

AVENIR CORPORATION

INVESTMENT MANAGERS

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As the economy has slowly recovered over the past few years, the stock market has performed surprisingly well with limited volatility. The Federal Reserve's quantitative easing programs have worked in the sense that low interest rates gave relief to over indebted consumers and businesses, and led investors to a search for yield in riskier assets such as stocks and commercial real estate. Valuations overall have risen as multiples expanded to reach prefinancial crisis levels. With the Fed signaling that it will start raising rates modestly later this year, coupled with the re-emergence of the Greek financial crisis and adverse economic developments in China, sentiment is shifting, and after an extended period of unusual calm, volatility is returning to the capital markets. We think this is an opportune time to engage with you and discuss how recent events relate to our investment process and what it means for your portfolio.

Over the first half of 2015, equities posted modest returns with the S&P 500 and Wilshire 5000 rising 1.23% and 1.77% respectively. In general, Avenir portfolios posted favorable returns relative to the major indices, although we assign no value to short-term performance. More importantly, we are pleased with the operating performance of the businesses within your portfolio.

Greece, Puerto Rico and China

The Greek financial crisis dominated the headlines in June, culminating in Greece's default on its loans to the International Monetary Fund on June 30th. Worldwide stock indices fell, then recovered as expectations of some sort of agreement or "deal" remained in place. While it appears that the Greek debt situation will likely be resolved in some manner over the next few months, the potential adverse impact of a Greek default on the global financial system is greatly diminished compared to the crises in 2010 and 2012, when Greece's debt problems threatened to swamp European commercial banks. Since that time, the European Central Bank has essentially socialized this risk by acquiring much of the Greek debt held by those commercial banks. Greece's economy is small, roughly 1.4% of U.S. Gross Domestic Product, and losses on Greek debt can be absorbed. At this point, it is a political crisis, and whether Greece can stay in the Eurozone is unknown and may not even matter; the real issue is what precedent is set for other troubled states including Italy and Spain, as well as Portugal.

Amidst the Greek drama, the Governor of Puerto Rico announced at the end of June that the Island is essentially insolvent and pleaded for the U.S. Congress to enact legislation to enable the U.S. Territory to declare bankruptcy. It is a different approach from Greece but likely to end with a similar outcome: a politically driven settlement where the lenders take a haircut in return for modest reforms. These two items illustrate that six years after the global financial crisis, the world remains awash in debt which will remain a drag on the global economy for years to come. As policy makers struggle to find solutions to economic and financial imbalances, investors face the challenge of allocating capital in a low growth environment.

Greece and Puerto Rico are sideshows to the deteriorating Chinese financial picture. At \$10.4 trillion in Gross Domestic Product, China's economy is more than half the size of our \$17.4 trillion economy. Recall that China responded to the global financial crisis with massive intervention in its domestic economy, rapidly accumulating enormous debts to fund dubious real estate and infrastructure projects. The bill is coming due as China's economy is slowing, which is already affecting many developing market economies tied to the global commodity complex. Meanwhile, it is clear that the Chinese government is attempting to control financial markets and has wittingly fueled a speculative bubble of epic proportions. In the 12 month period prior to mid-June, the Chinese stock market appreciated over

150% before plunging more than 25% in the final weeks of June and erasing more than \$3 trillion in equity value. There are many eye-catching elements of the Chinese debacle but an especially noteworthy one is the Chinese government's public view that the problem is rooted in policy, not valuation, despite powerful evidence suggesting the opposite – Chinese stocks currently trade at a lofty 40x median price-to-earnings ratio, though down from over 65x earnings at their peak. Rather than let markets clear, the Chinese government is pretending that it can prop up prices by ordering brokerage firms and state-owned enterprises to buy stocks as well as by lowering interest rates to encourage margin borrowing, the amount of which is already in record-setting bubble territory. This margin buying initiative is particularly troubling because it is the equivalent of throwing gas on the fire, since massive borrowing by uninformed investors to buy stock is a reliable way to create a bubble. Simultaneously, the government has put in place a six month ban against selling by large shareholders. Thirty years ago, the Japanese government also thought it could control its stock market by dictating stock prices. Share prices there are now half of what they were in 1989.

Where China goes from here is hard to predict, but we know that market forces ultimately prevail, which is simply another way of stating that valuation always matters. Price discovery is a central function of any market, and no amount of government manipulation can permanently delay the inevitable reckoning that follows the excesses and imbalances present today in the Chinese economy. Unlike Greece and Puerto Rico, the weakening Chinese economy is likely to have a significant impact on the global economy, and the Chinese government's excessive intervention in equity markets is bound to have a negative outcome.

Managing Through Volatility

You should naturally wonder how all this affects your portfolio. This discussion should start with a recap of Avenir's investment objectives and philosophy: we seek to preserve capital and generate real profits through capital appreciation and income. We pursue these objectives by acquiring shares of businesses that have three characteristics. First, the business has an inherently superior business model that permits high, sustainable returns on invested capital. Second, the business is led by a talented and honest management team whose primary objective is compounding per share value at the highest rate compatible with a margin of safety. Third, we seek a bargain price. We are not "in the stock market" *per se*. We are in the business of owning fractional interests in businesses, and the stock market is merely the mechanism whereby we effect our ownership. In short, we are long-term investors with a focused, detailed knowledge of our businesses. Our preferred holding period is a tax-efficient "forever" and we are unmoved by volatility except to the extent it permits us to buy or sell opportunistically. While financial markets may be shaken by events in Greece or China, it is not likely that either will be a major factor in determining the fortunes of your portfolio over the next ten years.

Our investment process necessarily focuses on understanding the knowable and trying, imperfectly but as best we can, to insulate ourselves from the risks of the unknowable. This process gives us an appreciation for businesses with cash flows that are predictable through thick and thin. For example, our approach has led to a concentration in businesses providing physical internet infrastructure. Demand for bandwidth is poised to increase exponentially for several years and the physical network requirements are likely to grow, independent of both economic cycles and the inevitable out-of-the-blue shocks. Our pillar assumption is that bandwidth consumption will continue to increase – one we feel falls clearly on the side of the knowable. We are interested in assets that have long lives, are difficult to replicate, and are located at key "chokepoints". Examples include a wireless infrastructure owner and operator which enables the explosive growth in mobile applications; a data center owner and operator that provides critical physical connections in the digital economy; and a fiber provider that owns strategically located, high-quality, "dark" fiber optic cable. Each has excellent management which has passed our rigorous examination.

Our process also guides us toward businesses with models that provide a significant advantage over peers throughout the economic cycle. The retailers and restaurant operators we own have carved out unique niches within their respective spaces, earn high returns on invested capital, and have franchises that cannot be disintermediated by the internet. Moreover, these businesses have ample opportunity for new

store development, have sound balance sheets and are buying back shares with excess discretionary capital. For example, one of our most successful investments is an automotive retailer and some might think it is hostage to economic trends. This is true to a limited extent but ignores the strength of the company's unique retailing franchise. Although many have tried, no one has been able to replicate the model of selling high-quality used vehicles at fixed prices across every brand and model in one location. The company is the dominant used car retailer in its existing markets and is only present in about 60 percent of its addressable markets, implying many years of new store development. Our enthusiasm for this business is compounded by knowing that it is well-managed by some of the most thoughtful capital allocators we have come across in our decades of investment experience.

In another example, our investment in the discount retailer space is a company that has a simple mandate for its suppliers: provide high quality merchandise at an average per unit cost of \$0.65 that can be sold quickly for \$1.00. The business model is that simple and it works, consistently generating 20%-plus returns on capital. Underlying this business is a state-of-the-art sourcing and distribution system that would be uneconomic to replicate. In addition, the returns from this superior business model are compounded by the skills of a gifted management team that has augmented terrific operating returns with superb capital allocation, which will be prominently displayed as management integrates recently acquired but previously undermanaged stores in the same industry segment. It would be easy to lump this company with more economically exposed retailers, but two key factors need to be considered: its typical customer is value-conscious and this pool expands during economic downturns. This combination is why the company's earnings grew rapidly during the recession, unlike the vast majority of retailers.

As mentioned previously, our focus is to find great businesses run by great managers and acquire them at bargain prices. The first two criteria are easy to satisfy, but the challenge in today's investment environment is valuation. We are still finding interesting ideas in areas such as broadband infrastructure, financial services and energy, but the opportunity set is smaller. Prices have tripled since the start of the bull market on March 10, 2009, and in general, Avenir portfolios have exceeded this return. While not sky-high by historical standards, valuations are at a level where preservation of capital is foremost in our minds.

We are grateful to have the privilege of working with you. Your trust in our firm permits us to make a living doing something we love. In return, you should know that your capital has our undivided attention. As our personal investments mirror yours, our interests stand side-by-side with yours. Going forward, we intend to communicate more frequently. Look for our Annual Letter in early 2016.

We wish you an enjoyable summer.

Respectfully,

Peter C. Keefe

James H. Rooney

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