SVC

January 27, 2018

SVC ended 2017 with a consolidated return across all accounts of 13.4% before fees and 10.5% after fees. The S&P 500 ended the year with a 21.4% gain, including an estimated 2% dividend. While I'm certainly not pleased with our underperformance, it was not surprising to me given the market's current level. The table below shows our performance over the first year and a half of operations.

Returns

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**
2016 **	21.7%	18.3%	7.7%	14.0%	8.8%
2017	13.4%	10.5%	21.4%	(8.0%)	(10.9%)
CAGR #	**24.0%**	**18.3%**	**19.6%**		
Return Since Inception	**38.0%**	**28.7%**	**30.7%**	**7.3%**	**(2.0%)**

* Results are unaudited
** 6 months ending December 31, 2016
# Calculated based on 1.5 years

As the year ended, all of the accounts managed by SVC were heavily in cash, i.e., money we haven't put to work, with some more so than others. The range of cash levels is anywhere from 50% to 77% of assets, even though my goal is to have all accounts look nearly identical. I'm sure you're wondering why we have so much idle capital, especially because the stock market has seemed to do nothing but go up lately. In fact, the S&P 500, after turning in great 2017 results, has shot up almost 7.5% so far in January. I have one word for the reason we're sitting on so much cash: risk.

There are two main ways that I mitigate risk: (1) purchase quality businesses with strong competitive advantages and (2) purchase those businesses at fair prices. I spend the majority of my time researching and discovering quality businesses and have compiled a list of businesses that I would love to own. I continue to expand that list as I find additional businesses meeting my exacting standards. That list has been developed without regard to price, but price is a critical component when it comes to making a purchase decision. I won't buy businesses that are priced above the value I estimate them to be worth. Generally higher prices result in a shrunken opportunity set for us. In theory, the buy-low, sell-high approach to the stock market sounds simple and easy. In practice, almost no one follows it. As Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is."

Price = Value (Or Not)

There is a mental shortcut that most people take which has to do with equating price with what something is actually worth. If you walk into a jewelry store and see three diamond rings, all identical to the naked eye, your initial assumption would be that they were all worth the same amount. Of course, you look at the price tag for each and realize that the first one is $1,000, the second one is $3,000 and the third one is $5,000. You would immediately take a mental shortcut and assume that the ring with a price tag of $5,000 was worth more than the other two. In actuality, the only thing you know is that the three rings look almost identical. In this case though, you could safely make this mental leap and to no one's surprise, the $5,000 ring has a diamond in it of a much higher quality than the $1,000 ring. This little mental shortcut serves us fairly well in everyday life, although there is one particular place that this mental shortcut causes particular harm - the stock market.

To be successful at investing, your approach must be counterintuitive. The primary reason is that when the market is priced the highest and optimism is at its peak, risk is also the most present and prospective returns are the lowest. Of course, the opposite is just as true. When the market has gone down and pessimism is greatest, risk is at its lowest and prospective returns are the highest. Most investors and speculators alike believe that price increases are associated with a concomitant increase in value. In reality, that just isn't so.

Over the long term, price changes are based on underlying value. Over the short term, price changes are based on supply and demand of shares. If you assume that the quantity of shares available to the investing public is fixed over the short term – probably a safe assumption to make – than price changes in the short term are really a matter of the demand for shares and the mood of the investing public. Bitcoin is the perfect example of an asset with very high and increasing demand and a relatively stable supply. The heavy demand has driven the price up with very little regard to for the value of a Bitcoin. By the way, I have no idea what the value of a Bitcoin is.

So where does that leave us today? John Templeton had a great quote: "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." The extended bull market that we're in today had a long phase of pessimism, with an even longer phase of skepticism. It seems now that most of the skeptics have gone and optimism rules the day. I wouldn't say we're at euphoric levels yet, but we're getting close.

It's also helpful to look at today's stock prices in historical context. I find the price-to-earnings (p/e) ratio to be a good proxy for the relationship between price and value. Only two other times in the history of the S&P 500 has the market been priced so high in relation to earnings and one of those times was due to a severe drop in earnings, not a price bubble. The first was right before the internet bubble burst at the turn of the century, and the second was after the housing bubble burst. It should be noted that there was a severe spike in the p/e ratio in 2009 not because of high prices, but because earnings dropped off the table for a short period of time. During the only other occurrence where a price increase drove the p/e ratio to a level similar or above the current level, and in many other situations where there was an asset bubble that did not reach this height, optimism was high, greed was high, and very little fear or pessimism was present. The ultimate result of each of those asset bubbles, especially the internet bubble, was a severe decline in prices.

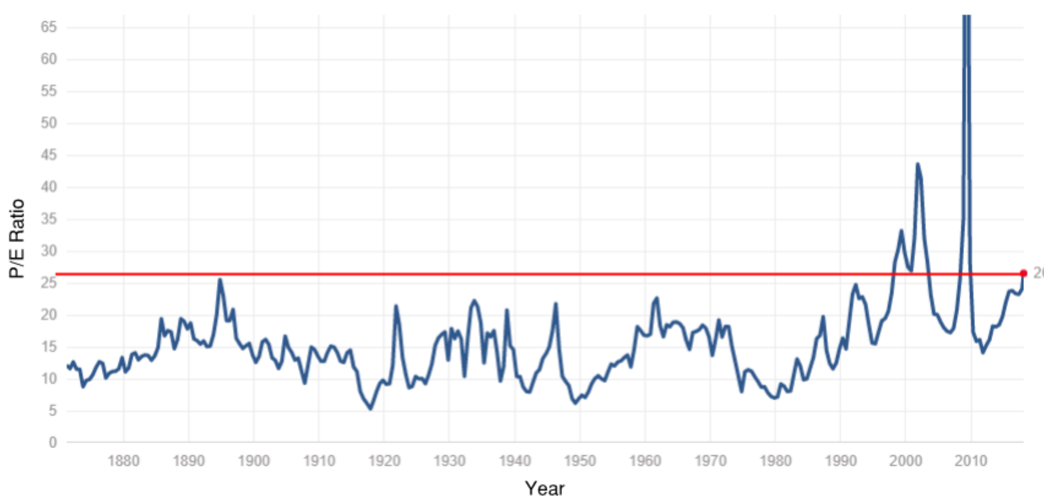

**Chart and data come from multpl.com*

I'm a bottom-up investor, meaning that I look for individual businesses to invest in and don't spend much time thinking about the stock market as a whole. However, a rising stock market will, in general, lift the prices of most companies and a falling stock market will, in general, drive down the prices of most companies - regardless of the fundamentals of each individual business. This is the main reason that this letter has a focus on the current stock market level. Currently high prices across the board have priced us out of a lot of opportunities that we might otherwise have. So the question becomes, where do we go from here?

Going Forward

I want to revisit something I said in my August 12, 2017 letter:

> *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.*

Patience and discipline are the name of the game for us today, where I must avoid capitulating and investing our money in overpriced securities. It can certainly be tempting as we may miss out on what seem in the moment to be opportunities to make easy money. The problem is, when the music stops, who is to say we wouldn't be the ones holding the bag - and quite frankly, no one knows when the music will stop. Investing with the hope that there will always be a greater fool willing to pay more for what we own is neither prudent nor conservative.

I can't predict nor forecast when the stock market will turn, but I feel confident that it eventually will. To quote Herbert Stein, "If something cannot go on forever, it will stop." When that happens, I'll be prepared to deploy our currently-idle capital in meaningful ways. In the meantime, if selective opportunities present themselves I'll deploy our capital, but price will continue to be a dominant factor in my investment decisions. An example of my latest purchase decision is appropriate, which will show just how quickly we went from purchasing a business to sitting on the sidelines.

In late September, I started to purchase shares of Discover Financial Services, which everyone will see they own in their account statements. Shares were priced around $62 at the time of initial purchase and I made purchases up until the end of October, when shares were nearing $67 - what I would consider the higher end of my purchase-price range. Since then, the price has shot up and currently sits around $81, an almost 31% increase from the initial purchase price. I'm willing to own Discover at this level, as I believe the company will continue to increase its intrinsic value over time because of its durable competitive advantages and prospects for growth. However, I'm not willing to purchase additional shares at the current price because it's no longer a bargain and we would lack the margin of safety I require.

In my letter dated December 7, 2016, I wrote the following:

> *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.*

We're currently in a period of speculative excess and we'll struggle to keep pace with the market if it continues higher. The problem we have is twofold: (1) we have no idea when the market will turn and (2) we have no idea how much higher the market will go before it turns. In early 1998, the S&P 500 was at or near the current levels of the S&P 500 on a p/e basis - somewhere around 26x. It wasn't until the latter half of the year 2000 when the market reached its peak price and headed downward, around a year and a half after the market reached a level close to what we see today on a p/e basis.

It's important that my partners understand this, because even though I'm telling you that the market is currently overpriced, that does not mean that it won't continue to be overpriced for an extended period of time and it won't continue to go higher. The best that I can offer you is that when the market does turn, we'll have available cash ready and waiting to scoop up the bargains. For now, patience and discipline are the name of the game.

Should you have any questions, please do not hesitate to get in touch with me. Most importantly, I want to thank you for entrusting me with your capital. I will continue to invest your capital just as I invest my own. I will leave you with a quote from the father of value investing, Benjamin Graham:

> *"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook."*

Respectfully,

Brian Binder
Stonebridge Value Capital, LLC

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