Rewey Asset Management
A member of Advisory Services Network, LLC

Dear Friends and Clients,

This quarter's commentary focuses on how we think about investing in a stock market that is in the ninth year of advance, and how despite the broad market indexes posting record highs, we can identify investible ideas that are supported by the three pillars of our investment philosophy.

When evaluating the market's advance, it is important to recognize the ascension of index investing, as new cash inflows create continual buying that is skewed to the highest weighted stocks in the index, regardless of valuation. In contrast, our investible universe of stocks contains over 3500 companies[1], and we believe this universe is not representative of the top weighted stocks of the major market indexes. Moreover, none of our new buys this quarter were near 52-week highs, and several were close to 52-week lows.

The value of being a patient and opportunistic buyer is that we target long-term returns which often stand in contrast to short-term relative trends. By focusing on a 15-25 position portfolio with a 3-5 year investment horizon, we have ample opportunity to find compelling opportunities for investment, regardless of broader market conditions.

Market Overview

The market cadence seen in the third-quarter was strikingly similar to what we observed in the second quarter. Most broad market averages advanced, posted new record highs and then modestly sold off into the quarter-end. The U.S. Federal Reserve again raised its Federal Funds target rate by another 25 basis points, marking the 7th raise this cycle. We saw cautious investor sentiment as fears of trade tariffs dominated news headlines. In contrast to these fears, the broader economy logged healthy economic statistics, with highlights of 4.2% linked quarter GDP growth[2], the unemployment rate falling to 3.9%[3] and U.S. average hourly earnings accelerating from 0.2% month over month in June to 0.4% in August[4].

While we will not prognosticate on how long a bull market can continue, we will say that the U.S. economy is healthy, and barring an unexpected exogenous shock, we do not see conditions that would cause a severe sell off in the broader markets. Several sectors of the major market indexes appear fully, if not overvalued, but rest assured, this is not where we are investing.

Commentary

Many clients have asked about our approach to investing in a market that 'appears to be near a peak'. Perhaps another way to ask this question is what sort of risk we are willing to take in the markets? While it is impossible to avoid risk completely in equity investing, our investment process is structured with the intent to risk time and not capital. Since we do not own the market, rather a concentrated portfolio of small and midcap stocks, we see little correlation to the major stock indexes. Additionally, we do not build our investment cases to be reliant upon macroeconomic predictions, but rather in-place fundamentals reflected in the three pillars of our investment philosophy: 1) a strong balance sheet, 2) the ability to grow profits and return on invested capital and 3) a compelling discount to our Assessed Fair Value (AFV) of at least 30%. We believe that these strong fundamentals allow the passage of time to be our ally, versus an investment risk if economic conditions do not unfold according to predictions.

Another question related to market highs is whether we are still able to find value opportunities in this market? We will analyze many more companies than we will ever own. Those that meet our balance sheet and profitability pillars upon initial review, but do not meet our valuation discount discipline are added to our "on-deck" list. Most every company will encounter periods of weakness at some point, and this weakness usually will drive a decline in share price. By continually following the companies on our on-deck list, we can move quickly and confidently to purchase shares if price declines are large enough to meet our valuation hurdles. Stocks rarely trade at a compelling discount when the news and investor sentiment is positive. Moreover, investor neglect of out of favor companies not only offers an investible discount, but can also provide downside protection over time as investors have already digested and discounted the bad news.

Given our philosophy of opportunistically buying into neglect, we did increase our investment activity towards quarter end, as the market sell-off created the valuation discounts needed to turn our patience into action.

Portfolio Highlights

First Horizon

We added to our position in First Horizon National Corp. (FHN) in the quarter, as the share price weakened in spite of a strong second-quarter earnings report and a positive capital event on the sale of Visa Inc. shares in September.

First Horizon is a mid-size regional bank, with a leading market position in its home state of Tennessee, and a strong market position in the southeastern U.S. states of Virginia, North Carolina, South Carolina, Florida, Georgia and Mississippi. Its subsidiary, FTN Capital operates as a middle market investment bank.

First Horizon meets all of our investment criteria and remains a compelling investment in our opinion. FHN has a strong balance sheet as measured by its Tier 1 RBC ratio of 9.95% as of 2Q18, and on September 5th, this metric improved to 10.42% as FHN sold is holdings in Visa Corporation for a $0.49 per share gain in Earnings Per Share and Book Value, which also added 47 basis point of capital to its Tier 1 ratio.

Led by Bryan Jordan, CEO, FHN has improved its regional banking profitability by 55% since 2013 through focusing on profitable lending relationships and cost cutting. We believe FHN has high visibility to continue this improvement, spurred by the acquisition of Capital Bank which closed in May. We believe investors misread the second-quarter announcement which had various merger expenses in reported results and neglected the good news that FHN raised the accretion targets for this merger from 8% to 17%, and has successfully completed the system conversion onto FHN's platform. Additionally, Bryan Jordan and his team continue to trim riskier loan activities, like shared national credits and sub-prime auto portfolios, which have historically been areas of higher loan losses in economic slowdowns.

At quarter-end levels of around $17.65 per share, we see a compelling risk return opportunity up to our Assessed Fair Value (AFV) of $24, based on a blended Price/Earnings multiple and Book Value multiple approach, representing roughly 36% upside, plus an annual dividend yield of over 2.7%[5].

Ultra Clean Holdings

We initiated a position in Ultra Clean Holdings (UCTT), a manufacturer of critical tools and sub-systems focused on gas delivery for the semi-conductor equipment industry. We believe the shares represent a compelling investment opportunity at quarter-end levels of approximately $13 per share, down dramatically from October 2017 highs of over $34.50, and down 35% from its additional share offering of $20 in January 2018[6].

We believe investors have sold down UCTT due fears of slower customer investment demand for the second-half of 2018, in a short-term move that disregards the compelling longer term outlook for market growth, driven by mobile devices and 5G, the internet of things, autonomous driving and artificial intelligence. Moreover, smaller chip configurations and increased costs of manufacturing processes should continue to support the outsourcing of critical sub-systems to third-party suppliers such as UCTT.

Even more compelling, in our opinion, should be the positive impact the recent acquisition of Quantum Global Technologies (QGT), which closed on August 27th. Quantum is a leading service provider of cleaning and anti-microbial services to semiconductor manufacturers and should benefit UCTT in several ways. First, QGT has no overlap with UCTT, but brings the diversification of a highly recurring revenue stream and diversity of customer concentration to UCTT, which should help lessen its revenue and earnings volatility. Despite the fact that UCTT expects no merger synergies from the integration, it does expect earnings accretion of 25%, as QGT is a healthy company that has higher operating margins than UCTT.

UCTT was very familiar with Quantum as a client, and thus was able to move quickly when the private equity owners of Quantum wanted to sell. The company did not go to auction and was purchased for roughly 6.2x 2017 EBITDA, a compelling price for a company with recurring revenues based on operating rates vs. capital equipment spend. UCTT had a net cash position as of 2Q18, and post deal the balance sheet remains strong, with only moderate leverage of 1.5x Debt/trailing pro-forma EBITDA, with debt reduction a priority for UCTT's free cash flow.

We have set our AFV for UCTT at $19.50 per share, 50% up from its current level of $13. We will re-evaluate this target post third-quarter earnings, when UCTT provides more detail on its expectations for QGT accretion and forecast margin levels. We do believe due to low-sell side coverage, only four analysts cover UCTT, and the late August close of QGT, that there is significant neglect of understanding of the benefits of the acquisition and moreover a short-term focus on the base operations, which are historically volatile, in-spite of the compellingly positive long-term industry outlook.

In closing, it is important to reiterate that our view of outperformance rests more in the absolute than relative to a given index. While in the short-term, markets and individual stocks will be volatile, we believe that with a longer-term horizon, volatility can be reduced and outperformance can have a greater chance to be forecast correctly.

Thank you for your continued trust and support. Please do not hesitate to contact us for client service, to discuss our commentary or to just opine on the market and stocks.

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1 Bloomberg screen of U.S. traded companies with market capitalization of $200 mil. to $6.5 bil. as of 5/31/18.
2 GDP sourced from the U.S. Bureau of Economic Analysis.
3,4 Unemployment and Wage Growth data sourced from the U.S. Bureau of Labor Statistics
5,6 Historical stock prices and financial information sourced from Bloomberg. Projections are estimates sourced from Rewey Asset Management proprietary analysis.