Dear Partners,

Eschler Recovery Fund (ERF) NAV increased 3.2% in June and 1% in the first half of 2017. A blind optimism, if not euphoria, has taken hold of the market-cap weighted indices. Growth and passive investors appear firmly back in charge while value investors, after the briefest of romances with outperformance last year, are back in the dog house. Just as I have since launching the fund in 2012 I continue to position the portfolio to accommodate big changes in the market's mood. Complacency is surely sowing the seeds of a different kind of market, one where more variability of returns is likely, where styles shift and fashions evolve. Selected undervalued recovery plays, prominently including precious metals stocks, as well as plenty of cash (20%+) comprise the portfolio.

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Volatility Absorption

In June 1994 your fund manager, at the time a fearless third-year university student, landed in Frankfurt, Germany and headed for the youth hostel. With $400 in my pocket and no summer job I proceeded to knock on doors. In a triumph of chance over preparedness, I secured a paid internship at Union Bank of Switzerland. By January 1995 I was interning at Salomon Brothers in a similar role while studying on the side. Things were looking up. And then came the fall. That spring, I sent at least 50 letters to German banks in Frankfurt seeking full-time employment every single one of which was rejected. By July I was broke and had joined a paid one-month training program at a local brokerage. This turned out to be a bucket-shop selling risky foreign exchange futures to its retail victims. I developed a few leads but converted none and by month-end had taken a job waiting tables at a local restaurant. Quite a come down. It was from this low point that prospects rapidly improved. After responding to an ad in the local paper from Goldman Sachs for a "trading assistant" within days senior advisors on the 40th floor of the Messeturm were subjecting me to a series of interviews. I will never forget one surreal encounter where a private banker described a complicated set of asset class movements, told me to calculate the resulting return, and just left the room. Despite such harrowing moments and the reams of earlier rejections I soon had an offer for a full-time position as a career-track financial analyst.

Why the trip down memory lane? This episode 23 years ago speaks to the volatility inherent in life experience. Low points can often sow the seeds of personal recovery and vice versa. As in life, so in markets: Cyclical weakness often sows the seeds of recovery. At his recent shareholder meeting in Omaha, Tom Gaynor, Co-CEO of specialty insurer Markel, talked about the concept of "volatility absorption" in the context of writing insurance. The idea is to take advantage of volatility in pricing, writing less insurance when pricing is soft while expanding premiums into hard markets when many competitors step back. Premiums written in soft markets can lead to write-offs ("reserve strengthening") later whereas premiums written in hard markets earn a better return with lower risk. In a similar vein, the investor focused on values welcomes volatility in price. From time to time the market becomes intensely emotional. But as in life intense emotions do not last and the pendulum swings back. Indeed, any investor worth his salt knows that cyclical bear markets are the authors of bull markets. To quote the late Shelby Davis, "*you make most of your money in a bear market, you just don't know it at the time*".

As an investor focused on values, my approach is thus to structure the fund and deploy capital in such a way as to be able to "absorb" inevitable volatility. Where a conventional portfolio investor might define risk as the extent of volatility of periodic returns, I characterise such volatility as creating opportunities to lower risk and improve expected return through attractive entry points.

Instead, the risk to be avoided is that of permanent capital loss. One quick way to impair capital is to use leverage and get caught out as investment values fall. One has to be able to ride out the storms. So I run the portfolio with a small balance sheet allowing room for manoeuvre when volatility arrives. The goal is to invest in ideas whose depressed capital values have long-term upside but low risk of permanent impairment. Portfolio construction and this risk mind-set enable it.

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Review

Over the six months gross exposure ticked down from 84% to 83% and net from 80% to 79%. A casual observer might conclude that your manager had taken a literal interpretation of Warren Buffett's preferred stance of "*lethargy bordering on sloth*". But that would miss some activity below the surface. I sold several energy holdings and made one new purchase in the USA, initiated three new UK-listed positions and (prematurely) nibbled on several gold stock holdings. As a result, North America exposure fell from 37% to 20% of NAV while UK-listed rose from 16% to 25% and gold stocks from 25% to 32%.

Having already discussed the gold stock position ad nauseam in past letters, a rationale for the increased activity in the UK market is perhaps more timely. Simply put, I am finding more ideas in the UK. Part of this is the ease with which I can access UK ideas from my London base. But from my strategic vantage point there is also a richer opportunity set in the UK right now as compared to the US. On a cyclically-adjusted basis UK equities appear to offer a long-term local currency annualised expected return of ~6% as compared to -1% for the USA. Consider that the Alternative Investment Market (AIM), a small-cap UK proxy, has risen only 44% since the end of 2009 while the Russell 2000 is up 160%. Value shares in the UK, as elsewhere, have underperformed growth shares for a decade now. To top it off, Sterling is 15-20% cheaper post-Brexit vs ERF's U.S. Dollar base currency. Sterling is also cheap by a similar magnitude as compared to OECD purchasing power parity (1.44) and the Big Mac Index (1.61). It is not hard to imagine these trends reversing in the future, with US stocks underperforming; value outperforming growth globally as the bond bubble deflates; and the U.S. Dollar falling vs Sterling. I plan to fully take advantage of my London base to build my knowledge and create a watch list of small and midsized UK companies competitive in global markets.

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One exciting aspect of running a small investment practice is the ability to deploy more capital (as a % of NAV) into small- and mid-cap companies with bright futures at prices reflecting short-term, transient headwinds. A snapshot of one of these holdings follows.

Goodwin PLC is a high-quality owner-managed UK engineering company headquartered in Stoke on Trent. There are 6.8m shares outstanding and the market cap is £113m. ERF's cost base of £16 per share equates to 6x trailing five-year average pre-tax profit. The bargain purchase was possible because the company's cyclically depressed oil & gas end market has seen the shares fall 55% over the past three years as margins fell. Goodwin is a leader in heat- and pressure-resistant specialty steel castings primarily for the oil & gas, LNG, petrochemical and power generation markets and also holds a leading position in refractory powders used in the manufacture of jewellery. The focus is on technically advanced niche products for growth markets. >70% of sales are to export markets primarily in emerging parts of the world, particularly Asia.

The company is well-managed by owner operator members of the Goodwin family who hold a majority of shares. While the company does not follow AIM corporate governance recommendations to the letter, I am not concerned. On the contrary, executive compensation is modest, employee turnover is low, communication with stockholders is forthright and this board *really* eats its own cooking. There has been little equity dilution over the years. More recently, effective use of government grants has facilitated non-dilutive capacity expansion in excess of what could otherwise have been achieved from retained earnings alone.

Long-term results speak for themselves. Over the past 10 years (encompassing both the global financial crisis and the energy bust), capex/depreciation has averaged 2.4x, revenue growth 7.8%, pre-tax margin 12.7%, return on capital employed 24% and gearing 22%. In my valuation I assume revenue growth of 7% and a gradual increase in pre-tax margins from the currently depressed 7-8% toward 12% in 2021. I apply a 10x multiple. I assume a 10% cagr in the per share dividend, less than halve that of the past 15 years (dividend up 8-fold). The implied 3-4 year IRR is 25-30%. Management is well-incentivized to drive results and the share price back toward peak levels.

What could go wrong? The main risk is if the recovery in the company's energy end market takes longer than expected necessitating continued pricing initiatives to expand market share. While I am less concerned about top-line growth there is some risk, baked into the fund's purchase price, that margins stay lower for longer. Ongoing diversification into refractory engineering and radar systems should continue to offset the cyclicality of the energy end-market.

In May I hosted two interviews, available at www.eschlerasset.com, where I relate my background to the investment approach and describe what I look for in a business.

Thank you for your continued support.

Theron de Ris

10 July 2017