From the Desk of Tobias B. Shute
January 30, 2015

2014 Investment Review

Dear Reader,

It has been quite a while since my last (/first) year-end letter! That missive was penned following a successful year of investing for my personal account in 2010, and led directly to a terrific opportunity that kept me out of the market and under a cone of silence for the next several years. With the cone now removed, I am free to write to you once more. I have also taken to tweeting @tobyshute, which has proven an unexpectedly rich source for new connections and ideas.

Performance

I'm not able to present a tidy high-level performance review for 2014 as I did in 2010, because I wasn't in the market for the entire year, and I was managing different family accounts for different periods of time. Things didn't really kick off in earnest until my wife handed me the keys to her 401k rollover, which I parked at **Interactive Brokers** (Nasdaq: IBKR) -- IB for short, and more on those guys later. That account got funded on July 8, and from that point through the end of the year my managed accounts collectively returned 7.8%. It was an unspectacular but entirely satisfactory result.[1]

Most important, within the IB account I succeeded in following my wife's investment policy statement. It's a rather dark spin on Buffett's Rule No. 1: "Don't lose this money, or I'll kill you." So far so good, honey!

I incurred my fair share of realized and unrealized losses in 2014, but most were of the paper cut variety and on balance things worked out alright. I'll adopt the approach of my friend Eric Burnside[2] and start off with the things that didn't work. Interestingly, none of the top three detractors from performance was a stock pick gone awry.

Dollar Domination

My costliest activity in 2014 – at least in terms of impact on the P&L between 7/8 and 12/31 – was diversifying internationally. While the underlying performance of the foreign-denominated securities I purchased was positive, the FX translation on those securities plus cash held in other currencies robbed a full 2% of performance from the IB account. (My family's other accounts don't have such globe-trotting capabilities, and were thus inadvertently insulated.) The dollar rose against every major

[1] For spectacular returns, you'll have to check out my friend Steve Kiel (@Steven_Kiel) of Arquitos Capital Partners. Whereas most value managers failed to keep pace with the S&P 500 in 2014, Steve lapped it several times.
[2] Eric is one of the sharp young fellows I got to know through Twitter last year. He's @ejburnside and runs a fledgling RIA business in Portland, OR called Acme Capital.

currency for the first time since 2000, and both emerging markets and developed international markets collectively fell for the year, albeit gently compared to their double-digit declines in 2011.

The lesson here? There's none that I can discern. Currencies will fluctuate, and I'm not about to stop scouring foreign exchanges for mispriced securities. As long as I don't do something remarkably stupid like taking a leveraged short position against the Swiss franc prior to it getting unpegged against the euro, I should be fine.

Hedging: A Waste of Time, Most of the Time

A second rather expensive choice was my attempt to hedge out some market exposure by owning RWM, an ETF that returns the daily inverse of the Russell 2000 small cap index. While flawed, this seemed like the best instrument for the job, given my inability to short stocks or purchase put options in our retirement accounts. As it turns out, this wasn't a job worth doing, and the hedging activity detracted 1.4% from performance across all accounts.

I bought put options on IWM, the Russell 2000 ETF, back in '07-'08 and that was a pleasantly profitable experience. It made me feel smart and prescient. Since then, all my index-based hedging activity has been a drag, and has more or less negated all of the profits generated by those earlier put purchases. I would expect this to be the general pattern over time: regular losses as the market marches onward and upward, roughly offset by the occasional burst of profitability following a panic or crash. This is probably not a great use of my time or money.

The Seductive Allure of the Cheap Stock Trade

The third-biggest drag on my 2014 performance was overtrading. This has not been an issue for me in the past, and I can chalk it up to at least three causes. One is that I had not been actively investing for the FA for several years, and one could say I was a bit trade-deprived. Pulling the trigger felt good, and I got a little trigger-happy. Second, most of the money I am managing now sits in retirement accounts and is either not taxable or tax-deferred, so I am more likely to take short-term profits. Third, commissions on the IB platform generally run $1 (unless you buy large blocks of low-priced stock or shares on foreign exchanges, both of which I did). The remarkable cheapness of and ease of execution on this platform can have a real influence on your trading activity if you allow it to.

Some of this more active trading was helpful, as I was able to cost-effectively scale in and out of positions rather than try to get the low or high tick in a single trade. I also established some small "getting to know you"-sized positions – a number of which I exited upon further research – with minimal frictional costs attached. On balance, though, I placed far more trades than necessary, and total commissions detracted 1.3% from performance across all accounts. That's unacceptably high, and cost me more than any single stock selection, excluding the inverse ETF discussed above.

Two Stocks Not Well Bought

Rounding out the Flub Five were two stock picks that went south and are unlikely to recover any time soon. I'm choosing to omit a warrant position that is marked at a significant loss, but which is inherently more volatile and in which I have a great deal more confidence going forward.[3]

First was **Evolution Petroleum** (NYSE MKT: EPM), a smallcap E&P that I recommended to *Motley Fool Special Ops* members back in 2010 at ~$5/share. The thesis played out well over the ensuing years, with EPM pushing up into the low teens as the enhanced oil recovery project in which the company holds an interest progressed. Not everything has gone according to plan, but the plunge in crude prices was by far the biggest reason for EPM's tumble to $7.34/share at the close of 2014.

Given this exogenous event, I wouldn't necessarily characterize this investment as a mistake. Taking a concentrated position would have been, given Evolution's dependence on unpredictable commodity prices, but position sizing helped limit the damage to a 1.1% loss across accounts.

Second was **Altisource Portfolio Solutions** (Nasdaq: ASPS), a technology company that provides mortgage- and real estate-related services to related party Ocwen as well as other real estate market participants. This purchase was an unambiguous error of commission.

At the time of purchase, Altisource struck me as an appealing platform business with high margins, low capital requirements, and recurring revenue that was locked in over a long contractual period. At ~7x expected cash earnings, the valuation on ASPS seemed to more than adequately discount for the cloud of regulatory uncertainty hanging over the company's head.

The Ocwen complex had come under great regulatory scrutiny, in part owing to an issue with backdated notices of default being sent to homeowners. With ASPS down from $170 to $50, and with the company having repurchased boatloads of stock at the $100 level during Q3'14, I thought it was probably safe to walk into this burning building. It was not long before flaming timbers proceeded to pummel me from above.

Founder Bill Erbey stepped down from all of his publicly traded entities a few days before Christmas, suggesting at least the possibility of some serious impropriety, and ASPS ended the year at $33.79. I've lost count of how many shoes have dropped here, but after a number of additional events in recent weeks, the stock is now trading below $20. ASPS detracted 0.8% from performance in 2014, which understates the (unrealized) damage done through to the present date. While the range of possible outcomes here is wide, Altisource is likely to make a repeat appearance in the lowlights section of my 2015 letter.

[3] These warrants, issued by a certain Chicago-based merchant bank, also don't expire until 2023, so it is very early innings here.

Bullets, I've Dodged a Few[4]

In the close calls category, I will place **Jason Industries** warrants (Nasdaq: JASNW), Quarter Merger Corp rights, **Pangaea Logistics Solutions** (Nasdaq: PANL), and **Rayonier Advanced Materials** (NYSE: RYAM). These are all investments I made and then quickly sold, avoiding 30%+ subsequent drawdowns. RYAM produced a small loss partly offset by an even smaller gain on JASNW, while the combination of Quartet and Pangaea (the former was a special purpose acquisition company that became the latter following the consummation of a deal) produced a material gain. I was profoundly lucky to escape from that debacle with profits on two separate occasions – and I got to meet the talented Jacob Ma-Weaver in the process.[5]

In the case of Rayonier Advanced Materials -- one of many spinoffs that went sour in 2014 -- the stock is off ~47% since I sold it for a small loss after reevaluating their end markets, competitive position, and integrity of management. Rayonier AM looked attractive as a spinoff with high orphan potential, as it was likely to be cast off by yield-seeking investors in parent **Rayonier** (NYSE: RYN). The former parent CEO moved to the spinoff, which was a promising signal.

RYAM makes cellulose specialty fibers, a significant use of which is cigarette filters. This is the first product listed in the company's information statement on Form 10, which discloses that over half of sales for the prior three years were tied to this end use. Searching for the word "cigarette" on the company's website turns up zero results, however, and the image of a cigarette is certainly not included among the ten products pictured on the site's "Our Fibers In Your Life" page.[6] I've seen plenty of misdirection and misrepresentation by companies over the years, but this is a pretty flagrant case. The unveiling of this whitewashed website was a big contributor to my decision to jettison the stock, along with other minor issues like industry overcapacity and the fact that cigarettes are horrible. That sale helped me avoid a 0.5% hit to overall performance through year end.

Chicken Dinner

Reflecting a relatively diversified portfolio (see my wife's investment policy statement and you will understand the gravity of running a highly concentrated portfolio on her behalf), 2014 saw 13 different investments contribute at least 0.5% to performance, or 14 if I count the Quartet/Pangaea combo. I will just touch on a few here.

My biggest winner in 2014 was also one of my most bitter disappointments. I had very high conviction in the quality and growth runway of the core energy brokerage platform business at **World Energy Solutions** (Nasdaq: XWES). This business quality was obscured by both a crummy secondary division and an accounting restatement that obscured the earnings picture for over a year. I was pretty lukewarm on management, but some activist shareholders came in and started agitating for change, such as focusing

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[4] This section is dedicated to the elder gentleman who delivered a rousing rendition of My Way at Santa's Pub in Nashville, TN back in July. They don't mess around with their karaoke in that town.
[5] Jacob presides over Cable Car Capital in San Francisco. Check out his blog at cablecarcapital.com or follow him @cablecarcapital.
[6] http://rayonieram.com/performance-fibers/products/our-fibers-in-your-life/

on the core business. I agreed 100% with their concerns, and hoped to see a sale of the inferior energy efficiency business. Instead, management shopped the entire company, and they accepted an all-cash bid from **EnerNOC** (Nasdaq: ENOC) that I felt significantly undervalued the company and stole material upside away from XWES shareholders. No other bidders emerged during the go-shop period, however, so I had no choice but to sell in late December.

A secondary frustration here was that my position sizing was too small for a Best Idea at less than 7%. I realized this by late October, but as I sought to increase the position I encountered an evaporation of liquidity. I was able to purchase all of seven shares on 11/3 and 31 shares on 11/4, the day that XWES was halted after hours pending the announcement of the cash bid. The position contributed a gain of 3.1% across my managed accounts. I'm getting annoyed all over again, so let's move on.

The second-biggest gain for the year came from a position that I continue to hold, and which has risen many times over in value here in the first month of 2015, such that it is now up nearly 750% from my cost basis. It's a bit surreal. Then again, I bought this stock with the expectation that it could rise at least 20-fold, so the performance is not exactly unexpected, and I'm not selling any. I'm sure I will have a lot to say about this one next year (unless there is a clamor for quarterly letters!), but for now I'll just thank Thomas Braziel for putting me onto the scent here.[7]

Rounding out the top five P&L contributors are an odd-lot tender offer, an NOL shell, and the aforementioned Interactive Brokers. I am mildly embarrassed to admit (to you and to myself) that two of the most lucrative investments I made all year required practically zero analysis. Then again, there are no extra points awarded for difficulty. On June 11, **CBS** (NYSE: CBS) announced the split-off of billboard company **CBS Outdoor Americas** (NYSE: CBSO), enabling the parent to offload the remaining 81% of the company it still owned following an IPO in April. This was achieved via an exchange offer that allowed CBS shareholders to tender their shares and receive CBSO shares at a 7% discount on a tax-free basis. This is free money, and it's called an odd-lot tender offer because of the following key provision:

> **proration:** If the exchange offer is oversubscribed and CBS cannot fulfill all tenders of CBS Class B common stock at the exchange ratio, then all shares of CBS … that are validly tendered will generally be accepted for exchange on a pro rata basis in proportion to the number of shares tendered. We refer to this as "proration." Stockholders … who beneficially own "odd-lots" (that is, less than 100 shares of CBS Class B common stock in the aggregate) and who validly tender all their shares will not be subject to proration.

As long as you tender no more than 99 shares into such an offer, you are guaranteed to have them all accepted. That is what I did, and I made a ~11% return on the position in about a week. That was good for a 1.8% contribution to overall performance, which tells you what a short stack I'm playing with.[8] This kind of opportunity doesn't scale well, but so long as I'm not managing multi-millions I will continue to keep an eye out for similar situations.

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[7] Thomas is the CIO of B.E. Capital Management in NYC. If you read this interview he did with Chris DeMuth Jr. (of whom I'm also a big fan), you will understand why I follow his investments very carefully: http://www.becapitalmanagement.com/uploads/2/6/7/4/26748813/interview_with_chris_demuth_jr..pdf

[8] That's a poker analogy just for you, Bruce.

The NOL shell that will remain nameless was one of several that I purchased in 2014. These are companies with no remaining business operations, but with some cash on hand and substantial net operating losses available to offset future taxable income. I continue to hold several of these stocks, which in some cases offer a more or less free option on a deal being consummated. **ALJ Regional Holdings** (OTCMKTS: ALJJ) is the Platonic ideal of such situations.

I criminally undersized my position in ALJJ, and this position sizing error kept the stock just outside of the winner's circle of top five contributors. Instead, fifth place goes to Interactive Brokers. Unlike the more esoteric, "early Buffett"-style situations I tend to invest in, IBKR is more of a "late Buffett" value investment: great business, highly skilled and well-aligned management team, attractive price. The firm's brokerage business -- which generates most of the profit at this point despite the firm's origins as a market maker -- is growing like mad, especially in Asia. Based on its low cost and superior execution, I expect the firm's market share gains to continue at a strong clip for a long time, both among individual traders and in the RIA/hedge fund space.

One of the biggest reasons IBKR is mispriced is the fact that it is majority owned by insiders, which results in a low "free float" of shares available to other investors. This situation keeps it underfollowed by sell-side analysts and underweighted in popular stock indices. I recommend reading Murray Stahl's writing for more insight on such situations.

A Public Pitch

Another of my favorite compounder-type ideas for the years ahead is **Westaim** (TSXV: WED), which I had the privilege of presenting to an esteemed audience of discerning value investors in January of this year. My writeup was published in the January issue of *The Manual of Ideas*, and my audio presentation was made available to attendees of ValueConferences' Best Ideas 2015 online conference. I owe many thanks to the Brothers Mihaljevic for the opportunity; they are true gentlemen. I have attached the excerpt from the publication along with this letter.

Closing

While 2014 presented more than its fair share of personal and professional challenges, it was a year in which I formed a lot of new relationships that I value highly. After cobbling together my addressee list, I see that I also lost touch with many of you over the past few years. I hope this note prompts us to reconnect.

I had some interesting new experiences last year, such as presenting an investment idea at the High Church of Compounding Machines (the stock remains stubbornly above the level where I believe it should be bought), calling up a large number of hedge funds to see if anyone wanted $200 million to manage, traveling around Italy with a toddler, and running on a dissident slate of nominees for election to the Board of Directors of a public company. I look forward to more opportunities to learn, grow, and challenge myself in 2015.

On a personal note, my family is actively seeking to relocate to Denver this year, and I would appreciate any and all personal introductions, job leads, daycare leads, Mexican food recommendations, etc.

All the best,

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