Eschler Asset Management LLP

Eschler Recovery Fund SP
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Dear Partners,

The Agave franzosinii plant can take 40 long years to bloom but when it finally does it can quadruple in height to 30ft within weeks. Put in that context, the wait for Eschler Recovery Fund's ("ERF") 44.2% net return in U.S. Dollars last year seems more tolerable (even more so the wait for a 72% *Sterling return* for those of us resident in the UK in so tumultuous a year as 2016).

The bad news is that over the past three calendar years, on a total return basis in U.S. Dollars, ERF's 8.9% p.a. return, *net of fees and expenses*, lagged the stockmarkets of Jamaica, Pakistan, China, Slovakia and Vietnam. The good news is that it beat the 88 other primary country indices—*including the S&P 500 total return*. Three years is an arbitrarily short period in which to evaluate a trackrecord but allow me a moment in the sun because the journey felt lonely. To quantify loneliness, ERF's correlation of weekly returns to those of the S&P 500 was all of 17%! ERF zigged when the S&P 500 zagged. We owned none of the "growth at any price" or "yield compression" plays so sought after by investors. We had to patiently wait for the year 3 recovery to reverse the frustration of years 1 and 2. The key was to keep studying while avoiding rash decisions that veered off course. "*We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting and not a lot of thinking.*" Some activity is necessary but for me this mindset espoused by Lou Simpson (of GEICO fame) remains an aspirational behavioural blueprint.

ERF's net return is still annualising below the S&P 500 total return over its initial four years, though the gap is narrowing. It took Sir John Templeton, one of my investing heroes, six years before his Templeton Growth Fund (TGF) pulled away from the S&P 500. Below I present his annualised net total returns starting in 1955 alongside those of the S&P 500, with those of ERF on the right thrown in for good measure. All hope is not lost!

	TGF	S&P500	Alpha	ERF	S&P500	Alpha
4yr	8.5%	11.3%	-2.8%	9.4%	12.2%	-2.8%
5yr	9.6%	10.7%	-1.1%	?	?	?
6yr	10.3%	8.3%	2.0%	?	?	?
10yr	9.5%	9.0%	0.5%	?	?	?
20yr	11.1%	4.2%	6.9%	?	?	?
25yr	14.6%	6.2%	8.4%	?	?	?
Cumulative	**2917.0%**	**350.0%**	**2567%**	**?**	**?**	**?**

Notice also how Sir John Templeton's trackrecord improved over time. The moral of this story is that a value-oriented strategy can take time to show its merit. By taking a long-term approach (at least five years but preferably ten?) investors maximise their chances of capturing excess returns.

Strategy

I am a big fan of John Maynard Keynes' pioneering approach to investments, so much so that I have broadly attempted to implement the philosophy he concisely espoused in a 1938 memorandum to the King's College Estates Committee while running the Chest Fund:

1. A careful selection of a few investments (or a few types of investment) having regard to their cheapness in relation to their probable actual and potential *intrinsic* value over a period of years ahead and in relation to alternative investments at the time;

2. A steadfast holding of these in fairly large units through thick and thin, perhaps for several years, until they have fulfilled their promise or it is evident that they were purchased on a mistake;

3. A *balanced* investment position, i.e. a variety of risks in spite of individual holdings being large, and if possible opposed risks (e.g. a holding of gold shares amongst other equities, since they are likely to move in opposite directions when there are general fluctuations).

Keynes was also a speculator in commodities, once famously threatening to fill Kings College Chapel with a consignment of wheat from South America. Whilst better known for calling the gold standard a "barbarous relic", rather more interesting, at least to me, was his belief in the utility to a portfolio of a holding in gold shares. Apparently he was not joking about point 3 above and had the majority of the Chest Fund in South African gold shares in 1933. I bring this up because ERF has held a meaningful holding in gold shares over the past several years with the exact same justification. Any sector that has fallen nearly 90% attracts my attention, with the added benefit that gold shares can be uncorrelated with the broader market. Indeed, they have been known to rise significantly during some of the worst bear markets in recent memory (in particular 1973/74 and 2001/02). This remains a very lonely position, just the way I like it (they say that in resource markets you are either a contrarian or a victim). If you are interested in a more detailed rationale I encourage you to read my gold strategy excerpts in the last three annual letters.

I should like to shed light on my bottom up approach through the lens of a recently consummated investment in **Apollo Education (APOL)**. APOL is a leading US-based for-profit education company in an industry suffering from the double-whammy of increased regulation and a recovering economy (adult students go back to school during recessions but leave to find jobs during recoveries). APOL runs the University of Phoenix online university as well as a global education business in the Americas and Europe. Any cash-generative business with a strong balance sheet whose shares have fallen 90% over the past five years is always intriguing, and APOL had been on my watch list. I finally pulled the trigger in early February last year at $7.2 per share when the board announced they were evaluating "strategic alternatives", later doubling the position at $8.6 per share. My investment case was driven by 1) deep value, 2) a strong balance sheet with a large hidden asset in the rapidly growing international unit and 3) a possible exit via corporate activity. At purchase Apollo's enterprise value was a mere $170m for a company with EBITDA of $328m in the prior fiscal year. My sum-of-the-parts valuation looked like this:

- $5.50 per share in net cash
- +$5.40 per share for International (1.3x price/sales based on deal comps)
- +$4.70 per share for the struggling University of Phoenix assuming 3x forecast consensus FY16 EBITDA of $170m.

I thought the shares could realistically command $15-16 over a period of years. In the event, APOL immediately received a fully-financed "vulture bid" of $9.50 per share from private equity sponsor Apollo Global in early February. The voting A shares held by insiders were in favour but one wrinkle is that the deal also required majority approval by the non-voting publicly-traded B shares. This lowball bid infuriated long-term shareholders, three of whom (Schroders, First Pacific and the Alberta Pension Fund), having paid on average $20, went public ahead of the April 28th vote saying the equity was worth $20-$30 per share. Why did I stay invested? The deal spread remained wide ahead of the vote and the risk-reward was excellent: Downside to net cash if the deal fell through was ~20% but upside to the (more likely) deal approval outcome was 20%. More importantly, I had increased conviction that intrinsic value was multiples of the current share price. *There was clearly a compelling margin of safety and I was comfortable holding the shares for the longer-term.* In the end, B shareholders approved the deal, Apollo later increased the bid to $10 per share and I exited the position in December at $9.5 per share having found an alternative with a higher expected return than the remaining 5% on offer.

Back to the Future

The jury is out on the impact of the Trump administration but I've just made one important refresh to the core portfolio that is likely to benefit from both increased economic activity *and* volatile markets. Original ERF shareholders may recall that at inception 4 ¼ years ago Canadian insurance holding company Fairfax Financial (FFH) was a large 9% holding. We owned shares from $C375 per share or 1x price/book in October 2012 through early 2015 when we exited at $C635 per share or 1.4x price/book. The capital appreciation of 69% during the period was twice the increase in book value per share (BVPS). In late December I repurchased a 10% holding at $C595 per share.

CEO Prem Watsa, inspired by the insurance strategies of Warren Buffett and the value investing philosophy of Benjamin Graham, turned Fairfax into a money making machine during the 1980s and 1990s by deploying insurance subsidiary "float" into value investments. He also honed an acquisition strategy that scaled by maintaining a strictly decentralised approach (only 35 staff at headquarters) similar to Berkshire Hathaway. Driven by 9-10% average investment returns, well in excess of the cost of float, from 1987 through 2009 BVPS compounded at 21.3% (and this *excludes* FFH's first year 1986 when BVPS rose 180%). In 11 out of those 23 years BVPS rose more than 20%. In 2008 BVPS rose by a third as short bets against US mortgages paid off. Then in the 2010 shareholders letter Watsa announced an equity hedging strategy as a result of analysing the 1930s in America and 1990s in Japan. The idea was to protect against a "*100-year flood*" that would usher in long-term deflation. During the ensuing six years (2010-2015) BVPS compounded at only 5% (though insurance underwriting results improved a lot). More recently Watsa had even purchased a large position in long-term US treasury bonds exposing Fairfax's shareholders equity to a 13% haircut for each 100bp rise in long-term interest rates.

The reason I bought the shares back is because the Fairfax strategy has just been refashioned toward once again targeting serious wealth creation. Watsa now believes that doing business in the USA will be easier again in coming years and value investing will work as the cost of capital normalises. Right before the US election Watsa sold nearly all of the treasury bond position. After the election he cut the equity hedge in half and may reduce it further. Only a few weeks ago he announced the acquisition of highly successful specialty insurer Allied World for $4.9bn. Major initiatives are also underway to expand in India and Africa. These are seismic changes!

Though I personally side with a more inflationary future, I am open to the view that one resolution to the global debt overhang risks a deflationary depression. It was no doubt tempting for the Fairfax investment team to position for a repeat of their 2008 heroics. But I am impressed that, having evaluated recent results and the changed backdrop, they had the courage to change course. The leverage to improving investment returns at Fairfax is significant. Over 31 years investment returns have averaged 8.6% per annum but barely 3% over the past six years. With nearly $3 of investments for every $1 dollar of book value, it should only require a 7% investment return to grow BVPS by 20% assuming underwriting breaks even. This will not happen overnight, what with ~1/3 of the investment portfolio in cash, the remaining partial equity hedge and reinvestment risk in the mortgage book. Perhaps the best thing that could happen to Fairfax would be a garden-variety bear market over the next year into which they could deploy huge investment firepower. I'm pleased with ERF's entry cost at 1.05x book value pro forma for the Allied World deal and excited to see how this story unfolds in coming years.

Outlook

In last year's letter I lamented the recent parallels with the year 2000: In particular, a two-tier market, underperformance of the value approach and massive index flows. Today, we seem to be *exiting* that environment: Index flows are still massive but value investing is working again and momentum investors are struggling. Overall market valuation is at nosebleed levels but at least reversion to the mean within and amongst sectors and themes is now evident below the surface. The portfolio has benefited and might continue to do so from this changing of the guard.

In the short term equity investors seem to have discounted a Trumponomics-driven recovery in nominal growth but not the associated inflation and normalised cost of capital. Business-friendly initiatives may well reduce ultimate downside risks, but a near-term equity bear market could be quite convenient for the new Republican leadership: Take the pain quickly, blame it on the past administration then bask in the recovery.

Last year's positioning was appropriately conservative: gross exposure averaged 106% of net asset value, net exposure 69% and cash 12%. Today the cash position has risen to 20%. Indeed, between portfolio cash and the "look-through" buying power of investees like Fairfax, ERF's potential to redeploy portfolio capital, at the right price, is substantial.

To my stoic clients who have stuck with me while I spent the last several years preparing for a market setback that never materialised, thank you. To those readers interested to learn more, please visit www.eschlerasset.com. I look forward to providing an update in one year's time.

Sincerely,
Theron de Ris
8 January 2017