January 4, 2017

Thousands of years ago, Sun-Tzu observed in The Art of War that, “in the midst of chaos, there is also opportunity.” At no recent time was that more evident than in 2016. In a year when we saw Britons vote to reverse Europe’s march toward ever closer union, voters on this side of the Atlantic delivered what was arguably the biggest electoral upset in the history of our country. In our mid-year letter, we wrote about a world turned upside down. Now, just six months later, we write about a seemingly whole new world altogether. And, yet, in the midst of that chaos, your portfolio is well-positioned to seize opportunities.

There is always a delay between seizing an opportunity and realizing the rewards of that effort. In our 2016 Mid-Year Letter, we noted that “oftentimes, we need to wait years to reap the reward for great ideas,” and “that waiting can be difficult, and some investors may be tempted to chase a perceived quicker reward.” With seeds planted some time ago, your portfolio is now poised for reward.

The conventional wisdom about the 2016 Presidential Election was that a Trump victory would wreak havoc upon the global financial structure. Contrary to that thinking, though, the election result provides a golden opportunity for philosophical cohesion across the political branches of the Federal government. That opportunity will, in all likelihood, manifest itself in the form of sensible tax and regulatory reforms and enhanced infrastructure spending. Because of that tax reform, we should see repatriation of the approximately $2T which is now trapped overseas. American companies might well use that cash for business reinvestment, debt reduction, greater dividends, and stock buybacks.

Even before the election, 2016 equity returns were respectable. Generally, investors rewarded those stocks which were most undervalued at the end of 2015 and, during the year, oil and industrials recovered. We now find ourselves in the early phases of what should be a multi-year cycle of value outperformance.

The now ongoing recovery of the equity markets is accompanied by a sharp sell-off in the bond market. After reaching a generational low in July (1.36%), the 10-year Treasury now trades at a 2.5% yield, with most of that movement having occurred after November 8th. We expect that trend to continue and that, as the bear market in fixed income intensifies, money will move from bonds into those non-bond like equities which are leveraged to higher growth (e.g. commodities, materials, industrials, and financials).

Asset-sensitive financials, of course, are well represented in the GDS Investments portfolio. We purchased those pre-2016 with an eye toward a rising interest rate environment. That is the very
environment in which we find ourselves today. In addition to their receptiveness to rising interest rates, the banks in the portfolio are very-well capitalized, and prepared to do well in an era of smarter regulation.

In its latest 10Q filing, Bank of America (NYSE: BAC) estimated that a 100 basis point increase in rates would generate an additional $5.3B in annual net interest margin. Those types of projections, combined with the less-reactionary, and more targeted, regulatory atmosphere which we expect from the new administration, should work quite nicely for our earlier investments in financials.

GDS Investments is also well positioned in agriculture. That sector should experience growth with a cyclical rebound in crop prices as the record output of recent years works itself through the supply chain. The portfolio includes FMC Corporation (NYSE: FMC), which, in April of 2015, purchased Cheminova A/S. As a result of that acquisition, FMC Corporation now enjoys additional leverage to cyclical improvement in crop nutrients suppliers, a decrease in the company’s reliance on the corn and soybean markets, and opportunities within the more attractive “niche” coffee, cotton, and rice markets. Furthermore, FMC Corporation owns sizable and rapidly-growing positions in businesses which sell natural ingredients to the food and pharmaceutical industries, and battery-grade lithium to electric car manufacturers. Even after its substantial gain in 2016, FMC remains materially undervalued.

We also hold The Mosaic Company (NYSE: MOS), which recognizes itself as “the world’s leading producer and marketer of concentrated phosphate and potash crop nutrient.” Demand for that product is accelerating while supply rationalizing is in “full swing,” resulting in 6M to 7M tons of potash capacity being removed over just the last 24 months. Having realized significant operational efficiencies, The Mosaic Company is now spring-loaded for enhanced profitability when demand for phosphate and potash crop nutrient improves.

General Motors Company (NYSE: GM) remains a stalwart in client portfolios. The American icon has $20B in cash on hand, $10B in annual free cash flow, and is committed to large buyback of common shares ($4B to be completed before year-end 2017). That buyback is in addition to a $5B repurchase plan which the company completed ahead of schedule, and at an average purchase price of $33.45 per share (well below intrinsic value). General Motors Company retains $50B in net operating losses (NOL’s) and a growing and well-covered annual dividend of $1.52 per share.

We remain committed to the energy sector, where industry reaction to low prices means that decreased production remains the norm. Oil is getting harder and harder to discover, and many oil producing countries (i.e. Mexico and Venezuela) find themselves without the infrastructure necessary to support ever-more difficult exploration. Meanwhile, other oil producing countries (i.e. Iraq and Libya) still must grapple with the even greater problem of political and security instability. The energy sector positions in the portfolio are fully-integrated, and skewed toward diversified global activities (e.g. BP PLC (British Petroleum) (ADR: BP)). We also know that energy tends to outperform in an environment of rising interest rates, as evidenced by its massive outperformance in the 1970’s (the last prolonged period of rising inflation). As noted above, that’s the very environment in which we’ll find ourselves in 2017, and beyond.
We count several other positions which should fare quite well in the move away from bonds and bond-like equities. One of those is health care, which dramatically underperformed the major indices in 2016. In that sector, we hold Abbott Laboratories (NYSE: ABT). That company is led by long-serving Chief Executive Officer Miles White. Mr. White has consistently made very large purchases of the Abbott Laboratories’ stock (i.e. 731.5K shares at $43.23 after the company reported Q2 earnings in July, and 370K shares at $40.54 in November). He was also instrumental in Abbott Laboratories’ 2013 split from AbbVie Inc. (NYSE: ABBV) and its forthcoming merger with St. Jude Medical, Inc. (NYSE: STJ), a significant participant in the medical device business. That merger, which is expected to close on January 4, 2017, will make Abbot Laboratories more competitive in the important medical device sector.

Another position is QVC, Inc. (NYSE: QVCA). This capital-light business enjoys a notably wealthy, and exceptionally loyal, customer base. Having acquired the zulily brand in 2015, QVC, Inc. added to that customer base, and quickly realized revenue and expense synergies. With a very skilled management team at the helm, QVC, Inc. should continue a strong history of growth, share repurchases, and value-enhancing acquisitions.

The past twelve months were anything but normal, and may have left you feeling unsettled amidst the seemingly constant chaos which marked 2016. Human history, though, proves that chaos is a crucible for great opportunity, and for ongoing realization of the benefits of the GDS Investments strategy. We will continue to implement that strategy in 2017, as we continue to maximize those opportunities on your behalf.

With warm regards,

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