February 2017

Outlook

The election of Donald Trump to the presidency has had a profound near term impact on the capital markets and is expected to usher in abrupt changes in tax policy, regulation and international trading relationships. The new administration is taking shape as one of the most pro-business and pro-growth administrations in recent history, and the promise of lower taxes and reduced regulation is a near term positive for business, which is reflected in the rise in stock prices since the election. Indeed, prior to the election, the market was up about 4 percent for the year, and since the election the market has risen 7 percent or so. While the new administration has made many comments about business, thus far none of our holdings have been directly impacted by the tweet of the day.

Offsetting this positive outlook is the potentially disruptive effects of the new administration's views on international trade, tariffs and currencies. The administration's professed "economic nationalism", if implemented, would reverse the globalization trends of the past several decades and alter well established economic and strategic relationships. In addition, while the prospect of lower taxes and reduced regulation is certainly attractive, there are several structural factors to contend with, namely budgetary constraints that may limit spending on infrastructure and defense, as well as the prospect of rising interest rates and, correspondingly, a strengthening dollar which will hurt exporters. Lastly, while the 10 percent lift in the market since the election is discounting perceived improvements that have been promised but not delivered, the new administration still has to deal with a potentially recalcitrant Congress as well as its own internal contradictions on both domestic and foreign policy. In summary, change is clearly coming, and there will be puts and takes for many businesses and industries, particularly those with international exposures. While it is too soon to tell what exactly is in the cards, we believe that capital markets are likely to be more volatile as the new administration's policies are introduced.

As for Avenir portfolios, the outlook is better to the extent corporate tax reform gets done, regulation is streamlined and confidence improves. While we do not know how much of the rhetoric will actually get transformed into meaningful policy, the types of businesses we seek to own, i.e. those with strong franchises, sustainable and predictable cash flows and great managements will adjust and prosper come what may. Meanwhile, the brighter business climate coincides with a gradually strengthening economy and improving employment picture. While rising protectionist sentiment is a negative factor for the global economy, the structural advantages of the U.S. economy are enduring and unmatched. As a result, we remain confident in the long term outlook and know that equities will be materially higher in the years and decades ahead.

Capital Allocation

While it seems that the rules may be about to change, or at a minimum, significantly altered, the means by which businesses create value, the allocation of the marginal dollar of investment,

remains constant. In light of the uncertain road ahead, we think this is as good a time as any to review this core concept in value investing.

For any business with strong, recurring cash flows, management essentially has six options to allocate free cash flow: reinvest in the business, repurchase shares, do nothing, pay dividends, reduce debt or acquire something. The easiest and best situation is when a business has the ability to continue investing in its core business at attractive returns. This is the surest way to compound intrinsic value and is the gold standard for any investment. Barring this fortunate circumstance, the next set of decisions is a bit harder and requires judgement and fortitude. It is this aspect of management that separates the winners from the also rans, and it is what we spend most our time discussing when we speak with managements.

As indicated, our preference is for companies to retain capital and compound it on a per share basis, and this is the first use of capital for all of the businesses in our portfolios. If there are not enough opportunities to reinvest in the business through capital expenditure, then the next best option is to repurchase shares when they are selling below intrinsic value. About three quarters of our top holdings are actively repurchasing shares. Such action has two beneficial outcomes for shareholders: management is making a good investment on an absolute basis and the compounding effect for existing shareholders is powerful as each shareholder will own proportionately more of the business. Economists and asset allocators often do not appreciate this aspect of share repurchases but they are a proven, powerful mechanism for compounding intrinsic value per share.

Further, if a company's shares are selling above intrinsic value, then our preference is for management to simply hold cash until the market gives it a chance to take advantage of changing prices. This would be the "do nothing" option, and it is in this context that volatility helps the patient, thoughtful investor, for when markets turn down, then share repurchases at better prices can be made. Several of our holdings are in this position because their share repurchase activity is designed to accelerate as the price of the shares becomes more attractive. In this sense, many of our investments are designed to take advantage of volatility.

Our view of share repurchases is in direct contrast to the conventional view of paying dividends that is currently in vogue. As we discussed last summer, in the current low interest rate environment, many investors have turned to equities with attractive dividend yields as an alternative to fixed income. While this strategy can work on a selective basis, taken as whole it is fairly naïve and will likely lead to disappointment as rates increase. Chasing dividend yield is dangerous and leads to over valuation in many cases. Further, dividends do not create value, they come with a tax bill to the recipient, and require a reinvestment decision. We much prefer companies that retain capital and reinvest in the business through share repurchases on a pre-tax basis.

Of the remaining capital allocation options, paying down debt is the most intuitive as such action simply shifts value from the debt holders to the equity holders and increases financial flexibility going forward. Generally the businesses we own have an appropriate capital structure but in some cases this can be a good use of free cash flow. In addition, this use of capital may be revisited if the tax deductibility of interest is modified. Lastly, the final use of capital noted above is external: acquiring a business outside of the company's core business. This course of action is often fraught with danger as it requires management to be great investors as well as great acquirers. Years ago Warren Buffett spoke eloquently of the "institutional imperative" that

often leads management teams to get off track through acquisitions simply because they can or an investment banker talks them into it. We do not own and will continue to avoid any businesses engaged in such corporate activities.

Summary

We think this review of capital allocation is timely, for periods of political volatility often translate into market volatility, leading to terrific investment opportunities. Both the businesses we own and those we are considering for investment are in great shape and are ready to take advantage of any opportunities that may present themselves in the months and years ahead.

We appreciate the opportunity to work with you and will work hard to compound your capital at attractive rates in this new, unrestrained environment. If you have any questions, please do not hesitate to call.

Respectfully,

Peter C. Keefe James H. Rooney

This letter is a modified version of a letter sent to clients and represents the views of Avenir and its portfolio managers at the time indicated. The views expressed in the letter are subject to change at any time thereafter due to changes in market and other conditions. The information contained within the client letter was prepared by Avenir's portfolio managers based upon information that was believed to be reliable. Reference to specific industries are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell securities in the referenced industries. Specific industries are not representative of all the industries in which securities have been purchased, sold, or recommended on behalf of advisory clients. At any date past the month indicated on the letter, investments in the industries discussed in the letter may no longer be held in accounts managed by Avenir. The reader should not assume that investments in the industries identified and discussed were or will be profitable.