Greenfield Seitz
CAPITAL MANAGEMENT

2019 Annual Letter

January 22, 2020

Dear Investor,

The Greenfield Seitz Core Composite was up 24.9% (net-of-fees) for the the year. This compares to a 27.7% gain for the MSCI World Index and a 31.5% gain for the S&P 500 Index.[1]

We were aggressive buyers of stocks in December 2018 after the S&P 500 sold off 19% in the fourth quarter a year ago. The market has rebounded to all-time highs over the past 12 months since those 2018 lows.

Our 2019 performance was enhanced by our position in the stock of Dexcom. Dexcom is one of our largest holdings and appreciated 82% in 2019. We highlighted our investment rationale for Dexcom a year ago in our 2018 Annual Letter.

We continue to make healthy returns on your capital despite not owning the popular stocks. Microsoft, Apple, Amazon, and Facebook are the four largest companies in the S&P 500 Index (comprising 14% of the entire index). We do not own any of them because we believe they have become over-valued as investors follow the herd into these momentum stocks. Recall, Greenfield Seitz outperformed the S&P 500 Index by 40% in the Dot-Com bust as we owned very few tech stocks (Past performance does not guarantee future results). Last year, Apple and Microsoft contributed 17% of the total appreciation of the 500 stocks in the S&P 500 index (5.2 percentage points of the index's 31.5% gain). Having a handful of stocks responsible for the bulk of the market's move is rare. The Technology sector and Communication Services sector accounted for roughly half of the market's gains last year (more than the combined returns of: Financials, Healthcare, Industrials, Consumer Staples, Utilities, Real Estate, Basic Materials, and Energy). Furthermore, Apple's value now exceeds the entire value of the S&P 500 Energy sector (4.6% vs 4.2%).[1]

Economic Update

After growing consistently for much of this 10-year bull market, corporate earnings were flat (down 0.2%) last year.[2] This means that the growth in stock prices was driven from higher P/E multiples and not earnings growth. The forward P/E on the S&P 500 Index is now 18.5x compared to the 10-year average of 14.9x.[2] It was fascinating that the Index gained 31.5% last year as earnings decreased.

Earnings were hurt by the trade war with China and a global economic slowdown. Exports were down 5.2% and manufacturing costs were increased by tariffs on imported goods. The tax cuts that boosted earnings in 2018 were a one-time benefit to growth that is now behind us. Additionally, it could be that after twenty years of cost reductions from technological innovation and globalization, profit margins have peaked. Lastly, the benefits from low borrowing costs are wearing off as we have been in a low rate environment for 10 years.

The consumer remains strong with record low unemployment. Overall, the economy appears healthy but slowing. GDP growth is still averaging around 2-3% and unemployment is at a 50-year low of 3.8%.[3]

Buying Good Long-Term Businesses While They Are Out of Favor
We have had success buying good long-term businesses during periods when their stock has temporarily sold off. Typically, these selloffs are over-reactions to short-term issues. We would like to highlight several recent examples:

Disney (DIS $143.56) - We initially bought DIS shares at roughly $62.40 (6/24/2013) as investors were negatively focused on the struggles of ESPN. Disney's Media Networks, which was primarily ESPN, accounted for 46% of 2012 sales and was in serious trouble with cord cutting of ESPN subscribers. But investors were not giving credit for the franchises of Disney and its 2010 acquisition of Marvel for $4.2 billion and its 2012 acquisition of Lucasfilm (Star Wars) for $4.0 billion. Since then, Disney has leveraged Marvel for more than $17 billion in box office sales and Lucasfilm for more than $5 billion in sales. This year, Disney rolled out its streaming service Disney+ and is signing up more than 1 million subscribers a day.

Kinder Morgan (KMI $20.93) – We bought shares of KMI at roughly $14.81 (4/12/2018). KMI stock was off 67% from its highs as investors soured on MLP structures, energy investments, and recent regulatory issues. But we saw a well-managed system of 70,000 miles of pipeline that was a very sustainable business with a 7% dividend yield. We compared this business to a toll road in our 2018 Mid-Year Letter.

Dexcom (DXCM $231.62) – We added to DXCM shares at roughly $128.70 (3/22/2019) when a short seller wrote a negative report on the stock highlighting its addressable market and competition from Abbott Lab's Libre 2. Dexcom's stock has since rallied 85%. In November, the company announced 49% sales growth for 3Q19 and EPS of $0.65 versus the consensus estimate of $0.18. We highlighted Dexcom last year.

Resmed (RMD $161.94) – We added to RMD at roughly $93.60 (1/30/2019). Shares of Resmed fell 23% the day it announced quarterly revenue growth slowed to 8%, which also missed expectations. In November, Resmed announced quarterly sales growth of 17% and EPS growth of 14%. The return to strong growth helped boost shares to all-time highs. We have owned shares of Resmed since 1997 when we initially bought at $1.33 and we recently highlighted the stock in our 2009 Annual Letter.

Fed Funds Rate
Last year, the Federal Reserve began lowering the federal funds rate target for the first time since the 2008-2009 financial crisis. After three 25 basis point cuts, the fed funds rate is now 1.5-1.75%. This preemptive move is seen as an insurance policy to offset the trade war and global slowdown. It also worked to boost stock prices. Typically, the Fed starts lowering rates during a financial crisis or as a response to an economic downturn. This time is unique because GDP is still growing at 2% and consumer spending, which accounts for 70% of the U.S. economy, grew 2.5% last year.[3]

We believe much of the rebound in the market was the excitement about the Federal Reserve switching to an easing mode. "Don't fight the Fed" has been historically true with the S&P 500 gaining in 11 of 14 easing cycles with an average annualized gain of 20%.[4]

Outlook
Market gains have rewarded speculative investors recently, which is typically a sign we are in the late stages of a market cycle. It appears speculators have been lured in by the ongoing bull market and trained that every dip is a buying opportunity. Now they are trying to chase the last returns out of a 10-year bull market.

Warren Buffett famously advised, "Be fearful when others are greedy and greedy when others are fearful." We note that Warren Buffett's Berkshire Hathaway now has $128 billion in cash (up from $20 billion 10 years ago). Cash is now 18% of Berkshire's total assets. He recently said, "we hope to move our excess liquidity into businesses that Berkshire will permanently own, but the immediate prospects for that are not good as prices are sky-high for businesses with decent long-term prospects." It seems counter-intuitive but we think now is a time to be fearful with stocks priced at historic highs on valuation (S&P 2020 estimated P/E: 18.5x, 2019 actual P/E: 19.3x, and Price/Sales 2.1x).[5]

The herd mentality of investors buying into a handful of technology stocks always ends badly. We believe the focus of the investment management industry on short-term performance drives this herd phenomenon. Funds that outperform the benchmark receive more money to invest and funds that underperform have money taken away from them. Therefore, mangers must chase returns by owning the hot stocks. The funds with hot tech stocks have no incentive to sell them and the funds without the hot stocks must buy them to stay in business. This all creates momentum and higher prices for the stocks, which is exacerbated by index funds blindly buying more of the same hot stocks. This is eerily like the Dot-Com Mania when the funds with the most tech exposure had the most inflows and other funds (such as Energy) suffered heavy outflows and went out of business. Ironically, energy stocks outperformed technology stocks in the years following the Dot-Com Bust.

As long-term investors, we aim to invest in great companies at an attractive price (valuation). This process is determined by current fundamentals, valuations, and the outlook for each company. The prudent investor stays true to the discipline of a successful long-term approach.

As always, please contact us anytime if you have any questions.

Sincerely,

Greenfield Seitz Capital Management

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Past performance does not guarantee future results.
1 MSCI and Standard & Poors. December 31, 2019.
2 Factset Earnings Insight. January 10, 2020.
3 FRED. St Louis Federal Reserve Economic Research.
4 Strategas. July 30, 2019
5 Yardeni Research. 2019
All company information is from company filings