To: Eagle Point Capital Clients
From: Matt Franz, President
Subject: 2017 In Review

The philosopher Kwame Anthony Appiah once said, “In life the challenge is not so much to figure out how best to play the game; the challenge is to figure out what game you’re playing.”

The game we are playing is simple but not easy: to avoid the permanent loss of capital while maximizing the increase in long-term purchasing power of our funds. Put another way, we aim to build an indestructible long-term compounding machine.

To do this we try to figure out what things are worth and pay a lot less for them. Our bread-and-butter business is buying undervalued securities and selling when the undervaluation is corrected. We also invest in special situations where the profit is dependent on corporate, rather than market, action.

Our investment philosophy rests on three pillars. When applied together, with discipline and consistency, we expect these to produce a powerful framework for compounding wealth over long periods of time.

1. A security represents a partial ownership in a business.

We think like owners and analyze securities as if we are going to purchase the entire business and retain management. We consider the business’s competitive position, management, and estimate its future cash flows.

In 1936 John Maynard Keynes published *The General Theory of Employment, Interest and Money.* In it he described what is now known as a “Keynesian Beauty Contest.” In this contest participants are asked to select the six most attractive faces from a collection of hundred of photographs. The participant who selects the most popular photographs wins a prize.

Keynes wrote:

> "It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees."

This description aptly describes many stock market participants.

We avoid the circular logic of a Keynesian Beauty Contest by focusing on the security we find “prettiest” regardless of what others may think. We never buy something simply because we expect someone will offer us even more for it.

2. Mr. Market is your servant and not your master.

In *The Intelligent Investor* Ben Graham asks readers to imagine they own a business with a manic-depressive partner named Mr. Market. Each day Mr. Market offers to sell his share of the business to you. Some days he is pessimistic and offers a very low price. Other days he is widely optimistic and offers a very high price. Most days he is realistic and offers a reasonable price.

What would you do? You would buy when he is overly pessimistic and sell when he is unrealistically optimistic. In between, you would do nothing.

Now consider the prices of the top ten companies of the Fortune 500 in 2017:

Company	Current Market Value (billions)	52-Week Low	52-Week High	% Change (High/Low)	Change In Market Value (billions)
Wal-Mart Stores Inc	295.6	65.28	102.35	56.8%	109.8
Berkshire Hathaway Inc.	510.9	237,983.80	310,220.00	30.4%	119.0
Apple Inc.	900.2	118.21	177.20	49.9%	302.9
Exxon Mobil Corporation	368.6	76.05	87.41	14.9%	48.1
McCormick & Company	13.3	89.65	106.50	18.8%	2.2
UnitedHealth Group Inc	218.1	156.09	231.77	48.5%	73.2
CVS Health Corp	79.0	66.45	84.72	27.5%	18.5
General Motors Company	62.1	31.92	46.76	46.5%	21.1
AT&T Inc.	223.7	32.55	42.70	31.2%	62.3
Ford Motor Company	52.2	10.47	13.22	26.3%	10.9

Source: Fortune, Yahoo Finance, Accessed 2018-01-11

These are among the most well-known, closely-followed, and stable businesses in the world. Yet, on average, they fluctuated 35% over the past fifty-two weeks. And this was during the least volatile period for U.S. stocks since 1964 (Wall Street Journal, 12/14/17).

It is clear that stock prices fluctuate more than underlying business values - and therein lies our opportunity. Just as we would from Mr. Market, we aim to buy securities when they are offered to us at overly pessimistic prices and sell them when we are offered at wildly optimistic prices.

3. Always invest with a margin of safety.

In *Margin Of Safety* Seth Klarman wrote, “A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world.”

The concept of a margin of safety is not unique to investing; its roots are in engineering. When you are building a bridge that needs to hold 500 tons, you don’t use steel with a maximum strength of 500 tons or even 550 tons. You use steel that will hold 1,000 or 2,000 tons because you never know when a bigger-than-expected truck might try to drive across.

We use the same principle when selecting investments. We aim to buy something worth $100 for $50 or less, not $80 or $90. We look for clear and large discounts to intrinsic value. A large margin of safety means lower potential loss and higher potential reward. That’s a win-win proposition.

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“Time and patience are the strongest warriors.”
— Mikhail Kutuzov in Leo Tolstoy’s *War And Peace*

What makes Eagle Point Capital unique is not our investment principles but how we apply them. We have three distinct advantages:

1. The flexibility to fish where the fish are.
2. No investment is too small or too complex.
3. We think long-term and have clients that don’t confuse activity with results.

On CNBC Jim Cramer likes to say “There’s always a bull market somewhere.” But the key to generating high returns is a bargain purchase price, which can be hard to come by during a bull market. Instead, we prefer the mantra “There’s always a bear market somewhere.”

Even during an extended bull market like we are experiencing today there are always pockets of the market that offer bargain prices. These are special situations that include spinoffs, bankruptcies, mutual-conversions, and tender offers, among others.

Our ability and willingness to fish in these smaller ponds on the fringes of the market are a major competitive advantage. Special situations are attractive because:

- Management often undertakes the corporate action to increase shareholder value.
- The companies involved are typically too small for larger investors.
- The corporate actions can be complex and confusing which discourages many smaller investors.
- The details of the corporate action are often filed quietly with the S.E.C. and the *pro forma* financials are not reported on financial aggregators like Morningstar or Bloomberg. Interested investors have to hunt down the data themselves.

During bull markets we hunt primarily among special situations, and during bear markets will hunt among generally undervalued securities. We expect this to yield a portfolio with an attractive risk/reward proposition throughout the market cycle.

Most investors and analysts are limited to large-cap stocks in a particular industry, and don't enjoy the flexibility we have to follow the bargains across capitalizations, industries, and geographies. Furthermore, most investors are concerned with their monthly performance, which limits their ability to think long-term about what factors really drive a business. Our ability to maintain a long-term horizon while analyzing the most attractively valued areas of the market is a significant competitive advantage.

Even so, we don't expect to make more than a couple major investments in a year, if that. Good ideas are hard to come by and we would rather put our capital into our best ideas than spread among many mediocre ones. We analyze hundred of companies in a year, but most simply don't meet our strict standards. We're willing to be patient and wait for the very best opportunities. In investments, it's patience, not trading, that makes money.

We could not afford this luxury without our final competitive advantage, which is you, our clients. Your patience and long-term horizon allows us to look beyond the minutia of quarterly earnings and think about the factors that are truly important to a business in the long run. This is a luxury most investors can't afford, and allows us to have unique insights distinct from the crowd. Our client's long-term perspective is our most valuable advantage over other investors.

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Fiat, Ferrari, and Exor

We became interested in Fiat and Ferrari in late 2015 before the impending IPO and spin-off of Ferrari from Fiat. We felt the true value of Ferrari was being obscured while it was held inside Fiat and that Fiat and Ferrari would be more valuable separate than together. This thesis played out wonderfully.

Both Fiat and Ferrari experienced a significant rise in value while we held them. As they approached what we considered fair value we sold them. The proceeds were re-deployed into Exor.

Exor is a holding company controlled by the Agnelli family, which founded Fiat. Exor owns large stakes many businesses. Most notably they own:

- 100.0% of ParnerRe
- 63.7% of Juventus FC
- 42.4% of The Economist
- 29.4% of Fiat-Chrysler
- 22.9% of Ferrari
- 26.9% of CNH Industrial

While Fiat and Ferrari's stock have performed well, Exor's has stagnated. We purchased Exor at a 30% discount to its sum-of-the-parts net asset value (NAV). We expect this discount to narrow and NAV to continue compounding at a low double-digit pace while we wait.

Exor is run by John Elkann and Sergio Marchionne, two proven capital allocators. Their recent purchase of PartnerRe, a reinsurance company, demonstrates an openness to diversifying their investments away from the cyclical and capital intensive auto industry, which we like.

Consol Energy and CNX Resources

Consol Energy is one of the oldest coal miners in the U.S. It owns a significant amount of land with mineral rights in the Utica and Marcellus shale formations and in the past several years has begun producing natural gas there. As a result, over half of the company's value is in its natural gas operations. But the company is still thought of as a coal company. It is covered exclusively by coal analysts and the its market value ignores its natural gas operations.

In order to correct this management chose to split the company in two. This fall the company split into Consol Energy, which retains the coal operations, and CNX Resources, which contains the gas operations.

Our thesis is that the two companies are worth more separate than together. Apart, their management teams can narrow their focus and modify their capital structures to suit their individual needs. CNX Resources has already bought out Nobel Energy's interest in its CONE Midstream joint venture, and Consol Energy has initiated a share buy-back. These are both positive developments.

William Thorndike is the Chairman of the Board at CNX Resources and founder of Housatonic Partners. He also the author of *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*. We often look to invest alongside "outsider" CEOs, and Thorndike's capital allocation and incentive compensation decisions so far are straight out of the book.

Inotek Pharmaceuticals

We opened and closed a position in Inotek in 2017. Inotek was a clinical stage biopharmaceutical company whose only drug candidate failed. In the wake of the failure the company suspended all R&D activities and hired Perella Weinberg Partners to explore strategic alternatives.

As a result the company's stock price collapsed. We were able to buy the stock for approximately 50% of their cash on hand, net of debt. Our expectation was a sale of the company or liquidation inside of a year.

Soon after our purchase Inotek announced that they were being acquired by Rocket Pharmaceuticals. The consideration was 100% stock. Rocket Pharmaceuticals is a clinical

stage biotechnology company which makes its future cash flows impossible for us to estimate. Therefore we sold Intotek shortly after the announcement for a gain inside of a few weeks.

<u>Other Investments</u>
In addition to the investments already discussed we continue to hold interests in Bank Of America, Wells Fargo, Berkshire Hathaway, Markel, and Seritage Growth Properties.

Like military generals, Wall Street analysts tend to continue fighting the last war well after it has ended. So it was with financial stocks after 2008. We picked up shares of Bank Of America for approximately 1x tangible book value just as their legacy legal costs were set to decline. Since then Bank Of America has continued to cut costs and simply its business.

Wells Fargo shares fell out of favor after news of their recent scandal broke. While this was a terrible abuse of the public's trust, it has done little to dent Wells Fargo's strong economic franchise. The true value of a bank is in its ability to gather lots of low cost deposits. Wells Fargo does this on a scale unimaginable to any other American bank. Low interest rates have obscured this, but if rates do rise Well Fargo will see its profits increase dramatically. We own Wells Fargo October 2018 TARP warrants. Unless we find a more promising investment between now and October, we expect to exercise our warrants into common stock shortly before expiration.

Berkshire Hathaway continues to compound at an above-market rate. The company is a cash-flow machine and now sits atop over $100 billion of capital. This is such a large sum that it makes all but the largest companies too small to move the needle for Berkshire. And a consistently rising stock market has made bargain priced acquisition targets scarce.

Berkshire represents an "antifragile" investment at these prices. Nassim Taleb coined the term in his book by the same name. It refers to something that gains from disorder. Someday when there is a panic and stock prices fall, Berkshire will be buying. This buying will set the stage for above-market growth for years to come.

Similar to Berkshire but less well-known is Markel. Markel is a specialty insurance company with an enviable underwriting track record and world-class capital allocation. Tom Gaynor invests Markel's float much as Lou Simpson invested GEICO's for Berkshire. Markel also has a small but promising division it calls Ventures. These are whole companies which the company owns and offers a new area to allocate capital outside of public markets.

Finally, Seritage Growth Properties is a spinoff from Sears. The company is structured as a real estate investment trust (REIT) and owns and operates over 200 Sears stores. The spinoff was a win-win for Sears and Seritage: Sears gets rid of stores it wanted to close and Seritage gets to re-lease them to new tenants. Sears pays only $4 per square foot to Seritage, which is well below market. So far Seritage as been able to average nearly $18 per square foot upon re-leasing to new tenants. Seritage is deploying capital at 10-12% unlevered returns, which we feel is attractive in this low-rate environment.

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In closing, I would like to thank our investors for their continued support and patience. We cannot predict what the S&P 500 or economy will do over the coming year, but we promise you that we will continue to play defense before offense and remain invested alongside you.

As a reminder, clients can expect to receive a letter like this twice annually from us. Our goal is to explain to you what you own and why you own it. Any feedback you have for us is much appreciated.

If six months seems like too long wait, I encourage you to check out my blog at *mattfra.nz* (yes, it's a New Zealand domain). You can subscribe to receive an email of all new posts each Sunday at the bottom of each post. I find writing helps clarify my thoughts and root out any sloppy thinking. You can always visit your Interactive Brokers account for up-to-date performance and holdings, or simply reach out to me - matt@eaglepointcap.com

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