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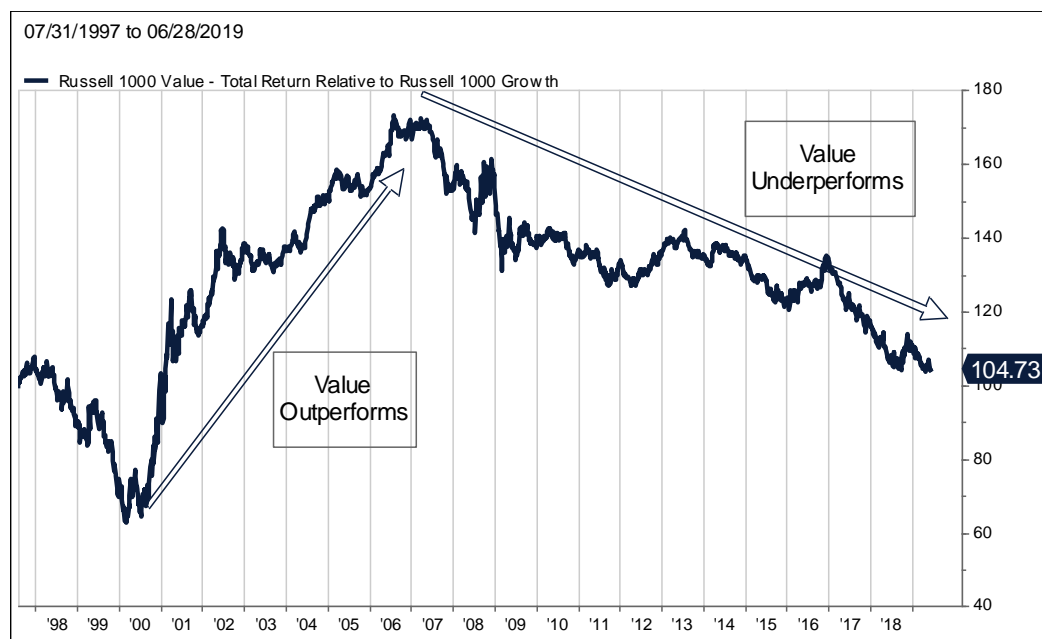
Prospector Partners Quarterly Commentary

"I am a Tariff Man." – President Donald J. Trump (December 4, 2018)

While the first quarter of 2019 ended with a sense of optimism that trade negotiations were going well with China, the second quarter was a roller coaster of renewed tensions with Beijing, plus new threats against Mexico (in May, President Trump promised to impose tariffs on Mexico if the country didn't do more to stem illegal immigration into the U.S.). And while the White House announced a 180-day reprieve for slapping tariffs on EU and Japanese autos, the potential for trade disruptions here looms large. These threats served to add further economic uncertainty, and, while the Fed left interest rates unchanged during their June meeting, the central bank has grown increasingly dovish. Indeed, in his June testimony, Chairman Powell indicated that, "Apparent progress on trade turned to greater uncertainty, and our contacts in business and agriculture report heightened concerns over trade developments. These concerns may have contributed to the drop in business confidence in some recent surveys and may have started to show through to incoming data...While the baseline outlook remains favorable, the question is whether these uncertainties will continue to weigh on the outlook and thus call for additional monetary policy accommodation." Given this backdrop, and the now high probability of rate cuts in the near term, the bond market rallied during the second quarter and the 10-year Treasury once again dipped below 2.0%. And, while the S&P 500 continued its march higher, the Atlanta Fed's estimates for 2Q GDP are for 1.4% growth as compared to 1Q19's 3.1% growth.

One of the more useful axioms on equity investing is "Don't fight the Fed." So the inflection point shift to a dovish stance that started in the fourth quarter 2018 market selloff has reignited the bull market for stocks.

A Contemplation of Value Investing



Source: FactSet

As can be seen in the above chart, value investing has underperformed growth investing significantly over the past thirteen years. This has resulted in broad market benchmarks such as the S&P 500 and the Russell 1000 tilting further and further towards growth investing as a consequence of their market cap weighting methodology. As long as the growth over value cycle persists, boosted by the powerful passive over active cycle, value portfolios will continue to struggle to beat increasingly growth-tilted general market benchmarks. Consequently, value investors continue to experience redemptions, further exacerbating the down cycle.

Are all value investors the same? Do they utilize a common set of techniques to select stocks and construct portfolios? The short answer is, no. Underneath the value investing umbrella, portfolio managers utilize a wide variety of strategies and techniques such as: low price to earnings ratio, low price to book value, high dividend yield, private market value (PMV), free cash flow yield (FCF), low price to earnings before income taxes, depreciation and amortization (EBITDA), and pure contrarian investing.

All these techniques have merit and many serve to reinforce others. At Prospector, we heavily rely on two of these techniques in order to identify value and we are especially attracted to situations where we can use both at the same time. Our fundamental favorites are PMV and FCF.

Private Market Value (part 1):

Private market value can mean different things to different people. At Prospector, we engage in two types of private market value analysis. First, there is the most common PMV technique which is to compare the selling price and metrics of whole companies which have been sold to independent third parties to the metrics of share prices (which are partial, minority stakes) of public companies in the same industries. If the public shares sell at a meaningful discount (creating a margin of safety) to the implied takeout prices, that could create an opportunity for a successful investment if there is a decent chance that the public company would agree to a sale within a reasonable timeframe. A corollary PMV analysis we execute is to calculate the PMV of various units of a diversified company in order to determine if a wide discount exists between the value of the public share versus the sum of the parts of the company on a PMV basis if management were

to sell parts of the company rather than the whole.

A relevant example of this type of analysis is our sum of the parts (SOTP) work on Berkshire Hathaway (BRK-A/B). We have developed, over a very long time, a proprietary model whereby we strive to measure whether the company is selling at a discount or premium to our SOTP analysis. Simplistically, we start by calculating the required capital each of Berkshire's insurance units would need were they to be stand-alone companies. Our history of analyzing insurance companies (and serving on insurance-company boards) gives us valuable insight here. From that, we then determine how much of their investment portfolio would be considered "excess capital" and we mark the stock portfolio to market. Then, we attribute a private market value to Berkshire's other, non-insurance subsidiaries and also take into consideration parent-company debt. We feel our Berkshire SOTP model has done a good job through the years of signaling buy points and sell points for the stock.

Private Market Value (part 2):

The second type of PMV analysis we perform at Prospector is to transform a GAAP balance sheet into a statement of net asset value (NAV). Essentially, we mark a balance sheet to market using our own proprietary research into the carrying values as determined by management.

This is a crucial technique for analyzing balance sheet driven financial institutions such as lenders and insurers where half of the balance sheet is a "blind pool." By that we mean that the stated values on the balance sheet for a loan portfolio in a lender or the claims reserves for an insurer are management estimates. In other words, management gets to grade their own exams over the short term. We try to identify managements whose estimates are consistently either conservative or optimistic over time.

One such example is a medical malpractice and workers comp insurer that we have recently purchased. Management, who we have long followed and admired, has consistently set reserves very conservatively over a long period of time – an important quality when dealing with such "long tail" insurance lines (where the ultimate cost of claims isn't known until years after the business is written). While management's history of conservatism could be relatively easily ascertained by most investors, we also take the extra step of manipulating the company's statutory reserve data to try to get a rough estimate of how over-reserved the company currently is. We feel the company continues to have "equity in their reserves" and the valuation of the company does not fully reflect this position. Additionally, we view it as a potential m&a target. Our estimate of the company's private market value, based on recent acquisitions of specialty insurance companies, as well as our view of its excess reserve position factored meaningfully in our decision to re-establish a long position in the stock.

Free Cash Flow Yield Analysis:

This brings us to free cash flow yield analysis. Free cash flow means just what it sounds like. It is the dollars of cash left over after management has properly tended to the required reinvestment of capital into their business. That capital can be in the form of hard asset capital expenditures or even additional investment in working capital to support the core business. The actual FCF metric we use is to estimate the sustainable free cash generated by a company and divide it by the enterprise value, which is the equity market value plus the balance sheet debt net of cash. We like companies that generate more cash than they need. These companies tend to carry low levels of debt which protects them during unsettled equity market conditions and/or economic downturns. The easiest route to a permanent loss is when a financing happens during adverse market conditions. The cost of equity and/or debt spikes and permanently confiscates value from pre-transaction equity holders.

Portfolio holding, Oracle Corp. (ORCL) is one example of a company we were attracted to based

on their FCF profile, and rock-solid balance sheet. Oracle, which the market perceived as having missed the move to the cloud (led by Amazon Web Services and Microsoft's Azure) had underperformed peers. However, we recognized that ORCL had what we deem a "second-mover advantage." With the company's large customer base remaining intact, Oracle has the ability to transition customers to the cloud at the clients' own pace. When we made our initial purchases of ORCL stock (mid-2018), the company traded at close to a 9% 2019 estimated FCF yield, while Microsoft (for example) traded at a 5% FCF yield. Microsoft has executed splendidly, and deserves their valuation. However, we feel as ORCL makes the transition to the cloud, this valuation gap will close. Meanwhile, Oracle has a very solid balance sheet and is aggressively buying back stock.

Popular press has postulated over the past few years, "Is value investing dead?" We say no. During our careers, we have experienced long cycles of outperformance by both growth and value investing. In other words, there is an ultimate tendency to regress towards the mean between growth and value. Current market conditions are reminiscent of the late 1990's with extended valuations for a relatively short list of large capitalization growth companies plus speculative valuations on technology-centric initial public offerings. When that cycle ended abruptly in early 2000, a seven-year period of value investing dominance ensued. While we cannot predict the timing of an inflection point, we are confident that it will ultimately occur. When it does, we plan to be ready.



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