Bernzott Capital Advisors

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Beyond "The Noise"

Behaviorally speaking, humans are an optimistic bunch. This optimism bias has played a key role in our species' survival. We tend to believe we will be much better off in the future than we are today. Most of us overestimate our odds of success and we underestimate our chances of bad things happening to us. This optimism promotes a bubble of "hope" around each and every one of us. As Andy Dufresne said in *Shawshank Redemption*, "Hope is a good thing, maybe the best of things, and no good thing ever dies."

However, from time to time, our survival instinct runs a stake through that bubble of "hope". Daniel Kahneman, winner of the 2002 Nobel Prize for Economics, noted that the way humans solve problems and make decisions does not always manifest in the most accurate or best outcomes. Humans make decisions that are essentially the most efficient in terms of time and energy expenditure and are "good enough" for our survival. Looking at the current Ebola scare, the odds of a mass outbreak are extremely low, and yet, the run on Hazmat suits despite the fact that they may not offer 100% protection, highlights how our survival instinct can overwhelm good decision making. Not surprisingly, the cost ($600 to $800, plus $2,000 to $4,500 for mandatory self-contained breathing apparatus) is not part of the decision making equation.

In times of panic, investors will sell first and ask questions later. As noted above, it just feels better to rid ourselves of what is causing the pain regardless of the economic outcome. While the age old adage, "where there is smoke, there must be fire" can be true, more often than not, that fear is misplaced and panic is over blown. Ebola, while devastating to the poor regions of West Africa, is not the potential threat that we have seen with prior pandemics like SARS, the avian flu, and the West Nile virus. Unfortunately, media outlets and pundits alike have sensationalized Ebola so much so that it's filtered into our collective psyches stoking fear and hysteria across the country. While difficult to attribute selling pressure to Ebola alone given concerns about a slowdown in global growth and political tensions in the Middle East and Russia, sectors reliant on consumer spending, including Airlines, Hospitality, and Retail have underperformed disproportionately. The investment thesis for selling is simple even if it's misguided; consumers fear Ebola and as a result, they will stay home instead of spending money at malls and restaurants or on entertainment and travel.

There is no doubt that there are real risks to the U.S. economy including a slowdown in economic growth, rising interest rates, inflation, and most recently, deflation. Generally speaking, we take Warren Buffett's approach to investing. Like Buffett, we think long term, we invest in companies not stocks, and we pay little attention to the macro and political environment. We find it's prudent to ignore useless data, hype, and sensation aka "the Noise". That said, market conditions and valuations matter. We have been saying for some time that finding companies that meet our purchase criteria were becoming more scarce on the account of valuation. Thankfully, fear and panic in capital markets leads to opportunity and we are certainly taking advantage of the current volatility to source and vet a number of new, interesting ideas.

Third Quarter Overview

During the third quarter, investors had little appetite for risk. A number of geopolitical and macro concerns, namely continued strife in the Middle East and Russia, along with concerns over the sustainability of economic growth here in the U.S. and in Europe weighed heavily on investor's minds. Add to the mix the United States' first confirmed Ebola case in late September and it is no surprise risky assets, particularly small cap stocks, found little traction during the quarter.

Despite the upheaval in small cap land, BCA's third quarter results were excellent on a relative basis. The U.S. Small Cap Value composite's return was down -2.55% (net) compared to the both the Russell 2000 Value and the Russell 2500 Value which fell, -8.58% and -6.40%, respectively. This continues the strategy's momentum from last quarter when it outperformed both benchmarks as well. On a year to date basis, the U.S. Small Cap Value is down -.73% versus -4.74% for the Russell 2000 Value and +.96% for the Russell 2500 Value.

	MTD	QTD	YTD	1YR	3YR	5YR	7YR	10YR	SI*
BCA (Gross)	-2.55%	-2.40%	-0.73%	10.48%	21.19%	15.32%	8.77%	9.31%	14.56%
R2000V	-6.75%	-8.58%	-4.74%	4.13%	20.61%	13.03%	5.08%	7.25%	10.59%
R2500V	-5.83%	-6.40%	0.96%	9.88%	22.82%	15.16%	6.60%	8.65%	11.72%
+ / - R2000V	4.20%	6.18%	4.01%	6.35%	0.58%	2.29%	3.69%	2.06%	3.97%
+ / - R2500V	3.28%	4.00%	-1.69%	0.60%	-1.63%	0.16%	2.17%	0.66%	2.84%

	MTD	QTD	YTD	1YR	3YR	5YR	7YR	10YR	SI*
BCA (Net)	-2.70%	-2.55%	-1.19%	9.80%	20.41%	14.53%	8.02%	8.50%	13.64%
R2000V	-6.75%	-8.58%	-4.74%	4.13%	20.61%	13.03%	5.08%	7.25%	10.59%
R2500V	-5.83%	-6.40%	0.96%	9.88%	22.82%	15.16%	6.60%	8.65%	11.72%
+ / - R2000V	4.05%	6.03%	3.55%	5.67%	-0.20%	1.50%	2.94%	1.25%	3.05%
+ / - R2500V	3.13%	3.85%	-2.15%	-0.08%	-2.41%	-0.63%	1.42%	-0.15%	1.92%

* Product inception date is January 1, 1995

Outperformance during the period was driven primarily by strength in Energy (+290 bps), our Financials underweighting (+200 bps) and Consumer Discretionary (+170 bps). This was offset by weakness in Materials (-130 bps), Healthcare (-60 bps) and Industrials (-50 bps). M&A and activism within our portfolio continued to be a theme this quarter. In the Energy sector, the primary contributor was Dresser-Rand (+30%), which rallied sharply on news it is to be acquired by Siemens. Within the Consumer Discretionary sector, the primary contributors to performance were International Game Technology (+8%) and PetSmart (+15%). Both companies benefited from this theme with IGT announcing it was being acquired by Italian lottery company GTech, while PETM's management announced it had hired an adviser to explore strategic alternatives to unlock shareholder value. Not surprisingly given the volatility in the quarter, we had our fair share of detractors to performance. Landauer (-21%), Owen-Illinois (-25%) and Clean Harbors (-16%) were laggards. We highlight some of our winners and losers below.

Company Highlights

Top Contributors:

MICROS (MCRS): Discussed in 2Q14 market commentary- on June 23, Oracle (ORCL) announced it was purchasing MCRS for $68 a share in cash, a 22% premium to MCRS price before June 16 when rumors about the potential sale surfaced. We sold the entire position on July first.

Dresser-Rand (DRC): In early July, the stock rallied sharply after a German magazine "manager" reported Siemens was examining a bid for DRC and would consider a hostile bid if required. Subsequently, DRC hired Morgan Stanley to field offers. Sulzer, Siemens and GE were the rumored suitors and DRC accepted an $83/share bid from Siemens on September 22. This was a 37% premium to the price before rumors surfaced about Siemen's interest. We sold approximately 50% of the position in the quarter and will look to sell the remainder as new opportunities arise.

International Game Technology (IGT): Following weeks of speculation that the company was going to explore a potential sale, IGT rallied on news that the company had retained Morgan Stanley. Shortly thereafter, Italian lottery company GTech announced it is going to acquire IGT for $18.25 per share. This is a 46% premium to the price IGT traded at on June 6 prior to rumors surfacing about the possible sale. We exited our position in IGT prior to the end of the quarter.

PetSmart (PETM): PetSmart was up +17% in the quarter after JANA Partners (activist hedge fund) announced a 9.9% stake and long-time shareholder Longview Asset Management increased its ownership stake from 7.5% to 9.0%. The company is exploring strategic alternatives which include paying a special dividend, an outright sale of the company or possibly a merger with direct competitor Petco.

Verint System (VRNT): Verint System (VRNT) was up +13% in the quarter. Its recent 2Q15 earnings report had very strong results coming in ahead of consensus and last year. They also tweaked 2015 guidance up slightly. Results are being fueled in part by the large KANA acquisition the company made earlier this year.

Worst Detractors:

Landauer (LDR): Landauer was down -21% in the quarter on a less than stellar earnings report. The primary driver of the 3Q14 miss was a decline in Radiation Measurement revenue due to the timing of military orders. While LDR missed for the quarter, management reiterated their full year guidance which implies 4Q14 results will be well above then consensus expectations. Additionally, LDR has experienced management turnover this year and is currently seeking a permanent CEO and CFO. Despite the noisy quarterly results and the possibility of a dividend cut which is likely priced into the stock, we believe LDR trades at a significant discount to fair value given its market position, pending military orders, and next generation products. As such, we added to the position on weakness.

Owens-Illinois (OI): Owens-Illinois (OI) was down -25% during the quarter. OI shares fell in late September after management announced Q314 EPS would be down -5% vs. last year compared to prior guidance for EPS to be up +10% vs. last year. OI generates 40% of revenue from Europe and as such its stock is correlated with the Euro which has been weakened versus the Dollar. On the positive side, the 2014 full year cash flow target of $350 million was not changed. The company also announced it will spend up to $100 million in 2015 on share repurchases. We used the price weakness to increase ownership from roughly 2.5% to 4.0%.

Clean Harbors (CLH): Clean Harbors was down -17% in the quarter. In early September, sell side firm BB&T came out with a negative report lowering its rating to hold. The key points: weak base oil prices will impact CLH's oil re-refining segment profitability and foreign exchange headwinds will impact revenue. BB&T lowered its 2015 EPS from $2.43 to $2.10. In early October, $6 billion activist hedge fund Relational Investors, which owned 9% of CLH, announced it was winding down operations as its co-founder and public face of the firm Ralph Whitworth took an immediate leave to deal with a recurring throat cancer condition. We suspect Relational was selling shares prior to and following this announcement.