# TAKE 5 VIEWS

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## A conversation with Mario Gabelli

As 2018 winds to a close, we have asked industry veteran Mario Gabelli for his thoughts on the markets and economy. In more than 40 years at the helm of GAMCO Asset Management, Gabelli has established a reputation as a successful and astute observer of the stock market, the global economy and investment trends.

The issue opens with Gabelli's thoughts on consumer demand and corporate spending, and continues with a discussion of current factors impacting stocks: tariffs, taxes, the 10-year bond and technology. We continue with a question on current valuations and the prospects for higher revenue growth. Finally, Gabelli closes out the issue with his thoughts on mergers and acquisitions—where we are in the cycle and what areas are ripe for consolidation.

GAMCO ASSET MANAGEMENT

1 *What aspects of the U.S. economy do you evaluate as you assess risks and opportunities going forward?*

2 *What do you see as some of the major issues that will impact how you invest going forward?*

3 *How do you view current valuations?*

4 *Historically, your firm has had a strong focus on certain industries or areas of core competence. Can you tell us about these areas today and how that has evolved over time?*

5 *You have had success in your portfolios with M&A activity and companies being taken over. Where do you think we are in the M&A cycle and which areas do you think are ripe for future consolidation?*

### 1 What aspects of the U.S. economy do you evaluate as you assess risks and opportunities going forward?

Let's take a step back and think about the broad economic environment that we are in. We start with Gross Global Product, which the IMF has pegged as $87-$88 trillion and forecasts growing to $100 trillion+ by 2020. The U.S. and the E.U. each make up about 25% of that, and China and Japan together are also ~25%, with China itself making up about 16%.

When we think about Gross Domestic Product (GDP) here within the U.S., consumer spending makes up about 70% of the economy, investments (including housing and business capital expenditures) and government spending roughly split the remainder and the final category is net exports. In China, about 40% of the economy is driven by consumption. Because such a large proportion of the U.S. economy is driven by consumers, we are dependent on the health of the U.S. consumer: U.S. employment is rising, wages are rising and food prices are stable, though we've seen a slight impact from the rising price of gasoline. The overall wealth of the consumer is $107.7 trillion, net of about $15 trillion in debt and, overall, consumers are optimistic.

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Business investment spending is another big driver of the U.S. economy. The tax bill's allowance for a 100% deduction on capital spending this year has been a huge benefit for the economy and many companies are taking advantage of this. Companies are also prepaying their pension contributions based on incentives from the tax bill. Lowered corporate taxes are beneficial and also translate into larger buybacks of company stock.

The government raises $3.5 trillion annually and spends $3.4 trillion. Our net exports are the last piece of this equation which I'll highlight in more detail below.

## 2 What do you see as some of the major issues that will impact how you invest going forward?

The markets over the balance of the year will be shaped by "four Ts": **tariffs**, **taxes**, the **ten-year** and **technology**.

Let's start with tariffs and trade. The U.S. GDP is $20 trillion, with exports of $2.4 trillion and imports of roughly $3 trillion. The trade deficit is ~$570 billion—$337 billion of that is with China. We are essentially giving China an 'IOU' to pay for this so Chinese ownership of U.S. debt is rising. This is where trade negotiators come in and think about how we solve this balance of payments issue.

Ultimately are tariffs good or bad? I would say both. There are competitive advantages of free trade, as we know all too well from an element that caused the economic challenges of the 1930s. The notion of protecting intellectual property comes into play and is an important one. We've seen arm wrestling with NAFTA and China. After some success with Mexico and Canada, the hope is that we make more progress with Europe and then finally China. The recent impact on soybean prices has been somewhat painful for farmers as prices fell from more than $10 per bushel to $8.50. The situation also creates some volatility—the old normal in markets. This allows patient investors like us to buy companies a little cheaper. We tend to focus on smaller companies, which usually have a more domestic focus, so the impact to our portfolios has been minimal.

Second, let's talk about taxes. The cut in the corporate tax rate from 35% to 21% has made the U.S. very competitive. We have moved to a territorial tax system from a global system for corporations, which is good. Two key components of the tax bill highlight this: GILTI (Global Intangible Low Taxed Income) basically keeping U.S. earnings in the U.S. for tax purposes and BEAT (Base Erosion and Anti-Abuse Tax) which aims to reduce leakage to foreign arms of U.S. companies. Taxes are a big part of P&L, and have a big impact on where companies locate their businesses. The new tax structure makes the U.S. historically attractive on a global basis. On balance, there has been some impact for individuals: there is no SALT (state and local taxes) in cities like Nashville, for example, while in New York, those at the highest tax rate, who are now paying close to 47% and can no longer deduct SALT over a certain level, were not helped.

Next, let's talk about the ten-year bond, which is currently at 3.08%. U.S. Federal Reserve Chair Jerome Powell and the Fed will most likely continue to raise rates, which is the beginning indicator of the end of an economic cycle.

We see the German 10-year bund yield at 0.5% and the Japanese 10-year is below 0.25%. Are we heading to an inverted yield curve? Everything else constant, an inverted yield curve signals a slowdown in earnings and potentially a recession. But everything is never equal. We are closely watching the implications of what U.K. Prime Minister Theresa May is doing with regard to Brexit (the U.K.'s decision to exit the European Union), what is happening in Turkey with President Recep Erdogan, and other events around the world.



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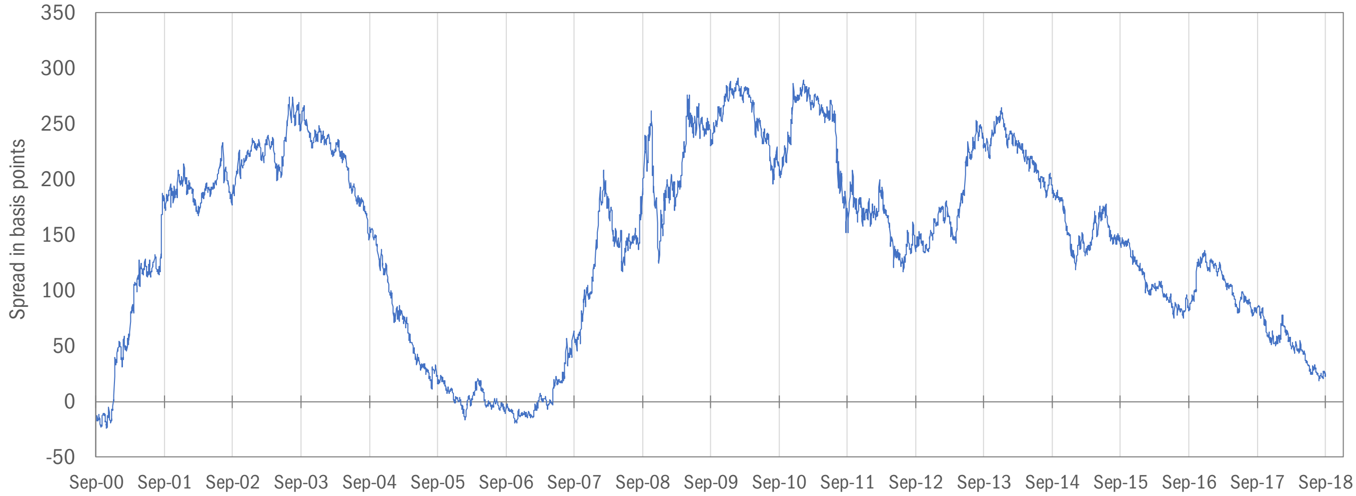
**2-Year - 10-Year U.S. Government Bond Spread**

September 30, 2000 - September 30, 2018




Source: Bloomberg

Ultimately, the question is, what would I pay for $100 in earnings growing at 6%-8% over the next 10 years? If rates rise, clearly I would pay less. There is a reasonably uncertain element with the sustainability of today's earnings.

Lastly, let's talk about technology. We have a service center economy which provides us with a tailwind. How will companies innovate going forward? We have a massive amount of research and development spending. It is attracting a lot of attention in the stock market and will continue to do so.

## 3 How do you view current valuations?

The market is a function of earnings—what will revenues grow by in the future? In general, the current environment has been positive. We have a nominal growth rate close to 6% spurred by less regulation, a cut in corporate tax rates and stimulus.

The real question is: what is the multiple today? Is it sustainable? And what is the margin of safety? We've seen 6% to 8% revenue growth. The Cost of Goods Sold is impacted by rising transportation costs and rising inputs. Selling, General and Administrative expenses as part of Cost of Goods Sold, should be reasonably maintained. So earnings are good, and we also consider how many shares are outstanding, which has been helped by recent buybacks.

Going forward, taxes will not change much incrementally. Which gets to the multiple, or the price we pay for a certain level of earnings. A broad market index will likely do 6% to 8% in the next 10 years, lower than the last 8-9 years as multiples are on the high side now and rising interest rates provide a headwind. All of the additional capital expenditures and pension contributions this year, motivated by incentives from tax reform passed in December, will dilute earnings growth for 2018. Cash flow will improve in 2019 as companies have taken advantage of many of these incentives already this year.

Of course, we are not as concerned with the broader market because we are looking for opportunities in different pockets of the market. We have had a focus on smaller companies since our firm's inception, where there are typically fewer analysts covering companies and more opportunities to find underfollowed, unloved names.



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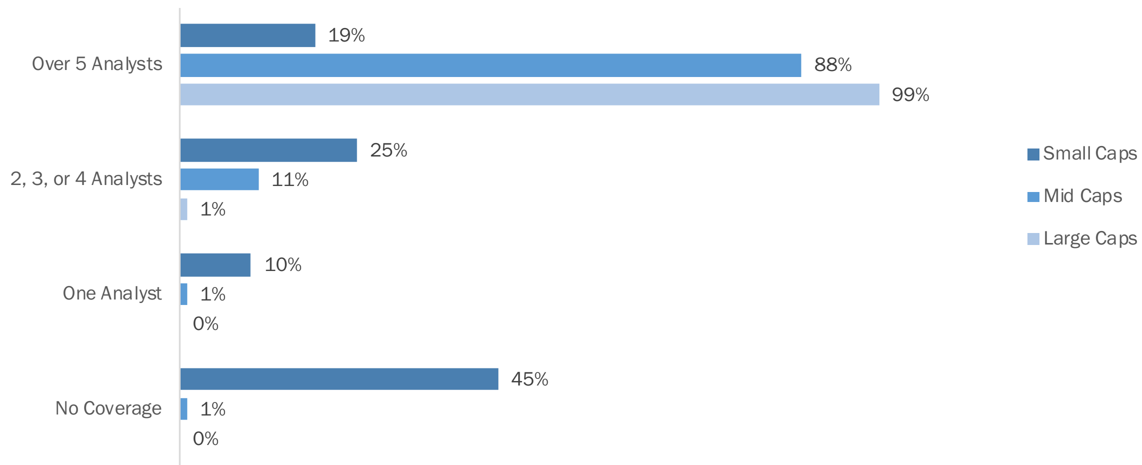
**Pricing Inefficiencies in Small-Caps are Attributable to Lack of Research Coverage**

Breakdown of Analyst Coverage by Market Cap




Source: FactSet August 2018

## 4 Historically, your firm has had a strong focus on certain industries or areas of core competence. Can you tell us about these areas today and how that has evolved over time?

We prefer cash-generating "franchise businesses" that can command pricing power over the long term. We have a core competency in certain industries in which we have compounded knowledge over many decades from covering these companies and industries deeply over time. These areas include the consumer staples, consumer discretionary and industrial sectors. We are always thinking about what changes are taking place in the industries that we follow.


While focusing on bottom-up fundamental research of individual companies, GAMCO also takes a step back to identify themes that may provide fertile ground for investment over the long term. In Wayne Gretsky's words, we are constantly looking at where the puck is going. For instance, what do Gen Z and Millennial consumers like, and how important are these preferences in the way that consumers spend money? We follow trends in these areas as they evolve over time, including things like consumer tastes for less sugar, less salt, and antibiotic free foods. Our focus on the preferences of the next generation, for example led us to the notion of live entertainment as Millennials prefer to spend on experiences instead of things.

One idea in this area is the Atlanta Braves. They have $60 million shares outstanding at $25/share for a $1.5 billion market cap. They have a new stadium in Cobb County under the SunTrust brand, and they own the land surrounding the stadium, as well as other assets. They are having a great season this year, and just made it into the playoffs. The Supreme Court overturned the PASPA (Professional & Amateur Sports Protection Act of 1992) earlier this year which is another driver in this area. This means that there will be more advertising dollars and more eyeballs watching live sports, too.



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We are also focusing on a unique theme that we call The Aging of Cars, Trucks, Aircraft and People. As the population ages, people are dealing with replacement body parts. We are also looking at suppliers to auto makers. There are 1 billion cars worldwide, 250 million of them are in the U.S. What does the prospect of self driving cars do to this industry? Will we have cars that don't need roads? We have followed this area very closely for many years.

## 5 You have had success in your portfolios with M&A activity and companies being taken over. Where do you think we are in the M&A cycle and which areas do you think are ripe for future consolidation?

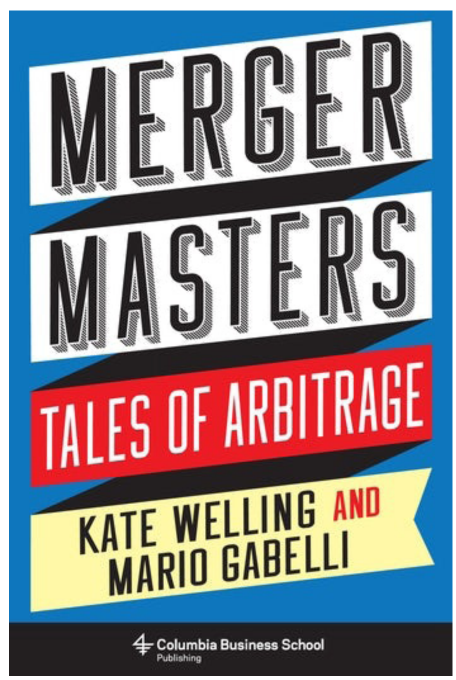
Deal activity is very strong with global merger and acquisition activity totaling $3.3 trillion through September 30, 2018, an increase of nearly 40% versus the first nine months of 2017 and the highest reading for this period since records started in 1980. The underpinnings for industry consolidation remain strong: historically low interest rates, improving business confidence and scarce organic growth opportunities. Deals for companies in the U.S. alone were up 50% compared to 2017 levels for the same period, on the heels of the tax bill passed at the end of the year.

We're seeing lots of consolidation in utility companies and my sense is that we'll see more companies in the healthcare industry combining. We've also seen a lot of deals involving companies in the pet care market which we refer to as Pet Parents. There are 94 million cats and 84 million dogs, and anyone that has a pet knows that people are willing to pay a lot for products and services for their pets.

Another area that we like and think will benefit from future consolidation is companies focused on the military as the defense budget increases. Historically, we spent $660 billion on defense over a 10-year period. Today it's $630 billion, and that's now starting to rise. China has increased its spending to around $90 billion and Russia spent $36 billion growing to more than $60 billion.

Commercial airlines are also growing, with the rising middle class in places like China and India as more people are flying. We like companies supplying parts to the airline industry.

We also have a focus in Merger Arbitrage investing where we look to buy a company after a deal has been announced. We have a new book coming out this fall called *Merger Masters* which profiles several corporate deal makers and arbitrageurs and all of the dynamics that are involved in this approach.



*Mario J. Gabelli, CFA® is the Chairman and Chief Executive Officer of GAMCO Asset Management, Inc., the firm he founded in 1976. A 1965 summa cum laude graduate of Fordham University's College of Business Administration, he also holds an M.B.A. from Columbia University Graduate School of Business, and honorary doctorates from Fordham University and Roger Williams University.*

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