

August 12, 2017

Thank you to all who have entrusted Stonebridge Value Capital with your money. Our returns for the year ending June 30, 2017 were 27.4% prior to fees and 20.2% after fees versus a 17.5% return, including a 2% dividend, for the S&P 500. These results should leave partners relatively happy, but it's also my job to temper future expectations as I don't think these results are achievable on a repeatable basis. More on this later.

A significant portion of our results were due to a generally rising market, of which I don't believe we deserve any particular applause. As Warren Buffett once said, "a rising tide lifts all boats." Our outperformance - both prior to and after fees - on the other hand, is certainly pleasing, but passing judgment on a single year's results - especially the first year - is like saying that someone ran a great marathon just because they were leading the race after the first mile.

In each annual letter, including this and future letters, I will provide a table showing our annual returns before and after fees, measured against our established benchmark of the S&P 500. I'll keep this table in all of the letters and include rolling five-year compound annual growth rates (CAGR) once we reach that mark. The 5-year CAGR will be the best measure of our performance, as our year-to-year results will fluctuate a great deal. The fact that our portfolio is quite concentrated will also cause our results to fluctuate more than I would expect the S&P 500 to fluctuate, on both a good and bad basis. The fact that our portfolio will fluctuate more means our results will be lumpier, but over the long term, this is inconsequential. In the game of investing, it matters where we end up, not how we got there.

Year	SVC Return Before Fees	SVC Return After Fees	S&P 500 Return (including Dividends)	SVC Before Fees Vs. S&P 500	SVC After Fees Vs. S&P 500
2017 *	27.4%	20.2%	17.5%	9.9%	2.7%
CAGR	27.4%	20.2%	17.5%		
Overall Return	27.4%	20.2%	17.5%	9.9%	2.7%

* 12 months ending June 30, 2017. Results are unaudited.

One more note on our results before I discuss a number of other items. I will publish our yearly results at the end of each calendar year. However, I am reporting them this year at June 30, 2017 because it is the end of our first full year in operation. I thought it would be silly to wait to start SVC until January 1, 2017 just because it would simplify reporting. With that, you will see results right now for the 12 months ended June 30, 2017 and sometime in January 2018, I will report to you the results for the 12 months ended December 31, 2017 and the six months ended December 31, 2016. After that, all results will be reported at the end of the calendar year. You will find that a significant part of the outperformance occurred prior to December 31, 2016, resulting in slight underperformance in the first half of 2017.

Our Approach to Investing

In my December 7, 2016 letter sent to prospective investors, I provided you with a detailed description of my investment strategy and the advantages we have in our quest for above average returns. It's worthwhile for me to outline that information here in a condensed list of what I'll call the SVC Tenets to Investing:

- (1) Risk is paying too much for a business, not volatility. I am willing to concentrate our capital in my best ideas because diversification reduces volatility, not risk. Purchasing a diversified portfolio of overpriced securities carries significantly more risk than purchasing a concentrated portfolio of undervalued securities.
- (2) I only purchase businesses, or assets, when I can buy them for less than intrinsic value, providing us with a margin of safety. When I can't find businesses that meet my demanding criteria, I am willing to hold cash.
- (3) I focus on the long term, not the short term. With that, I measure our results on a three-to-five-year basis, not on any individual year. I also measure our results on a relative basis against the chosen benchmark of the S&P 500, not on an absolute basis. It's important to understand that the market will significantly affect our performance on an absolute basis, in both the positive and negative direction. Consistent relative outperformance will lead to satisfactory absolute performance in the long run.
- (4) I never try to predict what the market will do, because I understand that it is not predictable. I focus on the things I can control - understanding and evaluating businesses and purchasing them at favorable prices in relation to value.
- (5) I am willing to pay up for quality businesses, but prices must be reasonable in relation to value. To be more specific, when I purchase quality businesses, I require a smaller margin of safety in the purchase price.

Investing requires both patience and discipline. Patience because sound investing requires a significant amount of inactivity and discipline because when opportunities are lacking, I must be willing to sit on my hands and wait for the market to provide opportunities. Similarly, during periods of declining markets, I must also have the discipline and conviction to hold our investments. If we own quality businesses where the fundamentals have not deteriorated and the only difference is how the market is pricing the businesses, we must hold or even add to our positions in the businesses we own.

Tempered Expectations

While I would love to tell you that a 27.4% return before fees is achievable every year, I can almost certainly say that it is not and I will explain why. First, we shouldn't expect the market to do better than 6% to 8% per year on average over the long term, although any individual year may fluctuate wildly from that average. The 12 months ended June 30, 2017 is the perfect example, with the S&P 500 returning 17.5%. Second, our outperformance over the S&P 500 was 9.9% this past year, a number that will be quite difficult to replicate on a consistent basis. Third, the market currently sits at elevated levels in comparison to its long-term average. These combined factors don't suggest results will continue at the high rate of return experienced this past year. We should discuss each point in slightly more detail.

- (1) Long-term market returns should be in the 6% to 8% range. Future returns will be driven by earnings growth and dividends. Assuming constant margins - which is quite an assumption to make - GDP growth can be a good approximation of earnings growth. With real GDP growth somewhere in the 2% to 3% range and inflation in the same range, we can reasonably expect nominal GDP growth to be somewhere in the 4% to 6% range. Average dividends of 2% result in an overall range of return between 6% and 8%. Returns in any given year will most certainly vary from this range, but I would be willing to guess that long-term results will end up pretty close to the range.
- (2) 9.9% outperformance. While I'm pleased with our outperformance for the year, I don't believe it's realistic to assume that we could continue to outperform at that level. My goal

will continue to be 5% outperformance on average, which is a reasonable yet quite difficult goal to achieve. As mentioned in previous correspondence to you, I believe that this outperformance is achievable by purchasing high-quality businesses at discounts to their intrinsic value.

- (3) The current market level. The current market level in relation to earnings is considerably higher than the long-term average, implying that future returns for the market as a whole could be less than the 6% to 8% I suggest above. My expectation is that the market will eventually revert to the mean and multiples will contract. I could not tell you when this will happen but I can say with confidence that it will eventually happen. I'm not in the business of predicting markets and don't believe it's relevant to the long-term investor. However, short-term market fluctuations will affect our short-term results and it's my job to make sure my investors are prepared for these aberrations.

Being Mentally Prepared

If it hasn't felt like I've rained on our parade yet, I'll give it another try. It's inevitable that we'll experience substantial market declines over the years. A 20% to 30% decline in any given year would not be surprising and it's quite possible that a decline could be greater than that. In 16 of the past 60 years, the market has had negative returns as measured by the S&P 500, meaning that we can expect the market to be negative one out of every four years. When dividends are included, the market has not provided a negative return since 2008. According to market history, we're overdue. I cannot predict when a substantial decline - or even a decline at all - will occur. It really does not matter. What does matter is how we react to a market decline.

When the market falls significantly, we want to be buyers of businesses, not sellers. For reasons that are not so obvious, most investors end up doing the exact opposite, buying high and selling low. First, investors tend to take cues from market prices, meaning that they believe that the market price always reflects the underlying value of the business or they don't recognize that there is a difference between the two. Second, herd mentality takes over. Some exogenous event may set off a selling frenzy, leading market "experts" to deliver negative commentary. This in turn leads to more selling and the lower prices provide cues to investors that prices will continue lower and this vicious cycle continues. Oddly enough, a similar pattern occurs in the opposite direction as well, leading to market bubbles and overpriced assets.

One of the surest ways to avoid this herd mentality is to make independent valuations of businesses and then compare that valuation to price. When prices are much lower than valuations, we buy. When prices are much higher than valuations, we sell. Significant market declines typically provide opportunities to make purchases at bargain prices, but you also must be willing to purchase when almost everyone else is selling. This may sound easy, but in the moment, it's extremely difficult.

What we can be sure of is that price will eventually align with intrinsic value, meaning that a business that is priced above its value has a negative return component built into its price. This reversion to an alignment of price and value could come about through (1) an increase in underlying value and a correspondingly lower increase in price, (2) constant value and a decrease in price, or (3) a decline in value and a correspondingly greater decrease in price. Interestingly enough, the exact same is true in underpriced markets; price will eventually equal value.

To summarize the above, I need to be mentally prepared to either hold or purchase more when markets decline. The only way to do this is to be able to properly calculate and have confidence in my estimate of intrinsic value.

Process Vs. Outcomes

The world we live in is probabilistic, not deterministic. This means that even if we make the right choice, there is a chance that we'll end up with the wrong outcome. Let's say that someone offers you a bet to guess the number that is going to show up on a six-sided die when rolled. The payoff for the bet they are offering is 1:1, meaning that if you bet \$1, you'll win \$1 from them and if you lose, you'll lose your \$1. Let's also say that, just by chance, you guessed correctly three out of four times, netting yourself \$2. Would you say that you made a good decision by playing this game, i.e., did you have a good process for deciding whether to play? Would you say that you had a positive outcome and that you're happy with your decision? The answer to the former question is unequivocally no and the answer to the latter question is most likely yes, and if you were betting big money, it would probably be a resounding yes. Let's look at this in a bit more detail.

Your process for determining whether or not to take this bet should be to determine the expected value of a single roll of the die. In a case like this, where the probabilities and payoffs are easily ascertainable, we can calculate the expected value with certainty. First, we know that the chance of winning any roll is 1 in 6, or 16.67%. That also means that the chance of losing any roll is 5 in 6, or 83.33%. Second, the payoff is 1:1, meaning that there is a \$1 gain for winning and a \$1 loss for losing when betting \$1. To calculate the expected value, we multiply the chance of winning (16.67%) by the payoff (\$1) and subtract from that the chance of losing (83.33%) by the amount lost (\$1). The expected value – the average result you should expect over many rolls – is a loss of \$0.66 for every roll. When the expected value of a game is negative, you should not play. Therefore, if you chose to play this game, your process for determining whether or not you should play this game is incorrect because you should have rejected the offer.

What about your outcome? You won three out of four rolls and made a few dollars while you were at it. The results, although not in line with the probabilities, could happen with ease solely due to chance. In fact, the outcome of any individual roll will be based on random chance. The results will tend to match the probabilities inherent in this game only over a very large number of rolls. We can conclude from this that while your outcome was positive over a very small sample, your process was flawed and over time will lead to an approximate \$0.66 loss for every dollar that you wager.

How does this relate to investing? Investing, similar to rolling a die, is probabilistic, meaning that making the right decision won't always lead to a positive outcome and making the wrong decision won't always lead to a negative outcome. However, over time, making the right decision will – on average – lead to positive outcomes and making the wrong decision will - on average - lead to negative outcomes. This leads me to the conclusion that process is more important than any given outcome and that a good process will lead to consistently better outcomes over time. I try to focus on my investing process – buying quality businesses at prices below my estimate of intrinsic value – and let the outcomes take care of themselves.

The issue with investing is that the probabilities and the payoffs - outcomes - are not easily ascertainable like they are with rolling a die. We can however, estimate probabilities and payoffs based on readily available prices and an estimate of intrinsic value. When we purchase businesses at prices below the estimate of intrinsic value, i.e., provide ourselves with a margin of safety, we increase the probability that we have a positive outcome. What we don't know is the extent to which the outcome will be positive, but having a margin of safety reduces the risk of permanent capital loss for individual investments.

Compound Interest

The final thing I want to discuss is compound interest and how important it is to long-term investing. If you're unaware of what compound interest is, it's easiest to explain through a quick example. If you invest \$100 and earn 10% interest on that \$100 over one year, you now have \$110. If you earn 10% interest in the second year in which your capital started out at \$110, you earn \$11 in interest and you finish the year with \$121. The additional \$1 of interest was the interest you earned on the interest earned in the previous year. That additional interest is compound interest. The effects of compound interest are small at first, but over long periods of time, they are significant. The table below illustrates the effects of compound interest at various rates of return for various durations. The example above would be a duration of 2 years at 10% compounded. You can see from the table that you end up with 1.21x your money, or \$21 earned on \$100 invested.

CAGR	Duration (years)											
	1	2	3	4	5	10	15	20	25	30	35	40
1%	1.01x	1.02x	1.03x	1.04x	1.05x	1.1x	1.16x	1.22x	1.28x	1.35x	1.42x	1.49x
2%	1.02x	1.04x	1.06x	1.08x	1.1x	1.22x	1.35x	1.49x	1.64x	1.81x	2x	2.21x
3%	1.03x	1.06x	1.09x	1.13x	1.16x	1.34x	1.56x	1.81x	2.09x	2.43x	2.81x	3.26x
4%	1.04x	1.08x	1.12x	1.17x	1.22x	1.48x	1.8x	2.19x	2.67x	3.24x	3.95x	4.8x
5%	1.05x	1.1x	1.16x	1.22x	1.28x	1.63x	2.08x	2.65x	3.39x	4.32x	5.52x	7.04x
6%	1.06x	1.12x	1.19x	1.26x	1.34x	1.79x	2.4x	3.21x	4.29x	5.74x	7.69x	10.29x
7%	1.07x	1.14x	1.23x	1.31x	1.4x	1.97x	2.76x	3.87x	5.43x	7.61x	10.68x	14.97x
8%	1.08x	1.17x	1.26x	1.36x	1.47x	2.16x	3.17x	4.66x	6.85x	10.06x	14.79x	21.72x
9%	1.09x	1.19x	1.3x	1.41x	1.54x	2.37x	3.64x	5.6x	8.62x	13.27x	20.41x	31.41x
10%	1.1x	1.21x	1.33x	1.46x	1.61x	2.59x	4.18x	6.73x	10.83x	17.45x	28.1x	45.26x
11%	1.11x	1.23x	1.37x	1.52x	1.69x	2.84x	4.78x	8.06x	13.59x	22.89x	38.57x	65x
12%	1.12x	1.25x	1.4x	1.57x	1.76x	3.11x	5.47x	9.65x	17x	29.96x	52.8x	93.05x
13%	1.13x	1.28x	1.44x	1.63x	1.84x	3.39x	6.25x	11.52x	21.23x	39.12x	72.07x	132.78x
14%	1.14x	1.3x	1.48x	1.69x	1.93x	3.71x	7.14x	13.74x	26.46x	50.95x	98.1x	188.88x
15%	1.15x	1.32x	1.52x	1.75x	2.01x	4.05x	8.14x	16.37x	32.92x	66.21x	133.18x	267.86x
16%	1.16x	1.35x	1.56x	1.81x	2.1x	4.41x	9.27x	19.46x	40.87x	85.85x	180.31x	378.72x

Let's look at what happens over long durations. If you were able to earn 10% compounded for 30 years, you would have 17.45 times your initial capital invested. If you were able to earn just 2% more per year for a 12% CAGR over that same period, you would have 29.96 times your initial capital. That is almost 72% more money because you earned just 2% more per year. If the same scenario occurred over only 10 years, you would have just 20% more money if you earned 12% as opposed to 10%. Over time, the effects of compounding increase exponentially, which is why my focus is on the long term and not the short term.

If you knew – which there is no way of actually knowing – that you could earn a very lumpy 12% over the next 20 years versus a very smooth 10%, which would you take? The table below provides a table of hypothetical returns, one of which results in a CAGR of 12% over 20 years and one that results in a CAGR of 10% over 20 years. While the results on the left fluctuate a great deal more than the results on the right, I would choose the returns on the left, which provide the 12% CAGR over the 10% CAGR column. Our concentrated portfolio will most likely lead to our results looking more like the left column than the right

column, specifically because the left fluctuates more than the right. In absolutely no way does the table below reflect actual or projected results for us. It is solely there to make a point about the fluctuations we should expect in our results over the years and why I'm willing to put up them.

Year	Yearly Return	
1	20%	15%
2	3%	12%
3	25%	8%
4	-10%	-2%
5	15%	13%
6	17%	17%
7	-15%	-5%
8	36%	22%
9	15%	12%
10	15%	6%
11	-30%	-8%
12	28%	9%
13	14%	10%
14	25%	20%
15	20%	18%
16	22%	16%
17	-10%	-7%
18	34%	15%
19	26%	20%
20	18%	16%
CAGR	12.0%	10.0%

The bottom line here is that compound interest will do amazing things for your money over long periods of time. In a world where results are measured over shorter and shorter time periods, it seems that the goal investors have in mind at the outset is forgotten. My goal, and I presume my investors' goal, is to end up with significantly more money at some point in the distant future. Unless you're planning to spend your invested capital next week, the results from this week don't matter. The same goes for monthly, quarterly and annual results. I'll leave you with a quote that is attributed – although questionably – to Albert Einstein. “Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it.”

Going Forward

I want to thank you again for entrusting me with your hard-earned capital. My top priority is to protect your capital from permanent loss and my second priority is to grow your capital. I will continue to be a long-term investor with a value-oriented approach, looking to purchase great businesses selling at reasonable prices.

Should you have any questions, please do not hesitate to contact me.

Very Respectfully,



Brian Binder
Stonebridge Value Capital

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The performance data represents the composite performance of separate accounts managed by SVC. The results reflect the deduction of: (i) a quarterly asset management fee of 0.25%, charged in arrears; (ii) a quarterly incentive allocation of 25% of any increase in an account’s net assets in excess of a quarterly rate of return of 1.25%, subject to a high-water mark; and (iii) transaction fees and other expenses incurred by each account. During the time period shown, there were no material market or economic conditions that affected the results portrayed. Results are compared to the performance of the S&P 500 for informational purposes only; SVC’s investment program does not mirror the S&P 500 and may experience materially different volatility. The performance figures include the reinvestment of any dividends and other earnings, as appropriate. Past performance is not necessarily indicative of future results. All investments involve risk, including the loss of principal.