2016 First Quarter Investor Letter

April 25, 2016

2016 began with the worst 10-day start in US equity market history. The selling continued into February with the broader indices down nearly 11% midway through the month. The nervousness over China, falling oil prices, and weaker economic growth were not new concerns. Markets, however, rallied for the second part of the quarter, based on the equally less novel solutions of delayed rate hikes in the US and a further smorgasbord of negative rates and money printing abroad. Although sentiment may have improved, we do not think that the underlying concerns have been eliminated and we would anticipate further volatility later this year as many of the same fears that have recently subsided will again take center stage. While the vast bulk of our time will always be spent looking at the risk/reward of individual businesses, we thought it might make sense to spend a small amount of time examining a couple of broader themes that caused so much consternation in the early part of 2016.

Rinse, Lather, Repeat

For large portions of the past 18 months, markets have generally followed a pattern. A relatively healthy US economy (compared to other countries) has allowed the US Federal Reserve to either raise rates (December 2015) or talk about further increases. The possibility of higher rates contrasts with more aggressive monetary policy in Europe and Japan and results in a strengthening US dollar. The high dollar causes further pressure on an oversupplied oil market (oil is purchased in dollars) and weaker oil prices negatively impact several emerging economies, particularly China or multiple countries in Latin America. The prospect of weaker growth in China causes further monetary and fiscal policy responses, and these policies accentuate fears about capital outflows. US multinationals also suffer as their foreign earnings are hurt from economic weakness in foreign markets as well as translation headwinds on overseas earnings. Markets react negatively to this chain of events, and these negative reactions increase the possibility of a negative feedback loop to the real economy. Fearing an economic slowdown, the Federal Reserve decides against further rate action, the US dollar weakens, oil prices rise, and markets rally and investors "feel" better. The Fed then hints that the economy is strong enough for rate hikes and the entire cycle occurs again. *Rinse, lather, repeat.*

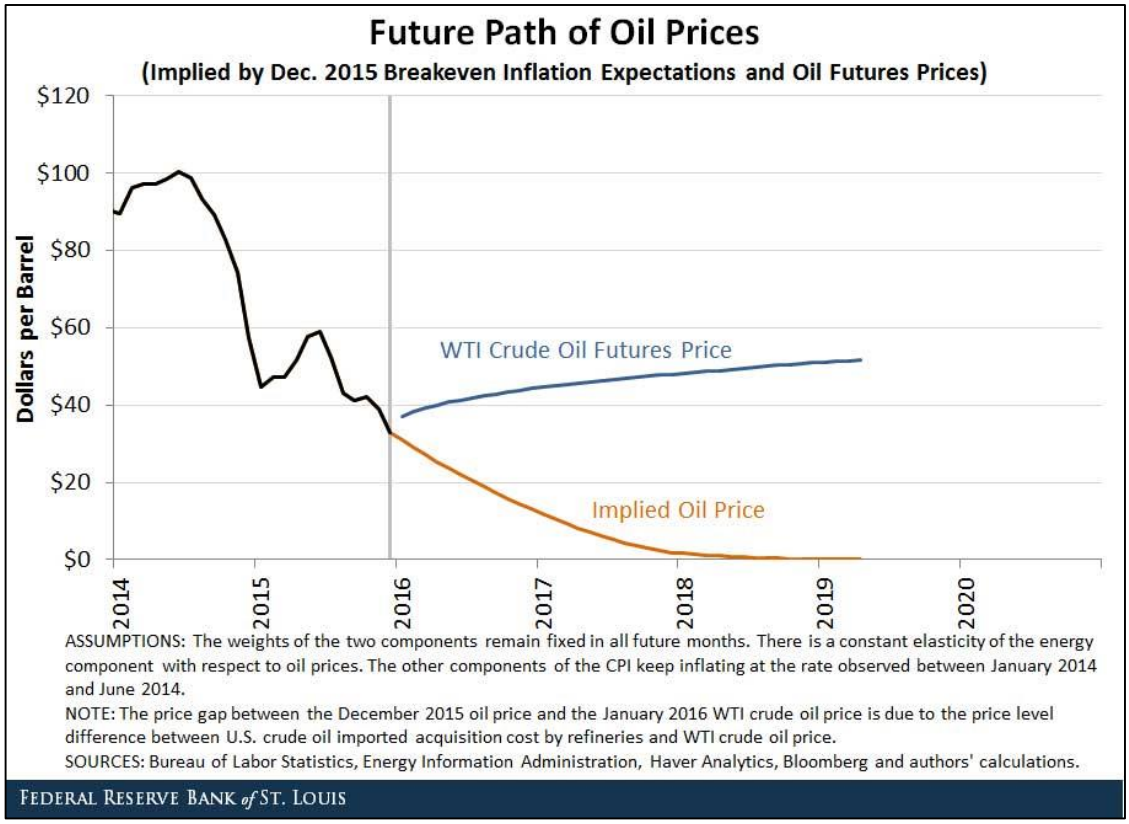
How long can this go on? While impossible to know the timing, we suspect the pattern will ultimately prove unsustainable. Uber aggressive monetary policy has already hit a bit of a wall as evidenced by Yen and Euro advances against the dollar this year despite further quantitative easing. As has been widely discussed, banks have difficulty passing along negative interest rates, and therefore further moves below zero might cause unintended credit issues. In some ways, investors have dealt with low interest rates for so long, they have almost become numb to the extraordinary nature of current monetary policy. If an investor from 2006 (let alone one from the higher inflation periods of the late 1970's or early 1980's) had a time machine and was magically transported to present day, we think he or she would have immense difficulty believing that during February of this year more than $7 trillion of government bonds offered yields below zero globally - or nearly 30% of the Bloomberg Global Developed Sovereign Bond Index. We could only imagine that the first hours for this time traveler would involve constant reassurance that the quotes are not misprints and, yes, investors are actually willing to accept a negative return for 10 years (Japan's 10-year bond currently yields -0.12%). On a side note, we think the same investor from the past would not be the slightest bit surprised that Argentina defaulted (again), but he or she would be mildly

puzzled that the country could sell debt less than 2 years after defaulting which was more than 4 times oversubscribed, including 30-year paper at 8% when inflation is running at 30%.

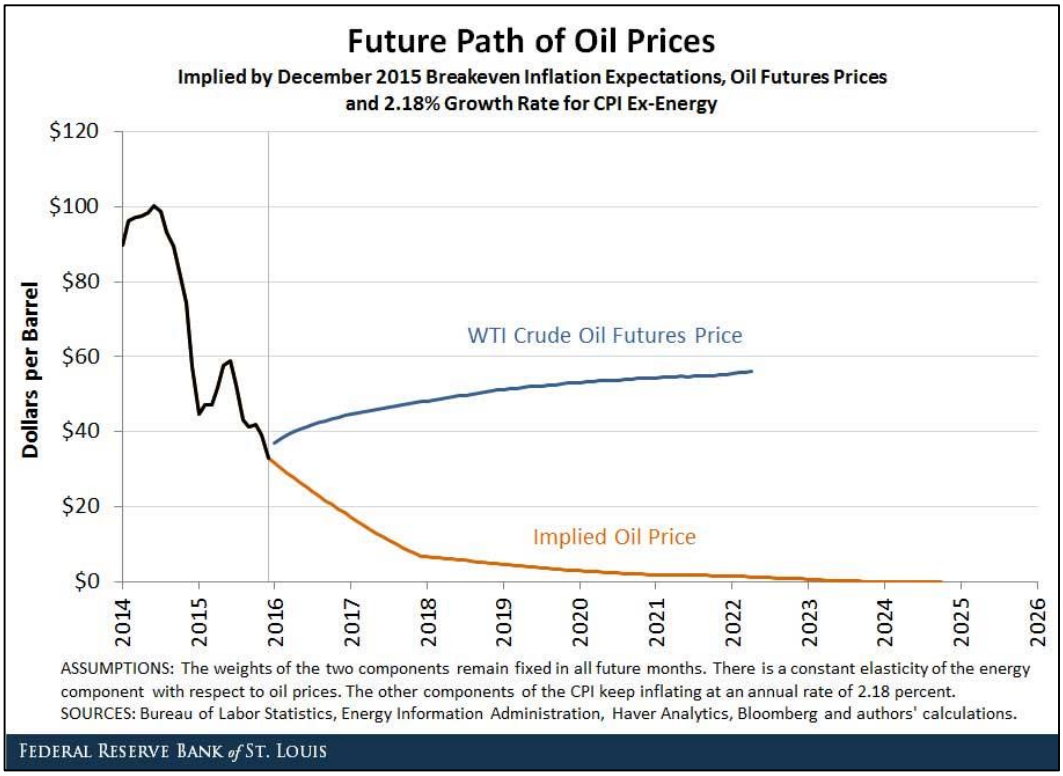
The Sun Also Rises?

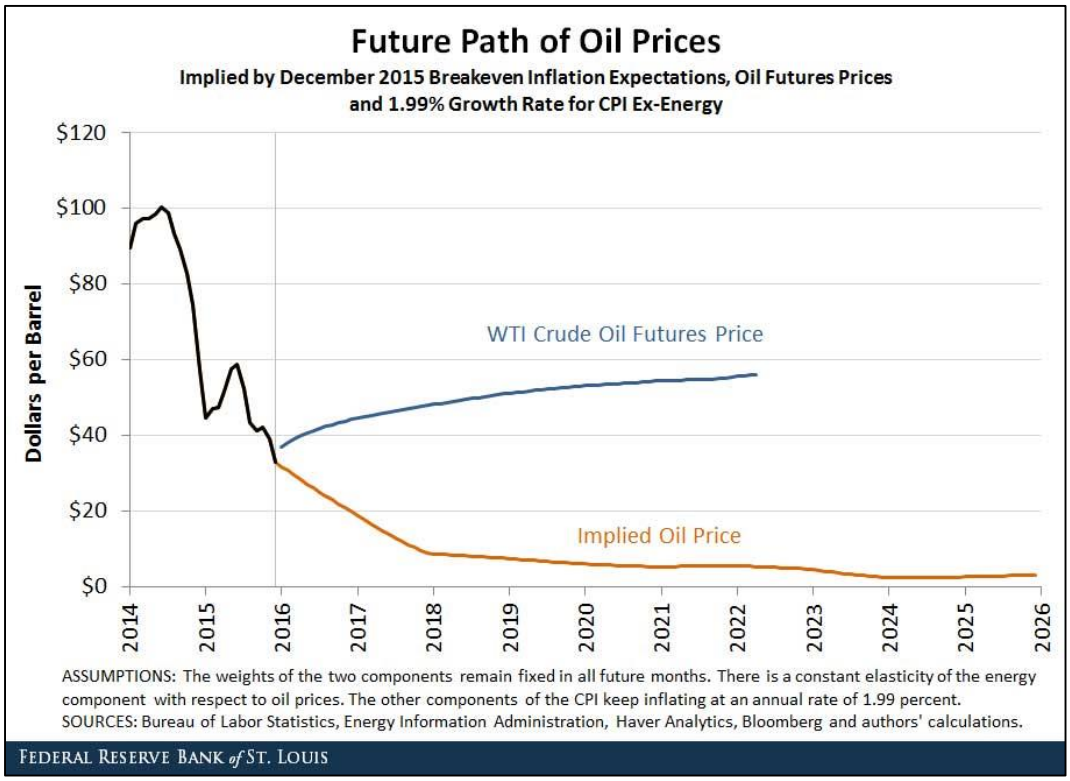
We still think it makes sense to consider the possibility that rates actually rise. This opinion has been wrong for years and, while many acknowledge that rates will eventually move higher, the continued downward movement in bond yields, the sell-off in financial stocks and continued multiple expansion in "safe" consumer staple stocks suggest that far more investors believe rates are unlikely to move higher.

During the sell-off in equities earlier this year, we came across an interesting chart on the St. Louis Federal Reserve's blog. The article was dividing the Consumer Price Index (CPI) components into two components – energy and non-energy – and looking at what the then current 10-year breakeven inflation rates (around 1.5% as of December 2015) implied about the future price of oil, given that the non-energy portion of CPI had been running at an annualized 2.87% from January 2014 until July 2014.



As seen from the above chart, holding the two other variables constant (breakeven inflation expectations and non-energy CPI), oil prices would need to fall to zero in order to hit the 1.5% inflation expectations. While we can understand the arguments of those who believe oil prices will not rebound, we suspect that even the most bearish oil analysts do not envision the above oil curve will materialize. This suggests that there is either a problem with future inflation expectations or that non-energy prices will slow materially. The Federal Reserve ran two more scenarios, assuming the non-energy components further slowed to 2.18% and 1.99%, and the implied oil curve is still far below the current energy strip. Perhaps inflation and interest rate expectations are too low?


Future Path of Oil Prices
Implied by December 2015 Breakeven Inflation Expectations, Oil Futures Prices
and 2.18% Growth Rate for CPI Ex-Energy
Dollars per Barrel
$120
$100
$80
$60
$40
$20
$0
WTI Crude Oil Futures Price
Implied Oil Price
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
2024
2025
2026
ASSUMPTIONS: The weights of the two components remain fixed in all future months. There is a constant elasticity of the energy component with respect to oil prices. The other components of the CPI keep inflating at an annual rate of 2.18 percent.
SOURCES: Bureau of Labor Statistics, Energy Information Administration, Haver Analytics, Bloomberg and authors' calculations.
Federal Reserve Bank of St. Louis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WTI Crude Oil Futures Price
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2014
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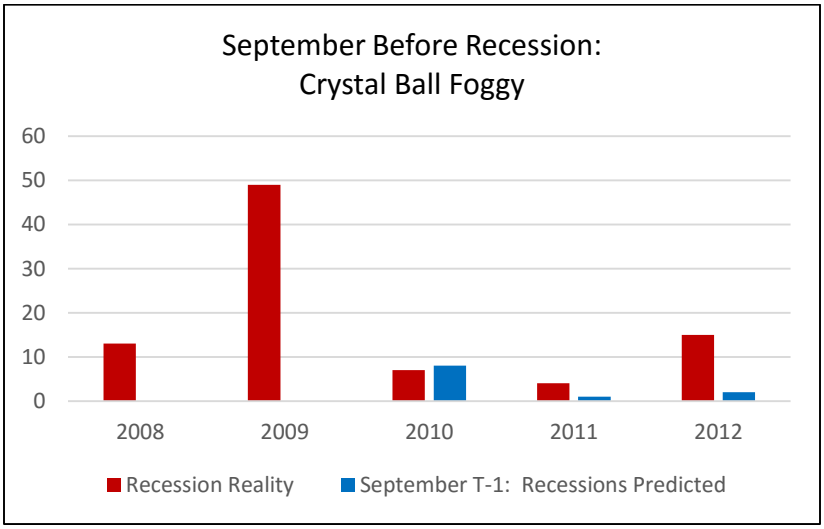
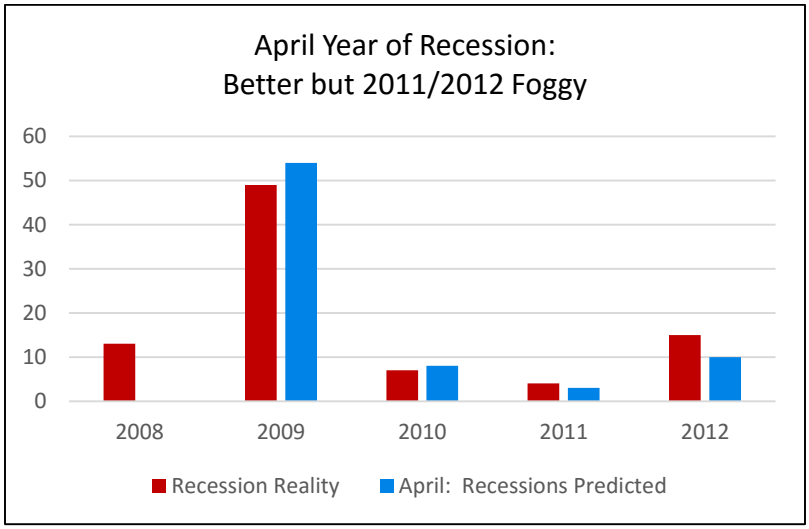
SOURCES: Bureau of Labor Statistics, Energy Information Administration, Haver Analytics, Bloomberg and authors' calculations.
Federal Reserve Bank of St. Louis

It's Difficult to Make Predictions…Especially About the Future

Given the possibility of the continued feedback loop described earlier, we suspect investors will spend some portion of 2016 again speculating about whether China, Europe or the United States will enter recession. In past letters we opined that a US recession appears unlikely, but we quickly noted that our crystal ball is far from perfect and we also expressed skepticism about anyone's ability to consistently predict future economic contractions. During the first quarter, we actually stumbled across a paper that further bolstered this point.

Hites Ahir and Prakash Loungani, two IMF researchers, looked at whether economists were able to forecast recessions over 2008-2012 (88 in total). The paper actually was a follow-up to a previous paper where Loungani found that only 2 of the 60 recessions during the 1990's were predicted one year in advance and 40 of 60 remained undetected seven months before they occurred. The results from 2008-2012 speak for themselves:





As seen from the above chart, economists[1] were nearly perfect in their inability to predict recessions in September before the recession began. When sampling predictions in April of the year of recession, forecasts improved dramatically, but even here results were not fantastic in 2011 and 2012. The authors were at a bit of a loss to explain the poor performance. They specifically noted that forecasts were frequently updated, but these updates had done little to improve performance over the past 20+ years. We suspect these findings will not be frequently cited on CNBC, and we believe that prognosticators will continue to boldly predict economic gains and failures in the years ahead. Remember this paragraph when you see articles that read something like: "Our back-tested, multi-variable model shows a less than 15% chance of recession in the coming 12 months and therefore we foresee the S&P 500 closing at…"

So what are the investment implications? We would simplistically state that fixed income investments remain broadly unattractive, that financial stocks could make money again and that holding higher levels of cash is not an irrational decision. We have discussed the first two in prior letters. It is possible for rates to rise which would be bad for longer-term bonds, but potentially positive for bank net interest margins and fixed income trading activity. Our elevated cash levels are partially a combination of specific portfolio actions but also reflect some degree of caution against "knowable unknowables" (possible recession, unintended consequences of monetary policy, steeper drop in some of our less covered/less liquid names during a market decline) and simply more difficulty finding compelling investment ideas. Market pullbacks do not affect all names evenly, as we witnessed earlier this year. While the broader market pulled back 10-11% to start the year, many equities, including several in our portfolio, declined 20-40%. We view the cash position as providing valuable optionality in such a downside scenario, as a market decline can quickly open several investment opportunities. Of course, higher cash positions could prove to be a headwind if markets move materially higher during the remainder of 2016. Conversely, the cash position will not fully protect portfolios if markets move materially lower if an unexpected recession materializes later in 2016 or early 2017, but it would allow us to deploy additional capital at favorable prices. While far from perfect, we think our positioning provides a low-cost hedge against a range of scenarios.

We continue to hold a portfolio of securities that offers (in our opinion) the best risk/reward within our circle of competence, even if some of those names could suffer more precipitous declines. We would contrast this approach with holding a portfolio of names that are fairly (or worse) valued just because we anticipate they will decline less in a possible recession. We would much rather own Liberty Global selling at lower historical valuation levels, knowing that it could drop further during a broad market selloff versus hiding in "high dividend/rising dividend" consumer staple names selling at elevated multiples, based on a belief they will hold up better during a recession (or that 3G/Warren Buffett will buy them if sales volumes remain negative).

Portfolio Actions: Conglomerates/Broadband/Cloud/Chips/Tankers

During the first quarter, we purchased several of the names we have discussed in past letters (including HRG Group and Liberty Global). A more recent pullback also provided an opportunity to purchase additional shares in online retailer QVC Group (more on this later). On the sell side, we reduced or eliminated positions in Intel, Microsoft, and National Oilwell Varco. We have described our rational for selling Microsoft in previous letters. At the beginning of 2015, we started selling what once was our largest individual holding and continued to reduce position throughout 2015 and into the first quarter of 2016.

[1] As source data, the authors used Consensus Economics, which provides forecasts of real GDP for a group of professional forecasters for a large group of countries.

In the case of Intel, we started selling shares earlier this year on concerns about possible competitive threats to their data center business as well as further difficulties in continuing their manufacturing advantage (Moore's Law) versus other competitors. In previous letters, we acknowledged our limited technical expertise but noted how Intel's data center business (which had projected growth of nearly 15% with 50% annual margins) might be worth a supermajority of the current value of Intel. We still believe this is a true statement. But, the key to maintaining the nearly 98% market share depends on continuing its manufacturing leadership position and therefore a slowdown in Moore's Law could prove problematic. We would also note that Intel's $17 billion acquisition of Altera during 2015 was not a cheap deal and Intel's win/loss record with past deals is mixed (being generous), including its 2010 acquisition of McAfee. We certainly did not have high hopes for the growth trajectory of personal computers and industrywide sales (down anywhere from high single digits to low double digits according to Gartner/IDC) have been as bad or perhaps slightly worse than anticipated. Intel has responded reasonably to these concerns, and the recently announced shrinkage of nearly 11% of its workforce was a difficult but necessary action. Trading at 13x 2016 estimated earnings, Intel is certainly not a widely overvalued name, but we think its valuation is less compelling, given some of the previously discussed concerns.

In our 2015 Q1 investment letter, we described our rationale for purchasing additional shares of National Oilwell Varco (NOV). Noting the company's dominant position in offshore rig platforms, the company's fortress balance sheet and acquisition history, we believed the company could acquire weaker competitors and become a stronger company when the cycle turns. We believe all of this could still materialize. We, however, misjudged the severity of the oil downturn and didn't fully appreciate that we were owning a company whose business could materially lag in any upturn, given the reluctance to invest in offshore platforms (regardless of the efficiency gains) during periods of weaker prices. In essence, we are sitting at the tail of the whip with little idea of how long it will take to uncoil. NOV's earning trajectory has deteriorated far faster than we anticipated, as a more severe decline in the price of oil has likely extended the ultimate recovery in offshore drilling platform sales. As noted, NOV's balance sheet will allow the company to play offense, and deal flow and/or a further upturn in the oil market could cause a meaningful pop in the company's shares. Unfortunately, one of the perils in investing in cyclical businesses is that the difference between being early and wrong can be semantics. We have maintained a lower weighting in the name, but we will reevaluate should we find better risk/reward situations.

QVC: Will Anyone Love Me?

We have generally noticed that many of our more recent purchases have been low or non-dividend paying names, and several of the more recent sales have been sought after names by dividend hunters (MSFT and INTC would fall into this camp). This is certainly not an absolute rule as General Motors (GM) sports a nearly 5% yield. As an aside, we have found that few actions can suck oxygen out of a room quicker than mentioning GM as an interesting investment idea. Recent results show substantial progress…but we digress. We have no issue with dividend paying names and believe dividends can often be a better use of capital in many situations. But, we have noticed that steady businesses with a history of increasing dividends have generally seen elevated trading multiples while investors have shown less enthusiasm for companies who regularly repurchase shares. And this brings us to QVC Group (QVC).

Concerns regarding a new Amazon shopping offering, selective overseas sales weakness, and questions regarding a recent merger have negatively impacted QVC shares, thus providing an opportunity to again buy the longer-term holding during the first quarter. In March of this year, Amazon starting airing a Monday-Friday 30-minute show discussing fashion trends and showcasing some of Amazon's apparel selections (we will quiz all clients about which outfits looked best in the second quarter). While the

offering appears far removed from QVC's 24 hour/364 days per year (they take a break on Christmas) shopping experience, investors became concerned that Amazon would look to further encroach on QVC's turf. While we are not privy to Amazon's intentions, we would note that the online shopping space's total market size would seem to be small potatoes relative to Amazon's ambitions (QVC 2015 Revenue: $9.2 billion, HSN Inc. (HSN) 2015 Revenue: $3.7 billion, Amazon 2015 Revenue: $107 billion).

While acknowledging Amazon's ability to disrupt businesses, we also believe investors should not underestimate the strength of QVC's business. Unlike other retailers threatened by online/mobile shopping, QVC has actually greatly benefited from the trends, as online sales (versus linear television) now account for a staggering 52% of QVC's total domestic sales -- with mobile accounting for nearly half this total. Unlike sales that occur via the traditional linear television channel, QVC pays no sales commission if the online product sales occur more than 24 hours following TV viewing. Unlike media companies where online advertising sales generates fractions of the revenue from 30-second TV advertisements, QVC's transaction based model occurs at the same price online, but with the benefit of higher margins. And finally, QVC travels well as nearly 30% of its total sales come from international channels and QVC has succeeded in markets where best-of-breed US retailers have struggled/failed (UK/Germany/Japan). While a weak yen and a tougher operating environment have hampered recent Japanese results, we believe QVC's international markets and international growth potential (France was the most recent market launched in August of 2015) will be a key driver of growth in the years ahead.

QVC purchased millennial focused retailer zulily (ZU) in October of 2015 (founded in 2010 with 2015 sales of $1.3 billion). While the headline multiple (16x forward EBITDA) was far higher than where QVC traded, it should be noted that QVC only approached ZU after its stock had fallen over 80%, and the transaction occurred nearly 15% below ZU's IPO price. Additionally, total synergies are expected to be $40 million+ and QVC believes there will be substantial opportunities for cross selling possibilities. ZU's average customer skews younger than QVC, and the company's growth rate will likely be a fair bit higher than QVC's domestic business. We would have preferred that the deal be financed exclusively with debt, but a combination of concerns about debt levels (given QVC's performance during 2008/2009, we disagree with this concern) and the desire of ZU's founders to participate in the equity upside led to a partially equity financed transaction. Liberty believes that faster growth from ZU could enhance the company's trading multiple and ultimately (while QVC does not explicitly say this) allow a tax efficient purchase of HSN.

QVC also suffers from a couple of other discounts. First, the company is a tracking stock of Liberty Interactive. Some portion of investors cannot own trackers, an even larger percentage hates them, and an enormous portion of both groups hate managers who keep buying tracking stocks. In addition to the tracker discount, QVC currently holds 38% of its primary competitor HSN, and investors detest partial ownerships in other publicly traded companies almost as much as tracking stocks. Finally, QVC is still amortizing intangible assets and customer values created when the remainder of QVC was purchased from Comcast back in 2003. We think there is little question that the brand strength of QVC has greatly expanded since the deal, but GAAP required amortization shows lower reported income and causes QVC to appear more expensive on a price earnings basis (especially if valuation is not adjusted for the HSN stake). After subtracting out HSN's valuation (surprise, surprise, we do not assume Liberty pays taxes), QVCA actually trades at 10-11x 2017 estimated free cash flow per share. We think this multiple is far too low for this quality of asset.

While not as recession resistant as cable stocks, QVC proved far more resilient than other retailers during the 2008 with total EBITDA only falling approximately 9%.[2] QVC also has very modest capital expenditures (2-3% of sales) versus other retailers and it generates large amounts of free cash flow. Like other Liberty entities, this cash flow will be used to retire shares rather than pay dividends. Assuming some margin improvement and a rising share price, we believe that QVCA will repurchase at least 5% of its shares annually over the next several years and that these repurchases will ultimately prove to be exceptional capital allocation choices.

In a market starved for yield, however, we get the distinct sense that QVCA might be valued much higher if it chose to inefficiently dump its HSN position, pay full taxes and then use the proceeds to pay a special dividend of nearly $1.40 per share. Further, the company could get another bump by paying out 60% of its free cash flow as a regular dividend (Today's Special Bargain: 4-5% yield!) and thereby subject shareholders to another round of taxes. The yield combined with the steadiness of QVC's business could make it a favorite for "Growth and Yield," "Rising Dividend," "Shopping, Yield, and Taxes," and "Yield and Full Taxes" strategies (Some of these marketing campaigns are still a work in process).

Again, stock dividends are a very reasonable capital allocation choice for many companies. But, we believe long-term QVC investors will ultimately be better rewarded for the company's tax prudence and capital allocation choices than if the company simply chose to willingly pay taxes/dividends. Ultimately, we do believe that QVCA will become an asset backed company and likely join the S&P soon after. But, hopefully, this decision comes after a large number of shares are retired near current levels.

Thank you for your continued support.

Patrick Brennan

[2] By way of comparison, Macy's, Inc., Saks Incorporated, and Nordstrom Inc.'s 2008 EBITDA declined -31%, -89%, and -28% respectively.

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