Eidelman Virant
CAPITAL

Quarterly Letter June 2017

Dear Clients and Friends,

The S&P 500 and Russell 2000 Indices continued their ascent, gaining roughly 9.3% and 5.0% respectively through the first half of the year. Despite larger "growth" oriented stocks being the star performers (+14% vs. smaller "value" stocks +0.5%), our portfolios performed well. We benefited from continued appreciation in community bank stocks as well as mostly avoiding the carnage in energy stocks (-15%). It has been a stellar period for the global equity markets and our portfolios over the past 18 months. Looking forward, we think we have the right strategy to keep up the momentum.

A key theme we will be emphasizing is the difference between our individually selected investments and the broad stock market indices like the S&P 500 and Russell 2000. While we have constructed a super portfolio of 30-40 individual investment ideas, we are not necessarily as optimistic for the broad market averages. Though market momentum remains strong, investor optimism, rising interest rates, and high stock valuations could act as a headwind for stocks. The median S&P 500 P/E valuation ratio currently stands at 24x, roughly 40% above its 50-year historical average of 17x. The VIX volatility index, often called the "fear index," recently hit multi-decade lows, indicating investor complacency. While the above risks warrant caution for equities in the S&P 500 Index, our firm is uniquely positioned to capitalize on opportunities that are under the radar of most investors.

Over the past decade, there has been a massive shift in the investment industry towards asset allocation strategies using mutual funds and passive exchange-traded funds (ETF) and away from individual stock selection. Not too long ago, most individual and institutional investors built portfolios based on their own research. Now, most advisors outsource active portfolio management or have switched to a passive approach. Passive investing involves purchasing baskets of stocks and bonds without making any "active" decisions to buy or sell individual securities. They seek to mimic an index like S&P 500 and keep costs to a minimum. Some of our clients utilize this strategy in addition to our core active investment strategies within our firm or with other money managers. The good news is that passive investing, especially in U.S. equities, has been a successful strategy. However, we believe massive recent inflows into passive strategies may reduce the effectiveness of such strategies going forward.

In the following letter, I will outline this "Passive Problem" as well as our "Active Solution" and finish with two of our latest and favorite investment ideas. I hope readers will appreciate the challenges presented by the proliferation of passive ETFs for all investors as well as gain confidence in our plan to navigate our way to superior investment results.

We are passionate about investing. We love meeting with companies and trying to uncover the winners of tomorrow. Our company owners, including David Eidelman, John Virant, John Virant Jr., and myself, have the vast majority of our personal net worth invested in the same securities as our clients. While there are many successful investment strategies, we are confident that our repeatable approach to investing in companies with great management cultures, strong competitive positions, low-debt balance sheets, properly aligned incentives, and attractive valuations gives us all the best opportunity to grow wealth over the long run.

Sincerely,

Tom Eidelman, CFA
Managing Director

THE PASSIVE PROBLEM

Passive investing was a revolutionary idea. Instead of trying to "actively" pick winners from the equity universe, "passive" investors purchase a market-weighted amount of most publicly traded stocks and hold for the long run. This strategy provides wide diversification at a very low cost. Such strategies are best exemplified by Vanguard and iShares exchange traded funds (ETFs). These passive ETFs have provided huge benefits to society by giving wide access to low-cost, diversified investment portfolios.

Passive ETF investing has gone mainstream. According to CNBC, passively managed U.S. equity funds now hold $3.1 trillion in assets while their active counterparts hold $3.6 trillion. In 2016 alone, a record $250 billion moved from active to passive funds. So what's the problem with more assets in passive ETFs?

The Free Rider Problem

A key assumption for passive investing is that competition among active managers sets efficient stock market prices. With no active funds, there would be no efficient prices which passive funds could rely on. Vanguard founder and architect of index funds, John Bogle, stated at the latest Berkshire Hathaway annual meeting that he knows there is a limit to index investing strategy's usefulness. "If everybody indexed, the only word you could use is chaos, catastrophe."

With more money flowing from active to passive funds, stocks are becoming less efficiently priced. Assets are being taken from funds who conduct detailed competitive and valuation analysis to funds that indiscriminately buy stocks with more liquidity and market capitalization. Given this phenomenon, it's no surprise that the five largest stocks in the S&P 500 (Apple, Google, Microsoft, Amazon, and Facebook) were up an average of 23% while the S&P 500 equal weighted index was up only 8% in the first half of this year.

ETF Inflows Driving Up Constituent Valuations

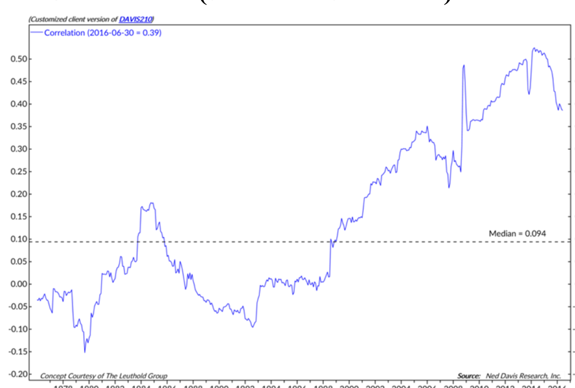
Any new asset inflows into a U.S. equity passive ETF is now putting 13% of assets in those five companies which trade at an average PE ratio of 30x earnings, 25% higher than the median S&P 500 stock. The median P/E ratio of the S&P 500 Index itself stands roughly 40% above the 50-year historical average of 17x. Passive ETFs do not take Price/Earnings ratios and other valuation metrics into account. They invest in the desired asset at any price.

Higher Correlations = Higher Risk for Passive ETFs

One of the biggest benefits of passive ETF investing is diversification. However, the real power of diversification comes from holding <u>non-correlated</u> assets. A classic example is owning an energy stock and an airline stock. High oil prices are good for the energy companies (they sell oil) and bad for airlines (they buy oil in the form of jet fuel). If both have an expected return of 25% if oil prices go their way or a 10% decline if oil goes against them, you could mitigate this risk by just buying both stocks and be assured a 7.5% return with less risk (25% + -10% / 2 = 7.5%).

Correlations among stocks within the S&P 500 have increased from roughly .40 to .60 over the past 8 years with 1.0 being perfectly correlated. Since 1998, the correlation of the S&P 500 to other asset classes (intl equities, bonds, commodities, etc.) has gone from zero to highs above .50. See Chart A below. We are seeing that anything that can be indexed is getting more correlated thus increasing the risk to ETF investors.

Chart A: Rising Correlations between the S&P 500 vs. Other Assets (Jan 1976– June 2016)



Note: Average of 60-Month Correlation of Monthly Changes in the S&P 500 with the Monthly Changes of: MSCI EAFE Index, MSCI Emerging Markets Index (starting 12/31/92), CRB Index, Spot Gold, Copper Futures (starting 1984), 10-Yr T-Bond Yield, 3-Mo. T-Bill Yield, Euro.

Conclusion

While passive U.S. equity investing has provided outstanding returns over the last eight years, past performance may not be indicative of future returns. With high asset valuations potentially muting returns and rising correlations among assets potentially increasing risk, we think a more "active" solution is the best way to maximize wealth in the coming years.

THE ACTIVE SOLUTION

ETF's Trash is Another Man's Treasure

About ten years ago, my wife and I were having an extremely difficult time finding her a new apartment in Philadelphia. We walked into our final showing along with the agent and two other apartment-seeking, college-aged women. The location was fantastic and the apartment was updated, beautiful, and 30% cheaper than similar apartments. After walking through, all five of us simultaneously looked out the window to see an enormous cemetery. The two college-aged women quickly shrieked "Creepy… no way!" and walked out. My wife and I looked at each other, shrugged, and said we'd take it. The apartment was terrific and we never had any problems with our neighbors.

ETFs need holdings with sufficient trading volume to handle large daily inflows and outflows. Examples of companies consequently shunned by ETFs are owner-operator companies with large insider ownership, micro-cap companies, and small issues of special situation securities. Who cares about these small orphan securities that represent under 2% of the world's equity market capitalization? We do! They are our treasure.

Higher Potential Returns

Owner-operated companies with large insider ownership can be some of the most desired investments. Over the past twenty years, such companies have compounded at 11% versus 8% for S&P 500. Owner-operator incentives are perfectly aligned with our interests to maximize long-term value as opposed to short-term compensation, making acquisitions, or hitting short-term earnings forecasts.

Micro-cap stocks are another investment that have delivered superior investment returns over time. From 1992-2016, the Dow Jones Micro Cap Index has compounded at 11.5% vs the S&P 500 of 9.1%. Micro-caps have also outperformed large-caps 98% of the time for rolling 20-year periods going back to 1926. We believe this outperformance is due to lower valuations, acquisitions, higher growth, leaner operations, and nimbleness to respond to changing market dynamics. Due to inefficiencies and low analyst coverage of micro-caps, studies have shown that active managers also have delivered more outperformance (alpha) in the micro-cap universe.

Lower Potential Risk

In addition to potentially offering superior returns, a portfolio of stocks falling outside the ETF divide may be less risky than many ETFs. They may experience lower volatility due to being outside of major fund flows. They will likely provide valuable diversification benefits due to their low correlation to other assets. Lastly, shareholder friendly management could implement buybacks or an outright sale of such companies should their stock prices fall below their intrinsic value.

EVC Value Select

As flexible, all-cap fundamental investors, we are ideally positioned to capitalize on such market opportunities. While I have focused this letter on the topic of insider ownership, micro-cap stocks, and the ETF divide, these are only a few of the many factors we consider in our arduous investment process. We also focus on strong management, energized corporate cultures, low-debt balance sheets, niche market positions, and issues that trade at attractive valuations. Such companies are not found at the top of the ETF holdings list. It takes painstaking work, but nothing excites us more than uncovering a winner.

Below is a look at a few of our top holdings in the EVC Value Select composite. In addition to the attributes mentioned above, you can see these stocks have an average of 37% insider ownership and trade at roughly a 29% discount to the market averages. See chart B below:

Chart B: EVC Holdings High Insider Ownership %

Ticker Symbol	Company Name	Business Description	Stock Price	Market Cap ($M)	P/E Ratio 2016 Act.	P/E Ratio 2017 Est	P/Book Ratio	% Insider Ownership
ATTO	Atento	Call Centers in Latin America	$ 11.15	$ 824	17.2	13.9	1.9	86.0%
KINS	Kingstone	Homeowners insurance in NY	$ 15.30	$ 163	14.0	13.5	2.1	10.3%
DISH	DISH	Wireless Spectrum + Satelite TV	$ 62.76	$ 29,215	20.6	23.0	6.3	49.0%
LGF.B	Lionsgate	TV & Movie Studios	$ 26.28	$ 5,453	26.0	16.0	2.2	30.4%
LEN.B	Lennar	Homebuilder in Florida	$ 44.97	$ 10,545	11.4	11.0	1.5	10.0%
				Top 5 Median	**17.2**	**13.9**	**2.1**	**37.1%**
				S&P 500 Median	**24.0**	**18.0**	**3.0**	**0.5%**
				Discount to the S&P 500	*-29%*	*-23%*	*-29%*	

Conclusion

While the majority of investment dollars continue flowing into passive asset allocation ETF strategies at a time when U.S. equity valuations and correlations are near all-time highs, we believe our firm is uniquely positioned to capitalize on opportunities that are under the radar of most investors. We think such a strategy puts our clients on the best path to both minimize risk and maximize investment returns into the future.

Recent Purchases

Atento SA – (ATTO) - Price: $11.15

Atento is the #1 provider of call centers in Latin America with roughly 50% of their business coming from Brazil. They were ranked five years in a row on the list of "World's Best Multinational Workplaces." They have a 99.5% retention rate of clients and 90%+ customer satisfaction rates. The company was spun out of Telefonica in 2012, but now has over 150,000 employees and 400+ clients where they provide outsourced customer service, sales, technical support, for telecommunications, financial, and other industries. 95% of their business is local to local as there is no cheaper place to outsource that speaks Portuguese.

On the surface, the company appears just fairly valued at 17x earnings; however, earnings are temporarily depressed as Brazil has been in the midst of a great recession and is set to rebound. The industry is growing high single digits and ATTOs margins are improving as they provide more value-adding "BPO" services to their clients. With this growth and paying down debt, we think ATTO can grow earnings in excess of 25% over time.

We sat down with ATTO's CEO Alejandro Reynal Ample and his management team at our office back in May and were extremely impressed with their ability to build a high performance corporate culture to carry out their strategy and ultimately improve profitability.

Bain Capital private equity currently owns 85% of the company as well as management owning another 1.5% leaving very little float currently. When this company is eventually sold either outright or in a secondary offering, we believe the company will be worth 15x it's 2019 EPS estimate or $15 per share, a 50% premium to the current price.

Lionsgate Entertainment (LGF.B) – Price $26.28

Lionsgate (LGF) is the combination of the Lionsgate movie and TV studios and the Starz channel. Lionsgate is best known for making such movies as the *Hunger Games*, *Twilight Saga*, and *La La Land* as well as hit TV shows *Mad Men* and *Orange is the New Black*. LGF controls a library of 16,000 movies and TV titles. LGF's library is one of the last remaining vaults of valuable intellectual property in a world where content is scarce and cash-rich companies like Amazon, and Netflix are battling old media for subscribers. LGF presents an attractive takeover target for a variety of larger media and telecom companies.

LGF management is both capable and incentivized to maximize shareholder value. LGF's management and board own 30% of the shares including John Malone, one of the most successful media and telecom investors in history, owns $300m in stock, or 6% of the company.

Given LGFs' knowhow of making great content, stable licensing business, and irreplaceable intellectual property, we think LGF shares should trade at 15x 2019 free cash flow estimates of $2.50, or roughly $37 per share, a 42% premium to the current price.