February 2018

Dear Client,

Enclosed are the return calculations for your account(s). Where applicable, three, five, ten-year and returns since inception are included as well. The S&P 500 returned 21.83% including dividends in 2017. Our composite returned 13.83% in 2017 (individual results may vary). Since inception on 01/01/2000, our composite has returned 314% vs. 157.75% for the S&P 500 with dividends. That represents a compound annual return of 8.21% for the composite vs. 5.40% for the S&P 500 with dividends.

It has now been almost ten years since the financial meltdown and accompanying recession of 2008. The S&P 500 has more than quadrupled from its March 2009 low and continues its seemingly relentless climb into the new year. With the reduction of the corporate tax rate from 35% to 21% and the continued very low level of interest rates, the aggregate increase in stock prices does not appear to be overly extreme but rather a rational response to the current investment landscape. The reduction in the corporate tax rate "transferred" ownership of 14% of a company's profits from one group - the government- to another- shareholders. That alone is a fairly significant event and increases the value of corporate equity.

Of course we are not in the business of forecasting the near-term direction of the stock market; a large component of what we do is an attempt at finding a "disconnect" between a company's share price and its intrinsic value. We have discussed some of the reasons for the "disconnect" in previous letters and will instead focus here on a real world example involving one of the larger security positions we referenced in last year's letter.

We mentioned Calgon Carbon in last year's letter as a position we had increased as the share price fell and one whose prospects weren't, we felt, accurately reflected in its share price. The shares ended 2016 at $17.30 and fell to $12 by late August 2017. We bought into the decline and made our last purchase on 08/24/17 at $12.14. On 09/21/2017 Kuraray Co., Ltd. of Japan made an offer to acquire the company for $21.50. It would be tempting to think that Kuraray's offer- a 77% premium over the prior month's price- reflected a dramatically improved picture for the company's principle product, activated carbon. It didn't; there was no change in the industry's or company's prospects from one month to the next. What the depressed share price instead reflected was the irrational pricing of a business by the stock market. This tendency by the market to frequently undervalue businesses is likely exacerbated by trading algorithms that blindly sell a security when an industry, or company, experiences some transitory negative news. This algorithmic selling (or buying) is often completely robotic, with no attention paid to business value, and all of the focus on recent news flow and price action. The rise of passive

investing utilizing ETFs has also contributed to creating these pricing “disconnects” since it is the mechanical flow of funds rather than any reasoned assessment of company’s valuation that determines where the investment dollars wind up. Those of us who have been around for a while have seen a variant of this type of strategy employed before; in the early 2000’s it was known as momentum investing and it ended poorly for most participants.

The example above was used to illustrate how in the short-term the stock market is often inefficient and how investors who diligently research businesses can be rewarded. In the case of Calgon Carbon, we were very certain given the favorable outlook for the industry, the multiples paid for acquisitions of very similar competitors and the skilled management at the company, we were getting a bargain. Our outcome with Calgon is by no means unique; over the years we have made many investments that have resulted in takeovers at significant premiums to quoted share prices.

In 2017 we increased our position in CNX Resources and initiated a new position in United Continental Holdings. CNX Resources is principally a natural gas producer operating primarily in the Appalachian Basin. The company owns over a million net acres of land in the Marcellus and Utica shales. Other exploration companies that lease land must make royalty payments and have to drill in order to maintain rights. CNX can be patient and drill when economically warranted. The company has reduced debt, spun-off its coal business and repurchased shares advantageously. Recent transactions for companies with similarly located land affirm the value of the assets. We believe the shares are materially undervalued. United Continental, like the airline business, has undergone a remarkable change in the last few years. There are fewer competitors, planes are almost always full and passengers pay for services that used to be complimentary such as seat upgrades and free bag check. This additional airline revenue is enhanced with a new, underappreciated line of business; the airlines generate a lot of revenue selling reward miles to credit card companies. This is a steady, non-cyclical source of revenue that has become material in nature. United now generates substantial free cash flow and profits. The company has repurchased almost 25% of the outstanding shares and recently authorized a new repurchase for an additional 15%. The shares recently sold-off as investors became concerned about additional capacity and its effect on margins. We believe this was overdone. If United continues to aggressively repurchase shares, they could repurchase 50% of the outstanding shares within the next five years. Even if United’s market capitalization- now at about $20 billion- were to remain unchanged over those five years, the shares could double with half the amount of shares outstanding.

The relative lack of volatility that has characterized trading sessions over the past year maybe coming to an end. The economy is accelerating, capital spending is up, inflation is up and interest rates, stuck for the last several years in neutral, are beginning a slow rise. In early February the market suffered its first meaningful correction- a 4.1% drop for the week in the DJIA- its biggest decline since January 2016. For the uninitiated and those new to investing, corrections and meaningful price declines can and will occur with regularity throughout a long-term investor’s horizon. They are impossible to time and must be accepted as an aspect of the stock market. The Wall Street Journal recently featured a quote from the former Fidelity

Magellan manager Peter Lynch, warning that “far more has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves.” One of our core holdings, Berkshire Hathaway, has been run by Warren Buffet for the past fifty-three years. Over that period, a $10,000 investment grew to about $88,000,000. Also over that same period, the share price has declined by fifty percent on four separate occasions. I know of many investors whose net worth grew significantly as long-term owners of the company and none who have earned a fortune trading in and out. Keep this in mind the next time a market pundit suggests a correction is coming and it’s time to sell all your stocks.

Please feel free to contact us with any questions or comments. As always, we appreciate your trust and patience.

Very truly yours,

Eckart A. Weeck
Senior Managing Director