



Investor Update

January 2015

The year 2014 was incredibly interesting from a market perspective and confounded most prognosticators with regard to both the stock and bond markets. It was widely expected that stock prices would migrate down, or be up only slightly, for all of 2014 and that bond yields were sure to rise from their historically low levels. Both guesses (and that's what they amounted to) were proven wrong.

To recap this past year, it is clear again that U.S. stocks were the leaders in 2014.

Asset Class	As Measured By:	2014 Return
US Large Cap Stocks	S&P 500 Index	13.7%
US Large Cap stocks	Dow Jones Industrial Average	10.0%
US Gov't Debt	Bloomberg Gov't Index of 7-10 year maturities	8.8%
US Small Cap Stocks	Russell 2000 Index	4.9%
Hedge Funds	HFRX Equal Weighted Strategies Index	-0.5%
Emerging Market Stocks	MSCI Emerging Markets Index	-2.1%
Gold	SPDR Gold Shares (ticker: GLD)	-2.2%
Int'l Developed Stocks	MSCI EAFE Index	-4.2%
Crude Oil	Light, sweet crude oil as traded on NYMEX	-45.9%

It is important to remember that we are absolute return investors. Our goal is not to beat a specific benchmark, although they can be helpful to use as a guidepost at times. Rather, we seek to generate returns substantially better than one could receive investing passively in a safe, secure investment like U.S. Treasuries. As investors, we need to be compensated for the risk we take. It is that simple.

Presently, investors seem enamored with passive or index investing. According to the *Wall Street Journal*, in 2014 \$12.7 billion was pulled from active managers and \$244 billion was poured into passively managed funds. Remember, if investors want to achieve index-like returns, they have to accept the downside with the upside. Investors

in the S&P 500 index on December 31, 2007 didn't recapture their losses on a price level until around mid-September of 2012. Notable as well, that while the market cap weighted S&P 500 was up 11.4% (price change only with no dividends) in 2014, the Value Line Geometric Index, which is more representative of the average stock, finished up 2.7% (price change only with no dividends).

To index now is truly following the herd. At times like this I'm reminded of the saying parents have repeated to their children for generations, "If Johnny jumped off a bridge, would you do it too?" We are disciplined investors and adhere to a process that has worked over long periods of time. The fact that we may trail the S&P 500 from time to time is not a signal to us that we should change our stripes to mimic an index in order to achieve its returns. I learned this lesson first hand when I joined a firm in 2000 that did just that. The firm used a consultant (first bad move) to enable it to essentially replicate the S&P 500 (next bad move) in the late 90's at the peak of the valuation bubble. They chose this path because the returns of their value investing discipline had trailed the index for a few years prior. This new direction caused the firm to experience the full brunt of the revaluation of the S&P 500, which declined approximately 40% from 2000 to 2002. The next few years were spent undoing the incredible damage this unfortunate decision caused.

If the performance leaders of an index to which investors compare you are: 1) overvalued; 2) outside of your circle of competence; 3) in industries or sectors you have purposely chosen to avoid; the worst thing an investment manager can do is change a well-designed and well-thought-out strategy to "chase" performance. We would rather live with the uncomfortable feeling of trailing the index than compromise our objective to protect investor capital first and foremost and only then to focus on the potential upside.

The Basic Tenets of Value Investing

A mentor of mine in my early days in the investment business and a good friend still today gave me the advice that people either intuitively understand value with regard to investing or they do not. If someone loves a bargain, if they like buying on sale and if they are willing to do the homework to find value where others are indifferent or lazy, then value investing suits them. If, conversely, they are indiscriminate buyers, if they are comfortable doing what everyone else does and if they are price insensitive, then it's very hard, if not impossible, to get them to appreciate our investment approach.

In much the same way this is true with a person's taste in music or art. Individuals inherently know what kind of music or type of art suites them and what doesn't and what feels or looks good and what doesn't. Each investor gravitates to their level of understanding and comfort.

We have listed below a few of the central tenets we believe are very important in employing a value discipline:

1) *Value investing is the willingness to stray from the herd.*

Howard Marks, a renowned value investor, wrote a memo to his clients dated April 8, 2014 titled, "Dare to be Great II." It focused on the essential elements of being a great investor particularly as it relates to being different:

- "The real question is whether you dare to do the things that are necessary in order to be great. Are you willing to be different, and are you willing to be wrong? In order to have a chance at great results, you have to be open to both."
- "Most great investments begin in discomfort."
- "Unconventional behavior is the only road to superior investment results, but it isn't for everyone."

2) *A margin of safety is of utmost importance.*

Establishing a margin of safety is the task of calculating how much you could lose before calculating your potential gains. It pays to remember that as prudent investors we need to continually and realistically understand the extent of our risk before focusing on how much we might gain. Capital that is permanently lost is capital not available to be invested in the future.

3) *Value investors view buying a stock as buying a piece of the underlying business.*

The hard part is valuing the business, not anticipating what the stock might do in the short-term.

We take a long-term view of our investments and we realize our ultimate success will come from our analysis of the underlying business. Hence, we are not overly focused on the stock quotes that come across the tape on a daily basis. Our belief is that if the fundamentals of the business are tracking our expectations, the market will reward us over the longer-term. Significant, unfavorable, dislocations between our calculated value and the quoted price of the security can sometimes be very uncomfortable for us and for you. However, as prices decline, it is generally a signal for us to buy more or, at the very least; to recognize that the risk inherent in our position has been lessened, assuming the value of the business remains constant.

Select Portfolio Positions

Over the past year, the increased volatility in the market presented some attractive investment opportunities. We deployed capital into both new and existing names during periods of wide price swings which really seemed to start last spring. I am happy to report that the businesses we own performed extraordinarily well in 2014. Unfortunately, the share prices didn't all come along for the ride. We do remain confident that the value we see will be recognized by the market in due time. Our portfolio currently trades at a larger discount to our estimate of fair value than at any other time in the last two years.

Two additions from 2014 are highlighted below.

We purchased **ACI Worldwide (Core)** in the summer of 2014. ACI Worldwide (ticker: ACIW) develops, markets, installs and supports a broad array of software products and services that facilitate electronic payments. The company has marketed its products and services under the ACI Worldwide brand since 1993, primarily to financial institutions (national, regional and global banks, community banks and credit unions), third-party payment processors, retailers, and billers. Smaller banks and retailers who lack the scale to operate payment processing software in-house typically use payment processors like ACIW. Globally, its software facilitates 120 billion consumer transactions per year enabling over \$13 trillion in payments on a daily basis. The three main product categories that make up the bulk of their revenues are: retail payments, online banking, and bill payment.

It is not often that we are able to find a high-quality business such as ACIW at valuations of roughly 13x our estimate of FY2014 Free Cash Flow (FCF). The company provides mission-critical services to its diversified customer base typically through a three-to-five year contract either on a licensed or SAAS (software-as-a-service) basis. These contracts have a built-in annual inflation kicker and allow for revenue increases based on growth in transactions volume. Currently, about 75% of ACIW's revenues are recurring, providing high revenue and margin visibility. The attraction, besides price, was this recurring revenue business model, a conservative balance sheet and return on tangible capital in excess of 50%. Impressive too, was the growing backlog of new sales bookings with a CAGR of 20% over the last five years and the potential for significant margin expansion due to acquisition related cost synergies and operational leverage. The introduction of the Universal Payments (UP) platform which facilitates real-time payments across multiple channels, serves as a significant catalyst. Over the past few months, acquisition related integration issues combined with longer implementation cycles resulted in the sell-side being less optimistic on the company's prospects. For those with a longer term view this negativity became a buying opportunity. At 12x - 13x forward FCF, we believe ACIW is attractively priced and is well-positioned to benefit from the secular tailwinds in the electronic payments industry. We calculate ACIW's shares could be worth \$35 - \$40 by 2018 resulting in an internal rate of return (IRR) of

17% - 20% over the next 3-4 years. Extremely low attrition rates and long term contracts combined with existing customers and relatively cheap valuation, serve as our margin of safety.

Conrad Industries (Enhanced) is a small cap stock purchased in April of 2014. Conrad specializes in the construction, repair and conversion of a wide variety of steel and aluminum marine vessels for commercial and governmental customers. It operates a total of five shipyards in the states of Louisiana and Texas. Historically, Conrad has primarily served customers in the oil and gas sector. However, through significant investments in the past decade, Conrad has managed to diversify its customer base and significantly expand construction capacity. Being able to serve a variety of customers is Conrad's competitive strength which has enabled it to safely navigate the down cycles. The company competes with other shipbuilders that build small to medium-sized vessels for government and commercial markets and it benefits from the U.S. Jones Act protection. Competition among shipbuilders is primarily based on price, available capacity, service, quality, and geographic proximity, all of which are strengths of Conrad.

Management has done an outstanding job in maintaining an essentially debt-free balance sheet and expanding the business through operating cash flow. In 2013, the company hit record revenues of \$303 mm and operating profits of \$43 mm and finished the year with a contract backlog of \$152.9 mm. Its strong operating performance has continued in 2014 despite weakness in the oil and gas sector, allowing Conrad's management to initiate a \$0.25 per share quarterly dividend (3% annual dividend yield) in addition to the \$1 per share special cash dividend paid in early January. Its current contract backlog stands at a solid \$170 mm and its revenue for 2014 is on track to surpass its 2013 record.

Conrad is very attractively priced at an EV/EBIT multiple of 3.2x or a pre-tax earnings yield of 31.5%. Despite being in the cyclical shipbuilding industry, Conrad's return on tangible capital has averaged around 40% over the last 10 years. Over its 65-year long history, Conrad has successfully navigated several economic cycles, including the most recent Great Recession. This is indicative of management's ability to successfully develop a moat around its business and allocate capital efficiently. Furthermore, the Conrad family collectively owns ~45% of outstanding shares. Conrad's revenues have more than doubled over the last three years due to a combination of industry tailwinds and additional shipbuilding capacity. We believe both revenues and earnings will continue to grow at a modest pace over the next couple of years due to several factors: 1) strong contract backlog for the shipbuilding business; 2) continued activity in the oil and gas sector due to shale plays; 3) new shipbuilding capacity at the Deepwater South facility; and 4) an aging US inland barge fleet coupled with the Oil Pollution Act of 1990, which requires US and foreign tank vessels to have double-hulls by 2015.

We calculate the intrinsic value of Conrad's stock to be in the range of \$45 - \$50 per share by 2016, which represents a 17% - 20%+ IRR based on current prices. Our

valuation does not assume any upside from the company's \$22.6m claim to the BP settlement fund created to pay damages related to the 2010 Deepwater Horizon oil spill and therefore, this comes as a free option.

Oil: Risk, Probabilities and Inexactness

Any attempt to predict the appropriate level and direction of oil prices, the general stock market, interest rates or even the profitability levels of certain companies causes us to operate in a world of probabilities.

Satyajit Das, the author of *The Master of the Universe and the Cult of Risk*, writes, "Inexactness undermines scientific determinism, implying that human knowledge about the world is always incomplete, uncertain and highly contingent." In 1927 Werner Heisenberg, a German theoretical physicist, showed that uncertainty is inherent in quantum mechanics. He developed the Uncertainty Principle which, in essence, states that the exact position and momentum of an atomic particle can only be known within certain limits. Thus, we have to work with probabilities and inexact information. At the Memorial Solvay Conference in Brussels in 1962 he stated, "Causality law has it that if we know the present, then we can predict the future. Be aware: in this formulation, it is not the consequence but the premise that is false. As a matter of principle, we cannot know all determining elements of the present."

We believe investing has parallels to the conclusions made by both Das and Heisenberg. So, in holding that belief, how then should we act? What risks should we underwrite if it's impossible to have all of the information? The price of oil has dropped more than 55% from its peak in 2014 as of this writing. Has worldwide demand shrunk so significantly? Has supply increased that much in such a short period of time? Production and demand levels over the past year do not point directly to such a significant drop in oil prices. It's evident to us that market participants do not have perfect information. Clearly, those in the oil and gas business did not have all the determining elements of the present in June of 2014, as crude began its relentless and very steep drop.

This concept is so important to understand as investors. Knowing that we live in a field of inexactness, we have chosen to invest in a way that allows us to better quantify and calculate our risks. We avoid hard-to-value scenarios. We don't try to value indices like the S&P 500 but rather individual securities. We don't attempt to predict things like oil prices but rather seek to understand the effect oil prices will have on the fundamental results of the securities we own.

Where oil prices will go from here matters less than the effective "tax cut" consumers receive from lower prices at the pump. The impact lower oil prices (and thus lower revenues) have on over-indebted companies matters too with regard to the high yield market. Our investment team is spending a considerable amount of time on these topics

and more with regard to oil prices. Our hopeful outcome is that there will be profitable investments to be made as a result of this work.

Other Business

We made one new addition to our investment staff in the early months of 2014 with the addition of Jimish Gandhi as a research analyst. Jimish came to us after completing his Masters in Finance from the London Business School where he interned for a London-based fund that had a very similar investment philosophy to ours. Jimish also holds a Master of Science in Industrial Mathematics and Construction Management from Michigan State University. I like to think we rescued him from academia as he was clearly on the verge of becoming over-educated! Jimish brings inquisitiveness, intelligence and a thoughtful approach to our investment team. Besides these very tangible attributes, he's genuinely just a really nice person and we couldn't be happier he is with us.

We have included as an Appendix the overview of our investment philosophy from our 2013 year-end letter.

As always, if you know of people who might share our affection for value investing, please let us know. We are always eager to meet like-minded investors.

We welcome any questions you may have and we thank you for your continued trust in allowing us to manage your capital.

Respectfully submitted on behalf of the investment team at VNB Wealth Management,

A handwritten signature in blue ink that reads "Mark".

Mark A. Meulenberg, CFA
Chief Investment Officer

Appendix

Review of Investment Philosophy

We employ a value-based, catalyst-driven investment strategy that is focused on generating absolute returns. We like to buy \$1 bills for \$0.50. An even better scenario is if we can pay \$0.50 for a \$1 bill (or \$1 of value) that is growing over time. The presence of a catalyst more quickly closes the gap between the current price of a security and our estimate of the intrinsic value and speeds up the compounding process of the money entrusted to us.

We invest across the capital structure in any security and situation where we can ascertain the underlying value. Our best investment opportunities tend to be off the beaten path. We search where other managers cannot or will not look. Before we make an investment we always consider the downside before the upside. Conservative assumptions are made in our analysis. When done correctly, this creates a margin of safety that will limit downside and avoids the permanent impairment of capital.

The flagship product of VNB Wealth Management is our Enhanced Core Strategy. There are clearly defined investment characteristics of the businesses we want to own in the “Core” portion of the portfolio. The goal is to structure a portfolio of Core investments exhibiting specific characteristics in meaningful concentrations. Investments are made in those companies that have high and increasing returns on invested capital, recurring revenues and substantial free cash flow generation. The “Enhanced” portion of the portfolio supplements the Core positions and are best described as having a higher risk/reward profile than a typical Core holding. Investments are made throughout the capital structure and usually occur in companies undergoing various types of corporate events.

Core Investments

The criteria we employ when looking to commit capital is below:

Business Characteristics:

- Essential product or service
- Generates high and increasing returns on invested capital
- Currently produces, or has the potential to produce, substantial free cash flow
- Leadership in an attractive market niche or industry
- Understandable business model
- Minimal risks and variables that are outside of managements’ control

Intangibles:

- Open market purchases of company stock by directors & officers
- Integrity of management
- Managements' ability to execute on strategy and allocate capital
- Presence of a catalyst

Valuation:

- Targeting 15%+ IRR on investments: free cash flow yield and/or earnings growth + increases in multiple + dividends; in any combination

Enhanced Investments

These include:

- Refinancings
- Balance sheet restructurings
- Distressed debt, sum-of-the-parts
- Spinoffs and divestitures

A particular emphasis is placed on microcap securities in this portion of the portfolio. Most institutions are not able to capitalize on these situations due to the small size of the opportunity or their unwillingness to invest out of the mainstream. We have developed the ability to uncover, value and trade in these assets through many years of practical experience.

Disclosures

This Investment Review is furnished for general information purposes in order to provide some insight into the investment management process and techniques that VNB Wealth Management uses to make investment decisions. It is provided for illustrative purposes only. Opinions and information provided are as of the date indicated. This material is not intended to be a formal research report, and as such, it should not be construed as an offer or recommendation to buy or sell any security, nor should information contained herein be relied upon as investment advice. Opinions and information provided are as of the dates indicated. VNB Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. The statistics in the article were obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed.

This article contains commentary regarding several securities that have been purchased by VNB Wealth Management on behalf of our clients. Individual account holdings may vary, and the views expressed herein may change at any time subsequent to the date of this article. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities referenced in this article. The price and value of securities referenced in this article will fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed and a loss of all of the original capital invested in a security discussed in this article may occur.

Past performance is not indicative of future results.

Performance results are not GIPS compliant.

Investments and Accounts at VNB Wealth Management:

- Are NOT insured or guaranteed by the FDIC or any other federal government agency
- Are NOT deposits of, or guaranteed by, a Bank or any Bank affiliate
- May lose value

Indexes represent securities widely held by investors. You cannot invest in an index.

Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

S&P 500 Index is a capitalization-weighted index calculated on a total-return basis with dividends reinvested. The Index includes 500 of the top companies in leading industries in the U.S. market.

The Dow Jones Industrial Average is a price-weighted average of 30 stocks of large and well-known U.S. companies.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of June 2007 the MSCI EAFE Index consisted of 21 developed-market country indices.

Crude Oil is the world's most actively traded commodity, and the NYMEX Division light, sweet crude oil futures contract is the world's most liquid forum for crude oil trading, as well as the world's largest-volume futures contract trading on a physical commodity.

The **HFRX Equal Weighted Strategies Index** is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to, convertible arbitrage, distressed securities, equity hedge, equity market neutral, event-driven, macro, merger arbitrage, and relative value arbitrage. The HFRX Equal Weighted Strategies Index applies an equal weight to all constituent strategy indices. This index cannot be invested in directly.

Hedge Funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences.

The MSCI Emerging Markets Index captures large and midcap representation across 21 Emerging Markets countries. With 824 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg/EFFAS indices, which includes the Bloomberg Government Index of 7-10 year maturities, are designed as transparent benchmarks for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector.

SPDR Gold Shares is an investment fund incorporated in the USA. The investment objective of the Trust is for the Shares to reflect the performance of the price of gold bullion, less the Trust's expenses. The Trust holds gold and is expected from time to time to issue Baskets in exchange for deposits of gold and to distribute gold in connection with redemptions of Baskets.

The Value Line Composite Index has two forms, the **Value Line Geometric Composite Index** (the original equally-weighted index) or the **Value Line Arithmetic Composite Index** (an index which mirrors changes if a portfolio held equal amounts of stock). The total number of companies in the Value Line Composite Index hovers near 1675, and is composed of the same companies as The Value Line Investment Survey®, excluding closed-end funds. These indexes are typically published in the Value Line Investment Survey, created by Arnold Bernhard, the founder and CEO of Value Line Inc.