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Q3 2015 Quarterly Letter

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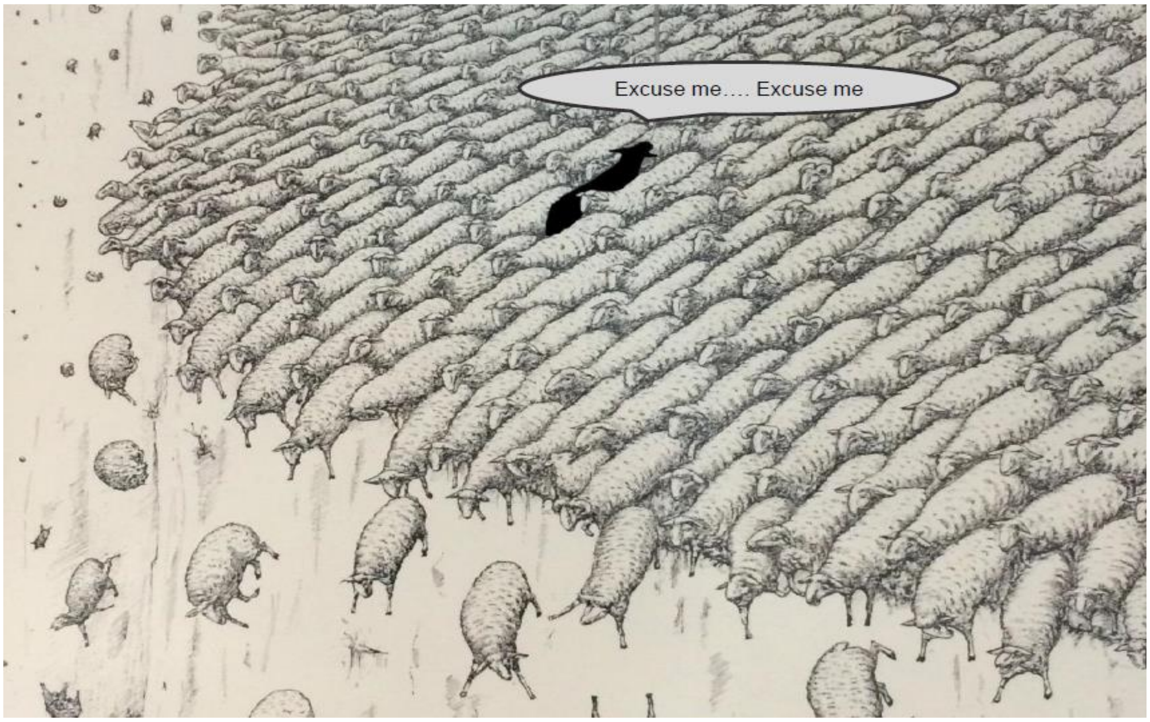
For those of us that practice the tenets of long-term value investing, there is no greater frustration than the experience of delivering poor relative returns. During the good times, it's easy to acknowledge and pay lip service to a period of time in the future when performance will inevitably suffer. And, make no mistake, it is inevitable: the very nature of investing in a relatively concentrated portfolio of mispriced and undervalued securities will produce short-term results that, from time-to-time, vary quite significantly from the market.

For the first 12 years of Carmel Capital's life, this variance was mostly positive. Conversely, the past 18 months have produced a different picture – one in which results significantly lagged the overall market. As we described in recent quarterly letters, part of this underperformance was self-inflicted (i.e. mistakes that we made and have now fixed) and part of it due to our value-oriented perspective (i.e. the reluctance to participate in over-priced investments that fueled much of the recent market advance).

Value investing, at its core, requires large quantities of patience and fortitude, and there is no doubt that both are currently being tested. It's not easy to invest in an unconventional approach which, during times like these, can be painful and emotionally taxing. Even though the ride can be bumpy, we know that history has proven value investing to be the surest path to achieve long-term superior returns. Despite the challenges posed by the recent underperformance, we are optimistic that the stable of investments we currently own are significantly undervalued and represent meaningful opportunity to outperform in the future.

Faced with difficult circumstances, its often reassuring to have someone you admire and respect validate your core beliefs. One such person we think very highly of is Bruce Flatt, CEO of Brookfield Asset Management (BAM). As you know, BAM is a long-term core holding in our portfolio – in no small measure due to management's contrarian value-oriented investment philosophy and the remarkable long-term track record they have achieved. We recently attended an investor meeting in New York with the management team in which Flatt discussed both the benefits and challenges posed by value investing. During that discussion, he shared with the audience a cartoon that we have included below. In this case the cliché is warranted – a picture is truly worth 1,000 words:



Third Quarter Review

After several years of muted volatility, the third quarter reminded investors that the market's tendency to exhibit periods of panic has not been vanquished. The decline was primarily a result of macro-related concerns on two fronts: first, mounting evidence of a slow-down in China and its negative impact on global demand, and second, uncertainty around the extent and timing of any change in interest rate policy by the Federal Reserve.

During the quarter our own performance suffered from the headwinds mentioned above. We experienced declines in almost every individual holding, with particular weakness in several commodity related investments (Chesapeake, Denbury and Titan).

Acknowledging that our macro-economic forecasting skills are average at best, our opinion is that a slowing China represents a legitimate and meaningful fear, while concerns around a rising interest rate environment are likely overblown. It's important to remember, however, that we don't maintain any competitive advantage in predicting macro-economic conditions and that our focus remains on bottom-up value-oriented security selection.

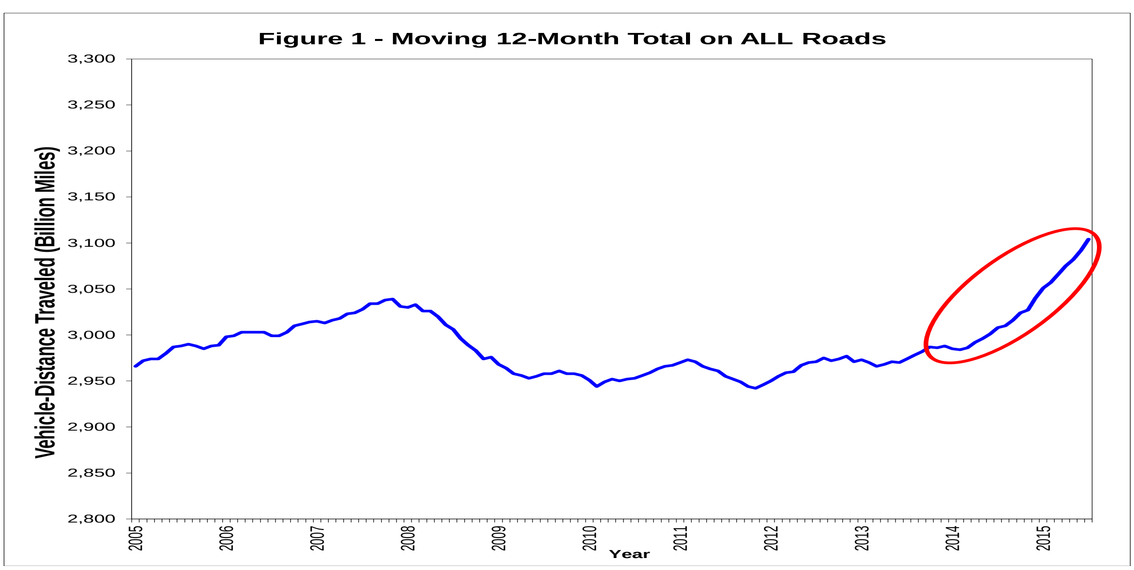
Furthermore, in contrast to the quarterly performance results, the underlying fundamentals for most of the businesses we own continue to steadily improve. We assess the condition of these companies based on their operating results and not the monthly or quarterly stock price movement. By that measure, we have certainly seen a slowdown in some of our commodity related businesses, but the remaining 90% of the portfolio is performing very well.

Energy Update

As mentioned above, performance during the quarter was negatively impacted by our energy investments, which in aggregate represent 8% of the total portfolio value. Despite the extreme volatility in the price of crude oil, the underlying market fundamentals are generally improving in-line with the expectations we laid out in recent quarterly letters.

On the supply side, it's now clear that domestic crude oil production peaked in April at 9.6 million barrels/day and declined to a current run-rate of approximately 9.1 million barrels/day. This decline is occurring at a faster rate than we anticipated and is a result of significantly reduced capital spending and the steep decline curve on existing production. Crude oil in the range of $40-50/barrel is simply not high enough to incentivize new drilling and it's very likely that production will continue to decline unless prices rise. Outside the U.S. capital budgets are also being slashed and 2016 is setting up to possibly see global oil supply decline compared to 2015.

On the demand side, the situation is more complex with a variety of competing forces at play. On the one hand, the slowdown in China and other emerging markets will negatively impact crude oil demand (however, it's worth keeping in mind that 70% of oil global oil consumption is used in transportation which is more insulated against slowdowns in investment and infrastructure spending). On the other hand, there is sufficient evidence that low oil prices have indeed produced a positive demand response – this is something we were admittedly uncertain about given the pro-longed stagnation in oil consumption in developed economies. For example, as you can see in the chart below, the total amount of vehicle miles driven in the United States meaningfully accelerated in the middle of 2014 after several years of stagnant growth, coinciding with the precipitous decline in fuel prices.



The recent volatility in commodity prices is certainly unprecedented and it does reinforce our belief that predicting commodity prices in the short-term is not just difficult but impossible. In the long-run, however, the underlying fundamentals and market forces, like those described above, serve as a mechanism for true price discovery: long periods of low prices will curtail production and incent demand, forcing prices higher. With 8% of our portfolio currently dedicated to energy investments, we feel the asymmetry of returns at today's commodity price represents a very attractive risk-reward payoff.

New Investments & Current Opportunities

In addition to our energy investments, we are also optimistic that the remainder of the portfolio reflects significant upside potential. The portfolio's current discount to fair value, a metric we track closely, is at one of its cheapest levels in the past five years – even after excluding the deeply discounted energy investments. Also, after a pro-longed period in which the market offered little value and forced disciplined investors to the sideline we are starting to see some exciting opportunities to put capital work.

During the sharp market correction in August we initiated a new position in Vereit (VER). The company is structured as a real estate investment trust (REIT) and primarily owns triple net leases in the retail and restaurant sectors. At the end of 2014, the company (under its former corporate name American Realty Capital) became entangled in a series of accounting irregularities and controversy due mostly to poor accounting controls and aggressive management behavior. After peaking at $18 per share in 2013 the stock plummeted to $7 per share in November of last year.

Over the past nine months the entire management team and Board of Directors was replaced and, after an internal audit, all financial documents were re-stated. Most importantly, the company announced the hiring of Glenn Rufrano as the new CEO – a highly regarded industry veteran with an excellent long-term track record.

Despite the turmoil at the top, the company's underlying business model consists of a collection of high-quality real estate assets generating a very predictable cash flow stream. In aggregate, the weighted average lease term is approximately 11.5 years with the vast majority of its leases earning guaranteed annual rental increases of approximately 1% annually. Because of the issues surrounding the company, which based on our research we deemed to be temporary, we were able to opportunistically purchase this predictable and stable cash flow generator at a very attractive valuation. At a purchase price of less than $8 per share, we are earning a 10% cash flow yield that is growing over time and likely worth more than $13 per share in today's interest rate environment.

We also took advantage of the market sell-off to add to several existing positions, including Corrections Corp. of America (CXW) and Apollo Group (APO). As a result, cash balances have declined into the low 20% range (at this time last year cash balances exceeded 30%).

Even though the S&P 500 index has only declined 5% from its high reached in July, the average stock in the index is 17% off its high (as of this writing). Unlike recent history when the market was highly correlated and moved in unison, the disparity in performance is creating opportunities to find bargains and mispriced investments. Given we have averaged 25% cash over the past 2.5 years the price declines and associated opportunities are welcomed. Our pipeline is as robust as it has been in sometime and we are hopeful that we can continue to put capital to work at attractive prices.

The recent volatility in prices is also starting to impact the fixed income market. Over the past several years – with interest rates stubbornly low and credit spreads narrow – very few fixed income investments offered attractive yields given the commensurate credit risks. In this environment, we remained patiently on the sideline even though it resulted in foregone profit. Recently, however, credit spreads in the corporate bond market widened out several hundred basis points and we are starting to see more attractively priced investments. We anticipate using some of our dry powder if this situation persists.

While the past 18 months have produced a difficult period of poor performance, we are optimistic that the current portfolio is well positioned to earn outsized returns going forward. As long-time practitioners of value investing, we realize this strategy is not always the easiest to traverse, but history has proven it's the most reliable road to long-term investment success. We are reminded of the following quote on the subject of value investing by Benjamin Graham, the father of value investing and Warren Buffett's mentor:

"The intelligent investor shouldn't ignore Mr. Market entirely. Instead, you should do business with him- but only to the extent that it serves your interests...Mr. Market's job is to provide you with prices; your job is to decide whether it is to your advantage to act on them. You do not have to trade with him just because he constantly begs you to…Always remember that market quotations are there for convenience, either to be taken advantage of or to be ignored."

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

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