JRW FINANCIAL LLC

Letter to Clients and Interested Parties
2nd Quarter 2016
July 20, 2016

Dear Clients and Interested Parties,

Our long-term investment approach is based on buying excellent businesses at reasonable prices and benefiting from business operators who focus on the long-term growth in per share business value of their businesses. This approach requires careful consideration of factors including the abilities of management, the competitive advantages enjoyed by the businesses, the threat of competition eroding profitability in the short, medium, or long-term, the pathways for reinvestment into the business in order to achieve the compounding growth in per share business value, and the price at which shares in the common equity can be purchased at present and its relation to our estimate of intrinsic value. As usual, you'll notice that our investment operations do not focus on politics, economic events, central bank policies, geopolitical tensions, or other exogenous events.

During the quarter, the United Kingdom unexpectedly voted to leave the European Union. This outcome was forecast neither by polls nor oddsmakers and caught the global markets completely off-guard. To be sure, there will be continued volatility and uncertainty ahead for much of Europe, and the UK in particular. No one knows the extent of the impact the UK's departure from the EU will have, and until the British Parliament formally invokes Article 50 and officially declares its intentions, we still do not know for certain that the UK will leave at all. Furthermore, the UK's decision might be the first domino to drop in Europe, as nationalism, sovereignty, and distrust of the central governing body in Brussels continue to gain in public support. There is a wave of populism running through much of the West, including here in the US. Time will tell what impact this will have on the global economy.

Many months ago, political pundits failed to give credit to the popular rise of Donald Trump in the Republican primaries, and his candidacy was not taken seriously until it was clear that a movement was afoot. Now, the US is engaged in a tense, acrimonious battle for the presidency between candidates with their respective fair share of supporters and detractors.

Such is the folly of prognostication, particularly with regard to market reaction to unexpected and unanticipated events. I've tried to counsel on numerous occasions that predicting short-term market prices is a fool's errand, even more so in response to macro and geopolitical events, and I will continue to do so. In general, markets reflect the collective wisdom of all market participants over short periods of time – and if I've learned anything over the years, it's that this wisdom cannot be easily or consistently forecast in advance. Will stocks, bonds, and currencies rise or fall? By how much? For how long? Answers to these questions appear only when these questions are answered – Yogi Berra would be proud.

I'll echo the sentiments laid out in the beginning of last quarter's letter – we have a process for long-term investing in great businesses and we adhere to this process regardless of market conditions. We took no actions in response to, nor in anticipation of, the UK vote, as the majority of the businesses we own will feel little impact in the short-term. We will do our due diligence to see how the earnings power and runways for reinvestment of our owned businesses are impacted by the aftermath of the vote in the long-term, but I do not foresee major changes stemming from this event.

There will be times when exogenous shocks such as the Brexit vote cause our holdings to decline in price over shorter periods. The key for our investment operations is to determine whether, and if so at what level, the facts indicate a material impact to the per share business value of the businesses we own for the long-term. While we were caught off-guard by the Leave vote, we knew it a possibility. Although we cannot position our portfolios to benefit in the short-term from all eventualities, we think long and hard about the potential long-term threats to our businesses.

It is important to remember that we invest in global best-of-breed businesses. These are companies with structural competitive advantages, the proverbial wide-moat, strong financial positions, and long runways for reinvestment. These businesses generate tremendous amounts of cash through their operations and are run by first-class management teams. When broader financial markets go through tumultuous periods, these are the firms best protected from downturns and best positioned to grow stronger and take advantage of new opportunities.

Speaking of new opportunities, we do foresee one potential positive for our investment operations stemming from the Brexit vote. We have no doubt that there are a number of businesses in the UK that meet our quantitative and qualitative factors for investment. The decline in the British pound and continued volatility in share prices might well provide excellent opportunities for investment in high-quality British companies. Suffice to say that we are busy familiarizing ourselves with some of these businesses to see if any are a wonderful match for our goal of compounding our capital over the long-term.

The Capacity to Suffer

One of the investors I admire most is Tom Russo of Gardner Russo & Gardner in Lancaster, PA. Tom manages a highly-concentrated portfolio focused on consumer goods, financial, and media businesses with strong brands and powerful long-term reinvestment opportunities. Tom is a focused, long-term investor who seeks out the best companies in industries he understands with management teams that truly manage the business as long-term owners and for the benefit of shareholders. I have learned a great deal from Tom's thoughts and ideas over the years, and a good portion of our investment operations echo his approach.

One of the concepts Tom talks about frequently is what he terms "the capacity to suffer." He wants his portfolio companies run by managers who have this inherent quality. Businesses with the capacity to suffer are those run by strong-willed management teams, oftentimes family-owned and operated, that are able to withstand the hits to current profitability that sometimes come along with reinvesting into the business for the purpose of long-term growth. Attractive businesses are those managed with an eye towards maximizing compounded value over decades and generations, rather than calendar quarters or years. Managers with the capacity to suffer focus on global growth opportunities and reinvestment into the business, rather than extreme cost-cutting and hitting the EPS number.

I also view the capacity to suffer as an inherent quality in long-term investors who are willing to stay invested in these businesses while managers invest for the future. Willingness to remain invested alongside managers with the capacity to suffer allows for investors to benefit from the long-term compounding of per share business value that is intended through sacrificing short-term profitability. This likely means investors will have to endure periods of short-term volatility, uncertainty, and declining share prices. The forethought in doing so is the investor's own capacity to suffer.

Wal-Mart (WMT) provides a good analysis of the capacity to suffer in action, both from a company perspective and an investor perspective. We initiated positions in WMT in early 2015 with average prices between $72-74. In October 2015, the company dropped what many analysts claimed to be a "bombshell" on investors. WMT announced strategic investments in technology and its online retail presence in order to stem the tide of customers utilizing Amazon and other sources of online retail. The goal of these investments would be to improve the customer experience by creating an enhanced multi-channel retail experience, including online and mobile, as well as its expansive in-store retail business.

WMT also announced a renewed focus on competitive wages for its employees. The company issued guidance for 2016 and 2017 which fell dramatically short of the expectations most Wall St. analysts had built into their models. The result of these strategic investments would be stagnant revenue growth and a short-term decline in profitability, the company said. One Wall St. analyst summed up the situation as, "Changes to benefit the customer, but at the expense of EPS."

WMT's share price was decimated as it reached multi-year lows in the aftermath of its announcement. In my Q4 2015 Letter, I wrote the following regarding our WMT position:

> What did this mean for us as long-term shareholders of the company? I can tell you that we did not sell a single share. In fact, after waiting out what we believed was the worst of the selling pressure, we added to our Wal-Mart holdings at the end of October, effectively lowering our cost basis while increasing our stake in the company. So why did we do that? In short, our temporal and psychological edges allowed us to take a differentiated view than most market participants. We plan to own Wal-Mart well beyond 2017, as it is still a fundamentally sound, entrenched discount retailer. Thus, short-term earnings struggles impacted neither our overall thesis for owning the business, nor the timeframe in which we planned to hold our shares. Moreover, we took the psychological edge of being greedy when others were fearful to purchase those shares the market sold off right after the announcement. Where the market saw the news as solely relating to earnings hiccups and negative outlook, we saw information from the company about the long-term benefits from building out the company's e-commerce platform and upgrading its technology. We believe those will benefit us as long-term owners of Wal-Mart shares. Our clients will be served well by our commitment to long-term share ownership and the advantage of remaining dedicated in our belief when all other market participants were telling us that our view was wrong.

We appreciated greatly management's change in direction and expanded investment in order to compete in areas where the company was weak. It took a strong will for management to announce to the market that its earnings and sales were going to be negatively impacted in a material way. In general, the Street never likes that sound of that. The dramatic share price declines were inevitable, and I'm sure management knew that. However, WMT's managers believe that the short-term pain will benefit the long-term for the company and for its shareowners. This decision exemplified the capacity to suffer, and is precisely the type of action we look for from our business managers.

We too exhibited the capacity to suffer by maintaining our positions and adding to them at much lower prices. Our long-term orientation allows us this opportunity, but it is not easy, and it is often questioned. I believe that the business of WMT will be much better off in five years than it is right now. It is the fundamental reason why we own the company. By suffering right along with management, we are certain that we will reap the long-term benefits of WMT's short-term pain.

Portfolio Updates

During Q2, the JRW Core Equity Strategy bought two (2) new businesses, added to three (3) presently-owned businesses, and exited two (2) businesses. The new businesses in the Core Equity Strategy are **Starbucks Corp (SBUX)** and **Foot Locker Inc (FL)**. I added capital to our existing holdings in **Apple Inc (AAPL)**, **Express Scripts Holding Co (ESRX)**, and **MasterCard Inc (MA)**. The positions sold from the Core Equity Strategy include **American International Group Inc (AIG)** and **Mondelez International Inc (MDLZ)**.

Some who are paying attention may ask why we added to our Apple position this quarter when we reduced the position last quarter. That's a fair question. While I try my best not to over-trade the strategies we manage, there will be opportunities in the construct of portfolio management that require some activity. We reduced our stake in Apple last quarter based on its size in the portfolio and the need to deploy capital to other opportunities I determined to have higher potential internal rates of return. After reducing the position, Apple declined roughly 10%, and reached a level in price that offered a substantially more beneficial IRR. With existing cash in the portfolio, we added to our position at a discount.

I will highlight a brief synopsis of our thesis in Foot Locker (FL). Foot Locker is the leading global retailer of athletic shoes and apparel, with over 3,400 retail stores throughout North America, Europe, and the Asia-Pacific region. The company's share price struggled throughout the first half of 2016 as investors showed concern regarding weakness in high-end basketball footwear from companies like Nike and Under Armour. Furthermore, declining mall traffic threatened to hamper Foot Locker's sales, as the vast majority of its retail stores are in shopping malls.

Ultimately, I believe Foot Locker's investment into its retail segments growing in popularity, including stylish active-wear geared towards women through its *SIX:02* retail concept, as well as strength in demand for running shoes and other active footwear, will stem the short-term declines in the basketball shoe business. The company too believes recent weakness in that segment will prove to be short-term. With a 20+% decline over the first half of 2016, I believe the share price became very attractive from a long-term investment perspective, with a 10% free cash flow yield and attractive earnings multiples. We initiated our position with the share price ~$53.

We remained inactive in the JRW Income Focused Strategy in Q2, choosing to let our higher yielding positions continue to distribute cash dividends while share prices benefited dramatically from the global "chase for yield." With negative and low interest rates pervasive among global fixed income securities, investors seeking current cash generation from security holdings have piled into the highest yielding sectors of the equity markets, including Utilities, Telecom, and Consumer Staples. A majority of our holdings in the Income Focused Strategy comprise these market segments.

Our inactivity should not be mistaken for complacency. We are always mindful of valuation for the holdings we own, and some of our Income Focused Strategy positions may be approaching valuations that offer less attractive future rates of return than when we purchased the businesses. As I said last in last quarter's letter, this is the process of portfolio management, ensuring that our portfolios are managed with the highest collection of internal rates of return that we can find, consistent with our strategy mandates. I continue to search for wonderful opportunities to add high-yielding, best-of-breed businesses, while at the same time, monitoring our portfolios for situations where trimming or eliminating positions may be necessary.

I hope you find these letters informative. As always, it is a true honor and privilege to manage money on behalf of clients, and I take pride in building relationships that last a long time. If you know of anyone who is not familiar with JRW Financial but may be benefited by our services, please feel free to send them my way.

With warmest regards,

Joseph R. Weidenburner, JD
President & Chief Investment Officer
July 20, 2016