April 18, 2017

Dear Friends,

In sharp contrast to wild ride at the end of 2016, 2017 began in remarkably calm fashion. While U.S. stock markets were broadly higher, gains occurred with the least volatility since 1965. Over the entire quarter, there were only two days when the S&P 500 moved more than 1% from one day to the next and these movements were relatively unremarkable; once up 1.4% and once down 1.2%. It had been over five months (October 11, 2016) between times the S&P 500 had a down day of greater than 1%! While the markets were complacent overall, when we peel back the onion we saw movement in many individual stocks.

The lack of market tumult is especially impressive considering government's inability to repeal the Affordable Care Act (ACA). We were surprised the market took this in stride, but think one of the main drivers of the Trump rally was the prospect of lower corporate taxes (lower regulations being the other). The Congressional Budget Office estimated the ACA repeal would cut spending by $1.2 trillion over the next decade. The ACA repeal had to be voted on before tax reform because it was such a large factor in offsetting spending. With repeal less likely now, tax rates are less likely to drop as far as everyone was expecting. The market didn't really react to the failed repeal effort, but sectors with the highest tax rates (those who obviously benefit the most from tax reform) did show some weakness. Banks, as measured by the KBW Bank Index, were down over 7% in March. They are a big beneficiary of lower tax rates and the prospect of less tax reform was likely one factor in their drop over the last month.

We are happy with the first quarter's performance as we handily beat in the Large portfolio and held our ground in the SMID portfolio. We did not buy any new stocks in our Large portfolios but did find one new idea in our SMID portfolio. The new stock was USG Corporation. USG is the country's largest manufacturer of wallboard and second largest supplier of ceiling tiles. USG's wallboard is called Sheetrock which is often used interchangeably with wallboard just as Kleenex is with tissue paper. Their business is driven by new home sales and remodeling. The company met all three criteria we look for in a new holding: (1) a superior business, (2) run by exceptional management that (3) is attractively valued.

We think the fundamentals of their business are strong (we will actually be buying some Sheetrock this quarter for our new office) and pricing power is finally coming back to the industry. What really intrigued us about USG is that they announced the sale of their distribution business to ABC Supply Co. last year. This should open up a large market for them because they were competing with their distribution customers when selling wallboard. Now that they sold the business, numerous distributors who were "competitors" can potentially become customers. To boot, they used the cash proceeds from the sale to pay down their debt, giving them a much-improved balance sheet that can weather potential downturns.

In our SMID portfolio we only sold Endurance Specialty as it was acquired by SOMPO, a large Japanese insurance company. The deal was announced in early October 2016 at an approximately 41.6% premium to the average share price over the previous 3 months. It is not our intention to own stocks for such a short time period, but we are happy if it is due to a takeout at a large premium. The company was sold at a 1.42x price-to-book multiple vs. its previous 10-year average at only .89x price-to-book value.

In our Large portfolio we sold AT&T and Gilead. We eliminated AT&T because we do not agree with their decision to buy Time Warner Inc. Time Warner is a diversified media and entertainment company with TV properties like HBO, CNN, and TNT as well as Warner Bros. film franchises like Harry Potter and DC Comics. While the deal has many attractive merits, we were uncomfortable with the additional debt and believe that paid content has major competition with user-generated content. Our own kids are perfect examples in that they consistently prefer to watch YouTube over traditional TV programming.

Gilead was our other sale. While it is incredibly cheap, the fundamentals continue to deteriorate. One of the main reasons the business is getting worse is due to how successful Gilead has been in curing Hepatitis C around the globe. Unlike many other specialty drugs where users must continually use the drug, Gilead’s Solvani and Harvoni drugs cure Hepatitis C entirely, thus negating any future use.

We made no purchases in the Large portfolios, so cash is up as we have not committed yet to any of the large ideas on our watch list. The names at the top of the list are broadly scattered across a number of sectors. We are closely following names in the Health Care, Energy and Insurance spaces.

As we stated earlier, the markets were relatively calm in the first quarter, but that doesn't mean there wasn’t any volatility on a name by name basis. We certainly saw it amongst our holdings.

On the negative side was Rite Aid. We bought the stock with the expectation that Walgreens would be able to complete the merger in the first quarter. The deal was announced over a year ago when Rite Aid was trading around $6 per share. At that time, Walgreens was willing to pay $9 a share in cash. All signs pointed to the deal getting done given that the FTC demand that Rite Aid divest of 500 to 1,000 stores was met in December last year. Fred’s Inc. announced an agreement to buy 865 stores for $950 million.

However, the FTC came out in January and said they were not satisfied. On that news, many investors threw in the towel and sold Rite Aid. The stock ended the quarter down close to 50%. Walgreen’s renegotiated the deal by lowering the deal price from $9 to between $6.50 and $7.00 based on the number of stores Rite Aid must divest. On Fred’s last earnings call they announced they would buy up to 1,200 stores which we believe should appease regulators. At this point, we still think a deal will get done and are maintaining our position. If the deal closes, we will, at best, end up around breakeven but we need the deal to close.

Thankfully, we had terrific performance out of Agrofresh as it was up around 70%!

We profiled Agrofresh in our last letter as it had been unfairly sold after not meeting expectations. If you recall from our last letter, Agrofresh makes a product that preserves apples and other fruits. It put up a respectable fourth quarter and gave guidance for 2017 that we think was very good. Subsequent to quarter’s end they announced a revised agreement with Dow Chemical and Avenue Capital that could benefit them to the tune of $85 million. That is in relation to their market cap of around $200 million at the time of the announcement. We still think the stock is undervalued in relation to its intrinsic value and look forward to seeing their progress.

We think the stock market is in the latter stages of its historic bull run. It is the second longest since World War II, which on its own is not enough reason for it to end. Two signs pointing toward an aging bull are that valuations are above long-term averages and insiders are noticeably absent. This past January marked the lowest number of corporate executives buying stock since 1988! If you remember what Deep Throat told Bob Woodward in a darkened parking garage in *All the President's Men* you will know that insider buying is worth paying attention to, "just follow the money..." One aspect which gives us comfort when making a new purchase is if corporate executives have also been buying their own stocks.

So given our view, we remain focused on buying and holding companies that we think have more relative downside protection than the overall market. We are mindful that trying to guess where we are in a cycle can often be a fool's errand.

Therefore, while we are convinced we are closer to a top than a bottom, it does not pay to time the market. We worried in 2016 that a recession was likely in 2017. That worry appears to have been misplaced now and had we acted upon the worry, we would have missed out on the recent market rally. That said, it still pays to be cognizant that valuations remain higher than average and that the value of the stock market versus our GDP is lofty. Today, market value of the Wilshire 5000 is at 120.8% of GDP vs. 104.9% at the credit-bubble and 136.5% at the tech-bubble peak.

We don't think an imminent economic decline is on the horizon[1], but again, we are more focused on buying and holding companies that we think have more relative downside protection than the market overall.

We look forward to moving into our new office in downtown Milwaukee (in between the Milwaukee **River**… and **Water** St.) in June and hope to celebrate the move with you once we set a date for an open house.

Thank you for your continued confidence and support and please let us know if you think of anyone who could use our services.

All the best,

Adam Michael Matt Laura

[1] The one economic indicator we focus intently on is initial unemployment claims. When claims start to rise at a double-digit rate year-over-year, it historically indicates a recession is on the way.