Bernzott Capital Advisors

PERSPECTIVES

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The Tide Has Ebbed

Warren Buffett has famously said, "Only after the tide goes out do you find out who has been swimming naked." The point of this truism is that when things are going well for most investors, when stocks are rising almost in unison and when any buy is a good buy, then flaws and blemishes in investments can be covered up. In fact, during times of rapid stock appreciation, it is often the companies of lowest quality that ascend the most.

When stock prices are going up, people tend to buy more, borrow more and pay ever increasing prices, which causes more buying and appreciating prices. Until something scares them. And the tide goes out. And instead of being prepared with a bit of dry powder and a portfolio of quality companies, the naked swimmer has a portfolio of low quality companies and no opportunity to take advantage of the new water level.

We don't like to see stock prices drop. But we all know it is going to happen at some point and over some period of time. The skill in investing comes from understanding why your portfolio is constructed a certain way and your plan for reacting to the inevitable decrease in prices. These are issues that should be addressed before one makes his first purchase. If a ten percent drop in prices will cause sleepless nights, then you should likely have your money in a savings account. That may feel good in the short-run, but the sleepless nights will come later when the purchasing power of that account over the next 10 years is decimated by inflation relative to the appreciation.

The overall market very often reacts to events that have very little effect on the companies we own. Political unrest in Korea or Puerto Rico may provide interesting headlines, but that activity has almost no bearing on the performance of companies in our portfolio. Unfortunately, in the very short-run, the companies we own will get caught up in the panic and the result is a decrease in stock prices. This last quarter provided a great example of the all-too-often disconnect between a company's operational performance and the short-term performance of the underlying stock.

Gentex (GNTX) is an industrial company based in Michigan whose primary product is auto-dimming mirrors for automobiles. The balance sheet is incredibly healthy. The cash flow is very good. Our thesis of additional sales due to deeper penetration of the mirrors into lower price point vehicles is playing out just as we anticipated. The second quarter results were reported in late July and we were very happy with them. They reported revenue and earnings per share above what was expected. They guided future sales as being higher and future expenses lower. The day all this good news was reported the stock went down 1%. Was it slowing growth in China? The Fed's lack of movement? Maybe it was the announcement that Jamaica beat the U.S. in a stunning Gold Cup soccer semi-final. The overall market was down slightly so maybe GNTX got caught in the wake. The point being something other than the fundamentals scared the investors enough to sell the stock at a price lower than when the day started. And given what we knew at the end of the day versus when the day started, that made no sense.

We point out this example as a reminder of how one should not equate price movements over the short run with how the company is performing. If we look back to 2008 (if you choose not to look back to 2008, we understand), there were dozens of cases where the overarching sentiment and lack of confidence decimated stock prices. Certainly there were issues with the credit markets, housing was taking a beating and the economy was stagnant. But looking back, the only investors that lost money were the ones who fretted over the market at that time and sold when prices were down.

It probably comes as no surprise that we continue to feel the same way today as we have in every other correction of stock prices. Every correction may seem a bit different, but in our estimation, this one looks very similar to other price pullbacks. Overreaction to world events such as North Korea, fear of the Federal Reserve and rising interest rates, and economic growth that is less than anticipated are all factors that drive the overall market yet have imperceptible effects on the companies we own. Yet there is no escaping the drag these events have on stock prices in the short-run. Additionally, prices were approaching fair value as 2014 closed. As a result, the potential for a temporary reduction in prices was much greater in 2015. Did we think prices would decline? No, but after several years of excellent returns, a retreat is surely not a surprise.

We have seen this before. You have seen this before. And no matter how many times we go through a correction, this one is no easier than the last. In fact, as Charlie Munger said about investing, "It's not supposed to be easy." He is right because if it were easy, everyone would do it with high degrees of success. There is no silver bullet for earning an outsized return. And earning an outsized return over a short period of time is for speculators, not investors. We are confident that this period of time will look like every other period of time on the chart of stock returns since the 1920s: a blip in an otherwise upward jagged line.

During the struggle of 2007 and 2008, *Perspectives* was full of articles about lower stock prices, how to "keep the faith" and how we felt stock prices would approach fair value as long as we had patience. While the dips in prices in 2015 are not comparable to the dips in 2007 and 2008, we continue to emphasize the long-term nature of our investment approach and we continue to believe that predicting prices over the next twelve months is impossible, but a portfolio of quality companies bought and sold at the right prices will provide excellent returns over a significant period of time. And even if the tide does go out, the type of portfolios we manage at Bernzott Capital Advisors will not leave our investors exposed.

Security Spotlight – Douglas Dynamics (PLOW)

With roots tracing back to 1948 and based in Milwaukee, Wisconsin, Douglas is a leading manufacturer of snow and ice control equipment. The company enjoys a 50%-60% share of the snow and ice control equipment market for light trucks. Products consist of snowplows and sand and salt spreaders, and related parts and accessories.

While sales can fluctuate due to the weather, Douglas has exceptional operational aptitude. Douglas has a broad product line, extensive dealer network, and superior lead times, all of which are critical during peak snowfall periods. Douglas has been able to raise prices every year, by an average of 3.0% per year since 2008. In December, 2014, the company acquired Henderson Industries, who also has leading market share of snow and ice control solutions for heavy duty trucks, focused on state Department of Transportation clients, counties, and municipalities. Douglas' lean manufacturing culture should help generate meaningful margin improvement at Henderson.

Douglas pays a solid dividend (4.2% yield), which the company considers sacred and something it can protect in all market/weather conditions.