



Monday, April 17, 2017

Dear Investors,

For the quarter ending March 31, 2017, the core portfolio was down 2.25% net of all fees and expenses compared to +6.91% for the MSCI All Cap World Index.¹ Since inception in June 2016 through the end of the first quarter 2017, the core portfolio has returned 17.11% vs. 13.45% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on initial investment date.

Given the current positive mood of the markets and economy, the underperformance during Q1 is disappointing. However, it is important to remember that the portfolio, at large, is still very much in its infancy. For example, CNXC, at ten months, is the oldest position in the portfolio. As a result, our positions, thus far, have lacked the opportunity to benefit from one of our primary strengths: a long-term perspective. Additionally, while overall economic sentiment data has been overwhelmingly positive; hard, financial data has been middling, which helps shed light on our performance this past quarter.

Driven primarily by the prospect of a business friendly political environment, the first quarter of 2017 began with bullish exuberance and an unleashing of so-called “animal spirits.”² The unleashed “animal spirits” have been quantified and evaluated via survey-based economic measures, for example ISM Purchasing Managers, one of the most well-known Purchasing Manger indices. At the end of March, the ISM was at its highest level since October of 2014. Other well-known indicators such as consumer confidence, as measured by organizations such as The Conference Board, estimate consumers have not been as confident as they are now since December 2000.

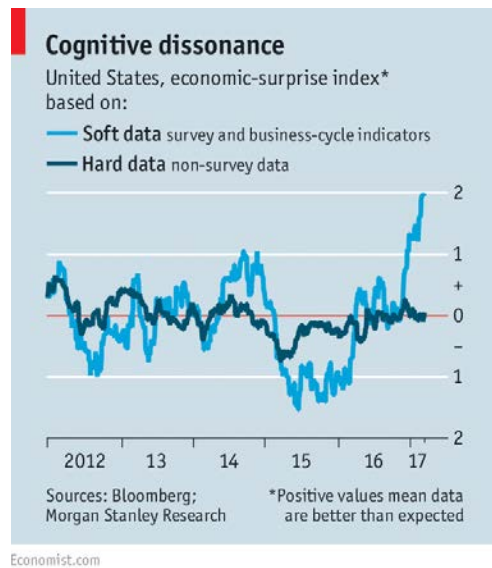
Two recently published market commentaries, one from John Hussman of *Hussman Funds* and one by *The Economist*, help shed light on the issues of soft economic data vs. hard financial data.³ As Mr. Hussman notes in his analysis, such measures have historically not correlated with future economic and

¹ In previous letters, we compared results to the S&P 500. Because the composition of the portfolio differs dramatically from the S&P 500, going forward, all comparisons will be to the MSCI All Cap World Index.

² There has been much said about the resurgence of “animal spirits” in the US economy since Trumps election. The phrase is usually attributed to John Maynard Keynes. It is worth noting that Keynes argued for the essential nature of “animal spirits” in a growing economy, but also believed that “animal spirits” were just a spontaneous burst of societal optimism. In essence, “animal spirits” are a national delusion, that may occur at times when “fears of loss may have a basis no more reasonable than hopes of profit.” (John Maynard Keynes, *General Theory of Employment, Interest and Money*)

³ Hussman Funds Commentary: [Echo Chamber](#) (April 10th, 2017). The Economist: [Eyes Bigger Than Their Wallets](#) (April 8th, 2017)

market returns. The 5-year rolling correlation of sentiment survey results with actual economic results is roughly zero, suggesting no relationship. One might say that sentiment indicators are just noise, the colloquial term in statistics for data with no informational value.



Although I am skeptical of sentiment, this characterization of sentiment is likely taking it too far. As with everything related to investing, reality is far more complex than a simple analysis suggests. Although the soft indicators should be read with great caution, people/companies are “responsive to a kind word,” as John Maynard Keynes noted. Outcomes will be affected by expectations, although it is unlikely that expectations will determine outcomes alone. Expectations do represent the prevailing bias, and as the chart to the left from the Economist suggests, the prevailing bias is positive, even if that positivity is overdone and not supported by underlying fundamentals.

For our portfolio, this means continuing our cautious accumulation of undervalued equities. My preference would be for panicked or depressed sentiment, but I will not wait for such a situation to buy. Timing the market is a rare talent, and I have no evidence that I possess it, as such I don’t attempt it. Instead I seek to accumulate at all times, through careful selection, a portfolio of assets acquired because of their cheapness in relation to their probable and potential intrinsic value.

Timing the market is an attempt to read investor sentiment, which is a fickle thing, and subject to change for any numbers of reasons. Marine Le Pen could win the French Presidential elections and threaten a French exit from the EU; Brexit could progress poorly; Russia and the US may fail to reach a détente; China may experience political upheaval; or any number of possible missteps by the Republican party attempting to pursue their policy agenda could occur. With any of these events, a dramatic and swift change in sentiment could follow.

Unlike investor sentiment, valuation does correlate strongly with future market returns, although not necessarily the returns of the economy: the stock market and the economy do not necessarily run together. Furthermore, valuation is not prone to dramatic short-term changes. As such, both valuation and a long-term perspective serve as the foundation of all the portfolio’s current and future investments. When the market is being guided higher by sentiment, rather than business fundamentals, as in the quarter that just ended, the portfolio will likely trail the broader market. At the same time, the focus on value means our portfolio returns will be tied to the businesses I invest in more than the mercurial feelings of the investing public.

New Positions

In the first quarter, two new positions were added to the portfolio: Barnes and Nobles Education (BNED) and Lucara Diamonds (LUC on the Toronto Stock Exchange).

BNED: Barnes and Nobles Education is a spin-off from Barnes and Nobles focused exclusively on the college/university bookstores. The company runs approximately 751 brick and mortar, campus

bookstores and about as many digital only college bookstores. The market is well structured for consolidation and growth, with roughly half of US colleges and universities responsible for running their own bookstores. Additionally, BNED only has only one competitor in the space: Follett, which is privately held and runs 1,200 campus bookstores. The campus bookstore business is facing difficult times as a result of declining student admissions and continued belief that books, and textbooks in particular, are going to be revolutionized into extinction by technology. That has not yet come to pass and it is unclear if it ever will.

LUC: Lucara Diamonds is a Canadian Diamond mining company with operations in Botswana. The firm has been producing diamonds from its Karowe mine since 2013 and has generated impressive returns every year since. This is a result of the steady stream of unique and exceptional diamonds the mine produces. Like BNED, the industry is well structured for returns with limited competition and tight control of supply by larger producers De Beers and Alrosa (a Russian Diamond Miner). Lucara is the fifth mining firm Massif Capital has invested in. To date, our mining investments have produced an average return of 54%.

Additional Portfolio Commentary

Unfortunately, the biggest movers in the portfolio in the first quarter were all to the downside. Two positions, in particular, contributed to our below average results: Och-Ziff (OZM) and Nevsun (NSU).

OZM: There are few things as maligned these days as active financial management. Och-Ziff suffers from not only the current trend against active management, but also a recent investment scandal involving bribery in Africa. In both cases, I believe the market has over done it. The trend towards passive investment and factor investing (a related shift in investment style currently underway at large institutional investors) is the result of a belief that both will be reliable and safe approaches to achieving better returns. Like many “sure-fire” paths to successful investing have in the past, these two in vogue approaches will prove less than they are claimed to be.

As a result of the confluence of events, OZM has experienced a meaningful reduction in assets under management and a hit to cash flow in the form of a SEC fine. Furthermore, the market has decided it has a distaste for the high degree of exposure that OZM has to “low quality revenue” (revenue generated via performance fees as opposed to management fees.) There is no question that this is a challenging investment. Returns made and assets under management are both highly unknowable and the primary drivers of OZM performance. Still, paths to improvement in both categories are numerous. A continued deterioration in the business is possible, as is always the case, but at current prices, most negative outcomes have already been priced into the stock.

Historically, OZM has returned 90% of its distributable earnings every year to shareholders. Should that trend continue, as it did in the fourth quarter of last year, it is not unreasonable to expect distributable income of between \$0.30 and \$0.50 a share, a yield of between 10% and 17% at our average purchase price.

NSU: Nevsun is currently the portfolio’s largest single position, and one we expect to grow over time. The Vancouver-based copper-gold-zinc miner has a single operating mine in Eritrea (a country on the east coast of Africa), and a development project in Serbia. Management has proven themselves to be

exceptionally skilled at executing mine development ahead of schedule and under budget, as well as thoughtful and deliberate capital allocators.

At the current time, the position is down roughly 10%. A confluence of two events is to blame for the fall in stock price (although the causality of short term price action is notoriously random). First, the company has historically paid a small dividend. This year, despite good 2016 results, the firm decided to cut the dividend so as to have more free cash flow from operations available to invest in expansion projects. Management's other option would have been to take on debt to finance expansion. Some may view this decision negatively; I believe it demonstrates management's focus on building a good business in the long-term rather than on short-term market returns. The decision has also preserved a pristine balance sheet that will serve as a solid redoubt should need arise.

A second ongoing issue has to do with the refinement of complex ore currently mined from the Bisha Mine in Eritrea. The ore, which has high grades of copper and zinc, has proven difficult to refine into pure copper and zinc concentrates. The firm continues to study the chemical composition of the ore and work to retool the refining process, but at the current time the firm is selling bulk ore concentrate, ore concentrate with high grades of both copper and zinc that does not fetch as much in the market as single-element-ore. Updates on the company's efforts to address the issue are expected toward the end of this month. A positive resolution of this matter would produce a nice boost to both the top and bottom lines.

Nevsun is a high conviction position within our portfolio and will likely have a long life. I believe it is reasonable to assume we will maintain a position in the firm for at least five to seven years.

The Next Three-Quarters

Going forward this year, I expect to continue adding to existing positions if/when favorable prices allow. Additionally, I plan to keep adding new positions to the portfolio when I find situations where the risk/return profile is in our favor, which is an increasingly difficult proposition as the market goes higher. Currently, I am looking at a Japanese industrial manufacturing company; overlooked oil and natural gas opportunities globally; and short targets in the US market, the quest for which seems to regularly bring me into contact with the telecoms sector.

I will suggest one book I read this past quarter to Massif Capital investors; that book is [*Concentrated Investing: Strategies of the World's Greatest Concentrated Value Investors*](#). In addition to being an excellent review of the strengths and weaknesses of a concentrated portfolio, the authors have written highly amusing anecdotes about the investors profiled, most of whom were extensively interviewed by the authors. As always, I am grateful for the confidence my investors have shown in me, and I endeavor to earn it via strong long-term returns. If you have any questions or concerns, I am always available via phone or e-mail.

Best Regards,

Will Thomson