We See Value Where Most Just See Price

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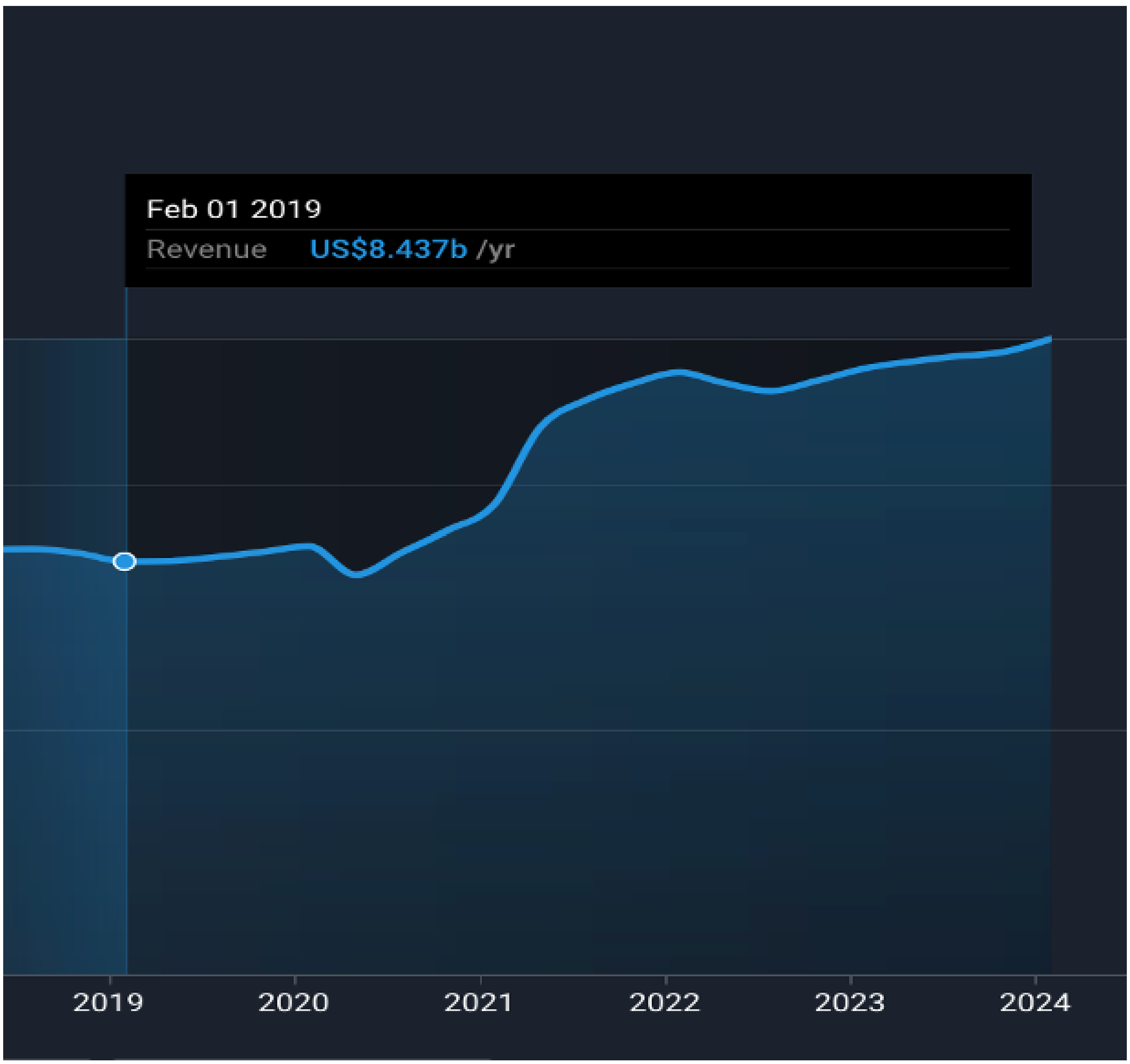
Last month, we highlighted one relatively new addition to our core equity holdings. I wrote about what we see in this company, which gives us confidence to buy at current price levels. Since purchasing the stock of last month's highlighted company, the share price has fluctuated between up to 10% and down 5% from a rough estimate of our average initial purchase price. This price movement so early in our holding period, which we hope will end up being three years or longer, is inconsequential to us, and we believe it provides zero indication of whether our decision process was sound.

When we often initiate a new equity position, we are drawn to a company's stock because the price has declined to levels that we deem to be incongruent with the long-term intrinsic value of the company. Unusually, we make an initial investment at the cycle-low price point. We expect that the sentiment or macro conditions that push an investment's price down to what we view as a compelling value can and will persist for some time after we make the initial purchase. Therefore, it is not uncommon for those initial shares we purchased to likely register an unrealized loss on more than one occasion during the first year or two after the initial purchase. Our typical fully diversified client portfolios will hold between 25 to 35 individual equity positions. At any given time, it is not uncommon for a portfolio to have at least a third of its positions sitting with an unrealized loss; this is especially true among those stock positions that were recently added. We do not attempt to pick the bottom or capitalize on a recent uptrend. Our assessment of price versus value drives our focus.

I will spend this commentary discussing one of our most widely held equities over the last two years. By the end of 2023, DKS stock had become one of our top three holdings in terms of overall dollar size. We first began purchasing DKS stock in December of 2021 at price levels between $107 - $110 per share. The chart below, generated by SimplyWallSt.com, shows the path of DKS stock price over the last three years:

As can be seen from the chart above, the drop in the stock price during the latter months of 2021 is what attracted us to the company at the end of 2021—by mid-2022, DKS stock price had dropped more significantly, back down to the level last seen during the early months of 2021. Dick's Sporting Goods (DKS) is a nationwide sporting goods retailer. As such, it experienced a significant negative impact during the height of the pandemic, resulting in social distancing and limited traditional in-store shopping. It was not until early 2021, with the more widespread availability of vaccines and the loss of pandemic restrictions, that most traditional retailers began to see foot traffic in their stores recover.

We can see from the SimplyWallSt.com chart below the 2020 pandemic-induced decline in revenues, followed by the last 2020 – 2021 reacceleration associated with the vaccine introduction and the loosening of restrictions:



2021 represented a period of the pandemic when vaccines lowered the fear in the population of contracting one of the many strains of COVID-19 and developing severe symptoms. Thus, retailers saw a one-time revenue boost as the pent-up demand from 2020 was unleashed within the economy. However, uncertainty persisted as we saw one virus mutation after another develop. At that time, it was unknown just how effective the vaccine boosters would be in combatting severe symptoms from now on. For that reason, we hesitated to jump into what looked like oversold traditional retailers. It was not until late 2021 that we got comfortable that the likelihood of returning to a period of COVID-19-induced restrictions was unlikely.

As the end of 2021 approached, we screened for one or two retail company opportunities to invest. Dick's Sporting Goods (DKS) was one of those resulting opportunities that we were drawn to for valuation, category, and management reasons. See below the SimplyWallSt.com chart, which shows the valuation, as measured by P/E ratio, for DKS stock over the last several years:

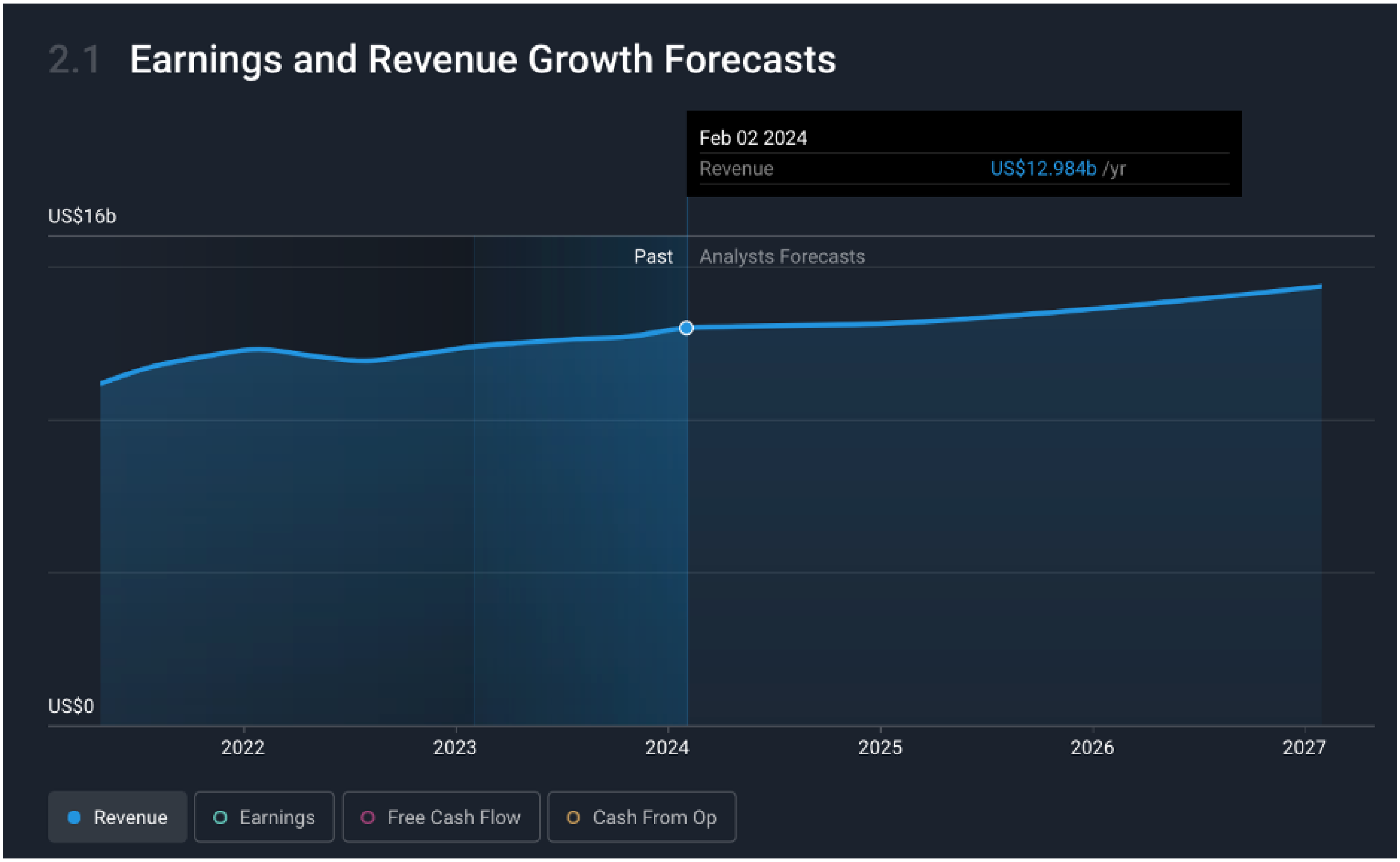
When we first purchased shares of DKS stock, the price-earnings ratio was in the high single-digit range, which was well below pre-pandemic levels and, more typically, in the 12x – 14x range. Little did we know then that over the next six months, the U.S. equity market would enter a Bear Market brought about by an abrupt about-face by the Federal Reserve related to tightening monetary policy through higher interest rates and the unexpected invasion of Ukraine. By mid-2022, the valuation of DKS stock, which looked inexpensive in late 2021, saw the price-to-earnings ratio drop to a mid-single digit multiple and a stock price reminiscent of levels last seen during the throws of the locked-down economy pandemic period.

During the middle part of 2022, we significantly added to our DKS stock positions and continued to do so over the remaining months of 2022 in periods of weakness. Based on stock price levels, our DKS stock investment looked dire, and to the untrained eye, it probably looked like we were throwing good money after bad. Even the equity analyst community seemed to lose faith in the company. We were undeterred and more confident than ever in our DKS stock position. Below is a historical graph of the stock price versus the consensus analyst estimate of DKS stock:

Our long-term fundamental assessment of the value of DKS stock when we made our original purchases was between \$150 - \$165 per share. As seen above, the equity analysts who cover DKS stock have moved their consensus one-year price target since early 2022 from approximately \$140 per share to as low as \$101 per share in mid-2022, only to move it dramatically higher just recently to \$224 per share.

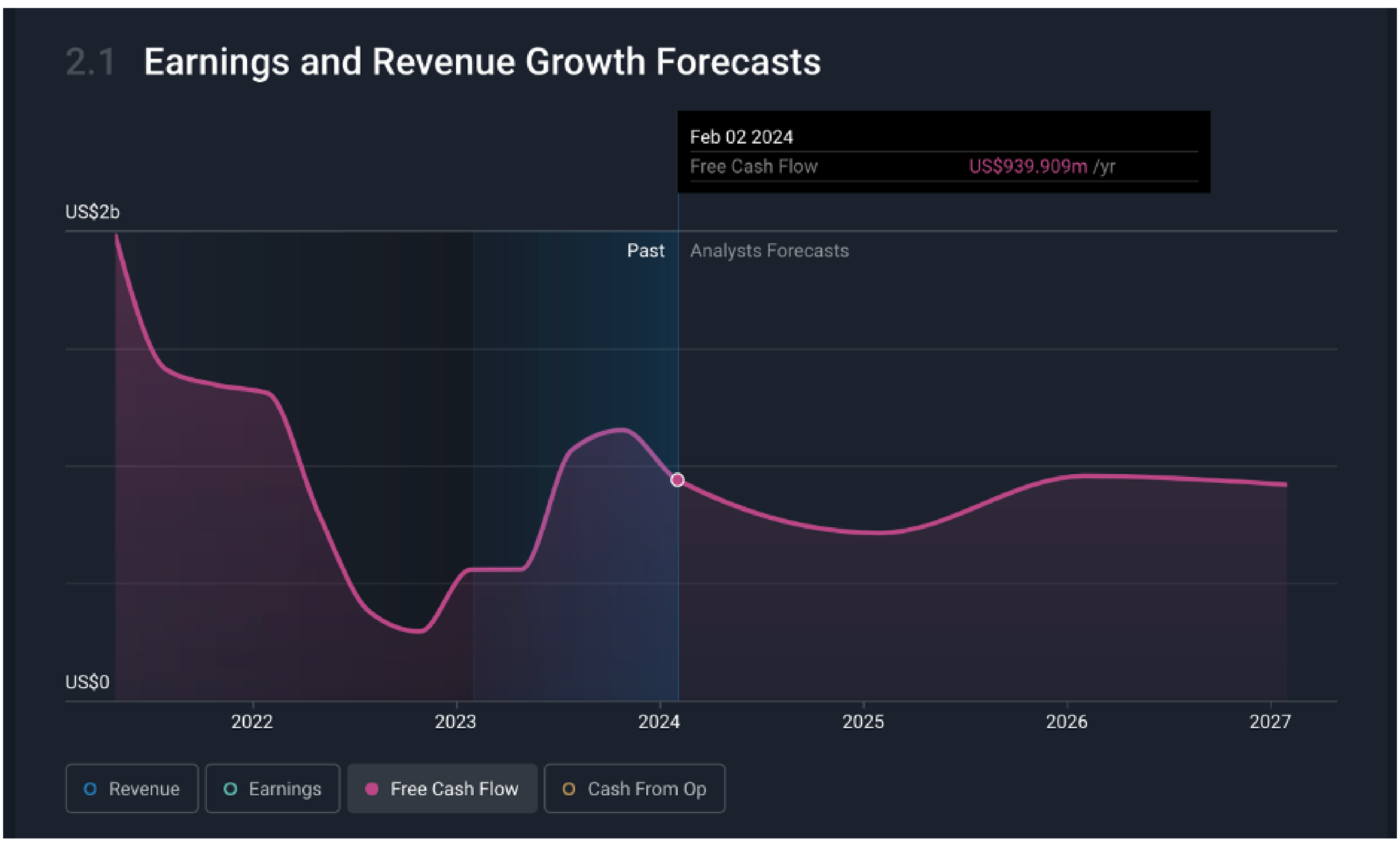
Our long-term fundamental stock price range today is lower than the current stock price. This does not mean that DKS stock cannot continue to appreciate within our portfolios, but it does mean that we do not see the stock at current levels as a compelling value opportunity. As highlighted last month, we look at many financial metrics to arrive at valuation assessments, but we emphasize free cash flow forecasts when it comes to driving wealth creation. Dick's Sporting Goods (DKS) is expected to grow both revenues and net profit over the next several years, but the increase in free cash flow is not likely to be commensurate. The following SimplyWallSt.com charts illustrate this situation:

Below is a chart of past revenues and forecast revenues through FY2027:



Below is the same graph showing net profit (earnings):

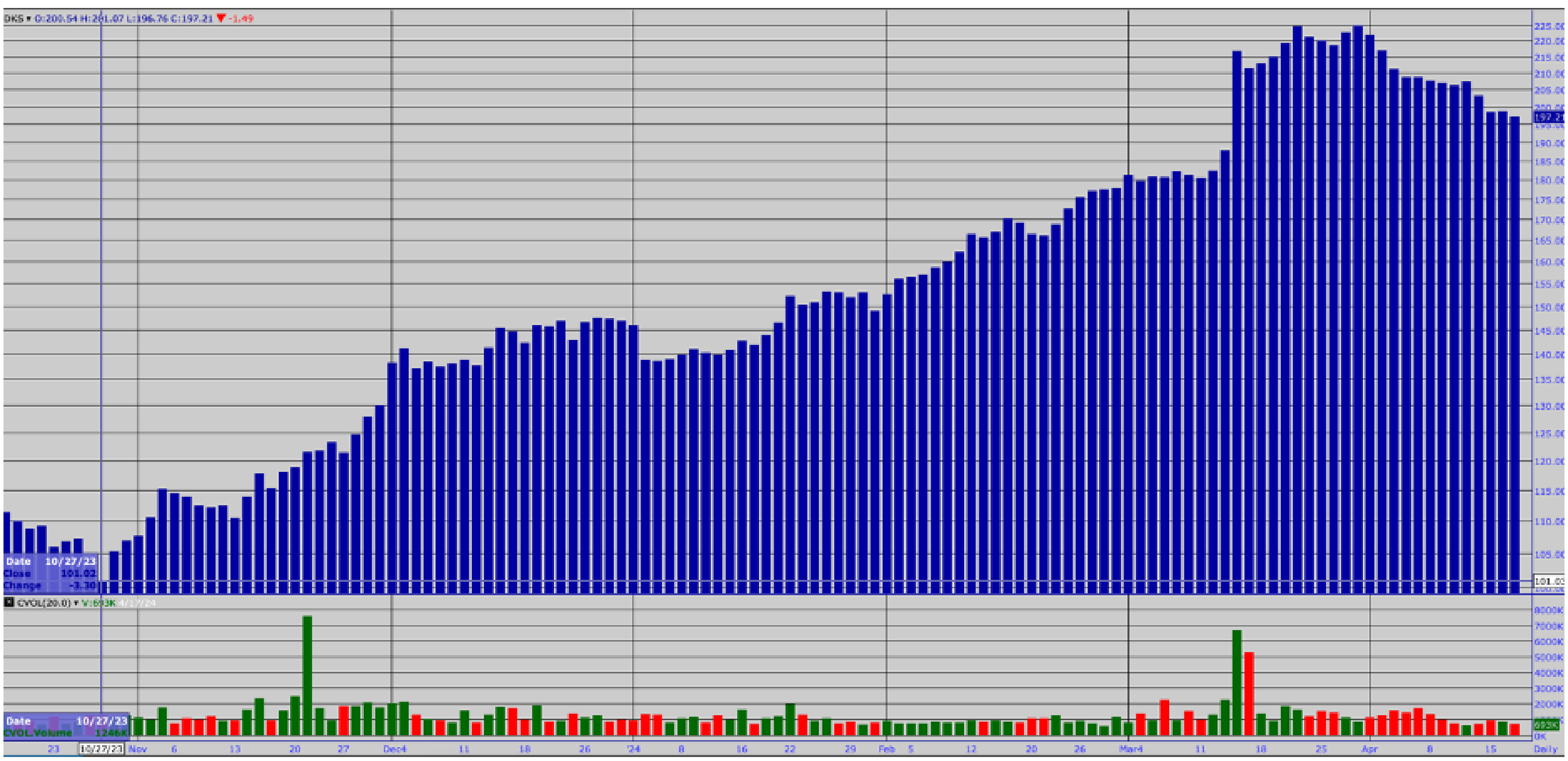
Lastly, below illustrates historical and future periods for Free Cash Flow:



Free cash flow drives stock buybacks, dividends, unlevered capital expenditures, and investment. Without growth in Free Cash Flow commensurate with growth in revenues and earnings, a company like Dick's Sporting Goods (DKS) will be challenged to grow shareholder value as robustly as it has in past periods when Free Cash Flow was fueling growth and value creation.

Our Dick's Sporting Goods (DKS) investment represents a lesson in patience and staying focused on fundamental factors that underpin our imputed valuations levels, as opposed to market-induced stock price volatility.

Sometimes, when talking with clients, I try to contrast what they see when they look at their accounts and stock holdings with what I see. This commentary and the history of our investment in Dick's Sporting Goods (DKS) is a glimpse into one stock position over the last several years and is a good illustration of how stock price can paint a very different picture for extended periods of time than the one we see. When we think about capital appreciation in equities, we think about a holding period of at least three years. With the stock of DKS, the time between our first buys and first sells was approximately twenty-seven months.



Our premise is that neither we nor anyone else can consistently time the entry and exit from a stock investment. Thus, we purchase shares when we believe they are trading at a price materially below where we assess that they would trade if market pricing always reflected long-term fundamental intrinsic value. We then wait patiently, buy more shares if the price gets more attractive, and sell some shares if the price reaches a material premium over our assessment of intrinsic value.

The mechanics of managing equity portfolios is a very simplistic process, given the tools we utilize to value securities. Still, executing is difficult for most investors because of forces beyond the process that cause impatience and doubt. I have said this in various commentaries: most of the investment mistakes I have made in the past have been selling too early and not holding too long.

I share many of our clients' sentiments that markets are often infuriating and seemingly nonsensical. Today's markets are the domain of short-term traders and arbitragers; they are not particularly friendly toward the sentiments of long-term investors who live by time-tested principles, many espoused by a younger Warren Buffett, like the following:

- "The best chance to deploy capital is when things are going down."
- "If you aren't willing to own a stock for ten years, don't even think about owning it for 10 minutes."
- "I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."
- "Price is what you pay, value is what you get."
- "The most important quality for an investor is temperament, not intellect."
- "Remember that the stock market is a manic depressive."
- "Do not take yearly results too seriously. Instead focus on four-or five-year averages."
- "Be fearful when others are greedy. Be greedy when others are fearful."
- "Don't pass up something that's attractive today because you think you will find something better tomorrow."

It is very easy to agree with Warren Buffett. I have never met someone who discounts his lifetime of wisdom and principles upon which to invest, but I have met scores of investors whose behavior contradicts most of the quotes above. That is why Warren Buffett famously stated, "Investing is simple, but not easy."

Disclosure:

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- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.
- The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately $4.3 billion, median

capitalization of $1.2 billion and market capitalization of the largest company of $18.7 billion.

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