LESA
SROUFE&CO INC.
VALUE ADVISORS

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Fourth Quarter Update and Outlook

What a year it was! After years of low stock market volatility, coincidental with U.S. equities marching higher, and a decade of ultra-low short-term interest rates, that all changed in the fourth quarter of 2018: The bubble stocks bombed, the anti-bubble stocks bombed far less and cash as an asset class led returns around the world. The LSC investment style has always been to look for inexpensive sectors and companies that are out of favor or have been forgotten by mainstream investors (hence the name anti-bubble). Our investment style too had been out of favor for much of the past few years, as investors have chased high growth companies with far more alluring stories than ours.

It is not often that one could say that “cash is king” but 4Q18 was one of those quarters in which it was. The U.S. markets hadn’t experienced any significant decline over the past decade; those market routs seem to have been saved for the international stock markets which have generally turned in poor performances over much of the past several years. The availability of cheap funding and more recently, the U.S. corporate tax cut enacted a year ago combined to create an investment environment that can be best described as “in overdrive”. U.S. corporations have spent billions repurchasing their own shares and making record breaking acquisitions, resulting in eye popping leverage for some companies.

We are encouraged by the sobering attitude that investors finally seem to be adopting. Balance sheets, liquidity, valuations, and economic cycles are starting to matter. The broad market’s decline in the fourth quarter was in response to a number of factors including rising interest rates, the threat of tariffs and more recently the unknown effects of an extended U.S. government shutdown. Not all investment strategies are fundamental based. As we look back on this era, some of the explanation for the past market rise and more recent decline is due simply to the rise and fall in demand for risk. We are likely in the early stages of a U.S. earnings slowdown that had already been the norm for the rest of the world. The tight U.S. labor market, rising cost of funding and cycling of corporate tax cuts will likely reduce profit margins for several industry sectors in 2019. Nevertheless, we are encouraged by the prospect of additional investment opportunities at these lower valuations.

During the fourth quarter, we added to our position in Pan American Silver. In November, the company announced its proposed acquisition of Tahoe Resources, a producer of gold and silver, with mines in Central and South America. The combined company will make a formidable combination, especially if Pan American can get approval to restart Tahoe’s Escobal gold mine in Guatemala. Pan American Silver has a strong reputation for working with governments and the local communities in which it operates in. We think investors will be nicely surprised by the earnings prospects of the combined company. We sold our position in Deutsche Bank AG. Deutsche Bank has had very little good news to report long after the financial crisis era ended. Our thesis for a turnaround in Deutsche Bank’s fortunes hasn’t come to fruition, partly due to significantly higher fines paid to the U.S. government than originally planned and an erosion of revenue faster than the bank’s cost cuts could be put into place.

The stock market pullback that we’ve expected did happen in 2018. Foreign markets in recent months have been more resilient than the U.S. partly because of their lower valuations and partly because there has been encouraging economic and political news for some of these countries. We continue to have exposure in companies that operate in Central and South America, where the long- term growth demographics remain favorable.

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