JUL 11, 2024

“It was the best of times, it was the worst of times…”

Samantha McLemore

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way. . . .”

***A Tale of Two Cities*, Charles Dickens**

I attended a refreshing value investing conference, Value x Vail, in June. Refreshing because there were true value investors, a dying breed, pitching some ugly and beaten-up value stocks. A breath of fresh air in a quality-compounder crazed environment. It took me back to my earliest days in the industry when the best investors were those with the heartiest guts of steel, best able to stomach the torment of a reviled but promising opportunity.

Of course, in today’s environment, investors pitched plenty of high growth names. Companies where you must dream the dream to make a case of undervaluation. There’s now broad recognition that identifying quality companies with long runways for growth is the best path to top performance. A far cry from the days when Bill Miller was pilloried at a Columbia Business School Value Investing conference for not being a “true value investor” because he owned Amazon.

When lucrative opportunities become widely recognized, prices get bid up. As expectations ratchet up, future returns tend to ratchet down. It’s one reason earning excess investment returns is so challenging. Generally, the best investments begin in a state of obscurity, neglect or disdain. High expectations are not the investor’s friend. Nor are they a recipe for immediate underperformance.

We see strong demand and high expectations for quality compounders, AI and technology. The bar for fundamentals is set high, with minimal room for error.

We see better relative opportunities elsewhere. Performance momentum, however, resides squarely in the darlings. Year-to-date, the number of stocks on pace to outperform the index sits at a record low. As the market notched new highs, many stocks were left behind.

Dichotomy characterized the second quarter. The S&P 500 posted a strong quarter (+4.3%), outpaced only by the Nasdaq (+8.5%). Large cap technology stocks surged to new heights, while most stocks struggled to keep up. Only 26.4% of the S&P 500 constituents outperformed the index. Nearly 60% of its stocks declined.

The more pedestrian and cyclical Dow Jones Industrial Average lost 1.3%. Smaller cap indices fared even worse, with the Russell 2000 down 3.3% and the S&P 600 Small Cap index losing 3.1%. More S&P 500 sectors declined than advanced. The Magnificent 7 alone contributed 61% of the S&P 500’s year-to-date returns (+15.3%). The path to prosperity was a narrow one.

Opportunity Equity declined 1.9% net of fees in the quarter, taking our year-to-date return to 9.6% net of fees, a respectable albeit lagging 6-month return. After two very strong quarters, consolidation isn’t surprising. Our smaller cap and low multiple names dragged on performance.

Fundamental underpinnings supported the performance divergence. First quarter year-over-year earnings growth for the Mag-7 was 50%, trouncing the rest of the S&P 500’s 2% decline. The gap is expected to narrow in the second quarter but remain wide (+28% Mag 7 vs. +4% SPX ex-Mag 7). By the fourth quarter, equal growth is expected for both groups at

+17%. While overall growth expectations appear too high, if it's even close to right, the laggards should perform strongly (and outpace the leaders) in the second half, much like we witnessed in 4Q23 and 1Q24.

An important consideration is the clearly slowing economy. First quarter real GDP growth was +1.4%, 36% lower than a year ago. Retail sales barely grew in May. Housing starts have weakened. Manufacturing Purchasing Managers Index (PMIs) continue to suggest contraction. The unemployment rate has increased more than half a percentage point from the lows to 4.1%, triggering the Sahm recession rule*. A conclusion supported by the payroll employment report and Leading Economic Indicators (LEI). Yet nominal income growth remains strong (+5.1% year over year (YoY) in June) and overall employment gains are still solid.

Slowing growth has helped inflation normalize. Core PCE, the Fed's favored metric, advanced only +2.7% YoY in May, down from 4.7% the prior year. Stories of price cuts fill the news. Fast-food chains compete to offer the biggest bargains, customers trade down, airlines compete on price and car companies discount to deal with high rates. Yet, the Fed wants more evidence we're on track to hit its 2% target before lowering rates.

This creates the risk that a backward-looking, too-tight Fed waits too long. As inflation falls and rates remain stuck at a high level, restrictiveness grows. Not encouraging as signs of weakness grow.

The Fed recognizes the risks and expects to cut rates later this year despite steady inflation forecasts. Fed governors Mary Daly and Austan Goolsbee recently spoke of the need to more seriously consider rate cuts. Growing recession risks are a factor weighing on certain stocks. This is partially why we took portfolio leverage down early in the quarter.

The economy and jobs still seem OK despite the weakening. Most companies say demand remains solid, with weakness at the low end. Consequently, our base case is for rate cuts later this year that take the market, and laggards, to new heights. The longer the Fed waits though, the more likely a less benign scenario emerges. Given the weakness and discounted expectations of some cyclicals and small caps, we think some protection exists against a recession should it occur. Any recession, though, would cause broad market weakness.

In the current bifurcated investment environment, winners win, and losers lose. Big time. Trends get taken to extremes. We've long thought an AI bubble was possible. I'd say we're there, though it may still be early.

Fortunately, we recognized Nvidia's potential and bought it early in the year. It was capturing the bulk of AI profits with a significant market lead and deep competitive advantages. We believed it was more like Microsoft than Cisco, which implied significant potential upside to its intrinsic value. It's since more than doubled and reached our bull case level. To justify current market expectations, we believe Nvidia needs to accomplish something unprecedented, like sustaining its current 65% operating margins for decades.

That's possible, but unlikely. Even if it happens, it won't be linear. What's more likely is that Nvidia continues to surpass near-term expectations with the launch of its Blackwell chips later this year, which will be undersupplied. Markets would likely extrapolate any strength.

Bill Miller once said markets go on a journey from undervaluation to overvaluation and back again. The same is true for securities. When we make an investment, we want to capture as much of that journey as possible. We recognize it's impossible to time your entry and exit perfectly. We work actively to mitigate our (and investors broadly) behavioral tendency to sell winners too soon.

In this case, we still believe it's possible for the AI/quality compounder momentum to get more extreme. Nvidia currently trades at 47x fiscal 2025 earnings, which corresponds to Cisco's mid-1998 level (the ultimate peak in March 2000 was 152x!). Likewise, the S&P 500 Tech sector trades at 33x 2024 earnings, a similar level to late 1998 and early 1999. During that period, gains continued for another 12-18 months.

We don't expect history to repeat but are cognizant that times of euphoria tend to last longer and get more extreme than

most anticipate. This one may end the way of the Nifty Fifty euphoria of the late- 1960's or the Tech Bubble of the 90's, namely a crash. That would be a painful outcome. Though in those prior crashes, low multiple stocks vastly outperformed.

We don't think we're there yet, especially as some of the Mag 7 still trade at reasonable valuations (Alphabet trades at 24x next 12-month earnings; Meta at 26x).

For now, we are watching Nvidia closely. It continues to outperform on most days and the fundamental backdrop remains intact. The market will likely give us the first signal that change is afoot. We never like to sell our winners after only a matter of months, especially in taxable accounts. We aim to maximize returns, which requires we remain flexible. Nvidia's giant move this year closed the discount to intrinsic value. While we can't make the case that it's undervalued, we also don't believe it's significantly overvalued, which is typically where euphoria ends. We will be monitoring it carefully.

We see the most compelling long-term opportunities in unloved areas of the market, which we've been shifting more into gradually. While that's hurt us short-term, we have conviction it's the right move long-term.

Smaller cap companies' stock prices have continued to lag. We have been building current names and adding new ones. We initially bought IAC Inc (IAC $46.85, $3.96B market cap) a year ago and added to it in the quarter. It's run by some of the best capital allocators in the world, Barry Diller and Joey Levin. It pulled back to levels below where we started buying despite significant improvement in business fundamentals. We think the stock is worth ~$90, including a 20% conglomerate discount, about double the current price.

We've bought more Kosmos Energy (KOS $5.54, $2.6B market cap), an offshore oil and gas exploration and development company on the verge of significant production growth, as well. Its' significant reserves of low-cost, low-carbon energy are an attractive long-term asset. As development CapEx falls, free cash flow should surge. At current commodity strip prices, we expect it to generate $1.30 per share in free cash flow next year, a 23% yield on the current stock price. It will initially pay down debt but should be in a position to return cash to shareholders in the second half of 2025. KOS is one of the only energy names we've found with significant potential upside at $65 a barrel WTI crude. We think it's an acquisition candidate, and worth more than double the current price.

We initiated a position in Everi Holdings (EVRI $8.40, ~$700M market cap) in the quarter. Everi is a gaming hardware, technology and services provider. The stock traded at $15 a year ago and hit a low of $6.37 in the quarter. Sales have slowed with the economy and in advance of new game launches, which will come later this year. The company announced a merger with IGT's gaming business. The combined company will be a market leader in an oligopolistic industry (leaving 3 main players post deal) with significant cash generation capacity. We think the stock is worth mid-teens using conservative assumptions, roughly double current prices.

We're not sure when smaller caps will start acting better, but as long as the market allows us to buy quality businesses at mouthwatering valuations, we will do so. We have confidence it will eventually prove profitable. Elsewhere, we aren't finding opportunities to double our money over a few years.

We still have significant travel exposure. Travel remains a source of economic strength as people prioritize experiences. You can't tell from the stock prices. Expedia (EXPE $125.99, $16.4B market cap) continues to execute on its technology transformation. Its B2B (business-to-business) segment is humming. People are just starting to understand its value. When properly valued, we think you're paying only 2-3x EV/EBITDA for the core consumer piece (which is still growing!). As Mr. Market is slow to reflect the value, the company is gobbling up its own stock. Repurchases alone should allow the company to compound earnings in the teens.

We continue to own Delta Airlines (DAL $47.44, $29.9B market cap) and United Airlines (UAL $48.66, $15.5B market cap), which earn the bulk of airline industry profits due to their premium positioning. Neither sees any signs of weakening travel demand. We think these are better businesses than the market discounts, and that time will prove this out. In the short term, both companies should begin buying back stock this year.

Norwegian Cruise Lines (NCLH $18.79, $7.5B) has been a volatile one. We pared it back in the twenties and recently added to our position around $16. We like the new management team's focus on costs and returns. If the company can hit its' 2026 $2.45 EPS guidance, which we think is likely in a normalized environment, the stock should nearly double over the next couple years.

We've also built exposure to several healthcare names amidst recent weakness. These names should have more resilience in any recession we might face. Excluding our small biotechs, our exposure is 10.0%. Our holdings are Biogen (BIIB $231.82, $32.9B market cap), Illumina (ILMN $104.38, $17.4B market cap), CVS (CVS $59.06, $71.1B market cap) and Royalty Pharma (RPRX $26.37, $15.3B market cap).

Biogen's new CEO Chris Viehbacher is executing well, and the company has a huge opportunity in Alzheimer's. Illumina is the market leader in genomic sequencing, where we expect long-term market growth. Following the Grail spin off, investors should see the earnings power of the core franchise shine through. ILMN's challenges gave us the opportunity to buy a quality compounder at an attractive valuation. CVS recently executed terribly in its Medicare business. It will take a couple years to sort through, but we believe the franchise is intact and the problems are fully discounted. As it gets back on track, we expect handsome returns. Royalty Pharma is misunderstood, but its team of savvy healthcare investors with a proven track record of funding royalties.

More than half the portfolio (55%) is in small-to-mid cap names, healthcare names and travel names. Most of these stocks have lagged the market year-to-date. Our philosophy is that when business fundamentals remain solid, falling market expectations create opportunities. It can produce deferred outperformance. We have significant conviction in our investments over the next five years. In the shorter term, they could act much better in the second half if the Fed cuts rates and economic growth continues.

One of the biggest challenges for investors is not to let simple mistakes destroy investment returns. Letting macro fears derail a sound investment portfolio. Letting FOMO (fear of missing out) suck you into what's hot at exactly the wrong moment. Throwing in the towel on laggards at the bottom. The current environment tempts fate in many ways.

The best strategy we've found for resisting temptation is to stay focused on our investment process. Where is there a gap between company fundamentals and discounted market expectations? We stay focused on investment fundamentals as prices eventually follow. When we're right in our analysis and patient in our approach, it's a recipe for success.

We hope we adequately conveyed the attractive opportunity set, and the potential risks. We have high conviction in the portfolio. We will do our best to navigate a tricky investment environment well, with equal doses of patience, prudence and opportunism.

Opportunity Equity Annualized Performance (%) as of 6/30/24

	QTD	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception (12/30/1999)
Opportunity Equity (gross of fees)	-1.66	10.17	22.38	-7.60	9.27	8.27	8.19
Opportunity Equity (net of fees)	-1.91	9.63	21.18	-8.53	8.19	7.20	7.12
S&P 500 Index	4.28	15.29	24.56	10.01	15.05	12.86	7.51

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Christina Malbon's 2Q 2024 Quarterly Investment Review

*Sahm Recession Rule: Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months.

Stock Data from Bloomberg as of 6/30/2024.

Data Sources: Bloomberg, Patient Capital Management

The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of NASDAQ securities and it includes over 3,000 stocks. The Dow Jones Industrial Average (DJIA) is an unmanaged index composed of 30 blue-chip stocks, each with annual sales exceeding $7 billion. The DJIA is price-weighted, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes, such as the S&P 500. The Russell 2000 Index is a small-cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index. The S&P SmallCap 600 Index seeks to measure the small-cap segment of the U.S. equity market.The S&P 500 Index is a market capitalization-weighted index of 500 widely held common stocks. Investors cannot invest directly in an index and unmanaged index returns do not reflect any fees, expenses or sales charges. Magnificent 7 is a group of stocks made up of mega-cap stocks Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Amazon.com (AMZN), Meta Platforms (META), Tesla (TSLA) and Nvidia (NVDA). Sahm Recession Rule: Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months. Leading Economic Indicators (LEI) is composed of 10 economic components whose changes tend to precede changes in the overall economy. Personal consumption expenditures (PCE), also known as consumer spending, is a measure of the spending on goods and services by people of the United States. The Nifty Fifty was a group of 50 large-cap stocks on the New York Stock Exchange that were most favored by institutional investors in the 1960s and 1970s. Capital Expenditures (CapEx) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. West Texas Intermediate (WTI) Crude Oil is the underlying commodity of the New York Mercantile Exchange's oil futures contract and serves as one of the main global oil benchmarks. Purchasing Managers Index (PMI) is an indicator of the prevailing direction of economic trends in the manufacturing and service sectors.

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