ROBOTTI
& COMPANY
ADVISORS, LLC

Investment Securities

One Grand Central Place
60 East 42nd Street, Suite 3100
New York, NY 10165-0057
Phone: (212) 986-4800
Fax: (212) 986-0816

December 31st, 2016

Dear Client,

Another year is in the books, and although we have said many times that one should be careful about judging investment performance based upon any single year, we cannot deny that even stalwarts like us welcome occasional market affirmation. Handily beating our benchmark, which itself was up over 25% may provide you with facts to support your belief in our investment approach. I hope you'll take a moment to look at your results for this year.

A Year to Remember

2016. To say this was a unique year seems like quite an understatement. From billboards across Manhattan not-so-fondly bidding the year adieu, to a historically divisive political campaign, this year has certainly created a lot of friction. Friction is derived from quick, repeated changes in direction. The most obvious example of friction we saw this year was from the predicted outcomes of several major events, and what actually happened. [e.g. Brexit, President-Elect Trump, etc.]

Bye bye Miss American Pie. 2016 was the year the prediction died.

Human ability to predict is an integral part of what makes us the most successful animal on the planet. In order to live our daily lives, we must constantly consider how our current actions will affect our future. These actions can range from the immediate – putting money in a parking meter to not get a ticket, to the distant – a 26 year old putting money in their 401k to save for retirement. Our minds are supercomputers running endless simulations on each and every decision that we make.

That said, there are significant limitations to our predictive ability. While we are good at predicting what outcomes our actions will have, we are fairly poor at predicting the actions & outcomes of those around us, and even worse at predicting for those we've never met. The further we get away from what we know, the harder it becomes. Unfortunately our confidence doesn't diminish at the same rate as our effectiveness to forecast.

We continue to believe that specific dedicated focus on trying to predict general macro trends is a poor use of our time. There may be some investors who are adept at this, but they are extremely rare and we have enough self-awareness to know we are not among them. Yet, we understand that macroeconomic trends are very important to the performance of our investments.

No business operates in a vacuum. Macro level trends do significantly affect businesses. Whether it is making strategic decisions, deciding upon capital allocation policies or forecasting cash flow generation, the macroeconomic environment plays a significant role. So how do we reconcile this apparent contradiction of not spending time specifically attempting to predict general macroeconomic trends, when we know certain trends play an important role in our investment process? We temper all such deliberations knowing there are three common mistakes made in predictions: timing, recency and unknown knowns.

Timing

Think back on many of the predictions you've heard this year. When will interest rates rise? When will oil prices change? These focus on the when. Logically, predictions are generally most wrong whenever we reach an extreme. The dearth of people who predicted the housing crash serves as case in point. Instead of focusing on timing, for example, we understand that today's supply/demand for oil is unsustainable and therefore will have to correct. We can't predict when, but when looking at the bigger picture, the facts indicate a very likely eventuality.

Recency

You can get used to anything if you live it long enough. For example, interest rates have been low for so long, people have come to think of 0% as normal, but it is ***the lowest interest rate environment in over 5,000 years***[1]. Quickly people will accept an irrationality as normal if they are constantly exposed to it. They then incorporate this new normal in their predictions of the future, often to their detriment.

Unknowns Knowns

When thinking about the future it is important for us to know what we can predict and what we can't. We have no predictive ability to guess when the next war will break out, what the weather will be tomorrow, or whether oil will be over $60 by the end of Q1. However, we do understand the economics of businesses that we follow, and are able to analyze important long term supply/demand dynamics to determine a range of likely outcomes, and invest accordingly in the mispriced.

By focusing on companies that lie within our core competency, analyzing if events will happen not when they will, and avoiding recency bias we don't delude ourselves into thinking we know things we do not. Instead we focus on valuing businesses. We assess earnings potentials, balance sheets, supply dynamics, and then compare them to the prices people were willing to pay.

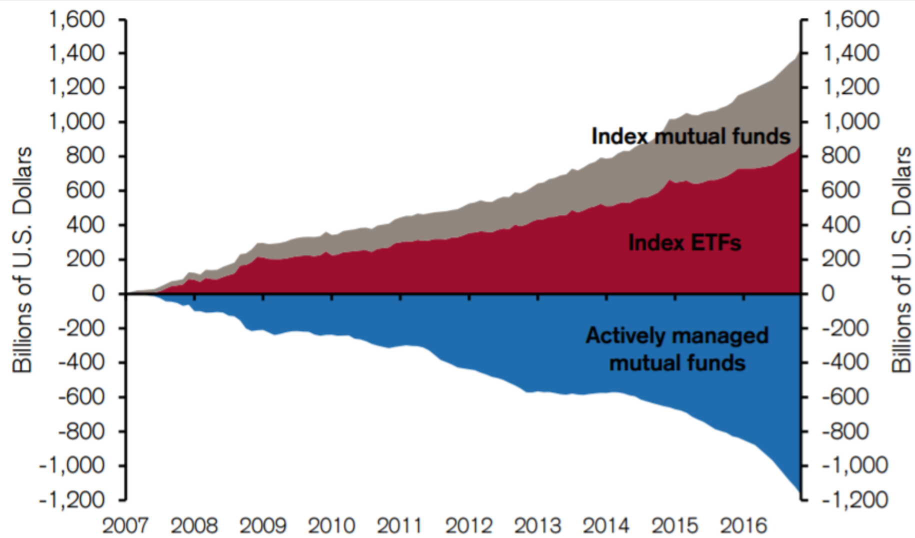
[1] Sydney Homer's A History of Interest Rates

(Remember, valuation is king!) As our performance this year indicates, we think it was a better use of our time.

Predicting the Death of Stock Pickers

Between 2007 and 2016 investors pulled almost $1.2 trillion out of U.S. actively managed funds while adding $1.4 trillion to U.S. equity index funds and exchange traded funds (ETFs).[2] According to FactSet a record $287.5 billion flowed into U.S Listed ETFs with $61.5 billion in the month of December alone. At the end of 2016 total U.S. listed ETF assets were $2.56 trillion.[3]

Exhibit 1: Flows from Active to Passive Funds in U.S. Equities



Source: Investment Company Institute; Simfund; Credit Suisse.
Note: U.S. domestic equity funds; 2016 figure as of 11/30/16.

The reason for the sudden acceleration of this trend is both simple and familiar: recent years' outperformance. A column this month in the Financial Times summed up the group think. Titled, "Follow the herd for now – contrarians should be sidelined" John Authers argues that you have to ride this wave of success, even if you know that the fundamentals don't add up. This should immediately bring to mind a bubble. We remember the immediate past with the most clarity, so it is human nature to think something that went up yesterday will do the same tomorrow.

In 2016 the media has all but pronounced the death of active management. Whereas the prevailing question was once "Does *passive* investing have a place in my portfolio?" the question is now, "Does *active* investing have a place?"

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[2] *Looking for Easy Games: How Passive Investing Shapes Active Management*, Credit Suisse 1/4/17
[3] ETF's Close Out Year With $2.56 Trillion in Assets: www.etf.com

The prevalent prediction to be drawn from this is that active management (where a portfolio manager selects individual securities) will continue to fade into obscurity, while passive management (which mirrors the returns of particular index or selects securities based on fixed parameters) grows forever. Investing with active managers such as ourselves has, in fact, become contrarian! And as you know, while we do not advocate being different for difference's sake, we do believe that most great investment opportunities, when supported by sufficient facts and data, are contrarian in nature.

Dusting off some grade school geometry proof lessons, one can argue:

If	Contrarian = Active Management
And	Contrarian (supported by evidence) = Investment Opportunity
∴	Active Management = Investment Opportunity

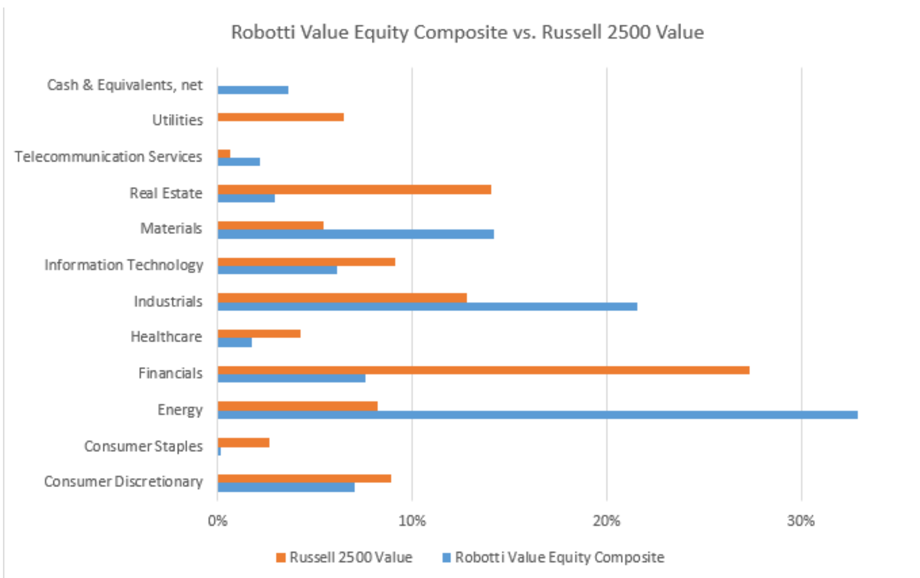
The critical question is whether there is enough evidence here to support a contrarian view? Is the herd correct in this case and should contrarians either join along or move to the sidelines? We believe the answer is an emphatic "No." This difference in approach highlights the 'timing' issue we explained earlier. The massive flow of capital into passive investment strategies puts investors at an increasing level of risk. In his FT article, Authers acknowledges that "there is more money to be made when you latch on to an unpopular notion that turns out to be correct," but then goes on to recommend following the herd.

In fact, a report published on January 4, 2017 by Michael Mauboussin, a Columbia Business School Professor and Head of Global Financial Strategies at Credit Suisse, stated that "there is growing evidence that passive investing may lead to less efficient prices and an increase in market fragility associated with lower liquidity." Index funds invest without regard to the quality of a business, its management or its corporate governance. As always, an inefficient market is a value investor's friend.

Most importantly, the majority of popular indexes invest without regard to price. As an active manager for over 30 years, I built Robotti & Company upon the notion that the market price of a security does not necessarily indicate its true economic worth. With deep fundamental research, a thorough understanding of the economics of a business and a belief in management's ability to run the business and allocate capital, we think it is possible to find dislocations in the market that can be a source of profitable financial opportunities. When an index rises in price the passive funds that mirror them, by their nature, must buy more shares at higher prices regardless of whether intrinsic value has kept pace. Today, the popular indexes are buying consumer staples and other shares at all-time high valuation multiples. As money flows into passive strategies increasing prices become self-fulfilling prophecy attracting even more capital. On the other hand, money flowing out of active managers who focus on fundamentals leads to an even greater discrepancy between price and value creating opportunities for woebegone stock pickers. Eventually intrinsic value, the true economic value of businesses will become so apparent the market won't be able to ignore them. This is why we believe there is still a tremendous opportunity in our portfolio, which is populated with companies perceived unpopular. That is how we bought them cheap.

<u>Our Portfolio</u>

Below is a snapshot of what sectors we are invested in for the composite of accounts compared to our benchmark. As you will notice, we have a significant overweighting in energy (even for us). This was initially predicated on the fact that we saw a tremendous opportunity in that sector, and has been compounded by the high returns we enjoyed in 2016.



Source: S&P Capial IQ

One of the biggest contributors to our outperformance this year was Subsea 7 (OB:SUBC), with shares rising nearly 75% in 2016. Even still, plenty of naysayers remain. New contract awards have been sparse and the backlog continues to be whittled down. As a counterbalance, the company's execution has been stellar (margins are at all-time highs). This has resulted in the company maintaining an excess cash balance that continues to increase; as of the most recent reporting period cash exceeded all debts by over $900M, almost $3 per share. The company's balance sheet has never been stronger. In part, this strong performance has been enabled by the company's downsizing of headcount and assets (from 14,000 employees to 8,000 and from 44 vessels to 29 active today. Much of this restructuring will be retained when recovery returns, therefore improving the company's earnings outlook. Should the business continue to contract, further adjustments will be made.

We also see the competitive landscape continuing to improve for Subsea 7. Certain contenders have disappeared or withdrawn from the business; others are financially troubled and their futures are uncertain. Yet Subsea 7 and its main competitor Technip continue to demonstrate engineering capabilities that enable them to deliver differentiated solutions that help make projects economic in this new environment. Each has partnered with best-in-class equipment manufacturers which only adds to further differentiation; specifically, Subsea 7 has formed an alliance with Schlumberger (OneSubsea), a leader in oil & gas equipment designs. Just this month the alliance was awarded a contract in the US Gulf from Murphy Oil for a long tieback. In the next year or so, oil companies should opt to pursue these sorts of options with increasing regularity. Once again, the landscape Subsea 7 competes in continues to improve. Our research gives us conviction that many deepwater projects have been reengineered, the scopes scaled back and costs dramatically reduced. Many of these past discoveries are very economic today. We believe the ingredients for a recovery are apparent and approaching. Oil price stability, even measured at current levels, should result in new contract awards.

So that begs the headline-grabbing question, “What’s the price of oil?”

As I’m sure you read in the papers, OPEC and certain non-OPEC producing countries have tentatively agreed to scale back production. Markets immediately reacted favorably to oil commodity prices and companies perceived to be affected.

While that development consumes the headlines, I will caution you; only time will tell if these production cuts actually come to fruition. That said, I'd suggest these cuts are more the ‘tail’ rather than the ‘dog.’ The ‘dog’ in my view is the ***demand for oil*** over the next few years ***versus its supply***. On this all important equation, I see demand continuing its slow growth while the supply produced from existing completed wellbores continues its inexorable decline. That supply is not being replaced as capital investment in drilling and completing new wells continues at a fraction of where it has been for many years. That shortage of reinvestment will continue for the short term further limiting new supply. There is reason to believe that the market today is already balanced. In any case, limited reinvestment and depletion of existing wells pushes us closer to tight supplies. If certain producers actually cut back current production then prices will continue to increase. New drilling and completions will be needed.

We look forward to the coming year as industry activity begins its recovery. This will focus investors on the earnings power of Subsea 7, which we believe is already significantly enhanced, both by internal restructurings and external developments. Internally, process enhancements have reduced cost – not only temporarily, but permanently. More importantly, Subsea 7 has increased its competitive differentiation through new engineered solutions and best-in-class alliances. Externally, the competitive landscape has improved with competition attrition and excess asset availability (if and when needed). As they say in those late night TV commercials – “But wait…there’s more.” The company has over $900 million in net cash, fully undrawn credit lines of $1.1B billion and an anticipated outlook of free cash flow generation, which are all latent opportunities for strategic investments here, at a low point in the market cycle (e.g. its acquisition of Swagelining Limited, the subsea industry's leading polymer lining technologist, to further expand existing polymer pipeline technology interests). We believe any such capital deployment should further enhance its earning potential.

Conclusion

It will be an interesting year on many fronts. We look forward to staying close to the companies we've invested in and attuned to opportunities that the market may present to us. We hope that you and your family had a happy holiday, and we wish you the best in the coming year. As always, thank you for your trust.

Sincerely,

Bob Robotti

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