ValueInvestor INSIGHT
The Leading Authority on Value Investing
March 31, 2019

Scarcity Value

Matthew McLennan's focus on the persistence of a company's earnings power rather than its growth may seem quaint today, but that's perfectly fine by him.

It's by design that companies in Matthew McLennan's portfolios at First Eagle Investment Management aren't exactly those that set investors' hearts racing with excitement. "We're happy to own businesses with what we consider a gradual positive drift to them," he says.

Since succeeding Jean-Marie Eveillard at First Eagle, McLennan's similarly low-key approach continues to serve investors well. The $46 billion Global Fund he manages with Kimball Brooker has over the past decade earned a net annualized 9.9%, vs. 8.2% for peer funds tracked by Morningstar.

Casting a wide net, McLennan and Brooker are finding mispriced value today in such areas as robotics, consumer products, oilfield services, timber and family-controlled holding companies. See page 2

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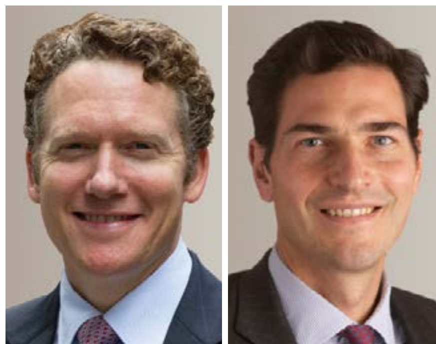

First Eagle Investment Management
Matthew McLennan (*l*), Kimball Brooker (*r*)

Investment Focus: Seek resilient companies with scarce tangible or intangible assets at times when market expectations for them appear to be overly modest.

Built to Last

To succeed, one needn't invest in dozens of ways that differ from the market, says Chris Niemczewski, just "in as many ways as possible that make sense."

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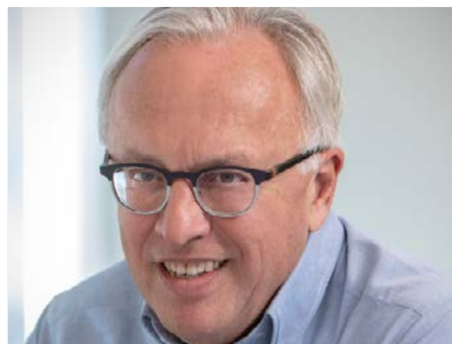

Chris Niemczewski
Marshfield Associates

Investment Focus: Seeks companies with the resilience to thrive through the stressful periods that from time to time can make their stocks attractively priced.

To Chris Niemczewski, value investing is as much a psychological game as an intellectual one. "It's an interesting discipline," he says, "where to succeed you need both a high tolerance for discomfort and, at some level, an intolerance for comfort."

Since founding Washington, D.C.-based Marshfield Associates in 1989, he appears to be striking the right psychological and financial balance for investors. The firm now manages $2.5 billion and its equity composite since inception has earned a net annualized 11.0%, vs. 9.6% for the S&P 500.

Patient in both buying and selling, Niemczewski and team today are seeing opportunity in such areas as bond ratings, for-profit education, diesel engines, auto-parts retailers and insurance. See page 11

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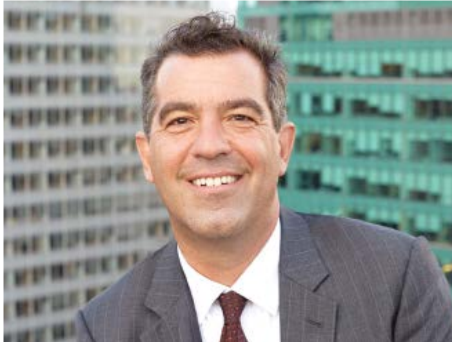
Hot or Not

Long/short investors like markets where valuations of both inexpensive and expensive stocks seem overdone. Charles Lemonides of ValueWorks thinks that's the market we have today, and has some ideas for how to take advantage.

INVESTOR INSIGHT



Charles Lemonides
ValueWorks LLC

On valuations today: "My job is to understand how stocks are priced and in instance after instance I'm seeing vast discrepancies in how companies are valued."

Editor's Note: *Having managed his long/short ValueWorks LLC investment strategy since 1999, Charles Lemonides has had to navigate more than his share of stock-market booms and busts. He's finding fertile ground in today's market on both the long and short sides, he says, because "things that are cheap are really cheap, and things that are expensive are really expensive." In this recent conversation he explains why that might be the case, and describes the long case for an idea he finds really cheap and the short case for one he finds really expensive.*

You've characterized today's market as one of extremes, where valuations of expensive and inexpensive stocks alike seem to be overdone. Why do you think that's the case?

Charles Lemonides: The first reason I think it's so is because I see it in the numbers. My job is to understand how stocks are priced and in instance after instance in the same industry or in the same types of companies I'm seeing vast discrepancies in how companies are valued.

Why do I think that's happening? We've been in an environment in which investors have capital to put to work, but they're doing it in a relatively indiscriminate way by pouring money into passive investments. Whatever the weighting is in the index, that's what gets bought. It seems logical to me that if lots of money is being put to work without consideration for price, stocks that are expensive can become even more so.

Another thing is that after ten years of mostly rising stock prices, investment winners are getting an inordinate amount of attention and also-rans are not. So the incremental investment dollar that isn't indexed is more apt to be chasing what's hot and working. Maybe it's big-name technology. Maybe it's the latest unicorn IPO. A year ago everyone was having a grand old time with bitcoin. Six months ago it was cannabis stocks. In times like this people want to own what's fun and dynamic and exciting and aren't thinking about downside protection or buying things on sale. That can exacerbate the differences in how stocks are valued at the low and high ends.

ON LONG BULL MARKETS:

In times like this people want what's fun and exciting and aren't thinking about downside or buying things on sale.

I would point out that it's entirely possible, depending on the overall economic environment, that this period could go on for quite some time. It's normal for markets to go from major crashes to giddy tops and I would tend to agree with those observers who argue, at least from a sentiment perspective, that this is not a giddy top. That doesn't change how I'm going to invest – I say we want to buy $1 worth of high-quality corporate assets for 50 to 75 cents and sell $1 worth of low-quality corporate assets for $2 – but all value investors should at least be prepared for today's market environment to last longer than they expect.

Starting first with a current long idea, describe your interest in United Natural Foods [UNFI].

CL: This is the largest publicly traded wholesale distributor of natural and organic foods in the U.S. It currently distributes more than 110,000 products to customers including specialty stores and conventional supermarkets. Its largest client, accounting for roughly one-third of total revenues, is Whole Foods.

The stock definitely falls in the category of not being fun and exciting now, but four or five years ago it was. Investors were enamored with the notion that natural and organic foods was a growth business, driven by fundamental changes in people's eating habits. The company had been executing against that positive dynamic for 15 years.

We'd argue that it has continued to execute against that positive dynamic – revenues grew from $8 billion in 2015 to more than $10 billion in the fiscal year ended last July – but the stock price has been decimated and is currently down more than 80% from its 2015 high. The first big issue has been some operating-margin contraction, and the second was the acquisition last summer of grocery wholesaler Supervalu, a deal the market hated. Our basic case is that this is more of a broken stock than a broken business, and that we don't believe either of those issues are permanent negatives for the company.

What's the rationale behind the Supervalu acquisition?

CL: The deal significantly broadens United Natural's reach and scale with more conventional food retailers. That's important as such retailers are themselves looking to become more competitive by offering a greater selection of the higher-value-add products United Natural has expertise in distributing.

We fully expect there to be some bumps in the road with the acquisition integration, but the company has proved by taking share over a long period of time that it's the best operator when it comes to distributing natural and organic foods. It's more difficult to distribute stuff that's fresher, more natural and less processed. As they bring their expertise to bear on a broader distribution footprint, we think the potential to improve profits and profitability is high.

Isn't Amazon increasingly perceived as a competitive threat, especially now that it owns Whole Foods?

CL: Whole Foods has been United Natural's most important customer and a major source of its growth. The risk would be that Amazon would try to bring distribution in-house and cut out United Natural. I've heard that argument, but what exactly is Amazon going to go after here? The huge, wide margins in wholesale food distribution? That seems silly. I think a strong case can be made that Whole Foods under Amazon is going to take share and grow in an increasingly attractive segment of the food-retail business. Given United Natural's relationship with Whole Foods, it should continue to take share and grow as well.

What upside do you see in the shares from today's $13.20 price?

CL: Today you're paying less than $4 billion in enterprise value for a pro-forma $20 billion revenue base. Given how much of the enterprise value is in debt, the upside to the equity value is dramatic.

To get to the roughly $3 per share we think the company can earn within the next two to three years, all that needs to happen is for organic revenue growth to be in line with what it's been – in the high single digits – and for the company to realize half of the $175 million in annual cost savings it's targeting following the Supervalu acquisition. On that $3, we think a 15x multiple would be reasonable, which would result in a share price more than three times what it is today.

That's not our best-case number on either the EPS or the multiple. If they ended up with a 1% net-income margin on the run rate of $20 billion in revenue, which is not at all inconceivable, that's $200 million. There are 50 million shares outstanding, so that's $4 per share. At the rate earnings would be growing at that point, you could do much better than a 15x multiple on that.

Turning to the short side of the ledger, describe your bear case for ETF-provider WisdomTree Investments [WETF].

CL: What WisdomTree has in common with United Natural Foods is that it a few years ago was also an investment darling, and that's much less the case now. The company is a pure-play ETF provider, which tries to differentiate itself on the

INVESTMENT SNAPSHOT

United Natural Foods
(NYSE: UNFI)

Business: Wholesale food distribution in the U.S. with a focus on natural and organic products; broadened scope and scale with 2018 acquisition of traditional wholesaler Supervalu.

Share Information (@3/29/19):

Price	**13.22**
52-Week Range	9.23 – 47.73
Dividend Yield	0.0%
Market Cap	$671.8 million

Financials (TTM):

Revenue	$14.26 billion
Operating Profit Margin	1.6%
Net Profit Margin	(-1.9%)

Valuation Metrics
(@3/29/19):

	UNFI	S&P 500
P/E (TTM)	n/a	21.2
Forward P/E (Est.)	6.5	17.0

Largest Institutional Owners
(@12/31/18 or latest filing):

Company	% Owned
BlackRock	13.6%
Vanguard Group	10.4%
Kiltearn Partners	9.2%
Dimensional Fund Adv	8.2%
Earnest Partners	3.3%

Short Interest (as of 3/15/19):

Shares Short/Float	16.3%

UNFI PRICE HISTORY

THE BOTTOM LINE

Its shares have been decimated by margin pressures and an acquisition the market despised, but Charles Lemonides doesn't believe either issue is a permanent negative and that the company should prosper in its secular-growth market. At 15x the $3 in EPS he believes it can earn within the next two to three years, its stock would more than triple.

Sources: Company reports, other publicly available information

equity side through weighting its products on fundamental factors rather than just on market cap. It was one of the earlier, higher-profile players focused on "smart beta," and for a time through marketing and relatively good performance grew assets at a pretty rapid pace.

As performance hasn't kept pace and competition has increased, there have been important outflows in some of the company's flagship products. At the time WisdomTree acquired an exchange-traded-product business in Europe from ETF Securities in late 2017, it touted the combined company's $66 billion in global assets. Even after a good period since then for overall ETF asset flows, the company's AUM today is around $60 billion.

Another concern we have is that they sell competitively high-priced products at a time when passive-vehicle fees are decreasing. Just doing back-of-the-envelope math on revenues as a percentage of AUM, the company has been realizing something on the order of 50 basis points in fees on its assets, at a time when Vanguard and Fidelity and Schwab are selling comparable products for annual fees of 10 to 12 basis points. WisdomTree appears to pay advisors very well for using its products, but even well-paid advisors are going to have an increasingly hard sell if the products for sale aren't competitive from a cost standpoint.

How high do you consider the risk the company gets bought, as is rumored from time to time?

CL: We think that's what they're hoping for, that a bigger player comes along and pays a nice premium to either expand or establish a position in a secular-growth part of the market. But who will pay a big premium for a business with an organic decline in assets and non-competitively priced products in an increasingly cutthroat business dominated by much larger firms? It could happen, of course, but we just don't see it. Something like this wouldn't move the needle for any of the biggest current players. And if you're not in the business, is this what you'd buy to compete with Vanguard and BlackRock and State Street?

How are you looking at valuation with the shares at a recent $7.05?

CL: As reality sets in that they're fighting an uphill battle as a small player without any sustainable competitive advantages in an industry of giants, we expect the stock to further re-rate downward. Even if they happen to hit the consensus estimates of 25 to 30 cents in EPS in 2020 – which is not what we're expecting – we think the business will deserve no better than a 12x multiple. In our view, they're going to have to do a lot of things really right to keep the shares above $3.50.

You could say 12x is a low P/E for an asset manager. But look at some of the other asset managers and where they're trading today. Legg Mason [LM] is at an 8x P/E. Invesco [IVZ], which we're long, trades at closer to 7x. And that's for a company with no debt – which is not the case with WisdomTree – and that even has three times the exchange-traded-product assets that WisdomTree does. That's the type of thing we're seeing that just doesn't make a lot of sense. VII

INVESTMENT SNAPSHOT

WisdomTree Investments
(Nasdaq: WETF)

Business: Asset manager specializing in exchange-traded fund [ETF] products covering equities, fixed income, currencies, commodities and alternative strategies.

Share Information (@3/29/19):

Price	**7.06**
52-Week Range	5.73 – 11.82
Dividend Yield	1.7%
Market Cap	$1.08 billion

Financials (TTM):

Revenue	$274.1 million
Operating Profit Margin	26.5%
Net Profit Margin	13.4%

Valuation Metrics
(@3/29/19):

	WETF	S&P 500
P/E (TTM)	30.8	21.2
Forward P/E (Est.)	25.2	17.0

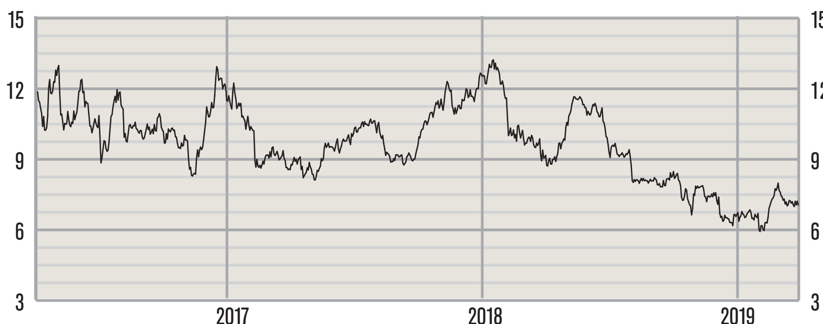
Largest Institutional Owners
(@12/31/18 or latest filing):

Company	% Owned
BlackRock	10.2%
Vanguard Group	8.1%
ArrowMark Colorado Holdings	6.9%
TimesSquare Capital	5.6%
ClearBridge Inv	4.0%

Short Interest (as of 3/15/19):

Shares Short/Float	9.0%

WETF PRICE HISTORY



THE BOTTOM LINE

Charles Lemonides believes once "reality sets in" and the market acknowledges the company is fighting an uphill battle without any sustainable advantages in an industry of giants, that the shares will re-rate downward. At 12x even consensus Wall Street estimates of 25-30 cents in 2020 EPS, the stock would be cut in half from today's level.

Sources: Company reports, other publicly available information