TEMPLETON & PHILLIPS
CAPITAL MANAGEMENT, LLC
A BETTER VALUE

January 31, 2021

Are *You* Different this Time?

"'This time is different' are among the most-costly four words in market history."

Sir John M. Templeton, March 1994

Whenever we notice a relative uptick in public references to Sir John's "This time is different" quote (above) it is usually a good idea to turn a critical eye towards general market behavior. Depending on your age and experience, looking at today's market brings back a bit of nostalgia for the late 1990s. Scrolling through a Twitter feed of investors and traders today reads like an echo chamber from the dotcom mania. Whether the year is 2021 or 1999 "You don't understand Tesla" (does anyone?) and "P/Es don't matter anymore" (caveat emptor), sound a lot like "You don't understand the new economy" and yes, the timeless "P/Es don't matter anymore" was as popular in 1999 as today.

To be sure, the point of our commentary is not to antagonize Tesla bulls or P/E haters since those debates are at best a red herring, if not a complete rabbit hole. Besides, reflecting on the fundamental arguments of the late 1990s reveals that the bulls had it mostly right. We say "mostly right" because many of their forecasts actually fell short. The internet changed the world in profound ways that arguably defied imagination. Instead, the real lesson from the late 1990s was that valuations—even P/Es—still matter.

One could draw on any number of examples from that era to validate our point. Perhaps the best illustration though comes from a household tech name since the 1990s, that still dominates today. First introduced in 1985, Microsoft Windows has maintained its desktop software prowess ever since with a formidable 77% market share (as of December 2020). From a 1990s tech bull's perspective, Microsoft has been living the dream. The company still dominates the market it created decades ago, as evidenced by its over 1 billion users. Far from a one-trick pony, in the last twenty years, Microsoft successfully tackled the gaming market and not to mention fought off Google during its transition into the cloud-based desktop with Office 365.

Despite its myriad successes during the past thirty years or so, investors that bought the shares at the height of the dotcom mania in the late 1990s had to wait 17 years to generate a positive return—yes, 17 years. In hindsight, it is relatively easy to see that back in 1998 Microsoft's Price to Sales ratio of 21.9x and its P/E of 61.0x had already accounted for almost two decades of success that would follow. Bear in mind that Microsoft was a remarkable company success, but a multitude of other popular tech companies (and their stocks) from that era have long since disappeared.

This returns us to the question of whether "this time is different." Before we answer, we recommend investors first face the question "are you different this time?" If so, then it requires a mastery of cognitive dissonance that eluded tech bulls in the late 1990s. In 2021, we count no less than 718 stocks in the U.S. trading at more than 20x sales; what are the chances these 718 companies will be at least as successful as Microsoft? This time is not different.

That does not mean however that this is a bad time for all investors. Continuing with our 1990s example, we watched Sir John profit masterfully by selling short tech shares as their IPO lockups expired—a strategy we discussed in greater detail in *Investing the Templeton Way (McGraw-Hill, 2008)*. Moreover, in the years coinciding with the unwinding of the dotcom mania, neglected shares offering real value to investors performed well despite the long bear market in technology shares that followed.

In our view, there are still areas in today's market offering attractive values, provided the investor can exercise patience. Not surprisingly these areas require a bargain hunter's mentality, if not an altogether contrarian mindset. We can summarize these pockets of value by geography and sector, and they include the U.K. and Real Estate.

Beginning with the U.K., we find an overall stock market that has underperformed its developed market peer group for several years due to the uncertainty surrounding Brexit, and more recently the devastating impact of COVID-19 on the country. These successive factors have also led to noticeable valuation gaps on a P/E (15.4x), dividend yield (3.9%), and free cash flow yield (5.8%) comparison with the U.S. and Continental Europe. Despite these discounts, the U.K. is also home to many attractive multinational companies, whereas only 23% of FTSE 100 listed revenues are from the domestic market. This last measure includes a higher concentration of sales into the emerging markets, representing 24.6% of the total (FTSE 100) versus 18.8% and 9.4% in the Euro Stoxx 50 and the S&P 500, respectively.

Within the U.K. we continue to highlight our view that shares in Unilever represent an attractive opportunity. From a valuation standpoint, we note that the shares' 3.6% dividend yield and 9x P/E Excluding listed EM subsidiaries is significantly discounted versus peers. On this last measure, we note that Unilever's discount to Nestle now sits at its widest point since 2008. Turning to the fundamentals, we have been encouraged by management's willingness to focus on capital allocation and further optimization of its brand portfolio, including the sale of its tea business. We continue to believe that as fiscal and monetary policy measures eventually slow and subside that strong capital allocators with well-managed balance sheets will be in the best position to grow through the remainder of the cycle. On this last point, we remain attracted to firms with reasonable valuations and a good track record of dividend increases through internal discipline on capital allocation. Finally, to the extent that U.S. fiscal and monetary policy continues to pressure the USD, we favor the GBP and EM currencies as the best historical performers on a historical basis versus a weaker dollar.

Turning to the real estate sector, we believe we are capitalizing on another depressed market facing significant near-term pessimism. The near-term pessimism surrounding the commercial real estate sector is understandable in light of government shelter in place policies during the past 10 months or so. Nevertheless, our selection bias favors the same attributes we see in Unilever and other holdings. Again, our focus is on owning firms with a demonstrated ability for skillful long-term capital allocation. In this instance, we have been adding a position in Brookfield Asset Management to our portfolios. Beginning with valuation, we find Brookfield attractive with a 10.8% free cash flow yield compared with 6.6% on a historical basis. In the case of Brookfield, we find the near-term pessimism surrounding its commercial real estate portfolio providing an attractive valuation while overshadowing a compelling case for higher future returns on invested capital.

To begin, the company has been able to use its strong balance sheet to improve its asset management business with the acquisition of Oaktree Capital Management, and therefore build a reputable distressed debt and real estate offering to complement its existing asset management portfolio. Throughout the

past ten months we have not lost sight of the fact that the pre-COVID corporate debt excesses have only since become much worse. In time, we believe these imbalances will correct, and we also believe that Brookfield is now positioned to capitalize even better than before in a distressed credit environment. Importantly, Oaktree's established footprint in the distressed space provides Brookfield with a new source of counter-cyclical cashflows that should help stabilize the firm's overall cash flows through the entire credit cycle. If so, we also believe this could lead to higher average returns on capital and in turn, valuation multiples. Likewise, we find Brookfield's positioning for success in the various interest rate and inflationary environments compelling on a long-term basis; i.e., real assets outperform with rising inflation, while alternative investment portfolios (Brookfield manages approx. $290 Billion AUM) focused on yield should attract capital (with strong fee generation) in low rate environments—the firm covers both scenarios. Finally, we are also optimistic about Brookfield's opportunity set in its leading Renewable Energy portfolio as we find ourselves in a market increasingly driven by ESG, climate change, and the likelihood of both public and private investment initiatives to support these objectives.

Based on our studies, the most successful share price returns for any ten-year period over the past thirty years are created by firms with rising returns on invested capital versus a consistent weighted average cost of capital. We believe Brookfield has made the necessary investments to accomplish this objective, while today's uncertainty and pessimism has created an attractive valuation for the shares.

Happy Bargain Hunting,

Templeton and Phillips Capital Management, LLC

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