VOSS CAPITAL

Voss Value Fund, LP
Investor Letter
Q2 2019

Dear Partners,

In Q2 2019 the Voss Value Fund, LP returned 6.7% to investors net of fees and expenses, compared to a 2.1% total return for the Russell 2000 and a 4.3% total return for the S&P 500. The Fund's total gross exposure stands at 156% and the beta-adjusted net long exposure is 56%. Our top 10 longs have a 66% weighting and our top 10 shorts have a gross weight of 31%.

Voss Value Fund, LP

ESTIMATED NET MONTHLY PERFORMANCE | 2019

PERIOD	VVF (Net)	VVF (Gross)	Russell 2000 TR	S&P 500 TR
JANUARY	7.44%	9.39%	11.25%	8.01%
FEBRUARY	2.97%	3.72%	5.20%	3.21%
MARCH	1.54%	1.95%	-2.09%	1.94%
1st QUARTER	**12.33%**	**15.68%**	**14.58%**	**13.65%**
APRIL	3.96%	4.91%	3.40%	4.05%
MAY	1.64%	2.06%	-7.78%	-6.35%
JUNE	0.99%	1.26%	7.07%	7.05%
2nd QUARTER	**6.71%**	**8.42%**	**2.10%**	**4.30%**
JULY				
AUGUST				
SEPTEMBER				
3rd QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
OCTOBER				
NOVEMBER				
DECEMBER				
4th QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
YEAR TO DATE	**19.87%**	**25.42%**	**16.98%**	**18.54%**

The table below shows the Voss Value Fund's Net Returns compared to some of the relevant indices:

Net Return Comparison as of June 30th, 2019					Compound Annual Growth Rate		
	1 Month	3 Month	YTD	1-Year	3-Year	5-Year	ITD
Voss Value Fund, LP	**1.0%**	**6.7%**	**19.9%**	**19.6%**	**18.9%**	**15.3%**	**18.3%**
S&P 500	7.0%	4.3%	18.5%	10.4%	14.2%	10.7%	15.5%
Russell 2000	7.1%	2.1%	17.0%	-3.3%	12.3%	7.1%	13.7%
Russell 2000 Growth	7.7%	2.8%	20.4%	-0.5%	14.7%	8.6%	14.8%
Russell 2000 Value	6.4%	1.4%	13.5%	-6.2%	9.8%	5.4%	12.5%
HFRX Equity Hedge Index	1.4%	0.0%	6.0%	-4.2%	3.2%	0.7%	2.5%

All performance figures are unaudited, estimated, and may be subject to subsequent adjustment. A limited partner's actual returns may vary from published fund returns based on the timing of capital and fee arrangements. This statement represents information based on the policies of the fund's managers and general partner. Please contact Kelli Walter, Chief Operating Officer of Voss Capital, LLC, with any inquiries.

"It was the best of times, it was the worst of times…." This quote by Charles Dickens is one of the most famous opening lines of a novel and although perhaps overused as a cliché literary reference, it is an apt description of the current state of the ongoing bifurcation beneath the surface of US equities markets.

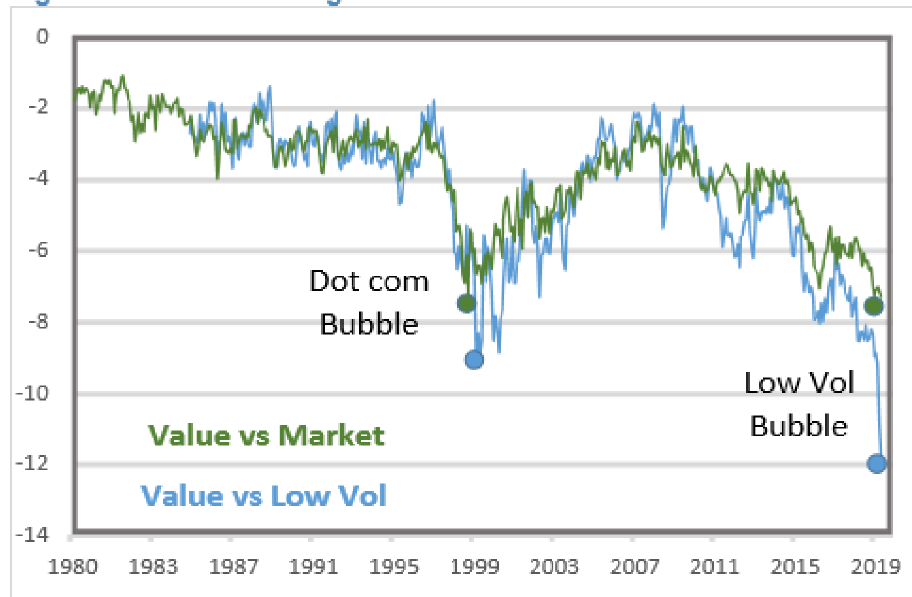
It is the worst of times for smaller, less liquid, cyclical stocks or stocks with leverage. Small cap cyclical stocks are now at their cheapest relative to mid and large cap defensive stocks since at least 1985, as measured by median forward P/E. Value stocks relative to growth stocks are hitting a 50 year low.[1] It is the best of times for larger, "defensive" stocks—defined simply as low realized volatility – that are expensive withe revenue and price momentum behind them. The valuation gap between these factors has not only continued to widen, but has started to blow out at an accelerating pace the last few weeks as low vol and momentum strategies have seen a sharp outperformance.

Rewinding the clock back to 2015, we highlighted Biotech and Consumer Staples as areas of extreme positive sentiment with rich valuations generally to be avoided. Biotech did peak in July 2015 and Consumer Staples have had long periods of underperformance since that time. At the time we coined this the "Barbell of Froth." That is now back with a vengeance. Put simply: expensive stocks have continued to get more expensive; cheap stocks have continued to get cheaper. This makes it feel as if half of stocks are in a nasty grinding bear market and half are unsustainably elevated with the factor spreads further widening recently. The divergence is masked by a forward P/E multiple of the S&P 500 at ~17x which makes all seem relatively normal on the surface. A Portfolio Manager of one of the largest money managers in the world (Baillie Gifford) says he doesn't think at all about the downside of his investments, only the upside and that it is a mistake to consider the downside[2]. This leads him to concentrate his portfolio into companies like Tesla (TSLA), where the downside in a base case or recession is conceivably -90% or more. There has been a steady drum beat of these "value investing is dead" type of articles and comments for years now, but their prevalence and frequency is noticeably increasing. What does this mean for Voss? This extreme sentiment is creating generational opportunities we can exploit on both sides of the factor chasm if we can continue to scale into ideas, control risks, and safely ride out a further potential widening of the style divergences in the near term. This also means that we need to have more of an emphasis on hard catalysts that can potentially break a stock out of a trend it is caught up in due to its factor exposures.

JP Morgan's equity strategist commented on this phenomenon recently and succinctly summarized what we have been feeling in the market's price action the last few weeks (and years, really):

> "Currently, there is a record divergence between value/cyclical stocks on one side, and low volatility/defensive stocks on the other side. The level of divergence is much more significant even when compared to the dot com bubble valuations of late '90s. Figure 2 shows the valuation difference (in forward P/E turns) between value and the broad market, as well as between value stocks and low volatility stocks. While there is a secular trend of value becoming cheaper and low volatility stocks becoming more expensive due to secular decline in yields, the nearly vertical move the last few months is not sustainable. **The bubble of low volatility stocks vs value stocks is now more significant than any relative valuation bubble the equity market experienced in modern history**." Source: JP Morgan report titled Market and Volatility Commentary, July 16th 2019, Global Quantitative and Derivatives Strategy.

Figure 2: Value is trading at record valuation discount vs. Low Vol



Source: J.P. Morgan QDS.

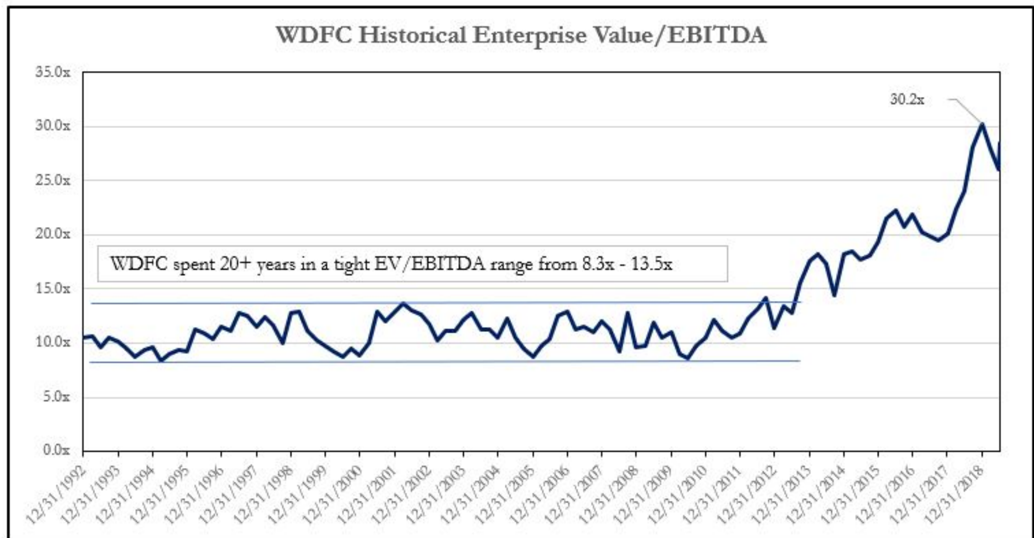
The chart above shows that the Value factor is trading at a 12x turn P/E multiple discount to low vol stocks. A large part of these historical extremes is explained by the relative under performance of Financials and Energy versus sectors such as Technology (Software within Tech), and Utilities. For example, the Russell 2000 Energy Index is still down 39% since the Russell 2000's August 31st, 2018 peak, while Utilities are up another 12.3%. These sector returns, especially a yield driven sector like Utilities, are in part explained by correlations to secularly declining bond yields.

In our previous letter we highlighted a basket of expensive enterprise software stocks and pointed out how they are about six times more expensive on a growth adjusted multiple basis than Salesforce.com (CRM) ever became. An equally weighted basket of the stocks we highlighted is up another 35% since that letter went out just three months ago. Like Veblen goods, the demand for these bubble stocks only seems to grow as they get more expensive. The sell side has also become complicit in their mental modeling gymnastics. In a recent initiation from JP Morgan on CrowdStrike, another recent high flyer, the analyst uses a target price equating to 42x 2021 sales and justifies it with a terminal free cash flow multiple in his DCF of 30x.

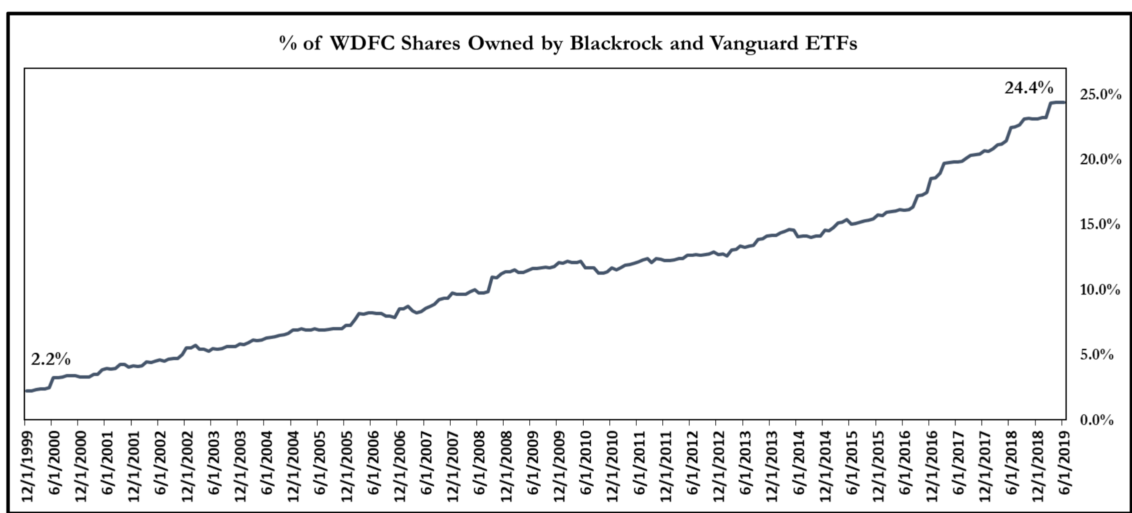
At the other end of the Barbell of Froth are the low volatility stocks, many of which have low-to-negative organic revenue growth. In sectors ranging from Industrials, to Healthcare related names, to Consumer Staples, we see historical valuation correlations between peer companies and relative valuation metrics breaking down. In many instances, we see multiples for companies 2x - 3x as high as their 10 – 20-year averages/medians despite company-specific growth being often only a small fraction of what it was at previous peak multiples.

For example, WD-40 Co (WDFC) traded at an EV/Sales multiple of around 2x from January 2000 to July 2013. It was around that time that it saw a steady march higher due mostly to major multiple expansion up to 6x EV/sales and has had no mean reversion in multiple in the last few years despite no material inflection or improvement in sales growth, margins, or return on invested capital (ROIC). WDFC's EV/EBITDA multiple stayed in a relatively tight range of 8x - 12x from 1992 to 2013

and it has subsequently tripled to 30x. On an earnings basis, WDFC now trades at 38x forward earnings estimates despite most of its underlying revenue being tied to cyclical industrial production and having only low-single-digit top line growth projected (3.7%).

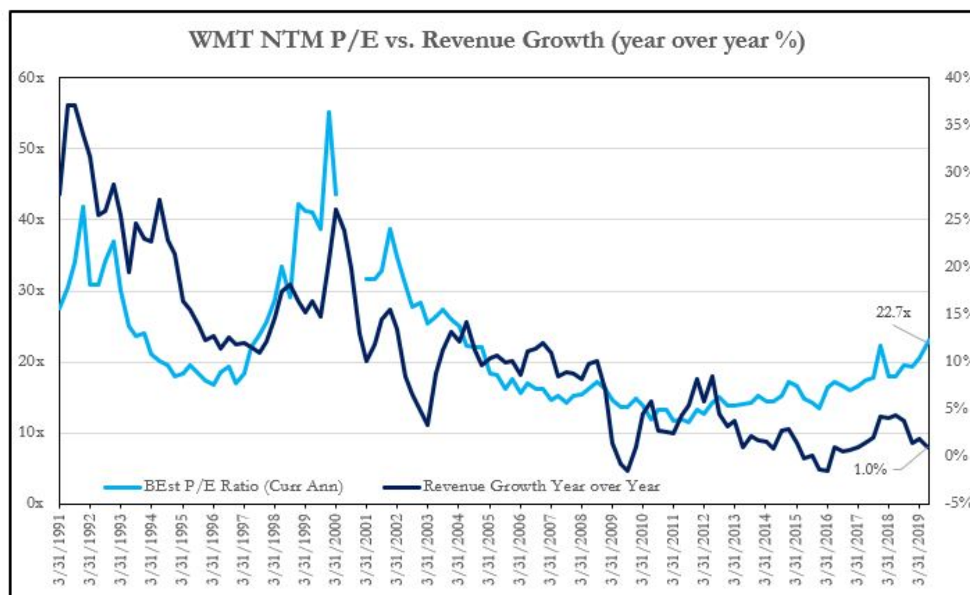


This is but one of hundreds of similar situations in the marketplace today. A large part of this extreme multiple expansion despite no material improvement in fundamentals is due to passive money flows. Just two low vol strategy ETFs, USMV and SPLV, account for ~25% of all YTD aggregate inflows into US equity ETFs[3]. These types of ETFs have been steady accumulators of shares regardless of company specific valuation, news flow, or estimate revisions—only style factors and fund flows matter. Together BlackRock and Vanguard funds now own nearly 25% of WDFC shares and they have been steady buyers despite the tripling in WDFC's valuation. Note that BlackRock and Vanguard, although the largest, are only two fund managers. In total, WDFC is owned across 88 different ETFs.[4] With a beta of only 0.25, WDFC continues to get relentlessly bid up as part of the low vol stock bubble.



WDFC management recently laid out their 2025 guidance. To meet their aspirational targets, they will need to achieve an 8% sales CAGR, which contrasts with their trailing sales CAGR of 2.8% from 2011 through 2018 (a period of uninterrupted economic growth with no US recession). Additionally, they will have to achieve record margins and expand them by another ~5% despite an EBITDA margin decline of 100 bps in the most recent quarter. Even if they pull off the Herculean task of sustainably tripling their growth rate this late into an economic cycle, the stock would still be priced at 14.6x their 2025 EBITDA target, which is six years out and 26% above the 35-year median trailing multiple.

Another well known but less extreme example of growth seemingly mispriced is WalMart (WMT). WMT's next twelve months P/E is up to 23x while its revenue growth has leveled off to just 1% year-over-year in the latest quarter. Its earnings multiple is back to its mid-90s and early 2000s level, when top line growth ranged from 12-20%.



While a short seller could have accurately predicted large negative earnings revisions for WMT in the past few years (2019 adjusted EPS estimates going from $8.68 to $4.84 since the estimates were established)[5] and thought shorting the stock would be a good idea based on this, the significant multiple expansion made the trade a big loser. This multiple expansion has come in conjunction with deteriorating margins and steadily declining ROIC.

With interest rates low and going lower all over the world, it is possible that WMT may look attractive to some on a FCF yield basis as a bond substitute relative to other investment options. Valuation could continue to sky-rocket despite lack of growth and could ultimately compress to a FCF yield closer to the 10-year yield (this would equate to ~50x FCF, up from 21.2x currently).

In a Bank of America survey of active money managers from July, **only 2% of portfolio managers expected value as a factor to outperform growth over the next twelve months**. It is rare to see such a near unanimous consensus on anything in the entire world, much less something in the capital markets. When value stocks as a group plunged to a similar relative low versus growth at the height of the dot com bubble, they went on to surge by 50% on a relative basis over the next year. While growth seems overpriced within the enterprise software bubble, it is perhaps even more egregious among low beta slow growers like WDFC at nearly 40x earnings and it may be a sign that it is time to tilt factor exposure more heavily in favor of value once more.

Again, part of this can be explained by treasury yields across the curve falling meaningfully, with inversion occurring again on the short end of the curve. The futures market has priced four Fed Funds rate cuts in by the end of 2020. Economic growth is sharply decelerating again, though still remains positive and expansionary overall.

In case there is still any lingering doubt that we long ago entered the credit twilight zone, over a dozen "high yield" issues in Europe have negative yields. Italy just sold debt maturing in 2067 at 2.85%. €3 billion of debt offered received bids for >€17 billion, a 5.7x bid to cover ratio, showing extremely strong demand. This is with an elevated 132% debt to GDP ratio. The less levered Austria sold bonds due in 2117 at just 1.2%.

Consensus EPS growth for Q2 for the S&P 500 is -2% (with a normal level of earnings beats, it may be flat), with negative growth slated for six out of eleven sectors. On the positive side of the ledger, unemployment is at an all-time low (50-year low registered in May at 3.6%), but this is starting to put upward pressure on wage growth and downward pressure on corporate margins. This year, S&P companies are expected to have 5% sales growth yet ~90 basis points of net margin compression.

A silver lining of the lack of robust growth overall is that it is creating an explosion of potential corporate actions and M&A announcements and we are filling our long book with more value oriented special situations.

Verso Corp. (VRS)

A recent one is Verso Corp. (VRS). VRS has announced they are exploring a sale and hired Houlihan Lokey to conduct an auction process. They currently have an interim CEO who was brought in for his experience in selling similar businesses and whose explicit sole purpose is to come in, review the business and get it sold.

VRS is the leading and lowest cost North American producer of coated papers. They also produce and sell kraft pulp, which is an input into manufacturing paper and tissue. The stock trades at less than two-thirds of tangible book value and under 4x pension adjusted EV/EBITDA.

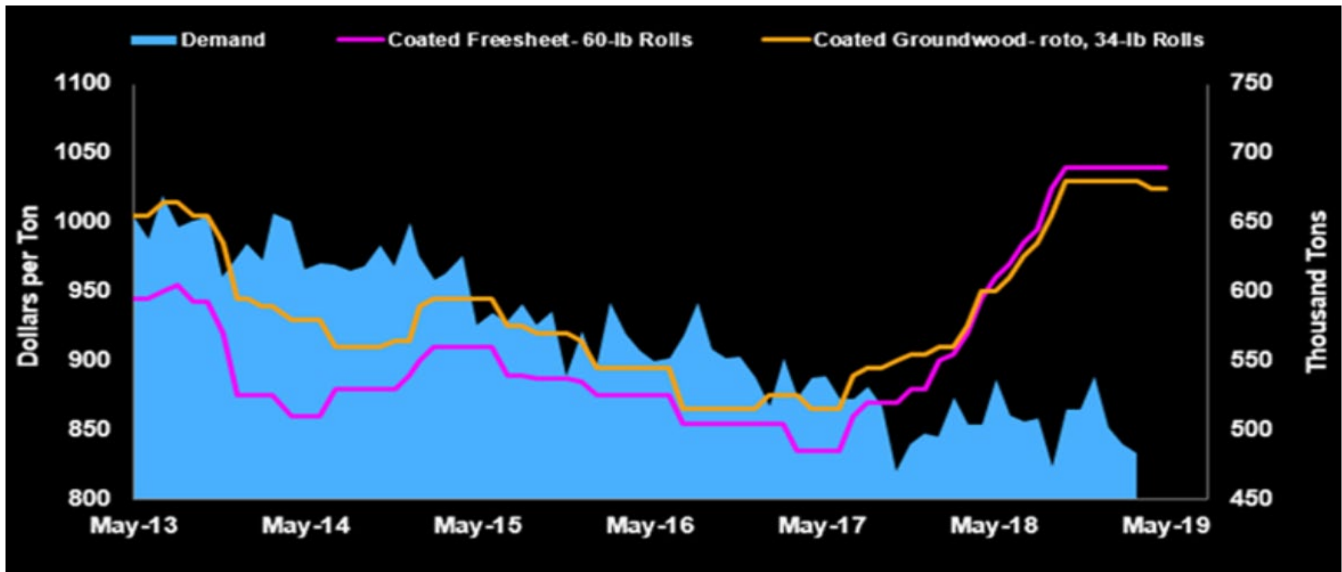
Potential Voss Variant Viewpoints for VRS:

- The stock has a potential hard catalyst within the next ~3-9 months as the company has hired Houlihan Lokey to auction it.
  - Corroborated by interim CEO's Restricted Stock Unit (RSUs) vesting schedule with 90% of his payoff dependent on a company sale.
  - Both private equity buyers and strategic buyers (mostly Chinese firms) have been hyperactive in M&A over the last 6-12 months in the industry.
- The stock is valued at a significant discount to replacement costs, which we believe exceeds stated book value.
- The company has hidden and high embedded strategic value given its vertical integration, including internal energy production and internal pulp production.
  - Internal pulp production saves VRS over $200/ton, creating significant cost advantages over peers.
- Capacity is quickly coming out of the Graphic Papers industry (~ -6-7% CAGR), including a recent large mill closure by VRS, which is *helping keep prices elevated* despite secularly declining volumes.
- The flexibility of VRS's asset base that allows toggling between grades of paper or to pulp production and provides even more strategic value and optionality.

- Either VRS or potential buyers can convert machines to produce specialty papers or packaging.

- VRS has significant tax assets – another source of hidden value.
- China has recently banned the importation of recycled wastepaper which is creating pulp shortages within China and boosting the strategic appeal of VRS with its pulp production and vertical integration.

As shown below, the demand for coated free sheet paper (blue), VRS's largest revenue driver, is secularly declining and down another 13% YTD. However, pricing is holding up at +12% y/y.



Source: Fastmarkets RISI, Bloomberg

One of the main risks to the VRS investment is that there is a secular decline in paper demand, especially graphic papers which comprise 61% of VRS's revenue. Fortunately, the combined capacity for all grades of paper in North America has contracted at a -6% CAGR in the last five years and Fastmarkets RISI projects a 7% annual drop in each of the next two years. This decline in capacity is helping to keep pricing stable. Also, there is elevated pulp inventory that needs to be worked off and will weaken VRS's near term results. Furthermore, China could increase the import duties on imported US pulp (from the current 5%) in retaliation to tariffs on Chinese goods. If VRS can't find a buyer, they may have to elevate capital expenditures to convert existing production to specialty paper or packaging paper.

VRS is undoubtedly on the wrong side of the market's currently favored factors-those being large, defensive, expensive, growing, has secular growth, has price momentum. Conversely, the market is shunning anything small (VRS has a ~$600M market cap), cheap, cyclical, not growing, or levered. The paper industry is all of these. With a potential hard catalyst forthcoming, being in the wrong style and factor buckets has created the opportunity in VRS shares. We believe a deal could be consummated as high as tangible book value of $24.80 within the next 3-9 months, giving the stock >40% upside. It is also possible that there is no buyer for the company in its entirety and instead the company's assets are sold piecemeal, thus stretching out the investment timeframe and lowering the IRR.

Acadia Healthcare (ACHC)

Another value oriented special situation we've bought recently is Acadia Healthcare Company (ACHC).

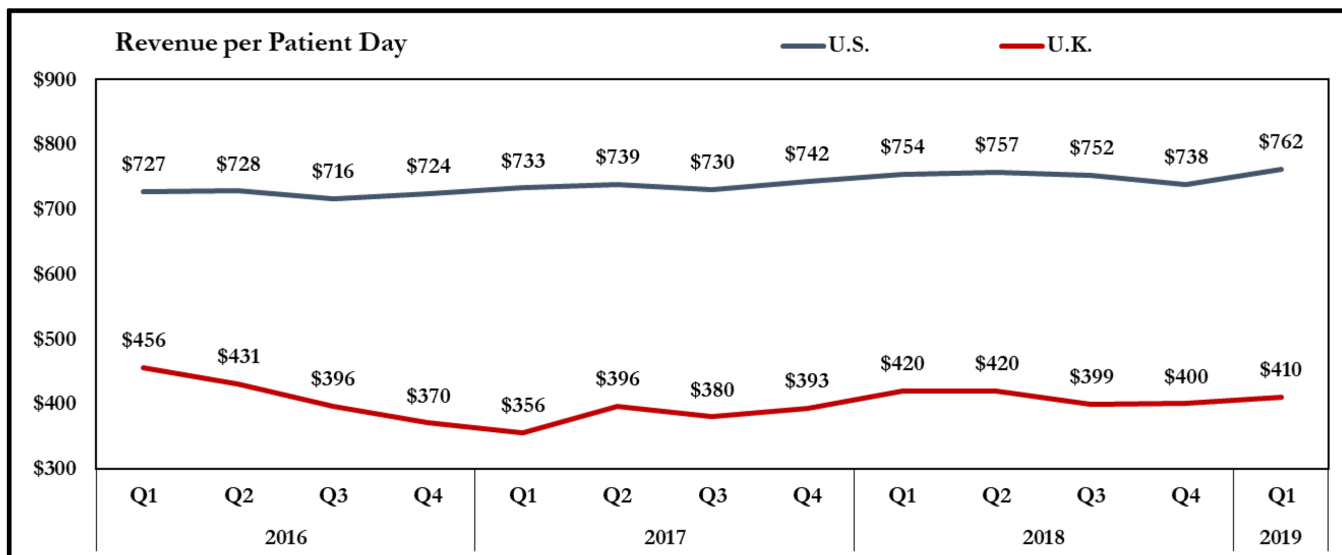
Acadia is a pure play behavioral healthcare provider with 503 facilities in the US and UK with 18,100 beds. The company's facility types include acute psychiatric care, addiction treatment (they're the largest opioid addiction treatment provider in the US), specialty care and residential treatment centers.

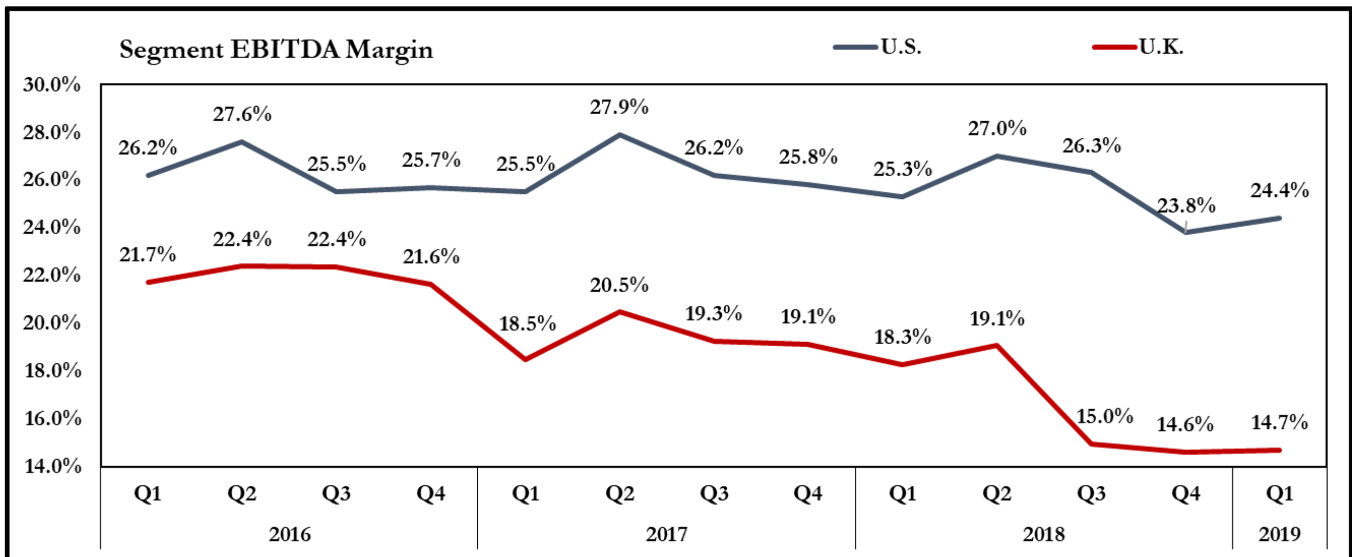
The company has two geographic segments: US and UK. The company built the UK business through two acquisitions: 1) Patient In Care in July 2014 and 2) the larger Priory acquisition in January 2016.

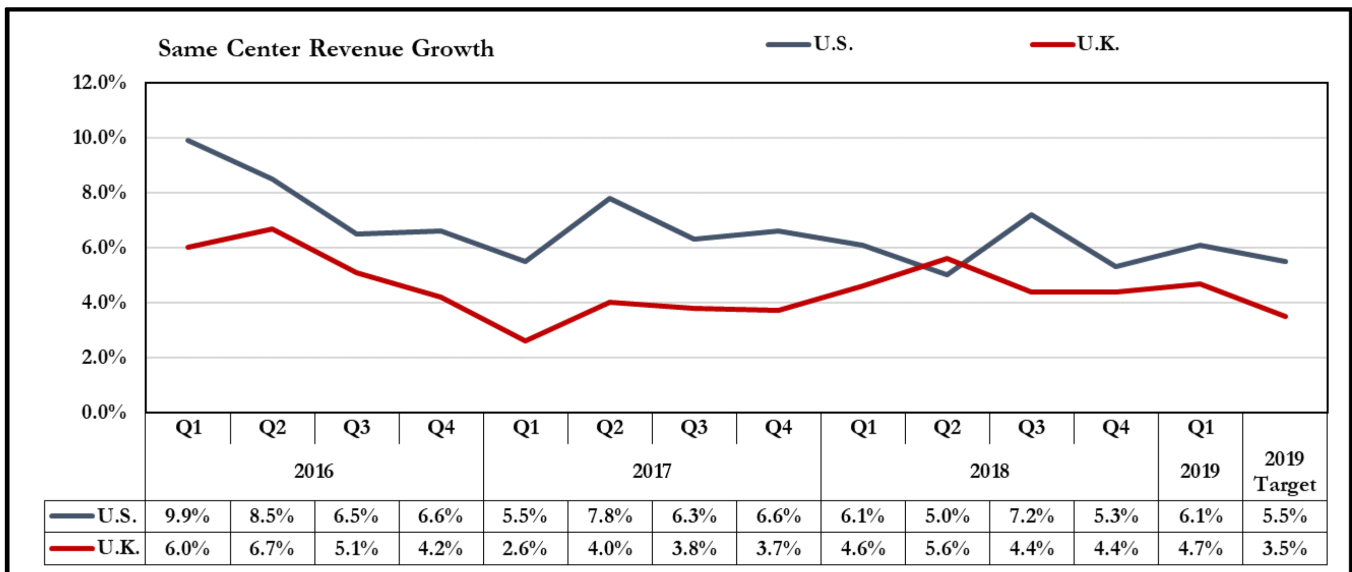
The US operation is performing well with 5% to 10% same-center revenue growth over the past three years. Management recently guided to 6%-8% organic growth going forward with an additional 1% to 2% topline growth from tuck-in acquisitions. LTM EBITDA margins in the US are 25% with some room for expansion as the new management team sets about cutting costs. The US also has a few secular tailwinds with the government's focus on combatting the significant levels of opioid addiction in the US. As one example, the SUPPORT for Patients and Communities Act, was passed in October 2018 and will add opioid addiction treatment to Medicare coverage beginning in January 2020.

On the other side of the coin, the UK business is facing a few significant headwinds including nurse labor shortages in the UK, which have spiked labor costs by forcing facilities to use temporary nurses from temp agencies which are on average 30% more expensive. Limited reimbursements from the National Health Service (NHS) have worsened the problem, although this seems to be improving somewhat with the NHS raising the reimbursement rate by 3% at the end of April compared to only 1.5% historically. Despite these headwinds the business seems to be stabilizing and part of our comfort in the UK segment's value is the fact that ACHC owns the real estate of 80% of their facilities. Their UK real estate portfolio was appraised at the time of the two acquisitions in 2014 and 2015 at a total value of $1.7 billion.

As shown below, the US business generates higher revenue per patient per day, has significantly higher margins and a superior growth profile relative to the UK.







	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Target
U.S.	9.9%	8.5%	6.5%	6.6%	5.5%	7.8%	6.3%	6.6%	6.1%	5.0%	7.2%	5.3%	6.1%	5.5%
U.K.	6.0%	6.7%	5.1%	4.2%	2.6%	4.0%	3.8%	3.7%	4.6%	5.6%	4.4%	4.4%	4.7%	3.5%

Selling the UK segment will be a positive for the stock by cleaning up the investment narrative and leaving the stronger US business with a better growth and margin profile (which traded at a mid-teens EBITDA multiple prior to the UK acquisition in 2016), while at the same time freeing up a significant amount of capital that the company can redeploy into growth opportunities in the US and/or use to rapidly de-lever the balance sheet (5.2x net debt/EBITDA).

Looking at eight UK-based behavioral health facility transaction comps over the past five years, the EV/Bed valuation ranged from $312,000 to $758,000 per bed with a median value of $450,000. Our base case assumes ACHC can get a valuation of just $250,000 - $275,000 per bed for its UK segment and the remaining US business then trades at 10.5x EBITDA which would put the stock into the low $40/share range or at least 33% upside from the current price of $31. Our bear case scenario would be if the UK segment sold for < $250,000/bed and the stock then de-rated post sale to 7x – 8x EBITDA. This would put the stock in the low-to-mid $20s but we view this as a less likely scenario for a couple of reasons. For one, the company post-UK sale will have an improved growth and margin profile, thus we believe should trade at least at the current multiple

of the combined company (9.6x), if not higher. Also, on the valuation of the UK sale side, a valuation of $225,000 per bed would represent an absolute value of $1.98 billion which would ascribe very little value above the $1.7 billion in real estate value (appraised in 2014/2015), and while the UK segment has faced its share of headwinds, it is still a mid-teens EBITDA margin business growing mid-single digits with low maintenance capex requirements, far from being worth nothing above real estate value.

Pro Forma Price Target Given UK Valuation and Multiple on Remaining US Business

Pro Forma EV/EBITDA NTM Multiple on U.S. Only Business	UK Segment Value/Bed							
	$225,000	**$250,000**	**$275,000**	**$300,000**	**$325,000**	**$350,000**	**$375,000**	**$400,000**
7.0x	$21.14	$23.62	$26.10	$28.58	$31.06	$33.54	$36.02	$38.50
7.5x	$23.67	$26.15	$28.63	$31.11	$33.60	$36.08	$38.56	$41.04
8.0x	$26.21	$28.69	$31.17	$33.65	$36.13	$38.61	$41.09	$43.57
8.5x	$28.74	$31.22	$33.70	$36.18	$38.66	$41.14	$43.62	$46.10
9.0x	$31.27	$33.75	$36.23	$38.71	$41.19	$43.67	$46.15	$48.63
9.5x	$33.81	$36.29	$38.77	$41.25	$43.73	$46.21	$48.69	$51.17
10.0x	$36.34	$38.82	$41.30	$43.78	$46.26	$48.74	$51.22	$53.70
10.5x	$38.87	$41.35	$43.83	$46.31	$48.79	$51.27	$53.75	$56.23
11.0x	$41.40	$43.88	$46.36	$48.84	$51.32	$53.80	$56.29	$58.77
11.5x	$43.94	$46.42	$48.90	$51.38	$53.86	$56.34	$58.82	$61.30
12.0x	$46.47	$48.95	$51.43	$53.91	$56.39	$58.87	$61.35	$63.83
12.5x	$49.00	$51.48	$53.96	$56.44	$58.92	$61.40	$63.88	$66.36

We would also note there were reports of private equity bidders for the whole company as recently as October 2018 when the stock price was $35-40 and trading at10.5x LTM EBITDA (9.2x NTM EBITDA).[6] With the company currently shopping the UK segment and potentially reducing the valuation and sentiment drag it has had since 2016, it is possible the remaining US business could get an even higher multiple as a pure play on behavioral health and addiction treatment in the US.

As with all investments, Acadia isn't without risks. The main ones here center around some past reports of abuse at a few of the company's facilities which could open the company up to regulatory or legal action. The previous CEO, who had a history of ignoring allegations like these at his previous company was let go in December of 2018 and replaced by Debbie Osteen. Osteen comes from 30 years at Universal Health Services (UHS), ACHC's largest competitor. She immediately initiated a strategic review at the beginning of the year which led the company to the decision to shop the UK segment. The review also identified $20 - $25 million in net cost savings for the US business (~5% of EBITDA) and most recently she brought in a new COO in July with whom she had worked at UHS. There has been a lot positive change at ACHC, starting at the top, that has yet to be reflected in the market.

The last few weeks have witnessed a renewed speculative rampage with each new greater fool rationalizing their reckless momentum strategy in a more creative and less substantiated way than the last. The past 8-10 weeks are likely the worst environment for Voss stylistically since our inception in Q4 2011. When there is minimal inner cohesion to market action for such long stretches of time, it is easy to get blown off course, throw caution into the wind and abandon all risk controls to chase the bubble stocks higher. While we work towards building conviction in bottom-up fundamental theses on individual companies, we are never doggedly certain in our views nor certain that the market will mean revert in a reasonable

timeframe. In hundreds of cases where stocks have risen to silly valuations that are objectively historical outliers, *years* have ticked by without the slightest mean reversion. Alas, we are forced to acknowledge that such paradoxes and discrepancies are a permanent fixture of the capital markets and are merely a reflection of human nature. Ultimately, we must adapt accordingly without abandoning our value principles. There is an old sailor's term "hold fast" which is a reminder to deckhands to hold onto a ship's rigging while working because a rogue squall could hit at any time and sweep them out to sea.

Abnormally good conditions for some style factors and abnormally bad conditions for others won't last forever. Despite our frustration with short term market aberrations, such inefficiencies are necessary and wholeheartedly welcomed for us to have any chance at continued sustainable alpha.

No matter how the market's mood may oscillate up and down, no matter how loudly the sirens of speculation sing, ever wary of a rogue squall we "hold fast" and stay the course with our grip as tight as ever on the guiding rope of our time-tested process.

To Continued Alpha,

Voss Team

Sources:

1: Chart on page 12 - MSCI World Value Index relative to MSCI World Growth and the long slog downwards for Value since 2007

2: James Anderson, Baillie Gifford Q2 insight video

3: Goldman Sachs Investment Research – Weekly Kick Start June 20th

4: Bloomberg's Fund Screening function.

5: Bloomberg consensus estimates.

6: ACHC in talks with KKR and TPG in October 2018:

https://www.reuters.com/article/us-acadia-health-m-a-exclusive/exclusive-acadia-healthcare-in-talks-with-private-equity-firms-sources-idUSKCN1MS1TY

Common Terms:

CAGR – Compound Annual Growth Rate	*IRR – Internal Rate of Return*
DCF – Discounted Cash Flow	*LTM – Last Twelve Months*
EBITDA – Earnings Before Interest, Taxes, Depreciation & Amortization	*NTM – Next Twelve Months*
EPS – Earnings per Share	*P/E – Price to Earnings*
EV – Enterprise Value	*ROIC – Return on Invested Capital*
FCF – Free Cash Flow	*YTD – Year to Date*
GDP – Gross Domestic Product	

From our Q1 2015 letter:

A Barbell of Froth

Another area in the market that forms a somewhat logical barbell to the frenzy of Biotech is the Consumer Staples sector. It's our view that managers are buying these stocks because they feel safe due to their relatively stable cash flows and their current dividend yields. Just as when Lee Iacocca said "auto buyers want economy and they'll pay any price to get it," investors want yield and they'll pay any price to get it, paradoxically driving asset prices up and yields down. At the end of Q1 US REITs were at 25.8x forward AFFO estimates versus their long term average of 16.4x (this is 57% above average). These sorts of stocks are the clear beneficiary of investors' habitat preference—if you are taken out of a long duration fixed income security you are likely to seek a similar replacement "habitat" and these stocks can be thought of as long duration yield vehicles. However, as we will demonstrate, many are underestimating the potential downside when these stocks correct to longer term growth adjusted valuations.

Thinking from a portfolio manager perspective, "barbelling" Biotech and Consumer Staples makes some sense. One may want to take advantage of the asset pumping Fed and buy the most speculative of stocks (pre-commercial Biotech), while at the same time desiring a hedge with "safer" stocks that are good relative values on the available yield spectrum. It is not a stretch to say this Consumer Staples froth is a direct extension of central bank policies. The rally in these names is worthy of skepticism and further investigation.

First, these stocks on a P/E basis are not the most expensive they have ever been and indeed were more expensive in the mid to late 1990s. If you look at the current constituents of the S&P 500 Consumer Staples, those that existed then (which is many of them) did indeed look more expensive:

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