Bernzott Capital Advisors

PERSPECTIVES

November 2014

2014 Update

We are now done with three-quarters of 2014, which has been a bit different than 2013. As Lloyd Bentsen might say, “I knew 2013. 2013 was a friend of mine. And 2014, you're no 2013.” While this year has not been another 2008, thank goodness, it has clearly been anemic compared to the prior few years. Of course this is the major reason for the 2014 slowdown: since the depths of 2009, equity returns have been extraordinarily good. Those types of returns are not sustainable forever, thus we were due for something a little more mundane.

When we are asked about our outlook on the market, we usually point to our portfolios. Our take on investment opportunities can be gleaned from looking at what we own, and what we don’t own. We believe bonds are generally overpriced, and consequently we own very few. We think that a Customized Multi-Asset Class strategy is the right approach for the majority of our Wealth Management clients. A portfolio anchored in diversified, quality companies that range from small to very large will provide a good return while controlling risk.

You may have noticed that cash levels have increased slightly over the past few quarters. While we would never proclaim “we want to hold X amount of cash,” circumstances have led to our selling or trimming some positions. Simultaneously, redeploying the cash from the sales has been difficult due to the dearth of buying opportunities for bargain hunters like us.
There are numerous reasons we sell. In some cases, the stock price reached our assessment of fair value (Covance, Energizer and Mobile Mini). In other cases, the company was taken out at a premium in an M&A deal (International Game Technology). In some instances changes in either the company or its business environment were significant enough to make the stock less attractive or more risky going forward (ADT and Outerwall). Finally, sometimes price appreciation results in a stock being overweight in the portfolio, in which case we trim the position to a more reasonable size.

As you can gather from the amount of selling we have been doing relative to amount of buying, our most difficult job right now is finding good companies to buy at the right price. Although many times there is an urge to do something – anything – often the best choice is to do nothing. The market rally over the past few years has left portfolios fatter, but opportunities thinner. So we exhibit patience - and don't confuse activity with progress - and hold some dry powder in case prices drop. We stick to our discipline of pricing companies based on operating performance, not market momentum. One of our biggest edges is our ability to be patient at all times and hold cash some times. Smart investors do not fold when the market panics, nor do they join the crowd in a euphoria.
Going forward, despite significant price appreciation, we still see room for further improvement. We generally don’t make macroeconomic predictions, but we do get a sense of sentiment by speaking with the management of the companies we own. The assumptions in our Discounted Cash Flow models are reasonable considering our expectations for the companies we own. There are always opportunities for patient stock pickers who do their homework. And we believe that when the store is jammed full of buyers, you are less likely to buy at a discount.

Prudent investors refrain from making material moves based on guesses. When clients ask if we see a significant market correction coming, we answer honestly by saying we don’t know. Selfassured market prognosticators would be wise to heed the words of Mark Twain: “It ain’t what you don’t know that gets you in trouble. It’s what you know for sure that just ain’t so.”

Finding bargains in this environment is not easy. And double digit returns are not likely year in and year out. However, we believe the companies in our portfolio are reasonably resistant to a slowdown in the economy, an increase in interest rates or most other macroeconomic events. We continue to avoid companies that are overpriced, over-regulated and over-levered, and consequently we own very few financials, utilities or REITs. Finally, while domestic equity prices are generally lofty, there is still some room for further appreciation. The companies we own should continue to be successful, and as a result, you will likewise enjoy success.

Security Spotlight – Rayonier Advanced Materials (Ticker: RYAM)

We choose to spotlight Rayonier this issue because it has been a recent purchase and quite disappointing up to this point. But the current price is not reflective of the value of RYAM. So as we continually preach, we have patience and allow the price / fair value gap to close.

Rayonier Advanced Materials is the leading global producer of high-purity cellulose, a natural polymer, used as a raw material to manufacture a broad range of consumer-oriented products such as cigarette filters, liquid crystal displays, impact-resistant plastics, thickeners for food products, pharmaceuticals, cosmetics, high-tenacity rayon yarn for tires and industrial hoses, food casings, paints and lacquers.

RYAM fits the profile we look for – market leader, strong margins, high return on capital, etc. It is also very similar to a firm we owned and had success with in the past, Buckeye Technologies, which was acquired by Georgia Pacific in 2013 at about a 30% premium. Finally, it has the significant benefit of starting out with excess capacity gained while it was part of its former parent company. While RYAM may face near-term pricing pressure related to this new capacity, we believe the market, in-time, will absorb the new capacity and RYAM will in turn generate higher revenue and improved margins. During this “absorption process” we also believe the company will be “re-rated” and receive a higher multiple which together with an increase in free cash flow will help it reach our estimate of fair value.

Year-end Planning

We are now in the final quarter of 2014 which means the holidays are just around the corner. It also means you have to start thinking about year-end tax planning.

Here are a few items to consider:

1) If you are over 70 1/2, check on your IRA Required Minimum Distribution.

2) If you have an employer sponsored Flexible Spending Account, make sure you have taken full advantage.

3) Beware of the Alternative Minimum Tax. In some circumstances, deferring a deduction may be the best option.

4) Tell a friend about Bernzott Capital Advisors. Long-term investors who avoid hyperactive trading enjoy tax advantages over short-term speculators. Besides excellent performance, we provide tax efficient portfolios for our Wealth Management clients.