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Maclura Investments

Quarterly Report

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Though stocks were broadly lower in September, market indices had a second consecutive quarter of significant gains and are now up for the year. The US Market Index, a broad index that captures 97% of the investable market, returned 9.24% for the 3rd quarter and is now up 5.84% for the year. A remarkable feat given where the market was in March after the self-imposed shutdown of the world economy to battle the COVID-19 pandemic.

From an investment style perspective, growth continued to outperform value companies as illustrated in the table below. Though value stocks performed better in September, as we have mentioned in our previous market commentaries, we continue to see a tailwind for the growth category over value for the foreseeable future. From a sector perspective, there are a number of sectors that have been more impacted by COVID-19 directly or indirectly, including travel, leisure, retail, and energy. The growth sectors that we focus on at Maclura Investments are listed below, and for the most part, with the exception of the Industrial sector, all have positive performance year-to-date.

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020 1st Qtr.	2020 2nd Qtr.	2020 3rd Qtr.	2020 YTD as of 9/30
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	-11.50%	29.86%	11.72%	28.39%
Growth	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	-11.51%	26.60%	13.83%	27.52%
Growth	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	-17.00%	34.66%	9.56%	22.45%
Growth	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	-21.45%	32.84%	7.35%	12.02%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-28.43%	13.82%	3.28%	-15.86%
Value	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-25.10%	12.45%	2.95%	-13.29%
Value	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-35.52%	18.78%	4.44%	-20.01%
Value	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	-39.68%	21.85%	2.99%	-24.30%

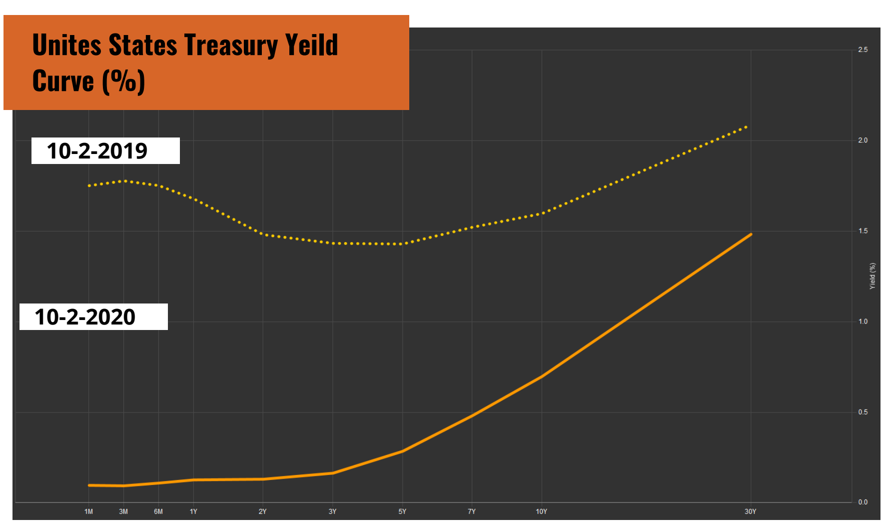
For individuals seeking income from bonds, the outlook for interest rates rising from current levels anytime soon is bleak. In September, the Federal Reserve signaled that it would likely not raise short-term rates from its current target range of 0.00% - 0.25% until after 2023. Yields are still considerably lower than where they were at the end of 2019 (see chart) with only minor changes in the curve from the end of June.

According to S&P Global Inc (SPGI), which generates approximately half of its revenues from credit ratings, research, and analytics, the purpose of the issuance of corporate debt over the last few months has been for general corporate purposes, and even though it could be used eventually for repaying debt, it hasn't been targeted for repaying debt at the time it was issued.

Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020 1st Qtr.	2020 2nd Qtr.	2020 3rd Qtr.	2020 YTD
Technology Sector	4.01%	14.06%	37.14%	-1.29%	46.66%	-12.27%	31.71%	11.82%	29.20%
Healthcare Sector	7.13%	-3.44%	22.71%	5.91%	21.77%	-12.80%	15.86%	6.09%	7.19%
Industrial Sector	-2.78%	18.71%	22.43%	-11.90%	31.40%	-27.47%	17.87%	10.98%	-5.11%
Consumer Cyclical Sector	6.29%	5.75%	24.47%	0.09%	27.25%	-22.03%	36.20%	20.12%	27.56%
Consumer Defensive Sector	5.57%	7.02%	13.27%	-8.40%	27.51%	-14.00%	11.43%	10.81%	6.19%
Financial Service Sector	-0.26%	20.63%	22.67%	-9.90%	33.37%	-29.53%	16.09%	4.76%	-14.29%

The company recently communicated at an investor conference that over the next three to five years, there will be a very strong, steady pipeline of corporate maturities that were issued 7 to 13 years ago that will need refinancing, coincidentally at the same time that the Fed would be considering raising short-term rates.

At Maclura Investments, we primarily focus on companies that are profitable and can either self-finance their internal growth through internally generated cash flow or have prudent levels of leverage to maximize shareholder returns. Over the past three months, as Corporate America validated their ability to swiftly modify their operational structure to accommodate the COVID-19 pandemic, questions from investors during company management calls have transitioned from “liquidity needs and requirements” to “priorities in investing excess liquidity.” We believe that mergers and acquisitions will pick up over the next year as most management teams have adjusted to the new environment and are more comfortable with the outlook for the future. Two Maclura client holdings, Intercontinental Exchange (ICE) and Analog Devices (ADI), announced transactions this past quarter. ICE announced a $11 billion deal to acquire privately held EllieMae, a software company that processes 35% of U.S. mortgage applications. ADI announced an all stock transaction to merge with Maxim Integrated Products to make it the second largest analog supplier behind Texas Instruments (TXN). Both of these announcements are noteworthy to the future growth prospects of each company and what we believe will be future value creation to their shareholders.



For the past twenty years, ICE has been converting paper (analog) markets to digital, getting its start by creating an electronic marketplace to trade energy futures contracts, to increase the efficiencies and reduce costs to market participants. Anyone who has gone through the mortgage process understands that it is a laborious process that’s heavily reliant on people.

By combining EllieMae with ICE's existing mortgage business, ICE will be established as the market leader in digitizing the mortgage process from origination to close.

Currently it costs lenders $8,000 to $9,000 just to originate a loan. ICE excels at taking a paper process and digitizing it to automate error checking and fulfilling compliance requirements. It then applies technology to electronically, efficiently, and reliably settle transactions. While doing that, there is a tremendous amount of unstructured useful information in real time that isn't readily available to the markets because of the complexity in manufacturing the data and packaging it for users. For end markets wanting to use data derived from the mortgage process, currently that data is at least three or four months old when it becomes available. ICE will be able to provide that information months ahead of anyone else. Just the data component of the EllieMae acquisition creates a $4 billion addressable market over the next decade in addition to the opportunity of digitizing an analog market. Clients of Maclura Investments have a variety of holdings within their portfolios of companies that are providers of propriety data to markets as it is an attractive, highly profitable business model with high competitive barriers.

Analog Devices (ADI) was already one of the leaders in the design, manufacturing, and marketing of a broad portfolio of high-performance analog, mixed-signal, and digital signal processing integrated circuits used in virtually all types of electronic equipment. In laymen's terms, ADI's products sense, measure, and connect the physical with the digital in the industrial, healthcare, transportation, communications, and automation sectors. The driver of the merger with Maxim was ADI's management's high conviction of the trend that has been playing out for many years that engineering talent, specifically analog engineering talent, is becoming a very valuable resource. As ADI's customers pivot more of their engineering spending to non-analog areas where they need to show product differentiation, the customers are relying more and more on their suppliers like ADI to provide the engineering and bench design work that's necessary for them to do their product development. Merging with Maxim will enhance their leadership position by increasing their pool of analog engineering talent.

While there are many secular tailwinds for ADI, the company stands to benefit from the moving of the communication network from 4G to 5G in the coming years. Although its communication business can be volatile, with quarterly results being up 50 – 60% and then down 30 – 40%, as more geographic markets start to really deploy 5G (currently China is only geographic market deploying 5G), ADI's communication business peaks and troughs should even out and become more consistent. During 2021, Korea, Japan, and North America are set to start rolling out their 5G networks, which will require more transceivers that have four times the amount of ADI content in them, driving revenues with the 5G rollout.

In a few weeks, companies will start to report their financial results for the third quarter. While we anticipate that certain segments of the economy will remain strong, we don't expect to see as many companies beating expectations as seen in the second quarter. The reasoning behind this is that successful companies have management teams that are good at finding ways to grow their top line (revenues) while implementing effective expense management to have margin expansion and increased profitability. During the second quarter, companies were forced to implement drastic measures to continue operations, resulting in most of the companies beating expectations on the expense management side of the equation. Now that investors and analysts have seen the results of expense management and adaptiveness to the new environment, expectations have been reset closer to probable results. In order to beat expectations going forward, companies will need to exceed revenue expectations, which is a task that will not be as widespread as expense management was during the second quarter.

Costar (CSGP), a provider of commercial real estate information, analytics, and online marketplaces to the commercial real estate and related business communities, mentioned on their investor call that they are encountering fewer stories about companies moving toward full-time work-from-home to hearing more about hub-and-spoke office models, where firms are looking to lease additional spaces closer to residential nodes from where their employees are commuting. With the economy coming to a standstill in March, commercial real estate looked dire, but commercial real estate near suburban areas will likely have strong demand over the next several years. For full disclosure, CSGP isn't currently held by Maclura Investments's clients, but is a proprietary data provider that is on the Maclura premier list of stocks and, at a more reasonable valuation, could become a holding to gain exposure to this unfolding trend.

When constructing a portfolio for the long-term, having a mix of companies at various points in their operational recovery helps to keep a balanced portfolio. Not all companies will be working all the time, and Marriot International (MAR) is a Maclura holding positioned to work over the long-term. Mariott's customer base is divided into three segments: leisure, business, and groups. In September, the company gave some insight on the evolution of their business where leisure travel has returned strong from April lows as vacationers hit the road for destinations to which they could drive. As businesses get more comfortable having their employees travel and their customers return to their offices and open to visitors, the increase of corporate bookings have grown from the April lows. A trend that has emerged within MAR's observation of the recovery is the blending between business and leisure, "bleisure", as they see an increase in reservations that go from a Wednesday through Sunday. The final customer base of bookings will be groups, such as wedding parties and conventions. Next year could prove to be interesting as weddings that were supposed to be this past summer get pushed into next summer, competing for space with the weddings already planned for 2021. Regardless, a vaccine or comfortability with the virus will cause a robust rebound in business and leisure travel, and we believe MAR will be a beneficiary of a return to normalcy.

Some holdings are seeing a recovery to their businesses at a level above the pre-COVID shutdown. During September, feedback from an investor call with orthodontists indicated that their practices were back to growing their volume of patients to levels above pre-COVID. As households decreased expenses by staying and working from home, they had more money to spend on orthodontic treatment for both themselves (adults) and their children. This could be favorable for Align Technologies (ALGN) (manufacturer of the clear aligner Invisalign product) third quarter results, even though management often gives conservative guidance with their results. This might be another environment where they give conservative guidance on the basis of being overly cautious on the increased demand coming from temporary pent-up demand from the offices being closed. From following the company since 2004, often the pullbacks based on cautious demand outlook are opportunistic to long-term investors.

The housing industry has been on a binge since May. Since the 2008 housing recession, the industry has been underbuilding as the demand for homes versus the number of new homes being built has continued to widen. Since most of us are spending more time at home, consumers are spending more money on their homes as well. Perhaps the Fed will finally get some inflation in the economy as lumber prices have surged because lumber mills were forced to shut down during the initial stages of the pandemic and increased ecommerce volume is creating more demand for wood pulp for containerboard. There are many areas of the economy that the increased demand has pushed inventories to record lows. The industrial sector should be positioned to benefit from this restocking event that some investment banks are calling the "biggest restocking cycle on record" and create a long tailwind for manufacturing activity and global trade over the next two to three quarters. This is an area in which Maclura clients could see either new additions to their portfolios or increased weight in existing names over the coming months. Getting the goods to their destination will be another story though.

The pandemic has wreaked havoc on the transportation sector, specifically air cargo. The amount of cargo that has historically moved on passenger planes is significant and, with the depressed number of flights as people have been reluctant to travel internationally, that cargo has had to find other modes of transportation that are slower. One of those beneficiaries is Kansas City Southern (KSU), as they reported in September that their traffic has had an unprecedented 50% increase since their rebound in early June. KSU also has the benefit of US companies near-shoring their manufacturing to Mexico, away from China. While significant focus is on the uncertainty of the trading relationship between the U.S. and China, most forget that the largest U.S. trading partner is Mexico, and with the USMCA finalized on July 1st of this year, the trading relationship between the U.S. and Mexico will likely flourish in the future as the trade disputes with China and the pandemic cause companies to revisit their supply chains and how they manage inventory. Mexico has the benefit of having lower wage rates than China and transportation costs are much cheaper from Mexico into the US or Canada than they would be from China. With the decrease in air cargo capacity, manufacturers would not be reliant on 30 to 35 days to transport goods from Asia. Instead, using Mexico, they can move products within 4 – 6 days from Mexico to any point in the US or Canada.

As the end of the year nears, there are a couple of items worth noting that we are monitoring. On Jan. 1, 2021, the four-year Brexit saga will be put to bed one way or another, and the U.K. will depart the European single market. A European Union – United Kingdom agreement must be reached by October to have any hope of winning final approval on both sides of the channel by December 31 when the existing terms of the economic relationship will cease to apply.

A non-deal scenario would make things interesting. If that were to happen, British-EU trade would default to World Trade Organization rules that would damage both economies by raising tariffs and delaying international deliveries. In September, the U.K. Cabinet Office Minister Michael Gove said in a letter to logistics firms that a "reasonable worst case" Brexit scenario would see two-day waits and lines of up to 7,000 trucks to cross the English Channel into Europe with freight flows declining by as much as 80% due to the introduction of new border controls and paperwork requirements. For companies importing to and exporting from the United Kingdom, on January 1, 2021, it will be like having to deal with a brand-new country. As businesses are having to rethink their supply chains as a consequence of the lockdowns and global trade restrictions, businesses need to consider the local trade climate and consider whether they're in the ideal locations for manufacturing and supply.

After November's US election, a predictable forecast is that nearly half of the population will be upset regardless of who wins the Presidential election. Fortunately, there is a difference between campaign rhetoric and policy implementation once governing, and it's rarely as draconian as the opposition would lead us to believe. The recent mandated shutdown of the economy validates that government actions can impact businesses, but the quick recovery within certain pockets of the economy also illustrates the swiftness of American businesses in adapting and excelling regardless of the circumstance. The secular growth tailwinds influencing the holdings of our client portfolios are not dependent on either party winning or losing. And therefore, regardless of the outcome of the election, any negative market reactions will be transient. At Maclura Investments, we take a long-term approach to investing for wealth accumulation and remain focused on secular trends providing a tailwind regardless of the condition of the economy and political noise.