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Dear Client,

We're pleased to report that in the most recent quarter, your investments with us outperformed the market indices (e.g. S&P 500 & Russell 2500 Value Index). This is now back to back quarters, so for the year we have also outperformed. Our conviction to stay invested consistent with our research and avoid the siren call of the market has begun to pay off. We believe this informed judgment of our investment process will continue to reward us (although most likely not in a straight linear progression from here) as our portfolio is replete with investments we know well, have high conviction on, and believe currently sell for a sizeable discount.

The two recent quarters remind us that when markets shift focus, valuations can, and often do, move dramatically. A promising aspect of this fact is that markets today are clearly mired in a post-financial crisis malaise with a strong aversion to 'risky investments' (how the market views most of our investments) and a lemming-like rush to yield, perceived safety and stability. We believe the table is set.

How Did We Get Here This Time?

The world's economies survived a potentially fatal shot to the chest in 2008. The bullet just missed the heart. In the early aftermath of the ‘08-’09 system shutdown it appeared we would experience a swift rebound. However, since its early stages, most economies have slogged through a recovery that has been long, slow and full of disappointments.

These disappointments combined with the resulting increase in volatility have festered to make investors all the more risk adverse. This has led to a momentum fueled search for high quality securities that provide a large measure of safety. Where better to look for securities with these qualities than in the same places that have recently worked out well? So investors have gone looking and believe they have found the combination of quality and safety in fixed income (bonds) and in equities of high quality consumer staples and new tech companies. Of course, in the current Fed-induced coma of 0% interest rates, a large number of investors require not only quality and safety but a high yield too. In fact, higher yielding utilities and telecoms are up +20% year-to-date. Makes sense, no?

Valuation – Déjà vu All Over Again

There is one serious problem with following these “winning” strategies – they do not consider valuation! “*The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd, yet the new-era theory led directly to this thesis.*” These words were written by Benjamin Graham and David Dodd in *Securities Analysis* in 1929. The new-era they refer to was the post-depression era. Fast forward 87 years and investors seem to have once again forgotten that valuation is the ultimate leveling mechanism of the markets. High quality companies can turn out to be poor investments. Determining the desirability of a security independent of its price - failing to consider the price you pay versus the value you receive - is no less absurd a view, in our opinion, in 2016 than it was in 1929.

To paraphrase Ben Franklin’s famous quote, those who would surrender freedom for security deserve neither. We suggest those who pay a premium for quality and safety are, in fact, gaining neither. Instead, they are unwittingly subjecting capital to significant risks. We don't know what events will bring about the realization that the winners are now priced for perfection and markets and economies are cyclical. Once again we believe we will be on the right side of those cyclicals.

Energy Markets and Investor Attitudes

Part of the explanation for our recent outperformance is the emerging dawn of a recovery in energy markets. North American natural gas prices have quietly moved up 40% from recent levels. As for the headline grabber, oil, I would characterize its price as flat since the fourth quarter of 2015 (although the press sensationalizes the recent trend as up 75% from its February low tick). Even so, the current price of oil is above this low tick and we believe the fundamental trends are positive. Price stabilization begins to inspire the confidence necessary for companies to start planning how to best capture the opportunities recent market dislocations have left behind.

More important than sentiment (which is just investors’ delayed recognition to the fundamentals), the fundamentals appear to be moving in the right direction. Energy production in the U.S. is declining and that decline should continue to gain momentum. At the same time, energy demand is rising. When you combine a decline in supply with an increase in demand the only uncertainty is the timing of the outcome. In our opinion, these factors have set the stage for strong performance by our investments. And many investors are beginning to focus on these developments.

Conclusion

As long as human beings are still involved in markets, there will be inefficiencies to exploit. Those inefficiencies tend to feed on themselves and persist, so markets can stay irrational longer than most investors can stay patient. This truism is all about investor behaviors - to lose patience and sell what has performed poorly is understandable and is what inevitably leads to opportunity. This is what makes investing simple (buy low) but not easy.

I recently read an apropos quote I’d missed before - capital tends to move from the active to the patient. As always, thanks so much for patience and conviction in our investment process. It has begun to pay off.

Sincerely,

Bob Robotti

Bob Robotti

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