November 7, 2017

October 2017 - Performance Update

If you are an accredited investor, please contact us for performance information.

Markets often experiences "short term turbulence" that produces knee-jerk reactions and impacts stock prices. To that end, we are currently in the middle of Wall Street's earnings seasons, and individual company performance is highly idiosyncratic based on reported results and the market's interpretation for company forecasts for the next year. While the overall portfolio rose sharply, there a few positions that contributed negatively. It is worth mentioning the losers, as the winners "take care of themselves".

- Specific to Arch Capital Group Ltd., the unprecedented hurricane season, Harvey, Irma and Maria, (Houston, South Florida and Puerto Rico) along with the Mexican earthquakes negatively impacted insurance and reinsurance businesses. Industry insured losses (including marine and energy losses) are expected to be substantial and reflect expected reinstatement premiums. As a result, Wall Street reacted with a sell off.
- With respect to AmerisourceBergen, the reports that Amazon.com (see below) may enter the pharmaceutical supply chain served as a drag. An industry-wide slump in generic drug prices, and slowing price hikes for branded drugs continue to weight on investor sentiment.
- TJX, the parent of T.J. Maxx, Marshalls and HomeGoods, has come under the Amazon threat (see below). The threat, real or perceived, of being "Amazoned" can impact a stock or an entire sector. The fact remains that in the TJX case, consumers are still shopping for clothes at off-pricer retailers such as TJX-owned stores due to the in-store treasure-hunt, and the bargain-rack shopping nature of the American consumer. TJX continues to grow sales and earnings, and we see the recent declines in the stock as unjustified.

One month is far too short to judge performance. At LRT, we try to abstain from excessive self-flagellation after a losing month and excessive victory laps after positives months. With that said, we remain vigilant to process and detect threats to performance and see no material reasons why our consistent performance cannot be sustained going forward.

Internet Delusions

Every day I read about Amazon – what Amazon is doing, what it will do, what it may do. This obsession with Amazon has real world consequences. Simply by announcing the purchase of Whole Foods, Amazon has wiped out a third of the stock market value of Kroger. A similar faith has befallen the auto parts retailers and pharmacies. Investors should really ponder if this is a rational reaction.

The common story from investment bank analysts has become: Amazon is in your industry, sell; Amazon might enter your industry, sell; Amazon will not enter your industry, you must be in a terrible industry, sell. Amazon is an incredible organization but they are not omnipotent. The great delusion of our times is Amazon – a company priced so highly that everything must go right for it to justify its valuation.

Amazon has expanded into many industries. The company has access to incredibly cheap capital as investors have bid up its valuation. But cheap capital and scale isn't everything and the incumbents in a number of industries will find ways to fight back against the Seattle giant. Amazon's success is not magic. It's business economics – and in some areas Amazon can and is more likely to be successful than in others. It's cloud business, AWS, is incredibly successful, while its forays into cellphones and travel search have been less so.

Today I want to focus on one sector where stocks have suffered in anticipation of the "Amazon effect": aftermarket auto parts retailers. The companies in this sector have produced very impressive returns for shareholders, with the "Big 4", Autozone, O'Reilly, Advanced Autoparts and GPC (parent of NAPA), now accounting for more than 50% of industry sales. Historically, the Big 4 have achieved high returns on invested capital (ROIC), high free cash flows, expanding bargaining power with suppliers and growing market shares. Together this has translated terrific 10-year annualized rates of return for O'Reilly (19.93%), Autozone (16.91%), Advanced Autoparts (10.12%) and GPC (8.96%), respectively. By comparison the S&P 500 delivered a total return of 7.4% annually over the same time horizon. What's more, the aforementioned companies delivered these returns with only 80% of the volatility of the S&P 500.

The Big 4 create value by stocking a huge assortment of slow moving inventory close to their customers. DIYers who want a specific part can immediately pick it up from any of the 20,000+ stores owned by the Big 4. Auto repair shows can have the part delivered to them, generally in under 60 minutes, allowing them to maximize the utilization of their service bays and technicians. The infrequency of purchases and the technical nature of the products discourages DIYers from shopping around. Driving from store to store comparing prices is expensive, and who really knows how much an alternator for a 2006 Nissan Altima should cost? Similarly, auto repair shops generally pass on the cost of parts to the customer. Finally, many simple parts are often installed for customers by store service reps, and returns are quick and easy. All of this translates into pricing power, with gross margins at O'Reilly and Autozone, the two best run of the Big 4, at over 50%. However, stock prices for the Big 4 have declined as much as 40% during the past 18 months driven by fears of Amazon's more aggressive push into the auto parts business.

At LRT, we believe that these fears are overblown and that Amazon will struggle to replicate the highly specialized supply chain and customer service developed by the Big 4. In fact, online auto parts sales are not a new phenomenon with both Amazon and RockAuto selling parts online for several years now. It is the small, mom-n-pop auto part stores that are most likely to be hurt by the increasing competition in this industry.

Both Autozone and O'Reilly are currently trading at meaningful discounts to their historic valuations and to the market as a whole. Both companies are likely to be in business a decade from now. We view both companies as possessing significant moats, above average free cash flow and the ability to grow through consolidation. Auto part retailers are one of the very few places in today's richly valued market where investors should be putting new capital to work. You can be sure that we have acted accordingly.

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Your individual account statements will be distributed in approximately two weeks. As always, your questions are welcomed.

Sincerely,

Lukasz Tomicki

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