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VALUE PARTNERS
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Dear PVP partners and friends

The market continued its move in a favorable direction in the quarter, albeit with some uptick in volatility. As we discuss below, this led us to be more active than usual during the quarter. The economy continues to move forward at a less-than-robust pace; inflation remains in check; interest rates remain very low; and companies are reporting results that are generally in-line with, or exceeding, expectations.

The biggest macro news of the quarter was the **Fed's long-anticipated announcement** that it would shrink the size of its balance sheet over time, which will ultimately have the effect of placing upward pressure on interest rates. It will accomplish this over an unspecified, though presumably long, time period, simply by allowing bonds to mature rather than selling them in the open market. Thus the Fed will begin to exit from its massive Quantitative Easing (QE) program begun after the financial crisis of 2008.

As the move had been well telegraphed for quite some time, there was little reaction to the announcement in the stock market. We believe the move matters little in the short/intermediate term. Longer term, however, while healthy for much of the financial sector, higher interest rates will generally be a headwind for stocks. The unanswered questions, of course, relate to the time frame of the Fed "normalization" and the ultimate level of the Fed Funds rate, not to mention the shape of the yield curve. These will most likely be determined by the behavior of the economy, and the market, in the meantime.

On the fiscal/political front, with "Graham Cassidy" the Senate has now crafted and failed to advance a third attempt at amending PPACA ("Obamacare"). As we write, the prospects for passing any health care bills appear low. In any event, with each subsequent iteration of "repeal and replace" bills, the proposed legislation seems less potentially meaningful and more merely symbolic. In our view, the likelihood of any potential new laws having a significant impact on our large health care exposure remains very low for the foreseeable future.

On the other hand, there seems to be a growing momentum for potential tax reform. While details are still not clear, if successful this could be a significant positive for the economy and for the stock market. If "cash repatriation" -- taxed at some modest level -- is part of the deal, moreover, it would be an additional boost to many of our larger companies with significant overseas cash. Currently such foreign-earned cash often just sits there in the bank accounts of foreign subsidiaries, but if such an agreement is reached it could be put to productive use. Given the legislative track record thus far of the Trump Administration, however, we are not yet counting our proverbial chickens.

In terms of sector leadership in the quarter, energy, where we have added recently but remain underweight, snapped back in a positive direction; while technology, where we are also underweight, remained strong. Consumer staples and discretionary, where we are also

underweight, were among the weakest sectors, which, as we discuss below, afforded us some new opportunities. As we have discussed previously, "growth stocks" have continued to outperform "value stocks" this year. This has been a modest headwind for value-oriented investors like PVP. [1]

In aggregate **PVP was up 2.5% in 3Q17, and is now up 11.6% ytd in 2017, 15.6% in the last year, and 32.8% since accepting our first partner assets in early February of 2016.** [2] Regardless of how strong or weak recent performance has been, **we will always caution our partners to take a longer term view when assessing our track record.** While we obviously cannot control or even predict the overall market direction in the short run, we can say that we continue to hold a diverse portfolio of free cash flow (FCF) generating companies, currently trading at a discount to the market, but with better quality characteristics.

A word on the market and PVP portfolio positioning

There has been a good deal of commentary about the recent direction of the market, and what that might bode for future returns. As we have been saying for some time, we acknowledge that current valuations are relatively high, historically speaking, but when we also consider the current historically low interest rates, from a valuation perspective **we do not believe the market is "overheated".** As we will describe below, we have still been able to find a number of attractive opportunities. Having said that, we are also cognizant that the market has been historically strong since 2009, and has been particularly consistently upward since February of last year. Also, lofty valuations don't cause corrections, but they do tend to exacerbate them when they happen. While we will continue to be opportunistic, **we would characterize our positioning as increasingly defensive.** We aim to "capture our share" of the upside, while, to the extent we can, protecting the downside. How do we do this?

First, **value investing is inherently defensive**. We strive to buy at valuations less than intrinsic value, and sell when that value has been realized. When we own stocks at less than their intrinsic value, there is a "margin of safety". Another consideration is that value investing has been generally out of favor vis a vis "growth investing" for quite some time now, with growth having outperformed value by 2.2% annually since 2009.

At the same time, we believe we have also constructed a **quality portfolio**. Quality can be described both qualitatively and quantitatively. In terms of the former, we seek out the leaders of industries that we expect to last a very long time, led by shareholder-friendly management teams who think like principals rather than agents. These characteristics tend to result in quantitative measures of quality such as high margins, and in fact our portfolio EBITDA margin of 31.1% compares favorably to the market at 19.1%. This in turn leads to higher returns on capital. The Return on Invested Capital (ROIC) and Return on Equity (ROE) of PVP's portfolio are 11.7% and 17.3%, respectively, compared with 6.8% and 15.0% for the market overall.[3]

Sector weightings, and our largest positions, are another way to consider our positioning. Health care, which is generally not economically cyclical, remains our largest exposure. Our biggest

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[1] *Sector leadership references the aggregate sector performance in the Russell 3000 index. Relative outperformance of Growth vs. Value references the Russell 1000 Growth and Russell 1000 Value indices, respectively.*

[2] *Returns are net, and assume a 1% annual management fee.*

[3] *Russell 3000 index referenced as "the market".*

position there, and for that matter in the portfolio overall, remains **Johnson & Johnson ("JNJ"),** one of only three AAA-rated non-financial companies. Financials, where **Berkshire Hathaway ("BRKB")** is our biggest position, is our second biggest exposure. Although most financials are economically sensitive, a rise in interest rates would actually benefit the margins of our banks. Moreover, in financials we own a good deal of generally more defensive property/casualty insurance. We are now underweighted in technology, which has done well recently, and our biggest positions are **Cisco ("CSCO"), Oracle ("ORCL")** and **Alphabet ("GOOG"),** with cash on their respective Balance Sheets of $70, $66 and $95 Billion. We are also relatively light in the economically sensitive industrials, where our largest position, **Macquarie Infrastructure ("MIC"),** is really more of a "toll booth" utility. Energy is another very cyclical sector we are currently underweight. In consumer cyclicals, our biggest position remains **Service Corporation ("SCI"),** the nation's biggest owner of funeral homes – not a terribly cyclical business.

Size is another consideration. While our "all cap" mandate gives us the flexibility to invest in companies of all sizes, with a current weighted average market cap of $133 bn per investment, we are mostly represented in the larger, more resilient companies. At the same time, we try to be opportunistic in the smaller companies when appropriate. These smaller holdings tend to be the leaders in niche industries that we expect to be with us for a long time, such as private equity consultant **Hamilton Lane ("HLNE"),** sporting goods manufacturer **Vista Outdoor ("VSTO"),** billboard advertiser **Lamar ("LAMR"),** and "runoff" insurance acquirer and manager **Enstar Group ("ESGR").**

Finally, we don't own "placeholder" securities. Every stock we own stands on its own merits. If we think any particular sector is unattractive at any point in time, we will not commit capital there. By no means does this mean we won't show negative performance sometimes. In fact, we expect it. But when it does happen, we strive to take advantage of it.

Actions taken in 3Q17

Buys in the quarter

As opportunities presented themselves, we were much more active than usual in the quarter. We have written previously about unattractive valuations in the consumer staples sector, but in recent months Amazon and other fears have weighed heavily on the space. **Anheuser-Busch Inbev ("BUD")** shares, purchased in the quarter, have underperformed in recent years, and are off 15% in the past year, notwithstanding the fact that the company's recent acquisition of SAB Miller will likely accelerate growth in revenues and profitability. In recent years beer has consolidated to become a cozy global oligopoly, with BUD the leader at 30% share. Rarely an inexpensive stock, BUD now trades at a very attractive 6% FCF yield, with a 3.3% dividend yield.

British American Tobacco ("BTI") is another European company which recently acquired an American business (Reynolds). Our opportunity in BTI was created in early August, when the FDA announced its intention to focus on nicotine content in cigarettes. This spooked investors throughout the world, who had perhaps grown complacent about real and or perceived regulatory risks. While we acknowledge the risk, we would note that the industry has historically thrived in an unpredictable regulatory environment, BTI is a leader in "next generation" tobacco products, and, at an attractive 6% FCF yield and 3.6% dividend yield, we believe we are being well compensated for the uncertainties.

Starbucks ("SBUX"), the world's biggest coffee retailer, is technically a consumer cyclical rather than a staple -- though we know many frequent customers who would argue with that designation! SBUX is another stock that is rarely inexpensive, but it has underperformed recently notwithstanding ongoing healthy Asian growth prospects and also the opportunity to finally succeed in complementary food. If we back out the company's new store expansion, SBUX trades at a 5+% FCF yield, but given SBUX's remarkable 40+% Return on Invested Capital ("ROIC") on new stores, we are happy to have management redeploy the cash flow for us.

Interpublic Group ("IPG") is one of a global handful of holding companies for advertising agencies. As so many industries are being disrupted by "the Amazon phenomenon", a perception has developed that advertising will drop precipitously and or ad agencies will be disintermediated. While there is certainly cyclicality in ad spending, we believe consumer-facing companies will continue to need the expertise of companies like IPG as the competition for customers only intensifies. IPG trades at a very healthy 8% FCF yield, with a 3.4% dividend yield.

Citigroup ("C") has been a laggard since the 2008 financial crisis. Behind the scenes the company has made a good deal of progress since then, but, as C has been in the regulatory "doghouse", its shareholders had not heretofore benefited. In 3Q17, however, the Fed announced that in its annual CCAR (Comprehensive Capital Analysis and Review) exercise, Citi was sufficiently capitalized to return a significant amount of capital to shareholders. This should quickly boost the company's currently quite humble Return on Equity (ROE) in the coming years to a more respectable double digit level. When interest rates rise, of course that will only help as well. C trades at just 1x Tangible Book Value (TBV).

Fairfax Financial ("FRFHF") is sometimes referred to as "Canada's Berkshire Hathaway". While that is a very difficult comparison, Fairfax, like Berkshire, is at its core also a property/casualty insurer with a tremendous long term track record, with heavy equity exposure, with a very well-known investor as CEO (Prem Watsa). Fairfax recently acquired the American insurer Allied World, which put some pressure on the stock and presented us with the opportunity to buy at a slight premium to Book Value (BV).

We also purchased shares of **Lockheed Martin ("LMT"),** the defense contractor, during the quarter. We like the visibility on future cash flows at Lockheed Martin, with the company's strong position in a number of DOD programs – especially the F-35 fighter jets and missile defense. In addition, defense spending is currently historically low relative to GDP, with a developing political consensus that it needs to be increased at a time when global threats appear on the rise. Finally, defense companies tend to behave quite well in a soft overall market. Thus we feel we are "playing both offense and defense" in LMT, at a 5-6% FCF yield that is more attractive than the market overall.

Seagate Technology ("STX") Seagate Technology ("STX") is an opportunistic new investment in an industry where we usually don't find value: technology hardware. Typically, hardware businesses produce poor returns, owing to fierce competition, low margins, and product commoditization. Seagate is different. Given the relative consolidation of the storage industry, with Seagate, Western Digital and Toshiba controlling the bulk of the market, Seagate is able to enjoy consistently high (20+%) cash flow margins and pay a generous dividend. STX now boasts a 7.7% dividend yield, which in and of itself is quite attractive. Although the overall shift to the cloud has caused STX's revenue growth to decelerate somewhat, data storage demand continues to grow at a healthy pace.

During the quarter we also initiated a position in **Cheniere Energy Partners LP ("CQH").** One of the positive outcomes of the "shale revolution" has been the enormous improvement in the production of Natural Gas in North America. Utilizing low-cost fracking technology, the US is poised to be among the lowest cost producers of natural gas in the world for many decades. And while natural gas is an excellent, low emission, energy source, transporting it has always been an economic challenge. To do it efficiently, multi-hundred billion dollar liquefaction facilities, which cool natural gas to liquid form, are needed. Once in liquid form, natural gas is cost efficiently transportable via ship to overseas markets. Cheniere, as the first company to build and launch a North American liquefaction facility, has an enormous first mover advantage in this very promising business. Both Europe and Asia are hungry for low-cost US natural gas. We expect Cheniere cash flow to grow very quickly, resulting in an attractive dividend yield based on the current stock price.

With almost an $800 billion market cap, we must admit that we are not exactly early to **Apple (AAPL);** however, as forward-looking, value-oriented investors, we still see a bright future ahead for Apple, for which we believe we are paying an attractive price. In recent years the ubiquitous smart phone, which represents 60+% of Apple revenues, has really become more of a consumer staple than a cyclical technology product, but at a discounted valuation to the market the stock is not yet valued that way. In addition, Apple continues to be an innovative company, with what is by some accounts the #1 brand in the world, so we also believe we are paying little or nothing for all of the optionality of the Apple brand, and the myriad products it could be attached to in the future.

With a new position in **Coca-Cola (KO),** on the other hand, we believe we may be early. Over the past four years, Coca-Cola has restructured all of its global bottling relationships. We believe there are significant opportunities for Coca-Cola to improve the profitability of its businesses globally, through more efficient bottler management and better coordination between Coca-Cola and its bottlers. In one example of a bottler we studied closely, the results have been profound -- higher sales at better margins. As a result, we believe Coca-Cola may be on the cusp of beginning a multi-year expansion of earnings not well understood in the marketplace.

Sells in the quarter

In recent years **Microsoft ("MSFT")** has turned things around quite nicely under the leadership of its new CEO, transitioning its business to the cloud, and shareholders have done very well. The stock is up about 50% from our original cost basis, surpassing our Price Target (PT), so we exited in the quarter.

Nextera Energy Partners ("NEP"), which manages clean energy projects with the backing of its partner, Nextera Energy ("NEE"), the parent of Florida Power and Light, has also been an outstanding performer for us, returning 57% ytd. We acquired NEP when there were fears that the Trump administration might not be so friendly to alternative energy. As those fears abated, and fundamentals only improved, shareholders were rewarded. In 1Q17 it was one of our top performers, and that strong performance continued through 3Q17.

Iron Mountain (IRM), the world's leading document storage company, which we just re-purchased just last quarter, gave us some immediate gratification as it bounced back very quickly, surpassing our PT. We believe it had been oversold, and now it is more appropriately valued, so we took profits.

Brown & Brown (BRO), the insurance broker, has been a tremendous stock for us, returning 46% from our original cost basis. While we continue to like the company, we also recognize that we do have a good deal of insurance exposure in other names, and BRO had achieved our PT.

As previously discussed, during the last quarter **West Corporation ("WSTC")** agreed to be acquired by Apollo Global Management ("APO"), the private equity investor. While the company sold for less than what we expected, nonetheless it was still a profitable investment for us. In 3Q17, as the stock price climbed very close to the announced deal price, we exited the position.

Our investment in **Weyerhaeuser ("WY")**, the wood company, was predicated on (a) an ongoing US housing recovery; and (b) a favorable resolution of the US/Canada trade dispute regarding timber. While both of these factors are playing out as we anticipated, we would have expected more out of the stock than its 12% YTD return. With those catalysts now mostly behind us, we think we can do better elsewhere going forward.

Our original thesis in buying **Liberty Global (LBTYA)** was that we were acquiring a company that is well-positioned to grow for many years delivering high-speed internet services to an underserved European market, at a healthy discount to the market, and that the impact of Brexit would create a relatively short-lived uncertainty window. While we still believe we were right on fundamentals and valuation, our doubts about the Brexit impact made this a difficult investment to continue to hold. The Brexit issue is dragging on longer than expected, and its implementation is likely to be more deleterious to the UK economy than we had anticipated. Overall, Liberty Global was a profitable investment for us, and was a modest outperformer in the quarter. Like WY, though, we believe we can do better elsewhere.

We wouldn't normally expect to do quite so much trading in one quarter; however, when opportunities present themselves we do our best to seize them.

Strong performers in 3Q17 [4]

Hamilton Lane (HLNE), the institutional private equity (PE) consultant, which earlier this year completed its IPO, continued its momentum with another strong quarter of growth, with revenues up 33% year over year (yoy). With ever-increasing demand for PE from institutions seeking alternative investments, we believe the wind will remain at Hamilton Lane's back for quite some time, and the company is still early in the process of being "discovered" by public equity investors.

Booz Allen Hamilton (BAH) bounced back in the quarter, as investor focus shifted away from the ongoing government investigation of its cost accounting practices – which hit the stock last quarter -- and toward the company's outstanding business fundamentals. Demand for cyber security continues apace, as reflected in BAH's strong yoy growth in backlog (17%) and revenue (5%).

Our patience with **Allscripts (MDRX),** the health care IT provider, was rewarded in the quarter, as the company showed continuing progress. Backlog and revenues grew 12% and 8% yoy,

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[4] *Top and Bottom Five performers in the quarter defined as the most value added or subtracted, in basis points, relative to the Russell 3000. Top and bottom stocks are presented, respectively, in descending and ascending order of value added/subtracted.*

respectively, and the company also announced its intention to acquire a complementary business from McKesson, at an attractive price.

Biogen (BIIB) also bounced back in the quarter, in large part as a response to more positive data from the clinical trial of one of its drug candidates, *aducanuma*b, for Alzheimer's Disease. While promising, the drug – *if* it is ultimately approved – still won't be available for a few more years. Biogen also showed strong results in its core MS business, and a successful launch of *spinraza* for spinal muscular atrophy (SMA).

Post Holdings (POST) also bounced back nicely in the quarter, defying the general underperformance of food companies. Management remains aggressive in its acquisition strategy, and this quarter the company announced its intention to buy Bob Evans ("BOBE"), maker of refrigerated side dishes such as mac and cheese and mashed potatoes. In spite of its very impressive track record, Post continues to trade at a substantial discount to the market on a FCF yield basis.

Weak performers in 3Q17

Although **Mylan (MYL)** grew its revenues and cash flow yoy in the quarter, the company lowered its financial "guidance" for the rest of 2017, mostly on account of ongoing delays of FDA approval for two generic drugs: *Copaxone* and *Advair*. With a new Commissioner (who appears quite pro generic drugs), the FDA is currently restructuring its approval processes. While we believe this is primarily an issue of timing, the market has taken the "glass half empty" view, and the stock was down 18% in the quarter.

Allergan ("AGN") has been quite a controversial stock since its expected acquisition by Pfizer ("PFE") was terminated last year due to regulatory concerns – which gave us the initial opportunity in the stock. Although the company reported solid results for the quarter, several questions have been raised about Allergan's ability to translate its drug pipeline and also to maintain its IP protection in certain franchises. In response to the recent stock weakness, Allergan's board authorized a major new share buyback program and committed both to accelerating its pace of debt paydown and to increasing the dividend.

Dish Network ("DISH") is a bit of an unusual holding for us, in that the majority of its value lies in its vast spectrum holdings rather than in its Pay TV business. As such, the stock is frequently buffeted by speculation about how, and when, Dish might choose to monetize those spectrum holdings. Most recently doubts have grown about the intentions and negotiating leverage of its founder/CEO, Charlie Ergen. We believe Mr. Ergen's track record strongly suggests that his interests are aligned with ours, and that the spectrum value will only grow over time, and so we added to the position.

Notwithstanding the company's very solid results for the quarter, with some very high expectations built into the September release of the new **Apple (AAPL)** iPhones, X and 8, the initial results were modestly disappointing. As we discuss above, however, we believe the company remains well positioned to leverage its brand, with new iPhones and various other products, well into the future.

Oracle (ORCL) had another outstanding quarter, in our view, further demonstrating progress in its transition to the cloud. Total revenues grew 7%, cloud revenues grew 51%, and eps grew 12%, yoy. Although we had taken some profits recently, the stock had moved upward too far too quickly, and expectations were even higher. We believe the stock movement was an overreaction, and that ORCL remains attractively valued.

Setup

As discussed above, we continue to refine the positioning of the portfolio. PVP owns a **diverse portfolio of high quality companies, operated by shareholder-friendly management teams with a proven track record in deploying capital.** While we are normally reluctant to rely much on benchmark data in the short term, some context can occasionally be helpful. Similar to previous quarters, as shown in the table below, the PVP portfolio remains cheaper than the Russell 3000, yet PVP's holdings have higher margins and greater returns than the Russell 3000, with similar leverage and growth rates.

	PVP [5]	Russell 3000
Free Cash Flow yield (2017)	6.3%	4.4%
Price/Earnings (2017)	18.8x	19.9x
Debt/Total Capital	44%	44%
Debt/EBITDA	2.8x	3.1x
2017 revenue growth	8.8%	5.4%
2017 eps growth	9.0%	9.7%
2017 EBITDA margin	31.1%	19.1%
2017 Return on Equity	17.3%	15.0%
2017 Return on Invested Capital	11.7%	6.8%

To put PVP's FCF yield of 6.3% into perspective, we must also consider the still quite low 30-year US Treasury Bond at 2.9%. This suggests an Equity Risk Premium (ERP) of 3.4% (6.3-2.9). While admittedly this number has fallen somewhat as the market has risen rapidly in recent quarters, we still believe we are being appropriately compensated to bear the risk of equities. Since we still expect volatility to increase, we will strive to position ourselves to take advantage where possible.

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[5] *Data for both PVP portfolio and Russell 3000 are generally via FactSet. In a few instances, we have made minor adjustments.*

As always, we are so appreciative of the confidence you have shown in PVP, and we promise to work tirelessly to make you pleased with that decision. We also want to be as transparent as possible. Please let us know if you have any questions, or if we can help in any way.

Sincerely,

J. Kelly Flynn

Chief Investment Officer

Albert Rosano

Managing Director

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