Portfolio Commentary/Examples – Excluding and avoiding high risk companies can be just as beneficial as investing in the right ones.

Notable Exclusions

Starbucks

We were recently forced to sell Starbucks after buying it several years ago. While it still meets our growth minimum and isn't overvalued, the company has taken on such a massive amount of debt in order to repurchase shares that it violated our debt ceiling. The Efficient Growth process scores higher debt negatively and has a cap on debt to capitalization. Starbucks not only exceeded that cap, its debt to capitalization is now *infinite* – it has so much debt and has bought back so many shares that it doesn't even have a debt to capitalization ratio. It's book value is now negative. We believe this practice creates both an operational risk (and therefore more downside risk for the stock) but also a significant headwind for the future even if the economy continues to perform. At some point, Starbucks will no longer be able to borrow and no longer to be able to repurchase so much stock, while more disciplined companies will continue to have that option available to them.

Here is a perfect example of the magnitude and impact of this practice.

Quarterly Comparison Q2 2019 vs Q2 2018

	Q2 2019	Q2 2018	Difference
EPS	0.54	0.47	+15%
Share Count	1.23B	1.4B	-6.1%
Profit	663mm	660mm	0.5%
Debt	9.1B	6.5B	+40%

Takeaway: Starbucks' profits did not grow from Q2 2018 to Q2 2019. However, the company increased its debt by 40%, used that debt to decrease its share count by 6%, and reported 15% earnings per share growth, despite no earnings growth. Many companies are playing this game of smoke and mirrors. We don't believe it is a sustainable practice and that it dramatically increases risk. Therefore, we avoid the worst transgressors.

Microsoft

Microsoft was in the Efficient Growth portfolio up until a couple years ago. At that time, it exceeded our sell price. It has continued to run up since. Per our model, Microsoft is now 55% overvalued, meaning it needs to decline by over 30% just to get back to fair value. Microsoft is the largest holding of a majority of growth managers, the Russell 1000 Growth Index, and the S&P 500. History shows that it doesn't pay to own the largest company or overvalued companies. This will likely be a valuable differentiator in the future.

American States Water Company

AWR is a perfect example of “know what you own.” AWR is a utility trading at a P/E of 41. It is yielding 30% less than the S&P 500. Massive amounts of money have recently moved into utilities due to perceived safety, pushing valuations to irrational levels. Due to a low dividend yield and high valuations, many companies thought to be low risk are likely to be the opposite. Running Oak manages downside risk in an unconventional manner and is therefore less susceptible to the adverse impacts of popularity. Meanwhile, the popularity of conventional low risk strategies has pushed valuations to unsustainable levels and is making them riskier by the day.

Sample Inclusions

The Efficient Growth strategy walks the line between growth, value, and (as seen above in the case of SBUX) lower downside risk. This makes it an excellent core strategy for any portfolio and an efficient S&P 500/diversified index replacement.

Carlisle

Carlisle is an example of a high growth company within the portfolio. CSL is expected to grow earnings by 25% over the next year. Meanwhile, it has net debt/equity of only 48 – versus SBUX which is now infinite and Netflix at around 150. CSL has performed well over the past year alongside other growth companies. Purchased in November 2018, CSL is up 37% in less than a year.

LKQ

LKQ is a good example of a company within the portfolio that is likely to behave more like Value than Growth. While expected to grow earnings by 9% over the next year – significantly higher than the S&P 500, LKQ lagged up until recently. Per our model, LKQ is worth approximately $72, yet is trading at just $31.50. Just a few months ago it was trading below $25. Between the recent slight rotation into Value and an activist investor taking a position, LKQ has risen 25% in the last month and a half, while many Growth stocks have faltered.

Summary

While both CSL and LKQ meet Running Oak’s rules for inclusion (higher than average earnings growth, undervaluation, and lower downside risk), they behave very differently. As opposed to strategies focused solely on Growth or Value, which are likely to experience long periods of both outperformance and underperformance, by walking the line between Growth and Value, *Efficient Growth is likely to experience more consistent, dependable relative performance and less prone to extended periods of underperformance – as Value has experienced over the past 10 years and Growth is likely to experience over the next 10.*