Dear Partners,

The Fund produced a strong result in Q2'18 with NAV up 9.8%, leaving the year-to-date result at -2.6%. Oil service and uranium holdings, such as Geospace Technologies (+42.5%), Now Inc. (+30.4%) and Energy Fuels (+18.9%) did the heavy lifting, as well as gold producer Kirkland Lake Gold (+39.4%) and Bank of Cyprus (+19.9%).

Gold and silver holdings also rose, in aggregate, in the face of declining gold. Whether this bullish divergence plays out as I expect remains to be seen. With nearly half of the fund invested in this industry, the outcome matters. We know that futures traders, who deploy massive leverage, love to short gold ahead of meetings of the Federal Reserve Board. As of today, speculator short positioning in gold futures is the most extreme since the end of 2015 which preceded a 30% rise in gold in the first half of 2016. Futures traders do not care one iota about anything but the next tick: The slightest reversal will force these traders to cover en masse. Gold should also see seasonal strength in coming months.

Meanwhile the mining shares languish at low valuations relative to their history, relative to gold and relative to the S&P 500. I discussed the cyclical set up for commodity-related industries in a recent presentation at the Value Investing Seminar in Trani, Italy. In a nutshell, there are tens if not hundreds of thousands of analysts in the investment industry attempting to estimate the near- and long-term growth rates of outstanding, defensive businesses. Estimating growth looks easy, reinforced by the ex-post returns of growth stocks over the past decade. But having experienced three bubbles and two busts since I began my career in 1995, first-hand experience has taught me that it most certainly is not. My primary activity is the purchase of cheap securities of well-financed businesses run by capable capital allocators, where I pay little for future growth. Currently I'm finding such securities in cyclical or bottoming-out commodity industries where most analysts fear to tread. One might posit that it is this lack of competition that has created greater mispricing in these areas. Precious metals, but also energy and uranium are fertile hunting grounds.

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The biggest detractor year-to-date was Biglari Holdings. Having contributed +255bp to NAV in 2017, the shares detracted -328bp in 1H'18. At the annual shareholder meeting in late April shareholders approved a dual-class share structure. This was expected but the actual event triggered forced selling by small cap index funds who are not allowed to hold dual-class shares. With shares back to where I purchased them last August, they must offer the same attractive risk-reward as they did then, right? Well, no. Quantitatively the shares have never been cheaper: The $590m market cap is well below the market value of the investment portfolio net of deferred taxes, leaving the wholly owned operations (Steak N Shake, First Guard Insurance, Western Sizzlin' and Maxim) with a negative value. But I can't ignore a growing list of negatives.

In his annual letter, not once did Sardar Biglari mention shareholder returns. If returns were acceptable in past years that would be fine but they have been dreadful, so I found his continued indifference alarming. Over the past five years Biglari Holdings shares have fallen 21.4% (for comparison, Eschler's NAV has risen 35.4%). I also noticed that Biglari Capital, Mr Biglari's hedge fund of which the holding is the principal limited partner, started charging the Holding a 1% management fee (~$7m annualised). This was not part of the deal. Mr Biglari already receives a $900,000 salary <u>and</u> 25% of any gains in the hedge fund's investment portfolio above a 6% annual hurdle <u>and</u> 25% of any annual gains above 6% in shareholders equity from operations (ex-investments). Furthermore, I learned that the 6% hurdles are <u>not</u> compounding. To make the implications of this concrete, if the 6% hurdle on Eschler's 0% share class had not been compounding, I estimate the fund's earliest shareholders would have paid over 400bp in incentive fees in 2016 instead of the ~50bp I earned that year. Then I learned that Mr Biglari received a gigantic $7.35m bonus in 2017 (when the shares fell 13%) merely because Trump's tax cuts boosted shareholders equity by reducing deferred tax liabilities on the balance sheet. Lastly, part of my original thesis was that the dual-share class structure could serve as a catalyst: Mr Biglari would retain his beloved control while redeeming from the hedge fund the Holding's non-voting shares it owns in itself and then, by cancelling them, greatly increase the Holding's per share value via a lower share count. Unfortunately, at the annual meeting Mr Biglari suggested this was unlikely.

I have no doubt Mr Biglari has read "*How to Get Rich*" by Felix Dennis, former owner of Maxim, the magazine that Biglari Holdings purchased several years ago. "*Please think about this if you want to be rich. Ownership is not the most important thing. IT IS THE ONLY THING THAT COUNTS*." (Page 191). Clearly Mr Biglari is shamelessly using his control of Biglari Holdings to take a great deal more money out of it than minority shareholders. Without the catalyst I expected to unlock value, I will look to sell the shares when the "operations value" reaches zero (a 25% return from here). But the clock is ticking. Other than the obvious mistake to back Mr Biglari in the first place despite an apparently strong trackrecord, is there anything else to take away from this saga? Yes: A very cheap entry price has (so far) completely shielded fund shareholders from permanent loss of capital.

Activity

On Friday, 29 May the Visa network in Europe stopped processing card payments. I was shopping for a drum set for my son and this created total havoc since I rarely carry cash anymore. We were in a rush and I couldn't pay for anything, not even the parking. For any of you doubters out there, real cash still matters! As it happens, a few weeks prior I had purchased for the fund a holding in De La Rue Plc, the leading printer of cash currency globally. My little crisis showed I was on to something, or at least allowed me to enjoy a little confirmation bias. But the reality is that, despite the inroads of electronic payments, the use of hard cash worldwide is steadily growing at the rate of inflation (rather surprisingly even in the UK).

De La Rue has a colourful corporate history having printed the first banknotes in 1861, the first playing cards in xxx and the first xxxx in xxx. In its current carnation, the company is focused on three areas: currency design and printing; Identity (primarily passports); and Product Identification (tax stamps, tracking tags etc.). Industry structure is attractive: 80% of global currency is produced by local printers in each country, but the 20% that is outsourced by 180 central banks globally is shared amongst an oligopoly of which De La Rue is a leader. Customer switching costs are high (as the UK government may discover to its detriment having replaced De La Rue with Gemalto to make the UK passport from 2019: apparently Gemalto has missed deadlines on contracts in Scandinavia). Overall it's an attractive business with above average margins and returns on capital. Here's why I purchased shares: 1) Streamlining capacity, reducing asset intensity; 2) investing in R&D in polymer-based cash and product ID; 3) trading at a large discount to private market value in a consolidating industry with no controlling shareholders. It would not be the first time a one-of-a-kind British Plc fell into foreign hands. Also pays a 5% dividend with no withholding tax.

Other activity: Sold KL and bought BVN. Sold UEC and bought UUUU. Sold NGD and bought SAND.

Outlook

The fund enters Q3'18 with 82% net equity exposure (108% of NAV long and 26% short) the entirety of which is invested in gold, silver, energy-related and uranium shares, in that order. All non-commodity holdings are hedged with fundamental short positions in US small cap growth shares, Australian and Canadian banks, US semiconductors and a few potential frauds. At the margin I am looking to reduce gross exposure somewhat (reduce longs and add to shorts) and believe the lunacy in markets, while persistent, will soon yield to harsh realities.

Theron de Ris
Portfolio Manager
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