July 15, 2019

Banyan's equity composite was up 17.03% through the second quarter of 2019 compared to the S&P 500's return of 18.54%. In the second quarter alone, our composite was up 7.00% compared to a 4.31% return for the S&P 500. We are satisfied with these results.

If you will recall, we concluded last quarter's letter with the following thought on valuation:

> At times, the height of the bar is the issue. At others, it is the athlete's health. Either way, the result is the same – a heightened chance of suffering a permanent loss. ***We prefer champion athletes facing low hurdles***. (emphasis not in original)

We found such a specimen in the second quarter. Mr. Market lowered the hurdle facing one of our "champion athletes," Cigna, on fears of healthcare reform. Within a few months, the stock fell 37% from a December high of $226.61 to an April low of $141.95. As the price fell, our estimate of Cigna's "earnings power yield" rose to exceed 11.5%. This prompted us to double our stake.

As always, our reasoning was simple. Cigna's past performance has been exceptional, and Mr. Market appeared overly pessimistic about the sustainability thereof. Accordingly, Cigna's "earnings power yield" appeared too generous to pass up. Allow us to elaborate:

**1. Performance** | We begin our analysis by looking backward and asking whether a firm has created both consumer value and owner value. The latter cannot persist without the former.

**a. Consumer Value** | Cigna has organically grown the lives within its commercial managed care business for eight consecutive years, and the retention rate within its pharmacy benefits business was 98.5% in 2018. A firm cannot attract and retain clients at those levels without delivering compelling value. For Cigna, combatting healthcare cost inflation is a defining trait of the value proposition. Has it delivered? Absolutely. Cigna's managed care clients have enjoyed industry-leading medical cost trends for *six consecutive years*, and its pharmacy benefits clients enjoyed drug cost trends of 0.4% (commercial) and *negative* 0.3% (Medicare) in 2018.

**b. Owner Value** | Most importantly, Cigna has created a lot of owner value in the process. Excluding cash, Cigna's returns on tangible capital averaged 44% between 2010 and 2018. In other words, Cigna earned an average of $44 per year for every $100 invested in its business. This is telling. High returns attract capital, which fuels the competition that erodes returns. Exceptions to this rule exist, however, where competitive advantages make replicating a firm's value proposition too onerous. The resilience of Cigna's profitability suggests it is such an exception.

**2. Sustainability** | The next question is whether Cigna's profitability is sustainable. To answer this, many factors must be weighed, the most important being the durability of Cigna's competitive advantages. Currently, however, the most pressing issue is politics. Our species is repulsed by anti-social behavior, and, if severe, we will employ the State to eradicate "bad actors." Some believe healthcare intermediaries like Cigna fit the bill. They are very profitable, but the benefits they provide are not directly observable. This creates a perceived disconnect between social value and profit, which violates our notions of fairness. Republicans and Democrats alike are seizing on the grievance this election cycle.

**3. Valuation** | There is a chance, therefore, that the government will intervene and impair intermediary economics, but we believe the likelihood of that is remote. In healthcare, the devil is in the details. Republicans, for example, campaigned on repealing Obamacare for years but fell short once in power. People adapt to their environment and are frightened by wholesale disruption. As a result, incremental change to the system is more likely, which made Cigna's generous "earnings power yield" appealing. When we doubled our stake, in fact, Cigna's earnings could have been gutted by 45% and it would have still traded at a discount to the S&P 500. That cushion provided the margin of safety we needed to invest.

We would like to add that we do *not* believe healthcare intermediaries are "bad actors." They keep powerful players in check, some of whom enjoy *de facto* geographic monopolies (e.g., a dominant local hospital network) or *de jure* product monopolies (e.g., a patented drug). Thus, they serve a critical function in the current ecosystem. Sadly, that fact can get lost in today's political hyperbole.

Investing in a dynamic environment can be risky; it can also be safe. Whether it is risky or safe depends on price. Cigna is priced for a draconian outcome we find remote. As a result, we believe the likelihood of suffering a permanent loss is low, but the potential for attractive gains is high. Capitalizing on such opportunities is a critical component of ***building permanent wealth***.

Sincerely,

Drew Estes
Partner & Portfolio Manager

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