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Q1 2016 Quarterly Letter

Anthony Josephson and Russell Silberstein 4/25/16

We are pleased to report improved performance during the first quarter of the year and the start of the second quarter. Our Equity accounts returned 3.90% in the quarter compared to a positive 1.35% return for the S&P 500, and our Balanced accounts returned 4.30% compared to a positive 2.31% return for the benchmark (which is weighted 50% S&P 500 and 50% Barclays Aggregate Bond Index).

Results benefited from positive performance in our three energy investments as the price of oil rebounded. In addition, most of our holdings gained as investors shifted their favor towards traditional value stocks and away from growth. While recent results have been gratifying, you should know by now that we don't put much weight in short-term performance. The merits of our investment approach will not be defined in quarters or even a year, but rather over long-term multi-year periods.

If nothing else, this past quarter served as a reminder that the short-term volatility of the market should be regarded as a potential opportunity, rather than a trigger for fear and irrationality. As Benjamin Graham, the father of value investing, once said: "the market is there to serve you, and not the other way around."

New Investments

The sharp decline in February provided us an opportunity to add two new names to the portfolio – New Senior Investment Group (SNR) and Fidelity National (FIS). We discussed SNR at length in last quarter's letter, so we will focus our attention here on FIS. The company provides mission critical technology infrastructure to the banking industry and other financial service providers. This technology enables back-end solutions like core account processing, bill pay and mobile transactions – essential elements for any financial institution.

We are particularly attracted to the sticky relationship FIS maintains with its customers and the recurring revenue nature of its business model. This predictability was evident during the financial crisis when the company grew revenue despite enormous challenges faced by its customers. Even though other competitors provide back-end solutions, the barriers-to-entry and switching costs are high enough to allow FIS to earn attractive returns with limited risk of customer loss.

We also believe the company will benefit from several secular trends in the banking industry which will propel revenue growth over the next five years. On the surface, this is a rather contrarian viewpoint because most casual observers recognize the challenges faced by banks today. Namely, that banks need to reduce costs and improve returns in response to stubbornly low interest rates, heightened regulatory requirements and increased competitive threats from “fin-tech” companies. However, in order to combat these threats, banks will require enhanced solutions from companies like FIS as they outsource a larger part of their technology back office. If banks want to compete effectively in the 21st century, then FIS will be a core partner in this evolution.

With FIS stock down over 20% from its high, investors misperceive the threats posed by the challenges confronting financial institutions and underestimate the company’s future growth potential. We believe the company could earn more than $7 per share by 2020 based on accelerated revenue growth and share repurchases. At a purchase price of $60 per share the potential return profile for this investment is quite attractive.

Truth & Transparency

Later this year we will release an overhauled website, with new content and improved functionality. As we work internally to prepare the new content, we have engaged in a process of reflection and review covering our first 15 years in business. We have spent time discussing changes in the industry since 2002, for better and for worse. We also reflected on the introduction of new products in the market place, and how investors perceive the industry. Our new website will include some of these observations.

As a teaser we’d like to share with you one of the most important foundational concepts we identified as a common thread that exists in all aspects of our firm. Its woven into the fabric of everything we do and was a primary reason we started the firm 15 years ago. We established Carmel Capital in 2002 because we believe that, in many ways, the investment advisory industry is deeply flawed. Not only are incentives often misaligned between clients and managers, but the very nature of what should be a trusted relationship is marred by the promotion of complex products purposefully designed to confuse the client and generate higher fees. Moreover, this smoke and mirrors approach is exacerbated by inconsistent and misleading communication intended solely to hide the truth.

The result: the investment industry is inherently structured to best serve the interests of managers and advisors, rather than the clients they are supposed to help.

Correcting this injustice is one of the foundational aspirations of our firm. While we strive to deliver superior investment returns, we cannot promise these results will always be satisfactory, especially in the short-term. However, we can and do promise that our relationship with you will be based on the fundamental premise of truth and transparency. This is accomplished with the following core set of principles that permeate our firm culture:

- **Independent Ownership**: Our firm will always remain independently owned by the two us in order to eliminate conflicts of interests. We will never subject our clients to the industry practice where large parent corporations force their advisors to sell sub-standard products solely to improve the bottom line.
- **Fee Transparency & Alignment**: The fees we charge will be clearly represented and simple to understand. More importantly, our sole source of revenue will be investment fees calculated based on a percentage of assets under management. We work for our clients and our clients only.
- **Timely, Accurate and Honest Communication**: We communicate with clients in the same manner in which we would wish to be treated if the roles were reversed. Most importantly, that means the willingness to deliver bad news, which is inevitable, in a transparent and honest assessment.
- **Always Err on the Side of the Client**: In an industry that is laden with potential conflicts of interest, nothing is more important than establishing a culture of integrity. Hundreds of decisions occur each year that pose potential moral dilemmas – some easy and some difficult – yet, there is only one right answer: if in doubt, always make the decision based on what favors the client the most.

While perfect alignment of incentives is impossible to achieve, we strive each day to reach that goal. Everyone who touches our firm – whether it be employees, vendors or even clients – appreciates quickly the importance we place in behaving truthfully and transparently. We realize the financial news media is often filled with stories about firms and advisors abusing the trust of clients. However, we hope that our deeply held commitment to maintain the highest standard of ethics – along with a 15-year track record of treating clients the right way – lets you sleep a little bit easier at night.

As always please feel free to contact us with any questions or comments.

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