COLBERT INVESTMENT MANAGEMENT

2017 Annual Letter to Clients

Our stock portfolio had been powering along until mid-summer, with market beating numbers overall, but we did not keep the pace into the end of the year. Although some of our stocks kept going up, others pulled us back, and on average, our relative performance was below the major market indexes.

In order to succeed as an investment manager, we must look at numbers as they are, not as we wish they were. Every time a selected investment performs well, we go back to our investment thesis to see what we got right, trying to separate luck from skill. Perhaps more vital, albeit painful at times, is a review of losers, what we got wrong, what mistake we made, what part bad luck played. A brutally honest appraisal of what went right, what went wrong, and why, enables us to improve our process.

Four big winners contributing to our year were Akorn (+47%, sold), Liberty Ventures (+47%), Apple (+46%) and CommerceHub (+37%). Although I would love to go into the details, I will not elaborate here, because nobody complains about what went right.

I will now go into more a detailed review of three investments that held us back. I do this in full knowledge that human nature means that you may want to sell those underperformers. “Selling low” is sometimes warranted, but it’s not a well-known formula for success. I endeavor to make the case why these laggards are tomorrow’s winners.

One way to illustrate our second half of 2017 is to take a look at one of our most favored industries, the cable broadband/TV oligopolies. I am very bullish on the cable broadband business in general. Cable companies are attractive because it’s the best way to get broadband internet service, which is still growing fast around the world. And that’s even before the forthcoming IoT boom (the Internet-of-Things) where more and more things get connected to the internet, things like refrigerators, cars, lights, climate control systems, security alarms, etc. The IoT tsunami is coming much faster than we think.

Therefore, we have important positions with ownership into Charter Communications, the second largest cable broadband provider in the U.S. after Comcast. Charter had been doing very

well in 2017, up 35% from January 1 to late summer 2017. By comparison, the overall stock market (S&P 500 index) was up 10% at the time. As I said above, we were powering along.

And then, due to short-term investor appreciation changes, the stock has gradually reduced its ascent, whereby late in November it was up 13%, which was still pretty good in absolute terms. Yet the S&P 500 was up 18% by then. At year-end, Charter ended up costing our equity portfolios about 5% in differential performance.

This is important because Charter's present business and future prospects are bright, even though its stock performance was less than the market overall. Cable broadband is the best way to access internet services, no matter what form they take. In fact, even though we are glued to our smartphones, most of the data usage done on cell phones is through a home or business Wi-Fi network, best delivered through cable broadband. On a risk versus reward basis, owning cable broadband businesses is a good place to be for the foreseeable future.

To give you an idea of valuation, just this past November, we learnt that T-Mobile Austria is buying the UPC Austria cable business for 11x EBITDA (a rough measure of annual cash flow). In other words, at the agreed upon price its total enterprise value (market capitalization + net debt) was around 11 times their EBITDA. In comparison, Charter had an enterprise value multiple to EBITDA of about 9.2x. Which means that the market undervalued Charter's enterprise value by roughly 20%. In addition, Charter's cash flow is growing faster than most cable companies. Charter's business is great, and it's expected that its stock price should resume its growth trajectory.

DISH Network is the 2nd leading satellite TV provider after DirecTV (bought by AT&T in 2015 for $65 billion or $3,250 per subscriber). There are two parts to DISH, the satellite TV business which is a cash flow machine with 13+ million subscribers, and the vast quantity of spectrum (airwaves for cellular/wireless communications) licenses owned. DISH bought the spectrum assets over many years to position itself for the enormous projected growth of video watched on smartphones, as well as the IoT tsunami I discussed earlier. Just like Charter, DISH shares were trading solidly on pace with the S&P 500, often pulling ahead, until early August 2017. Then market participants changed their expectations of how DISH would either sell or build out its spectrum assets, and the stock starting pulling back.

Note that nothing has changed in the underlying business. Investors waiting for DISH to announce a deal just started to run out of patience. DISH ended the year down 17%.

Yes, DISH shares contributed negative performance in 2017, but in this case, it would be a big mistake to discard DISH away as a mere loser. I will explain briefly why. DISH has an enterprise value (Market Cap + Debt) of under $40 billion. It has spent $21 billion to accumulate the spectrum assets over many years, which analysts now estimate are worth $39 to $51 billion. So, if (when) DISH makes a deal to partner or to sell the spectrum assets, that value alone would cover the whole enterprise value, leaving the satellite TV business in our hands, for free. AT&T paid $3,250 per subscriber in 2015, meaning DISH and its 13 million subscribers would be worth $42 billion. But the world has changed in 3 years, so let's put that price aside as probably too high. Looked at in another conservative way, DISH's satellite TV business is forecasted to

generate $1.5 billion in free cash flow in 2018, and using a range of valuation for that remaining business, the whole DISH company (spectrum + satellite TV) would be worth about $80 per share, or 67% more than its year-end 2017 price. This is value investing, when the price of the stock is far below the intrinsic value. The margin of safety here is very wide.

Another illustration of our second half of 2017 is to take a look at one of our favorite businesses, a cable broadband/TV provider in Latin America and the Caribbean often called "LiLA". The LiLA stock holdings, which we bought substantially around $21 in April/May 2017, had been going up gradually, trading above $26 in July-August (up 24% during that period).

And then several hurricanes hit the Caribbean region, particularly Puerto Rico which represents about 10% of their business. On September 6, LiLA closed at $25.50 (+21% from our cost in May). Therefore, before Irma hit on September 7 and then Maria on September 20, this would have been considered an excellent investment in the making in anybody's book.

After Hurricane Irma hit the electric grid and other infrastructure in Puerto Rico, the LiLA stock went down, closing at $20.80 by November 30. It should be noted that their businesses in Chile, Panama, and other countries are doing very well. Going forward, LiLA is investing in rebuilding/strengthening their infrastructure in PR, and consequently markets should regain a better appreciation for the whole company as business there normalizes. LiLA shares closed at $20.15 at year-end 2017, and are now trading around $22.45. LiLA's progress reports and other actions should turn it into a long-term winner for our portfolio.

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I recently participated in a Value Investing conference where my peers congregate to give their respective perspective on investment conditions. Value investing has had a rough going versus growth in recent years.

The stock market averages are heavily weighted with large cap growth companies, the big businesses that sell at high prices relative to their earnings (high P/E ratios), whose stock performances have entered a momentum phase. Many investors chase yesterday's winners without much consideration for valuation. One way to visualize this is by how the Pure Growth stocks have done (+37.73%) compared to the Pure Value stocks (+3.96%), representing an abnormally large differential. The Russell 1000 Pure Growth index has 155-member stocks like Tesla, Boeing, Amazon, Home Depot, Google, Illumina, Akorn, Facebook, Netflix, Tenet Healthcare. The Russell 1000 Pure Value index has 197-member stocks like AIG, Caterpillar, EchoStar, Anadarko Petroleum, Frontier Communication, Xerox, Liberty Broadband, JPMorgan Chase, Marathon Oil. We are doing better than the average Pure Value stocks, though not as well as we would have expected in a good year.

The last 80 years of U.S. markets have shown that stocks selling at low prices relative to their intrinsic value do better over time than stocks with high PE ratios. History also shows there are multiple-year periods when growth beats value, and the last 3 years or so have been one of these cycles. History also shows that value tends to regain the lost ground to growth in the next multi-year cycle, and then some. Hence the better long-term numbers. We only know about history in

retrospect, so what the next cycle holds for us is anybody's guess. But I am very comfortable with market leading, profitable businesses like Charter and DISH, whose prices far underestimate their intrinsic value, rather than going chasing after a company whose price already reflects a fantastic (yet uncertain) future potential.

We are now in a momentum market, where sexy stocks like Amazon and Netflix are up 24% or more this January alone. These are two great business selling at very high prices already, so it's not like investors suddenly discovered some obscure underpriced gems. When momentum dominates the market for too long, like it did in 1997-2000 before the internet bubble crash, value investors are left in the dust. Only for value stocks to rebound strongly like in 2002-2007, beating out growth stocks by a wide margin. The last 3 years have been tough for value-oriented strategies, yet this cycle, like others in the past, will change into our favor.

In the meantime, companies like Charter whose underlying businesses keep progressing, unperturbed by stock price variations, are a safer bet than shooting for the stars.

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That's a good representation of how value investors like us have been doing in this environment. As an update, so far in January we are gaining some of our mojo back, though not all of it yet, while always keeping an eye on the underlying business, on intrinsic value. I am firmly optimistic that our portfolio is well positioned to deliver on our collective expectations.

Karim Armand
President
January 31, 2018

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