January 2016

After moving in fits and starts throughout the year, U.S. equity markets ended 2015 on a down note and corrected sharply in the first few weeks of 2016. The primary factors negatively influencing equities markets are fears of slowing growth in China, the outlook for lower commodity prices, and the prospect of rising interest rates. While the volatility is startling, especially after several years of relative calm, we think the selling pressure towards the end of 2015 and into this year is overdone, reflecting extremely negative sentiment. While challenging, volatile markets also present opportunities. Avenir has invested successfully through several bear markets and we know that quality businesses emerge from periods of economic duress stronger and better positioned for the future.

Global Concerns and Challenging Energy Markets

As we referenced in our letter last summer, China is the world's second largest economy and has a disproportionate impact on many emerging market economies that are commodity based. In August 2015, China devalued its currency, spooking the markets, and since that time, uncertainty about China's economic prospects has fanned fears of a global slowdown which, in turn, could adversely impact the U.S. economy. These concerns gained momentum around the beginning of the year, leading to sharp market sell-offs around the world. As many economists have noted, the linkage of the U.S. economy to China is mostly indirect: the U.S. imports about four times as much from China as it exports, and it is estimated that China accounts for about only 1 percent of collective S&P 500 profits. All things being equal, lower import prices should be a net benefit to the U.S. economy. Nonetheless, a global slowdown against a strengthening U.S. dollar presents many economic headwinds, especially to U.S. exporters as well as companies with a significant overseas presence.

Concurrent with the economic turmoil emanating out of China, the decline in commodity prices signals slower global growth and fans fears of deflation. The commodity price slide has been exacerbated by a supply shock from the oil price war Saudi Arabia is waging against U.S shale drillers and other frontier oil production areas around the world in an effort to maintain market share and further its geopolitical aims. In normal times, lower commodity prices are generally a positive for global growth. In fact, oil demand continues to increase, rising around 1.6 million barrels, or nearly 2% per year. However, for the foreseeable future, the slide in commodity prices is being viewed negatively as a deflationary sign in an over leveraged world. While we do not know how long the negative sentiment will persist, eventually supply will come into balance and the benefits of an effective tax cut to consumers will filter through.

During the Fall, the negative sentiment induced by lower commodity prices began to spill over from the exploration and production sector to all energy related businesses, including infrastructure and utilities, which generally are not correlated with oil prices. Our energy infrastructure investments were caught in the energy sector sell off, though the underlying businesses remain operationally sound and well positioned for the future. For example, one of our positions is a large energy infrastructure owner and operator that is mostly tied to the transportation of natural gas under long term volumetric, fixed price contracts. Natural gas is in a secular growth trend due to several factors, most notably the conversion of coal fired power plants to natural gas. Approximately 90 percent of the company's cash flows are contracted on a long term basis, and the company maintains an investment grade balance sheet. This company also has a huge backlog of growth projects that require growth capital. As the credit and equity markets deteriorated in November, the company elected to lower its dividend significantly in order to retain more of its earnings to internally fund growth while maintaining its investment grade balance sheet. This action greatly surprised and disappointed investors but was the right decision for the business, given the macro-economic concerns about the sector. In addition, by retaining more of its earnings, free cash flow per share should grow at a faster rate over the next few years, enhancing the firm's intrinsic value. This is cold comfort for those who owned the company solely for the dividend, but the investment case remains intact and intrinsic value per share should continue to compound at an attractive rate. In other words, current operations remain solid, while growth remains on track and is funded. We estimate the company is currently trading at a free cash flow yield of around 14 percent that will grow close to 10 percent per year for the next several years. Energy transportation is essential to the daily functioning of the U.S. economy, and once the panic selling in the energy sector settles, we expect the stock prices of companies in this industry and other well capitalized infrastructure businesses to recover.

Meanwhile, our lone investment with direct commodity exposure is performing well operationally and is one of the few companies in the exploration and production industry capable of growing production profitably in a low commodity price environment. The company has one of the largest reserve positions, perhaps the best, in the Permian basin, which is the most prolific basin in the U.S. While most of its peers are cutting back, the company is drilling wells with 30 percent returns at current oil prices and expects to increase production 10 to 15 percent in 2016. Though all energy stocks were hit in the latter part of the year, the shares have held up relatively well and we expect the stock to continue to perform once oil prices stabilize. The company has a pristine balance sheet, is well hedged through 2016 and recently completed an equity offering in order to ensure its ability to prosper in a low priced environment that may persist for some time. We have held a position in the company for over ten years through several commodity cycles and continue to admire management's skill in allocating capital intelligently in any type of environment.

Lastly, against a muted outlook for global growth, the U.S. economy continues to perform relatively well, though notably below its long run growth rate. After seven years of easing, in December the Federal Reserve initiated the first of its long telegraphed series of interest rate increases. On an absolute basis, the Fed's anticipated actions amount to a small movement off the bottom that should not affect valuations of equities significantly; however, the notion of "tightening" during a time of uneven economic growth is counter-intuitive to most investors and has clearly contributed to recent volatility.

Going Forward

As selling pressure during the first weeks of the year has been indiscriminate, nearly every sector has been impacted. While unpleasant, the current turmoil, as in prior periods of heightened uncertainty, will present some interesting opportunities and the market will ultimately separate the good, sustainable business models from the weak. During such periods, it helps to keep in mind Warren Buffet's dictum that in the short run, the market is a voting machine, but in the long run it is a weighing machine.

Our portfolio is comprised of good businesses with strong franchises that will continue to compound intrinsic value on a per share basis regardless of the direction of the economy. If you have any questions or would like to speak with us, please feel free to call. Meanwhile, remember that our capital is invested alongside yours, and we are working diligently to take advantage of the current volatility to add to our stable of excellent businesses.

Sincerely,

Peter C. Keefe James H. Rooney