

Creating Value with Concentration and Flexibility

Companies generating excess cash are sound investment ideas, especially when management has a long-term track record of reinvesting free cash flow. Chris Pearson and George Smith, portfolio managers of the Davenport Equity Opportunities Fund, complement their concentrated and opportunistic approach with a rigorous research process that seeks to identify attractive business models run by superior capital allocators.

What is the history of the company and the fund?

Davenport Asset Management is the professional money management arm of Davenport & Company LLC. Since 1984, our foundation has rested on one core belief: to manage client money in the same way we manage our own. Today, we manage \$5.4B in assets across equity, fixed income and asset allocation strategies. We are dedicated to the principals of long-term investing and delivering exceptional service to our clients.

Presently, we have four investment strategies that are available under mutual fund structures, three of which are also offered under SMA structures. As part of our profit sharing, we offer employees the same products that we offer to our clients. In 2014, we began to offer our mutual funds outside of the Davenport distribution footprint. We are selective with how we grow so as not to compromise our results and we are fortunate to have a very loyal investor base.

The Equity Opportunities Fund has an interesting background, with the original separate account strategy going back to 2003, when it was known as the Mid-Cap Portfolio. However, in late 2009, we decided to implement a change in order to create a more flexible and opportunistic product with a different focus. On December 31, 2009 we changed the managers, we changed the name of the portfolio, we changed the approach and the holdings.

With this transition in mind, a more relevant starting point, in terms of measuring us would be January 1, 2011 as the first year was a bit of a transition year in which we were making a lot of changes. As a result, the turnover was a bit higher than it would normally be.

The fund is more concentrated under the current structure, and while it still has a mid-cap bias, it also has significantly more flexibility in terms of market cap and style. Our desire to expand this approach into additional market caps led to the launch of a small-cap fund on January 1, 2015.

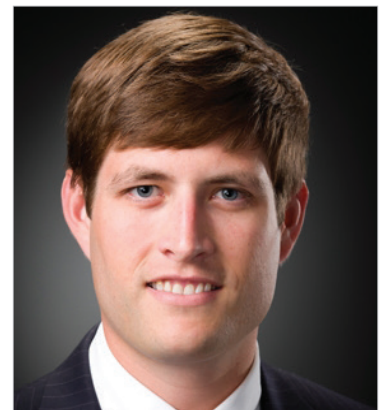
What is the investable universe of the fund?

Generally, with DEOPX we span the market cap spectrum with our (currently 29) holdings. The smallest market cap is \$1 billion, ranging to \$170 billion. We have a heavy emphasis on research, which enables us to know these companies very well. When we find them compelling we like to weight them more heavily. Having followed many of these companies for a long time, we are familiar with industry dynamics and performance cycles. This enhances our ability to understand the short-term risk versus less familiar investors.



George L. Smith, III, CFA
Senior Vice President, Portfolio Manager

George L. Smith, III is Senior Vice President and Member of the Investment Policy Committee at Davenport Asset Management, the asset management division of Davenport & Company LLC. Additionally, Smith serves on Davenport's Board of Directors and Executive Committee and as Vice President of the Davenport Mutual Funds. In this role he also serves as Co-Manager of the Equity Opportunities Fund. Previously, Smith was an Analyst in the firm's Equity Research Department. He has over 17 years of industry experience after starting his career with Davenport in 1997. Smith holds a BS in Finance from the University of Richmond.



Christopher G. Pearson, CFA
First Vice President, Portfolio Manager

Christopher G. Pearson is First Vice President and Member of the Portfolio Review Committee at Davenport Asset Management, the asset management division of Davenport & Company LLC. He serves as Co-Manager of the Equity Opportunities Fund. Previously, Pearson served as a Research Associate in Davenport's Equity Research Department. He has 8 years of industry experience after starting his career with Davenport in 2007. Pearson holds a BS in Finance from the University of Richmond.

"Our goal is long-term capital appreciation and we believe we can achieve that if we invest in quality companies that are generating excess cash and can reinvest that cash at high rates of return."

Our top 10 holdings are a good proxy for what we believe are our highest conviction ideas and those that we believe have the best risk/reward profiles. Although our average holding is closer to the mid-cap range, that is not necessarily by design; rather, it's a byproduct of where we see opportunities.

We are benchmarked to the Russell Midcap Index, but we also take the S&P 500 Index into consideration. Essentially, over a longer-term market cycle we hope to outperform all indices.

How do you define your investment philosophy?

Our overarching goal is long-term capital appreciation and we believe we can achieve that if we invest in quality companies that are generating excess cash and can reinvest that cash at high rates of return. We are long-term investors who believe consistent investment discipline combined with risk management leads to outperformance over a complete market cycle.

We typically look for companies that can compound their earnings at a 12% to 15% clip over a market cycle or a longer period of time. Additionally we hope to buy these securities for an attractive price, thus participating in any re-rating that may occur. Naturally, we realize that economic fluctuations may disrupt such a trajectory, but those are the returns we are targeting at any time.

How does this philosophy translate into an investment process?

Our investment process is research intensive and we both have research backgrounds. As generalists, we have the flexibility to look wherever we see opportunities. We also rely on our staff of research analysts as well as on sell-side research and other third-party independent research.

We have a deep working knowledge of a variety of companies across most industries. We filter this universe through the key criteria of our investment discipline: superior capital allocation, strong business models, talented management, and attractive or rising returns on capital. Once a candidate is identified, we commence our due diligence process. This entails financial analysis and modeling, management interviews, site visits, competitor analysis and other initiatives. Ultimately, we like to purchase stocks that meet our criteria opportunistically, thus providing a margin of safety that we mentioned earlier. That said, we are also willing to pay a fair price for a superior business with above-average growth prospects.

We typically start a position at about 2% to 3% of the portfolio. As we gain comfort with management, the story, and the company's prospects, we tend to add to that, especially if there appears to be unwarranted weakness that we feel we understand and can capitalize on. We believe that having followed most of these companies for a very long time gives us the ability to understand short-term risks better than less familiar investors.

Could you illustrate your research process using examples of companies you like?

First of all, our research process has qualitative and quantitative steps, so we start with the qualitative work in analyzing the business model, industry structure and the competitive dynamics.

Our qualitative work always starts with the experience and skill level of management, the attractiveness of the business and of the industry. Then, we try to combine that with quantitative measures, such as historical growth rates, returns on capital, and free cash generation.

Penn National Gaming (PENN) is one example of a long-standing holding that has done quite well for us. We have owned PENN since the inception of the fund and have liked it ever since because, first and foremost, they have very talented capital allocators running the company. What they have is a penchant for reinvesting free cash flow at very high rates of return. We prefer industry growth tail winds, but sometimes talented capital allocators can achieve value in mature industries.

Since we first acquired the stock, the company has split into Gaming and Leisure Properties Inc. (GLPI), which is a REIT, and Penn National, the operating company. The stock has been volatile and at times we have taken advantage of lower prices to increase our allocation.

There were times when the stock was out of favor and nobody was willing to give them any credit, because the industry had reached a point of maturity. Though the company faced new competition and shorter-term pressure on results, we felt comfortable that the company's significant cash generation could protect to the downside while we awaited more positive developments down the road. That gave us the opportunity to add to the position at exceptionally cheap prices.

The stock has done well over the last 6 months and we have scaled the position back. We still think it is cheap relative to the cash flow they will generate, and we are currently excited about some of the new development opportunities that they have in front of them. In the near term they are opening a new casino in Massachusetts this summer.

Would you provide another example?

Sun Communities, Inc (SUI), a manufactured housing REIT, is another example of a lesser known company that had fallen out of favor with the investing public. We discovered SUI through another of our top holdings—Markel Corporation (MKL)—a stock that we have had for some time.

A few years ago Markel's filings showed they were investing in manufactured housing parks and assembling a portfolio to manage and improve them. We thought that was interesting because we respect the investing acumen and historical returns of the team at Markel. Based on all this, we initiated our due diligence process.

Davenport Equity Opportunities Fund

Company	Davenport & Company, LLC
Symbol	DEOPX
Address	901 East Cary Street, Suite 1100 Richmond, VA 23219
Phone	888-285-1863
Website	www.investdavenport.com

Source: Company Documents

What we found was an industry that was adversely impacted by the bubble in the subprime housing market, which essentially pulled many of their best customers into the traditional housing market, with the allure of cheap financing and easy money. As those trends at the time of the financial crisis began to reverse, we saw an opportunity for increases in occupancy pricing, in addition to valuation uplift because manufactured housing stocks were trading cheap at the time.

We chose SUI mostly because we were convinced they were going to work very hard on strengthening the balance sheet. The management team did a lot of work to do that and also made savvy acquisitions along the way. They benefited from an improvement in the economy and an improvement in the relative attractiveness of their product.

As a result, there were not only occupancy and price increases, but the balance sheet improved, which gave way to a revaluation of the stock, in combination with the dividend yield, which was over 6% at the time.

We still hold the shares of SUI today because the company has assembled high quality assets while lowering their cost of capital. The stock has almost doubled since our initial purchase, so we decided to reduce the position recently as the shares had appreciated.

Would you tell us about a holding from another industry?

Another top holding is CarMax, Inc (KMX), a company based in Richmond, Virginia. The auto dealer of new and used cars is a great example of a company with a very large growth runway. In our opinion, CarMax is well managed and is capable of sustaining its growth with the reinvestment of the cash it generates.

The company struggled significantly in 2002, when they had to retool their business model and refocus the sales process. However, CarMax emerged from that downturn much stronger, creating a business model that can be leveraged across the country and that no one else has been able to replicate.

When you dig into the CarMax business model, you realize how process-oriented their customer facing organization is. They have a differentiated model, just in terms of the no-haggle pricing, that no one else has been able to replicate. There may be some compelling offerings coming up online, but CarMax is able to combat that not only with their own online offering, but with their massive inventory, which allows you to go touch and feel the product, purchase it with a warranty, and feel comfortable with its quality.

In our view, CarMax still has a low market share and the ability to essentially double its store base. Also, with the excess cash they are generating they have been buying back a lot of stock. The company is trading at a premium valuation at the moment, but we will not sell a business just because it is trading at a premium multiple. We tend to give great managers with great businesses a little bit of the benefit of the doubt. We still think there is a great runway of opportunity for CarMax and we continue to hold on to what we have.

What is your portfolio construction process?

Our top 10 holdings represent about 46% of the portfolio. We try to have our best risk/reward opportunities well represented in our top 10 holdings.

Our portfolio is diversified and the fund has outperformed especially in volatile periods in the market. This is as a result of our risk management process, our focus on balance sheets, and our avoidance of companies with significant business or industry risk.

If you look at sector weightings, we are currently overweight in consumer discretionary and financials. That is not a function of trying to play a sector theme; it is simply a function of seeing individual opportunities in those areas.

About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

You can find more fund profiles and view our other publications on Ticker.com and TickerFunds.com

Over time, we tend to be a bit underweight in areas such as technology, energy, and materials. In terms of technology, we are wary of companies that have short product life cycles, deflationary pricing, and threats of obsolescence. While we would never swear off an investment, it is difficult for us to get comfortable and is more likely than not for us to be underweight there.

In the energy sector we tend to try to avoid companies whose business models are heavily dependent on an unpredictable commodity price. It can be a well-managed good operation, but at the end of the day, if you cannot predict oil prices then you are going to struggle in that area. That is not to say we have not participated there, or that we will not, it is just an area we tend not to emphasize.


How do you define and manage risk?

Succinctly, we would define risk as the potential for permanent capital loss; when we are getting to know an idea we tend to look down before we look up. We are mindful of balance sheet risk and business risk. As we mentioned earlier, having followed most of these companies for a very long time gives us the ability to underwrite short-term risks better than less familiar investors.

What helps some of our higher weighted securities perform better in more volatile times is the fact that we tend to emphasize companies whose management teams are heavily invested in the enterprise themselves. We gravitate towards owner operator models.

We find that when managers' interests are aligned with those of shareholders in a significant way, they are bound to have a much greater mindset towards capital preservation. That can have a volatility dampening effect.

We do have upside and downside targets for each security that we own. As a security approaches those targets it triggers a review of the thesis. We monitor our securities on a daily basis. It is not impossible, but it would be highly unlikely that one would reach one of those targets without us already beginning to converse about it.

In line with our focus on consistency across cycles, our portfolio has performed best in more turbulent and volatile times. Owning a concentrated portfolio of stocks can certainly lend itself to above-average day-to-day fluctuation, and certainly higher tracking error versus the S&P 500 Index, but we are willing to accept that in pursuit of above-average returns in the longer term. 

EXPLANATORY NOTES – ARTICLE REPRINT

Ticker

“Contrarian and Disciplined”

(April 22, 2015)

This article was written by Ticker. The information contained in the article is not guaranteed as to its accuracy or completeness. This material should not be considered an offer for any of the securities referenced. The opinions expressed in this article were as of the date of the reprint but are subject to change. The information provided in this reprint does not provide information reasonably sufficient upon which to base an investment decision and should not be considered a recommendation to purchase or sell any particular security.

Past performance does not guarantee future results. Investing in small and mid-cap stocks is more risky and more volatile than investing in large cap stocks. The intrinsic value of the stocks in which the Fund invests may never be recognized by the broader market.

Portfolio holdings are subject to change. The performance of any single portfolio holding is no indication of the performance of other portfolio holdings of the Fund.

Investors should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. The Fund's prospectus contains this and other important information, should be read carefully before investing or sending money, and may be obtained from your Investment Executive, www.investdavenport.com, or by calling (888) 285-1863.