60 East 42nd Street
Suite 3100
New York, NY 10165-0057
**www.robotti.com**

December 31, 2017

Dear Client,

Contrary to what many market prognosticators would have predicted on January 1, 2017, worldwide equity markets performed very well last year. The call at the beginning of the year was for modest returns, but with the risk of disaster should the Fed aggressively raise rates. What we saw were three separate rate hikes without the 'expected' fallout. What is our conclusion? Market prognosticators know no more than the rest of us and deferring to them can be dangerous to your net worth.

As with most equity investors, 2017 was a very good year for us. We significantly outperformed the 10% return of our benchmark, The Russell 2500 Value Index. When I started this firm over three decades ago, we started with the concept that fundamental bottom-up stock research would allow us to identify companies that would outperform the market. We believe this process has, and will continue to help us identify opportunities that exist in the market. As always, our stock selection is the key to our long-term results.

**The Bull Market of 2017**

I was recently given a Christmas card that showed a cartoon of Jim Cramer telling his 'mad money' audience that rule #6 of a bull market is, "don't think about valuation." This is a frequent and recurring refrain in equity markets. Recall the Nifty 50 Stocks of the '60s. Then the refrain was 'buy them and forget them.' Of course in the internet bubble, enthusiasm for companies that had no business, let alone an extended valuation, was standard. So I can't say I'm surprised. In a world where 60% of US trading volume comes from robots, it's not shocking to see that momentum has reigned as king.

I don't think you'll be stunned to hear that I have a crazy notion that valuation *is* important and you should think about it, especially in a bull market. Valuation is the real litmus test for whether or not you are investing or speculating. Understanding the business, the balance sheet, the ownership and so on, is crucial to determining that valuation. Business fundamentals are the driver of performance, which is why we stick to what we know. In this era of momentum and speculation (see bitcoin mania if you don't believe it exists) value investors have a massive opportunity. The more money that flows without regard to valuation, the larger the disparity between price and value can become. As always, a market with this kind of disconnect is a value investor's friend, and stock selection will make the difference.

**Homebuilding**

This past year, two of our top five contributors to performance were related to homebuilding (Builders FirstSource and Cavco Industries). We spoke in depth about the opportunities in this industry in our Q3 letter, so I'll try not to rehash too much here. I'll just say that our base premise is that single family homebuilding is driven by demographic trends, and while headwinds exist, the long-term trend should win out over time. In an industry that is producing single family houses at more than 20% below the 50 year average (while the number of households

is 2x) there is a huge opportunity for reversion to a higher mean. While we did overbuild in the lead up to 2008, the pendulum has swung too far in the opposite direction (as is often the case).

Cyclical businesses go through catharsis, and that is what we have seen in homebuilding. Competitors have consolidated or gone out of business and cost structures have improved. The result is growth in the normalized earnings power of the survivors. All of these factors provide us with confidence that our investments in this industry remain extremely well positioned for continued growth.

One of our top contributors to performance this year was Cavco Industries, Inc. (Nasdaq:CVCO). Cavco produces manufactured homes. It is a well managed, well financed company that fought through a cyclical depression. Cavco endured a decade plus downturn, but was able to consolidate two of the larger competitors in Palm Harbor and Fleetwood during that time. Like many housing related companies, 2017 was a good year for the stock. We continue to believe that manufactured homes are a more efficient way to build a home than traditional site building. By building in a controlled environment, you can better ensure quality and reduce mistakes. The headwind to the industry has been mostly regulatory, as site built homes were given preferential regulatory treatment over manufactured ones. As lending opens up for manufactured homes, we believe we should see a significant tailwind for the industry.

This year also started off with a significant corporate action in the manufactured housing industry, as two of the larger manufactured housing companies (Skyline and Champion) agreed to combine. Three companies will control 80% of the market (Clayton Homes, a Berkshire company, Cavco and the new Champion). Strong fundamentals, deregulation and a consolidated industry in our opinion should provide a very promising 2018 for the manufactured housing industry and for Cavco.

**Energy**

Fake news is real, in yet another context. What I mean to say is that articles in newspapers are generally written by reporters with above-average writing skills, but potentially limited knowledge of the core tenants of the businesses they are writing about. Journalists writing about energy will often end up reporting what people tell them or what makes a provocative headline. We think this has led to a large misunderstanding about the real dynamics of the energy markets. An important data point is that oil prices are up nearly 20% in 2017, yet as a sector energy is underperforming. While one of our largest contributors was in energy (Subsea 7 was up 19.5%) the industry struggled last year (Philadelphia Oil Services Index down 18.6%), despite fundamentals improving. We believe many individual energy securities are disconnected from this development. Understanding the economics of the business, we also believe this oil price recovery is fact based and sustainable (with undoubted interim volatility).

It feels like it was not that long ago that we were talking about peak oil supply - when the world would run out of oil. Today the great fear is peak oil demand. We fully appreciate the new economy, replete with ride sharing apps, electric cars and cost effective renewable energy. (I don’t even own a car anymore – I am officially part of the new millennial economy!) The headlines about the death of conventional energy are certainly attention-grabbing, and like all good stories are at least somewhat based in fact. Demand will be affected by these changes to usage. That cannot be denied, but the story gets interesting from an investment perspective when you look at the facts that are being ignored.

U.S. onshore shale oil producers’ claims about their profitability at lower oil prices has caused a misunderstanding of the economics of the industry. Onshore producers told investors that they are economic at $50 a barrel – something we wholeheartedly disagree with (and the huge funding shortfall confirmed). These claims, and subsequent actions, exacerbate the issues in the industry, creating what we believe is a plausible risk over the next

year or two that we are actually *short* oil. This in turn would lead to higher oil prices. This profitability claim from onshore producers created the perception that offshore production was not viable. The truth is that at the same time, offshore economics have dramatically improved due to the cathartic process of lower prices pushing technological advancement, cost cutting and process changes. As the onshore producers struggle to generate returns at current prices, a significant part of the reserve replacement will likely come from offshore. We believe the valuations of our energy investments are compelling. The fundamentals give strong support to our positions today.

**<u>Conclusion</u>**

We are entering 2018 energized by the opportunities on the horizon and are excited to continue working towards providing you with great returns. We are cognizant that corrections are an inevitability, but are comfortable with our stock selection.

I am humbled to have clients like you, who understand our process and without whom our job would not only be more difficult, but less enjoyable. Thank you, and we wish you and your families the best in this coming year.

All the Best,

Bob Robotti

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