Q3 2024 - Large Cap Value Quarterly Update

[Music]

Hi, I'm Dan Babkes and I'm a portfolio manager on the US large cap strategies at Pzena Investment Management and today I'd like to give a brief update on the overall market environment and our portfolios. After a steep sell-off in August in response to some soft employment data, the markets were broadly sharper as investors began to anticipate the FED pivot towards rate cuts. Uh, notably, the rally was pretty broad-based this quarter as opposed to earlier in the year where the market was really led by a small number of mega-cap tech stocks. Um, with that said, the top-performing sectors were rate-sensitive, such as, such as real estate and utilities during the quarter. Value did outperform, perform the broader market. Um, but, uh, value is still behind year-to-date in terms of the portfolio performance. Our large cap strategies were up in the quarter but we did underperform the value indices. This wasn't driven by any particular sector macro theme, um, but really because we manage concentrated portfolios. Our performance tends to be much more driven by company-specific developments versus the industries that are, are quite broad. Um, typically, a company only makes it into our portfolio if a problem has really depressed the valuation and oftentimes there's a lot of near-term uncertainty around the company's performance. And what we're typically trying to do is effectively arbitrage some of this near-term uncertainty based on a longer-term view that we have around the valuation. And during this quarter, uh, a couple companies in the portfolio, um, did give updates that indicated the near-term performance was actually getting a bit worse. Um, and that th—those stocks did have pretty sharp pullbacks and that negatively impacted the, the portfolio performance on a relative basis. So I'll give a couple examples of these. Um, the first one would be Dollar General, which was our, our largest detractor in the quarter. Now Dollar General is a discount retailer that primarily targets the low-income consumer. This is actually the largest retailer in the US in terms of store counts; they have 20,000 stores, just to put that in perspective. Um, Walmart has about 3,500 super centers across, across the US. These tend to be much smaller concept stores targeting that low-end consumer, and the way they compete really is based on both value. So they're offering prices that are similar to Walmart but also convenience. They tend to be located a little bit closer to people's houses and the smaller format allows for quicker trips. So Dollar General has been under pressure primarily as a result of some supply chain issues that they faced coming out of the pandemic. Um, so as the demand patterns were fluctuating and their supply chain came under stress, they ended up holding too much inventory and effectively the wrong type of inventory as demand patterns started to normalize after the pandemic. And this has led to a whole host of operating issues that really depress their margins. Um, Chief among them is what the industry refers to as shrink, which is effectively theft.

Now our view has been that over time, Dollar General should be able to whittle down its excess inventory and normalize somewhere closer from the current depressed levels back to the somewhere closer to the historical levels that they've reported before this problem existed. Um, in the quarter, um, they reported that U their 2024 earnings are expected to be a bit worse than they thought. Um, this is in response to two things: number one is just macro pressure on the low-end consumer, so inflationary pressures are biting and that's, that's leading to some pressure amongst their core customers. And in addition to that, um, Walmart has, has created a, a bit of a more promotional environment, so they're making some price reductions as a competitive response. Uh, so the market interpreted this to mean that Dollar General's core business model may be structurally impaired and the, and the shares had quite a significant pullback in the quarter. We use this as an opportunity to add to our position. So while we don't discount the potential competitive threat from, from Walmart, um, we still believe the core issue that's been weighing on Dollar General's margins has nothing to do with the current competitive environment; that's only a pretty small incremental change. And the macro pressure on the low-end consumer is more cyclical in nature than it is structural. So, as the company is able to fix some of the issues from its historical supply chain problems, we expect those margins to start recovering in the coming years and we believe this has given us a pretty attractive entry point for Dollar General. The last point I'll make is the valuation is extremely compelling. So, the, the company historically reported margins well above 8% on average. This year, they're expected to do less than a 5% margin rate. If their margins never recover, meaning our thesis is completely wrong, then the shares are still trading at a below market multiple on the current level of depressed earnings. So, so we, we like the stock and we add it to it because even if our thesis is wrong that the margins should start to recover as they fix some of their issues, um, we're still going to collect a better earnings yield than if you bought the overall market. Um, another, another example of a stock like this is Humana, which was also a detractor in the quarter. Uh, this is a large health insurer and they're effectively a pure play in the Medicare Advantage market. Um, the big issue that Humana has been facing in, in recent history is elevated medical loss rates relative to the levels in which they priced their insurance plans. Um, this stems from the fact that during COVID, a lot of the elderly population that that uses Medicare Advantage plans had depressed utilization of hospitals and other, electrical, other elective procedures. As utilization has picked back up, their core Medicare Advantage offerings, um, were mispriced relative to the current elevated level of, of utilization that's driving these higher costs. This has happened historically in, in health insurance plans before where, where medical loss rates were, were unexpectedly high and what's happened historically is the insurance repriced to the current level of utilization and their margins eventually recover. Um, we expect that to happen again for Humana. The big uncert—uncertainty is it may take some time for, for that to materialize and in the short term, um, that, that problem has been getting a little bit worse and there has been some pressure on the reimbursement environment for the government, which is causing a bit of a further squeeze in the short term. So this is another example of a company where we believe long term this is a very high-return business with an exceptional growth, exceptional prospect for, for growth. The valuation today is very depressed because the earnings have, the earnings have been pressured by the elevated loss rates and over time we expect that to normalize. And if we're wrong again, the shares are still trading at below market multiple on their current depressed earning stream. So, we think the risk-reward looks, looks really attractive and we did also add to our, our Humana holdings.

As far as what we're doing in the portfolio, um, really, we've been rotating into stocks like Humana and Dollar General that that are presenting us good opportunities that have underperformed. Um, we've been funding that by trimming some of the stocks that have outperformed. Um, examples of that are California utility Edison International and some of our financials holdings that have done quite well over the past year. Um, and we're very excited about the portfolio from here. We think the valuations look extremely attractive on both a relative and absolute basis and the opportunity sets quite broad across diverse set of industries and there's a, a very significant company-specific overlay to most of the positions in the portfolio. So, we, we, we feel, we feel very good about the way we're positioned going forward. [Music]