Dear Partners,

Eschler Recovery Fund (ERF) fell 11.3% net of fees and expenses in the first quarter of 2018. Nearly all holdings fell, including precious metals shares normally less correlated with the market. This mark-to-market loss remains *unrealised* and is net of 460bp of *realised* hedge gains. These hedge gains should have been much larger (mea culpa: I sold the volatility hedge described in the 2017 annual letter literally one day too early).

On a positive note, the fund is up 6% (as of 9 April) from its March nadir with the S&P 500 down 4.8% in the same period. April-to-date the fund is up 4.3%. Perhaps we have turned a corner.

The current juncture reminds me of early 2016. The fund had suffered a double-digit decline the year before. Deeply depressed precious metals shares made up nearly half the fund and while I was convinced this positioning would win, it was a lonely time. I went to the cinema one evening and watched *The Big Short*—no doubt unconsciously looking for a little therapy! It did not disappoint. To see Michael Burry stick to his guns with his subprime bet despite all the doubters was to be encouraged not to deviate from my plan. The fund rose 44% in 2016. Here we are two years later and forward return prospects appear just as asymmetrically attractive as they did then. And yet this is the result of pervasive investor apathy toward the fund's holdings, an uncomfortable place to be. To quote legendary investor Felix Zulauf in a (highly recommended) recent interview on Real Vision, *you are always alone at the big turning points*. With that preamble, below I provide some evidence backing up my enthusiasm.

**Review:**

The strategy is currently heavily invested in a limited number of well-financed businesses generally in cyclical industries (gold, silver, uranium and oil services feature prominently) bouncing along their respective cyclical bottoms, as well as in several company-specific special situations. The top 5 individual positions comprise 38% and the top 20 comprise 91% of NAV.

Here is the current configuration (largest to smallest):

| Name | Industry/Category | % from 5-year high |
|---|---|---|
| Monsanto | Arbitrage | -1.2% |
| Fairfax Financial | Insurance | -16% |
| Biglari Holdings | Diversified | -11% |
| Goodwin Plc | Engineering | -60% |
| McEwan Mining | Gold & Silver Mining | -78% |
| Bank of Cyprus | Banking | -44% |
| Abitibi Royalties | Gold Royalties | -6.0% |
| Fortuna Silver Mines | Silver Mining | -46% |
| Now Inc. | Oil Services | -71% |
| Pretium Resources | Gold Mining | -46% |
| Fission Uranium | Uranium Development | -63% |
| Uranium Energy | Uranium Development | -52% |
| First Majestic | Silver Mining | -68% |
| Geospace Technologies | Oil Services | -91% |
| Continental Gold | Gold Mining | -41% |
| Energy Fuels | Uranium Mining | -84% |
| Kirkland Lake Gold | Gold Mining | -10% |
| NexGen Energy | Uranium Development | -43% |
| Yamana Gold | Gold Mining | -81% |
| New Gold Inc. | Gold Mining | -71% |
| Average | | -50% |

On average these shares languish over 50% off five-year highs. Focused as it is on extrapolating recent trends the market has been unwilling to anticipate that these businesses will ever see improvement in future operating performance. But in many cases fundamentals are already demonstrably improving. For example, gold mining margins average $470/oz. today, nearly twice as high as 2015. When gold margins were last at this level in 2012, the gold mining index was twice as high as it is today. I keep tabs on industry margins and recent progress through Q1'18 is evident:

| | | | | | | | | | | | Gain | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q415 | Q116 | Q216 | Q316 | Q416 | Q117 | Q217 | Q317 | Q417 | Q118E | QoQ | Cumulative |
| Average Gold Price/oz | 1103 | 1183 | 1261 | 1334 | 1213 | 1220 | 1258 | 1279 | 1276 | 1328 | 4.1% | 20% |
| All-In-Sustaining Cost/oz | 836 | 833 | 886 | 855 | 860 | 878 | 867 | 868 | 858 | 858 | 0.0% | 3% |
| Cash Flow/oz | $ 267 | $ 350 | $ 375 | $ 479 | $ 353 | $ 342 | $ 391 | $ 411 | $ 418 | $ 470 | 12.4% | 76% |
| *Free Cash Flow Margin %* | *24%* | *30%* | *30%* | *36%* | *29%* | *28%* | *31%* | *32%* | *33%* | *35%* | *+200bp* | *+900bp* |
| GDX (# reporting companies) | 21 | 28 | 26 | 25 | 24 | 30 | 25 | 26 | 25 | | | |

Source: Zeal LLC

Recent weakness in gold shares occurred despite strength in gold, which rose 4.1% in the first quarter. This anomalous divergence featured across all cyclical exposures in the fund. I have summarised the phenomenon in the table below not only for gold but also silver, oil and uranium. Only uranium spot prices fell in the period along with the shares:

| ERF Position | Q1'18 Return | Commodity | Q1'18 Return | % Differential | | % of NAV |
|---|---|---|---|---|---|---|
| Gold Stocks* | -11.8% | Gold ETF | 0.5% | -12.3% | | 28% |
| Silver Stocks | -6.6% | Silver ETF | -4.9% | -1.7% | | 15% |
| Uranium Stocks | -22.4% | Uranium Future | -12.1% | -10.3% | | 12% |
| Oil Service Stocks | -16.5% | Oil ETF | 11.1% | -27.6% | | 14% |
| Weighted Average | -13.5% | | -0.7% | -12.7% | TOTAL | 68% |

Source: Bloomberg

Look at oil Services. The price of oil has more than doubled from the bottom but industry share prices are flirting with the lows two years ago. In my humble opinion this industry may be the most mispriced in the entire US stock market. Below, for each sector in the Russell 2000 small cap index I have compared the current price to book ratio with the five-year high and low price to book ratio. The small cap energy sector's risk-reward using this simple framework is off the charts compared to all other sectors of the market.

| Sub-Sector | 10-Year Price/Book | | Current | Upside to High | Downside to Low | Risk/Reward |
|---|---|---|---|---|---|---|
| | High | Low | Price/Book | Price/Book % | Price/Book % | Ratio |
| Energy | 2.6 | 0.8 | 1.1 | 136% | -27% | 5.0 |
| Financial | 1.6 | 0.7 | 1.5 | 7% | -53% | 0.1 |
| Utility | 2.5 | 1.4 | 2.3 | 9% | -39% | 0.2 |
| Consumer Staples | 3.3 | 1.3 | 2.5 | 32% | -48% | 0.7 |
| Materials | 3.2 | 0.9 | 2.7 | 19% | -67% | 0.3 |
| Communications | 3.1 | 1.6 | 2.8 | 11% | -43% | 0.3 |
| Consumer Discretionar | 3.3 | 1.0 | 2.9 | 14% | -66% | 0.2 |
| Industrial | 3.4 | 1.4 | 3.2 | 6% | -56% | 0.1 |
| Technology | 3.7 | 1.0 | 3.5 | 6% | -71% | 0.1 |
| Healthcare | 5.5 | 2.0 | 5.1 | 8% | -61% | 0.1 |

Source: Bloomberg

During the quarter, ERF initiated a position in $1.1bn market cap Now Inc., the leading distributor of consumable products to the oil & gas industry. Now Inc. was spun out of National Oilwell Varco nearly four years ago and has minimal net debt. The share price has fallen by two-thirds over four years (below book value) but the company is stronger now having made a number of small acquisitions at cheap prices. Results are now improving with Q4 revenue up 24% year-over-year and positive cash flow. A conservative base case would suggest fair value for the shares in the mid $20s per share, up over 100%.

**Uranium update:** In early November I built a new position in several uranium producers (the year-end 2017 letter laid out the rationale). These holdings initially surged as industry leaders Cameco and KazAtomProm announced gigantic capacity cuts in November, and then retraced in early 2018 all the way back to where the fund bought them. Industry developments continue to be positive though. Leaving aside long-term nuclear reactor build outs planned in China and India which combined could double global uranium consumption in 15 years, shorter term developments in key legacy markets germane to my recovery thesis are worth highlighting.

Japan's reliance on fossil fuel imports of coal, oil and natural gas since Fukushima is costing $40bn per year and increasing the trade deficit. The country's 54 reactors comprise 13% of global demand and have been largely dormant since Fukushima. Two more reactors came back online in March bringing the total online to seven. Two more come online by the end of May as the pace of restarts picks up. Ultimately Japan targets 20-22% of its primary energy requirement from nuclear.

In the US, the largest uranium market (~100 reactors, 50m lbs annual demand) the Department of Energy suspended 1.6 million ounces of annual uranium spot sales it had been bartering to pay for nuclear clean ups, thereby removing 3-4% of annual spot market supply. Two US producers, fund holding Energy Fuels and UR-Energy, applied to the US government for section 232 relief from Kazakh and Russian imports which have been flooding the US market. Incredibly, the US has gotten itself into the unpalatable situation of relying on imports for 95% of its annual uranium requirement. In the process, the US uranium industry, a strategic industry if there ever was one, has been decimated. Only three decades ago the US supplied 100% of its own uranium! However, the Trump administration is a supporter of the nuclear supply chain and may well put restrictions on uranium imports. The sooner US utilities are discouraged from buying unsustainable spot volumes sourced from Kazakhstan and Russia, a drug they have relied on for a number of years, the sooner they will be forced to the negotiating table with their long-term strategic suppliers in North America. 1/3 of US utilities' demand is uncovered by 2020 but what these utilities will find is that their traditional suppliers have largely furloughed production. The price required to secure long-term supply will be 2-3x the current spot price.

**Outlook**

Bear market or bull market correction? No doubt the big one is ahead in the not-too-distant future but the historical record suggests the current variety is only a correction*. First, the 30-year average federal funds rate is 3.32%, nearly twice the current level of 1.75%. Recessions (and bear markets) tend to begin after the Fed has completed a tightening campaign. This appears some way off. Second, yield curve inversion has always (well, at least since 1985) been a prerequisite for the onset of recession. The current 10 year bond yield of 2.8% is still 105 basis points above the federal funds rate. Once the curve inverts recessions normally begin after a year or two. Third, the spread of junk bonds over the 10-year treasury is currently around 3.5%, within a typical range of 2.25% to 4%. A spread above 4% would be a concern but that is some way off. In addition, the Leading Economic Indicators are still trending up and corporate earnings growth is picking up.

In summary, the fund is positioned in late-cycle industries whose equity market cap collapsed in past years while the S&P 500 soared. A large portion of this exposure, in the form of extremely cheap precious metals equities, might be considered a form of hedge in the event of a recession. The current strategy is to extract excess returns from industries where cyclical volatility, investor apathy and career risk have spawned mispricing. I am very grateful to have partners who understand the value of patience and staying power when investing in depressed cyclical markets.

Theron de Ris
Portfolio Manager
10 April 2018

*Market Appears to Be in a Correction, Not a Bear Market, Century Management, February 7th, 2018