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Prospector Partners Quarterly Commentary

Current Market Environment

The third quarter was marked by a lot of "more of the same." The market charged higher, with the benchmark S&P 500 gaining 771 basis points. Growth companies and industries remained darlings, including technology stocks, which once again were among the leaders while defensive names lagged. Beneath the surface of this rosy landscape however, the level of worrisome "noise" has increased. The market has started to take note of some of these risks, as volatility has picked up sharply in early October, and the market has already had several dramatic down days.

On the domestic front, the U.S. ten-year yield rose above 3.0% during the third quarter, and shot even higher in early October, as the bond market reacted to an economy fueled by tax cuts, working capital builds in anticipation of tariffs, and to a tightening jobs market. With growth over 3%, and unemployment at 49-year lows, inflation fears are awakening. At the same time, a slowdown in housing (likely due to a number of factors, including rising mortgage rates, elevated building costs, and new limits on deductibility of mortgage interest and state and local taxes), has impacted housing-related enterprises. Additionally, the looming threat of tariffs is causing concern over impacts on the economy and inflation. Anecdotally, many companies have been front-loading purchases ahead of potential tariffs. How much of an impact on recent growth this has had remains in question.

Overseas, Britain's exit from the European Union looms on the horizon (March, 2019). Meanwhile, the ECB recently lowered growth forecasts, and Italy, the EU's largest borrower, has caused some consternation with deficit-inducing budget plans. Emerging markets continue to struggle as a rising U.S. Dollar and interest rates have caused capital outflows. Argentina and Pakistan have already sought IMF bailouts, and Turkey has recently seen its currency nose dive. With China slowing down, and uncertainty over the impact of U.S./China tariffs, the emerging market risk is only exacerbated.

We write this commentary just days after hurricane Michael wreaked havoc on the southeast United

States. The storm formed almost overnight with little warning, and made landfall just a hair under a category five. Conditions were in place for Michael to develop rapidly – Gulf of Mexico water temperature was four to five degrees above normal for early October, and wind shear wasn't strong enough to weaken the massive storm as it developed in the Gulf. Michael slammed into the Florida panhandle, which had never seen a storm anywhere near as strong, and thus much of the housing and infrastructure was not built to post 1994 Hurricane Andrew building codes.

Is Michael a metaphor for what we are currently facing in the equity markets? After a long, steady march higher, are the recent sharp selloffs indicative that we are in the midst of a developing severe storm? We aren't certain. However, we have felt for some time that while the probability of an imminent correction isn't unreasonable, the impact of one has the potential to be severe given the length of the bull market, and overall equity market valuation metrics.

Ten Year Anniversary of Financial Crisis: Lessons Learned

On September 15th of 2008, a decade ago, Lehman Brothers collapsed and failed. This watershed event precipitated the worst of the global financial crisis. One day later, AIG was rescued from a similar fate by a Fed bailout. In short order, the equity markets fell by 40%, credit spreads gapped wider, correlations between risk assets spiked, liquidity dried up, and worry (fear) gripped the minds of the financially aware. Although Prospector outperformed the S&P 500 in 2008, it was the most difficult performance year for Prospector in our 21-year history. The tiniest of silver linings was that this traumatic experience generated important go forward lessons for your team at Prospector.

As we cross the ten-year anniversary, we can't help but notice a couple of parallels between 2008 and 2018 such as all-time high price levels for the U.S. stock market and a long in the tooth economic cycle. These parallels are not nearly enough for us to declare that a category five storm is developing, but it does compel us to revisit and restate some of the critical lessons we learned or relearned in 2008.

Excess leverage is the root cause of permanent financial loss.
It isn't only the amount of financial leverage that's a concern, but the borrowings' characteristics or terms matter as well. There are no guarantees that debt refinancing will be available at all or on decent terms. For example, long term debentures are far superior to covenant-laden bank loans. At Prospector, our intense focus on balance sheet strength and free cash flow generating businesses often protects us from permanent losses as a result of excess debt. We monitor leverage at the individual investment level as well as at the portfolio construction level.

Never underestimate the value of liquidity.
A liquid investment offers key advantages such as the ability to sell it if a better idea comes to your attention or add to the idea if your timing was early (the averaging down process). Within the portfolio, we strive to maintain good liquidity on each position with a general guideline of owning less than a day's trading volume. This way we feel comfortable that we can buy or sell a position within a week at 20% of the daily volume. To the extent we own illiquid investments in the future, their weighting in the overall portfolio would certainly be modest.

Always maintain a margin of safety.
There are no perfect analyses. "Stuff" happens. No matter how comprehensive and diligent we strive to be as analysts, unforeseen events eventually transpire that lead to uncontemplated outcomes. We strive to anticipate all permutations and leave a margin of safety at the portfolio level by managing position sizes, sector concentrations, currency exposures, etc. We never over bet our hand with

respect to a single fundamental driver of performance. A corollary lesson is that new financial products created by Wall Street are often risky and, although back tested plenty, haven't been stress tested sufficiently. Caveat emptor.

The imperfection of risk versus reward.
Prospector's favorite all time investments actually combine low risk and high reward. These investments are rarely available, but can abound during the depths of a crisis. Two things are critical at that point. First, you must be able to recognize them for what they are. This is where a disciplined approach around security analysis and valuation such as free cash flow and private market value helps a lot. Second, you must have the dry powder to actually buy them.

In crisis, start buying on the way down.
You often have to start buying on the descent in a crisis because that is where the lion's share of the volume will trade. Once sentiment changes, there are often very few shares for sale at the same deeply discounted prices where there was abundant supply on the way down.

Keep your cash reserves safe and liquid.
Don't succumb to temptation during good times and reach for incremental yield with your dry powder cash. The only broad asset category that maintained value and liquidity during the 2008 crisis was U.S. Treasury securities. Plenty of over-trusting folks discovered less than creditworthy sub-prime notes in their money market funds, a couple of which "broke the buck" of a $1 NAV.

Rating agencies and regulators are unreliable.
Don't trust them. Governments are the ultimate short-term thinkers, always willing to kick the can down the road. This is driven by reelection cycles. Interestingly, one could make the case that the epicenter of the 2008 crisis, the sub-prime housing market, was created and cultivated by poor government policies imposed over the prior 15 years. This reminds us that the new financial regulatory framework of Dodd Frank and Basel, crafted in the aftermath of the crisis with the intention of lowering risk in the banking sector, remains largely untested.

There is nothing as expensive as a cheery consensus.
It feels reassuring and comfortable at family gatherings and cocktail parties to own popular positions here most agree that the business is outstanding and the management is superior. However, price is a critical component of risk. It is critical to combat complacency and cycle out of winning positions that have become risky by virtue of their higher valuations. During a crisis, premium valuations could melt away without any company-specific catalyst as the market resets.

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