JRW FINANCIAL LLC

Letter to Clients and Interested Parties
4th Quarter 2015
January 15, 2016

Dear Clients and Interested Parties,

As I'm sure you noticed from watching the television, listening to the radio, reading the newspaper, or checking your investment account statements, volatility has returned to the markets with gusto. The price of oil has continued its precipitous decline, and fears about the slowdown of the Chinese economy have gripped the financial markets. At least, those are the reasons most commentators ascribe to the heightened volatility of stock prices in recent weeks. Readers familiar with my musings will know that I subscribe to the belief that the daily price fluctuations within the stock market are noise and are to be largely ignored. Ben Graham's "Mr. Market" is an irrational and oftentimes combustible chap who sends prices every which way at times – including down for extended periods.

We are guided by our commitment to the business fundamentals of the companies we own, and our long-term, disciplined, patient approach to investing. The pit you feel in your stomach every time you see red next to the companies in your portfolio is an inherently natural response based on how our human brains are wired. But, we remain steadfast in our commitment to the belief that market price and per share business value are frequently not the same, and it is the latter which is of most concern to us as investors and part-owners of these companies. One of the greatest benefits I can provide as an investment manager is staying strong in the face of extreme volatility, and remaining disciplined within our process for investing in great businesses for the long-term. This commitment is likely to be tested throughout 2016, but I assure you that I am up for the challenge.

Our Focus on Quality

The vast majority of the holdings in your portfolios are in "stable" mid cap and large cap companies, with modest growth in revenues and earnings. Some pay moderate dividends. We like strong balance sheets, consistent free cash flow generation, and shareholder-friendly capital allocation policies of management. Rarely have we invested in what's "hot" at any given time, nor do we scour the ends of the investment world looking for "Graham-esque" stocks trading significantly below their net current asset values.

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The key to our investment success is the ownership of high-quality businesses with high probability of compounding per share business value over the next five, ten, and twenty years. We commit our research to only those businesses where we believe a true structural competitive advantage exists, such that returns on capital invested in the business will consistently outweigh the cost of that capital. Over time, this commitment to quality allows us to follow, research, analyze, and eventually own businesses that will create significant value through business performance. This value creation should reward our ownership with satisfactory investment returns.

The margin of safety offered by high-quality businesses is attractive. We look for businesses where the pathway for growth and compounding of value is long, and thus the probability of enjoying good investment returns is greater than the risk of losing permanently the capital we have invested in ownership of these businesses. When the upside is greater than the downside by a significant margin, we believe there to be a margin of safety in the investment opportunity, and that is vitally important to our management of risk.

There are thousands of businesses traded on the public stock markets. We can own any of them. However, with our long-term commitment to compounding investment returns, we believe the single best risk-adjusted method of investing is to own only those businesses that have exhibited a consistent operating history and that are likely to continue to do well into the future based on the inherent advantages those businesses enjoy.

We are selective in whittling down our investable universe to only those businesses we believe possess the characteristics for long-term outperformance. We then wait for a price that is right. That is, we wait to make sure the business trades at a fair price in the market relative to our assessment of per share business value. We make a value judgment as to the fundamental assumptions priced into the stock, and whether they are in line with our analysis for future compounding. If everything lines up correctly, we are happy to purchase shares and then wait for the business to perform.

We benefit from patience and discipline. Our investable universe is purposely a small subset of the companies available for investment. We apply our value-oriented filters to ensure that we are paying a price that gives us a high probability of successfully compounding our investment returns. Often we invest in mainstream, successful businesses that are going through a temporary disruption and are considered out-of-favor within the market. There always will be best of breed businesses that go through temporary missteps that cause share prices to plummet even though per share business value remains intact. If we are sure of the quality nature of the business, such that we know we have found a company that we will want to own for a long time, we are opportunistic about buying shares during times when those shares are considered "dead money" in the market. We are happy to take a contrarian view on best of breed businesses where our probability for long-term success is high.

<u>But Where is Our Edge?</u>

The question I grapple with often when I review the businesses we own and the portfolios I construct for clients is: what "edge" do I provide? A seasoned and talented investor for whom I have the utmost respect once remarked to me personally that the keys to success and longevity in the investment business are differential insights and a unique perspective. However, it's nearly impossible to possess differential insights and a unique perspective into businesses followed by a cadre of Wall St. analysts and media outlets. I will tell you up front, dear client, that I possess no unique perspective into Berkshire-Hathaway, Apple, or Alphabet (parent of Google), nor can I offer much by the way of differential insight into these businesses.

Your logical follow-up should be: So what am I paying you for? It's a great question, to be sure, and one as an investment manager that I consider daily in my research, analysis, and portfolio management. I think a great deal about the work I do in building an equity portfolio suitable for my clients that justifies their trust in me and in our goal of compounding capital over the long-term while preventing permanent capital loss.

Steve Mandel, proprietor of Lone Pine Capital, an incredibly successful investment firm, has stated in the past a quote that we find helpful when attempting to deconstruct our value as an active management investment firm. The quote, to which I was first alerted by Chris Begg, CFA, at East Coast Asset Management, whose letters are a veritable tour de force of investment-related goodies and intellectual stimulation, reads as follows:

> *"Our ability to identify businesses that have the market opportunity, product distinction, competitive advantage, and management skill to grow earnings and cash flow* ***for longer than is factored into consensus expectations*** *has distinguished our investment efforts over the years."*

What is our edge? Discipline, patience, and the repeatability of our process. Investing is a business where process is rewarded, even if outcomes serve as the scorecard. Our process for analyzing and researching businesses with an eye towards the long-term and a focus on how our analysis differs from what the consensus expectations show serves as a piece of the edge we offer to clients.

We focus on long-term, businesslike thinking. We research the fundamental drivers of business returns, and thus investment returns. We analyze what consensus expectations are factored into a stock's price, and we try to find businesses where our view is different than the consensus. We seek high probability investment opportunities, while viewing these investments over a longer period than most market participants. We view risk as the threat of losing all of our money, not as how volatilely a stock price moves up or down. As such, we are ever mindful that our goal first and foremost is to protect your money from permanent loss, and then we focus on compounding its value over the long-term.

A few months back, I saw a Twitter account of a finance-related individual remarking that it was ridiculous for individuals to pay active management fees to investors who hold Berkshire-Hathaway stock as their largest position. The theory behind the remark seems to be that active management requires building a portfolio or engaging in a process of such differentiation and uniqueness that the end results would not include Berkshire-Hathaway common stock as the largest individual position in a client portfolio. I believe the remark also surmised that an individual paying active management fees for the ownership of Berkshire-Hathaway is better off investing on his or her own and individually buying shares.

The remark points to the fact that active managers who focus on the most efficient areas of the market, which happen to be widely followed mid and large capitalization stocks, are believed to be unable to possess an edge sufficient to justify the payment of investment management fees. I believe this is fundamentally flawed thinking. The edge will not be informational. I believe the edge is temporal and psychological.

In general, the market as a whole focuses on short-term issues. CEOs and companies "guide to the numbers," where they do everything in their power to try and beat the consensus quarterly estimates of Wall Street by the slimmest of margins. When that doesn't happen, stock prices can be bludgeoned quite dramatically. And if a company provides commentary about challenges it faces over the next quarter or even year, the market sells shares in that company indiscriminately.

Our edge, then, comes from positioning our time horizon much further out on the curve. This is the temporal component. We do not concern ourselves with quarterly earnings misses or negative guidance unless the event portends a fundamental and permanent shift in the underlying economics and structural competitive advantage of the business in question. This requires the fortitude to weather sometimes messy near-term storms. This is where the psychological component of our edge comes into play. Prices can be extremely volatile and fluctuate dramatically. However, patience and discipline reward those investors who are able to stand by great companies going through tough times. This reward comes from the ability to differentiate your perception about a company from the market's perception, as well as from the ability to sit tight for, in some cases, a number of years while the company rights the ship. We must have the psychological strength to take the opposite side of prevailing sentiment – and in many cases this means we become buyers of businesses when the market throws them out with the baby and the bathwater. Furthermore, our psychological advantages come into play in our unending commitment to our investment process, and the supreme confidence we maintain in our approach at all times, regardless of what the market does in the short-term.

I will use an example of a business we purchased for clients to explain this concept in real-time (or as close as we can get in this format). We purchased a stake in Wal-Mart (WMT) for client accounts between $72-74 per share in the second quarter. Wal-Mart is the world's largest retailer. At the time of purchase the company was worth ~$230 billion in market capitalization. Wal-Mart generated $485 billion in revenue and earned $24.8 billion in pre-tax income last year as well as $16.4 billion in free cash flow. Pre-tax return on the equity base of $81.3 billion was around 30.5% (20.1% if using net income). Free cash flow yield on market cap at the time of purchase was close to 7%. On metrics alone, the purchase was attractive. Everyone knows Wal-Mart. Our edge was never going to be informational, but at the time we purchased our shares, we paid ~9.5x pre-tax income, which is right within our goal of buying great businesses at reasonable prices.

In October, Wal-Mart announced that its earnings for fiscal year 2017 were going to be depressed significantly (around 6-12%) due to the company's increased capital spending on technology upgrades and a focus on e-commerce, as well as due to increased labor costs based on increased minimum wages. Shares were poleaxed in response, dropping upwards of 8% in one day and 12% over the next few weeks. The news also brought headlines such as "Wal-Mart Sits at Multi-Year Low After Guidance Stuns." Wall Street analysts tripped over themselves in downgrading the stock in the days after the company's announcement.

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.

Our focus on the long-term competitive advantages and fundamental business drivers, our dedication to in-depth research and analysis of primary source materials, our patience during the swings of Mr. Market's volatility, and our discipline in adhering strictly to our process; these form the source of our edge. These form the source of our differential insights. These formulate our unique perspective. I believe this differentiates us in the service we provide. And I believe that this justifies the trust our clients place in our management of their investment portfolios. We will continue following our process for as long as clients continue to place their trust in our active management services. Over time, I am confident that our clients will be rewarded satisfactorily (as well as benefit from our ownership of both Wal-Mart and Berkshire-Hathaway).

What's New? - JRW Income Focused Portfolio

In discussions with current and prospective clients, we learned of the strong desire from many people to generate at least some semblance of current income from their portfolio holdings. Whether with people dissatisfied with the return on normal savings accounts or certificates of deposits, or with people closer to retirement age who want to ensure that there is a regular stream of income on which they can rely, we've had many discussions in the past few months about dividend paying stocks and tweaking our Core Equity portfolio to include more income generation.

These discussions gave way to the thought of developing a second portfolio strategy that would be beneficial and helpful for those clients and potential clients who wish to receive a coupon-like return from their portfolio capital. I undertook the responsibility of seeing if it were feasible to develop such a portfolio while remaining firmly entrenched within our philosophy and process for choosing competitively advantaged businesses with high returns on capital, strong management, a runway for future reinvestment opportunities, trading at a fair price in relation to a per share business value with a strong probability of compounding over the long-term.

My goal was to determine if I could be comfortable with enough businesses meeting that criteria that pay at least a 2% dividend annually and that have a strong capital allocation history and significant record of sustaining and growing dividends through good times and bad, with enough margin of safety built into the company's payout ratio and debt to capital ratios to where the safety of the dividend is as good as guaranteed. I went about developing portfolio guidelines for what makes a company appropriate for inclusion into our newly minted Income Focused portfolio, and the new strategy has come to light.

Beginning January 1, 2016, the Income Focused portfolio is available to current and existing clients. I have found a good mix of businesses that meet our fundamental, value-oriented, businesslike investing philosophy, and that have also a strong and consistent record of returning capital to shareholders through dividends and a clear pathway towards growing those capital payouts over time. You can be sure that we will not select companies merely on the size of their yield. Rather, we have selected businesses that meet most, if not all, of the criteria we have laid out in the past for businesses in our Core Equity portfolio, trading at fair prices in relation to per share business value, and that have at least a 2% dividend yield with at least 10 years of stable or growing dividends.

Core Equity Strategy Portfolio Composition

Our Core Equity portfolio is comprised of businesses in which I have the utmost confidence for compounding of per share business value over the next 5 to 10 years. These are the businesses I add to on any sign of material weakness in share price relative to our estimate of per share business value, and the businesses in which I would need to see a significant fundamental change in business prospects and competitive advantage to consider liquidating from our portfolio.

For current clients, these are the businesses that you will own for a long time, and for prospective clients, these are the businesses you will own for a long time should you wish to work with us. We target initial position sizes of 3%-6% on our Core Equity positions, based on multiple factors such as discount to per share business value, available portfolio capital, and percentage of holdings within a given industry already in the portfolio. For example, we established a position in Visa Inc. (V) this quarter, and did so with 3% of portfolio capital, based on its fair price in relation to per share business value, as well as our existing ownership of MasterCard Inc. (MA) and PayPal Inc. (PYPL). While I believe the digital payments industry is an exciting, long-term growth story, owning three businesses within the same industry requires some pruning of positions and proper position sizing so as to not overexpose the portfolio to industry concentration risk.

We believe in a concentrated equity strategy where our capital is focused into the best businesses we know for compounding capital. At year end, our Core Equity portfolio was made up of 20 businesses (21 actual holdings, as we own both Class A and Class C shares of Google's parent company, Alphabet Inc.). The most recent addition was purchased in late December. Some of the holdings have been in the portfolio since inception.

JRW CORE EQUITY PORTFOLIO HOLDINGS (12/31/2015)	
Company	Ticker
Berkshire Hathaway Inc	BRK.B
Alphabet Inc	GOOGL
Alphabet Inc	GOOG
Apple Inc	AAPL
American International Group Inc	AIG
Express Scripts Holding Co	ESRX
MasterCard Inc	MA
AFLAC Inc	AFL
Philip Morris International	PM
Time Warner Inc	TWX
Union Pacific Railroad	UNP
Baidu Inc	BIDU
World Wrestling Entertainment Inc	WWE
Interactive Brokers Group Inc	IBKR
Visa Inc	V

Lowe's Companies Inc	LOW
U.S. Bancorp	USB
Wells Fargo Co Inc	WFC
Mondelez International Inc	MDLZ
Gilead Sciences Inc	GILD
Wal-Mart Stores Inc	WMT

In The Warren Buffett Way, Robert Hagstrom outlines twelve immutable tenets Buffett uses as a framework for analyzing businesses. Hagstrom identifies three of these tenets as "Business Tenets." These tenets form the basis of what we look for when identifying a business we consider our Core Equity portfolio.

Core Equity businesses must:

- Be simple and understandable businesses – we should have a strong general sense of what the business does, how the business makes money, and who runs the business in order to make a sizeable investment;

- Have a consistent operating history – we like to own businesses that have had great success over a long period of time because we believe a long and consistent history of operations in a business that is simple and understandable, having provided the same necessary product or service over that period, provides a reliable lens for continued performance into the future; and since the future is not easily forecast, we prefer those companies where business operations have a high level of predictability;

- Have favorable long-term prospects – our qualitative analysis of a business focuses on the existence (or not) of a structural competitive advantage within the business (Buffett's moat), and whether that competitive advantage is expanding or contracting; the ideal Core Equity business will have a deeply entrenched competitive advantage that widens over the long-term.

These are the principles we keep in mind when researching businesses to own in our Core Equity portfolios and across client accounts for which this strategy is appropriate. Not every business we own will meet each criterion perfectly. However, on balance, we will strive to apply these principles to the selection of businesses in which we will invest our and our clients' hard earned capital.

Mea Culpa, Mea Maxima Culpa

Generally in these letters, I like to highlight a new business we own, or an existing business I believe is exciting enough to share with clients and interested parties. In previous letters, I have outlined our thesis behind owning Interactive Brokers and World Wrestling Entertainment. I've also detailed the investment thesis in another business, which we ended up selling in the fourth quarter, and about which I made a sizeable mistake. I believe in fessing up for my mistakes, partly because my clients deserve such candor, and partly because I take every mistake I make as an opportunity to learn and become a better investor. This will certainly be the case when I look back on our ownership of Outerwall Inc (OUTR).

I've done a lengthy post-game analysis on our ownership of Outerwall, in no small part because I pounded the drum pretty loudly on why I believed it to be a wonderful business that wasn't given nearly enough credit by the market. I believe my biggest mistakes were being deceived by the attractive quantitative metrics (seriously, I salivated over a high teens free cash flow yield) and not recognizing the extent to which the melting ice cube was melting. I acknowledged that this was a business in secular decline, but I believed that the decline was going to be far slower and much less dramatic than what others believed, and than what the results have shown. I believed the extensive footprint in most major retail locations was going to make up for weak box office numbers and the nature of the decline in the physical DVD rental business. I believed that the weakness in recent box offices would be more than made up for by incremental price increases, and that ultimately the company would benefit from the string of upcoming blockbusters movie studios have in the pipeline.

In reality, the DVD business is declining as quickly as one would expect from an outdated technology that is proving to be more obsolete by the day. There is a reason the free cash flow yield was and continues to be so high – it portends a dramatic fall off in the fundamental operations of the business. Redbox is still around, and may be around still for some time, but the ubiquity of streaming options and over-the-top applications are going to continue the DVD's long march to the way of the VHS tape – and ultimately, walk Outerwall on the path of Blockbuster. The ice cube continues to melt and frankly it's not likely to get any better. While the Coinstar business is a nice complementary business line, it's never going to be a revenue driver. And the company made an ill-fated attempt to invest in the echoATM concept which never caught on and which is easily replicated.

We took a haircut of more than 50% in our position across various accounts. This was a bad investment at a bad time by me, plain and simple. I apologize for what in retrospect was poorly placed support for this business. It might continue to be a viable entity, but it certainly should not have been a position in our Core Equity portfolio, and my inclusion of it as such was a bad error. Mistakes like this will happen again, but I promise to do my best to prevent them to the maximum extent possible, and to limit the harm to our portfolios when I do indeed make another mistake.

Conclusion

If the first couple of trading weeks in 2016 are a sign of the year ahead, we are likely in for continued volatility and heightened uncertainty in financial markets globally. If I may be so bold as to quote founding father, activist, and philosopher Thomas Paine from The American Crisis, "these are the times that try men's souls." While not nearly as dire a predicament as faced by revolutionary colonists, volatile stock prices cause fear and anxiety in investors. Your portfolios are likely to show continued weakness for periods of time over the course of this next year. The good news, however, is that I believe strongly in the business fundamentals of the companies we own, and I do not believe that a volatile stock market makes our businesses any less attractive to own. I will be selective in adding to positions in businesses we own at any sign of market-related share price weakness, and I am always on the lookout for additional wonderful businesses trading at reasonable prices for our portfolios.

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 us but may be benefited by our services, please feel free to send them our way.

Wishing you the best of health, happiness, and prosperity for 2016 and beyond.

Warmest regards,

Joseph R. Weidenburner, JD
President & Chief Investment Officer
January 14, 2016