Q1 2018 Partnership Letter

Dear Partners,

One of the clear themes dominating markets of late has been the United States flexing its economic muscles – and the market isn't a fan of the show. This all began with seemingly harmless primary and presidential election campaign rhetoric about unfair trade practices that were harming United States workers. The rhetoric escalated to action following the election, when there was immediate demand to amend NAFTA to re-balance trade conditions in the United States' favor. This NAFTA re-write was a small step (at least globally) to carrying out a campaign promise to implement protectionist trade policies. Interestingly, while Canada and Mexico took note, since they were the proverbial target, global markets didn't seem to mind. The MSCI World Index rose 10.1% between the announcement of NAFTA re-negotiations and the more recently announced global trade measures.

The market's nonchalant demeanor quickly changed when it was announced that tariffs would be placed on steel and aluminum from all countries, regardless of their relationship status with the United States. While a few countries would eventually be excluded, the message was clear: a pronounced shift from tough talk to tough action was unfolding.

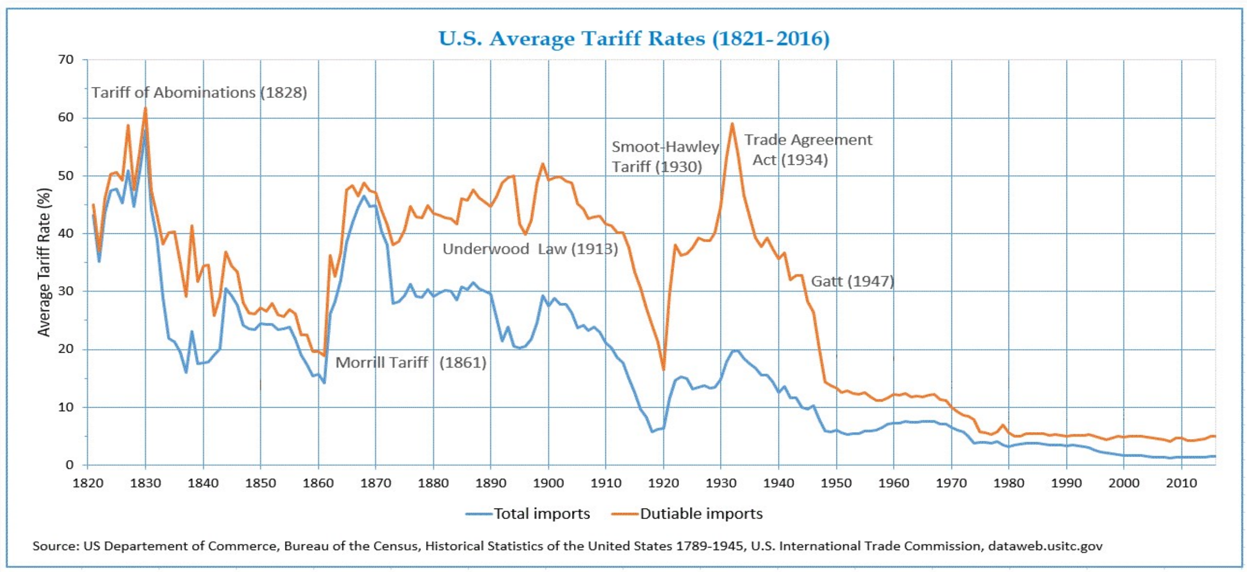
It wasn't long before China became the primary focus of President Trump's ire, when he threatened to apply tariffs on a broad basket of goods and services equating to $150 billion, or 31% of total Chinese imports to the United States. China responded with $50 billion of their own tariffs – coincidentally, 29% of their imports from the United States. A potential trade war between these two economic powerhouses is creating consternation in the markets. The negative reaction is for two reasons (1) the opaqueness of the tariff-setting process and (2) the United States is no longer afraid to directly target China.

Internally, we've been opining on this new approach to trade relations in the era of globalization. For market-moving events like this one, we like to take an analytical approach to place the potential economic impact into context. We do this because it helps us distinguish whether the event is cause for concern or typical market noise.

In this instance, we identified that the tariff announcements the United States has made only applies to 5.2% of United States imports – and 0.7% of the $20.8 trillion in annual global trade. China's $50 billion response represented tariffs on an additional 0.2% of global trade. When we consider that the announced trade dispute with China represents only 1% of global trade, it's hard to succumb to the market's notion that we're in the midst of a global trade war.

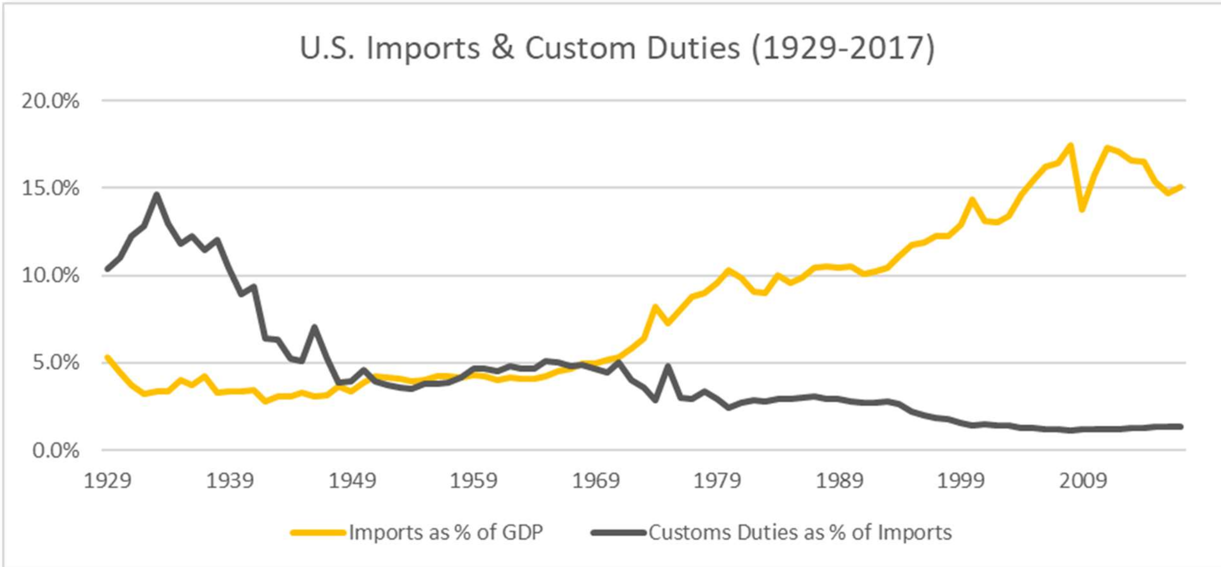
The question on everyone's mind is whether these protectionist policies escalate in frequency and impact – especially as it relates to the United States' trade relationship with China. For a point of reference, let's take a walk down memory lane to the most infamous protectionist period in United States history, the 1930's, when the Smoot-Hawley Tariff Act was drafted into legislation. Following years of economic despair, caused by the Great Depression, legislators thought that protectionism in the form of tariffs would benefit the American people. History would show that they were incorrect. The Act is widely thought to have unnecessarily exacerbated the Great Depression, instead of fixing it, which is why the era is forever etched into economists' psyche[1].

One distinction between then and now is the absolute level of tariff rates and their impact on the United States economy. For instance, shortly after the Smoot-Hawley Tariff was enacted, the United States' average Tariff Rate jumped to being just shy of 60%. While this indicated a high level of protectionism in the United States at the time, those figures alone don't capture the impact it would have had on the economy. To grasp this, we must also consider the total level of tariffs relative to all imports (not all items imported had a tariff applied to them) and how meaningful imports were to the economy.



In 1929, imports amounted to only 5% of GDP. However, high tariff rates meant customs duties amounted to over 10% of imports. Fast forward to today and the economic significance of imports has increased to 15% of GDP, but steady enactment of free trade agreements has since diminished the impact of customs duties to only 1.3% of imports. The combination of these evolving trade dynamics has reduced the impact of tariffs on the economy by 64%. While we'd agree that this may be an overly simplistic approach to understanding how higher tariffs might impact economic growth, we would argue that it is abundantly clear we're far from the most protectionist extremes in United States history.

[1] Reed Smoot and Willis Hawley, two republicans endearingly named the "bogeymen of trade", were both defeated in the first election following the passing of the Smoot-Hawley Tariff Act



Source: Federal Reserve Bank of St. Louis

Unfortunately, some of the United States' trading partners cannot make similar claims. Herein lies the rub. While most developed countries steadily opened their doors to trade, key developing nations have continued to protect their economies from competition through currency manipulation, tariffs, local ownership limitations and indirect (or direct) government subsidies and interventions. Until now, the United States and others left these unfair trade barriers largely unchecked – and rightly so. The goal was (and should be) to grow the size of the global economic pie instead of just taking a larger slice of it. This system works well until a country is believed to be taking advantage of the generous trade terms.

China is one country that has aggressively used their classification as a developing nation to maintain unfair trade practices in order to grow to be the world's second-largest economy. And their growth is far from over: China's GDP per capita is a mere $8,123 as opposed to the United States' $57,628. This disguises China's economic size – $11.2 trillion – but not its potential. The country is growing at about 7% per annum. At this rate, its economy will surpass the United States' $18.6 trillion worth of economic might in less than 11 years[2]. In practical terms, this suggests to us that there is limited time before America's economic negotiating leverage is greatly diminished, which will leave China in position to manage their economy completely unencumbered by long-standing global trade rules.

While the market is projecting that a trade war with China is undesirable, we're less certain. Our uncertainty stems from the economic benefits of globalization that may be realized if the United States can use the threat of a trade war to bring China to the negotiating table. It's here that a more reciprocal relationship can be established through the opening of China's economy to foreign investors and the requirement that they aggressively protect company patents, technology and trade secrets. We understand that what we're suggesting is counterintuitive – that the threat of a trade war may eventually lead to improved globalization. However, it's this logic, along with placing the tariff spat into historical context, which gives us comfort that the volatility it's created in the markets

[2] We presume that China will continue to grow at approximately 7% while the United States progresses at 2%

should be viewed as an opportunity to invest in select securities instead of a risk that should be broadly avoided.

Introducing Embedded Catalysts

The market value of our IBV Capital Global Value Fund decreased by 3% in the first quarter of 2018. Importantly, the intrinsic value[3] of our portfolio advanced 8.7% during the quarter. For comparative purposes, during the first quarter of 2018, the MSCI World Index decreased by 1.3%.[4]

Throughout the past year we spent much of our time exploring opportunities that were interesting, but not attractively valued enough for us to move forward with an investment. Over the course of the last few months, as volatility has heightened, we have found ourselves to be very active buyers of these opportunities – adding five new positions to the portfolio. These investments bring the total number of names we hold in the fund to 15.

What's distinct about the five new names is they each contain embedded catalysts (turnarounds, spin-offs, aggressive share repurchases, and hidden contractual obligations) that will unlock value over the next few years. This indicates to us that their returns will to some extent be idiosyncratic as opposed to market-driven. Considering market valuation multiples are at historically elevated levels, this will become a valuable and important return characteristic for us.

As market valuations have outpaced earnings growth (known as multiples expansion) we've become increasingly concerned about the market's ability to generate the future investment returns that investors are becoming accustomed to. We suspect that realizing attractive returns in a passive way will become exceptionally difficult. Instead, to generate returns, it will require relentless sleuthing to find new ideas, deep due diligence to uncover value, and in some instances active involvement to realize an investment's full potential. We're up to the task on all fronts.

As you may recall, we have been strategically building our cash position to address our concerns over elevated valuation levels. This has resulted in us holding more than our usual level of cash going into 2018 – 33.8% to be precise. By the end of the first quarter, our cash position was reduced to 18.6% as a result of our new investments. Historically, when we've used cash to invest in undervalued securities our intrinsic value gap has widened, and our portfolio begins to experience more pronounced changes to its day-to-day market value. We expect this to be the case again. Year to date, we've seen an increase in the intrinsic value of our portfolio and the market value of our portfolio has declined. This means the gap between the intrinsic value of our portfolio – what we think our portfolio is worth – and the market value of our portfolio widened to 55.9%.

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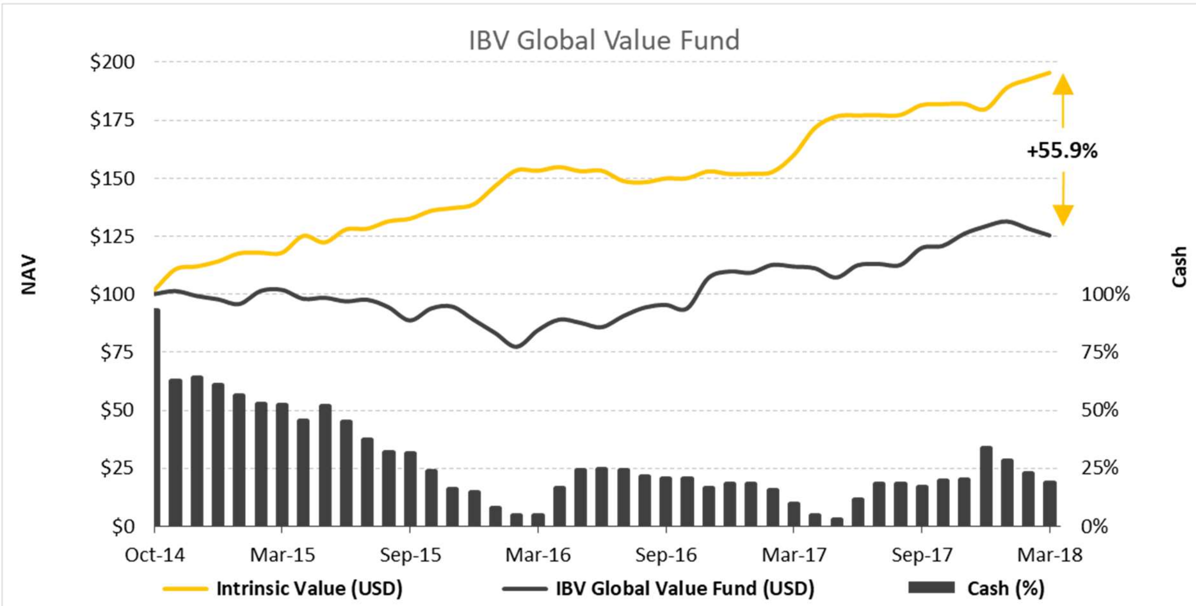
[3] We would encourage all new readers to visit the "Our Liquid Conglomerate" section of our Q2-2016 investment letter to assist them in understanding the meaning and importance of our portfolio's intrinsic value.
[4] "IBV Global Value Fund" consist of USD$ IBV Capital Global Value Fund LP Class M unit returns, gross of fees. Inception date of this class is October 1, 2014. "Portfolio Intrinsic Value" represents IBV's internally calculated intrinsic value for the cumulative securities within the IBV Global Value Fund. "MSCI World Index" is based on the USD$ returns MSCI World Free NR Index. Full investment disclosures are found on Page 8.



Naturally, as our portfolio shifts from cash, an asset with price stability (unless you consider Bitcoin to be cash[5]), to securities with variable market values, our portfolio's market volatility will increase. Since our latest investments are unloved, we would expect them to be even more susceptible to wider valuation swings than usual. As we perform these tactical investment allocations the probability our portfolio gets incrementally more volatile is heightened. This is a reality we should all be quite comfortable with by now – and emphasizes the importance of closely monitoring our portfolio's intrinsic value as opposed to its market value.

<u>Moving, Fast and Slow</u>

We recently disclosed our stake in Ascendant Group, a company that trades on the Bermuda Stock Exchange and owns Bermuda Electric Light Company (BELCO) – Bermuda's sole integrated electric utility. We've since seen the initial phases of our investment thesis come to fruition at a faster-than-anticipated pace.

In March, Bermuda's Regulatory Authority authorized BELCO's proposal to replace its aging generation facility and begin preparing for the adoption of renewable energy. This announcement solidifies our growth expectations for the company.

Shortly thereafter, the regulator released a proposed retail tariff design methodology for public consultation. This is an exceptionally important piece of regulation as it will dictate how electricity rates will be set in the future. It also represents a critical step forward in the path to a sophisticated regulatory environment. For shareholders, the rate methodology represents the pièce de résistance of our investment in Ascendant Group because it will determine BELCO's profit model for years to come.

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[5] We do not own any Bitcoin!

During the early days of our analysis on BELCO, we identified all the rate-setting methodologies the regulator had available to choose from, and determined that a return-on-rate base model would be both most appropriate and highly likely. This conclusion was driven by two realities: (1) the persistent lack of competition that exists on the island, a by-product of the small size of the electricity market, and (2) the need to secure an investment grade credit rating so market participants could cheaply finance future capital expenditure programs. It's now clear that our assessment was accurate. The regulator has proposed a move to a return-on-rate base model for BELCO's Transmission, Distribution and Retail businesses and Power Purchase Agreements for bulk generators.

Once adopted, it will mean that BELCO's profitability will be based on the size of its rate base (roughly its property plant and equipment plus elements of working capital) and the cost of capital associated with an appropriate capital structure. Since much of BELCO's infrastructure needs replacing and has been depreciated off its balance sheet, we expect to see the company's rate base grow in the years to come. With electricity rates being set using a return-on-rate base methodology, the company will now have the ability to finance this growth with debt instead of equity, as it has in the past. We're very pleased by these two developments and look forward to continued momentum on other value-creating initiatives.

While Ascendant Group's pace-to-value creation has hastened, we expect our position in Advance Auto Parts (AAP) to take some time to bear fruit. AAP is a leading automotive aftermarket parts provider in North America that serves both professional mechanics and do-it-yourself consumers through its 5,100-plus corporate stores and 1,300 independently owned Carquest branded stores.

We learned of AAP during the analysis we were conducting on the retail space throughout 2017. As we've stated in the past, when the investment community gets as negative on a sector as it did with retail in 2017, opportunities usually emerge, and AAP was one of them. To begin, we took to analyzing the company and its competitors – O'Reilly Auto Parts and NAPA Automotive Parts Association (owned by Genuine Parts Company). What we determined during this process was that the aftermarket auto parts distribution business has great economics and sound underlying fundamentals.

We also uncovered some specific AAP investment attributes that warranted additional attention. For instance, a comparison of AAP's operating margin relative to its public peers painted a vivid picture of inefficiencies. When we visited the management team at AAP's Raleigh, North Carolina head office to ask questions and tour their local store and distribution center, the inefficiencies were quite evident.

For instance, they had a store just a few miles down the road from the distribution center next to their headquarters that was being stocked by another distribution center that was over 100 miles away – and management was open about this not being an isolated incident. We were awestruck by the complete lack of supply chain efficiency. However, we were encouraged by the seemingly endless low-hanging fruit management would be able to pick from to make improvements. This discovery is exactly why we conduct road trips to visit facilities and meeting management teams. We would never have understood the company's challenges or potential sitting behind our desk reading their annual reports.

It's safe to say AAP's broken operating system is the outcome of a multi-year acquisition campaign by the old management team to build a national presence. By expanding through acquisition instead of growing organically through new store builds, two problems have emerged. First, previous management completed little, if any, integration of the disparate regional players they were purchasing. Second, their acquired distribution centers were not all ideally placed within their entire store system and were often clustered near existing distribution centers.

The new management team, led by former Frito-Lay North America President and CEO Tom Greco, have already identified areas of improvement such as overhead cost-cutting efforts to boost operating margins, optimizing their real estate footprint and overhauling their working capital levels. We see these as great opportunities to enhance operating margins, free cash flows, and return on invested capital. However, as an operationally minded shareholder, we appreciate that this will be a multi-year process with benefits that will come in fits and starts as every facet of the company is overhauled.

The largest headwind will come in the form of maintaining a happy customer base, something that has already proven to be difficult. Same-store sales growth, a widely followed Wall Street metric for the industry (and retailers in general) has fallen behind their peers. We're optimistic that the changes they are making will improve delivery speeds for current SKUs and allow them to make more SKUs immediately available. This should lead to happier customers and sales growth rates that gravitate back toward their peer group. Should we be accurate about this and the other elements of their turnaround, this will work out to be a wonderful investment.

Best in Class

We hope by now it's clear that the last few months have been about deploying a portion of the cash we've been strategically accumulating into very select investment opportunities. This has left us with many new positions that hold remarkable promise. When coupled with the gradual realization of our investment theses on some of our large legacy holdings, we are increasingly encouraged by the risk dynamics and return potential of our entire portfolio over the next few years.

As we build on the pleasing performance we've enjoyed over the last few years, please know that our performance success is directly attributable to having knowledgeable and steadfast investment partners. We're eternally grateful for having the best investment partners in the business!

Sincerely,

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