March 14, 2017

Dear Partners,

I'm happy to report that AVM Ranger was back in the black in 2016. We ended the year with a gain of 29.1% (before fees) versus 12.0% for the S&P 500. I'm thrilled with this result (hopefully you are too), yet it's akin to birdieing a hole in golf: it's nice, but the 18-hole scorecard is what really matters.

Our longer-term scorecard is more satisfying: over 8.5 years AVM Ranger has compounded at 30.7% per annum (before fees) versus 9.1% for the S&P 500. Needless to say, 30% is not a hurdle rate we try to sustain, and the usual disclosure applies: we have no chance of maintaining this level of performance long-term. As a sanity check for those immune to my warnings, consider this: if we continued to compound at 30.7% for the next 30 years (we won't), a 100k investment would turn into $307 million. That said, we hope our relative performance over the S&P will continue to add value to partners over time.

At the risk of being uninvited to parties based upon my dour warnings, it's worth noting that even small margins of outperformance, say 4%, over long stretches produce dramatic wealth creation given compounding's wonders (4% outperformance produces roughly 3x value over 30 years). Beating the market by 4% is a tall task, though a recent article stating that 60% of millennials trade on Trump tweets bolsters our confidence that we've got a fighting chance.

GENERAL COMMENTARY

Charlie Munger has famously espoused on the wisdom of figuring out what to avoid in pursuit of success. If you follow this wisdom then you'll be comforted to know that Arlington abstains from trying to forecast and profit from market-moving events. This stance served us well in 2016, as it was a year that baffled the odds-makers: early in the year, whispers of rising interest rates incited market tremors and a sharp selloff, portending a dire outlook for the market (the market finished up 12%); further jolts occurred in June as "Brexit" stunned pros and pundits alike; and closer to home, outside candidate Donald Trump shocked handicappers by winning the White House in November. While the media does not portray President Trump as having a calm, predictable disposition, the market found comfort in his election: since Nov 8th, a halcyon market has steadily glided higher, having gained 11% through February. The events of 2016 reinforce my attitude to avoid an education in forecasting the old fashioned way, by experience: *experience is what you get when you get what you didn't want.*

Our reaction to the noise around us was more muted. Other than taking a few toe-hold positions, we trimmed most holdings as prices rose and the risk/reward shifted. Our decision to pare back

most holdings left us with a large cash position, tallying 25.5% at year-end. While I'm no fan of cash as an asset class (it has lost 97% of its value over the past 100 years), I'm optimistic that the position will be temporary. We have two advantages that stoke my optimism: our small asset base, and a philosophy that requires only a handful of ideas.

It's worth adding: our cash position is not a "market call," it simply reflects an absence of ideas that we find attractive. We've never made hay by hoarding cash in anticipation of market corrections; a quick trip down memory lane serves as a reminder that we entered both bear markets (2002 & 2008) fully invested. We prefer partial ownership in businesses over snappy trades that require gazelle-like instincts to dart away from any hint of danger. We think attempting to time markets (knowingly or unknowingly) is a fool's errand and agree with Peter Lynch: "*Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.*"

PORTFOLIO COMMENTARY:

Despite the drag-effect of cash, we still managed to produce solid results in 2016. For the most part, what hurt us last year helped us this year: MSC, DNOW, and LUK.

MSC Direct

MSC has been besieged by stiff industry headwinds for the better part of 2 years. Amid these difficult conditions, MSC management has performed admirably. They have deftly managed the business by keeping a sharp eye on customers and costs. These efforts have produced outstanding results in the form of stable margins and growing market share, leaving MSC in a healthy position for future growth. MSC's business is poised like a coiled spring, ready to unleash strong operating leverage should headwinds abate and business activity pick up—which appears to be happening in early 2017.

NOW Inc (DNOW)

Wayne Gretzky once said, "*skate to where the puck is going, not to where it's been.*" My initial thesis behind DNOW—a unique competitive position to take advantage of distressed competitors, growing bargaining power translating into better economics, and technological advances that benefit DNOW's customers and support drilling activity—may have seen me skate past the puck. While it's probably too early to evaluate confidently, DNOW's results and underlying economics have been disappointing. Tighter working capital management and pricing leverage have not materialized to generate the returns on capital we expected. Higher oil prices and a growing rig count are positive developments, yet if DNOW's growing suite of products and services don't translate into greater bargaining power, the business economics will likely fall short of our expectations. Given a rising stock price and our waning confidence, we chose to sell a large part of our position.

Berkshire Hathaway (BRK)

Sticking with the hockey theme: If DNOW was my attempt at a difficult tic-tac pass and deke finish, BRK was the quintessential open-net tap-in goal. Past letters have expounded on BRK's unique qualities (they remain unchanged), which continue to produce impressive financial results: for 2016, BRK grew insurance float to over $91 billion, at negative cost (meaning BRK got paid to hold $91 billion), produced over $12,500 in pre-tax earnings per share, and had roughly $170,000 in investments per share, including over $85 billion in cash at year end.

Berkshire resembles a meat grinder that relentlessly piles up value year over year (and decade over decade). Over the past ten years, the two pillars of value, earnings from operating businesses and investments per share, have steadily grown at 9.0% and 7.8% respectively—impressive performance considering the enormous asset size. We think the current figures, combined with the likelihood of future growth, support attractive prospective returns for current owners.

Given that most of you know I'm a big fan of Warren Buffett, it's worth emphasizing that BRK is not a museum piece that sits in the portfolio based upon admiration alone. Rather our position is anchored to value. When attractively priced we've done well buying it.

Cimpress (CMPR)

Cimpress is a tale of two businesses: Vistaprint, and everything else. Vistaprint is a gem of a business with fantastic economics and a growing base of loyal customers. Its dominant market position (10 times larger than its closest competitor) and huge scale advantages have produced unmatched low costs and leading mindshare among small business owners. Vistaprint's core products are custom marketing materials—the face of a small business—at low price points, providing stability in most economic environments. Our ongoing research suggests that Vistaprint's competitive moat is widening; a trend we think will continue in the future.

The balance of CMPR is led by the Upload and Print (U&P) segment. CMPR's aggressive foray into the U&P space (having spent over $550 million on 7 acquisitions since 2014) is part of management's vision to create a Mass Customization Platform (MCP) that serves the marketing needs of a broader segment of small businesses worldwide. This vision entails a full-throttle capital spending program aimed across the company to build out the platform. And while the ambitious project carries payoff potential down the road, it also entails risks. The main risks are two-fold: one, an overly-aggressive capital spending program that fails to deliver adequate returns, and two, integration issues that alienate customers (quality control problems, order routing, late deliveries, etc.).

While it's still early, recent U&P results underscore our growing concern that capital allocation may fall short of expectations. The torrential pace of spending has seen debt grow to over $800

million (pushing the top end of debt covenants) due to a flurry of acquisitions and organic investments. This raises risk and reduces flexibility to opportunistically buyback shares—a favored option that's produced great results in the past. We hope the U&P adventure doesn't result in a lesson in "diworsification" as acquisitions fail to measure up to Vistaprint's standards.

Our somewhat cautious tone shouldn't be misconstrued: CMPR is still our second largest holding and we think the good qualities outweigh the risks that we highlighted. If capital allocation meets management's hurdles, and MCP is successful, shareholders will do well. If not, we feel our downside is limited.

Leucadia National (LUK)

Leucadia gives off the *impression* of a bad abstract painting: it's hard to describe and easy to dislike. Its disjointed make-up has caused bewilderment among Arlington followers, from our brokers to LPs—not necessarily a bad sign to a fund manager interested in buying undervalued securities. While LUK may cause confusion to outsiders, the appeal to us is simple: it's safe, cheap, and conservatively run by an owner-oriented management team that's focused on creating long-term value.

For over three decades LUK has displayed a conservative, yet opportunistic culture, that's been focused on sensibly allocating capital and creating wealth for shareholders. We think this culture has a long shelf life and believe the carrying value of its businesses (the book value), understates the intrinsic value of the company. A small example in LUK's 2016 annual report highlights Conwed, which recently sold for $295 million (with potential for $40 million in earn outs) versus the $101 million it was carried on the books. We think this example is a microcosm that applies to LUK in total.

While many of LUK's subsidiaries have struggled over the last few years (green shoots can be seen at National Beef and Jefferies), we think the challenges will prove to be temporary. Over time we're confident that the stock price will reflect LUK's intrinsic value and provide satisfactory returns to shareholders.

CLOSING

Arlington hit several milestones in 2016. Midway through the year Ben and I made the decision to close the fund to outside capital at year end (assets under management equal roughly $1.2 billion). Additionally, we hired Peter Lawrence to assist me in research (our first official hire since inception).

The two decisions were somewhat related, as closing the fund to outside capital allows me to work closely with Peter and focus on research, unencumbered by time-consuming marketing meetings. Further variables affected our decision as well: we have a growing cash pile and a

trickle of ideas; conservatively closing at a small size (huge assets drag down returns) is reciprocation for your trust in Arlington; and both Ben and I gain enormous satisfaction from adding value to partners and feel a smaller asset base increases the odds of producing solid future returns. We'd prefer to be among the best, rather than the biggest.

In this regard, we think Peter Lawrence will help us achieve our goals. As I mentioned in my October note, I met Peter a few years ago in NYC and have grown to appreciate his intellect and energy (plus he's a NY Rangers fan). Even before he was hired, Peter has consistently shown that he takes the high road by giving more than he gets. He's a good fit and we're happy that he agreed to join us.

While our atypical ideas and policies have not made for a fast or smooth ride, they have helped attract compatible partners, which has made the journey enormously satisfying. We've always held to the business motto of building a house we want to live in. We can't reiterate enough how grateful we are to our fantastic Limited Partners. You have helped us build a business that we love coming to work for each day, and you provide a huge advantage in our pursuit to invest intelligently (even if unconventionally) over the long-term.

And finally, hedge funds were frequently in the news this past year, having earned heaps of bad press for atrocious results. Hedge fund returns have dramatically underperformed for years. And while we're largely considered a hedge fund (even though we don't hedge) we're happy to cap assets to help ensure that the shingle outside our office door never mimics the industry's slogan: *Come for the underperformance, stay for the high fees!*

I look forward to reporting to you again next year.

Sincerely,

Allan Mecham

The information contained herein is a reflection of the opinions of Arlington Value Capital (Arlington) as of the date of publication, and is subject to change without notice at any time subsequent to the date of issue. Arlington does not represent that any opinion or projection will be realized. All the information provided is for informational purposes only and should not be considered as investment advice or a recommendation to purchase or sell any specific security. While it is believed that the information presented herein is reliable, no representation or warranty is made concerning the accuracy of any data presented. This communication is confidential and may not be reproduced without Arlington's prior written consent.

This letter discusses only certain specific investments or holdings during the time period covered. For a full list of the securities investments and holdings in Arlington's investment vehicles, see Arlington's Schedule 13F filings made with the SEC (available at www.sec.gov).

Indices are provided as market indicators only. It should not be assumed that holdings, volatility or management style of any Arlington investment vehicle will, or is intended to, resemble that of the mentioned indices. The comparison of this performance data to a single market index or other index is imperfect because the former may contain options and other derivative securities, may include margin trading and other leverage, and may not be as diversified as the S&P 500 Index or other indices. Index returns supplied by various sources are believed to be accurate and reliable.

Past performance is not indicative of future performance. Inherent in any investment is the possibility of loss.

This performance reporting is not an offer to sell or a solicitation of an offer to buy an interest in any Arlington investment vehicle. Such an offer may only be made after you receive the investment vehicle's Confidential Offering Memorandum and have had the opportunity to review its contents. This reporting does not include certain information that should be considered relevant to an investment in Arlington's investment vehicles, including, but not limited to, significant risk factors and complex tax considerations. For more information, please refer to the appropriate Memorandum and read it carefully before you invest.