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Dear Client,

I'm sure this last quarter has been as financially gut wrenching for you as it has been for me. I feel much like a school bus driver that loving parents have entrusted with their children's safety. As the portfolio manager of your accounts you too have entrusted me - with the safety of your hard-earned savings. In this past quarter the weather has been particularly treacherous and the roads are dangerous and icy. Under such conditions, there is no substitute for an experienced driver.

At times like this I realize it is particularly important for me to give you an update on where we are on our trip and to help give you appropriate comfort that your children are safe, well cared for and we anticipate getting them home to you safely.

Robotti & Company Advisors Mandate

At Robotti & Company Advisors we have always been focused on producing returns for clients, net of all fees and expenses, which "beat the market."

Simple but not easy! So how do we accomplish this?

Legendary investor Sir John Templeton long ago indicated that in order to achieve the goal of outperforming the market you must do something different than the market. The goal is not to be different for its own sake but to outperform by investing differently which requires expertise in a specialty. This specialty for us is investing in value stocks, which often tend to be prosaic businesses. Most of our investments are in small cap value stocks. By applying a consistent investment approach we have been able to outperform the market over the long term.

Inevitable result - Periods of Underperforming the Major Indices – We Are Here Today

Our historical results highlight recurring periods of underperformance. This current period is the most prolonged example I have experienced in over 35 years. So what are we doing in response? We are remaining consistent with our time-tested, proven approach (yet still always alert to the risks of "this time is different" for the markets as a whole and our companies in particular).

Based on 40 years of experience we believe our investment methodology and theses are well thought through, and have proven successful in applying them over the long-term. Still, results over shorter timeframes are an easy and readily accessible yardstick investors can use to evaluate managers. What are investors supposed to believe – when we keep talking about a transient period of underperformance where we remain confident of higher returns within a reasonable timeframe – in the face of facts that seem so

clear and persistent? We've driven the "school bus" through treacherous conditions before and want to share the experience of those journeys with you.

Please, Don't Get Off the Bus

Firstly, I, and many who work here have experienced situations similar to this over and over. I am reminded of a partner who came to me in 1999 to tell me he was withdrawing as an investor. As a doctor, he had a fact based, well-reasoned explanation. He invested with us in 1995, and was not an experienced investor at the time. Subsequently, he began investing on his own in addition to his investment with us. He had learned a lot since then, and his results had been very good. Based on the (irrefutable) facts, he had become a much better investor than I with very strong returns especially in 1998 and 1999. In fact, my results had been abysmal. I lost money in both 1998 and 1999 when everyone was making money. I had "lost it." Again, the results supported that reasoned conclusion.

As you are all aware, there is a mandated warning that accompanies all investment performance reporting that "past performance may not be indicative of future returns." The valuation gulf between the winners of 1998-1999 and the losers of that period (my portfolio) reached the tipping point. Between 2000 and 2004 the S&P 500 experienced an average decline of 2.3% per annum, while our clients enjoyed over 16.5% annual compounded returns. Do the math and you will realize client capital increased 2.15 times. This is clearly evidenced when you review the five year rolling returns of our Robotti Value Equity Composite.

Just as I told that doctor client at the time... "I understand it is self-serving to say, but based on my years of investing experience, the future may be different than what you think the facts are telling you."

It pains me to realize he locked in a mark-to-market loss with us and missed the dramatic recovery, most likely compounding his losses when he invested the capital into previous 'winners' his experience had lead him to invest in.

History Rhymes

To borrow from Mark Twain, the history of securities markets is a story that has many rhymes. Yet, it seems the lessons of this story remain hidden in plain view when one is in the moment. Chuck Prince, former CEO of Citigroup, summed up the reason why no matter how many times we have this similar experience, the lessons remain unlearned. In 2007 he responded to concerns of global leverage and liquidity by explaining, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Complicated doesn't even begin to describe what happened when the music abruptly stopped.

Today, in the midst of another period of rhyme, the music just keeps getting louder attracting more and more dancers who eventually believe the narrative has forever changed, and that this time things are different, and this time the music won't stop. Yet the facts exist, and much like a rubber band stretched to the edge, the further it stretches, the more likely it snaps back.

Remember the '60s?

In the 1960's there was a group of stocks known as the "Nifty Fifty." These 50 companies were widely regarded as solid buy and hold growth stocks and are credited with propelling the bull market of the early 1970's. They became known as "one-decision" stocks since it was widely regarded that you could buy at any time and hold them forever. The Nifty Fifty represented some of the best and most loved companies in America, market leaders with records of solid earnings growth, increasing dividends and favorable prospects. You know most of those companies:

As capital poured into the Nifty Fifty, they started to be assigned extraordinarily high multiples. Price-to-earnings multiples of 50x were common. When the market turned in 1973-74 these stocks were hit hard and experienced a decade of underperformance. They remain a shining example of what happens when investors, influenced by a positive market sentiment, ignore fundamental stock valuation metrics. We are reminded of the truism that great companies may not always be good investments.

The bottom line is, these were very strong, well-managed businesses, but Mr. Market pushed valuations years, or perhaps decades, ahead of their fundamental value. While popularity (largely a measure of recent market performance) may drive capital, in the end the market is a "weighing machine" and underlying intrinsic value will eventually determine stock prices.

Today, we have the more twenty first century sounding FAANG (**F**acebook, **A**pple, **A**mazon, **N**etflix, and **G**oogle). The S&P 500 represents the best performing major market index over the last 5 years. Sometimes it is hard for investors to appreciate since it is the home team and we see it every day. The FAANG stocks collectively account for an overwhelming portion of the S&P 500's stellar performance. These are companies which appear to be (and probably are) "one-decision" stock holdings. They are viewed as extremely stable growth companies, even over long periods of time, reinforced by historical experience. Many of these companies were darlings in the dot-com era that crashed in the early 2000s, yet today have much higher market capitalizations than the peak of those days. This fact helps reinforce the current conviction on these companies. Yet, today earnings multiples are nowhere near as inflated and business fundamentals are light years ahead.

The Redistribution of Capital

So what drove us to the point where the 1%ers (the Five FAANGs) separated so much from the other market participants (S&P 500)?

The world has perfected new investment products that excel at picking "winning" stocks. In the mid-80's it was automatic or program trading and portfolio insurance which took human-decision making out of the equation leading to the worst one day performance in the history of the markets - October 19th, 1987 – down 22%! Today it is ETFs. The growth in ETFs has helped propel certain companies higher. As the growth in quantitative investing further pushes the winners ahead, this vortex sucks capital from elsewhere and propels winners to even higher valuations, while the rest are marked down. In recent times the market is replete with data that the vast majority of trades executed today do not come from a person's decision to buy or sell a specific security but from flows of capital into or between these cutting edge new investment products.

Another consequence of the growth in ETFs is how easy it is to invest capital into and take capital out of the "market." At the touch of a button, we can buy all kinds of baskets of securities. These baskets are weighted so the best performing stocks draw in more capital - companies sporting excellent long term records, specifically long term records of strong stock performance. Price or valuation has become a secondary concern, if it is even a concern at all. The weightings of the best performing stocks continue to draw an increasing percentage of dollars invested irrespective of any other financial consideration until the basket becomes over-weighted and out of balance. No wonder we often refer to this as reaching a tipping point.

We must remember that just as easily as investors can put capital in, they can also take it out. Recent months have seen just that. Even the market darlings have seen valuations pared dramatically. Modest valuations - replete throughout our portfolios this year - seem irrelevant today. Almost universally, the managers we know are going through the next round of redemptions and liquidations, forcing them to continue selling positions that already were heavily discounted relative to their intrinsic values. And there is no new capital being allocated to buy these bargains. This brings to mind a comment made by the legendary economist John Maynard Keynes - that "markets can stay irrational longer than you can stay solvent."

An Equal and Opposite Force - What Sets up the Opportunity?

Recently I visited with the founder of a very large investment firm. A very thoughtful investor who has built a firm with a strong investment process and excellent long term investment results for its clients. He lamented that for the last 5 years, every quarter they have seen net outflows of investor's capital. The capital flows have to come from somewhere! Assets have declined from $35 billion to $15 billion (and I'm sure less today). That means $20 billion of capital has been sucked out. Their portfolios have constantly been net sellers. I know they do quality investment research and invest in well managed, modestly valued companies – yet, I also know these stocks have been sold on the market pushing down market valuations for those companies as a direct result of the need to pay cash to exiting investors.

Importantly, their experience is not an isolated event. It is compounded by a long and growing list of managers with long term records of success, experiencing client capital withdrawals that lead to a vicious cycle of liquidations. You get the idea.

OK – so that's what is hidden in plain sight, but where's the tipping point?

That's the million dollar question.

Conversations with People who Should Understand

This week I spoke with a multibillion dollar family office. The family controls one of our portfolio companies - an excellent company with an excellent record in a prosaic hard asset business, producing things here in the US with a competitively advantaged, sustainable cost structure. They have a strong record of deploying capital opportunistically to grow the business, with strong returns on capital. Pretax profitability is up over 8x in 10 years without any share issuance, implying that they accomplished this through smart capital allocation. That's over a 20% annualized compound rate of growth – not too shabby!

The family's wealth is primarily invested in their family controlled public company, with the balance invested in "passive strategies" and private equity.

When Does Reality Have Its Day?

Why do we believe there is possibly a tipping point close at hand? ***Valuation, valuation, valuation.*** Consistent with my argument regarding the gap between market value vis-à-vis intrinsic value, the market price discounts of the "have-nots" have gapped wider. Cash flows are the ultimate litmus test for business valuations. Today our portfolios are replete with companies valued at very modest multiples of future free cash flows. These are companies with strong balance sheets and cash flow, which help protect investor's capital from long term capital loss - but NOT from market pessimism and discounting. Again, opportunity, not the economic reality.

For example, the family controlled company I just mentioned was trading at $120 per share earlier this year. Its earnings yield was about 12% while earnings have grown at over 20% annual compound rate over the last 10 years. We believed that valuation was very modest for a good business with cost competitive advantages, strong free cash flow and an accomplished management/owner with a record of reinvesting to increase shareholder value.

An important driver of their continuing growth is the acquisition of a key competitor a few years back which resulted in: reducing competition from 5 companies to 4, integrating complementary segments, investing in underinvested/mismanaged assets, and reducing overhead costs. As a direct result, earnings will trend higher as these advantages are fully realized. It is also cheap when compared to the low risk 10 year US treasury that yields slightly better than 3%. At $120 an investor can capture 4x the return from a business which should be growing, versus a stagnant 3% yield.

Let's see where we are today. The stock price has declined over 40% from the $120 price! Today it probably has a 20%+ earnings yield; over 6x the return on a 10 year US Treasury. *Valuation, valuation, valuation*. A dollar bill for 18 cents? Rubber bands that stretch this far have a tendency to snap back dramatically.

The family controlled company is emblematic; in the meeting I said, "Your family has done an excellent job of creating value for its owners." The family member responded "yes, thank you, except in recent times."

And there's the rub. Mr. Market has sold off shares with no regard to valuation and the deep discount on the company is a transient economic reality. It is, in fact, a tremendous opportunity! The company's shares are off almost 50% from their high earlier this year! The shares are grossly mispriced at 5x trailing earnings. And the family clearly knows this opportunity well, as evidenced by them wisely buying back their shares in the open market. Yet, instead of believing that the market is full of similar opportunities, they remain invested in passive vehicles that mostly chase rising stock prices and disregard opportunities created by the combination of falling stock prices and improving results – the same kind of situation for which they have a front row view.

My point to them was that the same thing is happening to many, many stocks in the market today providing investors with a huge opportunity!

History Frequently Rhymes - It Almost Never Repeats

Today, my 40 years of investing experience leads me to believe that many currently favored investments that have worked for several years now have more risk than is recognized, due to excess valuations. Even more relevant to us, stocks that have struggled for years are now less risky due to bargain valuations and provide the strongest potential future returns.

I didn't mention the name of the company, Westlake Chemical, in the discussion above because it is just one example of an opportunity of an increasingly bigger opportunity set. Companies experiencing poor stock price performance end up even more heavily discounted creating a vicious cycle based on stock price alone. Many of these companies, including those in our portfolio, have experienced increasingly positive results and find themselves in significantly better positions than when their stock prices were significantly higher. Improving results and reduced prices are a power combination.

I would point out that Ben Graham opens his historic work, *Security Analysis*, with a quote from the Roman poet Horace,

Many shall be restored that are now fallen, many shall fall that are now in honor.

Some truisms are timeless.

I deeply appreciate your providing us the opportunity to invest your hard-earned savings. We remain fully committed to investing alongside you as we search for superior returns on our capital and dedicate myself and my colleagues' efforts to that end on a daily basis.

As always, feel free to reach out with your questions or concerns.

Most Sincerely,

Bob Robotti

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