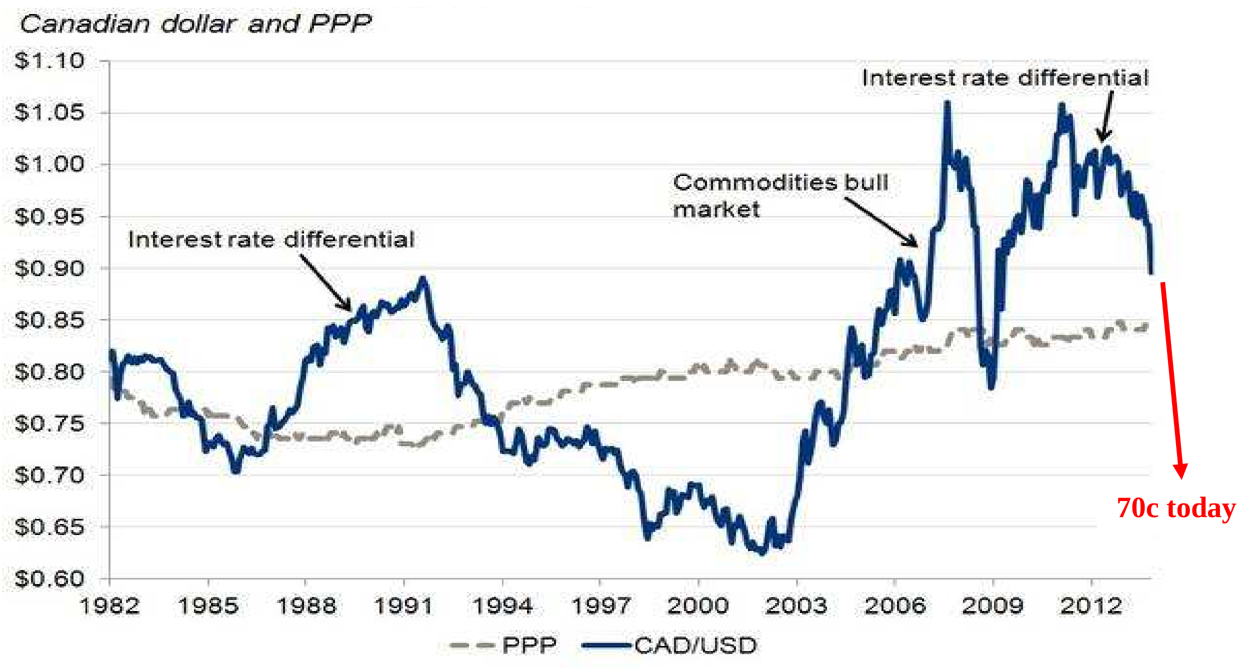
Eschler Asset Management LLP

Eschler Recovery Fund SP
www.eschlerasset.com

Dear Partners,

Eschler Recovery Fund ("ERF") NAV fell 16.2% in 2015 to 97.32. Over Christmas I found myself watching the Top Gear special where Jeremy Clarkson, James May and Richard Hammond drive V8 sports cars down the length of Patagonia. Richard's Ford Mustang Mach 1 is a well-designed car capable of fast speeds but initially succumbs to costly problems with steering and a fuel tank leak. ERF shares some characteristics with that car! The good news is that the car ultimately traverses 1600 miles across often treacherous terrain reaching its destination of Ushuaia in Tierra del Fuego, the southernmost city in the world. Minor mechanical flaws after the first few miles on the Patagonian plains did not stop that car from traversing the foothills of the Andes later on. Since it feels like the depths of 2008 at Eschler Asset Management right now, I find solace in focusing my gaze on the journey ahead.

Clearly if ERF was denominated in Argentine Pesos –indeed *any* currency other than the U.S. dollar—returns would look a whole lot better these days. It is one lucky country, America, who can triple its federal debt to 100% of GDP over 15 years from fiscal 2000 with the result that the interest rate it pays to service that debt falls by 2/3! But if gold's 10.7% annualized USD return over the past 15 years is anything to go by, there is no free lunch despite *recent* U.S. Dollar strength. Many other fiat currencies have already resumed their descent in Gold terms, and my view is the U.S. Dollar is not far behind. ERF has large exposure to gold equities listed in Canada and I removed the remaining currency hedge late last year. Purchasing power parity for the Canadian Dollar is up at $85c so there has already been quite an overshoot. Meanwhile, the Canadian dollar is joined at the hip with oil, itself currently trading at $26 per barrel, little more than one-third its marginal cost of production.



http://www.theglobeandmail.com/report-on-business/the-loonie-and-purchasing-power-parity/article16641864/

It has been nothing short of excruciating to maintain such substantial unhedged non-U.S. Dollar exposure in ERF; but I am reasonably confident that speculators will discover quite soon that buying the U.S. Dollar with abandon is not a one-way bet.

Speaking of the year 2000 the current market sports some parallels. As a young salesman at Goldman Sachs in the late 1990s I saw the two-tier market up close, when no price was too high for big-cap growth stocks, while "old economy" stocks were on sale. In 2000, I remember reading "Cisco and the Kids", an article in the Financial Analysts Journal that detailed the absurd valuations in the TMT sector. But it was only later in 2002 that my eyes were really opened to value investing—*after* losing some money on the way down. I suspect that today's momentum investors in the FANGs and the Unicorns will also, to paraphrase Charles Mackay, recover their senses slowly, one by one. Another similarity between 2000 and today is the extent to which classic value investors seem to be struggling. Back then, value investors had their backs to the wall but were ultimately vindicated by strong forward returns in the early 2000s (if they survived the late 1990s). Today, managers with very strong long-term trackrecords such as FPA Capital, Permanent Portfolio, Longleaf Partners and Greenlight Capital, to name but a few, continue to struggle while indexers and trend-following machines reign supreme. Just two institutions, Vanguard and Blackrock, raked in $376bn between them for their index funds last year. The consensus is well encapsulated by this quote in Bloomberg by a Cass Business School professor: *"If your business model can't beat index trackers, then you've got trouble. If your business model is trying to compete against computers that can make decisions a billion times faster than humans and having taken in a billion times more information, then you are basically going to go the way of the dinosaurs."* Discouraging stuff.

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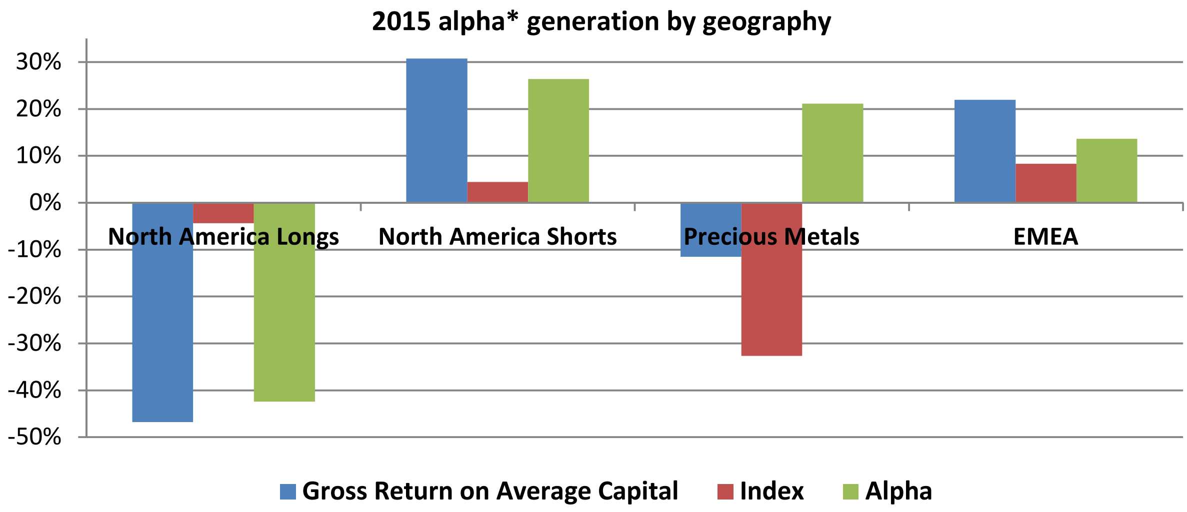
2015 Results

Despite the tough backdrop, it was not all doom and gloom in the portfolio last year. Allow me to point out a few positive aspects of 2015:

First, recall that last year I broke out ERF gross returns into four categories to show how the fund performed in each. As you can see in the updated chart* below, gross alpha was very strong in the short, EMEA and precious metals books.



*For this analysis I used gross returns for the numerator and average month-end capital employed by category for the denominator. For comparison purposes, I used the Value Line Arithmetic index total return for North America, the STOXX Europe 600 index total return for Europe and the Market Vectors Gold Miners ETF for the precious materials exposure.

Shorts that worked included concept stocks like Odyssey Marine, Organonovo and Textura. In EMEA I pitched 2 for 3 making a profit on UK-listed Mobile Streams and Vinaland, while Dolphin Capital Investors fell. Gold stocks that rose in a down market include Seabridge Gold, Sabina Gold & Silver and Endeavour Mining while losers included Silver Wheaton, Timmins Gold and Fortuna Silver Mines. Unfortunately, bad stockpicking in the North America category overwhelmed the positive contributions elsewhere. Three of the fund's top losers on the year were here: JG Wentworth, Avon Products and Horsehead Holding, though the fund did make a profit on Markel, Fairfax Financial and Leucadia. Given fund concentration, the sample size in the North America and EMEA long categories in any given period is very small so the gross alpha will fluctuate a lot and only take on real meaning over many years. However, the gold stock book tends to comprise 35-40 individual positions, and the short book 10-20 positions. I am gratified that in both these categories positive alpha has been consistent recently.

Second, readers keeping score will note that the holdings I showed in last year's letter (as of February 27th, 2015) would have fallen 33% annualized through year-end 2015 (on a position-weighted basis). The silver lining in this sordid statistic is that were it not for some reasonably well-timed buying and selling activity ERF's return might have been worse. What follows is a brief update on the activity during 2015 that made a challenging year a little less bad.

Mobile Streams Plc: Shares fell 33% on the year to 8.6p but ERF realized a 135% profit on average capital employed. As the company's market cap drifted below net cash I kept buying and was rewarded with a large gain in October half of which I crystallized at 20p. The company has launched subscription and ad-based gaming products with two of the three largest mobile operators in India where smartphone penetration has reached an inflection. Mobile Stream's edge is its carrier billing and relationships, a barrier to entry in markets like India where credit card billing is less prevalent. There is no need to get carried away but if they can even partially replicate the success they had in Argentina, India could be worth multiples of the current share price. With shares back at 7p the set up remains attractive as expansion in India is set to dominate the narrative. The position is 3.7% of NAV.

Chesapeake Energy: Having purchased the shares on October 15th 2014 at $17.8 I was lucky to exit at $15.2 five months later at a 15% loss. Shares fell 77% last year and are down by 1/3 again so far this year.

Avon Products: I doubled the position at $3 last November lowering average cost to $5.2. ERF lost 18.3% on the position last year including dividends received which was only 1/3 of the -54.9% total return for the shares. As it happens, Cerberus was happy to pay $5 a month later in December for 17% of the company. They get a preferred dividend but if they win, ERF wins. An activist investor group led by Barington Capital has also now deployed capital in the shares. It is true that current management inherited many challenges from the Andrea Jung era, not to mention gale-force external headwinds from a strengthening dollar. They have also cut debt, stabilized rep growth, broken even in North America and generated free cash flow last year. But the missing link was Board complacency, an SG&A to sales ratio much higher than the long-term average, and excessive management compensation. Cerberus and Barington Capital set the clock ticking for current management. I continue to believe the upside in Avon Products is considerable. The company has global, self-funding distribution comprised of 6 million women, *the largest salesforce in the world*. The current $1bn market cap values each distributor at a mere $167. In the event that internal change combines with multiple expansion, a revaluation of emerging markets, a resurgence of the value factor in the U.S. equity market, and financial leverage, upside could be downright combustible. For now, shares languish at $2.60 in a bad tape.

Markel: I first invested in September 2013 at $519 and cut the position in half seven months later at 642 realizing a 40% annualized return. I sold the other half primarily last July at an average $820. I have made the case for a much higher potential share price but at over 1.5x price to book the shares appear ahead of themselves and value is more palpable elsewhere.

Leucadia: I initiated a position in October 2014 at $21.9 and sold eight months later at $24.8 for a 20% annualized return. I went long LUK again one month ago at $17.70. At the current price around $16-$17 an investor only pays 1x price to book for Jefferies and receives a like amount of other assets, net of liabilities, for free. The current price to trailing book multiple for LUK of 0.55x-0.6x matches the low in the depths of November 2008. In the fullness of time I expect the current price to be viewed as a stunning bargain.

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Three-year Post-mortem (Oct 8th 2012 – Oct 31st 2015)

	ERF	40% HUI / 60% MSCI World	Excess Return	Gold Stocks (HUI)
2012	+8.05%	-4.68%	12.73%	-13.56%
2013	+0.42%	-15.58%	16.00%	-55.50%
2014	+7.00%	-2.56%	9.56%	-17.03%
2015	-4.50%	-8.38%	3.88%	-25.20%
Cumulative	+10.80%	-28.16%	+38.96%	-76.13%

In an initial three-year period when the Fund's long gold stock position averaged 35-40% of NAV I am pleased to have kept partners in the fund out of harm's way. After all, the gold stock index collapsed by 75-80%! In that time ERF NAV rose 11% compared to a fixed-weight index of 40% gold stocks and 60% MSCI World in USD that fell 28%. I am also pleased that 57% of the 139 discrete holdings over the first three years generated a positive return (hit rate). Within that, 46% of the 57 discrete ERF gold stock holdings (all longs) had positive returns while barely more than 1 out of 10 gold stocks in the universe rose during the three-year period.

Less satisfactory was ERF's "win rate" (average gain of winning holdings / average loss of losing holdings) of 0.91x, pulled down by a 0.75x win rate in the short book. Frankly, my risk management left something to be desired. For the deep-value, margin of safety strategy employed in ERF a stop-loss rule doesn't really fit. So how can I protect myself from myself? These simple rules should help to minimise future damage from runaway losing positions:

1) cover shorts after a 20% loss, no exceptions; until now I have only been capping the aggregate short book at 25% of NAV, paying too little attention to the losses in the individual positions.
2) stop adding to a long if the price falls below 15% of average cost, wait three months to re-visit;
3) cap equity positions in companies with junk-rated balance sheets at a maximum of 5% of NAV.
4) only invest in basic materials and energy-related businesses that are primarily equity-funded.

Had I had this epiphany several years ago your returns may have been higher.

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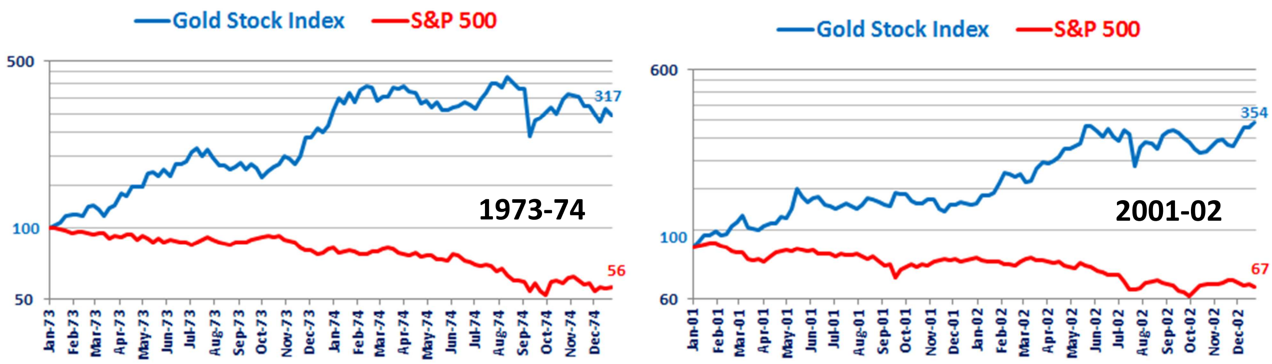
Strategy

It will be lost on nobody that I have a penchant for seeking out sound investments in *deeply* out-of-favour countries and industries. Doug Casey of Casey Research expresses this inclination of mine in his 2013 report, "*Crisis Investing in Cyprus*":

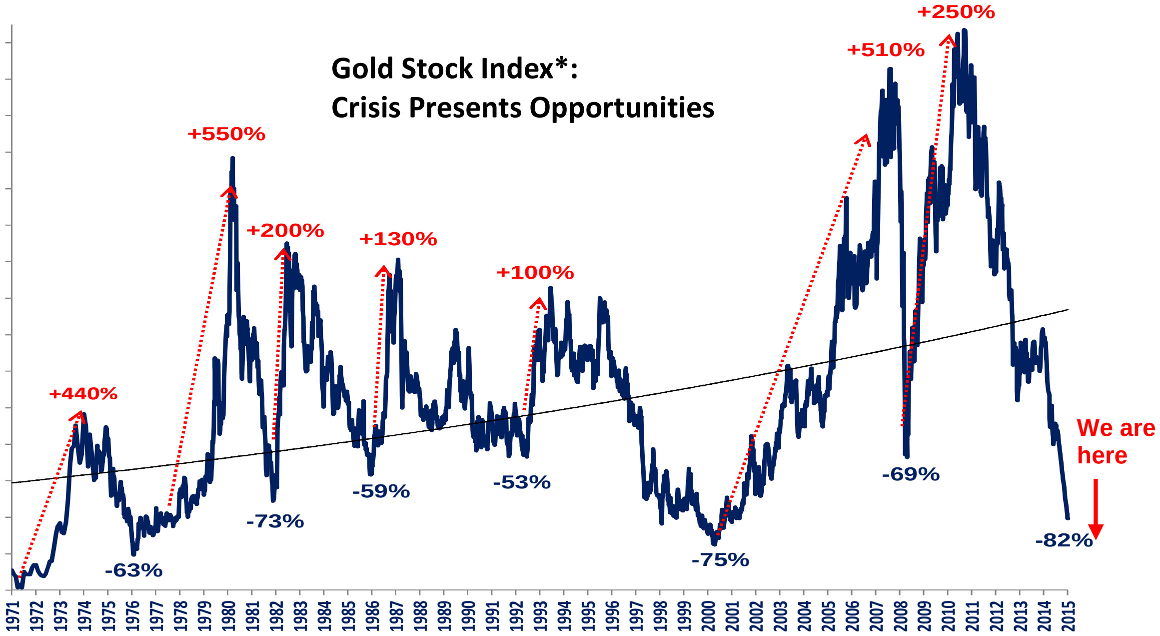
"*There are any number of intelligent approaches to profiting from stocks…we respect those approaches. But we prefer train wrecks. We're most attracted to fundamentally sound companies that have been beaten down by blood-in-the-streets macro factors. We like bargains that scream—stocks selling at severe discounts in shell-shocked markets*."

Obviously this approach comes with large drawdown and timing risk. Reliant as it is on reversion to the mean, such a deep value approach can even stay out of favour for years during certain market regimes. ERF's gold stock position is a case in point. Despite mostly deploying capital *after* a large two-year crash, here we are three years later with the sector down by another 60-70%. In last year's letter I described the rationale for a large holding in gold stocks and how I have constructed the holding. I suggested that this holding's return might have a lower than average correlation to the rest of the portfolio (pages 2-5 of 2014 letter). There is certainly precedent for large gold stock recoveries materializing *during* large bear markets in the S&P 500: In '73/'74 and '01/'02 gold stocks tripled off bear market lows while the S&P was cut in half.



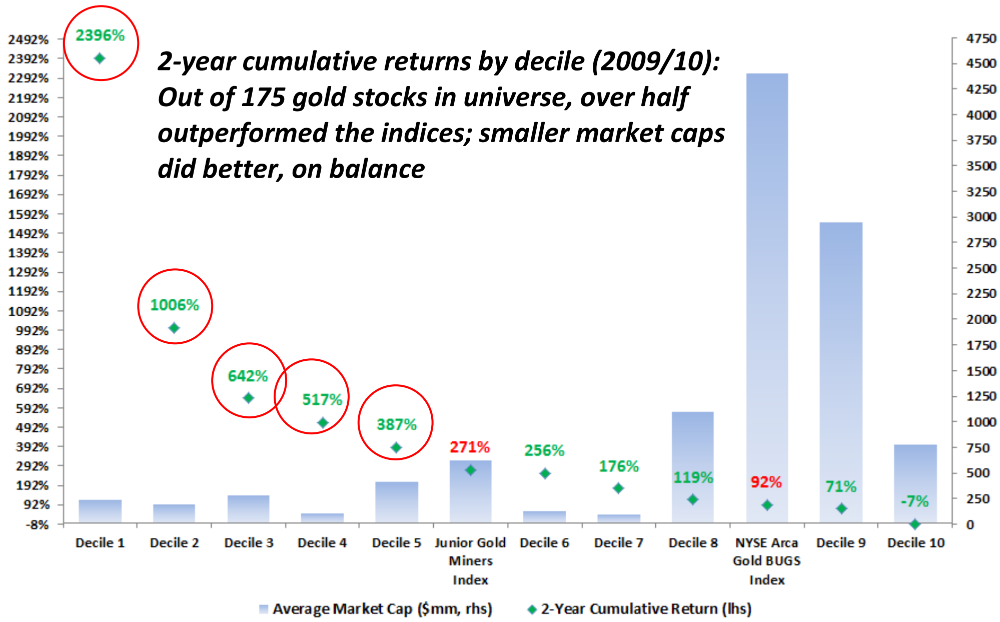
Source: Bloomberg

My analysis showed the current bear market was already materially larger (and longer!) than all but one of the five past episodes of the past 45 years implying cyclical upside of 3-4x, while a bear case could conceivably reach -83% peak to trough (matching the '96-'00 period) implying *another* 45% downside. Here we are 10 months later in late January 2016 and the sector has fallen *another* 40%. The junior gold sector is down 90% from the peak. To put it lightly, relying on any notion of reversion to the mean has been misguided in the current market. But this does not take away from the fact that prices today are at fire-sale levels that if history is a guide will, ultimately recovery spectacularly. I am also encouraged by signs of M&A (two ERF companies were taken over recently) and diverging performance with 20 out of 47 (43%) total ERF gold stock positions generating a positive return last year. Certain stronger stocks are breaking away from the pack reminiscent of the early 2000s bottoming process. Diesel prices and commodity currencies are down, providing relief to margins and project NPVs. With half of its capital deployed in this left-for-dead sector, ERF is positioned for recovery (and suffering mightily in the interim).



Several years ago at the Berkshire Hathaway annual meeting, Warren Buffett described the distinction between public "auction" markets that occasionally produce amazing bargains and private "negotiated" transactions (including IPOs and real estate) that never get that cheap. This stuck with me. He said almost anything can happen in "auction" financial markets. Despite huge money and brains committed to making money in junk bonds, for example, the downside volatility in junk bonds in 2002 was "extraordinary, astounding". Elements of this herd behaviour are on full display in the gold stock sector where we are now in the *sixth* year of consecutive negative returns. Guided by the concept above, I am treating lower gold stock prices as a big one-off auction not to be missed.

Understanding gold stock returns in up- and down-cycles is key. During down-cycles the smaller exploration companies with asset value but no current production have greater downside as all their value is in the future (like a zero coupon bond). The reverse is also true during upcycles. In the below chart** I show this concept. The chart shows cumulative return deciles for the gold stock universe during the most recent 2009-10 upcycle as well as average market cap in each return decile (the light blue bars). Notice how the higher return deciles greatly exceeded both the junior index and the large cap index.



*Source: Barron's Gold Mining Index, **Bloomberg

What this shows is that gold stock bull markets can be much more powerful than the large-cap indices imply. The key is to venture down the capitalization curve…and stay diversified! So, with many large or high-grade gold deposits trading for pennies on the dollar in the public market, I am employing a "land-grab" strategy. That is, I am investing in small-cap companies, ideally with high working capital relative to market cap, that own gigantic reserve bases whose value will only be capitalized at higher gold prices. I am also investing in later-stage development projects with very high grades which can deliver at current gold prices. Lastly, I am investing in royalty and streaming companies whose attractive business models, uniquely in the gold and silver industry, tend to compound value over the long-term. The goal is to outperform during the next upcycle. An example of each category follows.

Seabridge Gold

	2008 Low	Current	% Change
Share price	$7.03	$5.80	*-17%*
Market cap	$262	$292	*11%*
Debt-cash	-$32	-$4	*-86%*
Enterprise value	$231	$287	
Gold equivalent reserves	62	97	*56%*
Diluted shares outstanding	37.3	50.3	*35%*
EV per reserve ounce	$3.72	$2.96	*-20%*
Reserves per share	$1.66	$1.93	*16%*
Price to book	3.7x	1.4x	*-61%*

Reserves (in mm of ounces)	2008	Current	% Change
Inferred	20	34	*70%*
Measured & Indicated	42	16	*-62%*
Proven & Probable	0	47	*N/A*
Total	62	97	*56%*
Reserve Breakdown			
Inferred	32%	35%	
Measured & Indicated	68%	16%	
Proven & Probable	0%	48%	

Seabridge Gold is a development-stage gold company which owns the largest undeveloped, permitted gold mine in Canada (KSM) and 7th largest worldwide. With no sales or earnings, shares trade on resources in the ground which total 97 million gold-equivalent resource ounces, of which ~1/2 are in the proven & probable category. The mine life is 55-years averaging 538,000 oz/year production. With an initial capital cost of $5.3bn, this mine will only get built if gold prices rise. At $1320 gold, the project IRR would be 9.4% with an NPV of $1.9bn, 6.5x current market cap. At $1650 gold, project IRR rises to 12.2% with a $4.7bn NPV etc. Reserve scale and *quality* have improved considerably over the past several years on a per share basis but valuation is measurably lower than the lowest tick in 2008 (see left). Notably, the Canadian dollar exchange rate is 1/3 lower than that used in the KSM pre-feasibility study.

Pretium Resources

Pretium is a $620m market cap advanced-stage developer bringing the high-grade Brucejack project in British Columbia into production. Brucejack is amongst the largest, highest grade gold deposits worldwide:

- 8.5 million gold-equivalent ounces grading 15.7 grams/tonne
- 18-year mine life averaging 404,000 oz./yr. production
- Life-of-mine all-in-sustaining-cost/oz. (AISC) of $448
- Initial capital $746m
- First production in 2017
- After-tax NPV 5% @ $800: $620m, 16.5% IRR
- After-tax NPV 5% @ $1,100: $1,450m, 28.5% IRR
- After-tax NPV 5% @ $1,400: $2,280m, 38.7% IRR

A financing package from Blackstone agreed last September funds 70% of the project cost, while reducing NPV by a manageable ~20%. Importantly, the Canadian dollar rate is circa 30% lower than that used in the June 2014 Feasibility Study. Brucejack is a low-cost, high-grade, long-life gold project nearing production in a safe jurisdiction. Economics work at the current gold price and leverage to a rising gold price remains attractive.

Abitibi Royalties

This is a small precious metals royalty company ($32m market cap) run by a capable young guy named Ian Ball. Three years ago at the tender age of 31 he was already president of McEwen Mining, a company with 1700 employees founded by Rob McEwen, the former CEO of Goldcorp. The company holds equity stakes in two well-positioned gold majors, Agnico Eagle and Yamana, along with a valuable 3% net smelter royalty on the Malartic CHL project, part of the prolific Canadian Malartic mine (the largest in Canada) now owned by Goldcorp. Malartic CHL is jointly operated by Agnico-Eagle and Yamana who have recently increased their exploration budget for this deposit. Abitibi Royalties is also buying small royalties on early stage prospects with known mineralization near producing mines. It's a segment of the market way too small for major royalty peers like Franco-Nevada and Royal Gold. Whenever Abitibi Royalties' market cap dips below the value of its listed equity holdings, giving investors the royalties for free, I nibble at the shares. This is a 1.2% holding but will grow if shares can occasionally be purchased below tangible NAV. In joining Abitibi Royalties as president, Mr. Ball articulates a plan for compounding long-term value that is somewhat unusual for the industry. His 2015 letter to shareholders was interesting enough so that I have excerpted his parting statement below (you can read the whole letter at www.abitibiroyalties.com).

*"What does the **Best Gold Company** look like? For me it would look something like this:*

1. ***Share structure:** It has a small number of shares outstanding. Investors who purchase shares become partners in the business. They are also treated like partners.*
2. ***Per share value:** The company generates meaningful cash flow on a per share basis.*
3. ***Physical gold:** The company takes a portion of its royalty income in gold bullion, which would continue to grow each quarter. This should also defer tax.*
4. ***Share buybacks:** The share count goes down, not up. Few if any mining companies follow this strategy. We aim to be different.*
5. ***Exploration:** Provides exposure to exciting discoveries.*
6. ***Growing the business:** Continually builds its royalty portfolio through cash flow or other creative means.*

All of this will not happen overnight but let us set the stage."

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The top 10 individual positions in the fund currently are:

Avon (12% of NAV)
Silver Wheaton (8%)
Greenlight Re (6%)
Leucadia National (6%)
Dolphin Capital Investors (6%)
Seabridge Gold (4%)
Pretium Resources (4%)
Mobile Streams Plc (4%)
Pharma Bio-Serv (3%)
Asanko Gold (3%).

The gold basket is 49% of NAV. The fund is 95% invested (100% long, 5% short).

On the operational side, I am pleased to announce that Global Prime Partners is the new custodian for ERF. A big thank you is due the team at Morgan Stanley who have treated us well over the last few years. Trinity Fund Administration remains the fund's capable administrator. I am moving our IT infrastructure to the Cloud! With the help of Arbor Financial I will now be able to access my desktop portfolio from anywhere in the world (for better or worse). All four letters to shareholders, as well as recent white papers, interviews and due diligence material are on the new website at www.eschlerasset.com.

I look forward to updating you on the fund in one year's time. To my partners in the fund, thank you as always for your continued patience and support.

Sincerely,

Theron de Ris
Portfolio Manager,
25 January 2016

*Fooling Some of the People All of the Time (David Einhorn, 2008), p14