Eidelman Virant
CAPITAL

10/14/15

Dear Clients & Friends,

The S&P 500 and Russell 2000 Indices were down 6.5% and 11.9% respectively for the 3rd quarter, its worst performance since 2011. The S&P 500 and Russell 2000 Indices are now down 5.3% and 7.7% for the year respectively as of September 30th, but have rebounded a bit in the past few weeks. While painful in the short run, volatility is the reason stocks are priced to earn higher returns in the long run. If stocks rose slowly and predictably over time, they likely wouldn't deliver excess returns over bonds. For opportunistic investors like ourselves, volatility provides an additional opportunity to reallocate and "buy low and sell high."

So what do we think about the market going forward? There are key positive indicators that lead us to be optimistic for a year-end rally and potential rebound for lagging value stocks. While stock valuations are a bit above average, interest rates remain dramatically below their historical averages. In fact, we believe if interest rates stay at current levels (2.0% on the U.S. 10-year Treasury Bond) and historical equity risk premiums remain, stocks valuations could increase significantly higher. Charts A & B below show the favorable yield spread between stocks and bonds which is a key reason we see stocks outperforming bonds and cash over the long run.

Chart A: Stock vs. Bond Yields

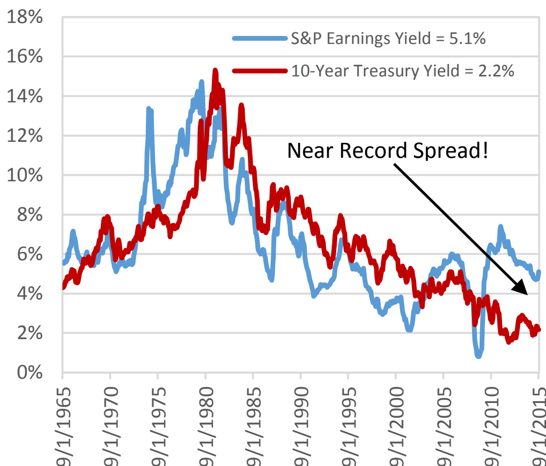
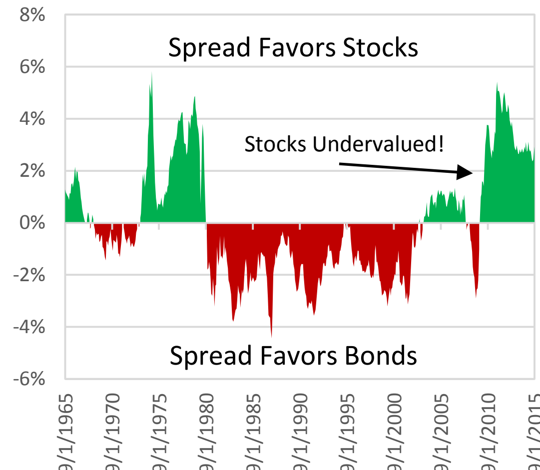


Chart B: Stock vs. Bond Yield Spread



Source: Shiller Data, Yale

So what are the best individual opportunities going forward? We recently returned from the Raymond James Bank Conference in Chicago where we met with over twenty management teams, including eight that we own for clients. We came away feeling even more confident and excited about our holdings. Nearly everyone has a combination of a dominant position in a niche or regional market, proper management incentives to maximize shareholder value, low levels of non-performing loans, healthy capital levels, and attractive valuation. The majority of our bank holdings have been able to grow book value around 8%-12% over time. If their valuations just stay the same and profitability (ROE) remains, we think their future price appreciation could equate to their book value growth plus any dividends they pay (which is usually another 1-3%). In addition, we are hopeful we will get a few buyouts that would come at substantial premiums. As a group, we believe these community banks can earn above average total returns with below average risk.

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One of our most recent purchases is Conifer Insurance (CNFR, Current Price: $9:00). Conifer is a fast growing company who sells specialty insurance such as liquor liability to bowling alleys and to companies that provide security guard services. Prior to starting Conifer, CEO James Petcoff founded North Pointe Holdings, an insurance company similar to Conifer, which he ultimately sold to QBE Holdings for 1.5x book value. This company is laser focused on efficiency and challenging fake claims with their in-house claims professionals to keep legal costs low. With management owning 33% of the stock, they are incentivized to repeat their past success. If management can successfully implement its growth plan, CNFR could grow earnings and book value to $1.25 and $12 per share respectively by 2016. Should this occur, we think shares could appreciate to $15 per share based on where their competitors' stock prices trade, a 67% premium over the current price.

An area that has been noticeably absent from our portfolios has been energy stocks. We do have some small positions in special situations like Renewable Energy Fuels (REGI, Current Price: $8.10); which we think could see its share price revert up towards our estimated year-end book value of $13 per share when congress passes a renewal of a blenders tax credit. However, we have been looking hard at adding investments in the energy sector. Despite the short-term oversupply from U.S. fracking and low demand from China's economic slowdown depressing current prices, we think the long-term fundamentals for oil prices are good. Meanwhile, stocks of oil drillers, service companies, and pipelines have declined significantly and many trade below their liquidation values. In addition, energy stocks will likely experience year-end selling pressure. We will be digging deep into these companies and looking to opportunistically invest in areas with the best risk/reward profiles.

In firm-related news, Rob Bertman will be leaving Eidelman Virant Capital at the end of the year to start an online financial training program targeting people in their 20s and 30s. It has always been Rob's passion to reach out and help Millennials make smart financial decisions and get them on the right path for future success. Rob has some fantastic ideas and we wish him great success in his new endeavor. Going forward, please contact Amy Jadav (amy@eidelmanvirant.com) for any administrative issues or me for investment related questions at tom@eidelmanvirant.com.

I just want to end by saying how much Rob has meant to the firm and to me personally. Over the last ten years, his ideas, positive energy, and impact on the firm have been exceptional. While I'm very excited for Rob's new venture, we will certainly miss him. Fortunately, our firm will always be better because Rob helped make it what it is today. We will continue our pursuit of providing a premier investment management experience including exceptional investment returns, outstanding customer service, and insightful research and education.

Thank you for your continued business and support. If you have any questions, don't hesitate to contact me.

Sincerely,

Tom Eidelman, CFA
Managing Director

Disclosures

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