Investment Securities

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Dear Client,

I just reread in this weekend's edition of Barron's an article titled "What Everyone Knows That Isn't So,"[1] which made an analogy between the first quarter and a roller coaster ride. Calling it hair-raising and frightening, but ultimately leaving you off where you got on. Quite accurate. So what is the reaction of most people who get off? *I don't want to do that again!* When applied to investing, that translates into putting your money where it can 'be safe.'

Later in the piece, it identifies equities most in favor as, "... those most bondlike" suggesting that "investors' eagerness is to pay up for safety [justifying that decision] not only because of the road they've traveled, but also due to the risks they see ahead." We believe that history has shown that paying up frequently makes an investment uneconomic and no longer provides safety. For example, see what happened to investors in MLPs a year ago if you don't believe me.

The article goes on to point out the fallacy that investors have the ability to "see the road ahead," by identifying various Q1 predictions for 'the road ahead' as viewed at the end of 2015 that were proved wrong empirically:

Year-end 2015 Prediction	Q1 Realty
● The US dollar can only continue to go up	● Down 4.1%
● Emerging markets are dangerous	● Up 5.8%
● Gold will continue to be weak	● Up 16.1%
● Interest rates will go up (government bonds down)	● Up 6.9%

Another article[2] by James Paulsen, Wells Fargo's Chief Investment Strategist, posited that often during a recovery the market hops back and forth like a bunny, making the market relatively flat, albeit quite volatile, over an extended period. He goes on to say that he believes in this environment it is difficult for buy-and-hold strategies, which makes short term trading become the style du-jour. We see it yet again from a different perspective – does this mean buy and hold is dead?

No. It is not. In our opinion that is what markets do: they embed transitory effects in our minds, that recency bias convinces us is the new paradigm. Being aware of the fact that cycles recur is important to help prevent you from learning the wrong lesson.

We believe that right now it is important to not look in the review mirror, but instead look out the windshield. We don't believe that this time is different, and think that over time fundamental

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[1] April 2nd Weekend Edition of Barron's
[2] "A bull, a bear, or a bunny?" March 21, 2016 Wells Fargo Asset Management *Economic and Market Perspective*

economic realities will prove out. We also don't believe in overpaying for the perceived safety of non-volatile securities, which are often only that way until they aren't.

Our decades of researching businesses and getting to know their managements, while discerning what both can do in a normal business environment is what consumes our days.

Risk On / Risk Off

One of my clients recently entreated to me, "Bob, I don't think you could pick stocks that are more volatile." Volatility is often used synonymously with risk, which we believe is a poor shorthand. I wrote a piece extolling the virtues of Subsea 7 (see attached), which has been volatile as of late, where I argue that the stock could trade for 4 times its current price sometime in the next 5 years. This would provide a 25% annual compound return, which would be none too bad in a 1% interest rate world. The rebuttal was yes, but clearly there are different risk levels between the two alternatives. This is why we have to look at *adjusted* risk.

The 'wild ride' has seemingly convinced yet another cadre of investors to pass on owning equities and instead take their money off the table, leave it in cash or government bonds and the like.

It seems to me that both ends of the risk spectrum are mispriced. There is a lot more risk inherent in those 1% bonds or those 'bond-like' equities, and the upside may be severely capped. Conversely, those volatile equities are not as risky as the price actions suggest, and the valuations more than compensate for the actual economic risk. The problems seem to be fear and fatigue. Investors are frightened and exhausted by the ride and want off.

I believe investors are overstating the risks and ignoring the returns given the recent fright. This is a perfectly normal human reaction, but one that can be detrimental to your financial well-being. While for certain asset classes that have performed well (some for an extended period of time) the reverse can be true. Investors are understating the risks inherent in their investments and overestimating the potential rewards from current valuations.

Thoughts on Energy

As with so many other assets, oil and commodities as a whole exhibited the same trend in the quarter except they rode in the front of the roller coaster. Higher highs and lower lows. While we could talk all day about the price of oil and not get any smarter, we can talk about the constructive direction of the industry.

- Pricing has dramatically reduced reinvestment, which has meant that fewer new wells are being brought into production.
- Existing wells are depleting further every day as oil continues to be pumped from them.
- US production is down 430k barrels since its peak in 2015, and that decline should accelerate as new spending continues to fall off dramatically.[3]

[3] Numbers from EIA.gov

- World demand continues to grow even with weak economies around the world (remember, lower prices historically have resulted in increased demand).
- The world's excess productive capacity is slightly over 2% of daily consumption.

Interesting how today, headlines are filled with mentions of Iran production set to increase 500k barrels a day, but with no mention of the US's production decline. It is not surprising that investors and the press don't focus on the facts that have yet to reach a tipping point. After all, it is widely accepted by the industry that US shale production most probably brought about the steep price decline in oil overnight. Yet, oil production in the US has been rising by 1mm barrels for 5 years before the world 'realized' it. Today we believe these trends are reversing and undoubtedly accelerating. For example, US production (as mentioned above) is down at least 430k barrels from peak.

It is not if, but only when. Next year? Later this year? As always, we make no claims of knowing, but while timing is uncertain, we believe the outcome is predictable.

The pricing of energy equities is largely determined by the current watchword – lower for longer. We believe that when reality comes to be recognized, pricing assumptions will adjust dramatically, as happened in 2014 to the downside.

Conclusion

I realize that these notes from us are consistent (certain investors may be less kind and call us repetitive), but we make no apology for that. Our record has shown being consistent is a successful way to invest, especially through periods of underperformance.

In the end, the most important thing for us to focus on is not the price of oil or whether we are in a bull, bear or bunny market, instead it is the underlying businesses we are partial owners in. In that respect we are confident in our portfolio of companies and believe that there will be more good news to come.

Thank you for your confidence and trust.

Bob Robotti

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