Booth Laird

Investment Partnership

2016 ANNUAL LETTER

Know Thy Investment

<u>To the Partners of Booth-Laird Investment Partnership:</u>

I. Review of 2016.

Volatility reigned supreme last year, clustered around three distinct events. The first was a fear-driven panic in January due to the confluence of oil prices unexpectedly dropping below $30 and renewed fear of a slowing Chinese economy. The second was the panic caused by the unexpected Brexit in late June. The third was the surprise victory of Donald Trump.

Interestingly, the panic-induced sell off lasted shorter each time. The first panic lasted all of January and half way through February before abruptly reversing course. The second lasted approximately one week before rebounding. The third did not last even the entire night post election before the so-called "Trump rally" began in the stock market the day after he was elected.

We were able to take advantage of the first sell off lasting through mid-February. We used our cash to add considerably to a number of existing holdings. That decision paid off handsomely by year end.

We wanted to take advantage of the Brexit sell off, but none of our stocks dropped enough to hit our pre-determined add price. We all went to bed that night knowing that Brexit had won the vote, and we woke up early the next day with the intention of adding to our two UK holdings. However, both of those stocks were actually up that day.

Also, while the "Trump rally" helped a number of sectors, only about half of our holdings were in those sectors. We did take advantage of the rising prices on some stocks to exit certain positions. In all, we went into November 2016 with 17 holdings and, by the end of January 2017, were down to 13.

Outside of those three periods, we found two new pillar stocks, added to a few other stocks opportunistically, and trimmed a few positions as their stock prices rose. These actions proved to be a substantial net benefit by year end.

Pillars vs Workouts.

As we have discussed many times, we have two primary types of investments: pillar stocks and workouts. Pillar stocks are our preferred investment, but we will happily invest in workouts that provide substantial upside potential with limited downside risk.

Pillar stocks are companies with a durable competitive advantage operating in an industry we understand and that have favorable long-term prospects. Pillars also have trustworthy management that have the shareholders best interest in mind. Finally, they must be available at a sufficient discount to our conservative estimate of their value. Pillars tend to be "compounders" in that they compound value year after year. Their return on capital exceeds the cost of that capital by a fair margin, allowing them to grow the business year after year. Importantly, they should be able to employ new capital at similar rates of return, which is key to the ability to compound value for many years. As a result, we expect to own pillars for many years.

Workout stocks are companies that may not necessarily have a durable competitive advantage or operate in an industry with favorable long-term prospects. However, the companies have trustworthy management. In addition, usually a specific fear or uncertainty is weighing down the stock price. We believe the issue will resolve more favorably than the market has priced into the stock. Workouts must be available at a substantial discount to our conservative estimate of net present value. Also, we should be able to identify a near-to-mid-term catalyst that will propel the stock price closer to our valuation. While our average holding period is still in excess of a year, we do not expect to hold workouts indefinitely.

Pillars

We currently own nine pillar stocks, most of which we have discussed previously in significant detail. Barring a change in the fundamentals of the company, a ridiculously high price we cannot pass up, or the need for funds for a much better opportunity (least likely), you can expect to see these companies discussed in this letter for many years to come.

This list includes six large-cap stocks, two mid-cap stocks, and one small-cap stock. The predominance of large-cap stocks makes sense, considering that a company compounding value year after year is going to grow to be fairly big. There is hardly any limit to how large most of these companies ultimately can become. Each one has favorable long-term growth prospects, durable competitive advantages (as evidenced by high returns on invested capital well in excess of their cost of capital), and are led by highly capable and trustworthy management. Below is the list of pillar stocks in the order we first acquired them **[TABLE REMOVED FOR EXTERNAL DISTRIBUTION - INVESTMENTS SHARED WITH INVESTORS ONLY].**

The table above [REMOVED] shows the 2016 growth in book value per share using the last twelve months available for each company as of the date of this letter. Book value per share is an imperfect metric, particularly for a company like [Company A] whose substantial brand and other intangible values are not reflected on the balance sheet. This makes sense because non-financial assets can be marked down when they lose value, but can never be marked up. However, the direction and magnitude of the change in book value generally reflects the change in overall intrinsic value of the company. For pillars, intrinsic value grows faster than book value on average, so we believe the 2016 growth reflected above understates the growth in intrinsic value for each company. Further, most of these companies return a significant amount of capital to shareholders via buybacks or, to a lesser extent, via dividends. Both reduce book value and usually reduce book value per share. Based solely upon book value and outstanding share count, the "2016 Growth in Book Value/Share" figures shown above do not fully reflect any return of capital, which were added benefits to holding the stock. For example, [Company B], which had the lowest growth in book value per share, was the most impacted because the company returned nearly 100% of earnings to shareholders in 2016.

Nevertheless, you might think that it is difficult to realize outsized returns for large caps due simply to the law of large numbers, but our experience proves otherwise. Consider [Company C], an investment we made in March 2016. It seems unlikely that such a great company led by such a great capital allocator could be undervalued. However, [Company C]'s stock was punished for its complexity and due to general concerns regarding the economy. [Company CEO] is well known for wanting to use [Company C]'s massive capital to acquire other businesses rather than return it to shareholders via dividends or stock buybacks. However, he established a floor price for the stock by saying he would consider buying back shares in [Company C] if trading at 1.2 times net book value or below. That target price for the B shares would have been roughly $124 in March 2016, and the stock actually hit that price in January and February before the Q4 earnings release. By the time we looked at the stock, it had risen to $138, but that was still fairly close to the floor price established by [Company CEO] himself. What's more, he even explained in his annual letter how to value his business. Our estimate of value was a conservative $180 per share, which we expected to increase annually by our discount rate of 10%. Therefore, our value a year from that point was $198, representing a 43% upside from the price available at the time. It was a no-brainer decision. By year end, the stock was up to $167 at its highest point, a gain of over 20% in approximately 9 months on one of the largest companies in the world.

Of the nine pillars, we have only sold pieces of two of them, and only because they increased so much in value that they became an outsized piece of the portfolio. Continuously we have added to all of them, except for the two new pillars found in 2016. For example, when we first invested in [Company D] at $26, we were a much smaller Partnership. If we had never added another dollar to the investment, we would have had a great return on that investment by itself (trading for over $66 at year end plus regular and special dividends), but it would be a small percentage of our portfolio. Luckily, we have had opportunities to add to [Company D] nearly every year, generally after a pullback from its most recent high. As a result, [Company D] remains a full-sized position today.

While pillar stocks sound easy, a number of potential pitfalls exist. First, we have to determine that a stock truly meets our pillar stock criteria and that it will remain a pillar stock for years to come. Fortunately, it turns out this may be the area where we most excel. We have only once misidentified a stock as a pillar when in reality its pillar days were behind it. That stock was Bed, Bath, & Beyond. It checked all the boxes at the time of our initial investment – great management, long history of profitable growth, high returns on invested capital well in excess of that capital, and favorable growth characteristics. The main criterion we misinterpreted was the company's ability to continue realizing high returns on capital newly invested. In other words, could they take the earnings from existing stores and earn the same returns on capital on the new stores they planned to build. It turned out they could not. Thankfully, they had the presence of mind to stop rolling out new stores *en masse* and mostly return that capital to shareholders via buybacks. Once we realized our original thesis was wrong and the future not nearly as bright as we expected, we exited the position at approximately break-even, which leads us to our next point.

Once we have identified a stock as a pillar stock, we still have to make sure that we are paying a good price for it. There are some wonderful companies we would love to own, but they simply are too expensive. A great company does not equate to a great stock if you overpay for the stock. Cisco is a prime example. No one doubts that Cisco is a behemoth in the IT sector, with a long history of solid growth and high returns on invested capital. However, the stock currently is selling at less than 50% of the price it was trading for at its peak in the year 2000 in the midst of the tech bubble, despite being a significantly larger and more profitable company today than in the year 2000.

Third, once invested, we must have the stomach to handle volatility in the stock price and the inevitable waves of negative headlines and general investor sentiment that hit every company at some point, usually more than once. Few companies seem to have more negative headlines (mostly ridiculous) than [Company A]. A website even tracks the number of times going back to the 90's that someone has predicted the end of [Company A], yet [Company A] just reported a record quarter. We have to be able to tune out the incessant noise. We also have to be able to withstand a negative quarter or two or three. Going back to [Company A], revenue declined last year for the first time in years, and the stock dropped by over 30%. We were not worried about a few slow quarters or even a slow year. We felt the company was undervalued with even zero growth factored in, so we were able to weather that cloud of negativity. In fact, although already our largest holding, we added to the investment significantly when the stock began dropping from a high in the $130s (and our lowest purchase price was in the $50s). We began adding at $120 and added all the way down to $90. The stock returned to $130 in February 2017 after a stellar earnings release.

The last point is key. We previously quoted this famous Peter Lynch (well-respected value investor) statement regarding investing, but it bears repeating: "The key organ in your body is your stomach, not your brain." It allowed us to use up nearly all of our cash investing in August 2015 during the one day 10% drop in the market and again in January 2016 when the market was down over 10% at its worst point. We stand ready to do it again.

Workouts

Pillars make up the backbone of our portfolio, but workouts provide greater upside potential (along with higher risk). While pillars are fairly uniform in their attraction and characteristics, workouts come in many different forms. Workouts can include spin-offs, companies where investors fear debt covenant violations, post-reorganization equities, companies subject to asset plays, companies in an out-of-favor industry or country, and cyclical companies, to name a few. A potential workout essentially is any company whose stock price is depressed for a specific reason, but the company does not meet our criteria for a pillar stock. The required upside for workouts is considerably higher than for pillars due to the higher potential risk. We do not expect to hold workouts indefinitely like we do pillars.

II. Where To From Here?

Our focus is on finding underpriced securities regardless of the market environment. We do not concern ourselves with macroeconomic predictions or politics, other than how any rule changes might directly impact our specific investments. Economists have a poor track record of predicting the future, and the market has thrived under all manner of presidential regimes.

A lesson learned in 2015 was "be prepared" as the oil price collapse, China fears, and general economic growth concerns led to more sudden pullbacks in the market than had been experienced in a number of years. These pullbacks presented buying opportunities – though these opportunities may be fleeting. Therefore, in mid-year 2015 we changed the process we used to analyze investment ideas. We had to be ready to seize a buying opportunity, so our research had to be absolutely complete and up-to-date. We could no longer afford the time to pull loose ends together on an investment decision. We had to determine exactly at what price we would buy a stock, and we had to constantly re-visit and update our analysis so that we could act swiftly when opportunity knocked. This new process allowed us to acquire our latest investment in October of 2016. We liked the industry and the company but wanted it at a price approximately 14% cheaper. The stock subsequently dropped later in the year without a change in our thesis, allowing us to invest at precisely the price we wanted. The stock price quickly rebounded.

We currently have seven stocks that we have fully analyzed, want to own at the right price, and continue to monitor. Two of those stocks are investments we sold recently but happily would buy in again at lower prices. Of the other five (all considered would-be pillars), we looked at four in January 2017. In fact, last month might have been the most productive month we have had yet. We are as hungry as ever to work hard, find ideas, and make money for our investors.

We are pleased with 2016's results, the current state of the Partnership, and our portfolio, but not satisfied. We will continue to seek out and analyze new ideas while growing the Partnership. We will also maintain a strong discipline on the price we are willing to accept before investing and will patiently wait for the right price. To that end, we would welcome a market pullback like we experienced in the beginning of 2016 and hopefully will get the opportunity to scoop up some new stocks or add to existing holdings.

As noted above, pillar stocks make up the backbone of our portfolio, augmented by select workout opportunities. We will continue to invest in workouts when we have a high degree of conviction that the risk of loss is limited. We will never be perfect stock pickers. No investor in history has ever been perfect. However, our batting average remains high and our new position-sizing rules and processes, which we continue to assess and hone, limit the damage done when we miss on a stock while still allowing us to realize excess returns as evidenced by our performance in 2016.

III. Closing Remarks.

Managing your funds continues to be a very gratifying endeavor, and we look forward each and every morning to working hard to improve the value of your investment. We continue to feel great about our current portfolio and are motivated by the long list of interesting ideas we still need to analyze. We are highly optimistic about the future.

As always, we are grateful for your trust in our ability, and we look forward to being your investment partners for many years to come.

February 12, 2017

Jonathan P. Booth

Chief Executive Officer