August 31, 2017

"It was a very difficult ten years of very hard work."

- Jeffrey Skilling, former CEO of Enron Corporation

Dear Investors,

In one of the worst corporate accounting frauds of all-time, Enron shareholders lost $74 billion after the company collapsed amid allegations of accounting fraud and deception. This infamous fraud was engineered by CEO Jeffrey Skilling, a former McKinsey & Company partner, who was eventually found guilty on 35 counts of conspiracy, fraud, and other crimes and sentenced to ten years in prison. The collateral damage of Enron's criminal activities resulted in the bankruptcy of a major accounting firm, Arthur Andersen, and ushered in a major piece of anti-fraud legislation, the Sarbanes-Oxley Act of 2002.

Skilling endeavored to artificially inflate the value of Enron's assets and, relatedly, its profits. Management used a number of off-balance sheet vehicles, called "Special Purpose Entities," to hide its liabilities from shareholders and improve its accounting profits. Many of Enron's executives sold Enron stock all along the way in their personal accounts, receiving $1.1 billion in proceeds between 1999 and 2001 alone. After the company filed for bankruptcy and the scheme became more evident, Skilling and several other executives, including the former CFO, Andrew Fastow, were sentenced to many years in prison. In the process, thousands of Enron employees, many of whom surely knew nothing about the fraudulent activity, lost their jobs.

Of course, schemes, frauds, and swindles have been around as long as money itself. Going back more than a couple of thousand years, there are eight different passages in the Bible that specifically forbid tampering with weighing scales because swindlers have always stood ready, both then and now, to separate the gullible from their hard-earned capital. Enron's gigantic accounting scheme represented neither a beginning nor an end to corporate frauds.

To be successful, a prudent investor must do a lot of things well. Among them, one must endeavor to identify and avoid fraudulent investments. This was true in the Ancient World, and it is just as true today.

In hindsight, corporate scams are easy to identify; hindsight vision is always clearer at the bottom of an economic cycle or at the bottom of a Bear Market after the money has disappeared. Warren Buffett described this concept eloquently in Berkshire Hathaway's 2001 letter to shareholders when he said, "You only find out who is swimming naked when the tide goes out." During the 2000-2002 Bear Market, corporate frauds such as WorldCom, Tyco, and Enron were exposed. Similarly, during the 2008-2009 Financial Crisis, investors learned about widespread securities fraud and mortgage fraud. Several large financial services companies, including Lehman Brothers, Countrywide Financial, and Washington Mutual, failed during this period.

As we write this letter, the capital markets are neither in the midst of a financial crisis nor an economic crisis, and yet the waterfront already seems fairly crowded with naked swimmers. Listed below are a handful of corporate scandals that have been exposed in just the last year:

- **Valeant** (**VRX**), a large Canadian pharmaceutical company, created a secret network of pharmacies to boost drug prices and its profits at the expense of patients, insurance companies, and Medicare/Medicaid. To execute its pricing scheme, Valeant management allegedly employed a combination of accounting manipulation, deceptive pricing practices, securities fraud, and Medicare fraud.

- The leading bank in Germany, **Deutsche Bank (DB),** previously indicted for colluding with Banca Monte Dei Paschi di Sienta SpA, a large Italian bank, to "window dress" its accounting statements, was recently found by German regulators to have been involved in 103 similar deals with 30 additional clients. Deutsche Bank has also been charged in recent years for manipulating interest rates, manipulating the price of gold and silver, defrauding mortgage companies, and laundering money.

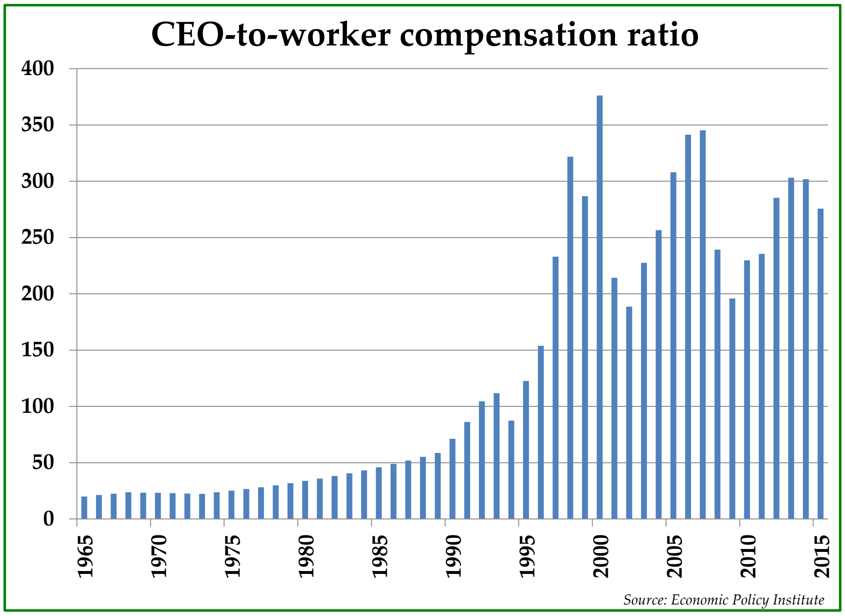
- **Volkswagen** (**VOW-DE**) executives confessed that the German automotive giant rigged emissions tests on millions of "clean diesel" vehicles over a ten year period of time, defrauding consumers and illegally emitting between 10 and 40 times the allowable levels of nitrogen oxide in the United States. Volkswagen's fraudulent business behavior has cost consumers and investors billions of dollars and resulted in 40,000 additional tons of annual nitrogen oxide emissions.

- One of the largest and oldest banks in the United States, **Wells Fargo** (**WFC**), created more than one million sham customer accounts to generate additional fees and meet its aggressive sales targets, betraying the trust of its banking and credit card customers. The bank has subsequently been fined $185 million by the Consumer Financial Protection Bureau, and CEO John Stumpf recently announced his forced retirement.

- **Theranos**, a relatively new private blood testing startup, which carried a private valuation of as much as $9 billion, ran 890,000 tests per year that required just one drop of blood. These revolutionary diagnostic tests were promoted to be inexpensive, painless, and effective. It now appears that the company owns zero proprietary technology, its diagnostic tests had little medical value, and, in all likelihood, Theranos endangered the lives of thousands of patients who relied on their inaccurate test results.

We could go on. The list of companies discussed above is far from comprehensive; indeed, it is merely the tip of the iceberg.

Importantly, this list includes only companies that allegedly broke regulations or laws. Many more boards and management teams have been making perfectly legal yet ethically questionable decisions to pay themselves with compensation packages that are both egregious and unjustified. Over the past 35 years, the ratio of CEO pay to the average worker pay has increased exponentially to nearly 300x, ballooning by a whopping factor of *ten times*.



It almost goes without saying that corporate corruption is a major economic and social problem. The five examples provided on the previous page have resulted in billions of dollars of shareholder value destruction, consumer fraud, and/or taxpayer fraud, not to mention impossible-to-quantify social and environmental costs. Worryingly, corporate corruption seems to be getting worse, not better. As investors, we are finding ourselves having increasingly frequent conversations about companies that are simply not investable because the board or management team's incentives are not aligned with shareholders. Moreover, corporate corruption has grown to the point where it is infecting the regulators responsible for preventing fraudulent activity. For many companies, hiring former regulators and politicians and settling multiple cases with regulators each and every year has become a key corporate strategy.

Active Management and Corporate Shenanigans

Avoiding corporate frauds requires high levels of vigilance and due diligence when we invest your capital. The increasing prevalence of corporate fraud is a great reason to be an active investor, and particularly so today when corporate frauds seem to be running rampant. As active managers, we can make a conscious choice not to own untrustworthy companies in order to minimize the probability of a permanent loss of capital.

Importantly, passive investors *by definition* own the entire market, or, depending on the index fund or ETF, entire sectors of the market, including companies that are rife with poor corporate governance controls. For example, passively managed funds indexed to the S&P 500 owned Enron, WorldCom, and Tyco in addition to Lehman Brothers, Countrywide, and Washington Mutual. Such passive funds owned these companies and, importantly, were most exposed to these companies when their market values were at a peak. Today, with the S&P 500 Index trading at a high valuation, it is quite possible that passive investment ownership of the next wave of corporate frauds could be similarly near a peak.

However, as active investment managers, we have the freedom to step aside from investing in companies that we deem to be unsavory or questionable. By doing our homework, we not only endeavor to find outstanding long-term investments, but we also seek to steer clear of potential situations that could result in a capital loss due to management wrongdoing. We perform intense due diligence on prospective investments, and that homework helps us in our efforts to avoid corporate scandals.

Below are a few examples of the research we perform on prospective investments that helps us to avoid investing in potential frauds:

- *Avoid self-serving management teams*
  We analyze management compensation and incentive systems, seeking to understand how well management teams and boards are aligned with other stakeholders. Our efforts are aimed at determining if management compensation is both reasonable and appropriate. In general, we would rather invest in companies whose management teams own a large stake in the company.

- *Examine corporate governance practices*
  We also pay close attention to the structure, policies, and arrangements with the Board of Directors. For example, off-balance sheet arrangements that companies might form with management or members of the Board of Directors are often important red flags. We seek to invest in companies with independent directors that will hold management appropriately accountable for any wrongdoing.

- *Follow the cash, and watch out for debt*
  We spend enormous effort understanding the financial business model of a prospective investment, including an extensive analysis of historical cash flow statements and balance sheets. Fraudulent companies often have weak balance sheets, negative free cash flow, or both.

- *Seek out transparent investments*
  A company's financial statements should be understandable and transparent. Financial statements that are unnecessarily complex, excessively opaque, or contain egregious legalese are not only difficult to analyze; they are also red flags for potential management wrongdoing.

- *Understand the track record*
  We seek to understand past indiscretions that have resulted in regulatory investigations and lawsuits. Sometimes past investigations and lawsuits are frivolous, in which case it might be a buying opportunity, but they are often good indicators of a management team who is short-term oriented and less inclined to play by the rules.

- *Avoid investing in excessively promotional management teams*
  Management teams that over-promise, obfuscate problems, and try to purposefully talk up the

share price are unreliable, at best. The same holds true for companies with poor governance practices. Overly promotional management teams and poorly governed boards are generally looking out for themselves, to the exclusion of other stakeholders.

- *Favor organic growth over acquired growth*
  Companies that grow organically, without the need for constant acquisition activity, are far less likely to be frauds than companies that depend on acquisitions to grow revenues and earnings. Acquisition-driven "roll-ups" often use acquisitions to hide underlying weakness in the core business. The same holds true for companies that constantly report adjusted earnings figures, which can be far different from actual reported earnings.

- *Seek companies who are honest about pensions*
  Companies who assume that their pension plans will generate an excessively high expected annual return are deluding their employees and their shareholders. Unrealistically high expected investment returns are often maintained because management and the board are afraid to properly account for a company's true liabilities. Sooner or later, a reckoning awaits.

After performing a proper level of due diligence up front, we try to follow Maya Angelou's suggestion: "*When someone shows you who they are, believe them the first time.*" For example, Enron would have easily failed at least five of the tests listed above. It was clear that Enron's management team was extremely aggressive in its accounting practices and, at the same time, executives were profiting immensely from the selling of their own shares of Enron stock to the general public.

With that said, sometimes red flags are not apparent until *after* making an investment. As a result, constant investment vigilance after making an investment is just as important as robust due diligence before committing capital. We are regularly analyzing recent developments in companies that are held in client portfolios in an effort to identify potential red flags that should cause us to reconsider our investment decisions. We meet multiple times a week as an investment group to discuss, review, and analyze prospective investments *and* existing investments.

In this letter we have been focused on avoiding mistakes. By applying a rigorous screening process to prospective investments, we hope to steer clear of corporate frauds, to be sure, but the same screening process also helps us in identifying outstanding companies for long-term investment. We believe those companies that are well-governed, that have significant inside ownership, and that have responsible management teams who are focused on building long-term value, tend to grow in intrinsic value over time.

By attempting to avoid corporate frauds through our decision making methodology, we hope to reduce investment mistakes that result in losses and allocate our clients' capital towards profitable investments. In doing so, we believe we improve our chances to generate attractive risk-adjusted returns. As it is with tennis or baseball, it is easier to win when you are minimizing unforced errors.

Sincerely,
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