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Q4 2015 Quarterly Letter

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During 2015 our Equity accounts returned -18.7% for the year compared to a positive 1.4% return for the S&P 500, and our Balanced accounts returned -12.1% compared to a positive 1.3% return for the benchmark (which is weighted 50% S&P 500 and 50% Barclays Aggregate Bond Index).

We are profoundly disappointed to deliver the poor returns described above. This past year represented the second worst in the firm's history (only to be exceeded by the financial crisis year of 2008.) Given our previous successful long-term track record and the continued high standards we seek to achieve, the results in 2015 were significantly below our expectations.

The poor returns can be attributed to two underlying factors: first, several investments suffered from self-inflicted mistakes that were no one's fault except our own, and second, we experienced negative repercussions from several trends afflicting the market over the past 12-18 months.

The Mistakes

Let's start with the mistakes. As we described in detail in previous letters, the single biggest error made was the over-weighted concentration in energy investments entering the summer of 2014. At close to 25% (including equity and debt positions) our single commodity exposure to oil was simply too high even though the individual positions on their own represented sound investments. Our current energy exposure is approximately 8% and reflects the potential asymmetric risk/return profile at today's cyclically low oil price.

In addition, several investments in the portfolio that can be classified as "turnarounds" were underwritten with assumptions that proved, in hindsight, to be too aggressive. These types of investments – which usually require a capable management team executing a new operational and financial corporate strategy – have historically produced successful results as part of our investment strategy. However, our recent experience reinforced an axiom we already knew to be true: most turnarounds are doomed for failure and those that do triumph don't travel a straight path to victory. As such, we have exited positions like Rent-a-Center (RCII) and Genworth (GNW) and reduced our weightings in Titan (TWI) and Wesco (WAIR). While our recent experience with turnarounds was ill-fated, there are special situations – based on very conservative underwriting and a relatively small weighting – when an investment is warranted. Under these conditions we would expect to make future investments in turnarounds but only on a very opportunistic basis.

Mr. Market

Aside from the self-inflicted wounds mentioned above, we were at the mercy of several market trends in 2015 that weighed heavily on performance. Although somewhat anecdotal, it became increasingly clear throughout the year that investors were favoring growth over value, momentum over fundamentals, and speculation over long-term intelligent investing, with valuation discipline playing little role in decision making. In fact, many of these trends were long-in-the-making and simply boiled to a crescendo in 2015.

For example, the epitome of this "growth-at-all-cost" favoritism was the euphoria bestowed upon two market darlings: Netflix (NFLX) and Amazon (AMZN). Both of these low-earning, high-multiple stocks trounced the overall market with gains of 134% and 118%, respectively. As you can see in the chart below, each of the 10 best performing S&P 500 stocks in 2015 trade at forward P/E ratios well in excess of the overall market multiple of 16x.

COMPANY	2015 Change	P/E Ratio
NetFlix Inc	134.4%	476.6x
Amazon.com Inc	117.8%	123.8x
Activision Blizzard	92.1%	24.5x
NVIDIA Corp	64.4%	31.1x
Cablevision Sys'A'	54.6%	379.8x
VeriSign Inc	53.3%	25.3x
Hormel Foods	51.8%	27.1x
First Solar	48.0%	16.0x
Alphabet A (Google)	46.6%	22.8x
Total System Svcs	46.6%	19.0x
	Average	**114.6x**

In an environment where the market abandons fundamentals and neglects the merits of value, our performance will naturally suffer. This is not intended to be an excuse for poor performance, but rather a recognition that disciplined, fundamentally driven value investing will not always be perceived as the best route to quick riches. And nor should it be: value investing is inherently a long-term oriented investment strategy. History has proven time-and-again that periods like this (such as the "nifty-fifty" in the 1970s or the tech bubble in the late 1990s) usually end badly for speculators. Ultimately, value investing wins the day because it is based on the sound reasoning that superior results can only be achieved if you pay a price less than intrinsic value.

Recent Volatility

The recent volatility in the markets can mostly be attributed to fears around a China slowdown and its impact on the global economy. Even though other geopolitical and economic troubles exist, nothing can compete with the scale and magnitude of a hard landing in China. In our opinion, the concerns are likely warranted; however, the picture is much more nuanced than most appreciate. And while we are not macro economists, it's certainly important to understand the ramifications of a potential deceleration in the Chinese economy on both our existing and future investments.

On the one hand, it's relatively easy to conclude that China's historic investment in infrastructure and real assets has slowed materially. Despite the government's proclamation of resilient growth, there are many indicators which suggest a substantial decline in capital investment – not the least of which are the decade low prices for basic materials like copper, coal and iron ore. Other data, such as declining electric power consumption and contracting imports, also point to a significant deceleration in investment.

Furthermore, almost all of the mining, materials, and heavy industry companies that we follow have reported significant revenue declines over the past 12 months (and stock prices to match). In many cases this downturn is worse than 2008 because the slowdown in China seems to be structural rather than cyclical. This is a key point and cannot be over-emphasized. Whereas in 2008 global investment spending contracted due to a cyclical economic slowdown, the current retrenchment in China is a result of long-lasting secular changes as the country shifts to a consumer driven economy.

The implications for businesses that rely on strong investment and infrastructure spending from China are profound: in essence, the future will continue to be challenging and any snapback is unlikely. Given these circumstances, we have chosen not to pursue new investments in cyclical companies reliant on improvements in Chinese capital spending, despite the fact that many of these stocks trade at seemingly low valuations.

On the other hand, there are many indications that consumer-oriented businesses operating in mainland China continue to prosper. Recent reports from companies like Starbucks, Nike, Burberry, and Alibaba confirm the growing demand for consumer goods from a burgeoning middle class. It's easy to lose perspective amidst the fear and volatility, but the great "China story" appears intact: a middle class of 50 million in 2010 is still expected to grow to 500 million by 2020.

Like most market panics, investors lose perspective and make decisions with a blunt instrument instead of a sharp knife. Consequently, even those consumer-oriented companies which continue to report growth in China are being treated with similar contempt by investors. If this continues there will likely be opportunity to find attractive investments amidst the carnage.

The Opportunity

As fears over China reverberate throughout the stock market we are starting to see more opportunities to put capital to work than in quite some time. As discussed in prior letters, our cash balances have been elevated for a number of quarters and thus we are encouraged to see the opportunity for capital deployment expand. Even though the S&P 500 is trading at a relatively fair market multiple of 16x, the reality is that this figure is being held aloft by a few large capitalization companies trading at premium valuations (some of which were listed in the table on the previous page).

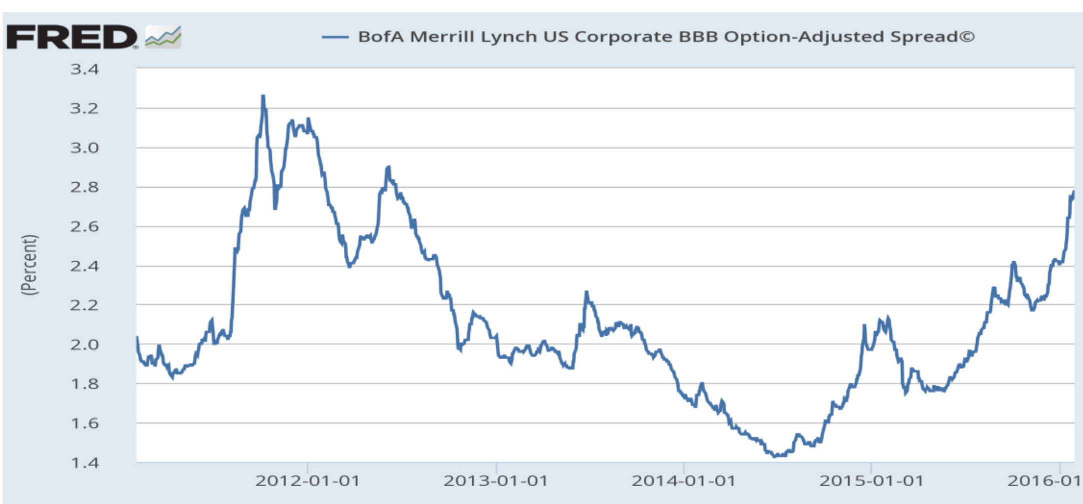
With many stocks (including those outside the S&P 500) trading at 30-40% discounts off of their 52-week high price, we are excited about the opportunity to find attractively priced investments. Granted, many of these companies operate in the energy sector, but there are also many non-energy related stocks that have been beaten up in the sell-off.

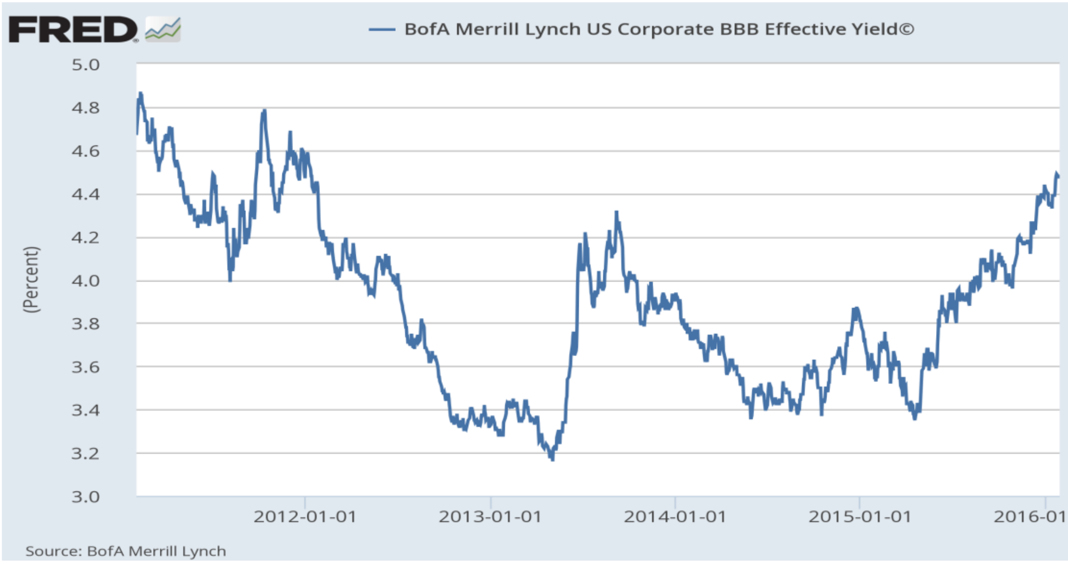
For example, many higher-yielding stocks (like REITs) have experienced precipitous declines in value over the past six months. In addition to purchasing a position in Vereit (VER) last year (which we discussed in a prior letter), we recently initiated a new investment in New Senior Investment Group (SNR). SNR owns and operates independent and assisted living facilities throughout the country that cater to the growing senior demographic. After declining by more than 50% from last summer, the stock is currently yielding 11% and the company is poised to grow the dividend by greater than 10% per annum.

We have also witnessed large price declines in high-quality global franchises that are currently suffering from major currency swings and perceived fears of a global economic slowdown. These are businesses with tremendous long-term competitive advantages that currently trade at below market multiples. Our hope is that we can add several of these names to the portfolio in the coming year.

Fixed Income Opportunity

The market disruption mentioned above is not confined solely to the equity markets. For many years the corporate bond market has traded at remarkably low yields and credit spreads, offering little in the way of value or buying opportunities for disciplined investors. Although outright bargains are still hard to come by, we are seeing the first signs of this dynamic changing. As you can see in the charts below, both credit spreads and yields have increased back to levels last seen in 2012.





In light of increasing spreads and yields, we have opportunistically added several new corporate bonds to our fixed income portfolios, including: United Rentals, ADT Security, and Wynn Resorts. Each of these bonds, which represent excellent credit quality, yield between 5.5-7.0% and mature in less than seven years.

Over the past three years we have been particularly cautious in purchasing corporate bonds at prices that did not adequately compensate us for the risk. As a result, cash balances increased and we reluctantly accepted the alternative 0% coupon payment. We are hopeful that this period is now behind us and that we can continue to find attractive new investments.

Always Prudent

While most investors fear short-term volatility, this should instead be viewed through the lens of opportunity. Often times a pessimistic market will present long-term oriented investors with potentially attractive investments. It's our job as patient, disciplined investors to sift through the wreckage and discover the true bargains. While it is too early to definitively proclaim the current landscape as value heaven, we are starting to find more interesting opportunities. As always, we will move forward with a heavy dose of skepticism and prudence, but we are certainly excited about the future prospects.

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

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