnings growth signals we see in the economy. The market is wrestling with uncertainty regarding relaxing burdensome regulations and the proposed tax overhaul. We still believe that these reforms will happen, but their timing is less certain. While the media seems to be relishing the headlines Washington is producing, the market is more concerned with underlying economic trends. The volatility in the current administration might roil the markets on any given day, but we do not believe this "trumps" the improving overall economic picture.

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To our earlier point on relying too much on sell-side estimates, we caution you against placing too much emphasis on these "guestimated" figures. We do not simply plug these figures into a magic formula to spit out a perfectly built model. Just like an artist, the creation of a diversified and well-constructed portfolio takes time. We are confident that our "Fin Tech" portfolio will benefit from the secular growth of the payments industry. In the event the overall market declines, our high-quality portfolio, that generates significant free cash flow, should outperform (on a relative basis) the market. As we stated earlier, this is just one piece of a larger jigsaw puzzle which cannot be replicated with an algorithm. This, to us, is our version of active management.

By staying true to our analysis and focusing on individual companies (not market timing or sector rotation), we have built a concentrated portfolio that should be able to predictably grow its revenue in the double-digit range. Using Zacks analytics, we can see that our "Fin Tech" portfolio is estimated to grow its top-line by over 20% in 2017 and double-digits in 2018. Considering many of our franchises do not require extensive capital expenditure re-investments, this revenue growth results in significant operating leverage. This allows earnings and free cash flow to grow at a higher rate than revenue. Zacks believes our portfolio will grow earnings by 14% in both 2017 and 2018. Of course, whether growth is double-digits or mid-teens isn't the ultimate question, but rather the ability to post consistent and predictable growth in excess of the broader market. We continue to believe our portfolio is poised to benefit with higher interest rates, inflation and increased volatility.

We remain grateful for your trust and we are always available should you wish to chat.

Warren

Warren Fisher, CFA
Manole Capital Management

Endnotes:

(a) Figures per WSJ's Steven Russolillo in his column "Ahead of the Tape"
It is estimated that AMZN has 60-65 million US Prime Customers which > # of HH's with landline phones
AMZN is estimated to be spending over $4 billion for video programming this year (vs NetFlix's $6 billion)

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Interesting Statistics on US Household Debt:

- Total debt held by American households has reached a record of $12.9 trillion, surpassing 2008 levels
- 8 ½ years post the Financial Crisis, the composition of this debt is quite different
- Total household debt represents 67% of nominal gross domestic product vs 85% in 3rd quarter of 2008
- Not only is the economy larger, but lending standards are much tougher and less debt is delinquent
- The rising stock market has lifted HH net worth nearly 40% above housing / bubble peaks
- Specifically, we want to focus on 3 key areas of HH indebtedness
- US housing related debt is lower, while there is more student and auto loans
- In the 1st quarter 2017, 68% of HH debt was from ***mortgages*** vs 73% during 3rd quarter 2008
- Since the crisis, subprime borrowers have declined from 15% of mortgage originations to 4%
- 30-year mortgage rates are still at historically low levels of only 3.9%
- In addition, debt service payments are quite manageable at only 4.4% of disposable income
- In the 1st quarter 2017, 11% of HH debt was from ***student debt*** vs 5% during 3rd quarter 2008
- Soaring tuition costs have burdened millions of parents who are increasingly supporting their children
- 1/3rd of new student debt loans are sub-prime and 11% are now over 90 days delinquent
- In the 1st quarter 2017, 9% of HH debt was from ***auto loans*** vs 6% during 3rd quarter 2008
- Since the crisis, the median credit score for auto originations improved from 706 to 764
- However, Moody's just uncovered an eerily similar data point on the auto lending industry
- Santander, one of the largest sub-prime auto lenders, verified income on 8% of its loans (sound familiar)
- These loans were then bundled into billion dollar securitizations
- The current securitized auto-loan market is over $1.1 trillion, with sub-prime at 16% of the total