Mid Cap Equity Strategy — 4th Quarter 2018 Commentary

4th QUARTER MARKET SUMMARY

“Staying Invested When Terrified”

The hot topic for most investors as we enter the New Year is what to make of the slow motion train wreck that the market has become since the beginning of October. The month of October, in lore at least, has earned a reputation as being the cruelest of months, and 2018 will not have done much to change this reputation. From the market peak on September 21, to its nadir on December 24, the market, as measured by the S&P 500 index declined over 22.0%. The stock market crash of 1987 by comparison resulted in a slightly LESS painful decline of 20.5%. The fact that the 2018 decline occurred over several months will be no salve to investors as the damage was broad-based, with essentially all asset classes declining comparable amounts over the same period. We’ve compared the two market moves for both the stark similarity in the end results but also for their glaring contrasts as well. Both declines were of similar magnitudes and ended with a very similar forward looking earnings yield. That is where the comparison ends however as the 10-year Treasury yield flirted with 10% in 1987 while the comparable Treasury yield today is only about 2.7%. All other things being equal, investors should be willing to pay a much higher P/E ratio for the market during times of low interest rates (the rate at which those earnings are discounted and which represent the competitive “risk-free rate”), and yet the ending earnings yields are also quite similar.

October 19, 1987 Black Monday		4th Quarter 2018 A Thousand Cuts	
	Next 12 Months P/E		Next 12 Months P/E
October 16, 1987	21.2 X	October 3, 2018	21.2 X
October 19, 1987	16.8 X	December 24, 2018	16.2 X
Market Decline	-20.6%	Market Decline	-22.0%
10-Year Treasury Yield	9.50%	10-Year Treasury Yield	2.70%
Ending Earnings Yield	6.00%	Ending Earnings Yield	6.20%

This basic comparison begs the next question: What does the market see that we have yet to discern about the future of interest rates or earnings? One of the truly remarkable aspects of the economic recovery that emanated from the wreckage of the Great Financial Crisis of 2008-2009 was how slow and shallow that recovery has been; perhaps not surprising given the depth and magnitude of the financial market dislocations that occurred but nevertheless no one that we have come across has characterized the current state of our economy as overheated, imbalanced or unsustainable.

When it comes to reading macro-economic tea leaves, the best data (and the most current forward looking data) is in the possession of the Federal Reserve Bank so we quote their thinking on the current state of the economy as of the date of their most recent rate hike. On December 19, the Federal Reserve decided to hike short- term interest rates another 25 basis points, targeting 2.25-2.50 percent. In its statement, the Fed noted that:

> *"Information received since the Federal Open Market Committee met in November indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year."*

While we find it curious and somewhat counter-productive for the FED to invert the yield curve during the weakest and shallowest economic recovery on record, we can have some sympathy for their plight as they were left in a particularly difficult spot by their predecessors. The FED, for the last several years, has been slowly and methodically trying to "normalize" short-term rates in order to have some capacity to ease again if economic conditions do soften suddenly and terribly worsen, for reasons that are uncontrollable or represent a "black swan"-type event. The current FED leadership was infamously put in this position by virtue of the Mr. Magoo-inspired monetary policies enacted by the leadership of FEDs past (yes, Alan Greenspan, yes, Ben Bernanke). The fear of not having any bullets in one's gun prior to one's next gunfight (and not knowing the future date of said gunfight) is the inspiration behind the current FED's policy path of the last two years. The fact that the FED has felt compelled to follow the policy of gradually tightening monetary conditions despite such a shallow (and relatively inflation-less) recovery tells you all you need to know about how scared they are to have been without bullets; we can hardly blame them.

When semester report cards show up in my household for my three sons, my wife has a regular and predictable tendency toward tightening monetary policy. This in turns causes my sons level of outside activity to decline, until such a time as a recovery in priorities has been achieved. However, the hysteria and noise around this change in policy is deafening despite the modest and legitimate changes that need to occur. Likewise, as the FED has been tightening, the economy needs a bit of time to adjust to a higher cost of capital and more rational investment decisions; meanwhile the current stock market behavior is a pretty *apropos* proxy for three teenage boys with no cash in their pockets.

As all of our investors know, we are bottom-up fundamental investors, and, therefore, macroeconomic forecasts have almost nothing to do with our investment decisions. But we are market observers, and there is a simple, glaring scarcity of economic imbalances: the banking system is exceptionally well-capitalized and becoming more conservative in its accounting practices; the housing market is stable and gives no indication of being oversupplied; industrial activity remains in positive territory; and, generally speaking, people are working and investing. If this is the onset of another pro-longed bear market, it flies in the face of any market or orthodox economic logic that we have seen.

According to Yardeni Research, there have been 20 episodes over the past 100 years for declines similar to those in the table above. In 15 of those episodes, stock market returns were positive in the following year. Three of the five episodes of negative returns happened during the Great Depression, one during the Arab Oil Embargo and one during the bust following the peak in the Internet Bubble in 2000. There have been 36 episodes (1 every three years or so) of the market declining greater than 10% just since 1950. In addition to stock market corrections being surprisingly common, they also tend to move with more swiftness to the downside in comparison to a bull market moving to the upside. Simply put, corrections tend to be violent in the speed with which they achieve double-digit percentage declines. The silver lining? These declines are usually very short-lived. Of the 36 S&P 500 corrections since 1950, 22 of them have moved from peak to trough in 104 or fewer days. Since 1982, just two corrections have taken longer than 10 months to fully find a bottom. Thus, while red arrows might be temporarily unpleasant, they don't stick around very long, based on historical data.

There is an old joke about the stock market having successfully forecasted 9 out of the last 5 recessions, and while we do not know whether a recession is on the horizon, we do know that the current market downturn is placing some very high-quality assets (including some we already own) on deep sale prices. We have been more active in the last 6 months in terms making adjustments to our portfolio and expect to continue to be active in the near future, for as long as the sale prices persist.

Meanwhile, Behind the Curtain

Time to reflect on the performance of our portfolio has been short as the market decline accelerated into the end of the year; and it can be unproductive and frankly dangerous to make snap judgements about the very recent past. That having been said, we were somewhat disappointed in the performance of the portfolio this year, though the jury is still out on how well we will have preserved capital in the current market downturn. We felt as though we haven’t been paid yet by the market for several investments that have evolved very positively and were overly punished for those that had a setback. Initial market sell-offs tend to be indiscriminate and panicky, very often causing periods of perplexing and counterintuitive stock price movements. Factors such as the explosion of fund flows into passive investment vehicles such as ETFs and Index Funds have further exacerbated the impact of tax-loss selling, stock rating downgrades and fund liquidations on individual stocks.

A case in point, one of our most recent purchases, Equinix (a Real Estate Investment Trust), has declined by almost 25% since September, despite reporting very strong underlying earnings results and maintaining a very positive outlook for 2019 growth. The REIT index, a good proxy for relative performance measurement was down only about 15% for the comparable period. One reason for the outsized decline in Equinix was that one of the company’s largest shareholders, SPO Partners, announced during the 3rd quarter of 2018, its intention to liquidate its entire portfolio as a prelude to shutting the firm. Setting aside the imprudence of sending an invitation to the market to front run your future selling activity, it is a very reasonable explanation, though no less painful in the short-term, for the outsized decline in the stock. Our two other REIT investments, Alexandria Real Estate

Equities and Mid-America Apartment Communities by comparison, returned -8% and -5%, respectively, during the same period and were meaningful positive contributors to relative performance, especially as the market decline accelerated.

HCM PERFORMANCE HISTORY

% Annualized Returns As of 12/31/2018	4Q 2018	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception 06-30-88
HCM Gross of Fees	-16.59%	-12.63%	4.95%	3.66%	9.62%	13.61%	13.41%
HCM Net of Fees	-16.84%	-13.55%	3.94%	2.65%	8.56%	12.51%	12.31%
Russell Mid Cap Value Index	-14.95%	-12.29%	6.06%	5.44%	10.89%	13.03%	10.97%
Russell Mid Cap Index	-15.37%	-9.06%	7.04%	6.26%	11.49%	14.03%	10.93%

Link to: HCM Performance Disclosures

The return of the Portfolio Composite for the year ended December 2018 was -12.58% compared to the Russell Mid-Cap Value Index return of -12.29, for a negative relative return of -0.29%. The primary detractors from performance during the year were our sector exposures in Consumer Discretionary, Financials and Materials, somewhat offset by positive contributions from the Information Technology, Health Care and Real Estate sectors. From an individual stock perspective, the main detractors from performance were Mohawk Industries, SEI Investments, Albemarle Corporation and PVH Corporation somewhat offset by positive contributions from Keysight Technologies, Euronet Worldwide, Ross Stores and Becton Dickinson. The table below encapsulates the annual results for a Model account (which differs from the Portfolio Composite):

LINKED PERFORMANCE BY SECTORS

12/31/17 - 12/31/18

BENCHMARK: Russell Midcap Value Index

PORTFOLIO: Model Account

GICS Sector	PORT Wgt	BENCH Wgt	DIFF Wgt	PORT Ret.	BENCH Ret.	DIFF Ret.	SECTOR SELECT	STOCK SELECT	ACTIVE CONTR	PASSIVE CONTR	TOTAL CONTR
Energy	2.85	7.80	-4.95	-23.77	-27.44	3.67	0.49	0.07	0.56	-0.86	-0.30
Materials	5.17	5.92	-0.75	-30.65	-18.70	-11.96	0.03	-0.60	-0.57	-0.38	-0.95
Industrials	23.36	12.07	11.29	-15.94	-16.68	0.74	-0.37	0.02	-0.35	-0.49	-0.84
Consumer Disc.	14.51	11.23	3.28	-28.25	-17.94	-10.30	-0.17	-1.59	-1.75	-0.62	-2.38
Consumer Stpls	0.00	4.50	-4.50	0.00	-16.00	16.00	0.13	0.00	0.13	-0.13	0.00
Health Care	11.00	6.60	4.41	-2.38	-10.06	7.68	0.10	0.78	0.88	0.16	1.05
Financials	15.01	19.33	-4.32	-21.91	-16.37	-5.54	0.16	-0.79	-0.63	-0.71	-1.34
Info Tech	12.62	7.88	4.74	17.95	-2.29	20.24	0.49	2.21	2.71	0.62	3.33
T-comm Svcs	0.00	1.00	-1.00	0.00	13.35	-13.35	0.01	0.00	0.01	-0.01	0.00
Utilities	0.00	10.30	-10.30	0.00	3.99	-3.99	-1.54	0.00	-1.54	1.54	0.00
Real Estate	11.88	13.38	-1.50	-5.99	-5.54	-0.45	0.05	-0.10	-0.05	0.87	0.81
Cash	3.60	0.00	3.60	1.74	1.74	0.00	0.54	0.00	0.54	0.00	0.54
TOTAL				**-12.52**	**-12.43**	**-0.08**	**-0.09**	**0.00**	**-0.08**	**0.00**	**-0.08**

Year to Date Ended 12/31/2018 – Model Portfolio vs. Russell Mid-Cap Value Index

	Top Four Holdings Relative Contribution			Bottom Four Holdings Relative Contribution			Top Four Sectors Relative Contribution			Bottom Four Sectors Relative Contribution	
1	KEYS	2.09%	**1**	MHK	-1.85%	**1**	Cons Disc	2.89%	**1**	Cons. Stpls	-0.99%
2	EEFT	1.19%	**2**	ALB	-0.88%	**2**	Industrials	1.49%	**2**	Energy	-0.58%
3	BDX	0.77%	**3**	SEIC	-0.86%	**3**	Financials	1.47%	**3**	CASH	-0.50%
4	ROST	0.74%	**4**	PVH	-0.67%	**4**	Materials	0.89%	**4**	Health Care	0.30%

For the 4th quarter, our Portfolio Composite returned -16.60% compared to the Russell Mid-Cap Value benchmark return of -14.95% for a net negative relative return of -1.65%. Again, the Consumer Discretionary, Industrial and Financials sectors underperformed the benchmark, somewhat offset by outperformance in Information Technology, Real Estate, Health Care and our modest cash holdings. The most significant detractors from performance were PVH Corporation, Air Lease, Mohawk Industries and East West Bancorp, somewhat offset by positive contributions from Euronet Worldwide, Mid-America Apartment Communities, Agilent and Keysight Technologies.

LINKED PERFORMANCE BY SECTORS 09/30/2018 - 12/31/2018 BENCHMARK: Russell Midcap Value Index PORTFOLIO: Model Account											
GICS Sector	PORT Wgt	BENCH Wgt	DIFF Wgt	PORT Ret.	BENCH Ret.	DIFF Ret.	SECTOR SELECT	STOCK SELECT	ACTIVE CONTR	PASSIVE CONTR	TOTAL CONTR
Energy	2.63	6.68	-4.06	-24.50	-35.38	10.89	0.90	0.34	1.24	-1.49	-0.25
Materials	4.82	6.08	-1.26	-21.69	-15.79	-5.90	-0.03	-0.18	-0.20	-0.05	-0.25
Industrials	23.90	12.11	11.80	-21.10	-17.65	-3.45	-0.25	-0.88	-1.13	-0.31	-1.45
Consumer Disc.	13.10	9.68	3.42	-24.37	-16.79	-7.58	-0.03	-1.06	-1.09	-0.18	-1.27
Consumer Stpls	0.00	5.17	-5.17	0.00	-10.26	10.26	-0.23	0.00	-0.23	0.23	0.00
Health Care	11.41	6.78	4.63	-13.94	-16.13	2.19	-0.04	0.24	0.20	-0.07	0.13
Financials	13.66	17.62	-3.95	-20.45	-15.92	-4.53	0.02	-0.63	-0.61	-0.15	-0.76
Info Tech	13.94	8.80	5.14	-5.83	-18.49	12.67	-0.16	1.68	1.52	-0.31	1.21
T-Comm Svcs	0.00	2.36	-2.36	0.00	-15.72	15.72	0.13	0.00	0.13	-0.13	0.00
Utilities	0.00	11.19	-11.19	0.00	-1.44	1.44	-1.35	0.00	-1.35	1.35	0.00
Real Estate	13.14	13.54	-0.39	-9.78	-6.31	-3.46	-0.07	-0.37	-0.44	1.11	0.66
Cash	3.38	0.00	3.38	0.54	0.54	0.00	0.54	0.00	0.54	0.00	0.54
TOTAL				**-16.49**	**-15.06**	**-1.43**	**-0.56**	**-0.87**	**-1.43**	**0.00**	**-1.43**

Quarter Ended 12/31/2018 – Model Portfolio vs. Russell Mid-Cap Value Index

Top Four Holdings

Relative Contribution

1	EEFT	0.69%
2	MAA	0.42%
3	A	0.41%
4	KEYS	0.39%

Bottom Four Holdings

Relative Contribution

1	PVH	-0.71%
2	AL	-0.62%
3	MHK	-0.45%
4	EWBC	-0.38%

Top Four Sectors

Relative Contribution

1	Info Tech	1.21%
2	Real Estate	0.66%
3	CASH	0.54%
4	Health Care	0.13%

Bottom Four Sectors

Relative Contribution

1	Industrials.	-1.45%
2	Cons. Disc.	-1.27%
3	Financials	-0.76%
4	Materials	-0.25%

What we got right in 2018

In 2015, when we received Keysight Technologies (KEYS) as a spin-off from former parent Agilent, the company was viewed as a sleepy, little- or no-growth, technology equipment company with highly cyclical end markets and a history of underinvesting in its business due to its prior corporate parent diverting its impressive free cash flow to higher-growth priorities. At the time of spin-off, the stock we received from Agilent was valued at about 11 times forward earnings while the broad market P/E was closer to 16 times; such was the lack of enthusiasm attributed to Keysight's long-term outlook. We met with the management team a few months after the spin-off, however, and came away very impressed, not just with their business strategy but with how comprehensively the management team had planned out its corporate future. There was no detail too small to ignore: marketing, sales, research & development, product roadmap, expense management, tax strategy, manufacturing footprint and so the discussion evolved; our respect for and enthusiasm about the prospects for Keysight's future growth and returns evolved very positively with those discussions.

At the spin-off price of $27, we were then expecting around $2.25 per share of earnings in 2015 and reasoned that if Keysight were only able to grow earnings at 10% per year over the next 5 years, we could reasonable expect a return of slightly approximating 13-15% per year, accounting for some additional valuation expansion as well as the return of some excess capital on Keysight's balance sheet. Fast forward to 2018 and Keysight has compounded at almost 24% during our 4-year holding period. The difference between our initial estimates and the outcome? First, a corporate strategy to evolve away from being an equipment maker to being a solutions provider by adding software, services and selling them along with Keysight's market leading equipment. Success in capital allocation was among the primary drivers of that transformation, with Keysight completing acquisitions totaling nearly $2.4 billion since the spin-off. Looking forward, Keysight has captured significant market share in a much more quickly growing set of end markets than had been originally forecast by market experts in communications technology, driven substantially by the roll-out of 5G cellular communications infrastructure on a global basis. This roll-out is anticipated to continue at a very significant rate of growth for the next five years, if not longer. At a recent price of $65, Keysight sells at a market average multiple of about 16.5 times the nearly $4.00 per share in earnings we are currently expecting for the fiscal year ending in October 2019, in line with the broad market valuation despite a superior balance sheet and highly promising business growth outlook. Again, we believe that Keysight will be compounding earnings at 13-15% for the next three to five years, based on the opportunity set the company has in front of the business today. That set of opportunities is also likely to expand along with the ambitions of the management team, who will have another $2 billion or so in free cash flow to deploy over the next three years. We have sold only a minimal amount as the position size has grown with outperformance, and we believe there is more to come.

What we got wrong in 2018

Mohawk Industries turned in a very disappointing performance in 2018, giving back much of our 3-plus years' worth of gains (Fortunately, we sold about a quarter of our position at much higher prices early in 2018). On paper, at least, Mohawk represents one of the most dominant business franchises in our portfolio, from a competitive positioning standpoint while also possessing a long history of superior management execution. Mohawk is run by Jeff Lorberbaum, one of the very best executives we have come across. Lorberbaum is a third generation owner/operator in the flooring industry, who along with Berkshire Hathaway subsidiary Shaw Industries, has consolidated the global flooring solutions market into two major players. Mohawk has market leading positions in every category in which it competes, is a serial innovator of new products and has unmatched distribution and manufacturing capabilities.

In 2018, however, the company faced something of a perfect storm of bad fortune, which was exacerbated by the first management misstep that we have seen them make since we have followed the company. Rapidly rising raw material and freight costs were always going to be a headwind for Mohawk in 2018 and pressures of which we were well aware. The prospect of pending trade war with China, however, provided a huge incentive for Chinese flooring manufacturers to flood the U.S. market with cheap product ahead of potentially massive increases in tariffs. This move de-stabilized pricing in the U.S. and had the knock-on effect of causing consumers to trade down to cheaper (lower margin) materials for the first time since the great financial crisis. In addition, a new category of flooring, LVT (Luxury Vinyl Tile) caught the U.S. market by storm, proving to be a very popular and very cheap flooring solution and causing a tectonic shift away from hardwoods and ceramic tile, both very large categories for Mohawk. The market shift, quite frankly, caught Mohawk somewhat flat-footed. While Mohawk has had a plan in place to more than triple its LVT manufacturing capacity by the end of 2019 (one new plant has already come on line with another due by the end of this year), it was clearly an uncharacteristically poor showing by Mohawk in terms of being behind, rather than in front of, market trends. Add in the fact that Mohawk did a poor job of communicating these incremental headwinds and the stock performed very poorly in 2018, declining by over 57% and costing us -2.25% in relative performance.

Jeff Lorberbaum, not one who suffers bad news well or is afraid to make changes, acted swiftly, replacing the head of North American Flooring. Soon thereafter, the company announced the pending retirement of its Chief Financial Officer. At a recent price of $125, Mohawk trades at about 11 times the $11.75 per share that consensus expects Mohawk to earn in 2019. Notably, $11.75 is down about 15% from the $13.60 that Mohawk earned in 2017, the most recent peak in earnings for the company. The long-term outlook for Mohawk's ability to continue to earn an outsized share of the economics of the flooring industry has not changed and while the stock collapsed by 57%, the vast majority of the decline was due to multiple compression rather than earnings degradation. We remain long-term holders of the company and view its future prospects, due to its competitive position, balance sheet strength and history of value-added management execution, just as positively now as we did upon our initial purchases. As a final note, at recent levels insiders have been large purchasers of the company's stock.

What we believe we have right but didn't work for us…..yet!

PVH Corporation is one of a very small handful of dominant branded apparel companies in the world. We are not talking faddish, risky, small brands but rather iconic, long-term oriented lifestyle brands that have dominated the apparel industry for a generation. In the case of PVH Corporation, it owns the Calvin Klein and Tommy Hilfiger brands globally. The two brands combined represented over $9 billion in merchandise sales in 2018 and over $940 million in operating income; the increase in operating income in 2018 represented almost 14% growth over 2017 and almost 24% growth over 2016. That same $940 million in pre-tax income represents a 12.4% pre-tax return on tangible assets, amongst the top quartile of all mid-cap companies in our investable universe. Despite all of this, the stock currently trades at approximately 10 times the $9.50 per share that consensus expects PVH to earn in 2019, a severe an unwarranted discount to the current broad stock market earnings multiple of over 16 times. The stock traded poorly in 2018, declining over 32%, and we added to it recently at just over $92.00.

An important footnote to our portfolio performance in 2018 is the severity of the current discount of the portfolio to its expected value, calculated by taking the current market value of all of the positions in the portfolio divided by our intrinsic value targets for those positions, on a weighted basis. There have only been three times since we started calculating this discount (in 2003) that it has exceeded 20%: March 31, 2003; March 31, 2009; and, December 31, 2018, are those three instances (see table below). In other words, the portfolio is selling at a historically severe discount to expected value, which has previously marked the beginning of significant periods of both positive absolute and relative performance. In addition, the recent market dislocations have afforded us the opportunity, through portfolio activity, to further enhance the quality and more importantly the risk-adjusted outlook for future returns. Significant market downdrafts are the gift that keeps on giving for the long-term oriented, high-quality biased investor.

Historically Cheap Portfolio Snapshots

Date	Expected Portfolio Return
March 31, 2003	23.45%
March 31,2009	42.10%
December 31, 2018	20.80%

PORTFOLIO ACTIVITY

Positions Added - New stocks in 2018

Air Lease Corporation (AL) – Air Lease is one of the largest commercial aircraft leasing companies in the world, specializing in the niche market of leasing new aircraft for the first eight years of their useful lives. AL uses its scale to purchase brand new aircraft from Boeing and Airbus at substantial discounts to listed prices and leases these aircraft to over 100 different airlines located around the world.

The aircraft leasing industry dates back to the mid-1960s when Boeing sold its first plane to a leasing company. Shortly thereafter, at the age of 26, Steve Udvar-Hazy (the founder of Air Lease) created one of the first aircraft leasing companies in 1973, International Lease Finance Corporation (ILFC). After having pioneered the industry, ILFC was eventually sold to AIG in 1990, where Mr. Hazy remained as CEO of ILFC until 2010 when he left to start Air Lease Corporation. With 40 years of industry experience, Mr. Hazy has purchased and leased over 2,000 aircraft from Boeing and Airbus and is an integral part of the investment thesis and success of the company.

While the airline industry has historically been extremely volatile and fraught with bankruptcies, the aircraft leasing industry has proven itself incredibly resilient and profitable. AL's competitive advantage comes from four primary sources: (1) its relationships with the OEMs and airlines, (2) its purchasing scale, (3) its specialization in new aircraft, and (4) the availability of its product (airplanes).

AL operates as a "mediator" between the airplane manufacturers and their end customers (the airlines). For over 40 years, the managers at AL have been working with the OEMs to design aircraft that will fit the airlines' desires, while at the same time, working with the airlines to help manage and plan their future fleet needs. This gives AL a unique perspective on airplane demand that smaller operators lack, making its service more valuable to its customers. Similarly, its scale allows AL to attain the lowest cost in the industry in two key areas: (1) cost of aircraft, and (2) cost of funds. Airlines utilize leasing to help manage expenses, reliability, and utilization rates, as they typically do not have the access to capital necessary to make large purchases from the OEMs, this makes lessors an integral part of the industry value chain. In addition, AL specializes in only purchasing brand new aircraft - these are the most efficient, lowest operating cost types of aircraft in the market and, as a result, the most desirable by airlines. However, if an airline would like to purchase a new aircraft, they will have to wait a minimum of six years given the waiting list of other customers and the time it takes to build an aircraft, leaving AL as likely one of their only options when it comes to obtaining a new aircraft. This gives AL significant bargaining power with both the OEMs and the airlines.

Underlying all of this is the resiliency and above average rate of growth in passenger travel demand (which drives aircraft demand). Over the past 40 years global passenger travel demand has compounded at ~5.5% annually with only three years of negative growth (first Gulf war, 9/11, and 2008) with growth returning the following year in each instance. With less than 20% of the world's population having traveled by plane and the global middle class expanding at the fastest rate in history, there is significant room left, as indicated by the industry's above-average growth rate.

AL's management team operates the business with a conservative amount of leverage and focuses on maintaining its investment grade debt rating to ensure the lowest cost of funds. In addition, its assets (new airplanes) are highly mobile and can be moved anywhere in the globe to any customer within 24 hours - over the past 40+ years, AL's management has never repossessed an aircraft and not been able to re-lease it immediately (maintaining a 98%+ utilization rate even during the Gulf war, 9/11, and the financial crisis). This provides protection to AL in times of industry distress as new aircraft values have historically been very stable and durable. Furthermore, AL's business has some of the highest visibility into future earnings of any business we have analyzed – with a forward order book of over $27 billion, AL has already pre-leased (with signed, guaranteed contracts) ~85% of its future rental revenues through 2022. Due to our initial and subsequent purchases, our average cost basis represents a greater than 50% discount to our current intrinsic value target. Notably, intrinsic value is expected to grow at a mid-teens rate over the next 5 years.

Equinix, Inc. (EQIX) – Equinix is a global data center (DC) REIT that specializes in interconnected data centers. EQIX provides data and network hosting and colocation facilities where internet service providers, telecom carriers and content providers can station equipment to interconnect their networks and operations. EQIX is the only data center company with extensive global scale, operating 200 data centers across 24 countries throughout the Americas, EMEA and Asia-Pacific. Equinix is an attractive investment due to its sustainable competitive position, strong secular demand tailwinds and experienced management team.

Within its DCs, Equinix houses a critical mass of networks, cloud and IT services. An average EQIX DC hosts 500 to 600 customers, and offers the ability to connect directly to more than 1,700 networks and 2,900 cloud/IT service providers. This rich ecosystem is a substantial and sustainable competitive advantage which enables EQIX to attract and retain customers and increase wallet share with existing customers. EQIX's unique density and global scale enables customers to solve for scale and the increasing complexity of digital business infrastructure. Most of EQIX's customers utilize multiple DCs within its network.

Equinix focuses on several customer verticals, including cloud and IT services (AWS, Microsoft Azure, Google, salesforce, Oracle Cloud), content providers (Netflix, DIRECTV, eBay, Reuters), enterprise (Ford, Chevron, Anheuser-Busch, Shire), financials (Aon, Bloomberg, LSE, NASDAQ), and network and mobility providers (AT&T, British Telecom, China Mobile, Comcast). The company's market leadership in co-location and interconnection, combined with its vertical industry focus, enables EQIX become a trusted partner to its customers. These deep customer relationships enable Equinix to offer technology products and build-to-suit developments in direct response to underlying customer demand.

EQIX is positioned in the highest growth, highest demand parts of the data center market, which include retail co-location (+7.5% expected 5-yr. CAGR) and hyperscale (+25% expected 5-yr. CAGR). Underlying secular demand drivers include growing digital business requirements, the accelerating adoption of cloud computing technology, and the continued growth and adoption of third party IT platform technologies (e.g., social media, mobile, gaming, big data and AI). Given strong underlying demand, EQIX has 29 announced expansion projects through 2019 to meet demand and drive additional monthly recurring revenues. EQIX has also announced initial hyperscale initiatives to deepen relationships with hyperscalers and further enrich its network ecosystem.

Equinix has an experienced and well-respected management team. Charles Meyers was recently appointed CEO and has served in executive operating roles, such as COO and President of Americas, since 2010. Peter Van Camp has served as Chairman since 2007, and was CEO from 2000-07. Keith Taylor has been CFO since 2005, and joined the company in 2001. Management built EQIX's rich global interconnect network by fostering deep customer relationships and scaling quickly both organically and through acquisitions. Despite having a strong pipeline of development projects and acquisitions, EQIX's balance sheet offers more flexibility than other data center REITs. Current net leverage of 4.8x is lower than the data center REIT avg. of 5.3x, with a stated 3-4x leverage target. In addition, management expects to receive an investment grade debt rating over the next 12-24 months.

Our initial purchases of Equinix were made at a greater than 20% discount to our internal estimate of intrinsic value. We have taken advantage of the recent downturn to lower our cost basis by another 10%, and we believe Equinix' intrinsic value should compound at a mid-teens rate over the next 5-7 years, even as the company de-leverages.

Positions Increased

Air Lease (AL) – We added to our position in Air Lease during the quarter as the company continued to execute on its organic expansion by taking delivery of commercial aircraft that are pre-leased to its airline customers. Our research indicates that Air Lease, based on its current commercial aircraft order book and lease commitments, should be able to increase its earnings at a mid-teens rate over the next 4-5 years. The stock price should increase at that rate (more if there is valuation expansion) while the company continues to develop new lines of business. We were able to increase our stake at a deep discount to our estimate of intrinsic value.

Equinix (EQIX) – We added to our position in Equinix during the quarter as the 4th quarter sell-off gained steam. Equinix has the best long-term growth profile of any REIT in our investable universe with demand for its various data center services remains robust and with trends such as e-commerce and cloud computing gaining additional market acceptance, Equinix has a very long runway to expand and follow its customer base around the world. We were able to add to our position at a very significant discount to our estimate of underlying intrinsic value.

PVH Corp. (PVH) – We added to our position in PVH during the quarter when fears of additional trade tariffs and their potential impact on consumer demand punished retail stocks during the quarter. The performance of PVH's core Tommy Hilfiger and Calvin Klein brands remains very strong with the company in the relatively early stages of a global expansion of the addressable market for these goods. We were able to acquire our additional shares at a greater than 50% discount to underlying intrinsic value, while we expect the company to compound revenues and earnings in the mid-teens over the next several years.

Wabtec (WAB) – We added to our position in Wabtec during the quarter as fears of a global industrial slowdown punished the shares of this leading railroad equipment manufacturer. We have owned Wabtec for more than 10 years and have seen several cycles of underperformance for this company that has demonstrated such great consistency at compounding earnings. Wabtec is in the final stages of closing a deal to acquire the locomotive manufacturing business of General Electric. This will effectively double the size of Wabtec and make it the largest railroad equipment manufacturer in the world with dominant positions in public transit markets, industrial markets and now locomotives. Wabtec's acquisition of GE's locomotive business will be accretive to earnings on day one and adds close to 20% to our valuation of the overall business. We acquired our incremental shares of Wabtec at a greater than 30% discount to our estimate underlying intrinsic value.

Alexandria Real Estate Equities (ARE) – We added to our position in Alexandria during the quarter as we view it as one of the best positioned REITs in our universe with a marquee health care and health science client list as well as a development portfolio that appears to be filled for the next 5 years plus. Alexandria enjoys some of the best same store rent growth rates in the industry due to the relentless global expansion in the broader pharmaceutical and health care research industries as well as a marquee reputation as the landlord of choice for these types of tenants. We picked up our incremental shares at a double digit discount to our estimate of Alexandria's underlying intrinsic value.

Positions Reduced

Keysight Technologies (KEYS) – We reduced our position in Keysight during the quarter as it approached our 5% position limit due to continued outperformance of its shares. As highlighted earlier in the annual letter, we have a high degree of conviction around Keysight's ability to extend its lead in core products and service offerings, execute on the large opportunity in front of it related to the global roll-out of the 5G cellular standard and drive additional outperformance in its shares through excellent capital deployment.

Positions Sold

Host Hotels & Resorts (HST) – We sold our share of Host Hotels & Resorts during the quarter as we viewed the deployment of that capital into our other new opportunities (Air Lease and Equinix) as a superior use of this capital. Host is a well-managed, highly cyclical owner of resort and hotel real estate which has benefitted from a near 9-year run of positive results, with little or no underlying growth. While the returns associated with Host have been satisfactory over this period we had expected growth in its asset base, which did not occur, despite its cost of capital advantage relative to other hotel owners.

Covanta (CVA) – We sold our shares of Covanta during the quarter as the company significantly outperformed the market due to the very stable but slow-growing nature of its business. Covanta provided adequate, if unspectacular returns during our holding period but ultimately gave way to higher quality, faster growing assets in our portfolio.

Reliance Steel & Aluminum (RS) – We sold our shares of Reliance Steel & Aluminum during the quarter, locking in a significant gain (and outperformance) in the stock over our holding period. Reliance is a highly economically sensitive steel and aluminum processing business and benefitted greatly from the dramatic recovery in industrial production and non-residential construction which took place over the last eight years. Given the prospect of slower growth ahead and having reaped the benefits of steel tariffs, we viewed Reliance as probably over earnings it medium-term potential and having reached our intrinsic value target, sold the shares.

Snap-On Tools (SNA) – We sold our remaining shares in Snap-On during the quarter as we have become increasingly wary of the company's self-promotional nature. Snap-On maintains a dominant position in aftermarket tools for auto-repair and other industries but has run afoul of short-sellers for its promotional nature. With risk management our primary focus, we grew increasingly wary of the company's public posture relative to its operational performance.

Outlook

We believe that the companies we own are exceptional, led by top-notch people, and destined for a great future. They should continue to prudently navigate the often troubled waters of the global economy. The valuations assigned by the market to these outstanding companies is very similar to the valuation of an average company in the Russell Mid-Cap Value Index, despite the fact that we believe our companies have better growth prospects than average. Therefore, we consider the appreciation potential for our portfolio, both in absolute and relative terms, to be well above average, especially when compared to other alternative asset classes, such as bonds.

It is imperative for us to not only select outstanding companies for our portfolios, but to also remain outstanding stewards of your capital. We certainly like to achieve good returns and have developed a taste for it, but it must not come at the cost of taking undue risk. Our philosophy to favor companies with solid balance sheets and dominant business models, along with purchasing these companies at reasonable valuations, is central to the risk management of our portfolios.

Central to our strategy of purchasing these high-quality assets is the concept of time arbitrage, whereby we leverage the market inefficiency that can arise due to a shorter term focus by the stock market that may, at times, cause a company's stock to not reflect its true long-term potential. There is some academic work that supports the validity of the time arbitrage concept, and along with our core risk management philosophy, it is at the core of what we are trying to accomplish: the purchase of superior companies based on the quality of their business models, balance sheets and management skill at discounts to their intrinsic values. We then hold those companies for long periods of time in order to let the magic of compounding take hold. The average holding period for stocks in our portfolio has very consistently been between 6-7 years over the history of our firm.

We believe that until you own businesses whose share prices grow to three, five, ten times your original investment, you don't really have an appreciation for compounding. Time is the ultimate arbiter of value, and when you have businesses that grow, and those that don't, only then, over the passage of time, can you truly understand the drivers of compounding. It may be all there in a discounted cash flow formula, but until you live and breathe it, we don't think you can understand or appreciate it. Investors that buy and sell frequently, thinking high levels of activity add value, don't allow themselves to learn the nature of and reap the benefits of compounding. All the great investors we know have companies in their portfolios that have compounded for years. We appreciate your support are grateful for your votes of confidence.

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