SVC

September 8, 2018

The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own. – Warren Buffett

SVC ended the first half of 2018 with a consolidated return across all accounts of 1.0% before fees and 0.5% after fees. The S&P 500 ended the same period with a 2.7% gain, including an estimated 1% dividend. The bad news is that more than 60% of our money continues to sit in cash, which tends to act as an anchor on our portfolio as the market continues its march higher. The good news is that I found a few select investments in the first half of the year that meet my criteria on both price and quality and I was able to deploy some of our capital, shrinking our large cash position slightly.

On a price-to-earnings basis, the U.S. markets have become somewhat less overvalued than when I wrote to you in my last letter in January, due in large part to the US tax cuts enacted in late 2017. Independent of the tax cuts, corporate earnings continue to grow as well, a great sign for the U.S. economy, but not an indication of future returns for the stock market. Future returns will be determined partly by the growth in the U.S. economy and partly by the changes in relative valuation. With valuations still running much higher than historical norms, I suspect that changes in relative valuation will have an inordinate impact on the future returns of the stock market. This does not mean we should expect a recession in the near future – I have no idea when one will occur, how bad it will be, and what will cause it – only that I believe it is a time to be cautious and patient, not aggressive.

It's important that I discuss at length my position on why we currently sit so heavily in cash. My assessment of the current market is that there are two likely outcomes: (1) the market never falls significantly, which results in positive future returns, albeit at rates much lower than anyone needs or wants, or (2) the market drops significantly, swinging below historical norms in relation to underlying value as the pendulum swings too far in the opposite direction during the correction.

I find myself with two choices: (a) deploy all or most of our capital now, even at the high prices we see today across most securities, and especially those that I like, or (b) sit on cash and wait for those securities to sell at much lower prices in relation to underlying value. This leaves us with four scenarios based on the decision I make and the outcome that occurs.

If I take the first choice (a) and deploy all of our capital now, and the first outcome (1) comes to fruition – we'll end up with below average, but nonetheless positive returns. I don't believe anyone will be too excited about this "slowly let the air out of the tires" situation, but it's a real possibility. Thinking back through the history of the U.S. stock market through the 20^{th} century, and especially through the last 25 years, I can't think of any soft landings like this occurring in the market. I'm not saying that it won't happen, it just seems highly unlikely if history is any indication of the future.

Under the second scenario, where we're fully invested (a) and the market drops precipitously (2), we would end up with significant capital loss. The only way we would be able to take advantage of the bargains and deploy capital in this situation would be to sell the things we already own, locking in the otherwise temporary losses and making them permanent. While it may feel good in the short-term to take advantage of the current returns in the market at these ever-higher prices, I believe the end results may prove those gains and good feelings illusory.

Alternatively, I can make the second choice (b) where we hold a significant portion of our portfolio in cash, foregoing the current returns with the expectation of deploying that capital aggressively in the future. If the first outcome (1) were to come true where we have a soft landing in the market, we would forego the small, but positive returns. This would be our opportunity cost for staying heavily in cash and we must weigh it against our other options to make an informed decision for investment.

Finally, we come to the scenario where we stay heavily in cash (b) and the market drops significantly (2). This scenario allows me to deploy capital in newly available opportunities without having to first lock in losses. It also allows me to add to our current positions as those prices become increasingly favorable. While this outcome may prove to be the most likely, the choice to stay in cash is the most difficult. Staying in cash now requires a long-term mindset from both my investors and myself, as the fear of missing out will become a feeling that is increasingly difficult to keep at bay if the market continues its march forward.

All things considered, I believe staying significantly in cash is the most prudent and least risky option for us as long-term investors. This is not to say that I will not deploy capital as opportunities become available; it only means that our opportunity set is very limited right now. We don't need the entire market to drop; we just need a few select opportunities. The level of the general market tends to be an indicator of the opportunity set that we have at any one time, with a higher market indicating a smaller opportunity set and a lower market indicating a larger opportunity set.

I was able to find a few of those select investments over the first half of the year, establishing positions in two companies for very different reasons. The first investment is Facebook (FB), which was purchased because of the strong economics of its business model and durable competitive advantages that I believe will endure for many years. The second investment, Brookfield Property Partners (BPY), is not an inherently great business like Facebook, but does have an outstanding management team. Brookfield was purchased in large part because of the track record of its management team for great capital allocation over various market cycles and the significant discount to its estimated net asset value (NAV). I expect to hold both of these investments for a long time.

Facebook

Facebook has been mired in controversy of late because of the company's mishandling of its user data. As a result, the stock has suffered. That allowed me to make our initial purchase at prices well below the underlying value of the company. When I make my final decision to invest in a company, I try to boil the thesis down to three to five things that will make or break the investment; a lot of the other information is just noise. For Facebook, those items include:

1. Growth in daily active users (DAUs), monthly active users (MAUs), and average revenue per user (ARPU) across all platforms.
2. Maintaining high return on investment (ROI) for advertisers through targeted marketing efforts.
3. Impact of regulation on the business and getting ahead of government regulation through self-regulation.
4. Continuing to monetize Instagram and WhatsApp.
5. Allocating capital because the business generates so much cash

I expect that capital allocation will become ever more important as Facebook grows because the business does not require significant capital investment and will continue to grow its cash hoard.

The most recent issue with Facebook is that they reported slowing revenue growth over the coming years during the 2018 second quarter earnings call. This caused the stock price to drop by 20%, losing approximately $120 billion in market capitalization. From the reaction of the market, you may have assumed that they reported shrinking revenues. However, the specific statement by David Wehner – Facebook's CFO – on the call was:

> *Turning now to the revenue outlook; our total revenue growth rate decelerated approximately 7 percentage points in Q2 compared to Q1. Our total revenue growth rates will continue to decelerate in the second half of 2018, and we expect our revenue growth rates to decline by high-single digit percentages from prior quarters sequentially in both Q3 and Q4.*

Revenue grew 42% in Q2. The guidance calls for percentage declines from very high rates of growth; not great news, but growth remains significantly positive. Expense growth is not expected to slow down as much as revenue, which will cause margin compression over the coming years. Nonetheless, the severe market overreaction provided another buying opportunity for us. I'm excited that we're owners of Facebook and look forward to management continuing to increase the earning power of the business for years to come.

Brookfield Property Partners

Our investment in Brookfield Property Partners is all about its management's ability to allocate capital. BPY is a subsidiary of Brookfield Asset Management (BAM), a separately-traded public company that invests in real estate, infrastructure, renewable power and private equity. BPY focuses on real estate and owns, operates, and develops office, retail, multifamily, industrial, hospitality, triple net lease, self-storage, student housing and manufactured housing assets across the globe. Brookfield takes a value investing approach to all its investments and has a stellar track record over a long period of time of purchasing assets for less than they're worth, increasing the cash flows of those assets, and selling them at a premium.

Brookfield is an excellent steward of our capital and has been buying back units of the company – BPY is a partnership and issues units, not shares – as the market continues to undervalue the company. BPY had a net asset value (NAV) of roughly $29/unit at the end of 2017 and we were able to enter our position at a fraction of that value. The large discount to NAV during purchase, coupled with Brookfield's excellent capital allocation skills provides us with a significant margin of safety in this position. Additionally, BPY issues a healthy distribution each year – what would otherwise be called a dividend for a corporation – which currently sits at $1.26/unit, roughly a 6.3% yield at current prices; our yield on purchase price is slightly higher. I applaud Brookfield's continued thoughtful capital allocation and look forward to many more years of partnering with them and watching our investment and distributions grow.

Conclusion

The word that came to mind most often in the first half of 2018 and continues to come to mind is <u>patience</u>. There will be a time to aggressively deploy capital; now is not that time. I want to thank my investors for entrusting me with their capital. The responsibility does not fall lightly on me. Protecting your capital – and mine – continues to be my number one priority. That will never change.

I intend to increase my correspondence with you going forward, switching from semi-annual letters to quarterly letters. This is not to provide you with shorter measures of our performance; you can find that in your brokerage statements on your own. The increased correspondence is to keep investors up to date on my disposition and let you know that, while there may not be much activity going on in the portfolio, I continue to diligently research and be patient about our current and potential investments. When opportunities arise, I'll pounce.

None of this precludes any of you from contacting me at any time. I'm always open for a healthy discussion about investing, especially since it is my favorite topic of conversation. Thank you again for your continued trust in me and I look forward to updating you at the end of the next quarter.

Respectfully,

Brian Binder
Stonebridge Value Capital

Disclaimer

This is not an offer to open a managed account with Stonebridge Value Capital, LLC ("SVC"). 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.

The performance data represents the composite performance of separate accounts managed by SVC. The results reflect the deduction of: (i) quarterly asset management fees; (ii) incentive allocation in accounts where incentive allocations may be charged in excess of a minimum return and 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.