April, 2018

Dear Partners,

As you know, I prefer to write letters only twice per year in order to reduce the negative effects that come with discussing our portfolio too frequently. However, it is important that all partners understand what we own and why we own it, so that when difficult times inevitably come, we can focus on the quality of our businesses and our management partners rather than the noise that will surely dominate the headlines. We have two new large positions in the portfolio, and as such, I felt an update was in order.

In our year end 2017 letter, I indicated that due to an infusion of new capital, we were holding a substantial cash balance, and that this cash would be a drag on our results should they be positive. Through Q1, on average we held a high teens percentage of our portfolio in cash and cash equivalents, and this cash position has indeed been a significant drag on our results thus far. This is of course frustrating in the near term, but the patient nature of our partnership ensures that we can ignore the near term, confident that our cash positions us well for the long term. More recently, we have put some of this cash to work, and I remain confident there will be more opportunities in the not too distant future. These opportunities may come due to a broad market dislocation, or perhaps due to idiosyncratic opportunities that we uncover in the under-explored corners of the market, regardless of what the indexes do.

Laughing Water Capital (LWC) returned +7.7% net in the 1st quarter of 2018, which compares favorably to the S&P500 and R2000, which returned -0.8% and -0.1% respectively over this inconsequentially short period. Please check your individual statements for your personal return. We have begun reporting net returns of our normal class as **the close of our lowest cost fee option is imminent**. If you know of investors that would be good additions to our partnership, please make them aware of the pending close.

As a further reminder, in the Year End 2017 letter I provided some context on how to view our recent success. I suggest all partners review the points that were made. While LWC has been specifically constructed to give us every possible structural edge vs. the market, our best chance for long term success is recognizing and understanding the behavioral aspects of investing that doom most market participants to underperformance. Given our 120+% gross returns in little more than 2 years, we must be especially cognizant of the "hot hand fallacy." Feeling as if we are entitled to returns in line with our recent history, or worse – striving to maintain returns of this magnitude – would be the quickest path to mediocrity.

Rather, we must remain patient, eschewing leverage and derivatives, while simply saying "no" to almost everything. This may result in long periods of boredom, and we may be left behind if the market resumes its climb upward. However, if we remain true to our process and continue to comb the hidden corners of the investment universe, on occasion we will find anomalies that offer limited downside combined with the possibility of outsized rewards.

We will also make mistakes. Our returns will not come in a straight line. Focusing on our process, not outcomes, will be our best defense during these difficult periods.

The fact that our strategy is largely devoid of originality should help us remain focused. We are simply walking the same path that was used by most of the world's greatest investors when they managed smaller pools of capital. These great investors all suffered through difficult periods, yet produced outstanding long term track records by staying true to their process. For this reason, almost the entirety of my and my family's wealth is invested in our strategy. Our interests are aligned.

Omaha

For current and prospective partners, if you will be in Omaha on May 4th or May 5th for the Berkshire Hathaway meeting and would like to meet, please email me at msweeney@laughingwatercapital.com.

A Brief Word on Beta

One of our newest partners was formerly employed by one of the world's largest institutional money managers, where he had the unfortunate task of managing a portfolio that was 1) large 2) responsive to the unknown short-term liquidity needs of his investors and 3) in line with the constraints imposed on him by the consultants that often drive institutional capital allocation.

Like the rest of our partners, he recognizes the enormous competitive advantages enjoyed by a partnership that is 1) small 2) long term in nature and 3) constrained only by the bounds of common sense, and he thus joined us. However, as part of his diligence process, he asked if our recent outperformance could be the result of beta.

For the uninitiated, beta is the term used to define stock market risk by academics, institutional investment consultants, and others that believe that the stock market is efficient and rational. Mathematically, beta is the covariance between the return of an asset and the return of the benchmark, divided by the variance of the benchmark over time. In layman's terms, the concept of beta suggests that risk in the stock market is dependent on how a stock moves in relation to the market as a whole.

As a reminder, we are unconcerned with the stock market as a whole. We are fully focused on finding the best possible investment opportunities, regardless of their relationship to the stock market day to day. Personally, when considering the merit of arguments that deviate from common sense and into the world of Greek letters, I find it helpful to consider what any small businessman would say if the Greek letter in question was applied to his business. For example, try telling your plumber that the value and risk of his business is tied to the movements of the stock market on any given day. It just doesn't make sense.

This concept of beta was perhaps most famously exposed as flawed by Warren Buffett through his purchase of shares of the Washington Post in the early 1970s. At the time, the shares were considered "risky" by efficient marketeers due to uncertainties surrounding the business and its reporting on *Watergate,* leading the company's market cap to dwindle to $80 million. Yet, Buffett's analysis led him to believe that the various assets owned by the company were worth somewhere between $400 and $600M.

Does it matter if the stock of a company moves around more than the market as a whole if you can buy the business for $80M and sell off the parts for $400M+?

The answer depends on your time frame. If you need the money tomorrow, or are investing with leverage, then conceivably it does matter if the stock has a higher beta than the market. From our perspective however, if you need your money tomorrow or are playing the market with leverage, you are gambling, not investing.

There are many reasons that a stock may have a high beta. Quite often, it is because the stock's value is dependent on lofty expectations for future growth. We avoid these stocks completely. However, many of our investments are in companies that are off the beaten path, which often means limited liquidity. This can lead to higher beta as larger market participants are easily able to push shares higher or lower with every purchase or sale. Similarly, many of our investments are in companies that are dealing with some sort of temporary operational, optical, or structural problems, which is exactly what attracts us to them. Absent some sort of difficulty, bargain purchase prices are rare, however, the uncertainty which attracts us further contributes to higher beta, as the market loves certainty above all else. Combined, limited liquidity and a cloudy near-term future means that shares that we own will often be more volatile than the market in the short term.

However, equating this volatility with risk is akin to judging the safety of an aircraft by the number of exits it has. More exits, and thus an improved ability to escape in the event of a disaster, will provide little comfort if the plane crashes. Safety should of course be judged in relation to the soundness of the aircraft itself, and the abilities of its pilot. By focusing our analysis on the quality of the businesses we own, the skill of our management partners, and the prices these businesses are available at, we are ensuring that we are in planes that are unlikely to crash, even if they don't have extra emergency exits. Patiently accepting near term volatility allows us to purchase securities that may be severely underpriced in the long term. This is because a large swath of market participants are afraid to touch them due to the near-term uncertainty. We much prefer a bumpy 15% return to a smooth 12% return.

In sum, it is possible that some of our recent outperformance could be due to beta, although the fact that our managers and businesses have been executing at very high levels suggests that the beta effect is secondary. Regardless, the impact of beta is why I always caution that we must ignore short term results: positive as well as negative. Our partnership is built on a foundation of patient, long term capital, which is an enormous advantage. We should feel no need to apologize for the fact that we deliberately buy stocks that are off the beaten path and clouded in uncertainty. That is why they are cheap, and the long-term nature of our partnership gives us an advantage in that we can look past their short term "beta," and focus on their underlying assets and normalized earnings power. If a company we own is able to double its earnings power over the next 3 to 5 years, the outcome will be favorable, regardless of the stock's beta.

New Positions

Bluelinx Holdings (BXC) - Bluelinx Holdings is a wholesale distributor of building products (40% structural / 60% specialty) with 39 distribution centers, primarily in the Eastern U.S. and Mississippi River Valley. Originally, the company was the captive distribution arm of Georgia Pacific (GP), the country's largest producer of plywood and other sheet goods. However, the business was carved out of GP by a private equity buyer in 2004, who promptly took it public and saddled it with debt just in time for the real estate bubble to burst. We first purchased shares in late 2017 shortly after the private equity sponsor – who was apparently focused on liquidity rather than price – dumped their shares on the market at a large discount. At the time, it was a small position for us solely because we did not have more cash on hand, but as new capital came into the partnership in 2018, we made BXC a mid-sized position.

While buying from a seller that is not concerned with price is a good place to start, by itself this is not sufficient for investment. We were further attracted to the business because of its mis-leading GAAP balance sheet, which we believed under-stated the value of the company's real estate by almost $200M.

Importantly, the company had been monetizing their real estate through sale-leaseback transactions, which allowed the company to paydown debt. While the mechanical screeners that rule the markets were viewing the company as levered ~8x, we believed the company had already reduced its leverage to ~6x, and could be theoretically almost debt free if they simply continued to monetize their real estate.

More important than this theory however, is the reality: they just don't need all of the land they have. Because the company started as a part of GP, their footprints were designed to accommodate storage of plywood and other sheet goods. Storing plywood requires a lot of space for a small amount of margin, and is thus not a good business to be in.

Additionally, a look at BXC's product mix vs. public competitors showed significant room for margin expansion through moving into more value-added aspects of the building supply distribution business. Combining the above elements, I felt that BXC was significantly mis-understood by the market, and that there were multiple ways to win in the years to come.

What I did not consider was that BXC would announce a merger with a competitor that has a highly complementary business and footprint only months after our purchases. Shares more than doubled on the news, driving BXC into a top 5 position for us. While it may be tempting to just take the money and run after a move of this magnitude, reviewing the transaction indicates that the combined company may be cheaper now in the low $30s than it was below $12 just a few months ago. This is a business where scale matters, and the opportunity to take costs out of the combined business and drive revenue through consolidating the footprint to more fully utilize square footage, leveraging purchasing power, leveraging administrative resources, and cross-selling complimentary products is very real. It is not difficult to envision scenarios where the combined company can generate $8 to $12 in free cash flow per share looking out a few years, which when combined with a likely de-leveraging of the balance sheet leads to the potential for significant additional upside. Andrew Jakubowski of Adestella Management deserves a mention for first bringing BXC to our attention.

Ocwen Financial (OCN) – Ocwen Financial is a mortgage servicing company that can best be summed up as a hated stock in a hated industry, due to a disastrous decade of mis-management, and intense regulatory scrutiny. However, ten years after the housing crisis threatened to collapse the global economic system and following a ~90+% decline in price, the company has developed a clear path past its past sins, is about to move past the last remnants of its regulatory problems, and has strong tailwinds from a rising interest rate environment. Additionally, I believe we are in the early innings of industry consolidation which will drive revenue and margins for years to come.

The headlines have painted Ocwen as a villainous entity taking pleasure in kicking people out of their homes… Yet, curiously, at present a large percentage of Ocwen's equity is owned by investors who specialize in mortgage bonds. In fact, more than 70 mortgage bond investors wrote to the bond ratings agencies expressing their support for Ocwen's ability to effectively service their mortgages. Essentially, Ocwen's own customers (the owners of the types of mortgages that Ocwen services) have publicly expressed support for the company, and have been rationally buying stock, while the media and politicians have been emotionally trashing the company, and saddling it with regulatory fines.

To be clear, looking back several years Ocwen did in fact fail in their duty to homeowners in more than a few instances as they struggled under the burden of their own rapid growth. However, the company has made great strides over the last few years, and was not malicious in its previous shortcomings.

At the time of our purchase, Ocwen was still dealing with many of their regulatory problems, although the clouds had started to clear. For our purposes, valuation of the company was based on the assumption that any fines tied to this latest regulatory action would be on par with the fines levied against the company by NY regulators in 2014 on a per total in state mortgage basis (ie total NY fine / total # of OCN mortgages in NY). However, for a variety of reasons, I believe this assumption is draconian, and a favorable settlement will be reached soon.

Despite my future optimism, these regulatory issues help explain the big picture for why OCN shares are available at a discount, even after a recent move higher. However, at the time of our purchase, there were non-economic factors adding additional pressure to shares. Ocwen's founder and former Chairman was essentially banned from the industry by New York State regulators in 2014, which coincided with the implosion of Ocwen's stock (as well as its sister companies), meaning that a man who was once a billionaire lost much of his wealth, at the same time as he lost his income. As such, he began writing call options against his shares in OCN in order to generate income. In May of 2017 he wrote calls against 10,000,000 of his shares at $2.50 and $3.00 per share that expired in January, 2018. An option trade of this size virtually guarantees that it is an investment bank on the other side of the trade, and with the stock approaching $4 in late 2017, the bank – who is not in the business of owning stocks - could lock in their profit by selling short shares of OCN, and then covering the short by exercising the call options. We thus had a situation where OCN came under heavy selling pressure as the bank sought to lock in its profit, regardless of the fundamentals of OCN's business.

Once again, a non-economic seller is a great place to start when considering a potential investment, but the quality of the business and the price are still paramount. In the case of Ocwen, despite all of the regulatory noise, I believe the quality is significantly higher than most realize. To be clear, the company has had many problems, and is still dealing with legacy issues, but at their core, non-bank mortgage servicers are an important part of the mortgage ecosystem. They increase availability of credit for homeowners (especially those without perfect credit), aid banks and other originators with their liquidity, and are generally better at high touch servicing than banks. Specific to Ocwen, there is reason to believe that the company is best in class when it comes to actually keeping people in their homes, as Ocwen has modified more mortgages than any other mortgage servicer.

Further, once sufficient scale is reached, mortgage servicing is a platform business with very high incremental margins. Additionally, the value of mortgage servicing rights goes up in a rising rate environment, because when rates are rising, fewer people re-finance their mortgages, which has the effect of lengthening the cashflows that the servicer is entitled to.

However, for the last few years (an eternity on Wall Street), this quality has been buried under rising regulatory compliance costs, and a mountain of legal costs tied to the previously mentioned lawsuits and third-party monitors. Further, as the company is currently prohibited from purchasing additional mortgage servicing rights (MSRs) for regulatory reasons, the operating leverage that makes this business attractive under normal circumstances is cutting the wrong way.

At the time of our purchase, I believed that OCN's economic book value per share was somewhere between $5 and $9, depending on how you viewed assets that were conservatively off balance sheet, assumptions around their pending litigation, other assets and NOLs, and potential to drive per share value through repurchasing their own stock. Despite this value, shares traded close to $3.00. This discount suggested that in a worst-case scenario, the company could sell off its pieces for scrap, and our investment would work out just fine. However, the real prize will come when the company moves past its regulatory problems and once again achieves the scale that is necessary to flex its operating leverage.

On this front, Ocwen will move in the right direction at some point in the next few months when they will once again be able to purchase portfolios of MSRs. However, zooming out to the industry level and considering all of the puzzle pieces reveals a larger opportunity with multiple ways for the company to win in the years to come.

For several years now, industry participants have been commenting on the need for consolidation in the wake of increasing regulatory and legal costs. Recently, that consolidation has started to take place. The first transaction of note, which was announced in early February, will see WMIH Corp (WMIH), which is essentially the tax shell left behind by the defunct Washington Mutual, merge with Nationstar Mortgage (NSM). The second transaction of note, which came as a pleasant surprise to us only weeks after establishing our position, will see Ocwen acquire PHH Corporation (PHH).

Starting with the Ocwen transaction, I believe this deal is very attractive. First, the fact that management pursued this deal prior to final resolution of the outstanding regulatory matters signals that they believe large fines are unlikely. Second, most of Ocwen's regulatory problems have been tied to insufficient technology to effectively run their business, and the company had previously announced that they would resolve these technology problems by moving their servicing operations onto a 3rd party system known as Black Knight. PHH already uses Black Knight, which should smooth the transition. Third, the combined company should have the scale to be solidly profitable, while effectively developing internal generation capabilities that will allow a self-sustaining business going forward.

Moving back to the WMIH transaction, there is reason to believe that there will be more transactions in the future. WMIH has $6 billion of net operating losses that will shield taxes for years to come, meaning that future acquisitions will generate substantial cash flow. NSM has previously said that at any time they can port $50B in unpaid principal balance (UPB) onto their platform with zero additional cost, and only limited costs to handle even more. A $6 billion NOL and extremely high margin incremental UPB seems to be a perfect match, and it is hard to imagine a reason why WMIH/NSM wouldn't move to aggressively acquire other industry players. Additionally, WMIH is funded by KKR, an entity that is no stranger to levering up equity targets. Given OCN's size, under-leveraged balance sheet, and expertise in non-agency servicing, they may be the most attractive target for WMIH.

Of course, betting on an OCN acquisition by itself would be unwise, and OCN's agreement to purchase PHH is clear proof that the company does not plan on simply sitting around waiting for a bid. Rather, following the PHH transaction they are likely to pursue more transactions. Perhaps the next target will be Ditech Holdings (DHCP, formerly WAC), which recently emerged from bankruptcy. Ocwen's 2nd largest holder, Leon Cooperman's Omega Advisors, owns more than 10% of OCN, and almost 50% of DHCP. These are complementary businesses, and a combined OCN-PHH-DHCP would be on par with NSM in terms of scale, and likely trade somewhere in the $8-$12 range based on comps today. If one believes that the entire industry will likely trade at higher levels a few years from now as the abuses of the housing bubble finally fade into the past, and the market recognizes that these are once again healthy, growing, platform businesses, upside could be substantially higher.

Lastly, Ocwen may choose to move increasingly to a sub-servicing rather than servicing model. Subservicing - which essentially means providing the labor to service a mortgage, but not the capital – is a lower margin business, but its capital light nature generates higher returns on equity, and it would isolate Ocwen from the balance sheet risk that would accompany any severe uptick in defaults, and in my view, thus deserve a higher multiple.

In summary, ten years after the housing bubble popped, I believe Ocwen has paid for its past sins, and will begin generating substantial cash flows shortly. Moving past its regulatory problems and returning to growth – organically and through acquisition – will allow the company to flex the considerable operating margin in its model, and cause Wall Street to take notice. There are multiple ways to win as Ocwen is well positioned as an acquirer, a target, and to transition its business to a less risky, lower capital intensity business in the years to come. With the downside theoretically protected by liquidation value, and multi-bagger potential on the upside, the odds are heavily skewed in our favor.

I had looked at OCN in the past, but David Rosenblum of Prophet Capital deserves a tip of the hat for encouraging me to dust it off. Prophet Capital is a mortgage bond hedge fund (that does not own shares of OCN), and David is one of our LPs.

In the case of both BXC and OCN, if the investments work out as envisioned, the credit belongs to those who encouraged me to examine them. If they do not, the fault is entirely my own, as failure will be related to shortcomings in my own extensive research.

Comments on the Housing Market

Our two new large positions are tied to the housing market, which implies we are strongly bullish on housing. However, this is not necessarily the case. It has become popular on Wall Street to point to housing trends in the post World War II era, or some period over the last X years, and proclaim that, "Y houses per year must be built in the coming years, just to return to trend."

The trend is indeed favorable at the moment, but in my view, this reasoning is at best lazy, and at worst intellectually dishonest.

The idea of a corporate pension was first invented by American Express shortly after the Civil War. However, it was not until the early 1920s when the U.S. federal government exempted corporate contributions to pension plans from taxation that the idea became widely adopted. Similarly, Social Security was first put in place in 1935, and regular payments to retirees did not begin until 1940.

In my view, we must at least consider that the birth of the corporate pension, the implementation of the social security system, and the economic boom in America that followed WWII combined to form a "lollapalooza" effect that allowed American housing and family structure to differ from all of recorded history, and the housing and family structure of almost every other culture on earth to this day. In other words, based on history and other present cultures, the American tradition of not having multi-generational households is somewhat peculiar.

Further, while for much of the last seventy years a corporate pension and social security check were a ticket to a middleclass retirement, in today's world corporate pensions barely exist, and social security checks alone essentially put one at the poverty level. Various studies have shown that almost half of Americans have less than $10,000 in savings when they retire, and a growing budget deficit and rising health care costs mean the Government is unlikely to come to the rescue any time soon. It is not clear how this will all develop in the years and decades to come, but as 10,000 baby boomers retire every day, the AARP has two suggestions: find a roommate, or live with your kids. Both scenarios suggest an increase in housing supply as seniors forgo independence.

For these reasons, we are taking the Wall Street predictions of a return to trend with a grain of salt. Nothing says that the housing market in the United States won't trend toward historical and cultural norms found the world over, rather than trend back toward the housing market that we have known for the last 70 years, which may have just been an anomaly created by the near simultaneous creation of the corporate pension system, social security system, and WWII.

So why do we own BXC and OCN? Because a return to post WWII trends is not necessary for success. Rather, both of these businesses fit well within the four-part framework that guides our investment decision making, even if they are exposed to the cyclical vagaries of the housing market, and these businesses should generate acceptable returns over the next few years even if the housing market does not accelerate.

Comments on Select Investments

Tejon Ranch (TRC) and Greenhill (GHL) – I received several comments that these investments seem to fail our "good business" criteria after mentioning them in our last letter. I have no objection to this view. Despite shortcomings in the quality of these businesses, they scored exceptionally high on the, "why does the opportunity exist," and the, "what happens when something goes wrong," criteria, which earned them small spots in our portfolio. For larger positions we are unwilling to compromise on the quality of our businesses, but we are happy to take advantage of smaller opportunities where the distribution of potential returns is heavily skewed in our favor. In the case of TRC, our assessment of value was tied to unique real estate, and we had hard evidence from the market that there was substantial demand for stock at or near our purchase price as there was a rights offering that was oversubscribed by 100%. In the case of GHL, our assessment of value was less tangible, but we once again had hard evidence that there was substantial demand for stock at or near our purchase price as the company had indicated a willingness to purchase ~50% of its own shares, but was unable to complete the purchase due to a lack of sellers.

To be clear, I much prefer taking large positions in companies that score highly on all of our criteria, and then tax efficiently holding them for long periods, but in the case of TRC and GHL, making an investment was akin to agreeing to play poker with someone who has shown you their cards. Broadly speaking if one knows there is a large buyer present, and no willing sellers, at least in the near term there is only one way for the price to go. We exited our position in GHL after realizing a near 50% IRR from our initial purchase, and shares of TRC have appreciated ~25% since our purchase.

Iteris, Inc (ITI) – Iteris, which has been volatile throughout our 2+ year holding period, traded down ~30% in the first quarter, and an additional 10% in the early days of the 2nd quarter, and has been a significant drag on our results. I believe this weakness represents a compelling opportunity, and have added significantly to our position. There are 4 reasons for the weakness, 2 one of which are legitimate, but short term, 1 one of which is unfortunate, but exciting for the long term, and 1 of which is just part of life when pedaling in small cap stocks.

First, on the fundamental side, the company got bumped down to a subcontractor position with the Virginia Department of Transportation. If this demotion was for any good reason, it would be reason for concern. However, the demotion is tied to an effort by the VADOT to consolidate their vendors. This effort caused the original contract to be rolled into a larger contract that includes less attractive elements such as providing road side assistance and rest stop maintenance. This is business that ITI rightly does not want to compete for as they are focused on building a software centric platform, not cleaning toilets. The revenue loss tied to this demotion is unfortunate, but the company continues to grow, and the revenue hole should be filled in by new projects shortly. Also on the fundamental side, a mix shift to Texas, where there is a middle man in the sales process has weighed on gross margin recently. Further weighing on margins, the company is investing in a centralized procurement team so that they can pursue bigger contracts. In my view, willingness to take short term margin pain in pursuit of long term gain tied to larger projects and the operating leverage that come with them is a sign of a thoughtful management team.

On the non-fundamental side, Lloyd Miller, owner of ~15% of the company and perhaps the world's greatest investor that most people have never heard of passed away, and his estate has sold shares. It is unclear if they will sell more, which is likely acting as an overhang. To be clear, Miller's death does weaken our thesis as his presence provided comfort on an investment where management does not own much stock. However, the present CEO and CFO who are relatively recent hires have proven themselves to be capable, and morbidity aside, buying shares from someone who is only selling because they are dead is attractive.

Also on the non-fundamental side, a fair amount of ITI's shares are owned by quantitative investors, and slowing revenue and declining margins – even if both are temporary – will typically cause quantitative investors to head for the exits. This selling led to a breakdown in share price that surely caught the eye of short term focused technical sellers that take their cues not from the businesses at hand, but the charts.

These factors are the type of things we look for when considering new investments. It is unfortunate that they all developed in a company in which we already owned shares, but the opportunity presented by them is exciting for the future. In my view, the transportation businesses alone more than justify current market prices, and have the potential to be worth multiples in the years to come as the move toward smart cities accelerates. This says nothing for the agriculture business, which is admittedly difficult to value, but if recent ag-tech deals are useful for comparison, they suggest that this business alone could be worth ~$250M, well more than the company's current ~$150M enterprise value. As a reminder, this business was carved into a separate entity last year, and the recently hired President of this business saw the company sold during his last 4 jobs, which seems to set the stage for an eventual sale.

Gaia Inc (GAIA) – Gaia completed an equity offering during the quarter, which diluted our ownership position in the company. While this dilution is unfortunate, I believe the equity raise will be very good for the business and the stock for several reasons.

1) Over the last year, I have gotten calls from several larger investors who professed to be very interested in GAIA, but reluctant to purchase shares because they believed the company would need to issue equity at some point. In a meeting with GAIA's CEO and CFO in January, they indicated they had heard the same from many investors. Thus, it seems there is significant demand for GAIA shares which has been sitting on the sideline. In the wake of the equity offering, this demand should move off the sideline, and get in the game.
2) The equity offering was 4x oversubscribed, indicating that at least in the near term, there appears to be very little downside to the stock.
3) The stock market rewards liquidity. A secondary offering increases the float, which increases liquidity, which is incrementally positive.
4) Members of GAIA's management team and board of directors purchased shares in the offering. Insider buying is always good, but it is especially noteworthy when it takes place in an under-written offering only a few weeks before the company will issue incentive shares to employees as part of annual bonuses. They are already going to get shares… but they wanted more.
5) 3 investment banks facilitated the deal. One of them has already launched research coverage on the stock (with a $23 target), which will draw attention to the company, and thus recruit more buyers. It is very likely the other 2 will follow suit shortly.
6) The company has indicated in the past that they may speed up or slow down their growth plans depending on the efficacy of their spend. For some time now, the company has said that their customer acquisition cost was lower than expected. This is largely because 25-30% of growth has been completely organic word of mouth. Raising money now to spend on recruiting new customers suggests that customer acquisition costs continue to fall, and the company sees an opportunity to accelerate growth.
7) When I met with the CEO and CFO in early January, they indicated they believe there is a real opportunity to raise the price of a monthly subscription, which Netflix and other services have done successfully. This is a business where incremental fees are nearly 100% margin.
8) As indicated in our 1H'17 letter, I have long believed there was an opportunity for GAIA to monetize its "Truth Seeker" community in new and creative ways. Management has agreed with this view in the past but indicated any plans on this front were likely a few years out. However, with the new capital, I believe these plans will be accelerated. This belief seems to be confirmed by the fact that GAIA has petitioned the local zoning board for permission to build an event space on their existing campus. I do not think the market is aware of this yet, and I think it could be very positive.

   The company has previously indicated that they have hosted events for their heaviest users in the past that were enormously successful. Quite simply, while it is likely difficult for those of us who are not Truth Seekers to understand, there is a portion of the population that is extremely passionate about this content, and they are willing to pay up for premium exposure to it. There will be a cost to build out an event space, but it is not difficult to envision scenarios where people pay to attend live events as they are filmed. As the event would be filmed anyway as part of GAIA's ordinary business, paid attendance would be extremely high margin. An event space also would be an attraction for well-known independent talent, which would likely drive customer recruitment for GAIA as followers of independent talent join GAIA in order to keep tabs on their chosen celebrity Truth Seeker. All of these elements of an event space should drive high margin revenue, while simultaneously reducing customer acquisition costs, which is a very attractive combination.

In sum, when we initially purchased GAIA, we believed shares were cheap even if their nascent video on demand (VOD) offering was doomed to failure. A few short quarters later, it is increasingly clear that this business is performing better than expected, and the well incentivized owner-operator is actively pursuing new angles to grow intrinsic value over the long term. In our initial writeup on the company, I believed that the VOD business could be worth close to $60 per share by 2021. Today I think that success is more likely, and that upside could be significantly greater than $60 per share if all goes as planned.

Growth of Our Partnership

When measured in quantity of LPs and assets under management, the growth of our partnership remains measured and thoughtful: to date we have rejected more money than we have accepted as I am unwilling to partner with those whose interests do not align perfectly with our own. However, when measured in quality of LPs, our growth as a partnership has been outrageous. Notable new additions include a former portfolio manager at one of the world's largest mutual fund companies, a partner in a multi-billion dollar hedge fund, a former C suite executive who had the opportunity to spend time shadowing Warren Buffett while working for a subsidiary of a Berkshire Hathaway portfolio company, private equity investors, several impressive entrepreneurs who have built and managed excellent family businesses, and several skilled professionals that make their living in fields such as consulting, tech, or medicine, while spending much of their free time thinking about investing. I am humbled that these exceptional individuals have chosen to join my family and I, and excited by the experience and knowledge that they bring to our partnership. I have no doubt that we are collectively building a competively advantaged investment vehicle that will aid us in our quest to compound wealth for the long term. If you are aware of individuals who are capable of stepping away from the crowd in pursuit of market beating returns over the long term, please refer them to the "letters" section of www.laughingwatercapital.com. Reading the materials located here will give them an opportunity to see if our approach resonates with them.

Looking Forward

As always, I have no idea what the market will do in the near term. Potential trade wars are the macro concern of the day, and have contributed to the recent return of volatility. This volatility has produced an avalanche of talking heads who are eager to spout their viewpoint on where the market will go next. Despite their eager predictions, the only thing that can be said for certain is that in the near-term half of them will be right, and half of them will be wrong, and in the intermediate and long term, none of it will matter.

Regardless of what happens in the near term, I am pleased with our current portfolio, and think we are well positioned for success over the next 3 to 5 years. There will certainly be negative periods in the interim, but quite frankly, given our cash position, we should all silently be rooting for those calling for a market down turn. It may seem odd to hear an investment manager silently rooting against his own portfolio, but our long time line puts us in the enviable position of being able to disregard any near term draw downs. To be clear, there is a zero percent chance that if there is a downturn we will be able to pick the bottom, and any decline will of course be emotionally difficult. However, I am confident that our individual businesses and our portfolio as a whole will benefit in the long term from any short term weakness.

Please let me know if you have any questions,

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