THE BERMAN VALUE FOLIO

A TREFIS INTERACTIVE PORTFOLIO | NOV 2016

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FOLIO: WINDING DOWN

Warren Buffett says his favorite holding period is "forever." It makes sense. Why ever sell a business with good returns on capital? Such a business will only be more valuable in five years, in ten years and, ideally, until the end of time.

Forever would be our ideal time horizon for many things, chief among them our lifespan or those of our children. As the Buddhists explain, however, nothing lasts forever. Change is the only thing you can count on.

In the spirit of change, I have to tell you that the Folio is winding down. Ideally, I would publish this Folio forever. I've enjoyed writing about value investing and engaging a small but devoted readership. But the circulation has not quite grown to a critical and sustainable mass. Meanwhile, my main business of managing money demands greater and greater time. After five enjoyable years, the next issue will be our last.

I plan to devote the final issue to some closing words on value investing, with a few pointers for those of you who plan to continue to use Trefis tools and value techniques to manage your portfolio.

Thanks for your readership over the past half a decade. Feel free to email questions—even after the Folio goes into early retirement!

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Ticker	Trefis Price	Market
AAPL	120	117
AXP	72.45	67.36
BA	145	136
CAT	85.21	86.33
CSCO	30.37	30.15
CVX	104	101
DD	58.14	69.70
DIS	111	93.03
GE	30.79	28.98
GS	200	175
HD	140	127
IBM	139	150
INTC	34.11	35.15
JNJ	115	113
JPM	75	68.49
KO	45.57	42.13
MCD	120	114
MMM	173	170
MRK	63.10	61.20
MSFT	56.05	59.66
NKE	61.91	51.77
PFE	38.09	32.18
PG	93.11	84.33
TRV	117	108
UNH	148	145
UTX	124	98.67
V	84.16	82.35
VZ	56.42	48.20
WMT	74	68.34
XOM	93.01	86.62
DOW	**18,735**	**17,681**
Undervaluation	**+ 6%**	

THE END OF CHEAP MONEY

As I often tell my students, money has a price to it—just like anything else. The price of money is interest rates. Ever since the financial crisis, money has been on sale, with rates plumbing zero (and even negative numbers).

It's become a common trade—and an economist's parlor game—to figure out when the Fed will truly normalize rates. Given that the average 10-year treasury yield is around 5%, more than double the current 1.73%, Janet Yellen has a long way to go. But make no mistake: it's not a question of *if* but *when*.

On the data side, employment is tightening and deflationary pressures (such as declining energy prices) are receding. On the anecdotal side, some unions are considering striking again, an unthinkable idea a few years ago.

As wage pressures build and employment tightens, the Fed will have no choice but to hike rates. Though normalization could take some time, the trend will be up. Today's mortgage rates will look quaint in a few years.

The implications for investors are several:

- Lock in fixed rates now (i.e., mortgages)
- Avoid variable rates for any loans that cannot be easily paid off
- Consider stocks that enjoy greater profitability as rates rise, such as custodial banks like BNY Mellon (BK) and State Street (STT), and payroll processors like Paychex (PAYX)—all of which are in the Folio
- Avoid companies that will be compromised by higher financing costs, such as those that are poorly capitalized and overleveraged
- Keep bond duration as low as possible (under three years), even at the expense of yield.

UTX: Top Pick for Next 5 Years

As the Folio comes to an end, I wanted to write about the one stock I would recommend now for a five-year hold—for those who wish to "set it and forget it." Such a company would have to fit Buffett's prime criteria: a wonderful company selling at a reasonable price. It would also have to have an ironclad balance sheet in order to see it through such a long stretch. Finally, it would need some stability and internal diversification.

My top pick to buy and hold for the next five years is United Technologies (UTX), a conglomerate with dominance in all of its underlying business units. In the wake of the $9 billion sale of its Sikorsky helicopter business, UTX is a more focused business than ever. Yet it still has a nice mix of divisions that make it less reliant on any given one. The crown jewels are UTC Climate, a leading maker of large HVAC systems, and Otis Elevators, one of the leading beneficiaries of worldwide "verticalization."

As Morningstar points out, UTX derives 44% of its sales from servicing revenue and other recurring cash flows, a feature that makes it less of a cyclical industrial conglomerate and more of a cash cow.

According to Trefis, UTX trades at a significant discount to intrinsic value, with a market price 20% below the $124 estimated fair value.

UTX: High EVA

UTX adds value for shareholders on a consistent basis. Economic Value Added (EVA) measures the spread between the returns on capital and the cost of capital. Though it's the rare company that generates positive EVA year after year, UTX is in that elite group. But as you can see from the Morningstar profitability metrics below, UTX has generated returns on invested capital

Profitability	2006-12	2007-12	2008-12	2009-12	2010-12	2011-12	2012-12	2013-12	2014-12	2015-12	TTM
Tax Rate %	27.20	28.76	27.15	27.45	27.94	29.34	24.76	26.92	25.48	32.64	32.73
Net Margin %	7.80	7.71	7.99	7.24	8.05	8.56	8.89	9.14	9.55	13.56	12.79
Asset Turnover (Average)	1.03	1.08	1.06	0.94	0.95	0.97	0.77	0.70	0.72	0.63	0.61
Return on Assets %	8.02	8.31	8.45	6.82	7.65	8.30	6.80	6.36	6.84	8.51	7.91
Financial Leverage (Average)	2.73	2.56	3.55	2.78	2.74	2.81	3.45	2.84	2.92	3.20	3.08
Return on Equity %	21.77	21.86	25.16	21.28	21.10	23.02	21.47	19.80	19.72	25.98	24.23
Return on Invested Capital %	16.54	16.86	17.93	15.18	15.74	16.70	14.06	12.60	13.34	16.53	14.87
Interest Coverage	10.06	10.59	11.07	9.17	9.72	12.30	8.74	9.04	9.08	7.84	7.46

Reprinted from Morningstar.com

(ROIC) averaging 15% over the past decade. The lowest year, 2013, still generated 13% on the underlying shareholders' equity. Given UTX's estimated weighted average cost of capital of 8.50%, EVA has averaged over 6% on a remarkably consistent basis, even through the depths of the financial crisis and the great recession. The stock's annualized return has matched 6% as well, showing the correlation between EVA and stock returns. As Warren Buffett always explains, returns on capital are much more important than conventional merits like growth rates because they show how well a company employs capital, the ultimate question for shareholders—and the ultimate determinant of value over time. Given UTX's record of capital utilization over the past ten tumultuous years, I have faith in the next five.

COMPANY HIGHLIGHTS

Boeing (BA) reported core quarterly earnings of $2.81 per share, better than the average analyst estimate of $2.62 in spite of declining revenue. Cost-cutting and more efficient manufacturing drove profit margins higher and improved operating cash flow by 12%, to a robust $3.2 billion. I believe BA's best days are still ahead of it, given the the continued growth in air travel demand—a market that has experienced 5% annualized increases on a historical basis. When you find a company that has a virtual duopoly (with Airbus) in a market growing faster than GDP, trading at a discount to its intrinsic value, you take it. That's BA in a nutshell.

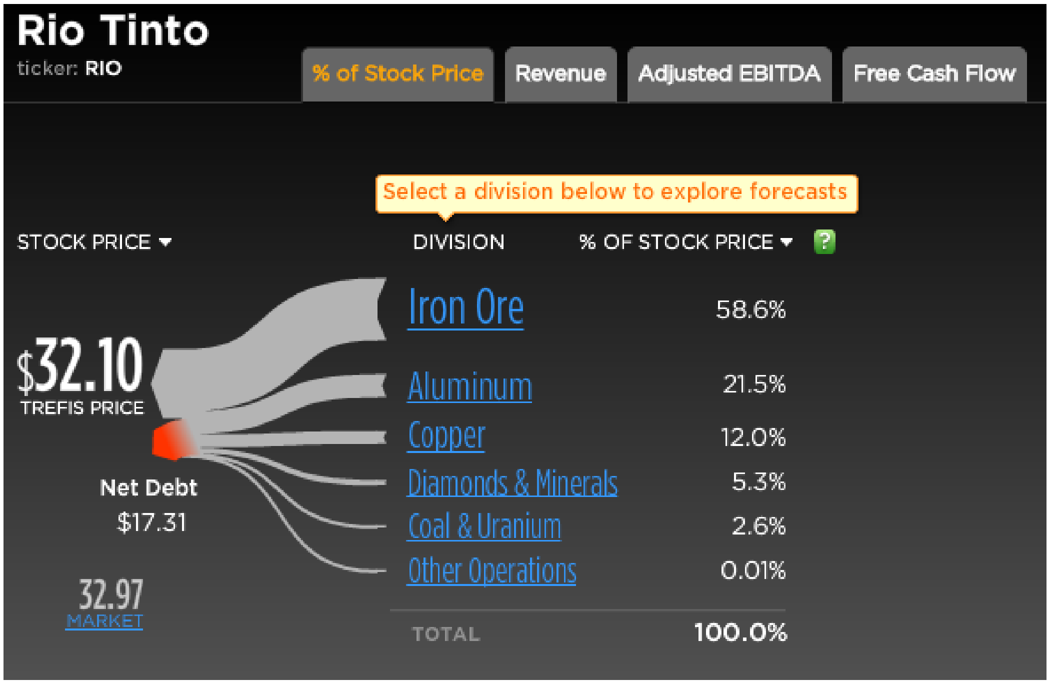
TREFIS KEY DRIVERS

Boeing's cash flows are likely to remain strong in the next few years driven by increased production of its 737 jets and plans to improve the profitability of the 787 Dreamliner. Furthermore, the company increased its outlook for the total deliveries in the year, up from 740-745 to 745-750. However, management warned that it may cut production of the 777 due to weaker-than-expected demand.

Market Capitalization	Annual Revenues	Dividend/Yield	52 Week Range
$88.9 B	$94.9 B	$4.36 / 3.05%	$102.10 - 150.59

COMPANY HIGHLIGHTS

Rio Tinto (RIO) is committing to its low-cost producer status, preparing for an oversupply of iron ore for the next 7 to 10 years. No company is better poised than RIO to do so, given its sterling balance sheet and $6 billion in costs removed since 2012. New CEO Jean-Sébastien Jacques vows to continue the cost-cutting enacted by his predecessor Sam Walsh. I like to invest in companies that are the most effective producer in a tough industry: the arduous conditions reinforce the high barrier to entry driven by the cost efficiencies. I would buy RIO at the current price if you have a long-term time horizon.



TREFIS KEY DRIVERS

Rio Tinto continues to ramp up its iron ore production despite a prevailing oversupply situation in global markets, though the pace of production growth has declined, as demonstrated by the company's Q3 production report. Though Rio Tinto can continue to operate profitably with prices at current levels, the company's iron ore mining margins are set to remain under pressure in the near term.

Market Capitalization	Annual Revenues	Dividend/Yield	52 Week Range
$65.5 B	$32.4 B	$1.51 / 4.38%	$21.89 - 37.25

COMPANY HIGHLIGHTS

United Parcel Service (UPS) increased revenue by 4.9% in the past quarter thanks to strong package volume. When a company of UPS's size and quality grows sales at 5%, you have to be thankful to the equity gods. This revenue number was significantly strengthened by international sales, where average daily volume grew 7.5%, an outstanding result. With a 2.85% dividend yield and mid-single digit sales growth, UPS can be a very profitable investment, even while trading at close to its intrinsic value—as it currently is. I'm upgrading UPS to "Buy" from "Hold" on the quality of its metrics in tandem with its reasonable price.

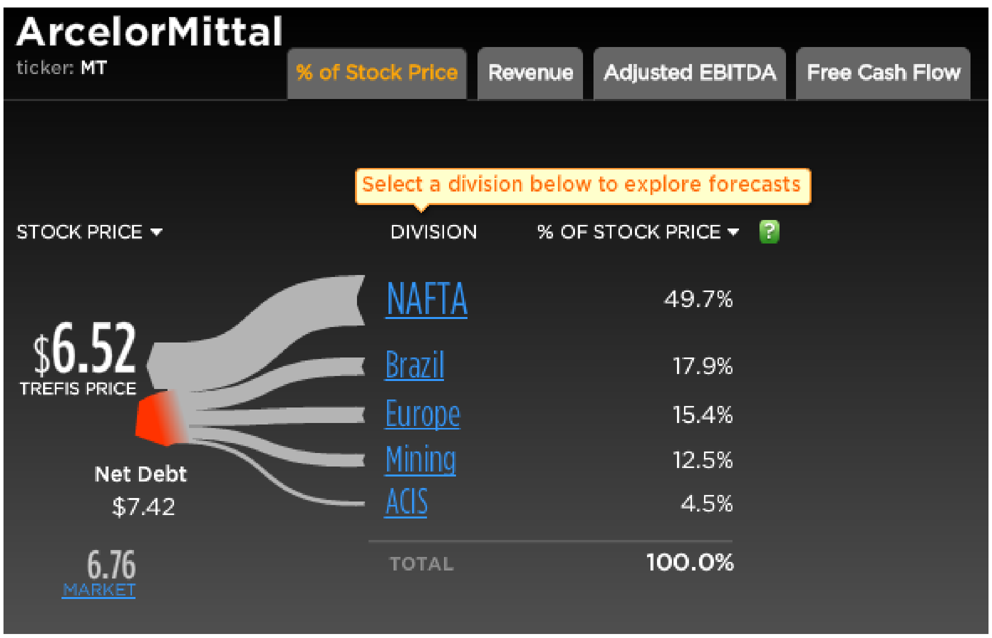
TREFIS KEY DRIVERS

UPS' U.S. Domestic Package segment, the company's main revenue contributor, continues to benefit from e-commerce growth, with B2C deliveries increasing 11%. in the third quarter. The segment saw a 6% increase in average daily package volume in Q3. Trefis expects further growth in volumes due to the aforementioned e-commerce tailwinds.

Market Capitalization	Annual Revenues	Dividend/Yield	52 Week Range
$94.1 B	$60.0 B	$3.12 / 2.90%	$87.30 - 111.83

COMPANY HIGHLIGHTS

To gain an insight into ArcelorMittal's (MT) competitive advantages, you can look at MT's Cleveland steel mill, reportedly one of the world's most productive steel mills and a producer of specialty steels that comprise a crucial component in modern, fuel-efficient cars. MT bought the mill from a bankrupt LTV Corp. after its closure in 2002, investing in new technology to compete with foreign steel production. As a result, the revitalized mill uses less labor and garners higher margins. The new world of steel production has hundreds of similar stories. To adapt, steel manufacturers have become leaner and more specialized. As steel demand recovers, MT will reap significant economies of scale.



TREFIS KEY DRIVERS

With steel prices tumbling over the past few years, ArcelorMittal has been looking to boost its margins by controlling costs in its steelmaking and mining operations, and seeking to shift its product mix toward higher-margin steels such as automotive steels at its NAFTA operations. A combination of favorable product mix and successful cost reduction measures are expected to provide a $1 billion boost to the company's EBITDA in 2016.

Market Capitalization	Annual Revenues	Dividend/Yield	52 Week Range
$21.4 B	$57.7 B	N/A	$2.93 - 6.90

THE BERMAN VALUE FOLIO

I'm upgrading UPS from a Hold to a Buy (see page 7)

Symbol	Company Name	Buy/Hold/ Sell	Purchase Date	Purchase Price	Market Price	Total Return Since	Trefis Estimate
Basic Materials							
MT	Arcelor-Mittal	Buy	9/21/2012	$16.06	$6.73	(55.9%)	$6.52
RIO	Rio Tinto	Buy	1/31/2014	$53.15	$34.85	(25.7%)	$34.62
Consumer							
HOG	Harley Davidson	Buy	4/30/2015	$56.22	$57.02	5.5%	$55.61
Energy							
SLB	Schlumberger	Buy	9/30/2014	$98.66	$78.23	(16.7%)	$81.75
BP	BP	Buy	12/21/2011	$41.33	$35.55	8.4%	$35.87
PBR	Petrobras	Buy	12/31/2014	$7.30	$11.67	60.1%	$10.40
XOM	Exxon Mobil	Buy	1/30/2015	$87.42	$83.32	1.2%	$93.01
Financial Services							
BK	BNY Mellon	Buy	12/21/2011	$19.43	$43.27	142.9%	$45.00
BLK	BlackRock	Buy	8/29/2014	$330.53	$341.24	9.0%	$380
C	Citigroup	Buy	12/21/2011	$25.74	$49.15	93.2%	$61.00
JPM	JPMorgan Chase	Buy	12/21/2011	$32.12	$69.26	145.6%	$75.00
STT	State Street	Buy	1/31/2016	$55.73	$70.21	28.1%	$68.00
PYPL	PayPal	Buy	7/17/2015	$36.00	$41.66	15.7%	N/A
Tech, Media, Telecom							
IBM	IBM	Buy	2/28/2014	$185.17	$153.69	(10.0%)	$139
PAYX	Paychex	Hold	12/21/2011	$29.14	$55.20	121.6%	$55.20
Industrials & Transportation							
BA	Boeing	Buy	2/29/2016	$142.43	$131.76	25.1%	$145
UPS	UPS	Buy	12/21/2011	$72.40	$107.76	69.2%	$109
UTX	United Tech.	Buy	4/21/2012	$80.40	$102.20	39.1%	$124
DE	Deere	Buy	3/31/2015	$87.69	$88.30	5.4%	$92.53
Total Return						99.0%	

Total return is calculated since inception date of 12/21/2011 and includes reinvested dividends.
When a stock is bought in the portfolio, it is added on an equal cash-weighted basis at the time of purchase.

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