QUANTICO
ASSET MANAGEMENT
of Wells Fargo Advisors

Uncommon Sense®

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The third quarter of 2018 saw the return of low volatility. However, that quickly changed in October as the fourth quarter began with an October equity correction. Long term investors understand that the market is generally an upward sloping sine wave. As such, there are usually one (or two) five percent declines a year, and a ten percent decline every other year. We wish it were sunny every day but we realize investing is as much about enjoying the sunshine as it is preparing for the rain. Corrections like this should normally be purchased when the indicators we watch (23 out of 24) do not suggest a recession is imminent. Our bias towards valued stocks acted as an anchor to windward, as our portfolio held up relatively well so far in Q4. From a Macro standpoint, the gradual upward interest rate path continues as the Federal Open Market Committee raised interest rates by another quarter percent at their September meeting, citing sustained strength in the economic fundamentals in the United States. As a result, yields continue to rise across the curve as the fourth quarter gets under way.

Performance for the quarter was as follows: The S&P 500 rose 7.7% (10.6%YTD), while the S&P 500 Value Index had a quarterly gain of 5.9% (3.5%YTD). The Russell Mid Cap Index finished the third quarter with a gain of 5.0% (7.5% YTD). The Russell Mid Cap Value index finished the quarter with a gain of 3.3% (Up 3.1%YTD). The Quantico Large Cap Model Portfolio finished the quarter with a net gain of 6.3%, (Up 6.0% YTD). Our Quantico Mid Cap Model Portfolio had a net loss of 4.3% for the third quarter, down net 1.0% for the year[1].

Recent volatility in early October has given us our second mini correction this year. Following our process of buying strong brands with solid management, we have been able to add and build our positions at attractive valuations. Further, these iterations of correction maintain a semblance of balance within the overall US market. From this point, we continue to see fair valuations in most potential Quantico names, making the hunt for deals more satisfying. There remain pockets of loftiness, but certain industries have come back to earth as guidance has down shifted from the exuberant to the rational (Tech/Semiconductors). Our theme for this letter will continue what we began last quarter, as we use this quarterly opportunity to shed some light on our checklist investment process here at Quantico. In this letter in particular, we will dive into our preference for avoiding land mines and our affinity for solid balance sheet fundamentals as we review the highlights of our internally developed screening tool.

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But first, as we have in the past, we wanted to use the first part of this letter to conduct a brief review of some of the discussions we have had in previous discussions. For this exercise, we want to review the value versus growth theme from our letter in the first quarter of 2018. As you'll recall, we used the allegory of the Tortoise and the Hare to contrast the two investing styles. Further, we cautioned against sky-high valuations in certain names, highlighting that the crux of the valuation was contingent upon the idea that growth was both secular and perpetually accelerating. As a case study, we highlighted that Netflix is overvalued versus Disney undervalued. October was a perfect example of Aesop's fable edition of reversion to the mean. Netflix dropped 32%, Disney rose 10%, and we own Disney. Stocks priced for infinite growth were repriced lower, as stocks priced for no or little growth were re-priced higher.

For this letter, we want to continue to shine light on our investment process and review how we generate ideas to dive in on for our Large and Mid Cap portfolios. While inception of new ideas into the core of our portfolios is a culmination of our checklist approach (highlighted in last Quantico letter) that includes a macro view, and examination of management, business operating power and valuation. We first use an in house quantitative tool to generate a list of companies worthy of analysis for a value portfolio. The crux of value investing is to find securities that are temporarily mispriced as opposed to permanently impaired. The former being the key to long term alpha (above market return), and the latter being the door to the value trap. Our team considers many factors when attempting to address this issue, but no factor is more important to the long term health of a company than the balance sheet. And since an a priori analysis of the entire balance sheet for every company in the universe would be enormously inefficient and time consuming, we developed the first portion of our tool to filter out potential problems based on a quick analysis of quantitative factors. This filter consists of the Altman Z-Score, a metric developed by Edward I. Altman in 1968 to evaluate the likelihood of financial distress for a given company by weighting five key variables. Further, we continue to filter companies by setting acceptable ratios for long term debt levels and overall enterprise capitalization, especially relative to their operating power.

After we filter out potential flawed investments, we are left with a narrowed universe of securities to evaluate. However, this filtered list is still too great to dive into each constituent security; therefore, we apply a set of four value-oriented metrics, and get a weighted ranking of each company left on the list. We look at both overall rank as well as the rank within each sector, as the comparison of intra-sector companies tends to be more significant. Our primary metric, and the one most closely associated with the concept of value, is the ratio of Enterprise Value to Operating Earnings (EBIT). The numerator, Enterprise Value, is the cost to buy the entire company. This can be calculated by taking the sum of market cap of the equity and the total debt, and then subtracting the cash on the balance sheet. As equity investors, as interest rates increase, it is important to consider the debt load employed in the capital structure as heavily indebted companies have higher fixed hurdles to overcome on their road to profit. We measure the Enterprise Value relative to EBIT to evaluate what we are getting for the price we are paying. As Buffett is fond of saying "price is what you pay and value is what you get". Further,

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normalizing the price relative to operating cash generating power at the operating level, allows us to appropriately compare companies across various sectors and industries.

The other metric of note that we consider is Return on Invested Capital (ROIC). The use of ROIC is again under the theme of considering the balance sheet and overall enterprise as we evaluate and rank the economic return we receive as owners. ROIC differs from the Return on Equity (RoE) metric as it includes the debt employed in the capital structure. As a quick example for why this makes sense, consider a company with a market cap of $1B and Debt of $10B. In this example, a profit of $100MM would seem attractive from and RoE perspective ($\frac{100 \text{ mil}}{1\text{bil}} = 10\%$), but when we consider the immense leverage employed (inherent risk to business model) to obtain this profit, ROIC of less than 1% ($\frac{100 \text{ mil}}{1\text{bil}+10\text{bil}} \approx 1\%$), ownership of this business looks far less attractive. Again, considering the overall capital structure allows us to compare companies across industries. ROIC is an important factor in the overall weighted rank. As a practical matter, we rank companies individually on each metric, then combine them to arrive at an overall weighted rank.

This ordinal approach allows us get a feel for the valuation landscape in an efficient and effective manner. On a relative basis, the results allow us to identify attractive companies and provide a starting point for the remaining, more in depth, portion of our research and investment process. From that point, we are able to vet ideas that look attractive on the surface and determine if it is a good fit in the portfolio. Depending on the sector of the potential investment, it is assigned to one of our four analysts. If it is an energy or industrialized company, Alex is the go to guy, healthcare and consumer industry is Sandra's specialty, Rob is Tech and Staples and Larry has the financial companies and is a generalist in all sectors. The remainder of the process includes the qualitative analysis that encompasses the management checklist as well as the quantitative aspect that implements a discounted cash flow projection to ultimately arrive at a price target. The committee then evaluates the merits and assumptions of the overall analysis and votes on the investment action. We hope that this enumeration of a segment of our overall investment process has led to a deeper understanding of the analysis that underpins our conviction when making investment decisions. As Buffett has said: Berkshire will participate in up markets but will likely lag the S&P in sharp up years. In more volatile or down years Berkshire has outperformed. The month of October has shown the wisdom of knowing what you own and how much to pay, especially as the high tech sector dropped over 10% with the S&P -7% and Quantico -4%.

We end this letter with what we would argue is our mission statement at Quantico Asset Management of Wells Fargo Advisors. We will continue to try to exploit opportunities in the market as excessive fear and irrational exuberance create oversold and overbought security prices. Our job is to identify those opportunities for our clients. If "fear" rears its head, with a corresponding reduction in asset price levels, we will invest excess cash to become fully invested. If "greed" shall resume, increasing asset price levels above fair value, we will accumulate cash by exiting or trimming fully valued positions. Buffett is fond of saying, "[t]he less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs". We agree.

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What worked for Quantico Large Cap:

1. Berkshire Hathaway (BRK.B) – Strong operating and portfolio performance.
2. QUALCOMM Inc. (QCOM) – Commitment to buyback in wake of abandoned NXP deal.
3. Apple (AAPL) – Crosses Trillion Dollar valuation.
4. Pfizer (PFE) – Strong pipeline with continued outperformance from Ibrance and Prevnor.
5. Microsoft (MSFT) – Continued momentum for Azure.

What didn't work for Quantico Large Cap:

1. General Electric (GE) – Management change and capitulation from weak longs.
2. Agnico Eagle Mines* (AEM) – Stagnant Gold environment in wake of strong equity market.
3. Kraft Heinz (KHC) – Weakness on takeover target uncertainty.
4. Barrick Gold (ABX) – Stagnant Gold environment in wake of strong equity market.
5. Campbell Soup Co. (CPB) – Weakness on sale uncertainty.

*Gold positions worked in Q4 so far

Positions Added: (at attractive valuation)

1. Van Eck Gold Miners (GDX) – Tax Swap while maintaining exposure to the space.
2. AT&T (T) – Solid content acquisition and on sale due to regulatory challenge.
3. NXP Semiconductors (NXPI) – Long Term exposure to automotive semiconductors on sale from abandoned acquisition from QCOM.

Positions Exited:

1. Sprotts Gold Miners (SGDM) – Tax Swap.
2. CVS Caremark (CVS) – PBM business model under secular threat from Amazon
3. Edgewell Personal Care (EPC) – booked tax credit on bounce in staples sector.
4. Nordstrom (JWN) – Reached/exceeded price target.
5. Kroger (KR) – Reached/exceeded price target.
6. Simon Property Group (SPG) – Reached/exceeded price target.

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What worked for Quantico Mid Cap:

1. Acuity Brands (AYI) – Rebound following renewed strength in lighting price increases.
2. Seritage Growth Properties (SRG) – Short-covering on bolstered liquidity provided by Buffett.
3. Alleghany Corp. (Y) – Strong underwriting results and positive portfolio performance.
4. FireEye Inc. (FEYE) – Cybersecurity sector strength on the tails of continued high-profile events.
5. United Therapeutics (UTHR) – Positive Remodulin news.

What didn't work for Quantico Mid Cap:*

1. New Gold* (NGD) – Sold Mesquite Mine to finance Rainy River.
2. Agnico Eagle Mines (AEM) – Stagnant Gold environment in wake of strong equity market.
3. Alamos Gold* (AGI) – Stagnant Gold environment in wake of strong equity market.
4. Del Frisco's Restaurant Group (DFRG) – Continued turnaround issues.
5. Greenlight Capital Reinsurance (GLRE) – Einhorn's value portfolio is underperforming.

*Our bias toward gold miners will continue to exhibit short term volatility (Q2+6, Q3-4), gold miners are close to the cheapest they have ever been. Relative to current gold prices.

Positions Added: (at attractive valuation)

- Applied Optoelectronics (AAOI) – Going back to the well.
- Barrick Gold (ABX) – Strong leadership and novel approach to Gold Mining industry.
- Brighthouse Financial (BHF) – Life Insurance spin-off from MetLife trading below book value.
- Vaneck Junior Gold Miners (GDXJ) – Tax Swap equivalent for Mid Cap space.
- Goldcorp (GG) – Well run miner on oversold conditions.

Positions Exited:

- Nordstrom (JWN) – Reached/exceeded price target.
- Store Capital Corp. (STOR) – Reached/exceeded price target.

In closing, we will continue to invest our clients' money as if it were our own and we also invest significant personal assets alongside our clients in the same strategies.

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Authors:

Lawrence D. Borger, CFA
Managing Director – Investments, Senior PIM Portfolio Manager, and
Founder of Quantico Asset Management of Wells Fargo Advisors

Sandra D. Simpson, CFA
Client Associate

Robert E. Immendorf, CFA
Associate Vice President – Investments

Alexander Fratti
Financial Consultant

Disclosures:

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Because advisory accounts are individually managed, and clients have the ability to impose restrictions on management, account performance and holdings will vary, perhaps significantly, from the statistics listed in this commentary. The strategies are subject to investment risk and there is no assurance that a strategy’s objectives will be attained.

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

S&P 500/Barra Value Index: The S&P 500/Barra Value Index is an unmanaged, market-capitalization-weighted index of the stocks in the Standard & Poor's 500 Index having the lowest price to book ratios. The index consists of approximately half of the S&P 500 on a market capitalization basis.

Russell Midcap® Index: The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Russell Midcap® Value Index: The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000® Value index.

The value style of investing cannot guarantee appreciation in the market value of a strategy's holdings. The return and principal value of stocks fluctuate with changes in market conditions. The value type of investing tends to shift in and out of favor.

1 - Performance figures listed are net of program fees and expenses. Please see composite performance reports for full performance information. Reports are available upon request.

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