Robotti Value Investors

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Dear Investor,

Our year-end letter discussed the concept of "financial Brigadoon," referring to the unique economic period marked by low inflation and interest rates, which created a foundation of easy access to cheap capital. Our point was that this magical place, like the legendary Brigadoon, is gone, not to return for at least 100 years. When we wrote this, we were referring to the opportunity in undervalued stocks that we believe will do well going forward but over the past few months we have started to witness the consequences of "financial Brigadoon" to capital that was misallocated. We see now that a lot of capital was misallocated based on the belief that easy access to cheap capital was the "new normal." The search for yield encouraged some investors to be so "clever" that they figured out how to earn more yield in a low-to-no yield environment - always a dangerous maneuver. This led to the recent unforced error of many banks and is only the most recent manifestation of a system that has been swimming naked and gotten caught by the tide going out. We think the tide has much further to go and would be shocked if this is the only outcome of risky capital allocation that comes back to bite investors.

In the case of Silicon Valley Bank and Signature Bank, ignoring systemic risks proved fatal. These banks had gotten drunk on low interest rates, both on their balance sheets and in the customer profiles. Risk diversification is incredibly important for banks, and what has been exposed is that many of them were not up to the task. Silicon Valley Bank had a group of customers largely made up of companies that had experienced huge growth due to low interest rates, so it stood to reason that as interest rates rose, they would become riskier businesses and need more access to cold hard cash. Simultaneously a decade of low interest rates encouraged the bank to hold a substantial portion of their assets in longer-dated bonds. This stretch for yield proved to be the key ingredient in the poison that took down these banks.

Financial news, and even mainstream media, has talked everyone's ears off about bank collapses, so we won't dwell on them. All we will say is that this is another indication of a turning point in the U.S. economy. The last vestiges of the artificial, manipulated world of "free money" have evaporated, and in the new world, the winners and losers will be very different. We continue to focus on those winners who can prosper and thrive in this new environment.

Homebuilding and the Inefficient Market

We marvel at how many investment prognosticators still believe that the markets are efficient. We're not sure how that theory can be reconciled with so many wild market gyrations over the last 25 years. In homebuilding we saw an overreaction highlighting how inefficient the market can be. The past quarter has seen many of our homebuilding stocks recover and we have benefited from substantial appreciation in our holdings. Yet, the fundamental moderation of homebuilding activity persists as affordability has been hit from every side. The fact is that the companies we own in this industry have spent the last decade consolidating their segments, rightsizing their operations, and building moats around their businesses.

We are seeing the fruits of those labors today. Even in an environment where housing starts have slowed down due to higher interest rates, these companies continue to perform well. Further, the structural supply deficit still remains and should only provide additional tailwinds for these companies going forward. Single family housing starts continued to decline throughout last year and have started to level off in the last few months at around 800k. This is still below the 1.1m needed to just maintain the housing supply, without taking into consideration the need to make up for the underbuilding that occurred over the last decade.

The true strength of these companies, however, lies in how they have performed even while housing starts have weakened. The market is starting to appreciate that these are not the homebuilding supply companies of the mid 2000's but are much more financially stable businesses with fewer competitors and much more pricing power. They have fortress balance sheets, financial flexibility and can moderate activity to match end market demand, which allows them to continue to generate earnings and free cash flow even at more modest activity levels all while further consolidating their businesses - and buying back stock with excess cash further increasing per share intrinsic values. Winning strategies even in a tepid environment.

Conclusion

We're pleased with the quarter's performance. More importantly, we remain excited as our holdings have strong fundamentals and very modest valuations. As always, these results are only possible with clients who understand our process. We are very optimistic about our prospects going forward and are always happy to answer any questions or concerns that you might have.

All the best,

Bob

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