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Dear Client,

Steady as she goes.

At the conclusion of the third quarter, our year-to-date performance net of all fees has significantly beaten both the major indexes and our benchmark. Our collective patience and persistence is beginning to reward us. We remain vigilant in our valuation of the companies we own. We see a composite full of businesses that we believe is poised to continue rewarding us for being invested differently. Investing and the resulting returns very rarely occur in linear progression, but we are encouraged by the dynamics we are seeing play out.

A Giant Sucking Sound

We believe there are frequently clear, obvious and prevalent signs that foretell how certain events are to unfold. In the present, however, we all too often fail to heed these signs. In hindsight people often say, "I should have known better," and more often than not, they did.

A recent example of this is the financial crisis that we are still recovering from. The large financial institutions saw what was happening, but everyone was making money. Each believed that they would be smart enough to either get out before the music stopped or, at the very least, manage the decline better than their competitors. Clearly this was not the case.

So where are the signs today that people will 'know better' tomorrow? To recycle the words of Ross Perot, "it's a giant sucking sound." Fear not. I'm not about to go into the quagmire of the current presidential race. The giant sucking sound we are hearing today is the huge demand of capital being pulled in by indexation and exasperated by the proliferation of ETFs.

Like all previous investment manias, success leads to excess. People are quick to accept 'the new reality' and rush to change risk parameters in order to avoid being left behind. Today's momentum trade into passive funds, specifically ETFs, will inevitably expose that capital to increasing risks, if it hasn't already.

Index tracking funds do not care about a business's quality, its management, the industry conditions, and most importantly its valuation. By definition, they care only about tracking the index. Remember, the higher the valuation the greater the vortex since in indexing, size matters. Most indices are market cap weighted, so the more expensive a security becomes, the more capital it pulls in. Rewarding the successful for success and not for fundamentals is a dangerous game.

Keep in mind, these are not the 'passive investments' they are purported to be. ETFs have clearly become vehicles used to quickly deploy capital into and out of the equity market. This sounds much more like a trade than an investment, and the more crowded this trade becomes, the more it becomes ‘dumb money.’

It is not just individual investors that are hearing the siren song of indexing. Active managers will often try to hug their benchmarks for fear of creating career risk- accentuated by the post financial crisis environment. This ‘closet indexing’ only serves to exacerbate the problem and make valuation dislocation even more prevalent. It is also not dissimilar from the career risk fears banks had in the mid-2000s. Everyone else is making money this way, so I’d rather be wrong with the group than left out in the cold.

So if we can read the signs, where are they telling us to go?

Valuation. Thankfully, valuation is always the great equalizer in investing. No matter how far the market diverges from this reality, over time, valuation will bring markets back (sometimes violently). As Ben Graham observed decades ago, in the short-term the market is a voting machine, but in the long-term it is a weighing machine, allocating rewards proportional to a company’s economic value. We’ll continue to look at the weight, and ignore the votes.

OPEC Production Freeze

Over the last few weeks business headlines have been filled with news that OPEC may agree to an output freeze aimed at boosting oil prices. More recently, talk of Russia joining in with OPEC is the hot rumor of the day. We should all take this news with a heaping helping of salt. Agreements between countries with very different agendas are always hard to reach. Of course reaching an agreement is still very different from implementing one. So we’ll choose to wait and see.

In our view, the really clear, obvious and prevalent signs are the continued depletion of every existing producing well combined with the lack of capital reinvestment to drill and complete new wells. This equation leads to no new production to replace depleting wells. As we saw in 2014, when the US was adding 1mm incremental barrels, there was a tipping point that resulted in a significant price response. Today, we believe the reduction of supply caused by depleting wells will also reach a tipping point, and will likely have its own significant price response. Albeit one that is in the opposite direction. We believe in hindsight these outcomes will be clear, obvious and prevalent.

The timing is uncertain but the reality is irrefutable. At some point those countries that rely heavily on the production of oil must capitalize on the opportunity to dramatically increase their economic bounty. We believe these countries, despite their abundant resources and low development and production costs, are still dependent on realizing higher prices to maintain their regimes. As always, self-interest is the most powerful motivator.

It is important to take all the conventional wisdom and strong belief about today’s energy markets and tomorrow’s outlook with another large dose of salt. The news headlines of the day are often wrong but never in doubt.

Contrast that with our decades of experience investing in the energy industry. We have high conviction that our investments are extremely well-positioned and continue to be valued today far below what their discounted future cash flow generation should indicate.

Conclusion

Our ability to perform differently from the market is predicated on the fact that we invest differently from the market. We will continue to do what we know best – invest in companies that we believe have a market price that is dislocated from its economic value. A universe that should grow in lockstep with the growth of indexation. These are usually not the same companies you will find in the indices, which is why we perform differently than ‘the market.’ We appreciate your continued patience, and look forward to continuing to produce great returns for you all.

Sincerely,

Bob Robotti

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