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Dear Client,

As we all know, for the last few months securities prices have been particularly volatile (volatile being a euphemism for down dramatically). You probably didn't miss the wild ride taken by securities worldwide in the last few days of August, even if you were on the last days of your summer vacation. These dramatic declines quickly lead to all kinds of questions about the state of the economy in general and stock price levels in particular. Investors immediately ascribe intelligence and accuracy to the movement of markets and security prices. Sometimes this is the case...sometimes it is not.

First off, we'd preach caution on the concept that markets are efficient and therefore prescient. It's astonishing that some investors dogmatically cling to the efficient market theory. The events of the last 15 years, starting with the dot-com bubble, and followed by the great recession, flash crashes and the volatility we've recently experienced in security prices, should convince anyone that the markets are hardly efficient. And of course, in today's day and age, media comes to us through many devices. There is no escaping the constant barrage of news content provided to us by intelligent, well-spoken, well-written people who have relatively little economic training or real-world practical experience. We'd caution you not to mistake what you hear and read in the news as an accurate assessment of economic facts.

So how do we maintain the courage of our conviction so that our fear of loss of capital doesn't drive us to make suboptimal decisions? Specifically, how do we avoid selling out 'at the bottom' therefore crystallizing mark-to-market volatility into realized losses?

We quote no better source than the most successful investor of our times, Warren Buffett. Among his many witticisms, Buffett is known for the comment to be fearful when others are greedy, and be greedy when others are fearful. We know, it sounds trite. However, oftentimes truthful sayings from intellectual luminaries are simplistic in nature. For instance, consider Ben Franklin's "a penny saved is a penny earned" (or more accurately paraphrased today - a penny saved is a penny and a half earned after income taxes). The fact that many of these sayings are simple does not make them any less true. "The definition of genius is taking the complex and making it simple." (Albert Einstein)

During this tumultuous time, there is no way you could have missed news headlines remarking on the state of energy markets. Oil prices have fallen dramatically over the last year and with it the market price of every traditional energy company. With this decline in the price of oil, many of our portfolio holdings in the energy field have declined precipitously. We have strong conviction that markets have severely overreacted and believe that this overreaction will provide us significant appreciation potential from here.

We have over three decades of experience investing in traditional energy companies. Over our decades of investing, we have learned that some of the most valuable information comes straight from the source – successful operators in the business. On August 26th, the Paris-based Schlumberger International, the world's largest oilfield service company, announced that it would buy rival, Cameron International, for $12.7 billion. Schlumberger didn't get to be the world's largest oil field service company by being lucky. It is widely regarded as the most effectively managed company in the oil field service industry, and it has the numbers to back up that reputation. When it comes to comprehensive knowledge about the oil and gas business, arguably, no one knows more than Schlumberger. As a premier oil service company, Schlumberger works with every major international oil company and successful independent producer across the globe. Therefore, the depth and breadth of their knowledge about traditional oil and gas and its future, we'd argue, is unmatched in the world today. Also, Schlumberger is known as the premier technology firm in the energy business – they focus on leading edge technologies, not the brute force of many capital intensive oilfield service companies.

There are several important clues we can glean from this transaction. First, the per-share price that Schlumberger will pay is a 56% premium to where it closed the prior day and near the all-time high for Cameron's shares. We expect Schlumberger believes at this purchase price, its acquisition of Cameron will still provide double-digit returns. So much for the market's ability to accurately value companies. The market was far off in valuing Cameron International. Second, in investing parlance one often thinks of who the smart money is and who it is not. We'd argue in this case, Schlumberger is a highly informed, intelligent party, quite unlike the public investors who had heavily discounted the stock of Cameron. Public investors are unwilling or unable to view the investments prospects outside the scope of their short term framework; a stark contrast to Schlumberger's investment conviction.

In addition to the broad based affirmation of the key premise of our investment thesis, this particular transaction is very instructive for one of our largest holdings, Subsea 7. An extremely important part of Cameron is its subsea segment. A few years ago Schlumberger identified this subsea segment as a growth market where its technology differentiation would add value and strengthen its competitive advantage. In May 2013, Schlumberger invested with Cameron in their subsea division to form a joint venture known as OneSubsea, owned 60% by Cameron and 40% by Schlumberger. With the recent decline in the price of oil and stock market valuations, Schlumberger saw the market's irrationality as an opportunity to acquire the balance of Cameron at an attractive valuation which should provide it excellent returns over time. We consider this an affirmation of Schlumberger's well-informed belief that deep-water and subsea production (the core business of Subsea 7) provides a strong business opportunity with an excellent growth profile.

"But wait, there's more!"

In July, OneSubsea announced it signed an agreement establishing a worldwide non-incorporated global alliance with none other than Subsea 7 to jointly design, develop and deliver integrated subsea development solutions through the combination of subsurface expertise, subsurface production systems, subsea processing systems, subsea umbilicals, risers and flowlines systems (SURF), and life of field services. That's a whole lot of technical jargon, but it essentially means Schlumberger has deep conviction about the outlook and growth in the subsea business and also believes Subsea 7 is the best firm to partner with to capture this market opportunity. Now, don't get carried away and think we're suggesting that since the OneSubsea joint venture between Cameron and Schlumberger led to the eventual merger of Cameron into Schlumberger, the global alliance between OneSubsea and Subsea7 is a precursor to Schlumberger's acquisition of Subsea 7. We actually don't believe there's any chance of that combination but the transaction is still an affirmation of the investment opportunity.

One of the important lessons about investing is it isn't only about strategy and good execution, but it's also about the price you pay. Great businesses at extremely high valuations may not translate into good investments. Once again, though, we believe our investment in Subsea 7 today has dramatic appreciation potential. Despite all of the headlines about low oil prices and the market's total misunderstanding of Subsea 7's value, we argue that all of the above firmly supports our understanding and appreciation for the growth potential in Subsea 7's business. Specifically, we think that Schlumberger is paying over 18 times trailing earnings to buy Cameron and yet we believe this investment will pay off well for Schlumberger. Subsea 7 is currently trading at slightly more than 3 times trailing earnings. A vast difference in valuation, made even more dramatic when comparing normalized numbers – a discussion we are happy to have with any interested clients.

Not only is the valuation extremely compelling today, importantly the current environment is undoubtedly providing Subsea 7 with acquisition opportunities. We're confident that Subsea 7 and its Chairman Kristian Siem have numerous opportunities today to deploy capital that can dramatically enhance its earnings power and it has the financial strength to do so – especially with so many of its competitors in troubled financial positions.

We have talked a lot about the specifics of one company, Subsea 7. My hope and expectation is that this will help you better understand how we invest capital. Yogi Berra is quoted as saying "In theory there is no difference between theory and practice. In practice there is…" So, instead of talking to you about investing theories we hope this discussion of the actual practice will be more instructive.

We own investments in public companies that we believe are significantly undervalued and have recently become all the more undervalued due to all of the headline news. Remember, be fearful when others are greedy. But in times like these, when the vast majority are fearful, being greedy is an investment strategy that has been demonstrated to work repeatedly.

Please feel free to contact me anytime to discuss this letter, or anything else regarding your investment.

Thank you for your confidence and trust.

Bob Robotti

Bob Robotti

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