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Q2 2016 Quarterly Letter

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We are pleased to report improved performance during the first six months of the year. Our Equity accounts returned 4.73% through the end of June compared to a positive 3.84% return for the S&P 500, and our Balanced accounts returned 6.48% compared to a positive 4.78% return for the benchmark (which is weighted 50% S&P 500 and 50% Barclays Aggregate Bond Index).

Performance in the first half of 2016 benefited from strong returns in several core positions, including Corrections Corp. (CXW), Lab. Corp (LH) and Brookfield (BAM). In addition, as you can see in the chart below, three new positions that were added in the past 12 months also meaningfully contributed to the portfolio (Vereit (VER), New Senior (SNR), and Fidelity National (FIS)). While it is certainly too early in the lifecycle to declare victory with these additions, we are pleased with their recent performance. Finally, the best performer during the first half of the year was Denbury Resources (DNR), which benefited from a rise in oil prices, as well as, management actions to de-leverage its balance sheet and reduce operating expenses.

Partially offsetting the positive contributions mentioned above were negative results from two core positions. SeaWorld suffered from intensifying competition in the first half of the year which forced the company to lower prices. Despite these pressures, the new management team – led by Joel Manby – has done a remarkable job improving the company's brand image by making the difficult decision to cease orca breeding and partnering with the Humane Society. While the stock has declined below our original cost basis, we believe the company is moving in the right direction and remains an undervalued asset.

Our position in Blackhawk (HAWK) also performed poorly during the first half of the year. The company's disappointing results were due almost entirely to issues around the implementation of EMV chip cards at retailers. This was an unforeseen challenge but one that is entirely short-term in nature and should be resolved by the end of the year. Blackhawk's dominant market position, profitable unit economics, and exposure to fast growing markets remain as attractive as ever.

Below is a chart which lists, in order, the top 5 and bottom 5 contributors to performance so far in 2016:

Top 5

Name	YTD Price Change
Denbury Resources	77.72%
Corrections Corp.	32.20%
Vereit	28.03%
New Senior Investment	24.33%
Fidelity National Info. Ser.	23.06%

Bottom 5

Name	YTD Price Change
SeaWorld	-27.22%
Blackhawk Network	-24.25%
Level 3	-5.28%
Chesapeake	-4.89%
Transocean	-3.96%

While our equity investments performed well to start the year, our fixed income positions performed even better. Overall, our fixed income portfolios advanced 7.2% during the first six months of 2016. Admittedly, the results were aided by a strong tailwind of declining interest rates – a topic we will cover in more detail later on. However, we also experienced strong relative returns as our preference for owning a carefully selected portfolio of corporate and municipal bonds proved advantageous.

We alluded earlier to new investments made during the first half of the year which contributed to positive performance. We took advantage of the stock and bond market sell-off in late January and early February to purchase new positions in SNR and FIS, as well as, Icahn Enterprise bonds. In addition, we added to our position in APO as the stock price declined to very attractive levels.

In May we added a new position in Johnson Controls (JCI) to the portfolio. Johnson is a leading global provider of commercial HVAC systems and automotive batteries (the company is in the process of spinning out its automotive seating business). Over the next five-to-ten years the company will be a primary beneficiary of two long-term secular trends: the need for increased energy efficiency in commercial buildings and the more stringent requirements for better automotive fuel efficiency. Both of these mega trends should propel future growth.

Moreover, the company’s pending merger with Tyco will create significant cost-savings synergies and potentially result in new cross-selling opportunities. This merger, along with the pending spin-off of the seating business, has created complexity and short-term uncertainty, leading to a 20% sell-off in the stock price. As a result, we were able to purchase the shares at a low double-digit earnings multiple (pro forma), and in return received a high-quality franchise with attractive long-term growth prospects.

The Challenge of Low Interest Rates

Eighteen months ago we devoted a significant section of this letter bemoaning the repercussions of abnormally low interest rates. At the time, the 10-year U.S. Treasury was yielding 2.1%. Today, the rate is 1.58% (and hit an all-time low of 1.37% on July 8th). According to some estimates, over $13 trillion of sovereign bonds are trading at negative yields. As long-term value investors, the single biggest challenge we face today is navigating a world of ultra-low rates and the distortions created by it.

As we have said before, interest rates act as gravity on asset prices, and the lower rates go the less gravity is available to hold down prices. This applies to all asset classes, not just stocks and bonds. In this environment, it's almost impossible to find investment bargains that are deeply undervalued.

Even the recent panic surrounding Brexit was short-lived. Despite the risks and uncertainty posed by Brexit, interest rates plummeted in the days after the vote and stocks are now exceeding all-time highs. Historically, events like this would have elicited the exact opposite response. Instead, we are increasingly living in an investment climate dominated by an unprecedented cycle: increased fear and uncertainty creates an expectation that central banks will remain extremely accommodative, which in turn lowers interest rates and raises asset prices.

Our strategy up to this point has been to remain cautious and disciplined in the event long-term interest rates rise. We are hesitant to commit capital in the face of rising multiples and all-time low interest rates. Yet, despite our continued devotion to a value-oriented investment strategy, the hard truth is that recent purchases like JCI and FIS would likely not have occurred in a higher interest rate environment. These are wonderful franchises that trade at discounted valuations but by no means are they equivalent to the bargains we owned several years ago.

While we are willing to pay a slightly higher price than in years past, what we are not willing to do is sacrifice on quality. In this environment, the only distressed opportunities that appear to offer large upside potential are distressed for a reason. The alternative we have chosen is to focus our investments in high quality assets that are reasonably priced. This is a conscious decision to accept the realities of a low-return environment, rather than "reach" for excess returns that carry much more risk today. Time will prove whether this strategy is correct but we think it's the more prudent approach.

The Passive Index Bubble

One of the more pernicious byproducts of an ultra-low interest rate environment is the huge migration towards passive index investing. Since the end of the Great Recession, approximately $1 trillion of net assets has flowed into passive index funds, while nearly the same amount has flowed out of actively managed funds. This trend is prevalent among not just retail investors, but also sophisticated institutional investors.

After seven years of declining interest rates and consistently rising asset prices it's easy to understand why passive index funds seem attractive. In addition to the benefits of a low-cost, highly diversified strategy these funds have also performed extremely well in recent times, reinforcing their attractiveness. Yet, like any good idea, this can lead to unsatisfactory outcomes if taken to the extreme.

As stock prices rise and more investors pile into these passive index funds, the average investor begins to own a broad basket of relatively expensive assets. By definition, these funds make no distinction between the quality of the underlying stocks they own or their valuation. Passive index fund investors end up owning a collection of richly priced assets of dubious quality and, as you can see in the table below, the outlook for future returns is not good:

Starting Median P/E Ratio & 10-Year Returns

Starting Date	Starting Median P/E	10-Year Annualized Return
12/31/1989	13.9	15.28%
12/31/2000	20.6	-0.48%
12/31/2001	23.5	0.92%
12/31/2002	18.8	4.94%
2/28/2003	16.9	6.06%
12/31/2003	21.2	2.17%
12/31/2004	20.3	5.54%
12/31/2005	19.0	5.24%
12/31/2008	12.5	13.21% *
2/28/2009	11.0	16.69% *
12/31/2015	22.0	???

* Less than 10 years (through December 2015)
Source: CMG Investment Research, Ned Davis Research, Worldscope

With the outlook bleak for passive index funds, the alternative approach of owning a carefully selected portfolio of high quality investments trading at reasonably attractive prices makes more sense. The ability to distinguish between different investments based on sound fundamental analysis provides us with better future return expectations as well as greater downside protection. We believe this to be true in normal times, and especially true when valuations are elevated.

In essence, we would rather use a scalpel to find attractive investment then a blunt force instrument. It's safer and provides potentially more upside. Over the past five years this hasn't really mattered as asset prices drifted higher on the back of unprecedented monetary policy. We think the future is likely to be different and we want to be prepared, as evidenced by our continuing high levels of cash.

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

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