Cove Views

October 1, 2015

Dear Client,

We are excited to present to you **Cove Views**, our inaugural quarterly newsletter! The purpose of this letter is to keep you informed of some of our positions and views on the market. We will mainly be focusing on industry wide topics that we find interesting, but as always, we are available to discuss any of these subjects on a company specific level with you at any time. The past three years have been a time of rapid change and growth for us at Cove Capital and we want to thank each and every one of you for your trust, insight and confidence in us. We hope you enjoy **Cove Views** and welcome and encourage your feedback.

Over the past several months many of you have been calling us with similar questions. There are a lot of concerns over the future of the markets and whether or not this is a good time to increase risk. As you probably know - we are value investors. We primarily focus on out-of-favor value stocks (those having low P/E and low price/cash flow ratios), developing companies, and special situations. We are not market timers. As the great Warren Buffet once said,

"Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

Our answer to your concern is: because holding cash is an expensive proposition, we would generally recommend that our clients understand their risk tolerance, make sure they have clearly communicated it to us, and ride these weak periods out. We do not try to time the market but instead look for value situations that we believe are cheap regardless of the intra-day moves of the S&P 500. Following are a few key themes we have been incorporating into our securities selection process:

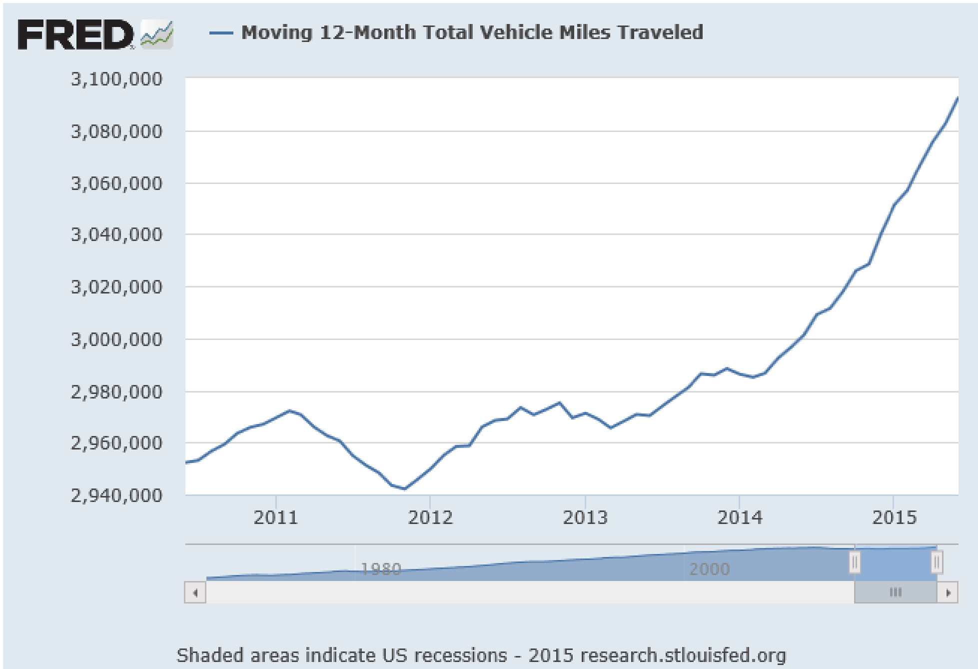
Energy Prices:

We expect energy prices to stay low for a long time. Our expectation is that the Iran nuclear agreement will be implemented and it will result in Iran bringing 500,000 – 2,000,000 barrels of oil a day online within the next couple of years. If the agreement is not enacted, we believe the embargo will become very weak and prices will still be suppressed. The industries we are focused on to take advantage of this are; **refiners, airlines** and **tire manufacturers.**

Refiners convert purchased crude oil into petroleum products like gasoline, heating oil, diesel fuel and jet fuel. Input prices (crude oil) have been falling much faster than product prices and so refiners' spreads (crack spreads) are very high because the drop in the retail price of gasoline has caused demand to soar. Many refineries are running at 95% capacity, which is extremely unusual. In addition, they are postponing maintenance in order to keep operating in this environment. Refinery stocks are trading at a huge valuation discount to the S&P 500, with many refiners trading at 8-12x earnings. Investors are skeptical that these refinery spreads are going to persist for a very long time but we feel they are underestimating that persistence. And interestingly, Warren Buffett recently announced a 10% stake in Phillips 66, one of the largest American refiners.

Another way we've found to play this theme is through **airline stocks**. In actuality, the airlines are a theme of their own given the consolidated industry structure and the pricing power they have but at the present time, low oil prices are a huge bonus. Each airline has its own hedging policy, which can vary from 0-100% of fuel usage but the beauty of their business model is that when oil goes up they raise their prices but when it comes down they don't lower them. Given our view, we prefer airlines that hedge less. Air traffic in the United States is growing steadily, and even faster in the rest of the world with the rise of the global middle class. Domestic airline capacity has grown (and even in some years been reduced) at a much slower rate. Domestic airline load factors are thus increasing. We have liked the airlines for a long time, even when oil was over $100 a barrel and despite the fact that our friend Mr. Buffett has said that he would never own an airline stock!

The final way we have chosen to participate in this extended low oil price theme is through **tire manufacturers**. Tire makers benefit from low oil in two ways. 1) Tire wear is proportional to miles driven which increases with low oil prices and 2) Petroleum products make up about 25% of the cost of manufacturing a tire. Because of long-standing relationships and heavy negotiations between the large auto companies and tire manufacturers, the profit margin made on tires sold to the original equipment manufacturers (OEMs) is relatively low compared to profits made in the after-market. Replacement tires, which cars typically need after about five years on the road, are much more profitable. During the financial crisis of 2008-09, auto sales were depressed, and began to pick up again in 2012. We believe that tire manufacturer's profit margins are about to recover nicely as those cars sold in 2012 will need new tires somewhere in the 2016-17 time period. As noted in the chart below, there has been a marked increase in overall miles driven in the US which should further accelerate demand for replacement tires. We especially like it when we can discover a company that is trading at a P-E ratio of 10!



Source: research.stlouisfed.org

Medical Devices / Pharma:

Medical devices and pharmaceuticals are currently being approved at an accelerated rate. We look for companies with innovative products that have already been approved to fit into the growth-oriented bucket of client's portfolios. Many of these companies are small, but face what we consider to be disproportionately large upside potential versus their generally small market capitalizations.

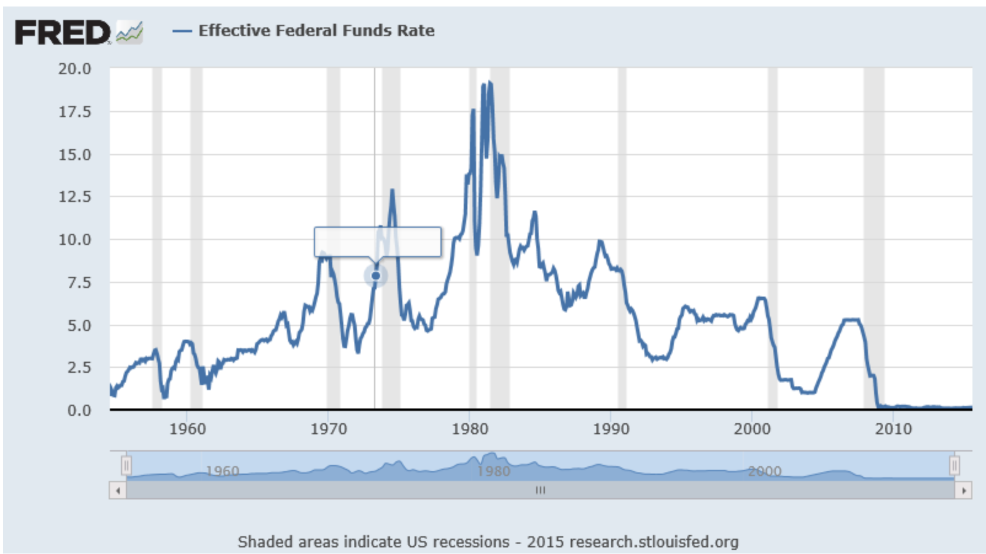
Another major benefit of these companies is that they tend to trade more on their individual merits and are less market correlated than other industries, although with so many recent ETF's focusing on the sector this is slowly changing. Recently, outlandish prescription drug prices have become a hot issue in the current political landscape. We believe much of this is noise and will blow over.

Interest Rates:

With interest rates being artificially suppressed, we have carefully chosen a few **life insurance** and **bank stocks** that we believe will help protect our portfolios when rates eventually rise.

Life insurance companies provide a fixed benefit stream over 30 years and are currently investing that money in low yielding investments. At the moment these investments are not paying much more than the annuity stream they are promised against, but when rates begin to normalize we believe insurance companies will be huge beneficiaries.

We have chosen to invest in **bank stocks** whose net interest margin (difference between their borrowing cost and their lending rates) will rise with any rise in interest rates. We particularly like large cap bank stocks that are trading below book value, and especially like those trading below tangible book value. This, like the life insurance company trade, is simply a leveraged bet on interest rates.



These are a few of the topics we're thinking about. As this is our first try at communicating via a newsletter, we welcome and encourage your comments regarding the content herein or other topics you would like discussed. Please feel free to request a more in-depth discussion on any of these themes as well. And, of course, please feel free to share these views with anyone who may find them of interest. Anyone is welcome to subscribe on our website.

As always, we appreciate your continued trust and support.

Dave Goldenberg, President

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