April 2020

If back to normal means acting like there never was a coronavirus problem, I don't think that is going to happen until we have a situation where you can completely protect the population. But when we say getting back to normal, we mean something very different from what we're going through right now. When we get back to normal, we will go back gradually to the point where we can function as a society.

- *Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases*

INVESTMENT COMMENTARY

In early March, we shared our initial thinking on the developing Coronavirus pandemic. A week later, with markets in freefall, we shared another update, followed by an investor call within days of the market hitting its low.

When we first started following the outbreak in China, back in January, our early research suggested that the crisis would likely cause a transitory shock:

These updates were meant to provide our investors with a glimpse of the panic we were seeing in the market and help them understand why we were responding by aggressively putting cash to work throughout the decline. Now, with the quarter behind us, we want to provide you with some color on those actions and update you on our current thinking.

Over the past several weeks, our thinking has evolved as events have unfolded. We now believe that this is likely to be something more than a temporary setback. Perhaps much more.

At the same time, while we've become more concerned with the magnitude and duration of this economic contraction, markets have become more sanguine. Recent data has provided encouraging signs that the spread of the virus is under control, and the growth of new cases has slowed around the world. Consequently, investors have shifted their focus from the growing death toll to the re-opening of the economy and the recovery that will follow suit. The market has recently followed suit, rallying over 30% from recent lows.

However, we believe investors should focus more on two key points:

- How the shutdowns end is as important as *when* they end.
- The world will likely look very different when economies reopen.

When we last wrote, it was clear that the outbreak and the newsflow would get worse before they got better. Yet, we were comfortable putting capital to work because we believed that markets would ultimately look past negative headlines and corporate earnings. But now, with the worst of the outbreak likely behind us, investors are celebrating the end of the lockdown, even before they've truly processed its consequences. **Said differently, the economic reality of having the world effectively shut down for months has not yet sunk in.**

Making matters worse, it's become clear that constraints from the shutdown will only be eased gradually. A new study estimates that social distancing may be with us through 2022.[1] While certainly not our base case, it's safe to assume that the investors who are pushing this rally higher have not even considered the possibility of two more years of limted economic activity.

As a result, although the economic decline was sharp and deep, the recovery is likely to be a slow and uneven process, rather than the sharp recovery driven by pent-up demand that we initially expected. Consider that almost two-thirds of US households have no meaningful savings. That will make it almost impossible to bridge the income shortfall from an abrupt and unexpected shutdown. This will have dire consequences for many of these Americans. And the longer the issue lingers, the greater the unintended consequences will be across the economy.

Stimulus checks may temporarily help bridge that gap (assuming they arrive in a timely manner), but they won't come close to making these unemployed Americans whole. Every day that passes there is another bill that will go unpaid and another party on the other end of that bill who won't be collecting payment. Every week that passes there is another job that won't exist when those unemployed are willing and able to return to work. In other words, what we are experiencing is a destruction of demand in addition to the delay of demand that we initially anticipated.

We understand, and share, the desire for optimism and the urge to reopen sooner than later. But we caution that the recovery from this initial phase of the outbreak is just the beginning. A limited re-opening will more likely result in a more limited recovery than we at first expected. And a full re-opening will likely be accompanied by more problems in the markets, which may disappoint the many investors who are eagerly anticipating a quick and robust recovery. The renewed surge of cases in Singapore should be a warning to those expecting a rapid return to "normal," as a second wave of infections in the US would likely cause a longer and more severe recession than has been forecast.

Finally, even as America begins to reopen, getting back to "normal" will likely require some getting used to. A recent poll found that nearly 3 out of 4 Americans won't attend sporting events until a vaccine is developed.[2] Even the final phase of CDC's Guidelines for Opening up America recommends that large venues continue to operate under limited physical distancing protocols. It's unlikely that we will return to yesterday's level of economic activity if restaurants, movie theaters, theme parks, and sports venues operate at 50% capacity. **The Fed isn't going to fill the middle seat on an airplane. Economic activity and corporate earnings are likely to remain depressed for quite some time.**

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[1] Projecting the transmission dynamics of SARS-CoV-2 through the postpandemic period
[2] Nearly 3 of 4 Americans Say They Won't Attend Games Without Coronavirus Vaccine Developed

RECENT ACTIVITY

"All of humanity's problems stem from man's inability to sit quietly in a room alone." — Blaise Pascal

Most investors' problems stem from their inability to sit quietly in a room alone. They suffer from the urge to do something. We do not. We are content to sit quietly. Our average holding period and historical portfolio turnover suggests that in a given year, one or two new investments per quarter is more than enough activity to keep portfolio humming along. Most of the time, we are sitting quietly in a room, reading, researching, and thinking. We recognize that doing something often does more harm than good in the form of transaction costs, tax bills, and other friction costs. Research has in fact shown that the more investors trade, the less they earn.

But this year has been anything but typical. When volatility spikes, months of research and due diligence can quickly translate into purchases over the course of a few weeks that might normally occur over the span of a few years. This was the situation in the first quarter. We provide a summary of notable developments in the portfolio along with a brief discussion of the investment activity below.

EXITED INVESTMENTS

ALLERGAN

Allergan (AGN) was our largest position at year end given the limited downside risk in the stock with the Abbvie deal nearing completion. In an excessively overvalued market, we liked the relatively certain upside potential that the deal offered. But as market volatility spiked during the quarter, our estimate of the risk/reward shifted materially. At the same time, a falling stock market created more compelling opportunities elsewhere. As a result, we exited our position in AGN in early March, with an eye toward redeploying capital at prices we believed offered much higher prospective returns. Our investment in AGN generated a positive, albiet minor, return in the first quarter.

PORTFOLIO-LEVEL HEDGES

We monetized the majority of our portfolio hedges during the quarter. Small cap stocks are often the first to be sacrificed when liquidity dries up (and often the first to bottom), so we liquidated our put options on a small cap index in early March at a substantial gain. Later in the month, as credit markets began to panic, we exited our put options on an investment grade credit index. Then, with credit markets in free-fall, evidence of forced liquidations, and discounts on both closed-end funds and ETFs blowing out to levels not seen since the depth of the financial crisis, we turned around and began buying a number of these funds aggressively almost immediately after liquidating our hedges. Notably, our investments in credit were among our largest purchases during the quarter and also our largest contributors to performance off the recent lows.

FANNIE & FREDDIE

We exited our investments in Fannie and Freddie (discussed in our annual letter) in March. Like our investment in AGN, these event-driven invsetments offered the potential for attractive returns with minimal correlation to (normal) market movemenets. But also like AGN, our underlying assumptions here changed rapidly as the crisis progressed during the quarter.

Our initial probability tree had three branches: 1) we believed there was a small probability that a deal would be reached prior to the election; 2) we assumed a very high probability of a deal being reached after the election should Trump win; and 3) at worst, we considered a Trump loss, continued uncertainty, and perhaps a full privatization on both companies. In short, with all branches of government 100% focused on the current crisis, the odds of a deal getting done this year are near zero. Meanwhile, we believe the odds of a Trump win have declined significantly in the wake of this crisis. After adjusting our estimates for this shift in potential outcomes, the risk/reward on this position was not nearly as attractive as it was at year-end. Our investment ultimately cost of a little more than 1% during the quarter.

TRAVEL & LEISURE

We sat tight as markets declined nearly double-digits in February. While general market indices still traded at historically expensive valuations, many areas of the market began to collapse. As such, our early purchases were focused on the travel and leisure industries, which were hit hardest. We established a small position in a basket of airlines and a small restaurant, all of which we had been following for some time. Our estimates at the time considered the impact of a sharp, temporary decline in activity, but as we began to consider the likelihood of a more protracted decline, along with the potential for significant equity dilution, we exited the investments to focus on higher quality businesses that became available at better prices as the sell-off worsened. In total, these investments detracted about 1% from performance during the quarter.

NEW INVESTMENTS

ENERGY

As if a global pandemic wasn't enough, during the quarter OPEC and Russia decided to add an oil crisis to the list of things for investors to panic about. After oil's largest one-day decline in history, we established a small position in Exxon Mobile (XOM) and British Petroleum (BP)—two of the largest, best managed, and well capitalized companies in the industry.

We don't have a short-term view on oil, but we do know that the best cure for low oil prices is low oil prices. And with the sector trading at its lowest level relative to the market in history, we are willing to bet that the current extremes in negative sentiment will revert to more normal levels—and more normal oil prices—at some point. In the interim, we are being paid 10% annually to wait.

ALCOHOL AND TOBACCO

During the quarter, we diversified our cirgarette exposure by adding Philip Morris International (PM), which distributes Marlboro, along with other brands, outside of the US. The thesis here is similar to our investment in Altria (our largest single position at quarter end), which we discussed in our annual letter. We passed on PM initially only because it was significantly more expensive than MO. But late in the quarter, a sharp sell-off in PM provided us with an opportunity to establish a position in one of the best managed tobacco companies in the world, one that also enjoys a dominant position in emerging markets and a rapidly growing next generation product, IQOS.

We also diversified our beer exposure during the quarter, adding a direct investment in Ambev (ABEV) to compliment our existing investment in Anheuser Busch Inbev (BUD). As the current environment has punished highly leveraged businesses like BUD (despite the company's ability to generate strong and recurring cash flow), the opportunity to own ABEV, with net cash on its balance sheet and the highest returns on capital in the industry—at a lower multiple than its parent—was too good to pass up.

Together, these names represent roughly 20% of our capital today. Given their cheap valuations, combined with the fact that beer and tobacco consumption has historically increased during recession, one could argue that we should have even more exposure to these *Sin Stocks.* In principle, we agree, and given the opportunity, we'd be happy to increase our positions. But in the interim, we are highly sensitive to maintaining balance in the portfolio. At one end, we own high quality, defensive businesses that should fare well in almost any environment. At the other end, we've begun building a portfolio of more cyclical businesses, positioned to rebound sharply and gain share once the clouds clear. We discuss a few of these investments below.

RESTAURANTS & RECOVERY

Bear markets generally have three phases. In the first, weaker, less liquid assets generally crack first and fall hardest. Next, as selling accelerates, everything plummets in unison, and investors make little distinction between high and low quality businesses. And finally, when the dust settles, investors begin to separate the wheat from the chaff. It is this middle period which creates the best opportunities but also presents the greatest challenges until the market begins to again pay attention to fundamentals.

The current crisis has played out accordingly. Weak companies fell first while good businesses held steady. But as the liquidation increased, bargains emerged across the market, and as such, our focus shifted towards higher quality businesses that were poised to benefit on the other side.

We established a position in Disney (DIS) around the time the company announced the closing of its parks. While the market is correctly concerned about this temporary drag on profitability, it has ignored the rapid growth of Disney+, which has grown to 50 million subscribers while parents scramble to keep their trapped-at-home kids entertained.

During the quarter, we also built a position in Bookings (BKNG), which we had been watching long before the crisis began. For the past three years, the stock has been under pressure due increasing concerns about the company's competitive positioning—in relation to both hotel loyalty programs and Google's search engine. And although Bookings will likely suffer in the short term, its more entrenched European business, combined with its strong balance sheet, should make it among the best positioned companies throughout the travel sector.

Finally, we established two new positions in the restaurant industry. Sysco (SYY), the largest food distributor in the country, provides essential services to restaurants, grocery chains, and convenience stores. Although the company will likely face short-term challenges, we believe management has a generational opportunity to consolidate share amongst smaller operators who don't have the cash or access to capital to survive. We purchased shares at the company's lowest valuation in its history.

Starbucks (SBUX) was one of the first US companies to warn investors of the financial hit from the pandemic. But after closing nearly 80% of its stores in China by early February, the company had already re-opened roughly 95% of those stores by March month-end. We established a position in the stock near it's lowest valuation in years as we gained confidence that the company's China stores would fully recover in a couple quarters. In the near term, mobile orders (which represented ~ 80% of China's sales mix in the last weeks of February) should put a floor under US sales, while the resumption of development in China, with best-in-class unit economics, provides a multi-year runway for expansion.

BOTTOM LINE

Bear markets don't end when the majority of investors are still eagerly looking for opportunities and attempting to call the bottom. They end when investors give up.

But rather than giving up, investors today have gone all in on a V-Shaped recovery, which is now required to justify current valuations. It is truly remarkable how quickly consensus has looked past this "dip" and shifted its focus to the recovery, even though the range of outcomes today is perhaps wider and more uncertain that ever in history. Consider that the ten lowest forecasts for 2020 GDP average -7.4%. The ten highest are -1.1%. How anyone can have confidence in the trajectory of economic growth or corporate earnings relative to that range of outcomes is beyond us. **Never before have forecasts diverged so greatly, which means that investors should expect the unexpected.**

Yet, on the heels of a 30% rally, most market participants have now fully bought into the narrative that policy makers will do whatever it takes to support financial markets. While that is certainly possible, we are no longer betting on it, as the market-implied odds have quickly shifted in the opposite direction. Aggressive fiscal policy and easy monetary policy may help asset prices, but they cannot prevent recession.

Record numbers of corporate credit ratings have now been downgraded or put on negative watch, but we have yet to see the spike in defaults that will ultimately accompany rising unemployment, major market dislocations, and recessions around the world. It's far too soon to declare the worst is over. Any number of events could derail the current optimism: increasing defaults and bankruptcies, earnings shortfalls and reduced guidance, a slower opening of the economy, or a second wave of the virus requiring an additional lockdown. None of this is currently top of mind for investors who fear missing out on the rally.

Reopening is unlikely to happen in a straight line. It will be bumpy, with starts and stops along the way. A couple steps forward, followed by one or more steps back. There will be hope, and there will be disappointment. But until a vaccine is widely available, which could be eighteen months from now, getting back to "normal" will be a gradual process, not the straight line currently expected by markets.[3] At the moment, investors are full of hope, leaving a lot of room for disappointment. **The good news, for those with their capital and confidence intact, is that a more prolonged period of disappointment should provide us with the opportuinity to make purchases at the best valuations we've seen in more than a decade. That patience should be rewarded with the best returns we've seen in some time as well.**

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[3] The first modern pandemic, GatesNotes

FINAL THOUGHTS

This has been a challenging time for investors and an even more challenging time for many friends and families. We hope that you and yours remain healthy and safe. This crisis has impacted all of us in ways that were unaminaginable just a few weeks ago. We must keep in mind that it's always darkest before dawn. We have much for which to be grateful.

In the meantime, please rest assured that we are working tirelessly to protect your capital while focusing our efforts on identifying and valuing high quality companies positioned to emerge even stronger on the other side. When the dust settles, we expect to own a stronger portfolio of companies with greater return potential. We have already begun that transition and are excited about the opportunity that lies ahead.

I couldn't be happier with the work our entire team has done throughout this crisis. While most of the world is home on an extended staycation, they've worked furiously and flawlessely to execute our process and position the portfolio to capitalize on the current dislocations. Pleaese take a moment to say thanks next time you hear from them.

We are equally fortunate to work with such a strong group of investors. Although many of my colleagues were bomarded with calls from panicked investors with finicky capital, the majority of calls we received during the quarter were from existing and prospective investors looking to increase their relationship with us. As such, I'm proud to say that Broyhill exited the quarter in a stronger position than where we started.

We believe that investors who are patient, and who have cash in hand, stand to profit tremendously in the future. Prospective returns on our portfolio are as high as we've seen them in a decade. Those returns might not develop over the next few weeks or quarters. But over a longer horizon, we believe you will be very happy you made the call to invest strategically. We encourage you to consider taking advantage of this opportunity.

We are extremely fortunate to have a group of high quality clients that understand what we are doing, have the confidence to let us do it, and the courage to run towards the storm when the rest of the world is fleeing in fear. It really does make our job much easier and much more rewarding.

Thank you. We appreciate your trust and your confidence. And couldn't ask for better investors.

Sincerely,

Christopher R. Pavese, CFA
Chief Investment Officer
Broyhill Asset Management

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Located in the foothills of North Carolina's Blue Ridge Mountains, we operate outside of the fray and invest with a rational, objective, long-term perspective.

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