Investor Update **January 2018**

"Revenue is vanity, profit is sanity, cash is reality"

A wonderful quote whose origin is most likely lost to the sands of time

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To Our Clients, Partners and Friends:

[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.]

Strategy Overview

Our objective in investing the capital entrusted to us is to generate returns significantly above what an investor could achieve via a risk-free rate, typically thought of as a shorter maturity US Treasury, while taking on an acceptable level of risk. We use the S&P 500 as a measuring stick or benchmark. It seems appropriate to do so given that most investors are familiar with the index as well as the fact that it has produced returns well in excess of the risk-free rate over a long period of time. ***We do not, nor will we ever, endeavor to maximize returns without regard to risk.*** In short, that would be akin to speculation similar to what one would find in a casino. If gambling is the desired activity, we are happy to help determine the odds at the table, but we buckle at the idea of us actually rolling the dice.

Part of the investment process involves understanding and evaluating "what could go wrong" when making an investment. We bring to bear over 20 years of experience to the analytical process of judging risk and return, and unfortunately, over time, we have learned some hard lessons when it comes to misjudging risk. Only after first assessing the probability and magnitude of potential loss should one turn their gaze to how much money can be made. Unfortunately, this truth becomes obscured at times such as when a bull market in stocks has stretched over 9 years!

Investing and Coaching Football

I recently concluded my 6th and final year of coaching youth football. We were fortunate to have great success over those 6 years winning 5 championships. The seasons typically started August 1 and lasted until just before Thanksgiving. As I sat and reflected on my experience, it became clear to me that having a plan and being prepared was the most important element our coaching staff brought to our team. Our season was scripted out practice-by-practice from the first to the last. We had the players complete drill after drill so that in a game situation the necessary actions came naturally and instinctively. Part of our time was spent studying film and in conversation with the other coaches to put our players in positions where they could maximize their strengths and abilities to the benefit of the team.

Through my experience, I have a new and deep appreciation for the coaches at higher levels of football. The most successful ones are the most prepared (think Nick Saban at the University of Alabama and Bill Belichick of the NFL's New England Patriots) and their sole focus is on process and not outcomes. If the process is correct, the outcomes will follow. The same is true in investing. For us to be successful requires discipline and focus while adhering to the foundational elements of our strategy which has outperformed its benchmark over many years.

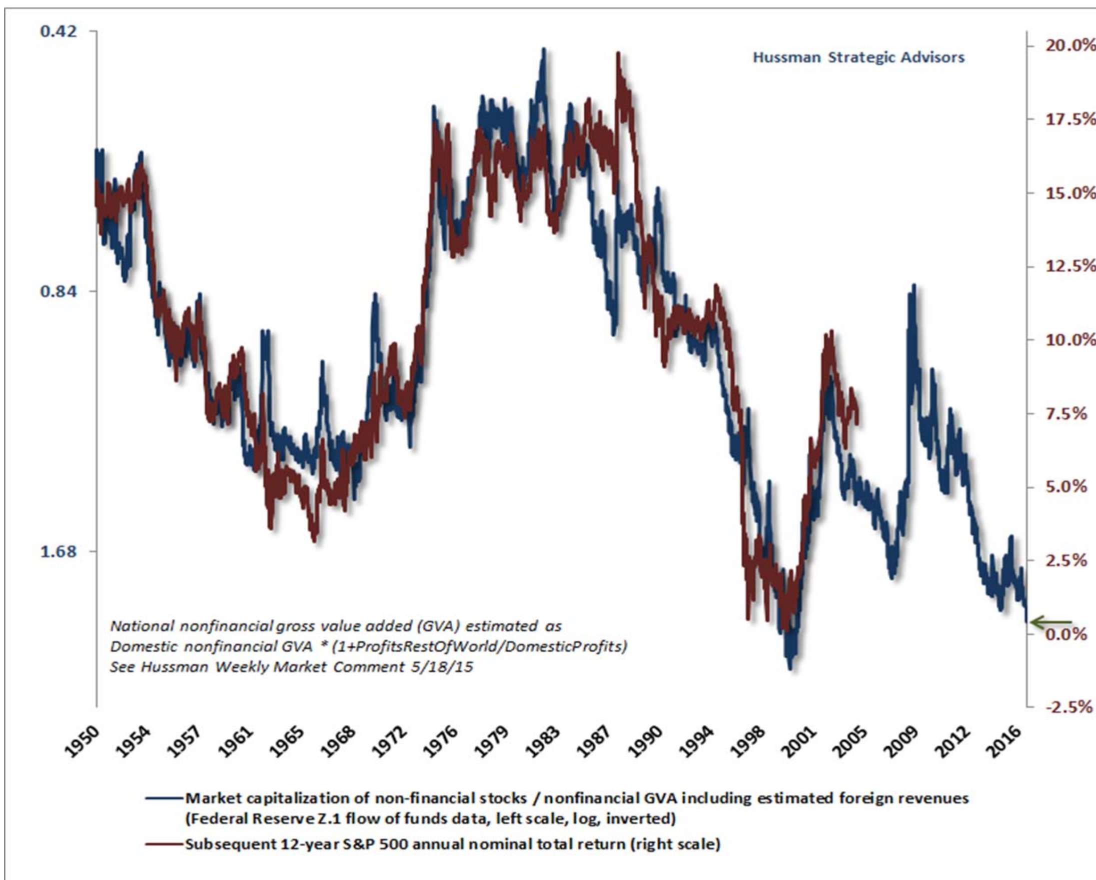
The 'market' becomes detached from fundamentals at times and, as a result, the past few years have not been kind on a relative basis to investors who prefer cash flow over revenue growth. The prevailing view shifts from time-to-time from preferring the cash a company is earning to the sexiness of revenue or subscriber growth. For those of you who are business owners, I think you can appreciate that revenue growth can't be used to pay your vendor bills. We choose to stick to our view that the ability of a business to generate an attractive cash return is one of the most important factors when deciding whether or not to make an investment. ***So, despite the current market conditions, we continue to be process-oriented knowing that in doing so the outcomes will be favorable over time, just not all the time.***

The current market pundits, and many institutional and individual investors, are acting like they are playing fantasy football at the moment. Fantasy Football is the game where you "draft" a player and their game performance each week determines the number of points you receive. At times, and this is certainly shaping up to be one of them, it feels like fantasy players believe they should call up the coaches of actual players and, with certainty and conviction, tell them what plays to call because the game looks so easy to them as fans. But, alas, as investment managers it is our undertaking to remain convicted in a well-thought out strategy, to be disciplined and to remind investors that to achieve satisfactory results in the long term one must first obey Buffett's most important rule, "Don't lose money." The game is actually much harder than it looks and this is true in both coaching football and in managing investments.

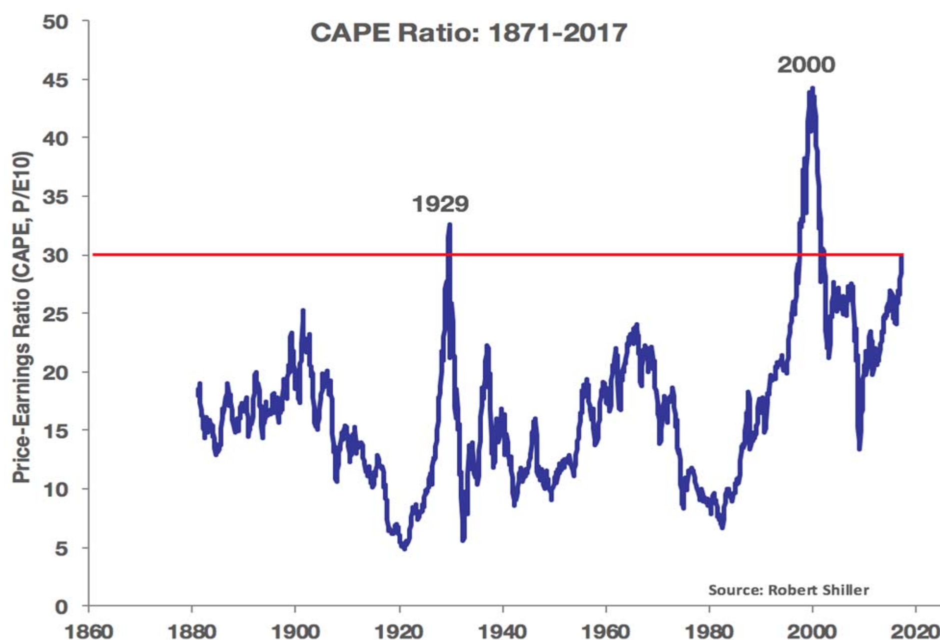
	Beg Balance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	
Investor A	$1,000,000	$1,130,000	$1,209,100	$1,390,465	$1,293,132	$1,616,416	$1,858,878	**$2,016,883**	**Average Return**
Return		13.0%	7.0%	15.0%	-7.0%	25.0%	15.0%	8.5%	**10.9%**
Investor B	$1,000,000	$1,250,000	$1,475,000	$1,740,500	$1,261,863	$1,413,286	$1,639,412	**$1,885,324**	**Average Return**
Return		25.0%	18.0%	18.0%	-27.5%	12.0%	16.0%	15.0%	**10.9%**
Better Return		**B**	**B**	**B**	**A**	**A**	**B**	**B**	

In the above analysis, Investor B and Investor A have the same average return over a 7-year period. Further, Investor B outperforms Investor A in 5 of the 7 time periods. Yet, Investor A has more money at the end of the analysis than Investor B. Why? The chart clearly shows the avoidance of loss as the main driver of investment gains over time.

With the increasing popularity of indexing many people are asking “why not just index?” Well, here’s why….

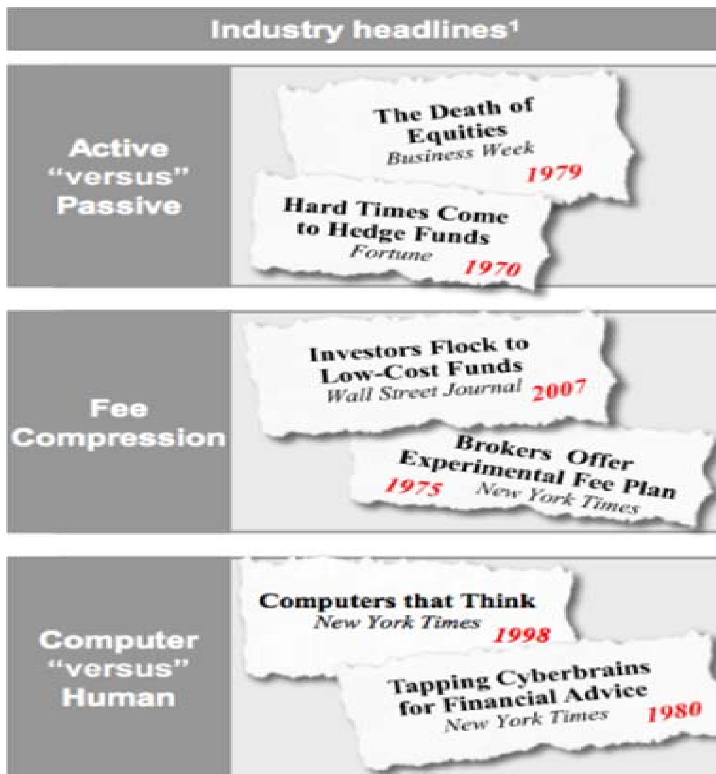


What the above chart tells us is that if history is any guide the current valuation level for US stocks is highly likely to lead to very poor 12-year returns going forward (valuation metric at left and subsequent returns on the right).



With stocks at valuations only reached twice before, first in 1929 and then again in 2000, it is a decent bet that an investment in an index, which by nature is made without regard to the valuation of the underlying companies, will not produce a satisfactory long-term return. During periods such as this in the past, the future returns of a general market investment have been below average and the risk of loss has been above average. Given that we see limited investment opportunities that meet our criteria, it seems prudent to us to not have a portfolio that is fully invested with limited cash reserves.

We tend to forget that the current themes are not really 'current' but rather recycled from the past and slightly changed to form the narrative of the present. The below was taken from a JPMorgan piece that we hope helps illustrates the point:



To highlight a few specifics from the preceding picture:

1970
The year was close to the end of what would be an 18-year bull market in stocks. Investing in the Nifty Fifty (50 companies that were awarded sky high valuations) was the predominant theme. This development occurred just before the recession of 1973-1974 and began what came to be known as the lost decade for equity investors.

2007
Within a year the S&P 500 would be down over 55% from its peak, the MSCI Emerging Markets index down over 65% and the MSCI Developed Markets over 61%.
History doesn't repeat but it sure makes a habit of rhyming…unless, of course, this time is different.

We have now lived through almost 10 years of quantitative easing which seems to have pushed up asset prices, dampened interest rates and produced record low volatility. It is impossible to determine with certainty whether or not we are near the end game, but with the market in a state of euphoria, exercising discipline in investing has almost never been more important. What we are seeing with some regularity is the opposite.

To illustrate, we share below the commentary of an analyst from the spring of 2017 as to why the shares of Tesla were upgraded at their firm.

> *"We are upgrading TSLA from Neutral to Overweight, and increasing out price target from $223 to $368. We have driven a Tesla for seven months in preparation for this report, and after conducting investor meetings with the company last week, we're finally ready to take a stand. Admittedly, before investors can follow our advice and buy TSLA shares, they will need to employ a "creative" valuation methodology and prepare for a bumpy ride. The multiple will likely exhibit sensitivity to Model 3 production headlines, and any setbacks might cause substantial volatility (a.k.a. buying opportunities). But even with all the risks, we think growth investors can't afford to ignore this stock."*

So, in combination, they are stating that through the act of driving the car for seven months, meeting with management (who are notoriously promotional) and using a 'creative' valuation, they have upgraded their price target. Whatever view one might have of Tesla's cars, the cocktail poured by this analyst does not constitute the basis of a sound investment case.

To review:

- Having a plan, being prepared and exercising discipline are necessary components of a successful investment strategy (and to be a successful coach)
- Many times the investment community, like fantasy football players, is seduced into thinking the 'game' is easy. Subsequently, at certain periods of time, investors believe: 1) valuations aren't important 2) cash flow doesn't matter and 3) indexing is a low risk, all-weather way to increase wealth regardless of valuation levels

Portfolio Review and Positioning

The past year provided us an opportunity to harvest gains from some long-held positions. Among those was Charter Communications (and its companion, Liberty Broadband, whose main investment is an investment in the stock of Charter). We initiated positions in Charter as early as August of 2013 at around $135 per share on an adjusted basis. The sales occurred at various prices but generally around the $380 per share mark generating an internal rate of return of approximately 30%.

We trimmed our position in Hudson Technologies during the course of the year as the stock ran up substantially and approached our estimate of intrinsic value. The partial sale of Hudson was done in consideration of our self-imposed position size constraints. The move proved prescient, as the stock retreated from over $9 per share to under $6 per share in a very short time period. We believe the long-term story is intact and it remains an appropriately sized position in the portfolio.

We remain long content companies (Discovery Communications, Lions Gate Entertainment), as well as the companies that deliver content through cable or satellite internet (Liberty Latin America, Viasat). If you took a JetBlue flight recently you could have watched the content from a company you own delivered by another holding (Viasat), which specializes in satellite broadband. The traditional content producers trade at startlingly low valuations (approximately 6x free cash flow and less than 3.5x revenue at the lows for Discovery as an example) versus the up-and-comers (negative free cash flow and over 10.5x revenue for Netflix). We believe we are well-positioned to capitalize on the exploding broadband usage in years ahead through a select group of companies with sound business models and inexpensive valuations. This is no small feat in today's environment. One holding is a spin-off (which we've found historically to be fertile hunting grounds) from a much larger company, Liberty Latin America, and the other is a misunderstood midcap stock with an amazing operator and capital allocator at the helm in Mark Dankberg at Viasat.

With regard to Discovery Communications in particular, this is a company we have followed and owned at various times for over 10 years. We believe we know the business quite well. Late this fall the market assigned the stock a multiple that approached 6x our estimate of free cash flow for 2018. It has been a long time since I've seen poorer sentiment around a name. To believe the bear case you needed to believe something along the lines of the following:

- Discovery's Q1 2018 acquisition of Scripps will be a disaster despite public comments to the contrary from the distinguished and very successful management team at Discovery. To hold this view would also be in direct contrast to the attractive cash flow generation and massive synergies that stems from the combined entities.

- Netflix is going to rule the world with regard to content creation and viewership and there is no way that their **negative** free cash flow generation of approximately $4bn per year will impede their business model at any time in the future. One then has to believe that Netflix at over 200x trailing earnings is a better long-term value than Discovery at today's very low valuation levels.

- Discovery will **never** find a way to capitalize on delivering their incredible content library in any way other than through a cable bundle and one also has to believe the cable bundle will continue to shrink dramatically.

- That Discovery's international business, which includes the creation of a 'Netflix for sports' in Europe, will not be an important part of the overall business although it is now about ½ of their current revenue.

To say we strongly disagree with the bear thesis would be doing our bullish investment thesis an injustice. In fact, we found the risk/return ratio so favorable that we made Discovery Communications our largest position late in the fall of '17. From prices that plumbed lows around $15.25 per share in November the stock has since recovered to close to the mid-$20's as of this writing (late January). We will continue to stay in the

game with regard to Discovery but anticipate trimming the position over time to stay within the maximum weighting constraints outlined in the strategy.

The portfolio is filled with companies that trade at very low valuations on an earnings or free cash flow basis. We invested in Fiat Chrysler early in 2017, when the math showed that if they were to execute as planned, the stock would have traded for around 1x earnings per share within the next few years. So much for the market being efficient! Over less than a year, the shares have appreciated from our purchase price of around $11.25 per share to over $24 in early '18. On almost any valuation metric (earnings, sum-of-the-parts) the shares are still cheap and worth holding for the foreseeable future.

A position was initially established in Dollar Tree (DLTR) in late 2016 and was added to substantially in the spring of 2017 at around $75 per share. The basic premise was that the Dollar Tree franchise was being undervalued given the uncertainty surrounding the integration and improved execution of Family Dollar, which was acquired in the summer of 2015. Applying a more appropriate multiple to the increasing value of the Dollar Tree franchise and assuming slight improvements in the Family Dollar stores resulted in a much higher share price than the market was offering to sell to us at the time. Since our purchase, we have come to appreciate the amazing assortment of $1 items you can find at Dollar Tree stores. If you have never been you should go! I find it hard to walk out without purchasing something. After all, it's just a buck.

On the smaller side, we continue to hold investments in language learning (Rosetta Stone), pet insurance (Trupanion), subscription-based yoga streaming (Gaia) and steel processing (Friedman Industries). An eclectic mix for sure and they all meet the defined criteria outlined in our strategy and offer substantial upside with limited downside.

Throughout the year we held options (puts) on securities or indices we viewed as wildly overvalued, setting us up to profit handsomely if the share prices dropped. We viewed these positions as relatively low-cost insurance to protect against a sudden revaluation of the overall market due to a plethora of potential factors. The securities underlying the puts had some common themes. They were in some combination or in total: 1) grossly overvalued when considering their ability to return cash to the owner of the business (the shareholders) 2) dependent on the capital markets to raise equity or debt to fund their operating business 3) long duration plays that, by their nature, are very sensitive to changes in interest rates. As is the case with insurance, just because you didn't need it doesn't mean you shouldn't have bought it. The risks we hedged were real but we didn't experience an insurable loss.

Outlook for 2018

The Tax Cuts and Jobs Act (TCJA) passed by Congress and signed into law by President Trump will have an immediate and profound effect on American business in the coming

year. Many in the investment community are taking a ‘wait and see approach’ with regard to trying to gauge the impact the tax reform will have on American businesses. As a result, it seems to us the benefit to companies with real earnings and cash flow is being under-appreciated. For the companies we own where we believe we have reasonable earnings visibility and an uncomplicated corporate structure, the impact of tax reform is quite easy to compute and it is also substantial. It would not surprise us at all if share prices of these businesses reacted quite positively throughout this year as this new, higher earnings stream is incorporated into the financials of these companies.

We are on the constant lookout for profitable investment ideas. To qualify the opportunity must: 1) meet our defined criteria 2) be thoroughly understood by us 3) trade at a discount to our calculation of intrinsic value and, 4) have a margin of safety. Although few and far between at present, we are finding a few interesting securities to evaluate in the area of banks, energy, and food distribution. In each case, we are trying to exploit advantages in our decision-making developed over many years designed to stack the odds in our favor:

- Our general knowledge of the financial services space is quite deep as I serve on the executive management committee of our parent, Virginia National Bank. In addition, we have a plethora of resources to draw on within the bank when evaluating other financial institutions.
- The investments and potential investments in the energy space involve under-the-radar stocks (generally smaller in size), post-bankruptcy and generally misunderstood situations.
- We have identified a security in the food distribution business that has many similarities to an investment we made many years ago. An investment in that company returned approximately 179% cumulatively over a 6.5 year period. It is our undertaking to determine if history can repeat with a different company using the same playbook.

We continue to look for ways to protect capital in a cost effective way by buying puts on companies or securities that represent a basket of companies with sky high valuations and little margin for error in executing on their business plans.

We are wary of the high valuations in the general market, the mania caused by Bitcoin, and the euphoria of investors that finally seems to be seeping in. The Millennials were the last players on the bench and by many measures it looks like they have now entered the game. As sports fans know, once the bench clears the game is usually nearing its end. There is no way to know how many minutes are left but it is safe to say we are nearer the finish than the start.

Other Business

This upcoming year will bring many new and exciting changes to VNB Wealth Management. As you may know, VNB Wealth was really the compilation of VNBTrust (trust and estate services), VNB Investment Services (wealth planning and investments) and the home of the Enhanced Core Strategy. It has been my privilege to lead this organization and these various business lines over the last few years. Our new direction appropriately calls for the appointment of leadership in each area who will be responsible for their respective businesses as we move forward. With this, there will be more announcements and information coming over the next few months with regard to our respective long-term visions, product offerings, team additions and new offices.

The objective of the reorganization is to allow our business to serve each of you better in the areas of: flexible, knowledgeable trust services through VNBTrust, prudent investment planning and management through VNB Investment Services, and continued outperformance via the Enhanced Core Strategy. Our continued partnership and integration with Virginia National Bank is integral to our success and we look forward to working together as we move forward.

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

We are very grateful for your continued trust and for the opportunity you have given us to be of service.

Respectfully submitted on behalf of the staff at VNB Wealth Management,

Mark A. Meulenberg, CFA
Chief Investment Officer

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 **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.

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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.