Eidelman Virant
CAPITAL

15th of January 2019

Dear Clients and Friends,

Former heavyweight boxing champion Mike Tyson famously said, "Everybody has a plan until they get punched in the mouth." In the fourth quarter, equities stunned investors with the S&P 500, Russell 2000, and NASDAQ indices falling 13.5%, 20.2%, and 17.5% respectively. While we were aware that valuations and investor optimism were high, our plan was to mitigate this risk by concentrating in companies with top notch management teams, strong competitive positions, low debt, and attractive valuations. While this strategy has historically performed exemplary in down markets, this time we took one on the chin. There is a reason one of the most famous investment books is called "The Battle for Investment Survival." This last quarter was painful. We intend on coming back stronger and are encouraged by the recovery so far this year.

With index funds representing over 50% of the U.S. equity universe, every stock is a constituent in dozens of exchanged traded funds (ETFs). These ETFs swing around with sentiment and macroeconomic factors and the underlying stocks are whipped around by these price indiscriminate funds. The result of this dynamic is that our investments may not be as insulated as they were in the past when broad market downturns led active managers to swoop in and buy companies with depressed valuations. While this new paradigm could persist, and may add more short-term volatility to our portfolios, it provides increased long-term opportunity. We will see more instances of "the baby being thrown out with the bath water" involving investors panic selling their passive funds which dumps all stocks indiscriminately. On the last page, I will outline two new investments that we made which capitalize on such an opportunity.

A key element of our success over time has come from investing in banks which dominate a local market, are conservatively managed, and trade at low price/earnings ratios. In addition to providing excellent total investment returns, we've also found them to provide downside protection in volatile markets due to government oversight, simplicity, and inherent conservative nature. This was not the case last year as the S&P Regional Bank Index declined 19% due to concerns over rising interest rates and a potential economic slowdown. While share prices have been hit, the underlying earnings and fundamentals remain strong. Citigroup CEO, Michael Corbit said it best when he recently told analysts, "We clearly see a disconnect between what we see in our business on an anecdotal basis and what the markets are saying. Right now, we see the biggest risk in the global economy is one of talking ourselves into the next recession, as opposed to the underlying fundamentals taking us there." Across Eidelman Virant's community bank holdings, we are seeing strong earnings and book value growth. With the recent selloff, our top 16 community bank holdings trade at a median 1.15x tangible book value and 11x earnings, a 25% discount to similarly sized banks and a 35% discount to the Russell 2000 small cap index. At these levels, it is cheaper for competitors to acquire these banks rather than open a new branch and compete with them.

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We have long been and continue to be believers in value investing. Made famous by Warren Buffett, value investing is the practice of investing in companies with low valuation ratios like price/earnings (PE) as opposed to well-known growth stocks whose prospects are often already discounted in the form of very high prices. Since 1979, investing in the 50% of stocks with the lowest PE multiples would have returned 11% vs 6% annually for the half with the highest PE ratios. Value investing within small capitalization stocks has yielded even better results over time and historically provided downside protection. In the six S&P 500 down years from 1979-2017, small cap value stocks outperformed large cap growth stocks by an average of 18% per year and only underperformed once. Nevertheless, 2018 was another anomaly and saw small cap value stocks underperform large cap growth by 11%, only the second time in 40 years. The good news is the last time this occurred in 1990, small cap value stock rebounded and outperformed large cap growth for the next three years by 15% per year.

Below are some of our top holdings and their prices at the end of the 3rd and 4th quarters respectively versus our calculation for their intrinsic value. You can see at the end of the third quarter, these holdings had an estimated 27% appreciation potential to our estimate of fair value. While their share prices declined in the fourth quarter, we believe their intrinsic values remain the same and thus their appreciation potential has more than doubled to 56% based on their year-end values. See table below.

			Eidelman Virant	**Price On**		**Appreciation Potential**	
Ticker	**Name**	**Business**	**Intrinsic Value Est.***	**9/30/2018**	**12/31/2018**	**9/30/2018**	**12/31/2018**
LEN.B	Lennar Homes	National Homebuilder	**$ 51**	$ 39.0	$ 31.3	31%	63%
ALLY	Ally Financial	Online Bank - Auto Loans	**$ 34**	$ 26.3	$ 22.7	28%	49%
USAP	US Stainless	Steel Alloy Company	**$ 24**	$ 19.6	$ 16.4	21%	44%
AIG	AIG Group	P&C and Life Insurance	**$ 58**	$ 52.8	$ 39.4	10%	48%
MRE.CA	Martinrea	Auto Supplier	**$ 19**	$ 13.2	$ 10.9	46%	78%
			Average Appreciation Potential to Target Price:			**27%**	**56%**

**Intrinsic Value was calculated using an average of 1) 2019 estimated tangible book value 2) An average of sell side analyst price targets, and 3) 10x estimated earnings.*

Our community bank and other value holdings are priced to offer attractive potential returns while providing downside protection in the form of real asset value. We also continue to invest in companies with great management cultures as defined by companies who treat employees well, wow customers, and target leading shareholder returns. We are optimistic for 2019 and are already off to a solid start. If you have any questions, please don't hesitate to give me a call.

Sincerely,

Tom Eidelman, CFA
Managing Director

New Purchases:

First Trust MLP & Energy Income Fund (FEI) – Price $9.70 – The First Trust MLP and Energy Income Fund is a closed-end fund composed of Energy Infrastructure Master Limited Partnerships (MLPs). Such companies own pipelines and make money from transporting and storing energy. FEI has a dividend distribution rate of 10.9%. As oil prices declined throughout the year, MLPs were unfairly pushed down with the overall energy sector despite the fact that low oil prices do not impact transmission profits. In addition, this fund traded at a 10% discount to its net asset value due to temporary forced tax selling even though it traded at a premium throughout 2017 and 2018. We think FEI could provide a total return up to 25% in the next twelve months due to a combination of its 11% dividend, recovery of its 10% discount to NAV, and underlying growth rate of 5%.

Ring Energy (REI) – Price $5.08 - One example of a company we purchased after it had significantly declined due to tax selling is Ring Energy (REI). Ring Energy is a small oil & gas exploration (E&P) company with key acreage in the Permian basin. Despite having some of the best acreage, profitable production, and roughly no long-term debt, Ring Energy shares fell 63% from roughly $14 per share to $5 in late 2018 as oil prices fell. Passive energy funds like the S&P Small Cap Energy ETF (of which Ring is a component) fell 43% with more than half of its constituents falling more than 30%. With a $7.50 tangible book value and $.60 EPS estimate for 2019 earnings, we think REI shares are conservatively worth $8.00, a 60% premium to its year-end price. As a confluence of selling hit REI due to hedge fund closures, tax loss selling, and window dressing, we capitalized on this opportunity to buy shares and are very optimistic for the investment in the near and long term.