13th of April, 2016

Dear Clients and Friends,

After suffering one of the worst starts to a year, declining 11% in the first few weeks, the S&P 500 has recovered its losses. The S&P 500 and Russell 2000 Indices ended the quarter mixed, up 1.3% and down 1.5% respectively. During this quarter, we fielded many calls from clients about whether this sharp correction could be the start of a bigger bear market. We think the market will continue higher and are hopeful for a solid year of gains for our clients' portfolios.

Ned Davis Research, a leading macro research firm, still sees U.S. equity returns in excess of 10% for 2016. The key reasons for their forecast are modest global growth, strong relative valuations, and easy global monetary policies. When looking at our individual stocks, we have similar return expectations for our holdings growth in book value, dividends, and thus total shareholder return. We are confident that our portfolio of companies with superior management, strong market positions, low debt, and reasonable valuations can help us achieve our return objectives.

Another noteworthy phenomenon taking place in global markets is negative interest rates. This is not merely a one-off market anomaly. Bonds with maturities between one and five years in Japan, France, Switzerland, and Germany are negative. Japan's ten-year government rate is now negative. While negative rates are indicative of weak global economic demand, negative rates are a positive for U.S. stocks as an investment alternative. As investors throughout the world search for relatively safe, long-term investment vehicles, U.S. stocks fit the bill.

One investment theme that we have recently begun to explore is energy bonds. While oil & gas equities are trading cheaply relative to their 52-week highs, we think the vast majority of such companies are too risky at this juncture since their future success hinges on a dramatic rebound in the price of oil. Many of the small oil & gas producers can't make money with oil at $40 a barrel. However, a few of the best operators in low-cost areas can be profitable, and the debt in these companies offer attractive rates of return at a much lower risk than their stocks.

We recently purchased bonds in an oil & gas company with key assets in a valuable "stack" play in Oklahoma, a term than denotes oil deposits at different depths under the same property. This particular company's reserves have been valued at over $1B by third party appraisers at currently depressed oil prices, versus only $425m in debt. With the senior bonds trading at $.65 on the dollar and a yield-to-maturity in excess of 30%, we think these bonds could appreciate by 50% and have significant downside protection due to their asset coverage. Company management has and will continue to pursue shareholder friendly actions, such as the sale of non-core assets, spending cuts, and paying off debt.

In summary, it was a volatile quarter, but we are optimistic looking forward. We continue to look for special situations similar to the energy bonds outlined above in addition to companies with our ideal combination of superior management, strong market position, low debt, and attractive valuation. Going forward, I will write more in-depth letters at the mid-year and year-end as well as briefer updates, similar to this one, at the end of the first and third quarters. Thank you for your continued business and support. If you have any questions, please do not hesitate to give me a call anytime.

Sincerely,

Tom Eidelman, CFA
Managing Director