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Dear Investor,

The efficient market hypothesis, or the general belief that the market is efficient, is widely accepted. It is also widely accepted that Mr. Market can be manic depressive. For those two beliefs to coexist is interesting. We would suggest that, based on our experience and research, the reason for this disparity is based on the time horizon of the analysis. Human emotions, mainly fear and greed (or in common parlance F.O.M.O.) drive the short-term gyrations of the market. In fact, we wonder if Mr. Market read an early draft of this letter because last week he showed us multiple examples of one of its more destructive manic/depressive episodes.

It began on Friday (8/2), on the heels of the Fed's decision to delay cutting interest rates, when Mr. Market was trigged by a disappointing jobs report that showed the highest unemployment rate since October 2021. Already a bit shaken, Mr. Market woke up on Monday morning to news that Japan's stock market had plunged 12%, the most in 37 years, wiping out all its gains for the year. This sparked the VIX index, which is a measure of expected volatility (or fear), to briefly experience its biggest rise ever. To make matters worse, Warren Buffett's Berkshire Hathaway disclosed in its quarterly SEC filing it had sold more than half its shares of Apple. Additionally, reporters took notice of the sky-high valuations of many artificial intelligence stocks, and geopolitical fears of a possible attack from Iran on Israel adding to the regional war. On Monday, traders in the U.S., who in many ways represent the archetype of fear, greed, and short-termism, drove down both interest rates, as well as stock prices, with the S&P 500 falling ~3%. By lunchtime on Monday, headlines were drawing parallels to Black Monday in 1987, when the Dow Jones fell more than 22%, and the S&P 500 fell 30%. An interesting parallel of when the market recorded its largest single day decline, only to end the year up.

Reporters were tossing around words like "crash," "meltdown," and "bloodbath." Fear took hold of Mr. Market as he wondered whether the Fed had missed the boat. Was the jobs report confirmation a recession was an inevitability? Did Buffett's sale mean that he thinks stocks are going to fall (or was it more likely a stock specific decision)[1]? Could the U.S. market fall like Japan's just did? At one point in the day NVIDIA, the most magnificent of the "Magnificent 7," was down

[1] In footnote 5 of Berkshire Hathaway's 10-Q They listed that the fair value of their investment securities decreased from 353.8B to 284.8B, further highlighting that Apple reduced from 174.3b to 84.2B. This shows most of the decrease came from one specific stock, and not a general sell off of equities.

~15%, and the S&P 500 Index closed with a 3% loss due to the concentration of the magnificent 7 in the index.

But then overnight Japan's markets began to calm, with its major index rising more than 10%, its biggest gain since 2008. By Tuesday morning the VIX had come back down and long-term interest rates began to rise as calm seemed to be restored. The markets ended up rebounding as the S&P gained 1%. I'm exhausted just recapping some of the market shifts which took place!

While this was a perfect illustration of one of Mr. Market's more intense manic/depressive episodes, it was also an example that was among his shortest. Why did prices fall so dramatically and rapidly? In the context of 48 hours, we can look back and have some idea of what caused investor fear to spike, but overvalued stocks don't really need a reason to fall, no matter how many people try to come up with one. When the markets are swept by fear and greed, as we saw in this case, undervalued stocks often fall lockstep. Further compounding the markets' efficient (or rather inefficient) pricing mechanism are changes in the landscape of bedrock financial fundamentals like inflation and interest rates - critical determinants for all investment valuations. No surprise this is conducive to recurring periods of V.U.C.A. (Volatility, Uncertainty, Complexity, and Ambiguity).

We are open to the idea that these types of volatile market gyrations are likely to become more common as fund flows are increasingly influenced by algorithmic trading, increased retail investing, and a deluge of information (much of which is inconsequential to the long-term prospects the underlying businesses). All of these flows exercise the "voting" (popularity) muscle response of the market, while the "weighing" muscles atrophy with few purchases of individual company shares based on specific stock analysis and valuation. This fact pattern means there is fertile ground for experienced analysts with judgement on valuations and businesses opportunities. As you can imagine, this makes us excited.

So, what should investors do when infrequent but recurring events like this happen? Most of the time the answer is nothing, unless you can buy more of the undervalued stocks you like. Many investors don't like that answer. How can I sit and do nothing? I didn't say it was easy but over time investments trend towards what their underlying value really is. Said differently, in the short-term markets are voting (popularity) machines, but in the long term they are weighing machines. All the news that sparked the sell-off was interesting. Perhaps some of it was even relevant. But is it earth shattering in the long-term, 3-to-5-year time horizon, that we use to assess our investments? We are skeptical, which is why we contend that markets can often be inefficient and, at times, magnificently inefficient. Ok, that's a fairly broad generalization, so we'll give you a more specific example in the form of the domestic steel market.

Steel

We believe the U.S. steel industry is a fantastic microcosm of a phenomenon we are seeing across several industries. The recent activity in the space highlights how hugely inefficient the market has been at pricing assets in an industry that has had difficult times for decades, but has drastically changed during that time period.

In 2023, Cleveland Cliffs made an unsolicited bid for competitor US Steel for $35 per share in cash and stock. US Steel had been trading for $22. This set off a parade of bidders leading to Nippon Steel's bid of $55, a 150% premium to the market. Now more recently, Cleveland Cliffs, uncertain with the eventual outcome of its continuing interest to buy US Steel, agreed to acquire Canadian steel producer Stelco. That $2.5 billion transaction represented an 87% premium to the pre-bid public market trading price for Stelco.

In short publicly traded steel companies have been targeted for acquisitions at large premiums to their market value, but even at these higher levels are still at large discounts to their intrinsic value. Clearly the views of value are vastly different between the "efficient" market and knowledgeable competitors. Someone has the valuation wrong! I think I'll go with the knowledgeable insiders versus the public market.

We have been closely monitoring these industry developments, particularly due to our exposure to Insteel Industries, Inc. (IIIN), which manufactures steel products and is directly impacted by steel manufacturing and tariffs. Recently, we made a strategic investment in ArcelorMittal S.A., marking our first direct investment in a steel producer in many years. We believe ArcelorMittal's focus on the more environmentally friendly EAF (electric arc furnace) method, combined with its attractive valuation, positions it as one of the best companies to capitalize on the ongoing changes in the steel industry.

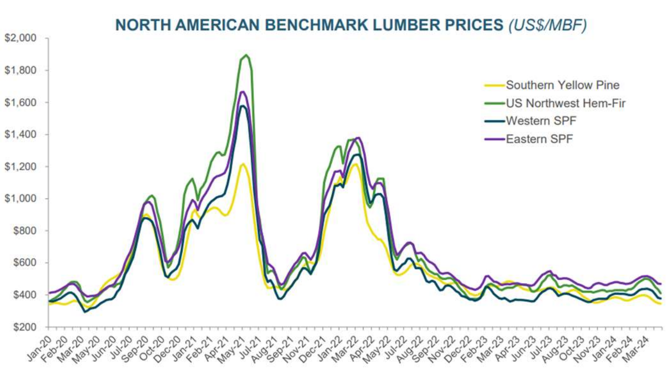
This investment highlights two of our core investment philosophies. First, our grassroots macroeconomic approach requires a deep understanding of a company's customers, suppliers, and competitors to gain a comprehensive view of the industry. This approach led us to identify ArcelorMittal and quickly grasp the dynamics surrounding its business. Second, this investment is a prime example of our "ugly duckling" strategy, where we seek undervalued companies with current obstacles but a strong potential for future growth. Despite facing challenges in recent years, including one-time events at their Kazakhstan operations and overall industry headwinds, we see significant upside for ArcelorMittal.

Investing in Difficult Situations

We have a recurring pattern of investing in businesses that are in industries experiencing difficult financial conditions with Stelco and ArcelorMittal as just the most recent examples. These are industries that have had disappointing results, declining earnings, potentially losses, are facing demand issues, or have an existential threat or seismic shift in their business model. An analogy we have used in the past is a rubber band stretching. As these difficult times last, the rubber band stretches further, and the further it stretches the harder it snaps back. We try and identify those rubber bands that won't break before the tension is released. What this means in practice is that as the companies we have invested in are working towards rightsizing their business, consolidating their industries, or simply outliving competitors, they probably trade down with the industry, providing us opportunities to average down continually increasing our return potential.

Interfor Corporation

Interfor is a North American lumber producer with sawmills situated throughout the continent in close geographic location to major timber baskets. We recently bought more shares of what we believe is a company fighting well below its weight class. The lumber industry is currently depressed due to heavily discounted lumber prices, which have declined significantly from the Covid-19 boom period for myriad reasons including a slowdown in new housing construction caused by persistently high-interest rates. Within this context, it's no surprise that Interfor's stock is under pressure. However, our investment in Interfor is not based on short-term earnings speculation. We didn't buy more shares anticipating the bottom; we bought more shares because we believe the company is currently valued at a substantial discount to its intrinsic value, which is the present value of its future cash flows. This results in a high return opportunity with manageable risk.



Source: Interfor Presentation May, 2024

Our investment is predicated upon the replacement cost of Interfor's productive capacity. We believe that rebuilding Interfor's business would cost multiples of the current valuation, and we are also confident that North America still needs lumber. Of course, no one would spend the money to rebuild the business in the current environment given the lack of any economic return. In fact, the opposite is likely to happen as the financial stress continues to weigh on less cost competitive and weaker financed competitors and capacities. We have confidence in Interfor's management team, having met with them on multiple occasions. Our colleague Mike DeRop has toured several of their southern mills, meeting many of the team members. Through this first-hand research we have found both the people and its capital properties to be assets of high quality, even as it struggles through the current industry weakness.

We like to focus on simple facts when we build our investment theses. Lumber pricing today is unsustainable. It has been below break-even for the last year. In this case we see that the best companies in the industry with the lowest costs and the best balance sheets are still losing money, and that is not sustainable. It follows then that if you believe lumber is still a necessary product the price will naturally have to return to more normalized levels of approximately $500 per thousand board feet, well above today's prices of ~$350. This pricing would lead to earnings not far off from the current market cap of the company. When this happens is what we cannot know, so we focus on the companies in the strong financial positions managed by savvy capital allocators who will be not only take advantage of the improved conditions simply surviving but also improve the ability of their businesses to generate free cash flow along the way.

We would be remiss if we didn't note that the balance sheet has leverage today, which does cause strain, but believe this debt structure is manageable. We further believe that the company has several levers to pull should the strain grow to a less manageable level. An example of that is the companies have cumulative duties of $570m, which they only carry on their balance sheet for $160m. These are deposits that the company has paid over time that are held in trust by the U.S. and if they sold these assets today they would likely be able to get 35 cents on the dollar, with a back-in on incremental recoveries.

Conclusion

Our long-term success stems from the fact that we are comfortable with volatile market prices (by that we mean mark-to-market losses) when we are buying a viable business at a fraction of its replacement value. The short-term difficulties have very limited impact on the long-term value of the business, yet those difficulties provide opportunities. We focus on simple math. Buying a business for 1/3 of its business value will provide a 25% compound return even if it takes 5 years to manifest. But even better, while difficulties discount the purchase price, they do little to change the business value, and further they provide business opportunities for well managed companies. So, a price decline can often serve up a compound return greater than the percentage decrease, especially as we average down our position. This is a mantra that we remind ourselves of frequently. Since we can't predict the timing of our expectations, we often are early, and companies will continue to trade down as headwinds continue. I can't recall a significant investment that we made that only went up after we bought our first shares and didn't decline at some point while we held it. That is why we focus on the price we pay vs. the intrinsic value of a business. While the market's voting/popularity machine may serve up ever larger discounts, the long-term weighing machine that is the stock market continues to be anchored to intrinsic value, supporting a very old, arcane truism – Value will out.

All the best,

Bob

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