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Dear Clients,

We want to reflect on the 2012 year, our current positions, and give you our thoughts on the future outlook.

Our Results

2012 was a year in which a number of our investments performed well. As a result, The Robotti Value Equity Composite[i] did well on an absolute basis (up over 20%) and a relative basis when compared to both the S&P 500 (up 16.00%), a measure of the vast majority of the publically investable capital, and the Russell 2500 Value Index (up 19.21%), an index of companies we believe most closely represents the universe we invest in.

	Value Equity Composite, Net	Benchmark[ii]
2012	22.54%	19.21
COMPOUND ANNUAL GROWTH RATE (THROUGH YEAR END 2012)		
3 Year	11.56%	13.35%
5 Year	3.63%	4.16%
20 Year Inception	13.04%	8.59%

Overview

We note that in 2012 we saw the continuation of a number of trends that have been underway for many years now. One particular trend we continue to see is the flow of capital from equities into bonds, which is exemplified by the chart on the right.[1] We feel that this continued outflow from equities exemplifies the tendency of investors to let the certainty of the past hold sway when confronted with the uncertainty of tomorrow. As the recent past is freshest in our minds, humans are drawn to conclude that it is a solid indicator of future performance. Viewed through this flawed framework of history dictating the future, equities will at best provide no return and possibly worse, negative returns. Additionally, as bonds have

Fig. 7: U.S. Cumulative Fund Flows Since 1996 ($BN)

Source: BAML. 1996-2002 data from Lipper FMI, 2002-onwards from EPFR Global.

[1] Morningstar Perspectives – 2012 in Review

performed well for decades they provide a seemingly safer place for capital. We believe this view is fraught with risks.

A number of uncertainties that are present today seem to support the "out of equities, into bonds" shift: the potential for the economy to continue being weak, the erosion of the United States' economic viability versus the rest of the world (with the possible exception of Europe), our Government's inability to cure our financial deficit, and Europe's severe risk of the EU imploding. Add to the above China, which has been an engine of world growth for a decade, beginning to decelerate. All of these facts continue to concern investors and dampen equity valuations.

As we mentioned last year, a 12 year period of flat equity returns has helped popularize the notion that "buy and hold is dead," and that the only way to effectively beat the market is to time it. Studies demonstrating the notion that equity market volatility compounds the irrationality of a "buy and hold" strategy are published with some regularity. The conclusion and logical course of action if one believed these studies is that investors should care little about what they buy, but rather, focus only on the when. We, of course, find this logic thoroughly flawed—we think that it is far more important to focus on "the what" and not as much on "the when." Our results have seemed to support our intuition that buy and hold still lives.

Our Investment Approach

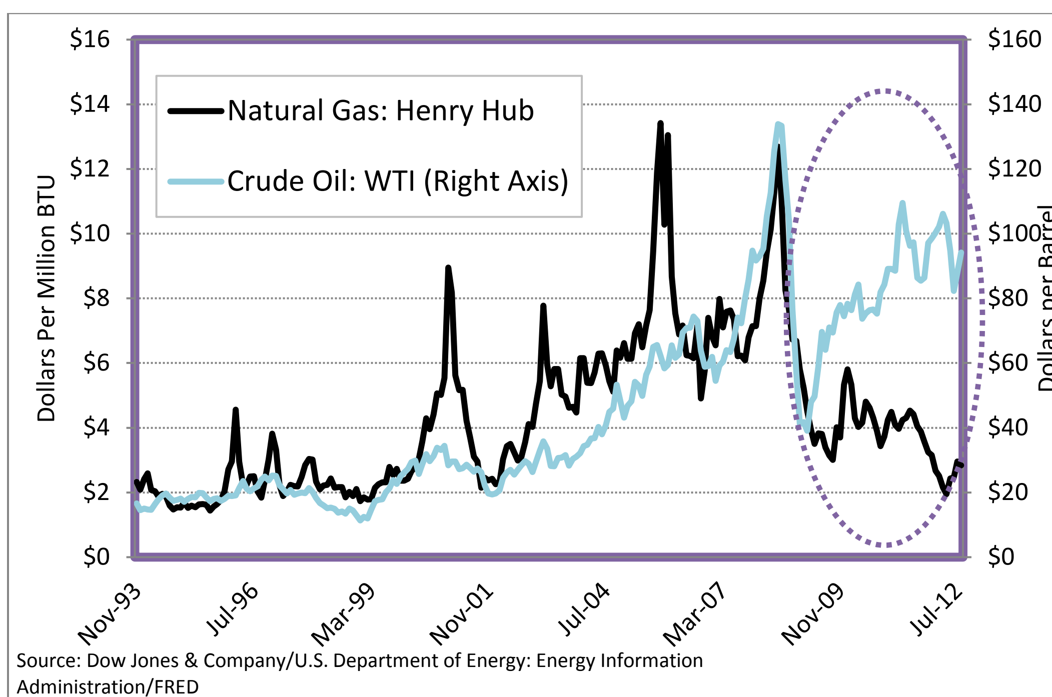
We invest in companies and industries that our research indicates are trading in the stock market at prices significantly below their intrinsic economic value. More often than not these companies and industries are going through difficult periods. As such, most investors do not like investing in them. The nature of the negative side of a cycle usually means that there is significant selling pressure. We accept that this means the market price of these investments will most likely continue to decline in the short term, and their contributions to our overall performance will be initially negative. Despite short term gyrations in market prices, our experience tells us that if we are right in our assessment of the intrinsic value of a company, our patience and conviction can pay off in multitudes over time.

How Our Portfolios are Invested Today

As mentioned above, we are invested in companies we believe are undervalued by the market. As you would expect with long term investors like us, our investments today are generally the same as when we entered the year, with the exception of a new core position added in Calfrac (TSE:CFW), and the closing out of our positions in Nexen (TSE:NXY) and Newmarket (NYSE:NEU), two long term holdings. Additionally, an important part of our stock selection process entails opening small positions, which as we become more familiar with management we may add to or exit. As such, we have opened and closed several positions over 2012, in addition to the three major changes mentioned above.

North American Natural Gas

Our view of the future holds an era of resurgence for the US economy. That view is colored by our long experience in energy investing. The driver of the US economy is competitively advantaged energy prices, driven by the technological advances developed by US based companies. The ability to drill wells horizontally through extremely long distances in marginally permeable rock, and to then fracture the tight rock formation to unleash trapped natural gas, has dramatically altered the quantity of recoverable oil and gas domestically. The fact that this natural gas is not currently exportable (nor do we believe it will be for at least the next five years) means that US industrial businesses have competitive advantages for the foreseeable future. The chart below highlights the cost differential of energy prices using oil, determined by world prices, versus natural gas, determined by regional prices.



Oil & Natural Gas Prices in the U.S.

Today North American natural gas prices are 1/5 the price of the equivalent energy output from oil. This disparity has already resulted in increased domestic manufacturing activity which will accelerate and drive substantial capital investment. The advantage is not limited to the oil & gas business, but benefits many industries which also tend to have much higher wage rates than many service businesses.

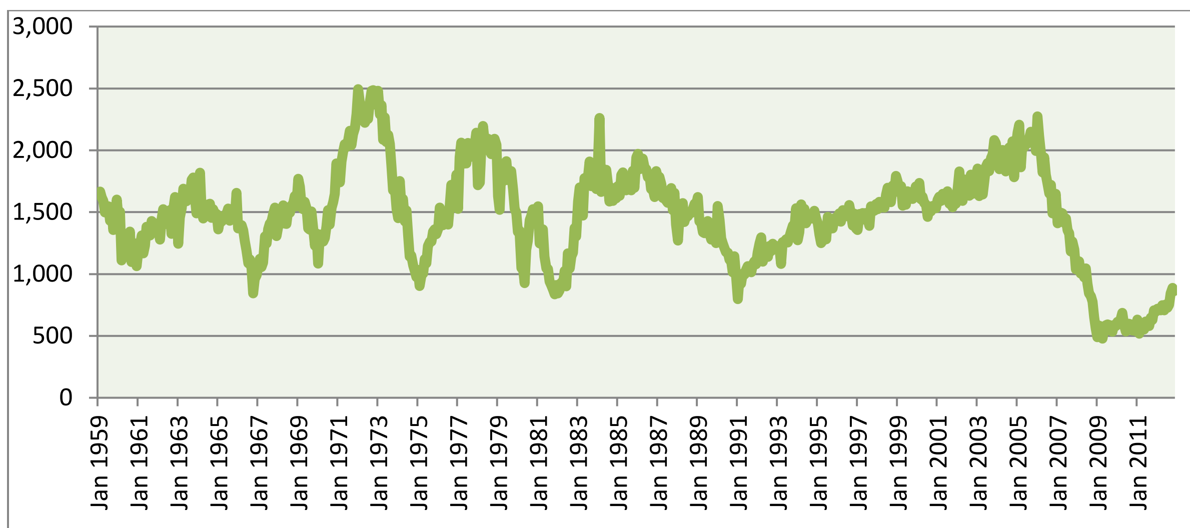
Slightly less than 10% of the strategy is invested in energy service companies which will benefit from the increased demand for their services in developing these resources. Additionally, over 10% of the strategy is invested in companies that will be direct beneficiaries of lower energy costs and therefore will see increasing activity levels and profits. We continue to research other companies with attractive valuations that can expand this trend.

As is often the case when we pick a theme or an investment, we often enter early. In 2012, North American natural gas prices continued to be weak, which in the short term has caused our investments in them to be detractors from our portfolio's performance. These systematic advantages that are not yet reflected in stock prices should reap their rewards once the long-term price picks up. During this time of price weakness, we have added to these positions, as we have strong conviction and believe we are only strengthening our future potential.

U.S. Homebuilding

As I believe you all know, we regularly look to invest in businesses/industries that we believe are cyclically depressed. We believe that current valuations determined by the recent depressed business levels are not related to the earnings potential of these businesses in a normalized environment. This provides significant opportunities. In addition to the very sizable rebounds which will inevitably unfold in a normalized environment, we have found that companies suffering through these downturns are frequently improved by the process. To survive the slowdown, businesses are rationalized, competitors depart, and the overall strategic position of the survivors is frequently improved.

Today, almost 20% of the strategy is invested in companies which are directly tied to US homebuilding activity. There is a reasonable percentage of the portfolio that may also indirectly benefit. Over the past year, investors decided that homebuilding activity in the US would not stay at recent anemic levels, and as such the market for these companies already exhibited the beginnings of a sizable recovery. As a result, our holdings in this area contributed significantly to our performance. To that end, in 2012 three of our top five contributors to composite performance were housing related investments. This turnaround can be seen beginning in the uptick in the chart below. We believe the runway is exceptionally long for these investments. We are not sure of the timing, but as the chart also makes clear, the normalized rate of activity is a multiple of even the current improved level of activity.

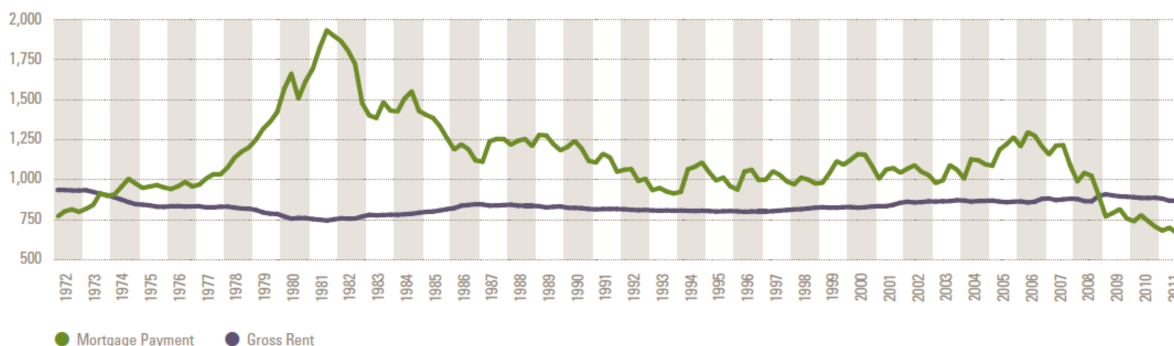


Housing Units Started in the U.S. – Seasonally Adjusted Annual Rate
Source: US Census http://www.census.gov/construction/nrc/historical_data/

The chart above shows an improved level of new home starts in 2012 that is far below its historical trend line. Between 1993 and the middle of 2007, the new home starts number never fell below 1 million homes, but since the middle of 2008 that number has averaged nearly half of that minimum level of five-hundred thousand homes. Add to this the fact that the affordability of home ownership versus renting has never been better, and one can see the pressure moving housing back to the historic norm.

Mortgage Payments Have Become More Affordable Relative to Rents

Monthly Housing Costs (2011 dollars)



Notes: Monthly mortgage payments are based on the median existing home price from the National Association of Realtors® and assume a 20-percent downpayment and a 30-year fixed-rate mortgage at the average rate for the quarter reported by Freddie Mac. The monthly gross rent is the median gross rent from the 2010 American Community Survey indexed to the Consumer Price Index for Rent of Primary Residence. Both series are adjusted for inflation using the CPI-U for All Items.
Sources: JCHS tabulations of Freddie Mac, Primary Mortgage Market Survey; National Association of Realtors®; US Census Bureau, 2010 American Community Survey; and US Bureau of Economic Analysis, Consumer Price Indices.

Over the longer run, the most important drivers of household growth are the size and age structure of the adult population. Assuming the economic recovery is sustained in the next few years, the growth and aging of the current population alone—including the entrance of the echo boomers into adulthood—should support the addition of about 1 million new households per year over the next decade. The biggest unknown is the contribution of immigration to overall population growth. Even assuming net inflows are roughly half the level in the Census Bureau's 2008 projection, the Joint Center for Housing Studies projects household growth should still average 1.18 million a year in the 2010 through 2020 period. The upside, though uncertain in its timing, argues for a sustainable level over 2x its current one. Given the nature of most of these businesses, the upside in profitability could be dramatic.

Subsea 7

Any discussion of our portfolio today would be remiss without some discussion of our largest position, Subsea 7 (OB:SUBC). During 2012 Subsea rebounded from its depressed valuation at year end 2011. As for fundamentals, this continues to be a story of realization deferred. The number of projects and scale continues to grow. The fleet of offshore drilling rigs drilling new wells continues to expand. The barriers to entry into the business grow larger (Allseas JV with Technip); however, project awards continued to be delayed. In recent months, contract awards have picked up (booking of new contracts versus project revenue is approaching 2 to 1). This trend should continue to accelerate, and when it does, the growth in revenues and profits should be clearly visible. This should be a positive for Subsea 7 shares.

Stolt-Nielsen

Another important investment is our position in Stolt-Nielsen (OB:SNI), a company focused on providing storage and shipping services to the world's chemical industry. For 2012 the position made no contribution to performance. Despite Stolt's flat price in 2012, a number of positive developments occurred: continued expansion of its terminal and container services business, financial difficulties for important competitors, improved outlook for the growth in chemical manufacturing in North America (again, driven by cheap domestic gas), and increased demand from the Middle East for more ton miles of shipping to Asian markets.

In December, private equity invested in the terminal business of a competitor, Odfjell, confirming our valuation of that segment of the business, and bolstering our belief in the company's valuation as approaching $50/share (versus its year end closing price of slightly more than $20/share.) This leaves plenty of room for appreciation.

Conclusion

If recent years have shown us anything, it is to expect the unexpected. However, our approach to investing remains consistent – investing in companies that we believe are extremely undervalued. The good news to our modest performance in recent years is that our companies have continued to increase their economic intrinsic value without much price appreciation – therefore the differential between price and value has widened and should provide support should difficulties emerge and also offer substantial appreciation potential in future periods. We appreciate your ongoing belief in our work. We look forward to continuing to reward your patience.

Most Sincerely,

Bob Robotti

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[i] The Value Equity Composite has been defined and created to include all fee paying, discretionary accounts with an initial size of $100,000 or more that are managed with an objective of capital appreciation through the purchase and sale of primarily equity securities that, at the time of purchase, are small to mid-cap and that have been selling for significantly less than their intrinsic value or those that may grow their intrinsic value at above average rates. This composite was created in December 2001. The Investment results of the Value Equity Composite are only for illustration purposes and it cannot be assumed that future results will be reflective of this past performance. Performance of this composite has been calculated using U.S. Dollars. These results were calculated based on reinvestment of dividends and other earnings. Individual account performance may vary.

[ii] As of September 1, 2011, the benchmark for this composite has been changed from the Russell 2000 Index to the Russell 2500 Value Index. The index was changed to better reflect the composite's holdings and strategy; because of the firm's buy-and-hold strategy, positions that were small-cap when purchased may have grown or merged to become mid-cap or larger companies, and holding larger cap positions is a natural evolution of this strategy. The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Index measures the performance of those Russell 2000 companies which represent the 2000 smallest companies in the Russell 3000 Index. As the Russell 2500 Value includes both small and mid-cap companies, the Firm believes it is a more appropriate benchmark for the composite.

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