February 2024

EXECUTIVE SUMMARY

Performance Review

The portfolio's largest contributors to performance for the quarter were Fiserv Inc. (FI), Fomento Economico Mexicano (FMX), and Nintendo Co., Ltd. (NTDOY). The largest detractors to performance over the quarter were LatAm airports (ASR, OMAB, PAC), Bayer, and British American Tobacco (BTI).

Portfolio Commentary

Portfolio activity during the fourth quarter was unusually robust. We exited ten positions and initiated six new investments. Many of these transactions were years in the making despite the seeming frenzy of short-term activity. Since a proper postmortem on every sale is beyond the scope of this letter and most readers' attention span, we grouped these decisions into three buckets. We trim or liquidate investments when we are right, when we find a better use of our capital, and when we are wrong. We also highlighted two themes of our new purchases: self-help stories and our classic temporary dislocation.

Market Outlook

Defensive stocks are trading at a material discount to the rest of the market as consensus is pricing in a smorgasbord of rate cuts next year. We think the setup in healthcare, sitting squarely at the intersection of growth and value, is particularly attractive. From today's depressed valuations, we see pandemic-related headwinds in the rearview mirror, inventory destocking nearing its conclusion, staffing levels back above trend, and procedure volumes rebounding. Should the much-awaited "soft landing" fail to materialize, or worse, recession warnings prove prescient, we would expect an even more powerful rotation back to the safety of these high-quality, recession-resilient businesses.

Organizational Updates

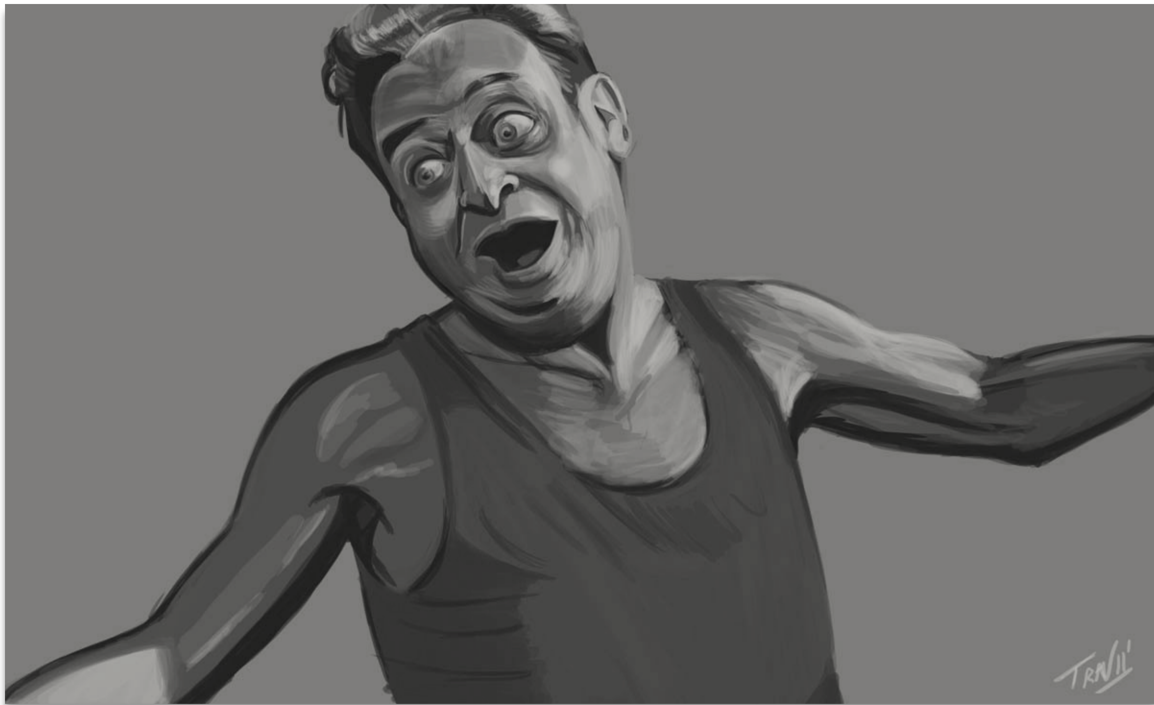
We want to thank Vince Calcagno and Michael Hensen at E78 Partners for their contributions to the firm over the past two years and welcome Kyle Minges aboard as Broyhill's latest addition and new Chief Operating Officer. I couldn't be more proud of what we are building and who we are building it with.

We look forward to meeting with a small group of family offices in Dublin at month-end before going on to host an invitation-only event for a select group of private investors in London. If you'd like to learn more about either event or connect across the pond, please reach out to our Chief of Staff, Pam Reid.

Bottom Line

During periods like this year when a few "magnificent" stocks dominated performance, it's important to note that buying cheap stocks is a feature of our investment philosophy, not a bug. It's impossible to generate materially different results by owning the same names as everyone else. If we did, we would have reported the same losses as everyone else in the prior year. While these companies drove most of the market's gains this year, the fascination with a handful of stocks left many bargains in plain sight for those willing to think differently.

Broyhill's fully invested managed accounts trailed broader equity benchmarks for the year, but having avoided trouble during the 2021-2022 declines, relative performance remains comfortably ahead over any longer-term horizon. So where does that leave us? Markets have come a long way in a very short time. So have investors anxious to celebrate the Fed on a job well done and now anticipating a perfect combination of declining inflation and moderate growth supported by rate cuts. Some are even calling for a new "Goldilocks Era" – where inflation and growth are not too hot, not too cold, but just right. That seems unlikely, unrealistic, and unbelievable, leaving stocks vulnerable to anything but the perfect porridge. The risk is that this "perfect porridge" of wildly optimistic expectations leaves little room for error. Once again, the consensus is "all in" on a bet that the Fed sticks the perfect landing – the infamous Triple Lindy, even! It's not impossible. It's just not probable.



Source: IBTravArt

PERFORMANCE REVIEW

For equity investors, the last two years were mirror images of each other. After falling 18% in 2022, global stocks rallied 22% last year. The defining feature of that rally was the massive outperformance of the Magnificent Seven – a handful of giant companies perceived to be the big winners of the AI revolution. After a mid-year sell-off that left markets up mid-single digits on the year, optimism that the Federal Reserve had concluded its tightening cycle propelled a rotation into riskier corners of the market, with money-losing technology companies and those with the highest short interest leading the charge. November saw the biggest retail inflows since 2021, with extreme concentration in large-cap tech. The shift to risk continued in December as markets melted up, with the most shorted stocks surging over 21% to close the year. The parabolic move in the most speculative stocks caught us flat-footed, and we underperformed in the final weeks of the year. Notably, every rip of this magnitude has been an opportunity to sell since the bubble burst. Time will tell.

The largest contributors to performance for the year were Activision Blizzard, Fomento Economico Mexicano, and Meta Platforms. The largest detractors to performance for the year were investments in Dollar General, First Horizon Corp, and British American Tobacco. The quarter's top contributors were Fiserv, Fomento Economico Mexicano, and Nintendo. Top detractors during the quarter were investments in LatAm airports, Bayer, and British American Tobacco. A brief recap of top contributors and detractors is provided below.

Top Contributors

Shares of Fiserv gained 18% during the quarter. We first outlined our investment in Fiserv here. Since then, the company has continued to fire on all cylinders. After reporting a solid third quarter and raising guidance, share gains accelerated following the company's November Investor Day, where the company reiterated its outlook for the year and introduced preliminary 2024 guidance of 11% - 13% organic top-line growth. Management also sounded quite confident in its new medium-term guidance, calling for 9% - 12% organic revenue growth and 13% - 17% earnings per share growth. Despite the company's near-flawless execution, shares closed the year trading at 15x earnings, more than a 20% discount to the market.

Shares of Fomento Economico Mexicano (FMX) grew 20% in Q4, as the stock's multiple rose from 10-year lows to its long-term average forward P/E of 22x. At the end of 2020, we began building positions in FMX and Coca-Cola FEMSA (KOF) and shared our thesis here. In short, we believed the market was underappreciating and undervaluing the company's Oxxo segment relative to its peers. As the market came around to our view, the discount to private market value closed. We exited our position subsequent to quarter end.

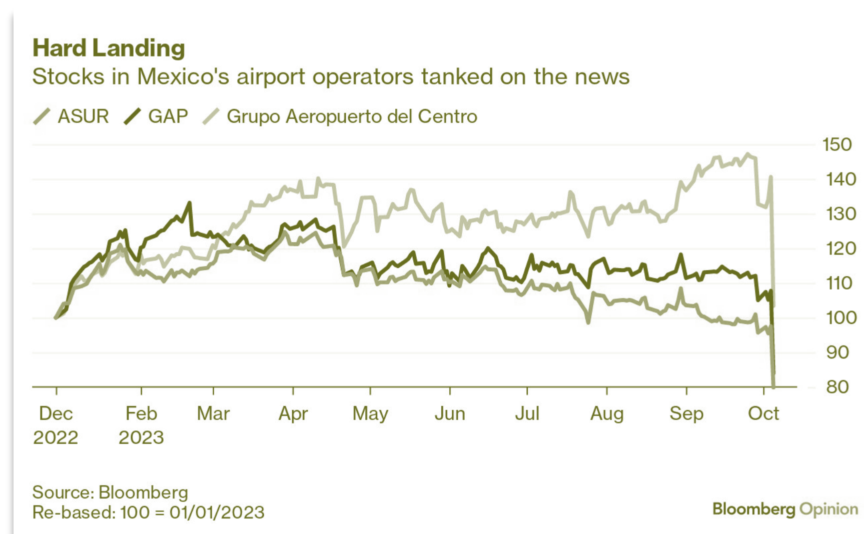
Nintendo surged 26% in the final three months of the year as we continued to build our position in the stock. We outlined our admiration for Japan's most creative culture in a recent interview with Value Investor Insight (VII). At the time, we speculated that Nintendo's fresh focus on monetizing its iconic IP represented a long overdue inflection point in management's strategic thinking that was materially underappreciated and undervalued by the consensus. Those suspicions proved timely. When the company reported better-than-expected sales and profit for its fiscal second quarter, it also raised forecasts for the year, compliments of a continued bump from The Super Mario Bros. Movie and its flagship Zelda franchise. More importantly, our thesis appears to be playing out as the business model transitions from manufacturing video games to more broadly capitalizing on the enduring value of its many franchises. Following the earnings release, Nintendo announced the development of an action movie based on its Legend of Zelda franchise.[1] Creator Shigeru Miyamoto's first post about the project was quickly viewed nearly 30 million times. Shares continued their ascent subsequent to year-end after CNBC reported the expected launch of the Switch 2 console this year.[2]

[1] A 'Zelda' Movie Could Mint Money for Nintendo

[2] Nintendo is Expected to Launch the 'Switch 2' Console This Year

Top Detractors

Mexico has quietly found itself in one of the best competitive positions in its history despite doing everything possible to handicap its success. Trade disruptions and kinks in the global supply chain due to the pandemic encouraged domestic manufacturers to explore options closer to home. At the same time, rising geopolitical risks highlighted the need for more resilient supply chains, pushing businesses to diversify sources, accelerating the movement to "near-shoring," and boosting Mexican exports, which surpassed China as the top US trading partner last year. Despite this strong fundamental backdrop, Mexican assets continued to trade at a steep discount to global peers, making it a particularly attractive hunting ground for value investors and a significant overweight in Broyhill's portfolio. While keenly aware of the geopolitical risks of investing south of the border, we believed we were being more than appropriately compensated for the risk. We also felt that, while authoritarian rhetoric appeared to be heating up, it was doubtful that Mexican President Andrés Manuel López Obrador (AMLO) would do anything to derail the billions of investments pouring into his country. This assumption that political agendas are founded in any logic proved incorrect. After AMLO leveraged the military to seize an essential portion of Grupo Mexico's railroads in May, we immediately trimmed our investments in the country's airports. In hindsight, we should have sold them all. A few months later, transport officials delivered a unilateral fee change levied against the airports, sending the stocks cratering on the news.[3] We liquidated all three investments as shares recouped some of the losses into year-end. While the fee increase turned out to be manageable for these highly profitable businesses, the uncertainty introduced and the blatant neglect of contract law are symptoms of a much more serious risk that is impossible to handicap.



After years investing across the tobacco sector, it became increasingly clear that owning anything other than the global leader – Philip Morris – made little sense. Consequently, we liquidated our investment in British American Tobacco after deciding that the (seemingly) cheap valuation wasn't worth the mental anguish. In a hollow victory, shortly after our sale, management promptly wrote down the value of its US tobacco brands by $31.5 billion, sending shares cratering.[4]

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[3] AMLO Shows He's Not Going Quietly With New Market Interventions

[4] BAT's US Writedown Puts Tobacco Transition in Spotlight

The German conglomerate Bayer may have appeared in the "Top Detractors" section of these letters more than any other investment at Broyhill. We're pleased to report that this is the last time it will do so, although we're not particularly pleased with the outcome. While patiently waiting for the stock's conglomerate discount to close, operating performance deteriorated, while pressure to break up the company proved fruitless. Despite a regular cadence of headlines highlighting the new CEO's "open mind" toward all strategic options and management dutifully toeing the party line on call after call, our confidence in the likelihood of actually seeing any action deteriorated. We liquidated our position and reinvested the capital alongside management teams more willing to take action aimed at increasing shareholder value (more on this shortly). Subsequent to our sale, in another "Kiss Your Sis" type of victory, shares of Bayer plunged as investors digested the failure of a critical drug trial, more adverse legal rulings, and management ultimately backtracking on promises of major changes to the business structure.[5]

PORTFOLIO COMMENTARY

At Broyhill, we manage a concentrated, long-term portfolio generally comprised of 10-20 securities, with the top ten of those investments making up the lion's share of the portfolio. We invest with an eye towards normalized earnings power 3-5 years out, where we believe we have less competition from day traders, pod shops, and your more typical hedge funds with time horizons measured in months or even minutes. Historically, this has translated into an average portfolio turnover of 15% - 20% annually, meaning one or two good ideas per quarter are sufficient to drive long-term returns.

In most quarters, our investors see little activity on their financial statements.

This was not one of those quarters.

Portfolio activity during the fourth quarter was unusually robust. We exited ten positions and initiated six new investments. As noted below, many of these transactions were years in the making despite the seeming frenzy of short-term activity.

Since a proper postmortem on every sale is beyond the scope of this letter and most readers' attention span, we'll group these decisions into three buckets, which nicely illustrate our sell discipline.

The first bucket is the best of the bunch. Simply stated, we trim or liquidate investments when our thesis has fully played out or when the security has approached our estimate of intrinsic value. In the case of Activision, this was a rather straightforward assessment; after an exhausting battle with regulators, the deal closed, and we received $95 for every share we owned. Estimating the intrinsic value of a business like Google or Meta Platforms is not as clear cut, but with the multiples on both stocks up over 50% and 100%, respectively, over the course of the year, we think it's safe to say that the "easy money" had been made. We have a saying at Broyhill that the number of questions one needs to get right is inversely related to price. Said differently, the lower the price, the fewer correct answers required. The higher the price, the more the details matter. At today's prices, investors in these stocks, and many others, need to get a lot right. Some investors may have these answers. We prefer to look for easier questions.

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[5] Bayer Moves Away From Breakup Despite Investor Pressure

The second bucket is the next best option: we trim or liquidate investments when we find a better use for our capital. Most investors interpret this as capital at risk, but it's just as important to consider one's intellectual capital at risk, which is an equally scarce and essential component of successful investing. Value investors are gluttons for punishment. One might even say that we are the BDSM equivalent of the investment industry. We get off on the weird stuff that others are afraid to admit, let alone write about in public (consider how many investors you know who are willing to admit they own tobacco stocks). But like BDSM practitioners, value practitioners also need to understand when enough is enough. Coming into the office day after day, repeatedly being told by the market that you are wrong, eventually takes a toll. Even value investors need a "safe word" to call it quits. A little extra rope may be helpful to allow certain practitioners the wiggle room to escape. It's also necessary to allow one's investment thesis sufficient room to play out, as it often takes time for others to come around and see the value in weird stuff. Successful value investing requires a balance between providing that rope and remaining cognizant of the opportunity costs – not only where capital could have been better deployed to earn higher returns but also where time and energy could have been deployed more productively. Sometimes, the gains on one's mental bandwidth from cutting that rope far outweigh any realized losses. This was clearly the case with our multi-year investments in Ambev, Bayer, and Anheuser-Bush Inbev and our shorter stint with British American Tobacco.

Source: DALL-E3

The third and final bucket is the most difficult: we trim or liquidate investments when we are wrong. Simply put, when we take in new data inconsistent with our investment hypothesis or outside of our expected range of outcomes, we will not hesitate to admit we are wrong and liquidate the position. As previously noted, we took in some "new" data regarding risks to our airport investments in the fourth quarter and liquidated all three positions as a result. You can't win them all.

We can also group our new purchases during the quarter into buckets. The first group is what we'd call self-help stories. A recent Bloomberg study of the largest acquisitions over the past five years found that less than half of the companies managed to cut leverage ratios since splurging on $1.3 trillion of deals.[6] Blue-chip firms with cheap funding were doing aggressive, debt-financed transactions that committed them to deleveraging that never materialized. When operating performance fell short of the mark, debt burdens became a problem as surging interest expense combined with shrinking earnings power led to higher leverage ratios and lower interest coverage. The result: CFOs have been forced to step up, increase operating efficiencies, streamline cost structures, and often spin off or sell non-core business segments. Hence, the self-help story. Recent investments in this bucket include Ball Corp, Fidelity National Information Services, and Avantor.

Self-Help Stories

Founded in 1880, Ball Corporation makes aluminum packaging for drinks, food, and other products. While arguably not the most exciting business in the world, a glimpse at the company's performance provides a valuable lesson: exciting business models are not a prerequisite for exciting performance. In fact, more often than not, we'd argue that those factors are inversely correlated. In the decade ending in 2020, Ball stock compounded at 20% annually, nearly 6% better than the market per year. Since then, performance has faltered, falling almost 60% from peak to trough, as the industry struggled with over-expansion, aggressive pricing, and other challenges. As interest rates soared, investors became increasingly focused on the leverage on Ball's balance sheet, which had spiked as high as 7.6x following the acquisition of UK's Rexam in 2016. The stock's multiple collapsed from highs near 30x in FY20-FY21 to lows below 15x last year, prompting management to go on the offensive. In August, Ball announced the sale of its aerospace division to BAE Systems for 19.6x EBITDA and its intent to pay down debt to ~3x or the low end of its target range, along with ~$2 billion of share repurchases.

Fidelity National Information Services is a payment provider for financial institutions and merchants around the world. We took a hard look at the business around the time we established our investment in Fiserv, discussed in detail here. Thankfully, we decided to pass at the time in favor of what we believed to be a much better competitively positioned business with a much stronger track record of execution. Since then, issues at FIS have gone from bad to worse. The $48 billion acquisition of Worldpay in 2019, which took leverage up to 5.5x on the balance sheet, hasn't turned out quite as well as Fiserv's acquisition of First Data. Fast forward to today, and FIS is unwinding prior mistakes, selling off a 55% interest in the recently acquired business (meaning we now have a hard number for the remaining 45% they own), and using proceeds to take leverage back down to 2.5x post close while repurchasing at least $3.5B of stock through next year. As a result, shareholders will be left with a cleaner balance sheet and a simpler organizational structure, consisting primarily of their very defensive, very profitable core banking business, which traded down to a single-digit multiple vs historical averages for the industry closer to 20x.

Avantor is another compelling self-help story with robust structural tailwinds. Private equity-backed management made a significant acquisition, pre-COVID, which took leverage up to 7x-8x right before the business hit a wall. While we don't have corporate actions on the horizon here to trigger an aggressive debt paydown, we expect leverage to fall back below 3x in FY25 as the cycle finds a bottom and volumes pick up, driving margin expansion and free cash flow generation on top of a largely fixed cost base.

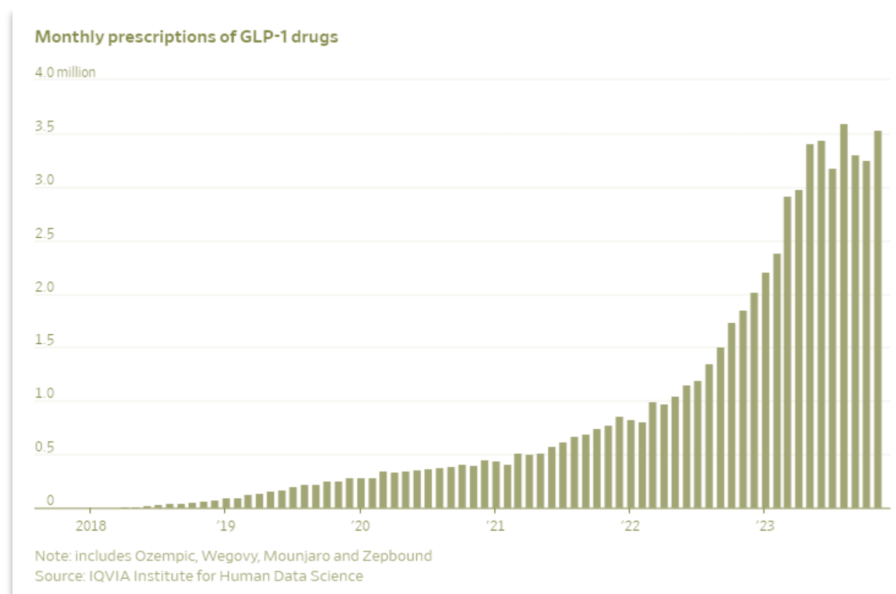
[6] A $1.3 Trillion Debt-Fueled Boom in Deals Faces a Grim New Reality

Temporary dislocations

The second group of purchases is a classic Broyhill investment on steroids, capitalizing on two different but equally extreme dislocations. The only thing they have in common is the size of the dislocation and the magnitude of the madness surrounding them. For investors willing to separate fact from fiction and differentiate between probable and possible, the speculative hype surrounding breakthrough technologies can create compelling entry points into businesses seemingly at odds with those technologies. Unlike consumer spaceships, flying cars, and underwater living, last year saw the emergence of two technologies that we believe are very likely to change consumer lifestyles and corporate workflows. The speed at which the world adopted AI and GLP-1 weight loss drugs was matched only by how quickly these breakthroughs captured investors' imaginations.

We recently shared our thoughts on AI with investors in a piece titled Absolute Insanity. We believe the threat of disruption weighed heavily on the IT Services industry, an industry we've actively followed and invested in for the past decade. While there is some truth to the AI narrative surrounding IT Services – many legacy players are particularly vulnerable to disruption – a handful of companies are positioned to enjoy a massive tailwind from this new technology. We established a new investment in EPAM Systems during the fourth quarter, as we believe the company's digital expertise positions it as an "AI Sleeper" – a prime beneficiary as enterprises look for assistance in strategizing, implementing, and maintaining large language models.

Second only to AI last year was the rhetoric and enthusiasm around GLP-1 weight loss drugs.[7] These drugs, which by some estimates will generate over $100 billion in sales by the end of this decade, were popping up on just about every earnings call last year, with analysts drilling management teams on the risks to their business and investors punishing their stocks. Our work ramped alongside the hysteria. We analyzed the implications of everything from coffee and beer consumption to snacks and candy cravings before landing squarely on obesity and diabetes, where we found the greatest potential threats, the largest dislocations, and the widest gap between perception and reality.



[7] To Pay for Weight Loss Drugs, Some Take Second Jobs

We established a position in Fresenius Medical Care, a German healthcare company specializing in kidney dialysis and related products, at "Peak Obesity" in October of last year. Before the word "coronavirus" entered the world's vernacular, dialysis volumes predictably grew at 3% - 4% annually, which made for a pretty good business for industry behemoths Davita (which counts Berkshire Hathaway as its largest shareholder) and Fresenius, who dominate the US market. That trend ground to a halt as mortality rates for patients on dialysis, which typically average 20% - 25% per year, surged during the pandemic, sending "predictable" volume growth sharply negative. Things went from bad to worse as new "miracle drugs" promised to put an end to obesity, lower the prevalence of diabetes and kidney disease, and "permanently" impair the value of businesses serving these critical markets. We think investors might have gotten a bit out in front of their skis on this one, considering that Fresenius shed nearly three-quarters of its market capitalization from the pandemic's peak. To start, the sheer number of assumptions across dozens of interrelated variables required to forecast these drugs' long-term implications makes for an incredibly wide range of outcomes. Yet, at current prices, shares appear to discount only the worst possible scenarios. It's just not that simple. For starters, the timing of any potential impact is up for grabs at this point. Even assuming the drugs are widely available (they are not), are fully covered by Medicare (they are not), and are taken forever (they are not), kidney disease progression takes place over many years, so any impact on dialysis volumes would not appear overnight. At the same time, any reduction in mortality rates (another benefit of these drugs) would extend the time patients are on dialysis, providing upside to current numbers, something the consensus conveniently ignores in their models. Considering that less than 40% of patients are on dialysis because of diabetes and as many as half of those "crash" into dialysis (meaning they are not diagnosed until they are hospitalized), the potential impact here seems far less worrisome than overwhelmingly bearish investors would lead you to believe. While only one in four analysts currently rate the shares a buy, 20 analysts rate the stock a hold or sell, yet still fail to forecast any material deterioration in the business. Instead, the biggest driver of the bearish call appears to be valuation. With the stock trading near a 50% discount to European peers and those peer multiples already considerably depressed, we find that argument challenging at best. As we see it, shares are trading at 12x depressed earnings, sentiment is thoroughly washed out, and new additions to the board and the executive team are correctly focused on increasing margins and returns.

Medical equipment and device manufacturer Baxter International was another Ozempic casualty. Shares slid 15% the day Novo Nordisk concluded trials showing the drug slowed the progression of chronic kidney disease, potentially impairing the company's Renal Care business, its largest division. This was only the latest of Baxter's problems. After levering up to buy Hillrom in 2021, every one of the company's business segments – we counted ten before the recent restructuring – hit a wall, as increasing costs drove operating margins below 14% in recent quarters from highs north of 18% just a few years ago. Simply put, the company's long-term, fixed contracts with large healthcare purchasing organizations were not designed to offset the levels of inflation brought on by pandemic-era supply chain struggles. As revenues slowed alongside hospital procedures, rising costs crushed operating profits. The multiple on the stock collapsed from the mid-20s towards the single digits, shaving three-quarters off the stock price and taking the market capitalization down to a low of $16 billion after shelling out nearly $12 billion for Hillrom just a few years ago. With shares trading at a trough multiple on depressed earnings, we see much room for upside surprises, and management is taking action to capitalize on the current dislocation. We expect leverage to fall back below 3x by FY25 after the company uses proceeds from the sale of its BioPharma business to pay down nearly $4 billion in debt. At the same time, the spin-off of BAX's Renal Care segment and recently revamped reporting structure should dramatically simplify the story. We see little risk to Baxter's normalized earnings power, which should approach $5 per share over our forecast horizon. We expect the completion of the spin and upcoming capital markets day to provide catalysts for the stock.

AGGRESSIVE DEFENSIVE INVESTING

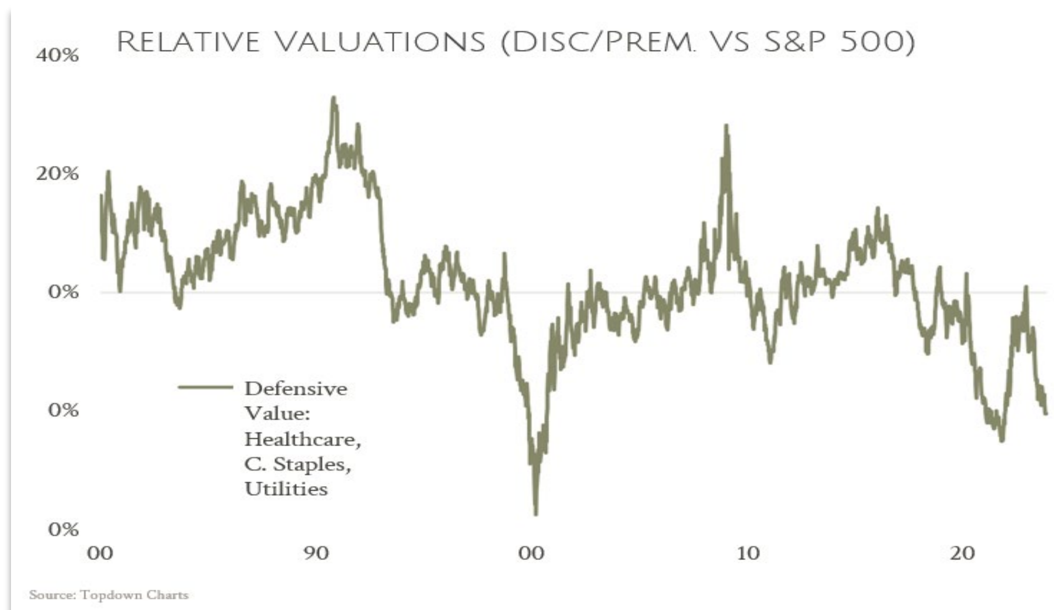
"I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year -- and through discipline to have highly superior relative results in bad times is less likely to produce extreme volatility, less likely to produce huge losses that can't be recouped, and, most importantly, more likely to work (given the fact that all of us are only human).
– Howard Marks

The above quote, from Oaktree's Howard Marks, perfectly encapsulates the investment philosophy at Broyhill. It's also one of the most underappreciated drivers of superior long-term performance.

Investors often confuse maximizing returns with minimizing boredom.

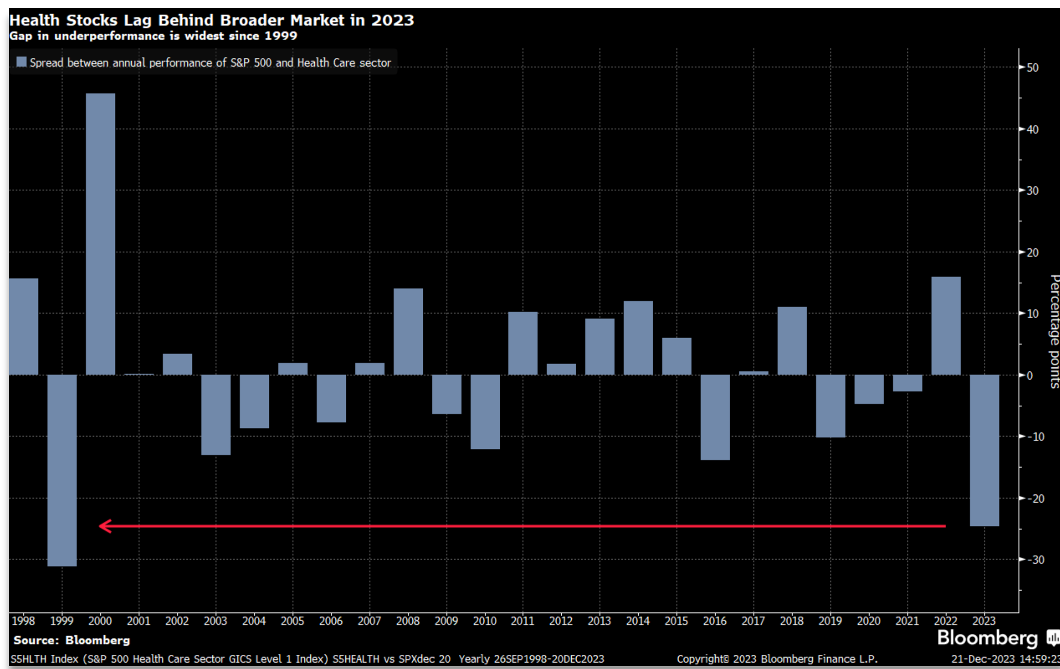
These two things are not mutually exclusive. As we've said in the past, people stay away from boredom for fear of being bored. But at the right price, boredom is as exciting as it gets. We think the price is right for boredom today.

Defensive stocks are trading at a material discount to the rest of the market (chart below). Consensus is pricing in a smorgasbord of rate cuts next year. As a result, the knee-jerk reaction, once again, has been to bid up profitless junk in the hope that falling rates and cheaper capital will provide a longer runway to profitability and a rebound in still-laughable valuations. Investors would be better served by taking a closer look at history. If they are right in anticipating aggressive interest rate cuts this year, they are probably wrong about earnings.



Aggressive cuts are more common during recessions and bear markets than speculative frenzies. In fact, over the last half-century, defensive sectors have outperformed by a wide margin following the first rate cut. Given the current macroeconomic backdrop and attractive starting valuations, that seems like a safe bet today.

We think the setup in healthcare, sitting squarely at the intersection of growth and value, is particularly attractive. Last year, the sector suffered its most dramatic underperformance in a quarter century (chart below), as companies across the industry were pummeled by Ozempic-fueled losses, vanishing biotech funding, shrinking pharmaceutical research budgets, and ongoing supply chain kinks and cost pressures. As a result, many high-quality businesses in the industry are trading at historically low multiples on depressed earnings. Yet, technological change, demographic tailwinds, and rising demand represent structural, long-term tailwinds that should serve the industry for decades. Consequently, we have aggressively ramped this "defensive" exposure in the portfolio, investing across a diverse collection of misunderstood companies with unique value drivers, near-term catalysts for change, and significant upside optionality.



As negative earnings revisions piled up, "overweight" institutional investors (pun intended) unwound positions and retail investors fled, resulting in more outflows than any sector other than energy last year. Management teams were equally surprised by the extraordinary events of the past several years, in contrast to what have historically been very predictable businesses.

Lack of visibility is not something executive leadership or institutional portfolio managers are particularly accustomed to in the healthcare industry. But in just the last few years, they were forced to manage through hospital procedure volumes disrupted by a global pandemic, followed by supply chain problems and staffing challenges, which ultimately led to cost inflation and an inventory cycle on par with the semiconductor industry.

From today's depressed valuations, we see pandemic-related headwinds in the rearview mirror, inventory destocking nearing its conclusion, staffing levels back above trend, and procedure volumes rebounding. Unlike the broader market, which has already discounted the Fed's Triple Lindy, we expect these businesses to report improving comps, accelerating top-line growth, better operating leverage, and various self-help initiatives, driving significant margin expansion. Given the magnitude of the dislocation, we think management teams and investors in the sector will once again be caught offside as upward revisions to consensus estimates drive valuations and stock prices considerably higher as the cycle finds a bottom.

Should the much-awaited "soft landing" fail to materialize, or worse, recession warnings prove prescient, we would expect an even more powerful rotation back to the safety of these high-quality, recession-resilient businesses.

At year-end, the portfolio's top five investments, in alphabetical order, were Fiserv, Fomento Economico Mexicano, McKesson, Nintendo, and Philip Morris. Defensive sectors (e.g., healthcare and staples) represented 70% of invested capital at year-end, more than triple the exposure of capitalization-weighted global equity and global value benchmarks. Importantly, while we believe these investments are priced to perform well under even the harshest economic conditions, we don't think we're sacrificing upside potential to protect the downside. Instead, we expect recent investments in the sector to compound at highly attractive rates of return over three to five years, with a lower risk profile than more economically exposed businesses.

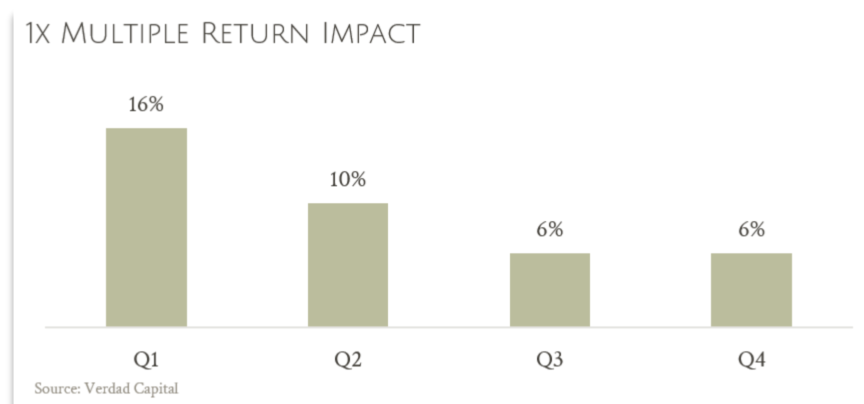
Contrary to popular opinion, greater risk doesn't always translate to greater returns.

Sometimes, it's just greater risk.

BOTTOM LINE

Investors got a hint of what a bursting bubble tastes like in 2022, but after last year's eye-popping speculative rally, which stretched the same assets back to record extremes, animal spirits came raging back. So, where does that leave us today? Simply put, we think a lot of good news is once again priced into stocks. Total equity exposure among discretionary managers reached the 86th percentile of data dating back to 2010, leaving sentiment extremely optimistic. Since 1987, equity investors polled in AAII Investor Sentiment Surveys have been more bullish only 8% of the time. The VIX is bouncing around multi-decade lows, credit spreads are tight despite rising bankruptcies, and equities are again off to the races. It's time to curb the enthusiasm. With defensive sectors of the market trading near historical trough multiples, investors have been given a second chance to rebalance portfolios away from indices heavily concentrated in last decade's leaders towards next decade's value.

Valuations can stay elevated longer than many investors can remain patient. But broken business models, dependent on an unlimited supply of cheap credit and the suspension of economic reality, can only sustain silly prices for so long. The promise of rapid growth may bid up valuations for a time, but eventually, those same investors run for the exits when said growth falls short of expectations. Recent research from our friends at Verdad Capital illustrates this point.[8] "Growth is neither persistent nor predictable. Expensive valuations multiples tend to revert quickly, while cheap multiples revert to the mean gradually over time." Translation for Broyhill: once the cycle turns, the runway for value should be long and profitable, as cheap stocks also have the most leverage to the upside – i.e., a one-turn increase in a cheap stock's multiple has a much bigger impact on performance than an increase in an already expensive multiple.



[8] The Persistence of Value & Growth

A few "magnificent" stocks dominated last year's performance. Consequently, our performance was markedly different from "the market." During these periods, it's important to note that this is a feature of our investment philosophy, not a bug – it's impossible to generate materially different results by owning the same names as everyone else. If we did, we would have reported the same losses as everyone else in the prior year. While these companies drove most of the market's gains last year, the fascination with a handful of stocks left many bargains in plain sight for those willing to think differently. Against this backdrop, the recent increase in portfolio turnover shouldn't come as a surprise. History shows that after an extended period of extremely narrow returns, when a broadening of the market does materialize, it can persist for years. We are looking forward to it.

Organizational Update

At year-end, Broyhill managed approximately $240 million for family offices, institutions, and qualified, high-net-worth investors across separate accounts, turnkey asset management platforms, and private funds. As we continue to build scale after spinning out of the family office, we are committed to growing deliberately, at a measured pace, remaining highly selective in choosing the right partners. To that end, we look forward to meeting with a small group of family offices in Dublin at month-end before going on to host an invitation-only event for a select group of private investors in London. If you'd like to learn more about either event or connect across the pond, please reach out to our Chief of Staff, Pam Reid.

Culture is everything for a high-performing investment organization, as the team must be able to discuss and debate ideas with vigor. "Strong opinions loosely held" is the only approach to consistently get at the right answers, which requires a keen focus on merit rather than delivery. As such, "choosing the right partners" is equally important when selecting investors as well as building a team. We want to thank Vince Calcagno and Michael Hensen at E78 Partners for their contributions to the firm over the past two years and welcome Kyle Minges aboard as Broyhill's latest addition and new Chief Operating Officer. I couldn't be more proud of what we are building and who we are building it with. Every member of this team works towards the same goal – generating superior risk-adjusted performance for our investors – with the discipline, passion, and child-like curiosity that make Broyhill, Broyhill. We are currently considering adding another investment analyst to the team. If you know someone who would be ecstatic to contribute to this culture, please don't hesitate to reach out.

We are grateful for your continued trust and partnership. We come into the office each day striving to earn it, and we realize just how fortunate we are to have such a wonderful group of like-minded, long-term investors who place their confidence in us. You enrich our network, strengthen our competitive advantage, and just make our work all the more enjoyable.

As always, please feel free to reach out at any time with questions. We enjoy hearing from you.

Sincerely,

Christopher R. Pavese, CFA

ABOUT BROYHILL

Broyhill Asset Management is a boutique investment firm, initially established as a family office in 1980 and guided by a disciplined value orientation. Founded in the foothills of North Carolina's Blue Ridge Mountains, we operate outside of the fray and invest with a rational, objective, long-term perspective.

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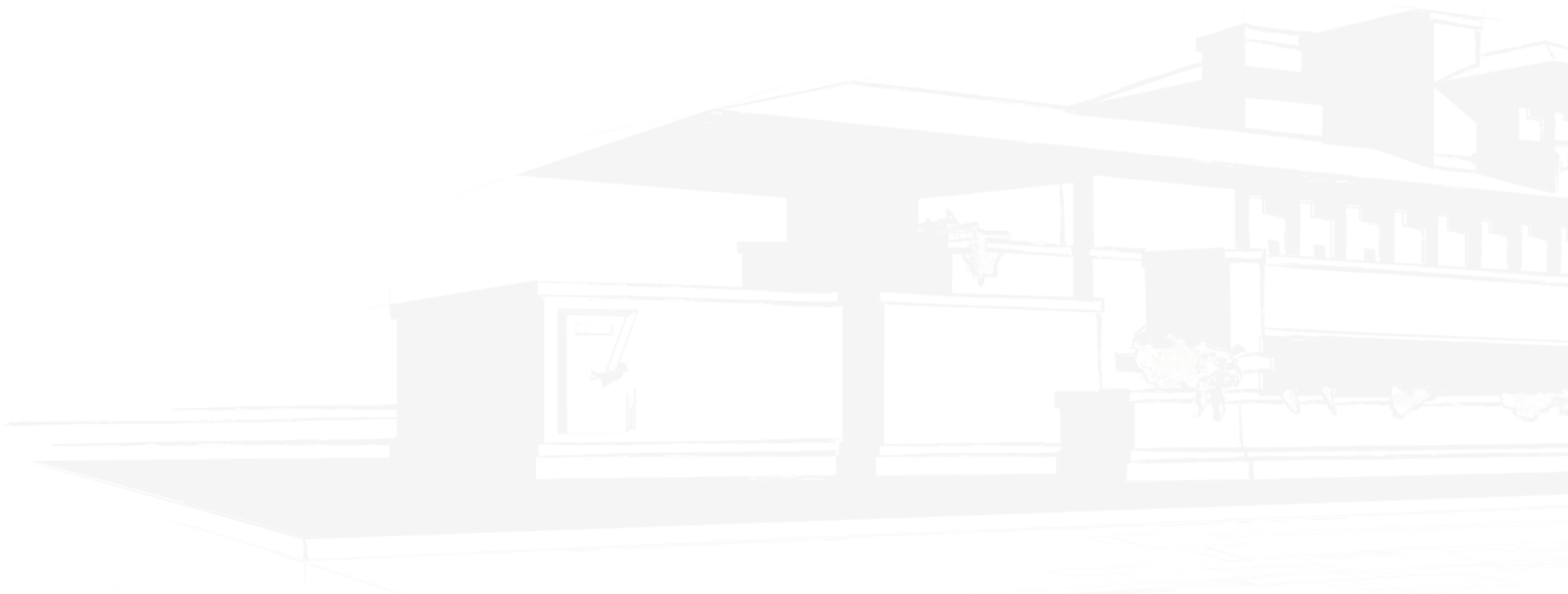

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For additional information about other indices or strategies mentioned here, you may contact us at ir@broyhillasset.com.

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