



Investor Update

January 2017

“Losing money is perhaps the only thing that makes most investors worry about losing money.”

Seth Klarman

We were pleased with the returns on our portfolios this year as many of our holdings began to be rewarded for their strong underlying economics. I’ve been at this now for quite some time (over 20 years) and lived through a few financial crises, an internet bubble and the Great Recession. While the market may be on its way to returning to a more normal environment, it still seems to us that a move away from relying on monetary and government policy to one driven more by market forces is in the early innings.

[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.]

With 2016 now behind us, our gaze has quickly shifted from last year’s returns to that of the heightened uncertainty we face as we enter 2017. It is evident to us that money has been misallocated over the past several years due to Fed policy. To further cloud the picture, the general market has not experienced a significant down year since 2008. It seems investors have moved away from the appropriate first level thinking of “how much can I lose” to the far riskier proposition of “how much can I make.” Seth Klarman is perhaps the most storied value investor of our generation behind Warren Buffett. Among some of the more insightful comments he has made are those on risk, investor time horizons and the desire for short-term returns. A few of his ideas on these subjects taken from Baupost’s 2004 annual letter are listed below:

- “Few investors are comfortable taking a long-term point of view, no matter how compelling the opportunity, because their results are measured in the very short-run.”
- “While others attempt to win every lap around the track, it is crucial to remember that to succeed at investing; you have to be around at the finish.”
- “What matters is not who performs best during sequential short-term intervals, but the attainment of a successful long-term, risk-adjusted, cumulative result.”

- “Oddly, risk moves to the forefront of investor consciousness only when things are already going badly.”

From our past writings, we hope it is clear that when we purchase a stock, we clearly view it as owning a part of the underlying business. Further, we expect the business to generate an economic profit and consider it management’s obligation to create, enhance and protect the value of that business. This is an expectation that to us is purely commonsensical in nature. You can imagine our amusement and surprise then, when Reed Hastings, the CEO of Netflix, gave his answer as to how he views his management obligation with regard to running Netflix for the benefit of its shareholders.

The following was taken from an interview published in the Wall Street Journal on Halloween of this past year:

MR. BERMAN: *Take us through the economics of greenlighting a show.*

MR. HASTINGS: We’ll collect this year about \$8 billion of customers’ money. We say that money’s in trust to create joy. We have to turn that into the most joy possible. We look and we say, for every show, if a show cost \$100 million, how much joy, how much viewing did it create? If it costs \$50 million or \$200 million, of course you want different amounts of joy. So we look at it as how much joy can we create of your money. And if we turn it into joy effectively, then you’re happy and you tell your friends and we grow.

MR. BERMAN: *Has your own value of joy changed?*

MR. HASTINGS: The highest-end TV, it’s about \$10 million an hour for the production budget. But in movies the high-end budgets are \$100 million of production cost for an hour. So right now, we are, in television, way under movies because we don’t yet have the distribution. We can’t afford \$100-million-an-hour television. What we hope is we’ll be able to figure out in the next couple of years what \$20-million-an-hour television will look like. As distribution grows, the high-end grows. And we’ll do more high-end productions.

It’s hard to even know where to start. There is no mention of profits, of any measurement of return on capital invested in the business, or really of any other measure of how Netflix is growing and enhancing the profits of the business to the benefit of the owners, i.e. the shareholders. Running a business where the end product is “joy” might be fun but it won’t pay the rent or put food on the table.

Tony Wible, an analyst with Drexel Hamilton, had this to say post earnings for Q4 2016 where the company forecasted negative free cash flow of \$2 billion for all of 2017, “The losses Netflix generates are its biggest competitive advantage. They make it incredibly difficult to compete.” One has to wonder how this view might be perceived if said to a loan officer while at a bank in search of funding for a new business model. As it stands, Netflix is tapping the bond market to fund their growth initiatives, the majority of which

is their incredibly ambitious spending on content. It is entirely possible the bond market wakes up and starts to behave in a similar manner to a local banker. In many respects, Netflix seems to us to be a House of Cards.

The Trump Trade and general portfolio positioning

The portfolio generated strong returns in the fourth quarter of 2016. Since Election Day, the market appears to be repricing various elements of risk and potential return and our portfolio has benefited. On the margin, it seems that higher levels of economic growth, higher interest rates, less regulation, lower taxes and less government subsidies to certain money-losing U.S. industries are all being baked into a Trump Presidency. Whether these occur or not remains to be seen. For sure, the early indication is that this may prove to be the most disruptive U.S. President in memory and we are working diligently to determine the potential impacts (both favorable and unfavorable) on our investments.

Here are some high level thoughts on our current positioning:

- **Net Neutrality and Broadband rules may be eased** and the FCC may cede some of their influence in this area. This would result in a shift of power from streaming services like Netflix to the cable companies / broadband providers.
- **We remain long General Motors** and believe it is materially undervalued and that the threat of new entrants and disruptive technologies has been overblown (Tesla, Uber).
- **Long content producers:** The more devices that are out in the world the more content that can be consumed. Quality content is king. We expect consolidation amongst content producers as well as distributors in the years ahead. It seems President Trump may well take a more favorable approach to mergers and acquisitions than that of the previous administration. The possible exception is the unfavorable view of an AT&T and Time Warner combination which is highly likely to be a product of the President's disdain for CNN.
- **Building products** retain a prominent place in the portfolio. Homeownership remains dramatically below the norms of the last 50 years. At this juncture, we believe we will continue to move toward a more normal homeownership rate as Millennials move out from the basements of their parents and into apartments and eventually new homes.
- **The cash position** is larger than it has been in quite some time at approximately 20% in the model portfolio but this is really a function of a lack of investable ideas. We believe our current holdings are undervalued and the overall portfolio should generate attractive returns over multiple years even with this hopefully temporary elevated cash position.

Select Portfolio Positions

CarMax (KMX) is a core position added to the portfolio in 2016. The company provides a wide selection of 50,000 – 60,000 high-quality used cars to consumers at no-haggle prices through its network of retail stores and company website. The business was built around the idea of providing a pleasant car-buying experience to customers through increased transparency and high-quality customer service. Selling used cars is a tough business characterized by intense competition, low margins, and a quickly depreciating inventory. The ability to price vehicles accurately is of paramount importance. CarMax's long history of buying and selling used cars for over 20 years gives them a significant competitive advantage.

Despite being the largest used car retailer in the country, CarMax's share of 0-10 year old cars is only between 2 and 3 percent. We believe over time CarMax will be able to increase its market share to the high single digits in its mature markets through strong brand awareness, a transparent selling process, and its focus on providing maximum value to its customers. The current store base of 170 stores is likely to double over the next 10 years as new stores continue to be built. We believe this long runway for growth will allow CarMax to compound its intrinsic value at a mid-teens rate for many years to come.

Our investment in **General Motors (GM)** is an example of the type of situation we are attracted to in the "Enhanced" portion of the portfolio. We made our first purchase of the common stock of GM in October 2014 when there was widespread concern about the ignition switch recall and associated liabilities and penalties. While the market seemed solely focused on this issue and on other negatives typically associated with the cyclical auto industry, we saw a significantly improved business with a management team intensely focused on earning an attractive return on invested capital and creating shareholder value.

Throughout our holding period, GM has consistently beaten the Street's earnings expectations quarter after quarter, increasing earnings per share by almost 50% in a little over 2 years. Yet, GM's stock price has only gone up 20% over that period. While increasing auto sales in the U.S. certainly served as a tailwind, a substantial portion of the earnings growth has come through realizing cost efficiencies, higher quality new vehicle launches, and most importantly, a maniacal focus on profitability versus market share.

Today, investors are concerned about peak auto sales in the U.S., an anticipated slowdown in auto sales in China, and various other macro factors, pricing GM shares attractively at just over 6 times trailing 12 months' earnings to go along with a 4% dividend yield. We view GM's continued prospects for increased profitability more favorably and believe that its shares still provide a meaningful upside from our original purchase.

Outlook for 2017

We continue to believe our current holdings are undervalued, in some cases drastically so, relative to their intrinsic value. As written earlier, it could be that we have seen the start of a more normal market environment but we are still in the early stages. Robert Arnott of Research Affiliates, LLC provides the following commentary and chart that reiterates our past views and gives us hope that we may be in for a meaningful period of outperformance in the years ahead.

“Protracted growth-stock bull market and underperforming value stocks.

In the three-year trailing period ending March 31, 2016, value stocks underperformed growth stocks in the MSCI World Index by nearly 3%, hovering near the worst decile of relative performance for the two strategies since 1976. Consequently, as Figure 4 shows, value stocks are the cheapest now relative to growth stocks than at any time other than the tech bubble (1998–2001) and the global financial crisis (2008–2009). Historical experience shows that starting valuations similar to those we see today in value stocks have led to their prolonged, massive outperformance, making a strong argument for rebalancing into a deeper value tilt and avoiding the popular, bull-market growth stocks.”

Figure 4. Relative Valuation, 1997–February 2016



Source: Research Affiliates, LLC, using data from CRSP/Compustat.



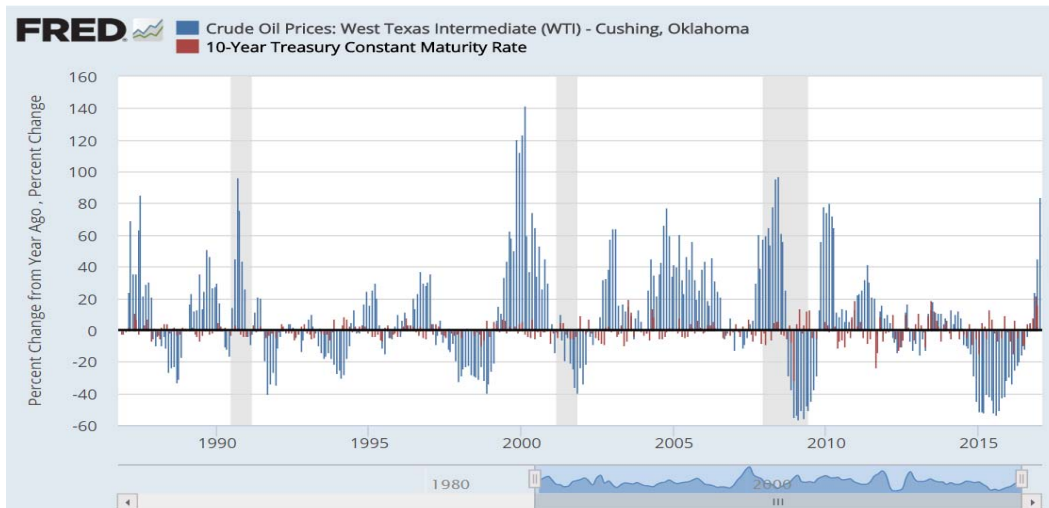
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While this provides some reason for optimism regarding our value-oriented investment approach, we do also pay attention to broader themes and market conditions using a variety of indicators. One of the most reliable as it relates to future economic and stock market strength or weakness is the year-over-year change in the price of oil. Key levels that have proven to be major inflection points are listed below:

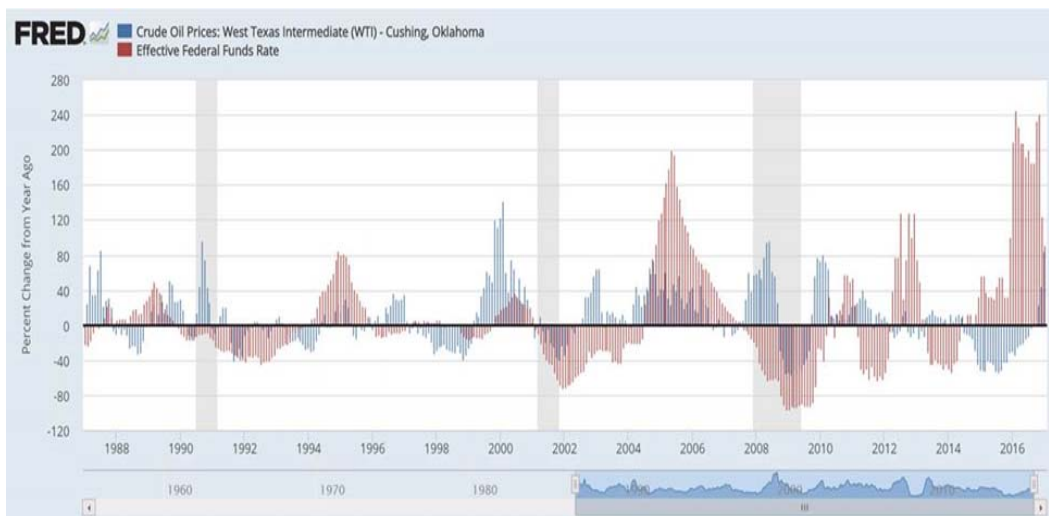
- When oil rises over 80% year-over year, the economy and the stock market have a difficult time and it doesn't portend well for future returns over the following 18 months.

- When oil is down 20% or less or rises 20% or less, this is an “all clear” signal for the general market.
- When oil is down 50% or more, this generally produces a very favorable return environment for stocks.

As of January 2017, we have officially crossed the “up over 80%” year-over-year threshold.



Further, there have been two other instances during the last 30 years when oil has both crossed the “up over 80%” mark AND the Fed was increasing interest rates. The first occurred in 1987 when the market raced out to a return of almost 40% in the first 8 months of the year only to plummet more than 20% in one day in October and finish the year up around 5%. The second occurrence happened in late 1999 / early 2000 as the internet bubble petered out and subsequently crashed. Coincidentally, this period led to substantial outperformance for value-oriented investors as many highly profitable and inexpensive companies were left forgotten by the investing masses during the previous years.



Credit is due to our analyst, Tyler Van Selow, for the preceding charts and analysis. We continue to prioritize protecting capital first and foremost, particularly in light of this information.

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,

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

Mark A. Meulenberg, CFA
Chief Investment Officer

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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.

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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.

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