COLBERT
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Annual Letter to Clients
December 31, 2014

The last four months of 2014 were punctuated by a burst of volatility in stock and bond prices. Stock prices quickly went down a few percentage points, only to rally upwards even quicker. This happened twice. Investors tend to react in a herd-like fashion to market fluctuation, only to regain an appreciation for the fundamental underpinnings of stock markets. As is usually the case, other than providing a buying opportunity, these bouts of volatility were non-events in the end.

This brings to light a story told by Peter Lynch, one of the best money managers of all time, about how fifty percent of his investors lost money during his years at the helm of Fidelity Magellan Fund. As incredible as that might sound, people simply like to buy when prices have been going up, and they feel pressure to sell when prices are going down. So the same people who would happily invest when his performance had been recently very good, only wished to sell when his fund would go in a down cycle.

Rules

Even to professional investors, emotional reaction to markets often make events appear worse than they really are. Which brings to mind a list of principles for investors to follow:

1) If you have access to your investment account online, stop checking how much your account is worth! You must monitor your account occasionally, but constantly looking at whether prices are up or down will only make you more emotional, more anxious. It's not good for your health.

2) Think long-term, not about the next 6 or 12 months. I think about what may happen in 2, 3, 5 years or more. We have owned some stocks for more than 10 years and have made good profits over time. Thinking short-term leads to a gambling mentality and poor results.

3) Everybody knows that every time markets have suffered big drops, they have represented great buying opportunities. Yet, investors worry about the next big market drop. Think about that contradiction: crisis represents opportunity.

4) Extrapolating is a very harmful habit. Millions of people in 1999 thought, wrongly, that internet stocks would go up forever. Nearly everybody in 2007, incorrectly, thought you couldn't lose when investing in real estate. Apple was, erroneously, given up for dead 14 years ago, and gold was, mistakenly, called the sure thing 3 years ago. Most investors are good at extrapolating the recent past into the future, but the next 5 or 10 years will look little like today. How many people were

expecting oil prices to collapse by 45 percent in the last 3 months of 2014? How many are extrapolating the current oil price of $50 - $60 into the future? How many are seriously contemplating the risk of oil going above $100 when supply and demand reach equilibrium?

5) When you have a diversified portfolio, some investments inevitably don't turn out as well as others do. Don't concentrate too much on the ones that are down because it's unfortunately unavoidable to have some losers. You just want to have more winners than losers and/or more invested in the winners than in the losers. In addition, lower stock prices don't always reflect the company's intrinsic value. If you only buy stocks that are going up, you are probably buying high (and will want to sell when they trade lower).

6) The public loves buying when prices are high. On the other hand, the investor who knows the intrinsic value of an asset is happy to buy more when prices go down. Market volatility is not a risk in itself, unless you succumb to its charm on the upside, or its repulsion on the downside.

Emotional temperature

One way to gauge the markets emotional temperature is to analyze the reasons why something is going down (or up). For example, the biggest expense for most airlines is usually jet fuel prices. Therefore, when oil prices were going down in September and October 2014, you would expect airline stocks to go up. But no, airline stocks were going down with oil prices because of the Ebola virus contagion fears. I had no way of knowing how badly the Ebola virus might eventually spread, but the thought that U.S. based airlines would be severely affected by Ebola smelled more of panic than reason. Therefore the sellers of airlines stocks at the time were merely reacting to falling airline stock prices, not to the fact that fuel price decreases would greatly benefit airlines. Emotional reaction to news headlines typically hamper rational behavior.

Oil spoils the mood

The biggest macro-economic event of 2014 was the rapid collapse in oil prices. While an abrupt 45 percent move absent a geopolitical event or a crisis is not normal, it does reflect the changing oil production dynamic in which increasing global oil production, particularly high-quality U.S. shale oil, has met with slower consumption in a world affected by slower growth.

According to most experts over the last 2 decades, U.S. production was projected to continue its unstoppable decline from peak oil of 9.6 million b/d (barrels per day) in 1970. Confounding all expectations, U.S. oil production had halved by 2008 only to now nearly reach its previous peak. America's shale-oil drilling prowess did not affect prices much between 2008 and 2014 because of increasing global demand, because of geopolitical issues (Iraq, Iran, Libya), and because of mismanagement in Venezuela. Therefore oil prices held steadily around $90-$100 for nearly 5 years.

Things started changing in the summer of 2014 when Libya (and later Iraq) got a semblance of stability, thus adding supply into the market, while slowing economic growth in China (and some other countries) moderated consumption growth. In summary, global oil production is now estimated to exceed consumption by roughly 2 million b/d, leading to much lower oil prices.

By November 2014, all eyes turned to OPEC's 30 million b/d production and particularly Saudi Arabia's 9 million b/d to see what action they might take to stabilize prices. While the Saudis historically acted as the world's swing producer (increasing/decreasing production in periods of very high or very low oil prices), this time they asked other non-OPEC countries to share in any reduction in capacity. Mexico (2.4 million b/d) and Russia (10 million b/d) are two countries who said no. In the end, Saudi Arabia refused to take the hit for everybody else, and aiming to also force higher-cost oil production offline by letting market forces decide prices instead of a cartel. And all Hell broke loose with oil prices during the month of December.

Oil wells are not all created equal

Back to commercial reality. Some conventional oil is profitable below $40 (for Saudi Arabia and others), while some deepwater oil fields don't make it under $100 (Brazil, North Sea, etc.), much of Canada's tar sands require $70, and a chunk of U.S. shale oil wells are unprofitable under $65. But there is no uniformity around this, as every producing country has wells that are profitable at various price levels.

Princes and dictators

Before the Arab (OPEC) oil embargo in 1973, big oil corporations controlled 80 percent of global reserves. Nowadays around 70 percent of oil reserves are controlled by state-owned (or controlled) oil companies who generate vast sums of foreign currency (mostly U.S. dollars) that oil-exporting countries depend on to balance their budgets (and to keep their people, or in some cases subjects, happy with big social programs).

Economists aim to roughly estimate a given county's "fiscal break-even", or the price needed by oil-exporting countries to balance their budgets. Saudi Arabia needs oil to average around $90-$95 to balance its 2015 budget. Estimates vary because of different levers countries can pull, but, Iraq needs oil around $105: Nigeria: $120; Venezuela: $120; Iran: $130; Ecuador: $115; Kuwait: $75; Qatar: $65; Russia: $105.

Not every country faces the same pressure through, as Saudi Arabia has about $700 billion in foreign currency reserves, and Russia has $400 billion in foreign reserves. But Venezuela has only $21 billion in foreign currency reserves, with $21 billion in foreign currency debt due in the next 24 months! (What Venezuela President Nicolas Maduro possibly refers to as a "conspiracy to make Venezuela look like it's bankrupt").

We should also remember that the U.S. is not an oil-producing/exporting country for two reasons. First of all, U.S. oil exports have been illegal for several decades (that may change). Secondly, the U.S. government doesn't control any oil company or dictate what the country's production level should be. Production depends on hundreds of private companies who decide how much they should risk/invest and produce. Market forces run the show, with relatively minor government policy influence through taxation, automobile fuel-economy mandates, etc.

Conclusion on oil prices

Almost everybody has an opinion about where oil prices are going, which is really based on nothing more than extrapolating from the recent past. The range of views for oil prices in 2015 could be $40 on the downside and $80 on the upside, and average $60.

The much vaunted U.S. shale oil and shale gas production has an Achilles heel in the form of high decline rates. A conventional oil well in Saudi Arabia, or Texas, may have a slow and gradual annual decline in oil produced over 20, 30 or 40 years. Shale oil and shale gas wells often show declines of up to 80 percent in their first year, before starting a slow decline over 20 or 30 years. As a result, a considerable amount of capital expenditures on new shale wells must be made, just to maintain current production. And the big decreases in oil company budgets for 2015 could have a quicker impact than markets are currently expecting.

Every single energy company is reviewing its 2015 capital expenditures budget for exploration and production. Many have already reduced capital expenditures by 20 percent or more, some by over 50 percent, moves that will impact U.S. (and global) oil production. In addition, automobilists may increase gasoline consumption by driving more, or longer distances, due to lower prices at the pump. These are some of the self-adjusting mechanisms that will ultimately stabilize prices when supply and demand reach equilibrium. At which price though is anybody's guess.

Core Equity Portfolio

Valeant

We first bought Valeant Pharmaceuticals in 2012 at around $48/per share after gaining a deep appreciation for their business practices, opportunity set and management skill. After many bumps along the way, Valeant's stock price closed 2014 at $143 per share, which is not a high price for a wonderful business with wonderful management. One of our big winners.

Liberty Media

I would like to highlight Liberty Media whose stock cost us in negative performance. Liberty Media is mainly composed of a roughly 58 percent ownership of Sirius XM, the U.S. satellite radio broadcaster. Think about Sirius as your cable/satellite TV provider, but only for radio in your car. Sirius has 27 million paid subscribers receiving 140 channels of radio programming. Sirius has highly variable margins as witnessed by 5 percent increase in subscribers in 1 year, bringing 10 percent more to revenues, and 32 percent more in free cash flow! The table below illustrates their growth and the multi-year opportunity at hand.

In Millions	2009	2014	*2017 (estimated)*
Subscribers	18.8	27.1	*30.5*
Revenues	2,500	4,150	*5,250*
EBITDA	463	1,425	*2,200*
Free Cash Flow	185	1,120	*1,600*
Sirius-Enabled Cars	25	70	*120*

But that's not all. Sirius is buying back tons of its own shares, to the tune of over $2 billion in 2014, the equivalent of 11 percent of its shares outstanding (Sirius has a market value of $19 billion). Sirius intends to continue to buy back shares as long as prices are attractive (I agree entirely), and if they continue at this pace, Liberty Media would own 100 percent of Sirius within 3 years or so, without spending one penny. Yet Liberty Media's stock went down in 2014. This is one of these anomalies that Mr. Market gifts us occasionally.

But that's not all. Liberty Media's sum-of-the parts net asset value, including its stake in Sirius, is worth 12 percent more than its stock price. Therefore, as Liberty Media shareholders, we are getting the Sirius share buybacks, at a discount. Unless Sirius' business starts to underperform, Liberty Media's stock price is now available at a big discount to intrinsic value

Chesapeake and SandRidge

In my last quarterly letter, I spoke about how Chesapeake Energy and SandRidge Energy were affected by short-term production issues and a drop in oil prices, and that their stock prices were much below my estimate of their intrinsic value. This was when oil prices were at $90, and when few oil analysts expected prices to go much below $75 in the future. In retrospect, with oil prices having dropped so much in such a short period (around $50 now), I was mistaken to increase these holdings at the time. These two (and other) energy-related companies were the main cause of our Core Equity Portfolio composite's under-performance.

I don't know where oil prices might be in 6 months or 1 year, and the companies we own were not selected as a bet on oil prices. Their value derives from growing their production and decreasing their costs, or from other business factors not always related to oil price volatility. Many oil producing companies have also hedged a big part of their 2015 production at much higher oil prices, thus protecting the year ahead from immediate damage.

SandRidge Energy is a fast growing oil and gas producer with a leading acreage position of 650,000 acres (over 2,500 km²) in the mid-continental U.S. (Kansas and Oklahoma). SandRidge has increased production by 20 percent in 2014 (increase which has partly contributed to the existing global oil supply/demand imbalance) while production costs have declined.

SandRidge's costs for horizontal single laterals have come down from $3.6 million each in 2012 to $2.9 million in 2014. They are targeting $2.7 million per lateral in 2015. However they have been pushing costs even lower by using multilaterals, and multilaterals represent only 20 percent of their drilling program now. They hope to be using mostly multilateral drilling within 3 years with costs down to $2.3 million per lateral.

While we are on the subject of cost, companies like to talk about the "cash cost" to extract oil which could be, say $50 for a particular well. But the "accounting break-even" which includes interest on debt and all other expenses could be $60 per barrel on that same well for example.

	$2.9 MM Lateral Cost			$2.7 MM Lateral Cost			$2.3 MM Lateral Cost		
Accounting IRR	0%	-	40 %	5%	-	55%	10%	-	90%
Oil/Gas Prices	$50/$3.50		$90 /$4	$50/$3.50		$90/$4	$50/3.50		$90/$4

The table above illustrates that if oil prices average $50 all year, SandRidge Energy's stock would be a good investment because their current stock price reflects sub-$50 oil prices for the foreseeable future. Above $60 oil, SandRidge's share would perform well. Above $70 oil, SandRidge's stockholders would be thrilled. As oil markets stabilize upwards in price, and SandRidge becomes even more cost efficient, its stock returns could be spectacular. And in all these cases, bondholders should be fine.

SandRidge has a debt load which will lead them to be very conservative when they probably announce very reduced capital expenditures plans for 2015 (they spent roughly $1.5 billion in 2014), spending enough to maintain production and service their debt. SandRidge's has no debt maturities before 2019. Unless oil prices go down to $40 (and stay down), I expect SandRidge's stock (and bonds) to recover over the next year or so, perhaps even go up dramatically if prices increase over $60 by year-end.

It may be wishful thinking, but to illustrate the impact on our Core Equity portfolios, had all our energy-related stocks not been present, we would have had a decent year. This is a testament to the diversification in the Core Equity Portfolio, as well as the quality of the other companies selected. Reality is a harsh master though.

Given the collapse in prices, the temptation to sell energy related stocks is, naturally, high. But that could be a big mistake. For example, Chesapeake Energy has an estimated intrinsic value of over $40 per share based on a sum-of-the-parts analysis of their different oil and gas assets. Southwestern Energy announced on December 22 that it completed the acquisition of one of Chesapeake Energy's producing assets, in the midst of oil prices tumbling down, for a cash price more than 20 percent above estimates. Chesapeake Energy subsequently announced a large share buyback program which, if fully executed at current stock prices, would represent almost 7 percent of its market value.

These 2 recent announcements highlight the disconnect between price and intrinsic value, and although I wish I didn't buy in 2014 at $26 per share, it would be foolish to sell when it had dropped to $17 or even now at $20. Chesapeake Energy is a keeper, and one with stunning potential to boot.

Thank you for your continued confidence.

Best wishes,

Karim Armand
President

The following three paragraphs cover the investments that had the most economic impact on our Core Equity Portfolio Composite in 2014.

Biggest Economic Contributors to Performance
Burger King delivered strong results, and also merged with Tim Horton's of Canada. Liberty Ventures and its spinoff Liberty TripAdvisor teamed to deliver the goods, and Liberty Ventures stands to deliver even more going forward. Apple had another banner year, confounding critics who said Samsung was eating their lunch. Live Nation's concert, festival, and ticketing (Ticketmaster) business is fantastic! Valeant Pharmaceuticals failed in its attempt to buy Allergan in a blockbuster deal, but the process highlighted how attractive Valeant's stock was. Liberty Broadband is the biggest shareholder in Charter Communications (the #4 U.S. cable/satellite TV provider), a company with lots of growth opportunities ahead. Others who did well for us were: Sears Holdings (after some complex rights offerings we participated in), DaVita Healthcare (a dominant kidney-dialysis provider with lots of upside), Bank of America (low expectations = low price-to-value), DirecTV (sold to AT&T), Berkshire Hathaway (let's hear it for Warren Buffett!), and, GP Investments (a Brazilian private equity firm which was a near mistake, so we sold).

Moderate Contributors to Performance
Some companies' contribution to our Core Equity Portfolio's bottom-line were positive, but underwhelming as compared to the S&P 500 index. They include AIG (insurance), Liberty Global (biggest European cable TV and broadband provider), RHJ International (a group of private bank and asset managers in Germany and the U.K.), Platform Specialty Products (an acquisition-hungry, fast growing specialty chemical producer), Citigroup (low respect from Wall Street = low price-to-value, and some potential catalysts around March 2015), EchoStar (manufactures broadcast satellite receivers and antennas, and offers commercial satellite services: cheap stock, looking to unlock their potential for value creation), Tenet Healthcare (hospital chain, great beneficiary of Obamacare, and with accretive acquisitions potential ahead), QVC (home shopping television network, a great business, with a lot of potential internationally), General Motors (unloved = low price-to-value), and, Starz (owner of premium video networks Starz and Encore).

Biggest Economic Detractors to Performance

SandRidge Energy (oil & gas), Sears Hometown and Outlet (small-to-medium-town retailer), Chesapeake Energy (oil & gas), UltraPro Short S&P500 (short the S&P, a costly mistake), Leucadia (owns Jefferies, an investment bank, and an opportunistic acquirer of assets in need of capital), Chicago Bridge & Iron (engineering, procurement and construction provider to the oil & gas, infrastructure, wastewater, chemical and power industries, with a huge backlog of future projects), CIT (bank), Liberty Media (majority owner of Sirius XM Satellite Radio), Goldman Sachs (investment bank), Lands' End (specialty retailer), and, Ally Financial (auto finance).

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