Argosy Investors

July 15, 2020

Dear Investors,

We can't imagine being more confused than we are now when it comes to how financial markets are responding to the news. There is significant and widespread unemployment, there could be a higher corporate tax rate if Joe Biden is elected in November as polls currently suggest, there is social unrest unseen at this scale since the 1960's, and we haven't even talked about what's going on outside the U.S. Based on the market's recent move upward, many market participants seemingly believe that the economy is in the process of snapping back to the levels of February 2020 within the year.

The S&P 500 continues to claw back losses on the backs of world-beating companies like Amazon, Netflix, Alphabet, Facebook, Microsoft, and Apple. Too be fair, many of these companies do benefit from the increased time many of us are spending at home, be it watching Netflix, shopping online through Amazon or Google, spending more time on social media apps like Facebook or having virtual meetings via Microsoft Teams. Do any of these businesses suffer during a recession? Ad dollars certainly contract dramatically. Businesses shut down and people are laid off, so there are fewer Microsoft accounts created. Discretionary incomes to purchase the next iPhone are likely lower. Netflix may be immune from the impacts of the virus, but it too faces significant competition from a host of streaming services, particularly Disney Plus.

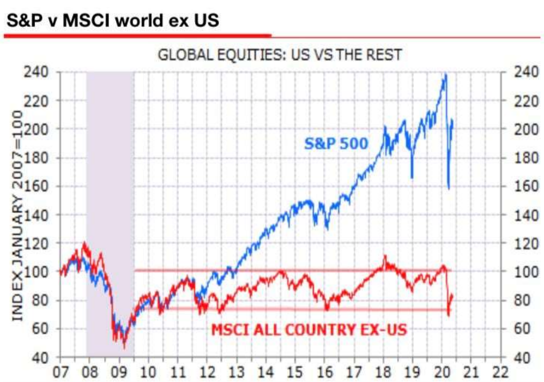
It is also difficult for anyone, let alone us and our meager resources, to understand approximately how many people will be furloughed or laid off after PPP (Paycheck Protection Program) funding expires. It is difficult to know how big the hole in states' budgets will be, and if that will result in layoffs or furloughs of state or local government-employed employees, including police and teachers. It is very difficult to know how spending evolves as the extra $600 per week for unemployed workers winds down (it will be down but by how much?). How many people will lose their homes, cars, boats, etc. when loan forbearance expires? What will happen to banks' willingness to lend to individuals and businesses trying to expand (Anecdotally, we know of two local financings where banks fell completely off the table after being initially interested)?

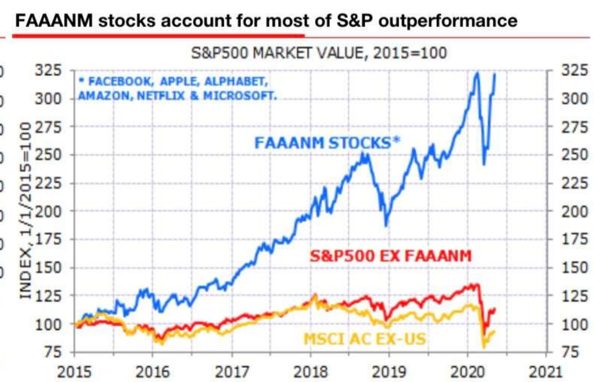
2 of the top 5 sectors of employment are 1) retail, and 2) leisure and hospitality, according to the Bureau of Labor Statistics. These two sectors have been hit incredibly hard as a result of this pandemic and the collective 30+ million people who work in these sectors (out of approximately 160 million in total) may be unemployed or underemployed for longer than a few months. That is what is interesting about this pandemic and the market's response. So-called Main Street is hurting, with businesses large and small closing or choosing furloughs, while the companies mentioned above and other stocks supposed to help us work from home are trading at nosebleed valuations. That combination has resulted in a relatively flat market through the first half of the year.

There are two broad scenarios we see playing out: 1) the virus exhausts itself fairly quickly as herd immunity (or some kind of treatment) begins to develop, or 2) the virus continues to paralyze many parts of the world and slowly works its way through society. In the first event, we could see a quicker return to normality which might reverse some of the gains of work-from-home beneficiaries, such as $73 billion Zoom Communications with less than $2 billion in revenue (40.5x) and less than $400 million in operating profit (182x), and $35 billion Docusign with about $1.3 billion in revenue (27x) and 78 million in operating profit (448x). These companies' values might decline as adoption of their services does not materialize as rapidly as hoped. In contrast, some of the more cyclical companies that have been hurt in the current environment would likely see their shares rebound as expectations for a more normal business environment take hold. These would be the cruise ships, airlines, hotels, theme parks, auto suppliers, and others that have seen their businesses limited by COVID-19. Putting these two broad phenomena together, the market might again stay roughly flat.

If scenario 2 happens, which we personally believe is more likely given some of the news we've read related to retail bankruptcies and airline layoffs to name a few, the market for many goods and services, including software, could be impacted. Cyclical companies may not recover very quickly, which would lead to the market being down, as investors realize that the largest tech companies can't grow their businesses very quickly when citizens at large are spending less.

The graphs below capture nicely how this market is currently divided into the haves (large tech stocks) and the have-nots (everyone else). The S&P 500 index excluding 6 large stocks is basically flat the last 5 ½ years and has not performed well during the pandemic. In contrast, the 6 large stocks (Facebook, Apple, Alphabet, Amazon, Netflix, and Microsoft) are collectively back above pre-coronavirus highs.





Source: Gerard Minack, Downunder Daily

This is a tough environment to invest in because looking back at the last 5-10 years, the best decision we could have made was to simply buy these 6 stocks and go enjoy our time doing other things. Some traditional value investors may criticize our ownership of Facebook and Alphabet, but these are the two companies which we believe offer attractive long-term prospects AND reasonable valuations.

In short, we see the opportunity set in the market in a more negative light at present. We continue to look for and identify attractive companies, some of which we can buy now at reasonable prices while others will need to go on our watchlist until prices become more attractive.

EXISTING PORTFOLIO ACTIVITY

During the quarter, we trimmed JD.com after a significant run to reflect our increased fears that U.S. markets may not remain open to Chinese companies. We added to Fairfax Financial as its P/B ratio fell to 0.6x, levels not seen in many, many years. Assuming the company merely delivers average returns over time, the business is probably worth double the approximate 0.6x valuation we purchased it at. The sexiest purchase of all, we purchased a Fidelity Bond Fund in an effort to earn low-risk paltry returns on our cash. We had moved some funds out of bonds into cash in expectation of imminent opportunities to purchase equities at attractive prices, but that dream was deferred a while longer.

REALPAGE

We purchased shares of RealPage (RP) during the second quarter, and the stock has tread water since our initial purchase. We have some degree of background knowledge given that in addition to following the public equity markets, we actively invest at a small scale in our local and regional real estate markets. Given our experience (albeit limited) here, we appreciate the one-stop shop for property investors that RealPage is building. They offer software that property managers use to manage property listing, tenant screening, tenant on- and off-boarding, rent collection, tenant communications, and more. They compete with many small software solutions but their customers are concentrated among the largest property managers. The real estate market is a large and increasingly institutionalized space. As the market grows more concentrated, RealPage should benefit as the largest property managers consolidate their positions. Additionally, as a result of RealPage either developing or acquiring new solutions for property managers, they can offer incremental services at high margins to existing customers. RealPage's largest public competitors are Appfolio and CoStar, although CoStar's expertise is more in property listing services. CoStar is however very aggressive and its CEO could easily expand into markets more directly competitive to RealPage. We believe we purchased RealPage at 24-25x cash flow and we believe RealPage can grow cash flows at double digit rates for an extended period.

PERFORMANCE

Year-to-date performance was 3.4% in select accounts. The S&P 500 by comparison returned -2.3%. (Note that some accounts which are relatively newer may have less capital invested and thus did not earn the returns mentioned above). Keep in mind Argosy's portfolio ended the quarter with 44% of its assets in cash and short-term bond funds. We believe these returns reflect both the solid performance of our top holdings (only one individual stock in the top 10 registered negative returns) and yet could have been a bit better had we held onto some of the riskier names we eliminated last quarter, specifically Covetrus.

CONCLUSION

With the first half of 2020 behind us, we can only hope the rest of 2020 brings us less surprises than we've had to date. While surprises sometimes mean opportunity in the investment business, we take no joy in the devastation that this virus is having on people's health and which the lockdowns/distancing measures (as necessary as they may be) are having on the financial health of individuals and businesses, large and small. We have been developing deeper understanding of the industries of the future, and new research resources are helping us develop deeper understandings of businesses we would love to own at the right price. A short list of businesses we admire but don't currently own due to price include Heico, Floor and Décor, Grocery Outlet, Watsco, Teledyne, Copart, and Danaher. We hope we get opportunities to own some or all of these businesses over the course of time. Stay safe. If you or anyone you know would like to learn more about Argosy Investors and what we can do for you, please e-mail mike@argosyinvestor.com.

Until October,

Argosy Investors

APPENDIX

Largest Holdings as of 06/30/2020				
Rank	Name	Ticker	% of Total	YTD % Return
1	Cash	Cash	23.6%	0.4%
2	Vanguard Gov't Bond	VGSH	13.4%	3.0%
3	S&P 500 ETF	VOO	7.8%	-2.3%
4	Fidelity Bond ETF	FBND	6.8%	6.2%
5	Trisura	TRRSF	4.6%	46.0%
6	Facebook	FB	4.2%	13.7%
7	Endava	DAVA	2.9%	5.8%
8	FirstService Corp	FSV	2.7%	7.5%
9	Fortive	JD	2.0%	-10.6%
10	Stoneco	FTV	1.9%	0.6%
	Total		69.7%	

Note that the above chart shows the concentration of all assets managed in all accounts. The performance reflected within the body of the letter only includes a subset of all accounts, but should be representative of investor experience over time. Many investors still hold high levels of cash because they are relatively new clients to Argosy.

We are still looking for additional ways to share more details on our aggregate performance on a consistent basis, given constraints related to how our various clients are set up at different custodians. We now can view the total portfolio in aggregate, but we are still gaining comfort with various aspects of the tools available to us.