ANCHOR
CAPITAL ADVISORS LLC

Value Opportunities
Portfolio Commentary
As of March 31, 2023

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Overview

It has been a very eventful quarter. The year started with hopes that we may avoid or see only a shallow recession. As a result of slowing economic growth coupled with the retrenchment of the banking sector in the wake of several bank failures, a recession has become more probable.

While it appears that regulatory failure and management oversight were the main issues, the regional banking crisis is more nuanced than that. In the last two years, deposits at banks have doubled due to stimulus payments and market appreciation. Meanwhile, interest rates have increased significantly causing the bank's investment portfolio bonds to lose value to levels below the deposits on hand. This caused an asset/liability mismatch.[i] The speed of interest rate increases has seemingly caught many banks unprepared. With over 60% of people in the U.S. using mobile banking[ii] and having the means to transfer money online helped accelerate withdrawals. This left us concerned about the ripple effect a banking crisis could have on the economy.

The Federal Reserve stepped in to backstop the banks by purchasing bank held government and treasury bonds at face value. These bond purchases allowed banks to raise cash to cover deposits.[iii] While not an explicit guarantee, it has helped provide support for the banks. In the last few weeks, the Federal Reserve has used over $300 million of its balance sheet to do so.[iv] The markets rebounded in late March on the news of the support to banks.

As a result, banks will now hold on to more cash, lend out less and be generally less profitable. Tighter lending and credit markets will cause the economy to slow down. We expect continued shakeout in the banking sector with the larger banks taking share from both small and medium sized banks. After several years of significant hiring by all the major tech firms, most are now having to reduce their headcount given slowing sales.[v] On the positive side, we are seeing rapid developments in artificial intelligence (AI).[vi] Microsoft was an early investor and adopter of ChatGPT, an AI tool used to answer questions for people in search engines, which we believe has given it a first mover advantage.[vii] Many other technology firms are quickly racing to develop their own AI tools. These cost cutting measures plus the excitement around AI has led the technology and communication services sectors to outperform.

U.S. Equity Markets

Despite high levels of volatility over the quarter, equity market performance was better than expected. The quarter began strong as the hardest hit stocks of 2022 rallied the most.[viii] As we entered February, Fed Chairman Powell indicated they were going to continue to raise interest rates and they would stay higher for longer. This dashed the hopes of many investors who believed that the Fed would pivot and start cutting rates[ix], which resulted in the markets selling off. In March we saw a banking crisis that resulted in three major banks failing and put others in jeopardy. This spurred the concern that we are now headed for a recession causing other cyclical parts of the market, like energy and materials, to sell off. However, with the Fed stepping in to shore up the banks, it allowed for a relief rally at the end of the quarter.

The technology and communication services sectors outperformed, while energy, utilities and financials sectors performed the worst.[x] Despite all this, the Nasdaq was up 17% and the S&P 500 was up 7.5%.[xi] Meanwhile, the Dow Jones, which has larger weights in the financials and energy sectors, was slightly up at 0.9%.[xii] Small Cap stocks were hit the hardest, but then rebounded ending is positive territory (+ 2.7%) for the quarter.[xiii]

U.S. Fixed Income

Since February, the front end (or 12 months) of the Treasury yield curve has steepened as a result of the Fed interest rate increases. Farther out on the curve, interest rates have declined on the speculation of a recession. This has caused price appreciation/positive performance in bonds, especially longer dated bonds. [xiv]

Credit spread between corporate and treasury bonds have been widening. Credit spreads typically widen when there are credit concerns and increased potential for default. Credit spreads were tight and did not indicate a recession until the recent banking crisis.[xv]

Commodity Markets

The commodity markets are anticipating a recession with demand decreasing. Oil prices have fallen from $80/barrel to $75/barrel over the quarter.[xvi] We don't believe there will be a massive sell off in oil given that U.S. oil producers have been limiting production. Also, with China re-opening post Covid, we think there is demand. We have seen commodities increasing in two cases. First, copper prices have been increasing due to global demand for more electric batteries and limited supply of copper.[xvii] Secondly, due to the global banking crisis, gold has been increasing as a safe-haven asset.[xviii]

Inflation

Inflation peaked in June 2022 and has been steadily falling each month since then. The most current Consumer Price Index (CPI) reading was 6% annualized.[xix] While the easy deceleration has happened, the challenge becomes getting the rate back to the Fed target of 2%. Inflation remains sticky in many parts of the economy, most notably wage growth. Goods inflation has fallen while services inflation has continued to increase. There have been many reports about the airlines and railroads having negotiated higher wages, and retail stores have also increased wages to remain competitive. To get rid of high inflation, demand needs to fall. That usually occurs during a recession.

Interest rates/Fed/Economy

Given the persistently high inflation, the Fed has been focused on raising interest rates to bring inflation down. Since March 2022, the Fed has increased interest rates nine times, bringing the rates from essentially 0% to 4.75% during that period.[xx] This has been one of the fastest periods of interest rate increases we have seen in recent history. Historically, there has been a lag effect between raising interest rates and how the economy reacts. We have just started to see the economy slow down. As mentioned before, Chairman Powell wants his legacy to be as an inflation fighter. To bring inflation closer to the Fed's mandate of 2%, interest rates would need to continue increasing. Given the banking crisis and level of national debt, the Fed is walking a tightrope. Investors are hoping that the Fed pauses or even cuts interest rates by year end.

The Treasury yield curve has been inverted over this period, which historically has indicated a recession 12 to 24 months out. Usually, the yield curve reverts when the Fed starts to cut interest rates.

Economic data continues to soften. The Purchasing Manager's Index (PMI), which measures manufacturing activity, continues to be in contraction mode with a reading below 50.[xxi] Retail sales in February declined by 0.4% month over month.[xxii] Existing home sales, which is facing over 7% 30-year fixed mortgage rates,[xxiii] has declined 12 months in row.[xxiv] The only area that continues to be supportive is the jobs picture with employment remaining fairly tight.[xxv] However, with more economic pressures we expect that job layoffs will pick up.

Performance Overview

The Anchor Capital Value Opportunities Portfolio outperformed the Russell 3000 Value index for the quarter. On a relative basis, the Portfolio benefitted the most from security selection in the Health Care and Energy sectors as well as an underweight allocation to the Financial sector. Security selection in the Real Estate and Consumer Discretionary sectors as well as an overweight allocation to the Consumer Staples sector were the greatest detractors from performance.

Quarterly Attribution Highlights[xxvi]

Sector - Top 3 Contributors	Sector - Bottom 3 Detractors
Technology	Financials
Industrials	Real Estate
Consumer Discretionary	Health Care

Security - Top 5 Contributors	Avg. Weight %	Contribution %	Security - Bottom 5 Detractors	Avg. Weight %	Contribution %
Salesforce, Inc. (CRM)	1.51%	0.61%	First Republic Bank (FRC)	0.94%	-0.39%
Marathon Petroleum Corporation (MPC)	2.40%	0.37%	Dollar General Corporation (DG)	2.16%	-0.34%
Analog Devices, Inc. (ADI)	1.72%	0.32%	NV5 Global Inc (NVEE)	1.44%	-0.34%
Apple Inc. (APPL)	1.23%	0.32%	Johnson & Johnson (JNJ)	2.43%	-0.30%
Microsoft Corporation (MSFT)	1.53%	0.30%	CVS Health Corporation (CVS)	1.26%	-0.28%

Quarterly Transactions

Purchased	Sold
Boot Barn Holdings Inc (BOOT)	Intel Corporation (INTC)
CME Group Inc (CME)	Eastern Bankshares Inc (EBC)
Qualcomm Inc (QCOM)	SS&C Technologies Holdings Inc (SSNC)
AstraZeneca (AZN)	First Republic Bank (FRC)
	Nicolet Bankshares Inc (NIC)
	Fiserv Inc (FISV)

Purchases

Boot Barn Holdings Inc (BOOT) is the largest lifestyle retailer selling western and work-related footwear, apparel, and accessories in the US. BOOT has 321 stores in 38 states, more than three times as many stores as its nearest direct competitor that sells primarily western and work wear. Approximately 50% of sales are Boots, 35% Apparel, and 15% Hats & Other merchandise. Western styles comprised ~70% of sales, with work-related and other styles making up the balance. Approximately 85% of the products can be characterized as “Functional” and 15% as “Fashion”.

BOOT operates as the largest player in a fragmented, niche market – the western and work-related footwear and apparel end market. We believe BOOT's product are more function and less fashion, resulting in less fashion risk than traditional retailers. We believe BOOT has room to grow its store base from 300 units to 900 and has some margin expansion opportunity through mix and economies of scale. BOOT’s brand and growth are supported by generally favorable trends in oil & gas employment, activity in construction and domestic manufacturing, and government regulations for workplace safety. In a normalized environment, we expect double digit top line growth driven by 10%-unit growth and MSD comps. At its current price, we believe BOOT is discounting a slowdown and weaker than Street modeled results, resulting in an attractive entry point.

BOOT is rated BBB by MSCI. 75% of the board is independent and the board has gender diversity at 37.5%. However, BOOT lags peers in adopting sustainable initiatives to source leather and cotton, which are considered environmentally intensive. In general, BOOT's ESG scores are average.

CME Group Inc (CME) is the world’s largest derivatives marketplace, offering a wide array of products across various asset classes, including interest rates, energy, agricultural products, metals, and FX. Due to the liquidity on its exchanges and the associated network effects, CME operates as a monopoly or oligopoly in many of its product categories. The beauty of its business model is that is doesn't require a lot of capital to grow and the incremental margins on each additional transaction it processes are near 100%. Those transactions also generate proprietary data that CME can repackage and sell. Over the years, the company has also proven its ability to innovate new products at minimal incremental costs, driving solid long-term growth and resulting in robust operating margins north of 60%. In addition, the business model allows the company to pay out a significant amount of cash to shareholders each year. CME pays a regular quarterly dividend that currently yields 2.5% and pays out all excess cash flows in the form of a special dividend at the end of the year. This typically brings the total annual yield to north of 4%. We believe it is exceptionally rare to find a company that can continue to grow over the long-term while also paying out a dividend of that size. As a leader in products that help market participants manage financial risk globally, CME is well positioned to benefit from ongoing market uncertainty and elevated volatility. The company has structural tailwinds in many of its key product categories including interest rates, energy, and metals.

CME Group is rated BBB by MSCI. CME has invested in its human capital development and corporate behavior. There have been some concerns about board members being over-boarded.

Qualcomm Inc (QCOM) designs advanced chips for handsets. The company's Snapdragon chipset platform is a global standard. QCOM has been steadily gaining share in high end phones. We estimate its market share in the segment to be close to 60%. Leveraging on its expertise, QCOM has been rapidly expanding into other areas of computing that require high mobility. It is a market leader in the fast-growing edge computing (IoT) and Automotive. Major OEMs such as BMW partner with QCOM in designing Snapdragon powered digital chassis. IoT and Automotive are expected to grow 15-20% through 2025. Overall, we believe QCOM should grow in LDD in the next few years. Valuation is among the cheapest in the sector due to a cyclical downturn in the main handset business. The company has virtually no debt and is highly cash generative. It trades at a FCF yield of ~ 9%. We see QCOM as a value opportunity.

Qualcomm is rated A by MSCI. Qualcomm leads its peers on conflict minerals sourcing. It also has strong governance practices. There are concerns about anticompetitive practices related to 5G modems.

AstraZeneca (AZN) has launched and commercialized seven new products in the past 10 years, which totaled over $20 billion in sales in 2022. This young portfolio of patented drugs translates into one of the strongest growth profiles among major pharmaceutical companies globally. Oncology accounts for more than a third of the company’s revenues with four major drugs expected to grow at a double-digit rate in the next 5 years. In many countries, its leading oncology drug Tagrisso is designated as a standard of care medication for several types of lung cancer. In 2021, AZN acquired a rare disease specialist Alexion at a very attractive valuation taking advantage of poor market sentiment at the height of the Covid pandemic.

AZN's rare diseases portfolio consists of a rapidly growing Ultramiris, which is the only approved medication for a rare life-threatening blood disease among adults and children. The growth is secure as it is the next generation medication with the patent expiry in mid 2030s. The company is expected to launch 5-7 new molecules in rare diseases in the next 5-7 years. AZN has large exposure to Emerging markets. China is their second largest market after the United States with a strong position in oncology and growing in rare diseases. In 2024-2027, we expect AZN to grow sales 8-12% and EPS 16-23%. The implied margin expansion is realistic given the accretive nature of new drugs in oncology, rare diseases, cardiovascular and renal. It is a highly cash generative company with a low level of balance sheet debt. The stock trades at 17.7x for 2023 and 14.9x for 2024.

AstraZeneca is rated AA by MSCI. AstraZeneca leads its peers in governance and has implemented a strong talent pipeline program. It is noted that AstraZeneca has lagged on product quality management, especially related to Covid vaccines.

Sales

Intel Corporation (INTC) is in a competitive position. It has lost technological leadership to AMD and Nvidia. The company continues to suffer due to its disproportionately high exposure to the PC market which is highly cyclical and commoditized. In face of the ongoing deep cyclical downturn, Intel chose to compete on price which is margin destructive. At the same time, Intel failed to gain traction in the fast-growing datacenter market. While their core business is underperforming, Intel is building an internal foundry. We are concerned about the prospect of higher capital intensity and lower cash flow for a prolonged period. We no longer have confidence that designing and manufacturing chips under the same roof would prove to be a winning strategy. We exited this position as we believe that there are better investment options in the semiconductor space.

Intel is rated AA by MSCI. Since the semiconductor industry is water intensive, Intel has put in place robust water management programs. The company has also made several acquisitions and has implemented talent management programs.

Eastern Bankshares Inc (EBC) is a commercial bank with branches mostly located in in Boston MSA where it has strong presence and top 5 deposit market share. EBC missed expectations and provided a weak outlook due to the competitive environment for deposits and loans that we do expect to improve this year. For EBC (and many smaller, regional banks), the rapid rise in interest rates has increased the competition for deposits among banks, and we believe EBC has lost more deposits than other banks, while it is also paid higher costs for brokered CDs. We expect continued NIM compression. Additionally, when we first invested in EBC, we estimated EBC had significant excess liquidity which is could use for M&A and stock buybacks, but we believe the current market dynamics have removed that excess liquidity position. We chose to exit given the deteriorating fundamentals and the weakening thesis.

Eastern is rated BBB by MSCI. It leads its global peers in business ethic framework. However, it does lag in workforce management practices, and it appears the bank lending practices have weakened.

SS&C Technologies Holdings Inc (SSNC) buys and aggregates financial technology firms and finds cost efficiencies. It is very similar to a private equity playbook. They have used debt to make acquisitions and help with their organic growth. SS&C's last major acquisition was DTC, since then the company has streamlined costs and tried to reduce debt levels. We exited this position as we expect that without major acquisitions organic growth will be below expectations and that interest expense on the debt will be a headwind.

SSNC is rated B by MSCI. The company lags peers in adopting strong information security measures and it trails in human management programs.

First Republic Bank (FRC) is a national bank with over $200 billion in assets focused on high-net-worth clients. They have been growing by taking market share from other banks, focusing on excellent customer service, and providing a range of banking and wealth management services. Over its history First Republic has had very low credit losses, far below most banks. More recently, First Republic has faced higher deposit costs due to higher interest rates and an impact to its investment portfolio also due to higher interest rates. First Republic had adequate assets to cover its liabilities, however with recent bank failures First Republic came into cross hairs. We exited this position as we became concerned that issues could sweep through the banking sector and take out some small and midsized banks, including First Republic.

FRC is rated A by MSCI. It is noted that the bank has strong talent retention practices and strong lending practices.

Nicolet Bankshares Inc (NIC), founded in 2000, is a full-service community bank serving Northern Wisconsin, Michigan, and Eastern Minnesota through 55 branches. Due to higher deposit betas, potentially deteriorating credit, lower net interest margins, and a higher cost of capital, we believe the current market environment will continue to be a struggle for smaller banks, including NIC.

Nicolet is rated B by MSCI. It lags in talent management practices and there are risks tied to potential product mis-selling.

Fiserv Inc (FISV) is a technology company that supports the financial services industry. Fiserv provides the bank office technology for small and medium sized banks. Fiserv also has a point-of-sale payment system called Clover. We exited this position given the banking crisis that we believe will bleed over into less lending and lower profitability for banks, ultimately altering Fiserv's growth profile.

Fiserv is rated A by MSCI. It has a strong ethics framework and strong controls to prevent cybersecurity threats.

Anchor's Positioning

Across the Anchor portfolios we have been defensively positioned for over a year. An inverted yield curve historically has given us clues about the direction of the economy. It was easy to get lulled in January with markets rallying and the headline inflation numbers coming down, but there were unknowns that have kept us cautious. The banking crisis caught everyone by surprise in the sense that most investors expect a credit situation, not an asset/liability mismatch. We have been underweight in banks versus respective benchmarks across all strategies.

Overall, we tend to be tilted more towards defensive sectors like consumer staples, health care and utilities, and have a good amount of cash in the portfolios. There are opportunities in healthcare as certain pharmaceutical companies have very strong drug pipelines. That said, we have found opportunities in other areas of the markets as well. Semiconductors have been going through a down cycle for three years, and we believe has room to improve from here. On the fixed income side, we are tilted more towards treasuries and government bonds, and we have been extending duration.

Outlook

We believe economic conditions will continue to tighten. The effects of higher interest rates and inflation are just taking hold now. This, in conjunction with the pull back on lending should slow the economy even more. We remain cautious on some of the cyclical parts of the market. We have increased cash levels in the portfolios reflecting that valuations are not exactly inexpensive. Given the economic outlook and growth we don't believe the market has fully priced in a recession. Our focus at Anchor remains protecting client assets and providing a smoother ride over market cycles.

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[vi] https://www.cnbc.com/2023/01/23/microsoft-announces-multibillion-dollar-investment-in-chatgpt-maker-openai.html

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In order to enhance current and prospective investor understanding of our process, approach and views, this letter includes detailed discussions regarding selected positions in our Strategy portfolios. In doing so, we hope this transparency enhances your understanding of our views on the investment opportunities we see in the marketplace and why we have positioned the Strategy portfolios the way we have. With such information available to you, we believe current and prospective investors are better informed and equipped to understand and/or challenge our views and approach to determine whether an investment in a Strategy is consistent with the mandate of each individual investor.