ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Through the Looking Glass

At what was then a highly uncertain time, Mark Oelschlager a year ago offered us a clear-headed explanation of where he was finding investment opportunity. At a time today that is no less uncertain, we contacted him to ask for an encore.

Editor's Note: *After a highly successful run at Oak Associates, Mark Oelschlager founded Oelschlager Investments and was three months into running its first fund, the Towpath Focus Fund, when Covid-19 upended the investing world. When we spoke to him just over a year ago [VII, October 30, 2020], he was focused on the wide valuation discrepancy between "growth" and "value" stocks and described a prominent theme in his portfolio at the time:*

> *Many businesses that were healthy before the pandemic that one could reasonably expect to prosper again are trading at 30, 40 or 50% below where they were eight months ago. People in many cases are afraid and don't want to go too far out on a limb in projecting when the pandemic eases, so the stocks of companies most negatively impacted by the decline in economic activity are dying on the vine.*
>
> *But think about what happens in the market on the day there's a significant, credible announcement about progress on a Covid vaccine. Things usually happen gradually, but on good vaccine news – and the real improvement in prospects for many companies that implies – I think the reversal in the share prices could be sudden and memorable.*
>
> *I would add that the day with good news on a vaccine could also be ugly for the stocks of many of the more prominent Covid beneficiaries out there like Zoom Video [ZM] or Peloton [PTON], for which the market seems to be pricing in that the favorable environment of today lasts forever. The reversal in share prices there could be dramatic as well.*

Since then the stock ideas he described in depth – Herman Miller (now MillerKnoll), Atlantic Union Bankshares, Steven Madden and Designer Brands – are up an average of 96%, vs. 44% for the S&P 500. Zoom and Peloton shares are each down more than 60%. Having seen so well through the uncertainty of a year ago, we wanted to check back in with Mark to see what was on his mind today. He was kind enough to accept that challenge.

It's been a mostly wonderful year for equity investors since we last spoke. Has the proverbial easy money been made?

Mark Oelschlager: It's probably fair to say the easy money has been made. Of course it's only easy in retrospect. I may have laid out a scenario that did more or less come to fruition, but as I said then, you always feel like you're missing something. You can never be sure things are going to play out as you expect, which is why you should be hesitant to bet the farm on any one outcome. I should have gone even bigger than I did, but you always feel that way – after the fact – when something works.

This has been going on for a while, but the big-picture issue for me these days is how much the macro – specifically the influence of interest rates – is dominating the dynamics of the market. More growth-oriented stocks tend to trade very much in line with Treasury bond prices, while lower-valued stocks tend to trade inversely to bond prices. That's notable in itself – the correlations are stronger than what we've seen historically.

Also interesting is that if you look at the forward P/E of stocks most correlated to Treasury bonds, it's never been as high relative to the market. And the forward P/E of the stocks most inversely correlated to Treasury bonds has never been lower. That's driving my pretty strong bias toward the anti-correlated group because you're getting paid more to make that bet. I'm not all in on that because there are other explanations for the valuation relationships that exist today, but I gener-

ally think the risk/reward on lower-valued stocks today is quite a bit better.

To come to that conclusion do you have to have an opinion on interest rates?

MO: It's difficult to predict interest rates, but I believe there's more upside to rates than downside, especially with real rates currently at multi-decade lows. Money has been loose as the Federal Reserve has flooded the system with cash and government spending has ballooned. It's likely that this has distorted the prices of stocks and various other assets, from cryptocurrencies to NFTs.

That sets up an interesting parallel with when we spoke last year. Then the market was behaving as if the prevailing set of conditions were going to exist for a long time, even though there were solid prospects for effective Covid vaccines. It was as if the market was saying, "Yeah, I know things are likely to change, and that that will change the market dynamics, but I'm still going to play the current game until it stops working." Sure enough, when the good news on vaccines came out, the shares of the Covid casualties spiked and those of the Covid beneficiaries declined.

Today there are all sorts of securities seemingly being propped up by loose money, but while an end to that loose money is in sight – inflation is high and the Fed has said it will gradually end its asset purchases – the market seems to be saying, "I'm waiting until it actually happens." Securities seen as beneficiaries of loose money continue to levitate. It's like a game of chicken. We know the ride is ending – some of the air has come out of the frothiest parts of the market – but people generally don't want to be the first one off. The stock market generally looks ahead, but it's almost as if it hasn't been doing that as much as it historically does.

Would you say there are any themes underpinning the lower-valued stocks you find interesting today?

MO: From a sector perspective, I would say financials look relatively attractive. Bank stocks in particular still trade at a significant discount to the market, at a time when credit quality is high and reserves are in excellent shape. Often at the end of a cycle you see banks get more reckless with their lending, but we're not anywhere near that right now. So it comes down to the potential for loan growth and an expansion of net interest margins that would come from higher interest rates. We think both of those are more likely to work in banks' favor rather than against them over at least the medium term.

More generally, valuation excesses out there aren't at all across the board. People are so interested in trying to make a killing in the next hot tech stock that they seem to be overlooking what might be considered boring, steady-Eddie businesses that are trading at interesting valuations. That's where I'm finding the most opportunity.

You wouldn't think it would fall in that category given what it does, but describe your interest today in cybersecurity firm Check Point Software [CHKP].

MO: This is one where it's hard for me to figure out why the stock trades where it does. Check Point is a leader in providing

INVESTMENT SNAPSHOT

Check Point Software
(Nasdaq: CHKP)

Business: Provider of enterprise-wide technology solutions meant to protect corporate and governmental clients against malware, ransomware and other forms of cyber attack.

Share Information (@12/30/21):

Price	**116.52**
52-Week Range	107.85 – 137.49
Dividend Yield	0.0%
Market Cap	$15.75 billion

Financials (TTM):

Revenue	$2.13 billion
Operating Profit Margin	42.8%
Net Profit Margin	38.8%

Valuation Metrics
(@12/30/21):

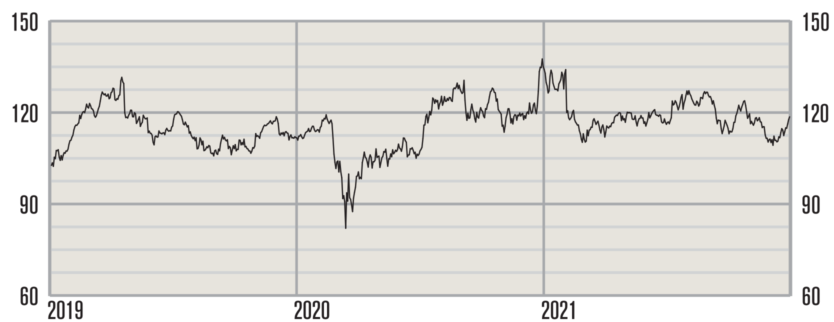
	CHKP	S&P 500
P/E (TTM)	19.2	28.8
Forward P/E (Est.)	15.9	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Massachusetts Fin Serv	5.6%
Harding Loevner	3.7%
Franklin Mutual Adv	3.0%
BlackRock	2.8%
Ninety One UK	2.6%

Short Interest (as of 12/15/21):

Shares Short/Float	5.3%



THE BOTTOM LINE
Mark Oelschlager expects the company's business to prove far more durable than is implied by the discount at which its shares trade relative to small, less-advantaged competitors. He would be content as a shareholder to earn the free-cash-flow yield at which the stock now trades, but expects a valuation re-rating to provide added upside.

Sources: Company reports, other publicly available information

computer and network security solutions, an area of secular growth as technology plays a bigger role in everyone's lives and the frequency and severity of threats increase. It's still run by the founder, Gil Shwed, and it consistently grows the top line at a mid-single-digit annual rate and generates returns on equity above 20%, with no debt. The business requires little capital investment, so it generates tremendous free cash flow. Over the past seven years free cash flow per share has increased every year and in that time has more than doubled. The top-line growth maybe doesn't get most investors' blood pumping these days, but the company otherwise has all the hallmarks of a great business.

The concern appears to be over competition from new players that have entered the field in recent years. So the key question is how durable Check Point's technology and business proves to be. I'd say a few things with respect to that. First of all, enterprises in an area like this gravitate to the bigger players, and switching costs tend to be high. You're less likely when it comes to cybersecurity to take a chance on a less-established competitor, and once you have an integrated solution it's not easy, cheap or without risk to switch.

Another advantage of experience and scale is that the more customers you have, the more threats you see, intercept and build defenses against. It's not a network effect like Google or Facebook might benefit from, but there is a self-perpetuating element to the business that makes a company like Check Point more attractive to existing or potential customers.

I would also highlight that this is a smart management team, run by a founder who owns close to 20% of the company and has proven to be a responsible capital allocator, which isn't always the norm in tech-land. You could argue they weren't a first mover in transitioning the business to the cloud, but they're never far behind and have consistently invested in new initiatives or acquisitions that have kept the business growing solidly and profitably over time. With no debt and $4 billion in balance-sheet cash, I think they're well positioned to continue along that path.

How inexpensive do you consider the shares at today's price of $116.50?

MO: Some of the newer competitors trade at 30-40x sales, but Check Point's stock today is at a trailing free-cash-flow yield on enterprise value of nearly 10%. And it's not that the high yield is explained by unsustainably high free cash flow; it has consistently grown year-in and year-out. If free cash flow per share stopped growing and stayed where it was over the next several years, I'd still consider this a very attractive investment at a 10% yield. Meanwhile, holding results steady, if the market wakes up one day and ascribes a yield of, say, 7% to that cash-flow stream – which would still be cheaper than the market average – the stock would be 45% higher.

ON OPPORTUNITY TODAY:

If loose money boosted asset prices, it stands to reason that tighter money may harm them.

The last thing I'd mention is that if you're worried about the market, this should prove to be a pretty defensive holding. If we have a 20% correction, I think it's very likely Check Point goes down less than 20%. That's another reason I think the market is making a mistake in overlooking something like this.

Describe your case for another "boring steady-Eddie," naval defense contractor Huntington Ingalls Industries [HII].

MO: Huntington Ingalls along with General Dynamics is one of two big shipbuilders for the U.S. military. You can dig into the product portfolio and make a case for incremental growth or decline in this program or that, but the reality is that the Navy will continue to need and budget for aircraft carriers, assault ships and submarines and that the vast majority of that spending will go to the two oligopoly competitors. Huntington's order backlog is massive, and with long project lead times the predictability of the business is high.

I describe the business that way because being dependent on the federal government has its pros and cons. On one hand, the government is going to control to an extent how much profit you make, but on the other hand it also wants you to survive and do reasonably well. I've learned over the years that it's difficult, and even hazardous, to make investment decisions based specifically on how you think government policies are going to change. I have a high degree of confidence that overall demand is going to continue to be there for the types of products Huntington makes. There are only two companies that can meet that demand and they have been fairly compensated for doing so. As long as that continues, you can get a fairly good sense of what that should be worth.

The company has been building out its software and systems expertise. Do you consider that money well spent?

MO: What they call Technical Solutions is now about one-quarter of the overall revenue and I've seen no reason so far to question the strategic rationale for the company to own more of the IT built into its programs. They know what the customer needs and wants and see this as a way to better deliver that. That all seems reasonable to me, though I always worry about companies overpaying for acquisitions. Huntington Ingalls took on additional debt for its recent $1.65 billion acquisition of Alion Science and Technology, and it's too early to tell if that price was appropriate or not.

How are you looking at valuation here with the shares trading recently at just over $185?

MO: The stock is still materially below where it was pre-pandemic and trades at just over 11x trailing earnings. Part of that might reflect concern about Covid-related impacts on supply chains and labor costs. It also might reflect short-term concerns

over U.S. military spending. Looking further out, though, I'd argue that the durability and profitability of the business is worth quite a bit more than 11x earnings. While revenue growth may not be exciting, it's also not bad. Total revenue over the last four quarters was $9.6 billion, up from around $7 billion in 2016.

This is another idea that looks like a pretty solid business that should trade at a higher valuation. Just getting back to a long-term market multiple of 16-17x would result in healthy upside from here.

If we get back in touch in a year for another update, what do you think we'll most likely talk about?

MO: That's a very difficult question, but it's probably not a stretch to think interest rates and inflation will be worth talking about. It will be interesting to see how much the Fed raises rates and the effect that has on asset prices. If loose money boosted asset prices, it stands to reason that tighter money may harm them. Some people believe the economy can't withstand significant rate hikes, but if inflation stays elevated, the Fed may not have a choice. Because inflation was low, the Fed for years could basically provide as much liquidity as it wanted to help the economy, and the market. That appears to have changed.

There's also the question of how much longer the great growth-stock run can continue. Will their superior top-line growth, margins and intangibles continue to be self-perpetuating, or will competition, policy, or a shift in market dynamics cause their valuation premium to narrow? These are questions I spend a lot of time thinking about. I'll also say this: Even though low-quality assets – unprofitable growth companies, meme stocks, NFTs, etc. – have corrected to a degree, I would not want to own them over the next year. VII

INVESTMENT SNAPSHOT

Huntington Ingalls Industries
(NYSE: HII)

Business: Manufacturer of nuclear-powered and non-nuclear-powered aircraft carriers, amphibious assault ships and submarines primarily for one customer, the U.S. Navy.

Share Information (@12/30/21):

Price	**185.23**
52-Week Range	156.36 – 224.13
Dividend Yield	2.5%
Market Cap	$7.43 billion

Financials (TTM):

Revenue	$9.60 billion
Operating Profit Margin	8.7%
Net Profit Margin	7.0%

Valuation Metrics
(@12/30/21):

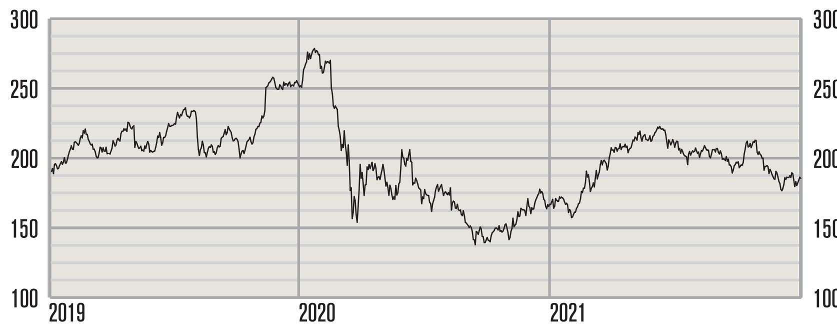
	HII	S&P 500
P/E (TTM)	11.1	28.8
Forward P/E (Est.)	12.8	22.7

Largest Institutional Owners
(@9/30/21 or latest filing):

Company	% Owned
Vanguard Group	11.1%
BlackRock	8.5%
State Street	8.1%
Fidelity Mgmt & Research	4.1%
Franklin Mutual Adv	3.3%

Short Interest (as of 12/15/21):

Shares Short/Float	2.1%



THE BOTTOM LINE

Given the company's "massive" project backlog and the relatively high predictability of its business, Mark Oelschlager believes the market is undervaluing the company's future prospects in paying just over 11x trailing earnings for its stock. "Just getting back to a long-term market multiple of 16-17x would result in healthy upside from here," he says.

Sources: Company reports, other publicly available information

To determine if this Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors, and charges and expenses before investing. This and other important information about the investment company can be found in the Fund's prospectus and summary prospectus. To obtain a prospectus or summary prospectus, call 877-593-8637. Please read the prospectus carefully before investing.

Mutual fund investing involves risk, including loss of principal. The value of the Fund's investments will vary from day to day in response to the activities of individual companies and general market and economic conditions.

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Towpath Focus Fund (TOWFX) seeks long-term capital growth by investing primarily in U.S. equity securities and typically holds 25-40 positions in companies of any size.

Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its stock price.
Market capitalization refers to how much a company is worth as determined by the stock market.
Net profit margin is the ratio of net profits to revenues for a company or business segment.
Operating profit margin measures how much profit a company makes on a dollar of sales after paying for variable costs of production, such as wages and raw materials, but before paying interest or tax. It is calculated by dividing a company's operating by its net sales.
The **price-to-earnings ratio** (P/E ratio or P/E multiple) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

As of December 31, 2021, Towpath Focus Fund's top ten holdings are:
Alphabet 6.1%
Bank of New York Mellon 4.6%
Charles Schwab 3.9%
Atlantic Union Bankshares 3.4%
GlaxoSmithKline 3.3%
McKesson Corp. 3.0%
AmerisourceBergen 3.0%
Prestige Consumer Healthcare 2.9%
Gentex Corp. 2.8%

Quest Diagnostics Inc 2.7%

Current and future portfolio holdings are subject to risk and change.

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