Opportunistic Strategy Composite
1Q 2023 Commentary

WATERFRONT ASSET MANAGEMENT

The Opportunistic Strategy returned 7.04% in the 2023 first quarter, higher than its benchmark but lower than the S&P 500. The OS is largely made up of value stocks, many of which are international and domestic small-cap. While a significant allocation to international improved 1Q returns, domestic small-cap stocks underperformed in Q1 as economic worries led to selling in small-cap stocks.

As of 3/31/2023	YTD	1 Year	3 Year	5 Year	Since Inception
OS	7.0%	-4.6%	31.4%	9.8%	15.6%
Benchmark	2.6%	-5.9%	16.4%	6.0%	7.5%
SPX	7.5%	-7.8%	18.6%	11.2%	12.2%

Inception: 9/1/2016

Although the strategy holds many small-cap value stocks, no small-cap banks were or are held. No mid-size regionals either. Risks of deposit flight were anticipated. The only banks held are national ones that have unique features. For instance, Ally Financial already pays quite a bit for its deposits and has a fast turnover asset book that is somewhat specialized. The regional bank stocks have lost appeal after the recent sell-off. European banks, however, now have appeal after the Credit Suisse led selloff.

Advancers/Detractors	2023 Return
Embraer SA	49.6%
Tri Pointe Homes, Inc.	36.3%
Kyndryl Holdings, Inc.	32.8%
Baidu, Inc.	31.9%
Canaccord Genuity Inc. (in USD)	30.5%
Veradigm Inc.	<26.0%>
Cigna, Inc.	<22.6%>
Hanesbrands, Inc.	<17.3%>
Conduent Inc.	<15.3%>
Macy’s Inc.	<14.7%>

Some of the best performing stocks in the first quarter included Embraer, Tri Pointe Homes, Kyndryl Holdings, Baidu and Canaccord Genuity. Embraer is a company that has struggled with margins and many investors had assumed it could never become a solid consistent cash generator. Some recent operating outperformance has been changing perception and investors are beginning to move back into the stock. Tri Pointe Homes has rallied for a couple reasons. First, investor’s fears over how damaging the margin collapse could be for homebuilders has been somewhat assuaged by recent company performance. Second, the decline in the 10-year yield has led to optimism that mortgage rates will soon drop back into a range that opens up affordability. Kyndryl Holdings is a company that investors viewed as in secular decline. Kyndryl put out financial targets for 2025 that most investors did not believe to be realistic. However, it is beginning to look like Kyndryl has a decent chance to hit those 2025 targets and the business is not in secular decline. Kyndryl is a great example of a stock that investors largely ignored due to a predicted long turnaround period. This type of business often takes an extended amount of time to turn around, but in this instance, it wasn’t an extremely long period. As time has progressed those distant 2025 financial targets seem a lot closer and more tangible. Hence, a strong rally. Baidu rose because there was a broad rally in technology shares, including Chinese ones. Baidu is also one of the most advanced AI companies in China and investor enthusiasm for AI companies was rampant in the first quarter. Canaccord Genuity received a management led buyout offer at a meaningful premium to trading price that is currently outstanding.

Some of the worst performing stocks included Veradigm, Cigna, Hanesbrands, Conduent and Macy's. Veradigm had to restate financials due to accounting irregularities. It is never pleasant to be holding a security when those situations arise. Often times investors overreact in these scenarios, but in my opinion, this was a serious inaccuracy, and I chose to liquidate most of the position even after it had sold off quite a bit. Cigna retreated as investors took profits in some of the safe haven stocks of 2022. Cigna did not deserve to go as high as it did in 2022 and the strategy lightened up last year, but a 22% correction this year seems a little too much without any meaningful company news. The strategy recently bought a little more Cigna. Hanesbrands continues to underperform. Investors don't see a good year for apparel companies. Hanesbrands also had to refinance debt at much more expensive levels, creating a servicing overhang that will linger for years. Hanesbrands still has a couple quarters worth of high-cost inventory to liquidate before it can get back to normal margins. While that doesn't bode well for near-term earnings, the 2nd half of the year will be here soon and once Hanesbrands starts showing a much-improved margin profile, the stock can rally meaningfully despite the high debt. The OS normally avoids high debt companies because cash flow gets used to pay down debt which does not go to shareholders or get reinvested back in the business. That creates a meaningful drag and for certain companies can last several years. However, Hanesbrands can be back to a more reasonable leverage ratio by 2025 and at that point, even a modest multiple to free cash flow would be quite a bit higher than the current stock price. Conduent is a self-help, margin improvement story. It is held for that reason but also because there is a good chance the investor base may force division sales to close the sum of parts discount. Those two reasons combined, potential for margin improvement and the potential for investor friendly moves, led to its inclusion in the portfolio but it is a lukewarm holding. I do think there is a better chance than not, division sales will take place in 2023. Macy's has sold off on renewed fears about department stores ability to survive the retail landscape. Time will tell if Macy's can prove investors wrong. If it does so, there is the opportunity for a meaningful rerating at some point. Bankruptcies of peer companies sometimes leads to selloffs of similar companies but that often means one less competitor to deal with. I continue to think that Macy's is not just a survivor but at some point, a growing company in the changing retail landscape.

Looking forward, the OS has a very heavy weighting to international stocks. Inflation is high in Europe as well as the US but the economic situation is stabilizing and European stocks look appealing. Japanese stocks look appealing as well. Stock prices in the United States seem high compared to the risks that lie ahead. There is a very large inversion between 3 month t-bills and 10 year treasury notes. Bond investors think the risk of a hard landing is meaningful. Yet, equity prices seem to reflect nothing more than a very shallow recession if one at all. The risk of stocks varies through economic cycles and right now risk for US equities seem to be elevated so a heavy international weighting makes sense.

The OS continues to invest in volatile equities and that won't change meaningfully despite the economic climate. However, recently some of the opportunistic buys have been on short-term CD's so the risk profile has moderated somewhat.

Chris Harrington
Portfolio Manager

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