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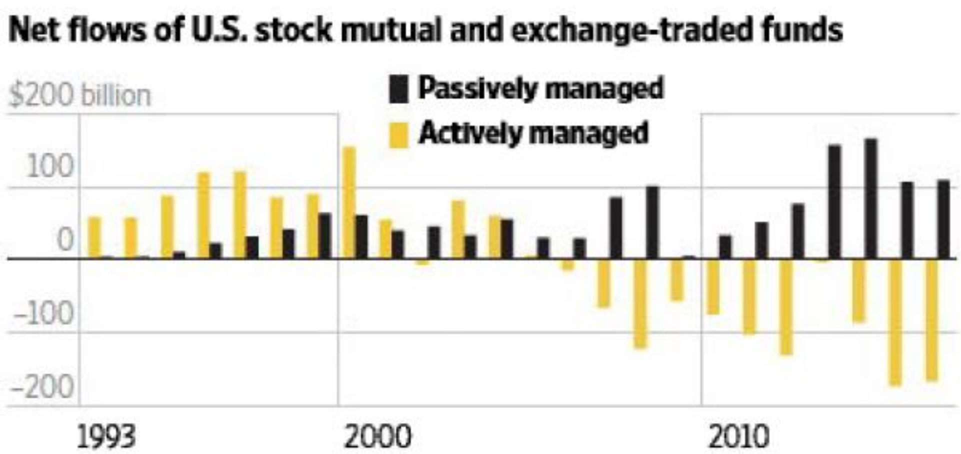
Q3 2016 Quarterly Letter

Anthony Josephson and Russell Silberstein 10/20/16

The impact of abnormally low interest rates continues to be the overwhelming driving force in the market. As we discussed at length in last quarter's letter, this new paradigm has the potential to cause irrational decision making and unintended consequences. One of the pernicious side effects of this ultra-low interest rate environment is the growing appetite for passive index investing.

As rates move lower and the stock market bubbles higher, investors are lulled into believing that passive index investing always works, irrespective of valuations. Just this past week, the Wall Street Journal highlighted this dramatic shift in a series of articles which included the following chart:



Despite the avalanche of capital into passive index funds, we continue to believe these investors are likely to experience subpar returns over the next 5-10 years. Although we hesitate to predict a large market decline, we do think medium to longer term returns will be muted, mostly as a function of the current market valuation. By its very nature, a passive index fund does not discern based on valuation, choosing instead to own a little bit of everything. Yet, there is a limited margin of safety and limited upside when one's entry P/E multiple is close to 20x.

Most investors do not have their return and risk expectations calibrated correctly when it comes to passive investing. We offer up as evidence the result of a recent survey conducted by Natixis Global Asset Management. We quote directly:

> "There were some interesting findings in this year's survey, as 62% of investors who participated in the survey agreed that index funds and exchange traded funds (ETFs) are a cheaper way to invest, but 60% also believe they are less risky."

The findings suggest that many investors have expectations that don't reflect a full understanding of the risks of index funds versus the benefits.

The survey found that:

- 60% of investors think using index funds **can help minimize investment losses**
- 61% believe index funds offer better diversification
- 55% believe index funds provide access to the best investment opportunities in the market

Source: Natixis: 2016 Global Survey of Individual Investors

We believe that like many good ideas taken to an extreme the flood of money into passive index investing will ultimately result in investors having an experience far less attractive than they bargained for.

Real Estate and Private Equity

Thankfully, we do not own a passive portfolio and believe the current landscape is well suited for our value-oriented investment style to thrive. Moreover, we are not sitting still. In an effort to further enhance your investment portfolio we will, over time, be adding both private equity investments and real estate to your portfolio. We have discussed this topic in review meetings with you but wanted to take this opportunity to summarize our rationale on paper and also provide an update on activity thus far.

Before going into more detail below we want to be clear on one point – we will only move forward with a particular investment after a discussion with you. This is a departure from the way we invest in public equities and fixed income but we believe this framework is more appropriate for these types of investments.

Over the past 12 months we laid the foundation both operationally and strategically to allow these two asset classes to be added to your account. We forged relationships with several firms specializing in private equity and real estate and we will partner with these firms on future investments. These partners all surpass our hurdle for high-quality individuals and a history of investment expertise.

In most instances, the investment opportunities will be externally generated in which case we will co-invest with these outside firms. Alternatively, there will be investments that are sourced internally where we will represent the majority of capital. While we will be partnering with outside firms we'd like to stress the following – the same level of deep due diligence and research that is a hallmark of our stock and bond portfolios will also be applied to private investments.

Our decision to move down this path is driven by several factors:

- First, we would like to expand the investable universe to deploy your capital beyond traditional stocks and bonds. As a firm we have a long history of opportunistic investing and applying this to private equity and real estate is a natural evolution.

- Second, the ability to invest across a broader set of asset classes will produce a more diversified and durable portfolio over the long-term. While we will surrender liquidity with these two investment options, we will gain exposure to attractive areas that might not necessarily be available in the public markets.

- Third, we believe our private equity investments will offer an opportunity for increased returns over time and we're comfortable sacrificing medium term liquidity (3 – 5 years) in order to achieve better returns.

- Finally, our goal with real estate is to consider capital preservation first, income second, and capital appreciation third. We will view all our real estate opportunities through this filter. Doing so allows us to again surrender liquidity in favor of incrementally better returns compared to publicly traded fixed income.

Of course, we are mindful that these two asset classes have experienced a tremendous amount of appreciation since the market bottom in 2009. Yet, we still believe there are pockets of opportunity. More importantly, we'd like to be prepared for the next down turn and position ourselves to have a broader set of investment choices beyond traditional stocks and bonds.

By way of example, over the past year we examined a number of private equity opportunities and progressed with three to the point of a signed Letter of Intent (LOI). On all three occasions we partnered with Silver Canyon Group, with our first offer valued at 5.7x EBITDA, our second at 5.6x EBITDA and our most recent at a 5.7x EBITDA multiple. In two instances we were outbid and in the third we elected not to proceed as the nature of the opportunity materially changed after the LOI. We provide this insight in an effort to share with you our activity to date and also to demonstrate our continued adherence to our valuation discipline.

Similar to private equity, we have examined multiple real estate opportunities but have not yet moved forward with any transaction. In one case we opened escrow but could not close due to issues uncovered during due diligence.

In summary, we firmly believe adding these two additional investment options offers an additional level of diversification, more durability to the portfolio, and positions us well to capitalize on a broader set of opportunities in the future.

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

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