Investor Update January 2016

Many shall be restored that are now fallen; and many shall fall that are now in honor.
Horace, Ars Poetica

FANG.

In case you haven't heard, the FANG stocks were the only place to be in 2015. What are the FANG stocks? FANG is an acronym for Facebook, Amazon, Netflix and Google (now called Alphabet). In a year of poor returns across all asset classes, these stocks stood out as the top performers returning over 82% on average between them.

[Please note this section of the letter included a discussion of performance and has been redacted for compliance purposes. Full reports are available upon request.]

While we continue to be focused on the long-term, we do feel it is important to understand the factors impacting shorter-term performance. So, in examining the returns of 2015 further, we find that while the S&P 500 returned -0.73% on a price only basis, there were ten stocks that collectively were up 1.75%. By default then, the other 490 stocks actually had a negative return of around 2.48%. The Value Line Geometric Index, which covers approximately 1,700 stocks and assumes an equal dollar investment in each and every stock, was down 11.24% in 2015. Last, the equal-weighted S&P 500 index (as opposed to the market cap weighted index) as measured by the Guggenheim S&P 500 Equal Weight ETF (ticker: RSP) returned negative 2.64%.

In a very real sense, the market return was driven by a handful of stocks that masked the underlying weakness in the vast majority of the rest.

It is probably prudent at this juncture to walk through the inherent danger of investing in or trying to beat a specific benchmark with disregard for the risk associated with underwriting this activity. Consider this:

- The collective trailing PE for 2015 of the FANG stocks is 330x EPS.
- The estimated PE for 2016 of the FANG stocks is 145x EPS.

- The estimated PE for 2016 of the S&P 500 is around 15x EPS.
- If the market return is to be dictated by the performance of a few heavily-weighted players and those players are trading at very expensive valuations, there is the possibility for substantial downside should those constituents trade closer to a multiple that resembles the historic norm.

In owning the index this past year, what investors really received was the return of a handful of really expensive stocks. The embedded risk in this basket of high priced stocks reminds us of similar behavior in late 1999 and early 2000 when a few choice companies captured the investing public's attention and money flows with almost complete disregard for the prices paid. This was done while ignoring a plethora of wonderful businesses available at abnormally cheap prices.

Could there be a stock bubble in index funds? According to the Investment Company Institute, based in Washington, D.C., from 2007 through 2014, domestic index funds, both equity mutual funds and ETFs, received $1 trillion in net new cash and reinvested dividends. Actively managed domestic equity mutual funds experienced a net outflow of $659 billion, including reinvested dividends, during this same time period. Recent research by S&P Capital IQ shows, and we believe it is no coincidence, that stocks that are in the Russell 2000 index are trading at a 50 percent premium to stocks that are not, up from a 12 percent premium in 2006 as measured on a median price-to-book ratio.

What we have seen since the beginning of 2014 and continuing throughout 2015 is the unwillingness of the market to recognize value and a propensity (largely facilitated by index purchasers and large institutional buyers) to bid up, to the point of extremism, anything that had hints of faster than normal growth.

We have included a paragraph from last year's letter that we feel is worth reiterating:

> *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.*

We recognize how uncomfortable it is to trail an index for any period of time. However, without digging in and examining the makeup of the returns it is very hard to get a clear picture of where and how the money is being made. We also know that owning investments that are not currently in favor with the market can be especially trying. In a piece titled 'Investment Advice from Your Uncle Polonius,' Jeremy Grantham wrote, "The market is gloriously inefficient and wanders far from fair price but eventually, after

breaking your heart and your patience, (and for professionals, those of their clients too), it will go back to fair value."

The good news is that: 1) the companies we own have continued to perform very well on an operational basis and, 2) very few of the securities we own are represented in the most popular indexes. This means they have not been bid up by the indexing trend but it also means they are being ignored at best, or, at worst, are being sold to fund index purchases. The result is that the inherent and growing value of the businesses we own is not currently being recognized by the market, resulting in meaningful underperformance relative to the index over the short-term. ***As such, we now calculate the current internal rate of return (IRR) of the portfolio to be well above 50%.*** This is simply a calculation of the expected return of the portfolio when factoring in the weighting of each security, the current price as well as the estimated value, and timing (how long we believe it will take to achieve our price target). By contrast, in early 2014 when we started performing this calculation, the expected IRR was in the mid-to-high teens. It is clear to us that a massive and growing disconnect between price and value exists in our portfolio. It is our belief that the market will correct this over time and reward us for our patience.

In carrying these thoughts further we, as investment managers, need to balance our desire for outperformance at all times with a steadfast and relentless focus on our process.
We offer the following:

1. It is the ***process*** that is of upmost importance in generating favorable risk-adjusted returns and, as such, measuring success solely on ***short-term outcomes*** can be a harmful distraction.
2. One of the worst mistakes a manager can make is to change the process to chase short-to-medium term results.
3. The success of the process can, and should, be measured on a longer-term basis against a relevant index. Judging a process on short-term results will almost assuredly lead to inaccurate conclusions on the validity of the process.

The table below details the challenges a typical value manager faced during a similar period of disconnect in valuations between perceived value and real value. The time period represented was during my first decade in the business of managing investments. The lessons learned will never be forgotten.

Value vs. Growth	12/31/1997 thru 12/31/1999	12/31/1999 thru 12/31/2007	12/31/1997 thru 12/31/2007
Russell 1000 Value	24.3%	69.1%	110.1%
Russell 1000 Growth	84.6%	-21.1%	45.6%
S&P 500	55.6%	14.1%	77.5%
**Percentages represent total return during those time periods which includes price change plus dividends.*			

Note the significant and lengthy underperformance of value during the heyday of the internet era. An investor who stuck to his value discipline during the 10 year period from 1998-2008 would have beaten the S&P 500 handily and would have realized more than twice the return of the growth investor. A very painful downturn in growth stocks that lasted from 2000-2008 would have been avoided also. But imagine how hard it would have been (and it was) to not succumb to the market's whims as value trailed by almost 60% over a two-year period!

We believe our process will make us right over time but not "right" all the time.

To revisit history, the great disconnect in the late 90's began when value started being assigned to eye balls, clicks per user and revenue growth instead of the actual profits of the business. Unfortunately, we seem to be repeating at least some of the same lessons with the likes of the FANG stocks and, particularly, with the very stretched valuations of private start-ups. Of particular note is the private company, Uber.

Earlier this year it was noted in the news that it only took Uber five and a half years to surpass the valuation of 107-year-old General Motors. As Uber was looking to raise another $1 billion in funding in late October of 2015, the ride-hailing app was hoping to fetch a valuation between $60-70 billion. A valuation at this level makes Uber worth more than General Motors, Ford Motor, or Honda Motor. It begs the question: does Uber really deserve a higher valuation based on future profits hoped for than the companies that manufacture and sell the bulk of cars around the world and actually generate substantial cash flow today? It's also funny to think that without the actual cars, Uber wouldn't have a business.

Perhaps most importantly, in leaked financials obtained by **The Information's** Amir Efrati, Uber lost close to $1 billion in the first half of 2015 up from a loss of $671 million the year before. Who cares about profits, Uber seems to be saying and the market must

be accepting, when revenue is on pace to triple in 2016 and you have $4.1 billion of investor's money in the piggy bank to spend?

General Motors did a presentation in early 2016 at the Deutsche Bank Auto Industry Conference and estimated their potential free cash flow (think of this as the money available to the owner of a business after all expenses, taxes, etc.) from 2016-2018 to be between $6 - $7 billion on an annual basis. So if you had $60 or $70 billion lying around, you could buy Uber and lose money today with the hope of large future profits, or, with that same money, you could buy GM at their current valuation, assume all of their obligations (pension, etc.), have some cash left over and still make $6 - $7 billion per year to spend as you chose. Hmmmmm……

Lest we lose faith that markets have permanently lost the ability to appropriately value its constituents, we thought it might be helpful to give an example of how the intrinsic value, or the inherent value of a company, can be realized even when it is being mispriced by the public market. Take the case of LoJack Corporation (unfortunately we do not own this security), which develops and markets the LoJack System to assist law enforcement personnel in tracking and recovering stolen vehicles.

On November 10, 2015, CalAmp Corporation offered to acquire LoJack for $5.50 per share in cash representing a 58% premium to its then price and a 75% premium to the average closing price over the previous 60 days. In the press release, CalAmp states, "For nearly two years we have tried to engage with LoJack in friendly discussions regarding a combination of our two companies, and in the past 14 months, we have made three all-cash offers to LoJack." So, for two years, this public company has been pursued at a level well above its trading price in the market. Assuming that the pursuer is willing to pay a price that allows it to realize an economic benefit from the purchase; there is clearly value in LoJack that the public market had trouble reflecting.

All of this is to say that:

1. The public markets can sometimes be very inefficient and disconnected from economic reality.
2. It can remain in that state for long and uncomfortable periods of time.
3. If you are right in the analysis regarding the inherent value of a security, the market will ultimately find a way to recognize that value.

Select Portfolio Positions

In our view, one of the biggest advantages an investor can have is the benefit of a long time horizon. It is our belief that the long-term investment returns of a company's equity will follow the return on capital that the business generates. Wall Street is extremely fixated on short-term performance and is known for downgrading stock ratings for businesses that do not meet their quarterly estimates or face near-term

headwinds. This creates opportunities for long-term investors, like us, to buy great businesses at very reasonable prices, for you.

The core holdings in our portfolio represent competitively advantaged businesses with high returns on capital and a long runway for growth in free cash flow per share. Additionally, these businesses are run by management teams with a stellar long-term track record for generating shareholder value. Over the past year, we took advantage of the increased volatility in the market to add to some of our existing core positions and also made a couple of new additions to our portfolio. Discovery Communications (ticker: DISCK) is one of our newer core holdings. We hope you had the chance to read the summary of our investment thesis for Discovery in our interview with *BeyondProxy* last summer and in the September 30, 2015 edition of *Value Investor Insight*. Please find below our updated thoughts on Discovery and some commentary on a core holding, Liberty Global LiLAC (ticker: LILAK), added this summer.

Discovery Communications (ticker: DISCK)

Discovery's business performance continued to meet or exceed our expectations through all of 2015. Some of the key positive developments announced in the second half of 2015 are as follows:

- Discovery acquired the remaining 49% minority stake in Eurosport from TF1 Group for $548 million. A recent Wall Street Journal article on Discovery viewed Eurosport as a potential candidate for becoming the "ESPN of Europe" with 205 million paid viewers across Europe, Asia, Africa and the Middle East.
- Discovery renewed a long-term contract with Comcast that includes "TV Everywhere" rights for Comcast's customers. With this renewal, Discovery has locked-in rates (with annual price escalators) with 80% of its content distributors. This will allow them to grow their U.S. business at a mid-single digit rate even in a "cord-cutting" environment.
- In its Q3 FY2015 earnings release, Discovery announced a $2 billion increase to its stock repurchase program and resumed share buybacks in the fourth quarter.
- Discovery made a strategic investment in Lions Gate Entertainment (ticker: LGF) in partnership with Liberty Global. Discovery and Liberty Global each paid $195 million for a 3.4% stake in Lions Gate and a board seat.

In our opinion, these developments significantly enhance Discovery's competitive position and make the risk-reward ratio even more favorable than what we had anticipated when we initiated our position in Discovery in Q2 2015. We remain highly confident in Discovery's long-term growth prospects (especially in its International segment) and in management's ability to create shareholder value.

Liberty Global LiLAC (ticker: LILAK)

Liberty Global created its LiLAC tracking stock in Q2 2015 to provide investors more of a pure-play on Liberty Global's (ticker: LBYTK) Latin America and Caribbean cable assets. We received shares in this issuance as a result of our Liberty Global holding. In Q3 2015 we added to our shares of LiLAC to bring the total position to close to 3%.

As a tracking stock, LiLAC trades separately from Liberty Global but is still able to leverage Liberty Global's balance sheet which essentially lowers its cost of capital. LiLAC's management plans on executing a roll-up strategy similar to the incredibly successful one implemented in Europe by its parent company, Liberty Global.

There are several elements of this strategy that we find attractive: 1) a highly fragmented cable industry in the Latin American and Caribbean landscape that is ripe for consolidation, 2) LiLAC already has a strong presence in Chile and Puerto Rico and has a solid understanding of the competitive landscape in adjacent markets, 3) low broadband and pay-TV penetration represents strong long-term growth opportunity, similar to where the U.S. was 20-30 years ago, and 4) an outstanding team of cable asset operators and capital allocators at the helm.

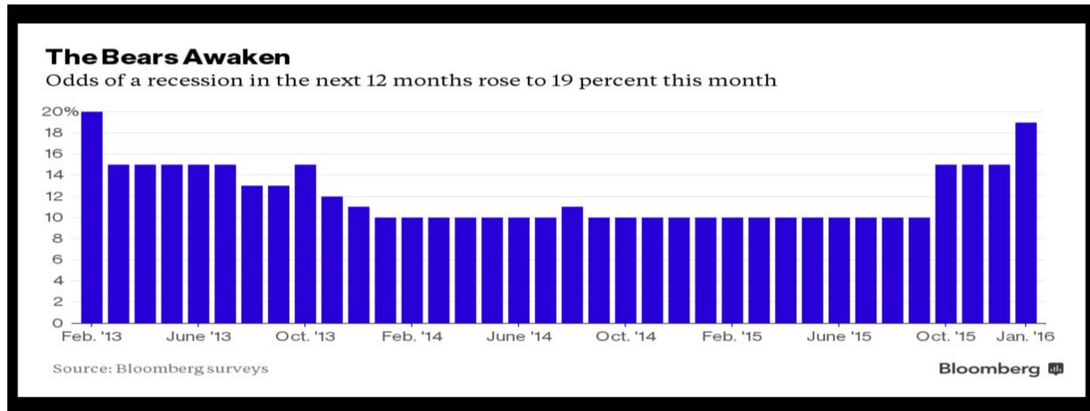
The recently announced acquisition of Cable & Wireless, a cable and mobile operator in the Caribbean, sets the foundation for a potential roll-up of cable and complementary mobile assets. We expect operating cash flow to grow at a double-digit rate over the next five years resulting in a free cash flow per share estimate of $5 - $6 in 2020. Applying a 15x-17x FCF multiple, gives us an intrinsic value estimate of $75 - $100 or an IRR of 15% - 22% from current prices.

<u>It was an inauspicious start to 2016</u>

2016 started with a global growth scare. Commodities, particularly oil, were in rapid retreat and a "running for the hills" mentality in global stock markets was the prevalent emotion. In raising interest rates in December of 2015, the Fed publicly stated their belief that the economy was on solid footing and poised for decent economic growth in 2016. They seem to believe that GDP growth could land somewhere between 2.0% and 3.0% to which market participants have said phooey.

Predictions of large and imminent declines in the US stock market are common headlines as are predictions of an imminent recession. These smart prognosticators couldn't be wrong could they[(1)]?

Below please find a Bloomberg survey taken in January of 2016 regarding the odds of a recession occurring this year:



So, the odds of a recession are approaching 20% and are now at their highest level since February 2013!

Does anyone recall how 2013 turned out? The S&P 500 finished the year up around 32% and GDP grew around 2.2%(2).

Other Business

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,

Mark

Mark A. Meulenberg, CFA
Chief Investment Officer

Footnotes:

1) CNBC couldn't be wrong could they? This was taken from an essay written on the subject of "experts."

   Below the headline of expert ineffectiveness were some more subtle findings. One was an inverse correlation between fame and accuracy. While famous experts had among the worst records of prediction, they demonstrated "skill at telling a compelling story." To gain fame it helps to tell "tight, simple, clear stories that grab and hold audiences." These pundits are often wrong but never in doubt.

   Another result, which is related to the first, was that what mattered in the quality of predictions was less what the expert thought and more how he or she thought. Tetlock categorized his experts as foxes or hedgehogs based on a famous essay on thinking styles by the philosopher Isaiah Berlin. Foxes know a little about a lot of things, and hedgehogs know one big thing. Foxes did better than the dart-throwing chimp, and hedgehogs did worse.

   It's not hard to see the link between these findings. Most topics of interest in the economic, social, and political realms defy tight, simple, and clear stories. But imagine you are the producer of a television show that covers politics. Who do you want to put on the air, the equivocal guest who constantly says "on the other hand," or the one who confidently tells a crisp and controversial story? It's not a hard decision, which is why many hedgehogs are both famous and poor predictors.

2) GDP growth in 2013 for the United States according to the World Bank.
   website: data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

Disclosures:

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- Are NOT insured or guaranteed by the FDIC or any other federal government agency
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- 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.

The **HFRX Event Driven Index** is designed to be representative of Event Driven Managers. These managers maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

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.

HFN Event Driven Index includes funds that take positions in securities with the expectation of specific events that may positively impact the valuation of their positions. Examples of specific events include acquisitions, reorganizations, spin-offs, debt exchanges and litigations.

HFN Hedge Fund Aggregate Index is an equal weighted average of all hedge funds and CTA/managed futures products reporting to the HFN Database. Constituents are aggregated from each of the HFN Strategy Specific Indices.