

Q2 2017 Newsletter

During the second quarter, we added a new core position and sold another core position after it announced it was being acquired, leaving the portfolio with thirteen core holdings at the end of the quarter. The second quarter results for our holdings met or exceeded our expectations across the board.

Overall, only 3 stocks are down on the year with a cumulative impact of negative approximately 0.5%. In other words, no stock is materially hurting us this year. We remain highly confident in our portfolio and continue to research new ideas every day.

Our Process in Action

As noted above, we acquired a new core holding during the quarter. As is our policy, we will not discuss a new holding by name or industry until we have owned it for at least six months. However, we did want to illustrate our process in action with this latest investment.

The company operates in a complex industry that is currently deeply out of favor with investors. We spent an entire month understanding all aspects of the supply chain in which this company operates. We analyzed the competitive landscape, pricing power, operating efficiency, and long-term prospects under different scenarios for each part of the supply chain as well as how each part affects and interacts with other parts of the supply chain. We read third party industry reports, numerous articles, press releases, etc. We did our best to remove management's hype and obtain an objective understanding of the industry. We even developed a flowchart of the industry, breaking down different parts of the supply chain and its characteristics, which we believe is more succinct and informative than anything else we could find by a mile.

As a result of our analysis, we identified the area we felt was both the best suited to adapt to any future scenario and had the best competitive positioning and pricing power. We also believed this area to be the most misunderstood and, therefore, contained the company with the highest potential upside in its stock price. More importantly, we believed the stock was beaten down enough that the downside risk was limited. We finally invested in early May at the price we wanted.

We could have called it a day and pulled the trigger earlier, but we wanted to make sure we truly understood this complex industry. That additional research allowed us to uncover crucial new insights and to better flesh out our flowchart demonstrating our understanding of the industry. We will never know all of the information, and part of investing is understanding when enough is enough. Any investor, even one as thorough as we aim to be, has to be comfortable investing with only 80% of the available information. Rarely does the last 20% make or break an idea, but that extra layer of uncertainty is why we require a high margin of safety before we invest even into pillar stocks.

Looking back at our biggest losers (we have only had a handful in eight years but, as you know, a few have been painful), we rushed the analysis of most of them because the stock had dropped quickly and we were worried it would rebound just as quickly. That is not a mistake we intend to repeat. We will

take our time and not worry about missing out if a stock takes off while we are analyzing it. Adding an artificial deadline to our analysis only creates additional pressure and noise in our research process when it is imperative to be as objective and free of bias as possible.

Final Thoughts

I just completed another Think Week, which is always a wonderful exercise to refocus on the fundamentals, learn some new insights on business or investing or life in general, refresh my mind, and add a slew of new ideas for future analysis. I always come away re-energized after a Think Week, which also gets Kevin excited because I will not stop talking, texting, or e-mailing about the cool new things I learned or stories I read or ideas I came across. We like to discuss the most interesting new insights and further develop our understanding of them between us. He is a great partner to have for someone like me. We both love to learn new things and better understand what we already “know.” We do not always agree, but that is part of what makes a great partnership. I look forward to being his partner and yours for many years to come.

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Jonathan P. Booth

Chief Executive Officer

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