1949

VALUE
ADVISORS

September 4, 2015

To our partners,

It is with great excitement that we write this inaugural Letter coincident with the launch of the 1949 Value Advisors *Global Value Strategy*. With sincere gratitude for the confidence placed in us by our initial investors, we look forward to the challenge of building a high quality global investment management firm with institutional credibility. Our long term success will be determined by how well we consistently deliver on investment objectives, exceed investor expectations, and provide superior client service.

As a conservative value-driven global investment firm, we aim to satisfy two investment objectives over time – preservation of capital and growth of capital. Over the long term, we expect to outperform our global peer group average and the MSCI World Index with less absolute risk. We endeavor to achieve these objectives by investing in global equity securities trading at a significant discount to appraised value (a "margin of safety"), a risk-averse investment strategy designed to avoid a permanent loss of capital, and to realize capital appreciation.

Discounts to fair value generally arise when investors' perception of a security's value are temporarily muddied by changing winds in the macro-economy, shifts in the competitive dynamics within an industry, or company-specific developments that might impact future profitability and the creation of shareholder value. Where there are significant discounts to fair value, there is typically negative sentiment, prompting investors to sell their shares out of fear of criticism or further capital loss. Simply put, holding securities in companies that are broadly deemed to be troubled in some way makes many investors uncomfortable. This creates an attractive opportunity for disciplined investors focused on long-term intrinsic values, but it requires a unique temperament. Most of us desire the comfort and safety of being part of a large group, and as a result, are reluctant to act against the crowd and consensus opinion. Successful value investing, by contrast, requires independent thought and analysis, patience and a willingness to be contrarian. By definition, value investing requires buying securities when most investors are negative, and selling when securities are in favor and fully priced. The cyclical nature of capital markets provides ample opportunity to do both, but surprisingly few individual investors have the required temperament to be contrarian. 1949 Value Advisors considers our unique temperament, our disciplined focus on long-term fundamentally derived intrinsic values, and the patience to realize the benefits of both to be among our competitive strengths in a world of increasingly short-term and emotion-driven capital markets. As long as human behavior plays a role in the determination of security prices, we believe that value investment strategies will hold a high place in investor portfolios.

Timeless Investment Principles, Applied to Modern Global Markets

Our Firm's guiding investment principles were described in a book originally published in 1949, *The Intelligent Investor*. Written by the "father of financial analysis", Benjamin Graham, *The Intelligent Investor* was described by Warren Buffett as "the best book on investing ever written" [1]. On the weekend of our very first wedding anniversary in New Hope, PA in 1992, I purchased a first edition (1949) copy of *The Intelligent Investor* for the grand sum of $1.00 in an antique shop. It has been my investing bible ever since, and now resides under glass in our offices in Mahwah, NJ. In reverence to Benjamin Graham and in appreciation for the impact that *The Intelligent Investor* has had on my life and career, our Firm's name honors his timeless principles which we apply to modern global equity markets, as I've done as a global equity Portfolio Manager since 1993.

Timeless principles from *The Intelligent Investor* (1949 edition) include:

- "If the price is low enough to create a substantial margin of safety, the security thereby meets our criterion of investment." *(page 260)*
- "Select companies that are large, prominent and conservatively financed." *(page 70)*
- "Buy when most people (including experts) are pessimistic, and sell when they are actively optimistic." *(page viii)*
- "Achieve adequate, though not excessive, diversification." *(page 70)*
- "Be indifferent to market fluctuations." *(page 36)*
- "Be impervious to business and stock market forecasts." *(page 36)*
- "Investigate, then invest." *(page viii)*

While many investors stay close to their home market, 1949 Value Advisors draws from more than 22 years' experience managing international and global equity portfolios. Consistent with our experience, we will focus primarily on mature companies within developed world markets, but we will also invest in select emerging markets where there is established rule of law, reliable accounting standards and little chance of rogue government renationalization. While there are many important differences one must consider when investing across country borders, we have found that investors typically respond similarly to a given set of circumstances, irrespective of broad differences in language, culture, financial reporting and corporate governance. If the next twenty years are as challenging and unpredictable as the last twenty years have been, the timeless investment principles that we employ should continue to serve clients of 1949 Value Advisors well.

Risk Defined

As value investors, we are essentially risk managers. 1949 Value Advisors defines risk as the permanent loss of capital. Our greatest tool in minimizing this risk is the careful selection of securities with very limited perceived downside – a "margin of safety" – and the potential to realize capital appreciation over time. This asymmetric opportunity requires a long term investment time horizon, since the determinants of intrinsic value are long term in nature, and short term market sentiment can keep values suppressed for extended periods.

Volatility is not risk. With the advent of technology, and advancements in modern investment theory, there has been great demand for models which can predict and control "risk". In order to model risk, it must first be measured. This has led to definitions of risk that have more to do with *temporary* share price fluctuations than sources of potential *permanent* capital loss. 1949 Value

Advisors views share price volatility as an opportunity, rather than a source of risk. We subscribe to a much more practical doctrine on risk - "Risk cannot be avoided. But by bearing it clearly in mind, we may succeed in reducing it." [2] Throughout our investment research process, from idea generation to portfolio construction, being ever mindful of risks that might lead to a permanent capital loss will help us to avoid securities that might hinder our ability to deliver on investment objectives.

Performance Review – August 2015

August was the first full month of performance for the 1949 Value Advisors *Global Value Strategy*. August was also the worst month for global stocks since May 2012, as the Morgan Stanley Capital International (MSCI) World Index (in US$) declined by 6.6% last month. The timing of our launch might have been somewhat unlucky, but our performance in such an unfavorable environment was respectable – the representative account declined by only 3.2%, outperforming the MSCI World Index by 335 basis points[3]. While we hope that our investors will reserve judgement on performance until our third anniversary (and rolling 3 – 5 year periods thereafter), we are pleased to have demonstrated modest downside protection from the very recent decline in global stocks.

We are optimistic about the securities in the portfolio, despite fears of a deepening Chinese economic slowdown, potential interest rate increases by the Federal Reserve Bank in the US and various other troubles gripping world markets. In almost every market environment, there will be pockets of under and overvaluation across global industries and country markets. In this inaugural Letter, as well as in future Letters, we will share with you samples of active investment positions that illustrate our investment style and philosophy. We welcome any and all feedback, questions, comments, and criticisms (just hold back the tomatoes). As is the case with all investment research, the devil is always in the details. In order to ease readability, we have kept the following position summaries rather short and have included only the most salient points of the investment thesis. A more full discussion is always welcomed at your convenience.

Birchcliff Energy (Canada) is a natural gas-weighted intermediate oil and gas company with operations concentrated within its one core area, the Peace River Arch in Alberta, Canada (the Montney/Doig Natural Gas Resource Play and the Charlie Lake Light Oil Resource Play). The company is among Canada's lowest cost producers, able to generate a profit even during 2012, the lowest average natural gas price in over 10 years. The company's large land base has enabled compound annual growth in 2P reserves of 27% since 2005, and compound annual growth in production of 32% since 2005. First class management is committed to continuing this record of growth, with CEO Jeff Tonken and his team working on a five year plan to grow production 15 - 20% per year. Profitable growth at this pace usually demands a very high valuation by the market, but the current cyclically depressed price of natural gas has driven all gas producers' share prices to dramatic lows. When the "good, the bad and the ugly" (from the lowest to the highest cost producers) are all down, we like to buy the *great*. Birchcliff's large and prospective land base supporting its very low cost of production, its ambitious but profitable growth profile, the meaningful added competitive advantage of 100% ownership of its PCS Gas Plant (processing facility), led by an excellent management team designates Birchcliff Energy as one of the "greats" among Canadian producers. With the company's share price down 60% since June 2014, we believe that we have a

margin of safety against a permanent loss, while execution of their five year plan should create significant value. Despite net debt of C$530 million, Birchcliff's ability to generate free cash flow, service that debt and fund growth capex at very low gas prices creates what we believe to be an attractive asymmetric investment opportunity with very little perceived downside and tremendous potential upside, irrespective of the price of natural gas through time. Additional upside from either higher natural gas prices and/or interest from a strategic acquirer is a free option in Birchcliff's currently depressed share price. The company's internal estimate of blow-down value, or liquidation value of 2P reserves, is above C$20 per share versus Birchcliff's C$6 share price today. This gives zero value for their gas plant or upside optionality from further reserve growth. Being able to generate free cash flow at today's depressed natural gas prices should allow Birchcliff to eventually realize a much greater fair value for their assets over the medium and long term.

American International Group, Inc. (United States) is a maturing restructuring story, following its government-led bailout during the 2008 financial crisis. AIG is one of the largest insurance and financial services firms in the world, providing both commercial and consumer lines of property and casualty, life and mortgage insurance, as well as other financial services. There are two primary elements to the investment opportunity in AIG shares – asset sales funding significant capital returns, and operational improvement in their core business. First, the company has been selling non-core assets, using the proceeds to buy back stock. Over the last three fiscal years, AIG has repurchased and cancelled more than 25% of shares outstanding. Year-to-date through July, AIG has repurchased $4.7 billion in shares, putting them on track for $7-9B for the full year. This would represent approximately 10% of shares outstanding. At today's $60 share price, AIG trades at 80% of tangible book value. The overcapitalized balance sheet and discount to book value likely provides a margin of safety against a permanent capital loss. Asset sales and large share repurchases can unlock significant value while the operational improvement story continues to progress. The company has demonstrated improvement in both underwriting and claims results, after investing heavily in systems under the previous CEO, Robert Benmosche. AIG's current CEO, Peter Hancock is a recognized derivatives expert bringing a theoretical approach to risk management and pricing. Hancock created AIG's "Science Team", a brain trust of AIG's smartest PhD's to analyze data. Although Hancock has no previous experience running a property & casualty insurer, he was recommended for the job by the Federal Reserve Bank, having helped the Fed fix Key Corp after the 2008 crisis. In addition, AIG has been over-reserving the last 3 – 4 years and a normalization of reserves should help drive increased profitability and return on equity (ROE). The Company's public goal is to achieve 10% ROE, a reasonable goal based upon industry comparisons, assuming further asset sales, share repurchases and operational improvement. If successful in achieving a 10% ROE, AIG shares should re-rate to a 20 – 40% premium to tangible book value, versus today's 20% discount, while book value per share should continue to grow more than 10% per annum. On a three year view, we think AIG shares are conservatively worth 1.2x fiscal 2017 book value per share, or $115 (+90%).

Franco-Nevada Corporation (Canada) is the leading gold-focused royalty company, with a portfolio of more than 300 royalties, of which only 45 currently produce cash flow. There is significant latent value and upside optionality in the balance of royalties on undeveloped properties, but the time to realization of this latent value is beyond most investors' time horizons. Of these, 41 royalties cover properties that are deemed to be in the advanced stage of exploration, meaning their time to realization of value is nearer, but still distant. Franco-Nevada's business model provides investors with gold price and exploration upside optionality, while limiting many of the risks associated with operating companies. We view our position in Franco-Nevada as a proxy for the price of gold, since its primarily revenue-based royalty model gives us predictable cash flows based upon the price of gold during the reporting period. Because most royalties cover the entire property, Franco-Nevada investors share in any realized revenues that result from further exploration and production, ad infinitum. And since most royalties are revenue-based, changes in the realized price of gold directly impact Franco-Nevada's reported cash flows and earnings. The royalty business model requires very little in operating expenses, allowing the company to remain profitable at extremely low gold prices, thus minimizing the chance of a permanent capital loss. With more than CAD 600 million in cash and no debt, Franco-Nevada is financially strong. As the industry's downturn inevitably limits financing options for attractive development assets, we expect Franco-Nevada to put their balance sheet to work. With net cash and a business model that will survive almost any pricing environment, our downside appears limited. If gold prices recover, which we believe that they will, significant upside potential will reward patient investors in Franco-Nevada.

It is worthwhile spending a moment on the merits of gold in a diversified portfolio. As value investors, we are risk-averse by nature. We worry about downside risks, trusting that over time, the upside will take care of itself. Risk is omnipresent in capital markets, and can emanate from countless sources, some of which relate to the operations of individual companies. These "micro" level risks can be minimized by the careful selection of quality companies that trade at a large discount to fair value, with limited financial leverage, managed by honest and capable management. Even some "macro" level risks to equities can be minimized in a similar fashion, as stocks that are "priced in the basement" generally have less room to fall in a general market meltdown. However, certain "macro" level risks – tail risks - exist today that warrant exposure to gold as the only material of monetary value that could help protect capital in a dramatic and unexpected negative global monetary disruption or exogenous event. We view gold as "financial fire insurance", which we hope to never *collect* on the policy (much like actual fire insurance). Concerted efforts by central banks around the world to reignite economic growth by "printing money" might have dire consequences for financial markets, as these extreme monetary policies are untested in the context of modern history. We are not expecting cataclysm, to be clear, but rather prudence drives our belief that gold should have a place within a conservative diversified portfolio. After six years of a declining gold price, now at a level relative to production costs that has historically signaled a bottom is near, the risk of loss seems limited. Valuations of companies that produce gold have reached historic lows. China and India, the world's top two gold buyers, account for about half of global demand, according to the World Gold Council. Normal supply and demand seems likely to stabilize the gold price from here, while any potential disruption from extreme monetary policy actions around the world could renew demand for "financial fire insurance" again. Unfortunately, the exit from any proverbial financial fire is narrow, with gold comprising less than 1% of the total value of global financial assets. As students of long term financial history and economics, we believe it is prudent to have approximately 5 - 10% of a conservative portfolio invested in gold related assets.

China Mobile (China/Hong Kong) is the largest mobile telecom service provider in China, with a 62% market share of all mobile subscribers. This dominant market position did not translate into outsized margins and profitability as one might have expected until 2014, since its inferior 3G network meant the company had to compete on price to retain market share. With 2014's rollout of China Mobile's 4G network, the company regained its previous competitive advantage as its 4G coverage dwarfs both Unicom and China Telecom's, resulting in much better network performance for high speed 4G service. In 2014, China Mobile captured 93% of the higher value 4G subscribers. China Mobile continues to dominate the 4G landscape, winning 75% of total net additions so far in 2015. This dominant position has resulted in greater earnings growth and higher operating margins and profitability than its two competitors. Both Unicom and China Telecom are investing heavily in 4G base stations to increase coverage to retain their higher value customers through the current 4G upgrade cycle, but are projected to have only 50% of the number of China Mobile's 4G base stations by the end of 2015. With China Mobile's 4G investment cycle now behind them, we expect very strong free cash flow growth going forward. Net cash on China Mobile's balance sheet exceeds 24% of its market cap, while their strengthening competitive position should result in increased returns on capital, and a higher equity valuation than today. Downside appears limited, given the comparatively low valuation, while the company's dominance in the new 4G mobile environment should result in significant value creation in the future.

Our position in **Michael Kors Holdings** (United States) today illustrates the dramatic difference between growth and value investing. The Company came public in December 2011 amidst great fanfare from investors seeking growth. KORS shares advanced five-fold over the next 26 months, as the Company enjoyed hyper-growth in revenues and earnings. At the stock's peak in February 2014, expectations for KORS were very high, evidenced by its trailing P/E and EV/EBIT multiples (33x and 18x, respectively). However, growth inevitably slowed due the law of large numbers, high expectations were lowered, and the shares declined 60% as disappointed growth investors sold with reckless abandon. Today, KORS offers limited downside, in our opinion, as expectations have been re-set and the valuation has compressed to 10x earnings and 6x EBIT. With more than 10% of its market cap in net cash on the balance sheet and generating significant free cash flow, the company has been aggressively repurchasing shares - a testament to our view of the asymmetric investment opportunity, and a sensible and value accretive allocation of capital by management. Today's stock price reaction to KORS' most recent quarterly results illustrates the merit to our approach – shares are up more than 10% as total revenues grew *only* 7.3% and net income *declined* 7.1% due to negative currency translation and lower operating margins versus the same period a year ago. When a stock rises on bad news, it is typically indicative of a bottom in the share price. We believe a longer term and more fundamentally derived valuation of this growing aspirational brand is significantly higher. Using the long term average earnings and EBIT multiples for market leader Coach as a proxy, and applying a 20% discount, would value KORS on 13x estimated March 2018 earnings, or $65 per share (+55%). As KORS exploits opportunities outside the US, where revenues in Europe and Japan grew 42% and 57% respectively (on a constant currency basis), the market should ascribe a more appropriate and fair value to its shares.

Outlook

Our aim is to create an excellent long term performance record by avoiding a permanent loss of capital, mitigating losses during temporary market downturns, while participating in market upturns. While one swallow doesn't make a summer, August proved to be a reasonable example of the benefits of this approach. As a global unconstrained and benchmark agnostic investment strategy, we have the flexibility to take advantage of changing market opportunities through time. Our focus on capital preservation, combined with our experience in navigating these varied environments since 1993, gives us the confidence to act in a prudent yet opportunistic fashion. As we embark upon this exciting journey together, we will be diligent in our search for undervalued securities of quality companies that will help us meet or exceed our investment objectives.

Thank you for your support, and we look forward to serving your global investment needs for many years in the future.

Matthew T. Haynes, CFA
Chief Investment Officer, Portfolio Manager

Footnotes:

1. Buffett, Warren E., *The Intelligent Investor* (collaborator – 2003 edition, with Jason Zweig)
2. Graham, Benjamin, *The Intelligent Investor* (1949 edition, page vii)
3. Performance of the representative account is stated net of management fees and other expenses. The MSCI World Index captures large and mid-cap representation across 23 developed markets countries. The Index is included to show the general trend in the performance of market indices during the month of August 2015. The Index is not intended to imply that the portfolio was comparable to the Index in composition or element of risk.

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