Quarterly Letter — December 2015

Dear Clients and Friends,

"There's always a bull market somewhere" goes the Wall Street cliché, but that wasn't the case in 2015. In 2015, the S&P 500 Index was up a modest 1.4%, while the Russell 2000 Index was down -4.4%. With sluggish economic growth and the Federal Reserve finally raising rates for the first time in a decade, investors piled into the few companies that were growing. Gains in the S&P 500 Index were concentrated in the "FANG" stocks, a clever acronym for Facebook (FB), Amazon (AMZN), Netflix (NFLX), and Google (GOOGL). Excluding these juggernauts, the S&P 500 would have been down for the year as well. Value stocks fared even worse with the Russell 2000 Value Index declining -7.5%. European and emerging market stocks were also down 1% and 15% respectively. Even the Barclays US Long-Term Government Bond Index was down for the year. The bottom line was that 2015 was a very challenging year.

To make matters worse, 2016 has started out very poorly. Pundits are blaming the market rout on China's economic weakness and plunging oil prices. I would like to turn the attention to the future which we believe will be much better than the recent past. In this letter, I hope to communicate some optimism. I'll talk about what we see for the next year in terms of the market overall and how we intend to focus on great management teams to help protect us in bear markets and grow value in the long run.

Looking forward, we are optimistic about the markets and our portfolios. Ned David Research, a leading macro research firm, sees U.S. equity returns in excess of 10% for 2016. The key reasons for their forecast is modest global growth, strong relative valuations, easy global monetary policy, and skeptical investor sentiment. More importantly, when looking at individual stocks, we are seeing some incredible values with many stocks trading well below their tangible book values. I will outline a few of these value ideas on the following page.

In tough times like these, it's good to evaluate what we've done right, what we've done wrong, and make sure we are on the right path going forward. This year further cemented the practice of cutting losses short. Last year, we sold numerous stocks at a relatively modest loss that would have turned into major losses had we held them. We will continue to be our toughest critic when evaluating stocks that "aren't acting right."

One investment principle that continues to be fruitful is focusing on companies with outstanding management teams. The community banks were some of our best performing investments last year, but this was mainly because we concentrated in banks that properly motivate their employees, provide great customer service, and are committed to driving shareholder value. In this letter, I'm going to dive into what constitutes great management and how we think an increased focus on this area could improve investment performance in the future.

In summary, it was a tough year, but we are optimistic looking forward. We think the recent selloff is ideal for capitalizing on our strategies of buying companies with great management teams and buying deeply discounted companies that have been thrown away by the market. One thing I can promise is that we will continue our relentless pursuit of finding opportunities and earning superior investment returns for our clients.

Sincerely,

Tom Eidelman, CFA
Managing Director

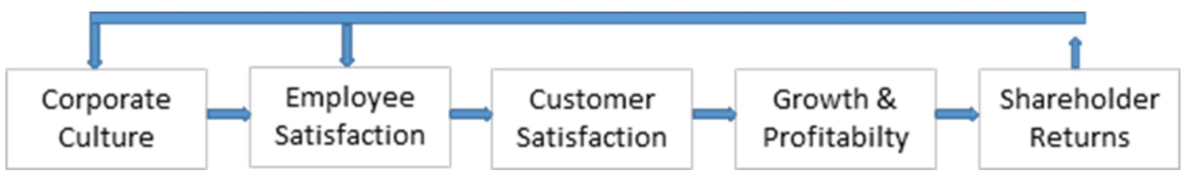
IT PAYS TO INVEST IN THE BEST MANAGEMENT CULTURES

TOM EIDELMAN

We often ask management teams: “Describe your corporate culture and how you incentivize and motivate your employees?” Often they reply, “That’s a great question and nobody has ever asked us that before!”

While nearly all investors would list “quality of management” as an important investment criterion, we think few investors understand what constitutes great management. Great management teams create a culture to make employees, customers, and shareholders happy. These world class cultures emphasize motivating and rewarding employees, exceeding customer expectations, and generating industry leading value for shareholders. Heskett, Sasser, and Schlesinger of Harvard Business School first wrote about this “Service-Profit Chain,” but I have expanded on this idea in the Culture-Profit Chain below.

Culture-Profit Chain



Herb Kelleher, visionary founder and former CEO of Southwest Airlines, said the following about their culture: “Southwest ranks employees first, customers second, and shareholders third. We believe that if we treat our employees right, they will treat our customers right, and in turn that results in increased business and profits that make everyone happy."

World Class Corporate Cultures

Have you noticed how Southwest Airlines employees are full of personality, Starbucks employees seem smart, full of potential, and interested in their customers, and Whole Foods employees care so much about healthy eating and the planet? These attributes represent the personality, beliefs, and character of the company. Often, a culture is so strong that management won’t even call them employees. Whole Foods calls their employees “Team Members” and Starbucks calls them “Partners.” This isn’t just lip service, these companies consistently earn top ranks among *Fortune Magazines* “The 100 Best Companies to Work For.” Not only does it make me happy as a human being to know that people are being treated well, but such practices leads to superior investment results.

Two different studies support the positive relationship between employee satisfaction and equity prices. Alex Edmans in the *Journal of Financial Economics* at Wharton concluded that a value-weighted portfolio of the *Fortune Magazine’s* “100 Best Companies to Work for in America” earned a return 3.5% higher than the market, after adjusting for other factors from 1984-2009. In March 2015, the chief economist of Glassdoor completed a similar analysis entitled “Does Company Culture Pay off?” Chamberlain concluded that stocks awarded “Best Places to Work” earned 22.8% annually from 2009-2014 vs the S&P 500 Index return of 14.1%.

Employee Motivation

A key to satisfying and motivating employees is to treat them like owners. This means empowering them to make decisions and reap the rewards. It is even more powerful when companies award stock ownership or a percentage of the firm’s profits.

Motivation isn't all about money. It's also about independence, development, and purpose. People relish solving problems and mastering something new and engaging. It is management's job to provide the right balance of formal training, experiencing the best way to do things, and allowing the freedom to solve problems creatively.

Another key motivator for employees is being connected to a vision or higher purpose. One of the reasons teaching has been found to be a profession with high levels of job satisfaction is that educators relish helping students. They understand their "Why." It is the job of management to connect employees with their corporate vision. If employees are treated like owners, enjoy the work they do, and connect to a vision, they are going to be fantastic ambassadors of the company and contribute to an outstanding customer experience.

"Raving Fan" Customer Service

The best companies are obsessed with exceeding customer expectations. Satisfied customers aren't enough. The best management teams understand they need "raving fans." Enterprise-Rent-A-Car in St. Louis focuses on this better than anybody. They focus on every detail from looking customers in the eye, smiling, dressing well, and shaking customer's hand to going the extra mile to make the customer feel special and *totally* satisfied. They religiously track customer service scores by branch and link getting promoted to knocking the socks off their customers. Like Enterprise, the best companies make exceeding customer expectations a core element of their culture.

Capital Allocation and Shareholder Value

While wowing employees and customers is critical, the best management teams also understand the importance of driving shareholder value. Without profits, a company's vision cannot be obtained and its employees and customers will soon suffer. We look for companies that understand their fiduciary duty to shareholders and take optimal actions with regard to reinvesting profits, making acquisitions, buying back stock, and paying dividends. The best companies are profitability focused, shareholder friendly, and opportunistic I their capital allocation decision making.

Using Culture to Pick Great Investments

We plan to put a greater emphasis on management teams that "get it." They get the importance of their corporate culture. They get that taking care of their employees, delivering exceptional value to their customers, and focusing on profitability are the best way to deliver long-term value to shareholders. Former IBM CEO, Louis V. Gerstner said it best: "I came to see, in my time at IBM, that culture isn't just one aspect of the game—it is the game."