Market Overview

The U.S. equity markets continued their yearlong rally into the fourth quarter with many indices and sectors closing at new highs.[i] Technology companies led the way with Microsoft and Apple both eclipsing the $1 trillion market cap level.[ii] The NASDAQ index, which is heavily technology focused, reached new highs, and had the best performance since 1999.[iii] Based on returns, equity markets appeared to overlook trade wars, Brexit, slowing global growth, earnings pressures, and finally impeachment. However, in the fourth quarter as markets looked ahead towards improving 2020 earnings and a better global economic environment, we observed a rotation to the more cyclical financial and industrial sectors. The only sector that significantly lagged was energy, despite the price of oil increasing to $60 per a barrel, up 30% from the start of the year.[iv]

U.S. Economy

Managed Accounts Model Performance[v]

Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

Strategy Performance	4Q19	YTD	10 Year Annualized
Anchor Mid Cap Value (Pure Gross)	5.86%	30.16%	11.92%
Anchor Mid Cap Value (Net)	5.06%	26.31%	8.61%
Russell Mid Cap Value	6.36%	27.06%	12.41%
Russell Mid Cap	7.06%	30.54%	13.19%

We have more recently been asked if we are going to see a recession. We do not have a crystal ball – however, we have observed that with prior recessions there was an excessive level of speculative behavior and significant over investment in several sectors of the economy. Recall that Y2K was one justification for the optimism surrounding Technology in anticipation of the year 2000 and why prices and investment in housing driven by excessive debt, reached unsustainable levels. Today, despite individual examples, we see much more rational behavior and very little of the "irrational exuberance" that could signal an end to the current economic cycle as it enters a record 11 years. For example, We Work tried to go public at an initial valuation of $40 billion, but failed to go public at any price as the market became very skeptical of its questionable business model and significant governance and leadership deficiencies.[vi]

The U.S. economy continues to be positive in the fourth quarter as employment numbers remained strong, consumer spending was robust, and housing numbers increased. The U.S. consumer, driving 70% of the GDP is helping with the expansion story.[vii] Manufacturing has been impacted by the U.S. and China trade war. This is evidenced by the Purchasing Managers Index (PMI) entering contraction territory in China and close to contraction in the U.S., which more recently has started to turn positive.[viii] It appears that the U.S. and China have reached a Phase One deal which prevents additional tariffs and helps facilitate some trade of agriculture products.[ix] U.S. CEO's have been uncertain about the trade talk progress and it is estimated that if the investment withheld in 2019 is invested in U.S. companies in 2020, it could add 0.5% to GDP growth.[x]

The Fed and Interest Rates

Another positive development was that the U.S. Federal Reserve (Fed) cut interest rates for the third time in 2019 with the latest cut in October.[xi] The interest rate yield curve had inverted in June, with the two-year yield higher than the ten-year yield, which often portends a future recession.[xii] To prevent a recession and slowing economy, the Fed quickly acted to cut rates.[xiii] Currently, there are opposing expectations for another Fed rate cut or if the economy does improve, the potential to increase rates late next year. The Fed has also stepped into facilitate the repo market. In addition to buying short-term treasuries to ensure there is enough liquidity in the market, it is now increasing its balance sheet.[xiv]

Fixed Income

With fixed income yields so low and the spreads between corporate bonds and treasuries narrow, we view equities as being more attractive than bonds.[xv] We are uncertain about the direction of interest rates, although we believe they could move a bit higher, but be relatively range-bound. In general, with Anchor balanced portfolios, we minimize our risk taking on bonds and use that as an opportunity on the equity side. We focus on high quality bonds that can have price appreciation and generate income while managing duration exposure.

Growth vs. Value

We are value investors in that we look to buy a stock at a valuation level that is relatively attractive and provides a margin of safety. We try not to become caught up in the growth versus value label as you will find stocks in the value indices that have growth attributes. The popular press is making a big deal of the performance spread between the growth and value indices. In 2019, there was a 10% performance spread between the Russell 1000 Value and Russell 1000 Growth indices.[xvi] We have not seen this wide of a spread between the factors since 2007 when value was significantly outperforming growth. Related to that is the valuation of the Russell 1000 Growth index is 21.5x 2020 earnings while the Russell 1000 Value index is 14.6x 2020 earnings, an almost 7 turns difference.[xvii] What we focus on more than classifications is whether we deem the company to be high quality, have attractive fundamentals, and be at a value price. To protect capital we continue to look for interesting companies that we can hold for long periods.

Valuations

As mentioned earlier we believe valuations are not stretched for the overall market. The S&P 500 index is trading around a turn higher than its average, the Russell Mid Cap index is trading about a half turn higher than its average and the Russell 2000 (small cap) index is trading around a turn and a half below its average.[xviii] Small caps in terms of valuation look attractive and that is primarily due to the higher weightings in financials and energy stocks, which have lagged until the last quarter.[xix] There are individual stock valuations that are stretched and we pay attention to valuation in our portfolio holdings. We routinely take profits or sell out when we see a stock valuation becoming elevated.

Cash

Cash is a natural outcome of our investment process and is most often based on three outcomes: valuation levels, take-outs of portfolio holdings, and availability of attractive investments. When valuations are high, we are typically selling or trimming positions, and frequently we see at least a couple of take-outs in the portfolios each year - both of which result in higher cash levels. Cash levels may stay high if we do not find new stocks to buy at attractive valuations. This year we have uncovered a number of interesting new stocks to add to portfolios, therefore averaging out cash levels within our portfolios.

Conclusion

Despite the markets reaching new highs we continue to find interesting stock ideas. Our focus is steadfast to finding well run, standout companies that are leaders in their respective industries and are maximizing shareholder value for the long run. When valuations become too stretched we will start paring back and raising cash, but currently we still see opportunities at attractive valuations as we go into the new year.

STRATEGY DETAIL

Quarterly Attribution[xx]

Security Contribution (5 Highest)
Ubiquiti Inc. (UI)
First Republic Bank (FRC)
NuVasive, Inc. (NUVA)
Liberty Broadband Corp. Class C (LBRDK)
SS&C Technologies Holdings, Inc. (SSNC)

Security Contribution (5 Lowest)
Hasbro, Inc. (HAS)
Hexcel Corporation (HXL)
Cinemark Holdings, Inc. (CNK)
Dorman Products, Inc. (DORM)
Baxter International Inc. (BAX)

Sector Contribution (3 Highest)
Technology
Financial Services
Producer Durables

Sector Contribution (3 Lowest)
Materials & Processing
Consumer Staples
Utilities

Quarterly Purchases

- Diamondback Energy, Inc. (FANG)
- Insperity Inc (NSP)

Quarterly Sales

- Cabot Oil & Gas Corporation (COG)

Further Insight: Stock Position(s)

Diamondback Energy (FANG)

Energy has been one of the hardest hit sectors over the last few years and valuations have come down across the board. While we do not devote a large amount of time to selecting energy stocks, we do believe there are opportunities to generate returns. In particular, we have focused our time on exploration and production (E&P) companies that we find have the best oil producing assets and are relatively well run. Furthermore, given potential geopolitical pressures we want exposure to oil commodities who will benefit as the commodity price increases.

We identified Diamondback Energy as a company that has been beaten up as a result of the sell-off in oil.[xxi] Since the summer it has traded for less than 10x price to earnings.[xxii] Diamondback drills for oil and gas in the U.S. Permian Basin with 342,000 acres in the Delaware and Midland Basin.[xxiii] It has issued guidance that it can increase production by 10-15% in 2020.[xxiv] In addition, Diamond is the low cost leader per unit of operations and can generate positive free cash flow at $45/barrel WTI oil price.[xxv] The company has driven oil well costs down 13% - 18% over the last year.[xxvi] If costs remain low and oil stays around $60/barrel then Diamondback expects it can generate close to $1 billion of free cash flow.[xxvii] From a capital allocation perspective, the company is keeping net debt to EBITDA reasonable at 1.6x, increasing the dividend by 50% in the last year and repurchasing shares.[xxviii] Overall, we have seen a transition from energy companies who routinely came to the capital markets and burned through shareholders cash to one where they are focused on costs, free cash flow and returning cash to shareholders.

Insperity (NSP)

A number of our opportunities come from stocks that are out of favor with the market. We identified Insperity after its stock price dropped by half after it missed two quarters of earnings.[xxix] Insperity is a Professional Employee Organization (PEO), which outsources human resources (HR) for small medium sized businesses (SMB).[xxx] With the growth in government regulations and laws, it is difficult for SMB to manage all aspects of HR included health insurance and benefits.[xxxi] Insperity has a scale advantage in providing HR functions including payroll, admin, benefits, and compliance.[xxxii] PEOs in have been growing 10% per year.

Insperity has a high single digit market share after ADP and Paychex and has been pursued by potential bidders in the past. It is known for high touch, high service and clients are diversified across industries and geographies.[xxxiii] One of the Insperity's benefits is managing health care costs for SMBs.[xxxiv] More recently, Insperity experienced higher than normal healthcare claims and this has only happened three times in the last ten years.[xxxv] Insperity will increase pricing with contract renewals to offset the increased healthcare claims.[xxxvi] Overall, Insperity is projecting 10-15% top line growth, 20% EPS and strong free cash flow generation.[xxxvii] After this short term hiccup we expect that the company will regain its footing and grow again. As value investors, with the stock down over 25%, this seemed like an opportune time to enter a high quality business with above average ROA and top line growth.

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[i] FactSet financial data and analytics; Charting
[ii] Ibid.
[iii] Ibid.
[iv] Ibid.
[v] eVestment Analytics. Gross of fee returns are presented Pure Gross and are calculated before management fees, custodial fees and transaction costs.
[vi] https://www.wsj.com/articles/2019-the-year-of-ipo-disappointment-11577615400?mod=searchresults&page=1&pos=8
[vii] https://www.usatoday.com/story/money/2019/08/29/gdp-up-2nd-quarter-consumer-spending-rises-us-economy-slows/2150057001/
[viii] https://tradingeconomics.com/united-states/manufacturing-pmi
[ix] https://www.wsj.com/articles/trump-says-he-will-sign-phase-one-trade-deal-with-china-on-jan-15-11577802332
[x] Stiefel Research, Barry Bannister
[xi] https://www.nytimes.com/2019/10/30/business/economy/federal-reserve-interest-rates.html
[xii] https://www.cnbc.com/2019/08/14/the-inverted-yield-curve-explained-and-what-it-means-for-your-money.html
[xiii] https://www.nytimes.com/2019/10/30/business/economy/federal-reserve-interest-rates.html
[xiv] https://www.cnbc.com/2019/11/07/the-feds-monetary-juice-has-tied-directly-to-the-rise-in-stocks.html
[xv] FactSet financial data and analytics; Charting
[xvi] Ibid.
[xvii] Ibid.
[xviii] Ibid.
[xix] Ibid.
[xx] FactSet financial data and analytics; Attribution
[xxi] FactSet financial data and analytics; Charting
[xxii] Ibid.
[xxiii] https://ir.diamondbackenergy.com/static-files/8df63284-bef7-4491-8447-d60d07a8f99d
[xxiv] Ibid.
[xxv] Ibid.
[xxvi] Ibid.
[xxvii] Ibid.
[xxviii] Ibid.
[xxix] FactSet financial data and analytics; Charting
[xxx] https://insperityinc.gcs-web.com/static-files/ca51fbd8-63e6-44f5-86b5-3a4343d9660b
[xxxi] Ibid.
[xxxii] Ibid.
[xxxiii] Ibid.
[xxxiv] Ibid.
[xxxv] Ibid.
[xxxvi] https://www.insperity.com/investor-relations/?i=news-releases
[xxxvii] Ibid.

Mid Cap Value Model Disclosures

MODEL DESCRIPTION: The Anchor managed accounts mid cap value (mcv) model was created on 12/31/05. The model returns do not reflect actual trading. Anchor Capital's managed accounts division created this model for purposes of presenting performance results, which approximate those of the managed accounts mid cap sponsor program portfolios in aggregate. The investment objective for the model is to achieve a high rate of return through the purchase of mid cap stocks.

MODEL DISCLOSURES: The model transaction history does not reflect all portfolio transaction activity for accounts in the sponsor program. Model transactions correspond with trading activity generated in the course of investment for substantially all accounts in the sponsor mid cap program. Model transactions and holdings do not reflect individual portfolio activity for new account investments, or account activity and holdings in various individual portfolios subject to tax considerations or individual client discretion. Model performance may differ materially from individual client portfolio results.

CALCULATION OF RATES OF RETURN: All securities in the model are valued at last sale price, as provided by independent pricing services. The portfolio valuation is reflected on a trade date basis. Model investment returns include the reinvestment of income. Effective 1/1/2010, dividends (excluding income on money market securities) are credited on an accrual basis. Time-weighted portfolio returns are calculated for each monthly period in the prior quarter. Quarterly model results are linked to determine annual returns. Individual client portfolio results may vary from the results presented for the model because of different investment objectives, tax status and other considerations. Returns of individual client accounts will be reduced by advisor fees and other expenses which might be incurred to provide investment management, custody, administrative, actuarial, accounting or other services to the client. The Russell Mid Cap Indices exclude fees. The Managed Accounts Mid Cap Value model returns are calculated on a pure gross of fee basis, before the deduction of Anchor Capital management and sponsor wrap fees. For all periods presented, the net of fee returns are calculated by compounding the monthly net returns to calculate the quarterly, YTD and annual returns. The numbers may be slightly different from net returns published in other Anchor Capital materials created outside of Style Advisor prior to 6/30/2017, which were calculated by simply subtracting 3% from the annual gross return. Additional information regarding policies for calculating and reporting model returns is available upon request.

BENCHMARK DESCRIPTION: The Russell Midcap Value Index measures the performance of the mid cap value segment of the U.S. equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell Midcap Value Index is constructed to provide a comprehensive and unbiased barometer of the mid cap value market. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid cap value market. The Russell Midcap Index measures the performance of the mid cap segment of the U.S. equity universe. The Russell Mid cap is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies. The Russell Midcap Index is constructed to provide a comprehensive and unbiased barometer for the mid cap segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid cap opportunity set. The benchmark returns include the reinvestment of income.

For a complete listing of all strategies contact Anchor Capital Advisors LLC (617) 338-3800.