December 7, 2016

Letter to Prospective Investors

If you are reading this letter, we have most likely already discussed me managing some portion of your capital. I am the owner, managing partner, and investment director of Stonebridge Value Capital, LLC (SVC), the business entity that will manage your funds. When you invest with SVC, I promise to treat your capital as if it were my own by investing the majority of my money the same way that I invest yours. I find this to be the best way to prove my personal and professional commitment to the investment strategies and practices employed by SVC.

At SVC, I invest mainly in equities, although I put no constraints on myself in this regard. The only investments that I avoid are those that are outside my circle of competence. I take a long-term, value-oriented approach to investing**.** My number one priority is to reduce the risk of permanent capital loss while earning an adequate return on capital employed. All of the investments that I make will be based on thorough due diligence of the underlying merits of a business, and not on the popularity of the issue or a speculative "hot tip". I also invest in special situations that are event driven where the results are uncorrelated with the market and the risk/reward profile is significantly in our favor.

Prior to investing with SVC, it's important that you understand my investment strategy, the advantages we have and my long-term goals. All of the information that I am going to outline for you is information that I would want to know if I were in your shoes, so I believe it's only fair that I provide it to you.

SVC Investment Strategy

While I've split up SVC's investment strategy into four different principles, not including the section on Special Situations, each piece is integral to the system and significantly overlaps and influences the other. My views on what I believe are our real risks as investors force me to have a long term, business-oriented approach to investing. Having a business orientation allows me to see the difference between the price we pay for a fractional ownership in a business and the value we get. I also understand that gaps in price and value are short term in nature and will converge over the long term. My business orientation also allows me to look for businesses that are selling for much less than they're worth, providing us with a margin of safety in our purchases. The margin of safety we have when I make purchases helps us mitigate risk by reducing the probability that we experience a permanent loss of capital. You may find me repeating myself in regards to some points from section to section which is a result of the overlap of principles. It also has the added advantage of reinforcing major points.

A Differentiated View on Risk

A discussion of risk and the way that I look to mitigate risk is probably the most important topic of this letter. I previously stated that my number one priority is reducing the risk of permanent capital loss while earning an adequate return on capital employed. Risk, to me, is initially paying too much for a business or adverse business developments being realized after purchasing, which permanently impair the value of the business. I reduce risk by purchasing securities for much less than they are worth (having a margin of safety) and by buying businesses that have strong, durable competitive advantages. This approach to risk implies a long-term approach to investing that is in sharp contrast to conventional wisdom on Wall Street.

The majority of investors and academicians alike define risk as the volatility of the price of a security in relation to the volatility of the stock market as a whole. This means that a stock with a price that moves twice as much as the market is viewed as twice as risky as a stock that moves the same amount as the market, regardless if that move is positive or negative. I agree that volatility can be a risk for short-term speculators or traders, but the daily price changes in the market are not a risk to a long-term investor. On the contrary, I believe that short-term volatility can be an advantage for purchasing securities at a discount. The general market's definition of risk is solely based on short-term price fluctuations, while my, and most value investors', definition of risk is based on the underlying fundamentals of the business.

By way of example, I hope that I can take somewhat of an esoteric concept and simplify it for you. Let's say that you are part owner of a brick and mortar movie rental business – those from my hometown will probably think of Talkies. Every day that you owned that business since inception, your business partner has approached you and offered to purchase your stake in the business or sell you an additional stake. The odd thing about your partner is that he offers you a different price each day, and sometimes the difference in that price can be enormous. Some days he offers you an extremely low price and some days an extremely high price, mainly dependent on his mood that day. Even more odd is that he doesn't get upset when you reject him and he lets you know he'll be back tomorrow to offer you a new price. Do these offers each day from your partner create or increase your risk in owning the business if you are never required to buy or sell?

I would say unequivocally no. If his price is too low, you can purchase an additional stake or do nothing at all and he'll still come back tomorrow. If his price is higher than you believe the business is worth, you can either accept the offer or keep your stake in the business. If it's not obvious yet, this is very similar to an investor's relationship with the stock market. If you own a stock and understand the value of the underlying business, you can choose to buy, sell, or hold, depending on where the price is in relation to the value of the business. You're never required to buy or sell and the market will always come back and offer you a new price. Any of you that are familiar with a book called The Intelligent Investor, by Benjamin Graham, will notice that the above example is based on his Mr. Market parable. As an aside, you'll notice that I quote Benjamin Graham often, as his teachings are the basis for my approach to investing.

On the other hand, real risk for a brick and mortar movie rental business, as companies like Blockbuster found out, is rooted in technological change and competitive pressures from new entrants to the market. Cable companies started renting movies on demand that could be ordered from the couch. Netflix made it easier to rent movies, first by mail order and subsequently by streaming service as internet speeds increased. Redbox put video renting machines all over the place, including at the entrance of grocery stores. These competitive pressures were the real risks to an owner of a brick and mortar movie rental business, as most of them are now out of business because they could not compete. As this example shows, our risks as long-term investors are driven by business developments, not the price someone offers us for our full or fractional ownership in the businesses we own.

My approach to risk drives the rest of SVC's investment strategy, including my business orientation, margin of safety principle, and long-term approach.

Business Orientation

As Benjamin Graham once said, "Investing is most intelligent when it is most businesslike." When you invest in a stock, you are purchasing a fractional ownership in the underlying business. Your ownership gives you rights to the assets and future profits of the business, although the assets and profits are controlled by the management of the company. This is another place that I differ with conventional wisdom, as most market participants typically let the price a business sells for in the market determine the value of the business for them.

I value a business based on its estimated future cash flows available to owners, discounted back to the present. In reality, any financial instrument is equal to the present value of all future cash flows, it's just that owning a business requires you to estimate those cash flows. In the case of owning a bond, the future cash flows – interest payments and repayment of principal – are known to the owner. In regards to a business, this "value" – called the intrinsic value of the business – is more of a range of values than a precise figure, which can be compared to the price the business is sold for in the market. Most of the time, the price of the business falls within the range of intrinsic value, rendering the market essentially efficient for that business. However, from time to time, price and value diverge from one another, and a business, or a fraction thereof, can be purchased for a price well below the estimate of intrinsic value. It's these inefficiencies in the market that I look for when purchasing securities. My business orientation gives me the ability to distinguish between price and value and exploit that difference when it is present. Finding a discrepancy between price and value is not a bonus, it's a requirement prior to purchase, which provides us a margin of safety against incorrect assumptions during analysis, as well as any future adverse business developments that could impair the value of the business.

Many people will tell you that the market is efficient and any discrepancy between price and value will quickly close, making it nearly impossible to exploit and profit from these discrepancies. I would agree that the market is *mostly* efficient, but one should be careful in describing a market that is *mostly* efficient as *always* efficient. These price/value gaps can persist for an extended period of time in the market leading to pricing inefficiencies in the short term, but eventually the gap will close and price and value will align. As I will discuss later, knowing that price and value will converge over the long term, but not knowing when it will happen, drives my long-term investment philosophy and also the way that I measure our results.

Margin of Safety

Anytime I make a purchase, I try to make it with a large margin of safety, which is the difference between the price we pay and the value we get. Ideally, I like to purchase businesses that are selling for less than two-thirds of the value I believe they're worth and even less than two-thirds if possible. This requires a tremendous amount of purchasing discipline on my part, because the good businesses that I look to purchase are typically not selling at a discount to intrinsic value. It is also critical to have conservative, disciplined valuation methods, as it can be easy to trick yourself into believing that you are providing yourself a margin of safety. Coupling purchasing and valuation discipline together provides us with a margin of safety against incorrect assumptions during valuation and any future adverse business developments that could potentially impair value.

Valuation requires making assumptions about the future, which is all but impossible to predict. Therefore, if we're able to purchase a business for two-thirds of its intrinsic value, I can be significantly wrong in my valuation and we can still make money. We won't make the money that we anticipated, but we've protected ourselves against a permanent loss of capital by purchasing at conservative prices in relation to value. Making purchases with a margin of safety is critical to our number one priority – reducing the risk of permanent capital loss. Having a margin of safety also provides us with an added advantage, as there can be additional potential upside when price and value converge over the long term. It's not a question of if, it's a question of when. As Warren Buffett stated, "the course of the stock market will determine to a great degree *when* we will be right but the accuracy of our analysis of the company will largely determine *whether* we will be right. In other words we tend to concentrate on *what* should happen not *when* it should happen."

Long-Term Approach

Another quote from Benjamin Graham, the patriarch of value investing, is appropriate here. "In the short run, the market is a voting machine but in the long run, it is a weighing machine." What he meant by this is that over the short term, prices are influenced heavily by the popularity of a security, as well as investor expectations and emotions. For these reasons, price and value can diverge from one another over the short term, providing opportunity to purchase businesses at discounts to the value that they're worth. On the flip side, it can also drive prices well above the intrinsic value of the business, exposing investors to significant risks of permanent capital loss by overpaying. Just think about the technology bubble of the late 1990s and early 2000s, where there was a complete dislocation between the exorbitant prices that technology stocks were selling and the value of the businesses. I should note that these dislocations can last for multiple years, implying that the short term isn't measured in just days and months, but also years.

As an example, Microsoft reached its peak price in late 1999 of almost $60 per share, adjusted for splits, in the technology bubble, a price that was over 83 times its most recent earnings in 1999 of $0.71 per share. It wasn't until a few months ago in 2016 that Microsoft reached that price again, and even now, Microsoft is selling at over 25 times its most recent earnings of $2.10 per share. I believe that Microsoft's current price can be justified, although it is a bit pricey for me at 25 times earnings. However, in no way could its price in 1999 be justified by the facts and I would conclude that the market for Microsoft's shares at that time was inefficiently priced. The results to shareholders would prove this to be true, as it took 17 years to get back to the same share price at the peak of the technology bubble. In this instance, and many other instances, the voting machine got it wrong.

When Graham says that the market is a weighing machine in the long run, he means that the price of the business will track the results of the business fairly close, although short-term aberrations will undoubtedly exist because the long term is by definition made up of a series of short terms. I'm looking for businesses that will have meaningfully higher earnings (on a per share basis) five or ten years from now, which will result in a share price that is meaningfully higher over the same period, so long as the business was selling at a reasonable price to begin with. As you can see from the Microsoft example, the price you initially pay is a very important factor in the results you achieve as an investor. I do not need to know exactly what the future earnings of a business will be so long as I know that they will be meaningful higher in the future. As John Maynard Keynes once said, "It is better to be roughly right than precisely wrong."

Short-term results are not based on business fundamentals, but are based on the popularity of an issue and investor expectations and emotions. Therefore, I have no idea what the stock market will do over the short term and will not pretend that I can predict its direction. In contrast, long-term results are based on the outcomes of the underlying businesses, of which I believe I am able to roughly predict, especially for businesses with strong, durable competitive advantages. This leads me to believe that the only sensible approach to investing is a long-term approach, where business fundamentals drive investment results.

Special Situations

I also invest our capital in special situations, which can include mergers, spinoffs, restructurings and recapitalizations to name a few. I do not invest in a basket of various special situations, but invest only where I understand the details of the corporate event and the risk/reward ratio is significantly in our favor. Because these investments are event driven, their results are typically uncorrelated to the results of the market and can insulate our portfolio in down markets. In rapidly advancing markets, they may also dampen our returns. However, on a long-term basis, I believe they will provide above average results, so long as I am careful in the selection of the issues with which we invest.

SVC Advantages

SVC has a number of advantages that are both derived from our investment strategy and inherent to our operations. These advantages include:

1. My views on risk dismiss the notion that the best way to minimize risk is through diversification, allowing me to concentrate our capital in my best ideas.
2. My margin of safety principle requires that I am flexible about the types of investments I choose and the amount of cash – funds not invested – as a percentage of assets we have on hand at any given time.

3. Our currently small amount of capital allows us to invest in smaller issues that have a higher potential to be mispriced. Larger investment operations don't invest in smaller securities because they can't move the needle.
4. My partnership philosophy aligns my goals as an investment manager with the goals of my investors.

Concentration Vs Diversification

Conventional wisdom – as I'm sure by now you can tell I'm not too keen on – will tell you that diversification reduces risk because owning a lot of securities will decrease the overall volatility of a portfolio. Because I don't believe that volatility equals risk, I also don't believe that diversification automatically reduces risk. I do, however, believe that heavy diversification will lead to average investment results, which is not my goal for myself or my investors (see investment goals later in the letter). I look to reduce risk by understanding the businesses that we own and purchasing them at a reasonable price.

I believe that concentrating our capital in my best ideas will provide us the greatest opportunity to achieve above average returns, while taking on less than commensurate risk. It does not logically make sense to me why I would put the same amount of capital in my best idea as I would in my fifth, tenth or even twentieth best idea. If my best idea is a really great business selling with a large margin of safety and good risk/reward characteristics, why would I not concentrate our capital in that idea? I typically limit myself to a maximum of 30% of assets in any single idea, but this limit is subject to change if the right opportunity comes along.

Let's quickly take a look at the mutual fund world and their views on diversification. In order for a mutual fund to be considered diversified, it cannot have more than 5% of the capital it invests in any one security, effectively requiring the fund to own at least 20 different stocks. Because diversification is such a buzzword in the investment industry, most mutual funds choose to be diversified and meet this 5% maximum requirement. While I agree that this certainly makes these funds diversified, it does not reduce risk and therefore does not make logical sense to follow blindly. I also believe that this is a reason why mutual funds struggle to outpace the general market. Heavy diversification leads to results that won't vary much from the market, leading to underperformance after fees and expenses are assessed.

Flexibility

Investors will see that our level of cash – capital not currently invested in stocks – will fluctuate from time to time based on the availability of investments meeting my strict criteria for both price and value. This will relate – in some general fashion – to the price level of the stock market. As the market increases, our level of cash will most likely increase with it. Higher prices generally mean that the relationship between price and value is less favorable for us. Conversely, when the market falls, our cash levels will tend to drop as well. This is because more opportunities to deploy our capital will be available as prices are lower in relation to value.

This type of cash flexibility is important because different market environments require different levels of capital deployment. As Warren Buffett said, "If you want to shoot rare, fast-moving elephants, you should always carry a loaded gun." In an overvalued market, we want extra dry powder – cash – available when prices eventually cool off and the pendulum swings toward undervaluation. I'll have our gun loaded and ready.

Flexibility with the types of investments I choose is just important as flexibility with our cash levels. An example of the opposite of flexibility in investment options should help prove my point that flexibility is important. Mutual funds typically put themselves in certain buckets and limit the investments that they can make to those types of securities. For example, Fidelity has a sector mutual fund called the Fidelity Industrial Equipment mutual fund that limits its investments to industrial equipment companies in the U.S. An arbitrary rule such as this will most likely lead to underperformance for investors.

As I've stated before, markets are mostly efficient and capital does a fairly good job of chasing the best returns. As capital flows into undervalued, higher-return assets, prices are driven up, and returns are driven down. It's not uncommon that asset prices will move into overvalued territory and future returns will be below average. As this is recognized, capital will move out of those overvalued assets and into other undervalued assets and the cycle will start all over again. If you are limited to owning only certain assets, at some point you will be required to own assets that are overvalued and at some point undervalued. The investment manager is precluding himself from making a rational and intelligent decision as to how to allocate capital. The result in this situation is typically poor for investors but still lucrative for investment managers. As you'll see later, having a manager's incentives aligned with his or her investors is important.

When I invest your capital, I will put no arbitrary constraints on the investments we choose. The only investments that I won't make are those that are outside of my circle of competence. This will certainly limit our investment choices, but investing in something that I don't understand will invariably lead to poor results, as there is no way the investment can be based on sound investment principles.

Firm Size

The size of our investment operation is a significant structural advantage that we have right now. Being small allows us to invest in issues that would otherwise not move the needle for an asset manager with a much larger asset base. This means that the entire investment world is open for us and I will take full advantage. Larger, more followed issues like Coke or IBM are priced fairly efficiently almost all of the time, but smaller issues may not be followed by any analysts and significant pricing inefficiencies can be found in excellent businesses. These types of issues can provide significant potential for above average returns because of the lack of interest from much of the investment community. When investing in these smaller issues, I still hold them to the same standards I've laid out in this letter that are applied to any other potential investment.

Partnership Mentality

When you invest with SVC, I will treat you as a partner – although we will not be partners in the legal sense – and try to align our goals and results as much as possible. I want to make money with you, not from you. Therefore, I will invest a significant amount of my own capital the same way that I invest yours. In a business such as investing, you want a chef that will eat his own cooking. Many mutual funds and investment managers invest their own money differently than they invest your money. I would question the conviction of the investment manager in his or her investment ideas. Otherwise, why wouldn't they invest their own money the same way?

The fee structure that I prefer – incentive fees and low management fees - helps to align our goals further, but regulations limit the use of incentive fees being charged to investors who meet certain net worth and/or income requirements. The fee structure will be discussed with investors on an individual basis. Incentive fees are only paid when we are successful, meaning that when you make money, SVC makes money. Management fees, on the other hand, are what you would typically pay an investment manager and are charged as a percentage of assets under management. While I believe that this fee structure incentivizes a manager to seek out additional assets rather than to seek better returns for existing clients, it's the next best alternative. Management fees will be charged to those investors who do not meet the regulatory requirements for incentive fees.

There are other types of miscellaneous fees that mutual funds charge, including 12b-1 fees and load fees. A load fee, for instance, can be charged when you initially invest in the fund or when you take money out. I believe these types of fees line the pockets of investment managers, but do nothing for the investor.

Investment Goals

It's important for us to be able to determine whether we've been successful over a period of years so that you can determine whether you should keep your capital invested with SVC. In order to determine our success, we need to establish what we are measuring against and the duration with which we should make those measurements. I will walk you through my thought process on what I believe is our absolute minimum requirement to be considered successful and also what I believe is achievable for us.

There is a lively debate that has gone on for a number of years as to whether active money management provides any value to investors. The logic behind this is that active managers only provide value if the returns they provide to their investors after fees are higher than the returns that can be earned in a passively-managed index fund. I generally agree with this logic and believe that success should be measured by whether or not a manager can beat a general stock market index. I measure our results against the S&P 500 index, which is an adequate representation of the market as a whole. Others may recommend alternative indices as a better representation of the market, but I like to use the S&P 500 because the data is readily available and it has a long historical record that we can use to glean some insight into our future expectations. It should be explicitly stated that we're looking for relative results in comparison to the overall market, not absolute results.

I measure our results and our success based on whether or not we beat the S&P 500 index over any five-year period. Whether I am able to beat the market in any single year is of little consequence to me, as price and value can be dislocated for extended periods of time. Short term results are heavily influenced by the moods of the market and don't necessarily bear any relation to underlying value. However, over the long-term, price and value will converge and I measure myself on this basis. While I measure our results over a five-year time horizon, the absolute minimum I believe we can measure our results is a three-year time horizon. As the timeframe with which we measure ourselves stretches out, business results become the dominating factor of our investment results.

It should be noted that in speculative bull markets such as the technology bubble of the late 1990s, we may have three-year periods or longer where the market beats us, specifically because I am not willing to overpay for businesses based on their popularity. While this may make me look out of step with the market, I will not take on additional risk by overpaying for businesses if prices being paid are well above the value of the underlying business.

I think it's best to provide a summary of how I measure success. *For our results to be considered successful, investor returns after fees and expenses must beat the S&P 500 index returns over any three-to-five year period, with the caveat that in speculative bull markets we may have extended periods of underperformance.*

Now that we have a minimum hurdle with which we must jump, I will discuss what I believe to be achievable results over the long term. My goal is to beat the S&P 500 index by 5% per year before fees and expenses, on average, over the long term. Notice that our minimum requirement for success is *after* fees and expenses, but my goal is *prior* to fees and expenses. I should also reiterate that this will not be achievable every year and there are years where we will significantly underperform the market. I take no great pleasure in telling you that, but it's extremely important that you understand that I expect we will underperform from time to time so that you do not have expectations of outperformance each and every year and come knocking on my door when we inevitably underperform.

While I've presented you with my goal of a 5% advantage per year over the market on average, I make no guarantees as to us actually achieving this goal. While I believe the goal is achievable, any small advantage over the market can prove significant over long durations. As an example, the S&P 500 has returned approximately 9% per year compounded, including dividends reinvested, over the past 50 years. These results assume paying no taxes on capital gains or dividends – think of a retirement account during the accumulation period – to simplify the example. If you initially invested $10,000, after 50 years at 9% compounded, you would have $743,575.20. Let's say that over that same 50-year period, you were able to eke out 1% more per year on average, so that your returns were 10% per year compounded. In that case, you would end up with $1,173,908.53, almost 1.6x more money from an average of a 1% advantage each year.

This means a couple of things to me. First, if we underperform the S&P 500 over a period of five years, we all – including myself – need to look for alternative places to invest our money. Second, even a small outperformance is meaningful over a long period, rendering our results successful if we're able to beat the S&P 500 after fees and expenses. While any outperformance should be considered successful, my goal is a 5% advantage on average.

It's quite important that current and potential investors are in agreement with me on the duration with which we measure our results. Results over a single year do not provide any insight into the soundness of an investment program and can be severely misleading. I would say this to you whether we trounced the market by 30% or whether we were down by the same amount. As long-term investors, we focus on long-term results. This paragraph may sound redundant but it's an extremely important point that I want to make so that we have similar expectations going forward.

Summary

In summary, I believe SVC has many advantages over the market, other funds, and investment managers. I cannot guarantee any returns for investors, but I can guarantee that:

1. My first priority is reducing the probability of permanent capital loss;
2. My money will be invested right alongside yours; and
3. Purchases will be made based on the value of a security in relation to price, not on the popularity of the issue.

It should be mentioned to all prospective investors that I currently have a full-time career in a different industry that takes up a significant amount of my time. Having said that, I would not be running this investment operation if I did not believe that I have enough available time to devote to this endeavor. I have invested my own money for a number of years while working a full-time career and do not foresee much change in that regard. Of course, there will be additional time spent meeting regulatory requirements and running a small business, but I believe those to be manageable.

Everything above is a basic outline of my strategy for successful long-term investing. While I can provide no guarantees to investors, I believe that our results should prove satisfactory over a period of years. If they do not, I will be the first to tell you, as I most likely will be looking for someone else to manage my money. If any questions should arise from the material in this letter, please do not hesitate to contact me by phone or e-mail. Should you find yourself interested in investing your capital with me, we should have a discussion of further details and make sure that our becoming partners will be in the best interest of both of us.

Very Respectfully,

Brian Binder

Disclaimer

This is not an offer to open a managed account with Stonebridge Value Capital, LLC. Any such account will only be opened for qualified investors by means of an investment management agreement in those jurisdictions where permitted by law.

The fees and expenses charged in connection with a managed account may be higher than the fees and expenses of other investment alternatives and may offset profits. No assurance can be given that the investment objectives described herein will be achieved or that an investor will receive a profitable return on his or her investment. Investment results may vary substantially over any given time period.