Beck Mack + Oliver

Newsletter: April 2024

The S&P 500 has undergone a substantial rally in the last several months, from less than 4,200 in late October to more than 5,200 at the end of March. The simplest explanation for this appreciation in the equity market is that the underlying economy and overall corporate earnings have been stronger and more resilient than many had anticipated throughout much of last year. One illustration of this strength is the labor market, where there has been steady growth in the number of jobs, the unemployment rate remains low, and the number of job openings continues to exceed the number of unemployed people.

During this period of ongoing economic expansion, what had been a trend of progressively lower inflation has seemingly stalled out. The year-over-year change in the Consumer Price Index ("CPI") reached a peak of more than 9% in June 2022, which was the fastest rate of CPI inflation since 1981, before declining for 12 consecutive months to 3% in June 2023. Since then, however, CPI inflation has not fallen below 3%. As a result, market expectations for how many quarter-point reductions in the fed funds rate the Federal Reserve will implement in 2024 have fallen from more than six as of the beginning of the year ago to fewer than three. This repricing of interest rate expectations has not thus far had an observable adverse impact on either the overall economy or the equity market.

Many of the themes that characterized the equity market last year have continued into 2024, such as the outperformance of large stocks over small and the outperformance of technology over other sectors. NVIDIA stock, after more than tripling in 2023, was up another 82% in the first quarter of 2024 and now has a market capitalization of more than $2 *trillion*. NVIDIA may be a wonderful company, but the sentiment towards the stock can fairly be characterized as ebullient. An even starker example of prevailing risk appetite may be the price of bitcoin, which recently went above $70,000, a new all-time high. Corporate bond spreads—i.e., the difference between the interest rates at which companies issue debt and those at which the US Treasury issues debt—have tightened significantly in recent months, which suggests sanguinity regarding the prospect of corporate defaults. The volatility index, which tends to increase during periods of market stress and risk aversion, remains quite low.

And yet there are important counterexamples to what is otherwise a broad market exuberance. Tesla and Apple, which have long been market darlings and constituents (along with NVIDIA) of the so-called "Magnificent Seven," were down 29% and 11%, respectively, during the first three months of the year.[1] The price of gold, which is often regarded as a kind of safe haven, has sharply appreciated recently and is at a new all-time high. Several banks and other financial companies are dealing with losses related to commercial real estate, particularly office properties where the national vacancy rate is nearly 20%. Meanwhile, Treasury yields, whose rapid ascent through October of last year caused a great deal of consternation (not least about the cost of fiscal deficits), have been trending higher but remain well below their peak levels in the fall.

On the one hand, underlying economic growth is generally providing a favorable backdrop for near-term earnings growth at businesses that we own and those on which we are conducting research. On the other hand, the market's run and prevailing valuations have, on balance, militated against initiating new investments.

---

[1] The Magnificent Seven comprise Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla, several of which were mentioned in our January letter.

Nevertheless, the Beck Mack + Oliver team has been working on a number of potential new investment ideas, any of which has the potential to come to fruition in the coming months.

In our January letter, we discussed, in light of the outperformance of large stocks over small over the last 15 months or so, how we had been searching for actionable investment opportunities among small and mid-sized businesses. The three most recent additions to Beck Mack + Oliver's "buy list"—Zurn Elkay Water Solutions, Rush Enterprises, and Fortrea Holdings—not only have much smaller market caps than the typical S&P 500 stock (i.e., $3-$6 billion vs. approximately $35 billion) but are not themselves even in the S&P 500. Other characteristics we believe that these three investments have in common include: (i) attractive end-markets with healthy long-term growth potential; (ii) strong competitive positions with opportunities to continue to organically gain market share; (iii) high incremental returns on invested capital; and (iv) management teams who are excellent at both operating the businesses and allocating capital.

Zurn Elkay Water Solutions is a commercial plumbing business that makes backflow preventers, valves, toilets, sinks, and other water-related products and systems. In 2022, Zurn acquired Elkay Manufacturing, which is best known for its ubiquitous water bottle-filling stations. Zurn has a #1 or #2 market share position across its product portfolio, possesses significant pricing power, and is highly regarded by architects, who often specify Zurn products in construction plans. Almost half of the business is tied to retrofit activity rather than new construction and almost half is tied to institutional buildings such as schools and hospitals, such that the company is not particularly exposed to new commercial construction, which can be cyclical. Overall, we expect Zurn to achieve 6-7% long-term organic revenue growth driven by industry volume growth, pricing, and market share gains. The business generates attractive margins today, which we believe will expand further in the years ahead, and the balance sheet is conservatively positioned. We think that CEO Todd Adams is a proven operator who also has a keen eye for capital deployment, whether that is a strategic acquisition such as Elkay or repurchasing stock.

Rush Enterprises is the largest commercial truck dealership business in North America, with more than 150 dealerships in the US and Canada, whose most common vehicle type is the class 8 heavy-duty truck. Rush also sells aftermarket truck parts and performs maintenance and repairs, and it is in this parts and services business where Rush generates a majority of its earnings. Sales of new trucks tend to be cyclical and lower-margin, while the parts and services business is not particularly cyclical and has good margins. We are of the opinion that Rush has the best commercial truck aftermarket business in the entire industry, which would be extremely difficult for another company to replicate, and it enjoys strong relationships with its customers, many of which are large national accounts that place a premium on service quality and minimizing downtime. Rush has zero corporate debt and, like Zurn, has recently been repurchasing stock. We have been deeply impressed with CEO William "Rusty" Rush, who is the son of the company's founder, has worked at Rush for more than 30 years, and owns more than 10% of the shares outstanding.

Fortrea Holdings is a contract research organization ("CRO"), which is a business that conducts outsourced clinical trials for pharmaceutical and biotechnology customers. The CRO market has grown in the mid-single digits or better over time based on growth in research and development spending by pharmaceutical and biotechnology companies as well as on those companies' increasing reliance on the CRO industry to perform clinical trials. In the summer of 2023, Fortrea was spun off by Laboratory Corporation of America Holdings ("Labcorp"), which is primarily a clinical lab business, and as a result of the spinoff Fortrea was no longer a subsidiary of Labcorp but its own independent public company. In addition to the attractive growth characteristics of the CRO market, we are excited about two company-specific aspects of Fortrea. First, there is a sizeable margin expansion opportunity, as Fortrea's margins were not optimized under Labcorp's ownership, largely because Labcorp's core clinical lab business is US-focused while Fortrea operates throughout the world. Other public CROs have substantially higher margins, and we expect Fortrea to achieve margins similar to those of its competitors over the next several years. Second, Fortrea's CEO is Tom Pike, who had previously been the CEO of another CRO, which, during Pike's tenure, completed an initial public offering, grew revenue and expanded margins, and then merged into a larger CRO at an attractive valuation. Based on that track record and on additional research, we believe that Fortrea is well positioned to grow its business and expand its earnings power in the years ahead.

With respect to all three of these investments, we believe that we are buying excellent businesses that will benefit from sustained fundamental tailwinds, which, along with the exercise of valuation discipline and under conservative financial assumptions, will support satisfactory stock-level total returns over a long period of time. These companies may not be in the spotlight in the way that, say, NVIDIA is, but one of our ongoing objectives as investors is to identify opportunities that others may have passed by.

Partners of Beck Mack + Oliver

Specific investments described herein do not represent all investment decisions made by the Adviser. The reader should not assume that investment decisions identified and discussed were or will be profitable. Specific investment advice references provided herein are for illustrative purposes only and are not necessarily representative of investments that will be made in the future.