Dear Investors,

"The big money is made not in the buying and selling, but in the waiting" - unknown

What a year! For the year ending December 31, 2008, AVM recorded a gain of 10.6% net of fees. This compares favorably to a -37.0% decline by the S&P 500. Our nine year average annualized return is 11.5% versus -3.6% for the S&P 500. Although the current environment is favorable to our style of investing, a 15-point advantage is almost certain to decline going forward.

While our conservative culture and philosophy may have held back our performance in years past, it showed merit in 2008. The linchpin of our philosophy is to think critically about risk, especially low-probability risks. Our old fashioned style embraces humble skepticism and is wary of most modern risk management tools and ideas (i.e. broad diversification, financial models, derivatives, etc). Our concern is such tools and ideas can act like mental shortcuts and subtly diminish one's appetite for critical thinking.

Our investment mentality puts a premium on figuring out 'what-to-avoid' rather than 'what-to-buy' (We are an exciting lot to be around!). We prioritize the simple and easy, and quickly discard the complicated. These straightforward principles helped us stay focused in a handful of companies that were resistant to the financial malaise in 2008.

When we analyze a business, we pay close attention to the qualitative and intangible variables – such factors are often difficult to 'model'. We are uneasy with fancy numerical models and broad diversification, which have almost ubiquitous acceptance by the high priests of modern finance. In both cases we believe one is susceptible to gaining a false sense of security, which can result in mental slothfulness and neglect. In the case of models, analysts tend to overweight what can be measured in numerical form, even when the key variable(s) cannot easily be expressed in neat, crisp numbers.

The 'model' behind our largest investment (FFH) required nothing more than sixth grade math, and a napkin – not a sophisticated spreadsheet capable of more numbers than I'm capable of counting. The conservative makeup of FFH's assets made sense to us, and offered massive growth potential under the right circumstances. The notion I suggested last year, that FFH was set up well for a market environment of deleveraging and distress, held true as FFH thrived amidst the chaos, recording huge gains on their investments, and generated impressive growth.

During 2008 we added just two significant positions, both of which enjoy dominant competitive positions and durable advantages. Both companies sell low priced products/services, characterized by stable demand with ample pricing power. I'm particularly drawn to these types of businesses, as they should do well in both inflationary and deflationary environments.

Extremely volatile markets allowed us to book short-term profits in two unique situations. We bought Constellation Energy after the stock dropped 35%, and was yielding 55% - 95% to two announced takeover bids. This spread closed quickly (less than one day) and we exited the position with a nice gain.

We also booked profits in Berkshire Hathaway (BRK) – a position we didn't hold at the start of the year. The cost to insure against BRK defaulting on its bonds spiked to levels suggesting junk-bond credit quality. It's interesting to note, the actual bonds, as opposed to the insurance, traded like true Triple-A rated securities. The stock price behaved as if the buyers of default insurance were right and fell approximately 50% in the space of seven weeks. Such an obvious mispricing didn't last long and we sold out as the stock rebounded quickly. These gains, as well as slight gains in our two largest holdings, were partially offset by a sizable mistake we made in mid July.

Overall, in 2008, we turned the adage of diversification on its ear, as we stayed concentrated in a small number of securities that were both safe and cheap. In fact, diversifying into almost any other security, or asset class, would have impaired our results. This attitude of focusing our investments is a byproduct of my limited mental aptitude and fairly efficient markets. The idea of specializing, or focusing ones mental and physical resources is intuitive, and obvious to professionals in other fields, yet the investment world by and large doesn't subscribe to such an obvious truth.

We will continue to follow a common sense based approach to investing, holding intellectual honesty and rigorous analysis as the keystones to success. We think our philosophy is an intelligent way to invest – regardless of whether we're characterized as 'growth' or 'value' investors. Such style-box definitions are not germane to stock picking success. Success is based first, on the accuracy of analysis, not style categorization; and second, upon not overpaying for the business in question. The traditional 'margin of safety' concept, often emphasized by 'value investors', has utility and is something I consistently apply, however it is secondary, and the value is dependent upon solid business analysis.

"It is better to know nothing than to know what ain't so" – Josh Billings

The financial markets continued to deteriorate in 2008 as extreme leverage, and panic-stricken counterparties proved to be explosive tinder with reinforcing effects. This resulted in continued deleveraging, causing market participants to sell what they could rather than what they wanted. Such conditions caused fear to set in throughout financial markets, with US Treasuries being the only asset class immune to the malaise. At one point during the year the contagion of fear was so rampant the yield on the 3-month T-bill turned negative – putting money under your mattress would have provided a higher return!

The combination of poor incentives, lax oversight (sometimes making me wonder if legislation from 1868, legalizing bribery in NYC, had been reinstated) and a 'whack-a-mole' like response to the financial crises caused gut-wrenching gyrations in the marketplace. The atrocious record of the rating agencies illustrates the importance of proper incentives. Consider that AIG, Freddie Mac, Fannie Mae, Ambac Financial, MBIA all had triple A ratings right before their collapse. Those who relied on rating agencies to measure corporate risk may have underestimated the power of incentives. "Whose bread I eat his song I sing." - Famous German proverb.

The economy also began to wilt in 2008. An incredible consumption binge built upon loose credit and rising asset prices resulted in a negative savings rate in 2007, down from 10% in the late 80's, and 6% in 1995 – Consumer spending accounted for 72% of GDP in 2007; unprecedented in modern history. Over the past decade the average American has seen his/her wages stagnate while the cost of living has increased meaningfully. This situation was more than offset by increased borrowings and tapping ever-rising asset accounts. Now, conditions look perilous, as debt-servicing costs remain high, while wages, employment, and assets values have all declined.

Roughly $10 trillion in consumer wealth evaporated in 2008. This wealth destruction will likely leave psychological scars, manifested by higher savings and lower debt induced consumption, a bitter cocktail for an economy so dependent upon the consumer; and potentially fatal for some firms overly reliant upon frivolous spending. The future earnings power of many businesses will be drastically lower going forward – which should give caution to investors who's strategies are based upon 'buying the dips' or being strictly contrarian.

Our government looks to have an unrealistic tolerance for any economic discomfort even if it's healthy for the long-term prosperity of America. Many of the proposed policies to reignite spending leave me cold, and give me the feeling we are focused on treating the symptoms rather than the underlying disease. I hope policy actions are aimed at sustainable job creation (via education, worker training, infrastructure, and energy alternatives) that will reduce America's dependence on imports and foreign savings, and avoid policies focused on perpetuating an unsustainable consumption binge financed by foreigners.

In the near term, standards of living will almost certainly decline, and economic activity may take years to reach previous heights. And while purging of the economic deadwood will be painful in the near-term, the rehabilitation process is much needed, and will help to insure a solid economic footing when growth resumes.

It is important to remember, the American system is a six-sigma event like the world has never seen. In the last 100 years America has enjoyed a 7-fold increase in productivity – unprecedented in modern history. What is new and cutting edge in one's youth is outdated and obsolete by the time one reaches middle age, if not sooner – a development that was unheard of before the mid 1800's.

For the most part I believe the ingredients that produced such prosperity in the past are still in place. The US has endured all kinds of difficulties in the past and ultimately prospered – I believe the future will be similar, although the duration of this downturn will likely linger.

LOOKING FORWARD

Prospective returns going forward are certainly higher than they were just 18 months ago, yet people are behaving as if the opposite is true. High uncertainty, and extreme volatility, coupled with massive deleveraging is a near nirvana-like backdrop for our investment style. Additionally, better oversight and lower leverage should mitigate the systemic risk threat going forward.

We will continue to look for lay-ups, or absolute no-brainer types of investments. The major advantage one has investing in the stock market is the ability to patiently wait for the slam-dunk opportunity. There is no reason to try anything overly difficult. We've spent a good deal of time, and effort, and even turned down large sums of money so as to attract a unique investor base that provides us with the freedom to wait for rare opportunities. Everyone invested in the fund has contributed, in no small part, to our success. Our ideas and philosophies are simple, yet effective. The reason why they are not more broadly adopted is because industry dynamics make it near impossible to implement. Non-activity in the face of short-term underperformance is simply not tolerated, even though realistic assumptions (you can't outsmart other smart people all the time) and basic math (lower frictional costs) confirm its worth. Most fund managers' capital would not stick around long enough so they simply comply with more standard methods of operation in the spirit of keeping their jobs.

While we benefited this year by recognizing the potential risks in an over-levered financial system, you can sleep well at night knowing the future success of your investment is not dependent on my ability to predict precise changes in economic activity. I try to guard against my own ignorance by rarely having a strong view on such complicated systems like the economy. Incredibly bright people are routinely humbled by their prognostications of the economy. Instead I will focus on simpler problems that have few key variables, such as sound companies with strong management teams. This approach has proved its worth in the past and I'm optimistic it will hold its value in the future.

I appreciate everyone's continued support. Please don't hesitate to call with any questions or comments. I look forward to reporting once again next year.

Sincerely,

Allan Mecham

February 24, 2011

Dear Partners,

Another year is in the books. I'm happy to report when the checkered flag dropped for the year ended December 31, 2010, Arlington Value (AVM) and AVM Ranger gained 23.4% and 31.4%, respectively – 20.5% and 25.6% net of fees – versus 15.1% for the S&P 500. AVM Ranger is one-tenth the size of AVM, which allowed us to build larger positions in two small-cap names that performed exceptionally well. Far more meaningful, this brings AVM's 11-year annualized return to 18.7% (16.2% net of fees), versus 1.0% for the S&P 500. AVM Ranger's 2.5-year annualized return is an unsustainable 51.9% gross, and 42.0% net. The below table may be easier to follow.

Arlington Value Management			
	Gross	Net	S&P 500
2010	23.4%	20.5%	15.1%
11-Year Annualized	18.7%	16.2%	1.0%

AVM Ranger Fund			
	Gross	Net	S&P 500
2010	31.4%	25.6%	15.1%
2.5-Year Annualized	51.9%	42.0%	1.1%

Though our relative performance has been red hot over the past three years, don't trick yourself into thinking momentum is on our side – our strategy doesn't enjoy the benefits of propulsion. Furthermore, and at risk of sounding like an investment chaperone, investors should temper future expectations: The degree of outperformance in all funds is certain to decline over time. Additionally, we won't always be on the winning end each and every year.

It's worth repeating our goals as we take on new partners. Our goal has remained the same since inception: to outperform the S&P 500 over the long-term (5-10+ years) net of fees *and taxes*. Our goal is relative because most funds (estimated at 75%+ by reputable sources) underperform the index over time, and low-cost index funds are readily available to investors. If we can't add value, we will not milk fees at your expense.

We think our philosophy is durable even though the margin of outperformance is likely to narrow. This shouldn't cause alarm since a small advantage adds enormous value over time. A mere 3% annualized edge will produce a 2.4-fold advantage over a 30-year period – the salient lesson that compounding teaches: the power of a long runway.

PORTFOLIO HIGHLIGHTS AND LOW-LIGHTS

We were active during 2010 (we added four new positions), which is always reason to pause. Frequent activity brings two kinds of costs: the costs of doing business and the costs of more mistakes. The major mistake I made in 2010 was selling our 18% Autozone (AZO) position at an average price of $155.67 per share (I'll let the more mathematically inclined figure the foregone gains based on AZO's year-end closing price of $272.59 per share). We've followed and owned AZO for years and admire the intrinsic qualities of the business – a leading market position, durable and counter-cyclical characteristics, strong growth prospects, and an impressive managerial record of capital allocation.

However, early in the year, my penchant for low-risk investments led us to swap AZO in favor of Berkshire Hathaway (BRK), a diversified conglomerate in a class by itself, with a risk profile unmatched in corporate America. BRK offered a unique opportunity to profit from an announced catalyst: inclusion into multiple indices. The inclusion forced index funds to buy large amounts of BRK in order to comply with their investment mandates. The abnormal buying pressure, combined with BRK's fiercely loyal and long-term oriented owners (annual turnover of only 14%), made for a slam-dunk opportunity. In addition, and importantly, we thought BRK was a compelling value at $107,000 per share (the price at the time), providing ample protection if the price didn't react as we anticipated. The investment appeal was not the enormous upside, rather the near-certain profit, coupled with minimal risk. BRK provided a nice return and ended the year at $120,450 per share. We still hold BRK and feel it's both very safe and reasonably undervalued.

We reluctantly trimmed our Fairfax Financial (FFH) position in 2010, though it still occupies a hefty portion of the portfolio. FFH didn't contribute much in 2010 but we continue to like the holding. In our view, FFH's management team is second to none, and has demonstrated an unwavering focus on building long-term intrinsic value. Contrary to most public companies, FFH's management shuns quarterly guidance. Rejecting guidance is rare among public companies, though it's a practice we applaud (represented in six of our nine current holdings). We worry that providing quarterly guidance may tempt companies to publish aggressive growth targets to appease Wall Street. Our concern is not that the aggressive forecasts won't be met, but rather that they will, at any cost! Earnings growth should be a consequence of sound strategy, not the object of it.

In the fourth quarter, we made the difficult decision to sell Philip Morris International (PM). Despite our high opinion of PM's business economics and powerful competitive position, we chose to sell our shares and reallocate the proceeds. PM provided a nice return with below average risk.

Potential investors often ask about our sell discipline. Selling is difficult, and my track record suggests it's usually a mistake. My view on selling is akin to the old sports adage, "the best

defense is a good offense"; the best sell discipline is a stingy buy discipline – which couples proper analysis with a bargain price. I'm leery of the seemingly simple proposition of "buying cheap and selling dear" if it entails jumping in and out of securities with frequency. Frequent activity rarely results in a smashing success. I agree with the late investor, Phil Carret: "Turnover usually indicates a failure of judgment. It's extremely difficult to figure out when to sell anything."

For much of the year we held significant cash, though by the fourth quarter we identified two terrific opportunities and became fully invested. Holding cash is difficult and not feasible for many funds. The incessant performance pressures and constant bombardment of information makes doing nothing (e.g., sometimes holding cash) extremely difficult.

I disagree with the notion that more information is always better. Resisting the urge to act, and maintaining focus, while sifting through the torrential flow of information – much of it noise (newsletters, blogs, internet articles, newspapers, SEC filings, investor conferences, message board fodder, and subscriptions of all types) – is often more challenging than the nuts and bolts of business analysis. The steady surge of information coupled with short-term performance pressures can push rational long-term investing to the brink of extinction. The easy access to information, and snack-bar nature of consuming it, suggests that disciplining one's temperament rivals the need for energy and action.

Over the past few years, work, energy, and the right temperament were all needed while we acquired shares in a small transportation company specializing in expedited services. We began purchasing shares in 2006 as the company transitioned into a more focused competitor. We continued buying intermittently, while watching the price drop more than 50% on multiple occasions. The price swings didn't bother us as our commitment to buying was based on the solid operating accomplishments and the bargain price of the shares. After three years of stagnation the stock price surged nearly 100% in three months, contributing handsomely to our 2010 results. This small company maintains an asset-light model and focuses intently on the key levers of intrinsic value, manifested by strong returns on capital (30%) and rapid growth. We continue to hold the shares and think the future is promising.

We added four new companies in 2010. Each position was added based upon safety, value, and price. Fortuitously, all four holdings have appreciated nicely (such timely appreciation is attributed to luck more than skill), and we continue to find both the value and prospects compelling.

POOR RESULTS & HIGH COSTS OF THE FUND/FINANCE INDUSTRY

Although in the past I've been known to toss a tomato or two from the back row, I don't take great pleasure throwing tomatoes for the sake of attention. Rather, I feel semi-obligated to opine

about industry practices I think are flawed and dangerous to investors' financial health. With that disclaimer out of the way, let me head to my garden.

The fund industry's dismal track record (most underperform passive index funds after fees *and taxes*) fails to inspire confidence in the standard conventions. The industry's unspoken alibi seems to be self-interest, as conformity and average equals safety and job security. The poor results don't necessarily stem from ineptitude or dubious ethics (though that variety does exist), but rather from an industry structure rooted in human nature, nudging managers to emphasize occupational performance over investment performance. From retail investor to fund manager, the liquidity of the market causes irrational behavior to permeate throughout the system.

We disagree with the standard playbook – that is, wide diversification (guaranteeing lots of mistakes and mediocre commitments), small position weightings, rapid turnover (insidious frictional costs via commissions and taxes), and running commentary that panders to asset gathering over investment managing.

Our style is neither common nor conducive to amassing assets quickly, yet we believe our unorthodox ideas are critical to sustaining market-beating results. We favor infrequent action (and commentary), patiently waiting for exceptional opportunities. The result is a concentrated portfolio that tends to be more volatile than the indices – a situation that's not well tolerated by lay people and Wall Street alike.

I'm sorry to say I think John Bogle is right: "Salesmanship has supplanted stewardship." The fund industry can appear confusing, overwhelming one with choices. The industry looks like the financial equivalent of The Mall of America, with a countless number of catchy style box monickers to choose from. However, I think the overriding determinant to long-term success is not the sound of the monicker but rather the skill of the manager.

Before dismissing me as old-fashioned (I am almost 34 years old), or a paid spokesman for the Vanguard Funds, consider the enormous financial costs of our bloated financial system: The average recurring cost in 2007 for all financial intermediaries was $528 billion dollars. That's an annual run rate of $5 trillion dollars over a decade. This incredibly high cost fails to account for the potentially larger opportunity cost of misused intellects: instead of adding value in other fields, America's best and brightest (that lets me off the hook) are leaving Ivy League addresses in droves, heading for Wall Street, which has a history of building financial fault lines worthy of collapse. Certainly not all funds or finance activities are bankrupt of value, however, I'm unsure the industry in total adds enough value to justify the huge costs.

It's not hard to understand the appeal of the industry: an asymmetrical risk/reward proposition. While the upside rewards can catapult one into the ranks of the Forbes 400, the downside of misallocating capital and systemic collapse lacks appropriate repercussions for the actors involved. The root of the problem is opposite to the message conveyed by a joke told by Kurt

Vonnegut: "But listen: If anyone here should end up on a gurney in a lethal injection facility, here is what your last words should be: This will certainly teach me a lesson."

GENERAL COMMENTARY

I don't feel I currently have any special insights regarding the economy or markets in general. Don't misinterpret my lack of commentary for laziness: If I have a vice, it's my morning coffee and daily stack of newspapers – keeping with our old-school style, I subscribe to the print versions.

Even though I'm skeptical of market forecasters, I do recognize the psychological benefits forecasts have on financial anxieties. Hearing managers wax eloquent on macro and market trends, and associated hedging strategies, makes it feel like they are earning their pay and have all the bases covered. However, trying to cover all bases at all costs (i.e., hedging) comes with costs, and for Arlington, it would likely bring an unpleasant caveat: mediocre performance. I'm uneasy deciphering macro and market trends. The trend may be our friend, but I've never met him.

Naturally, short-term commentary can lead to a short-term focus, which carries the risk of snuffing out more important long-range perspectives. If the above bemoaning of forecasts and commentary doesn't deter your desire for a market call, then I'll side with J.P. Morgan: I think it will fluctuate.

Arlington aims to play to our strengths, tailoring policies to encourage long-term investing perspectives. We think this provides a competitive edge and the best chance for long-term success.

Our strategy for difficult macro conditions is not to predict and profit from them, but to buy companies that are quasi-immune to them. We think a rigorous discipline of buying quality companies, when priced right and run by honest, intelligent management teams, offers the best defense against challenging macro conditions.

I'll continue to look for these types of companies going forward. I appreciate everyone's trust, and the opportunity to manage your assets. I look forward to reporting to you next year.

Sincerely,

Allan Mecham

March 12, 2012

Dear Partners,

I have good news and bad news: the good news is we finished 2011 with our 6th straight year of gains; the bad news is we underperformed the S&P 500, after fees. For the year ended December 31, 2011, AVM Ranger LP gained 3.0% gross and 1.4% net versus 2.1% for the S&P 500. Since inception three and a half years ago, AVM Ranger has generated a net annualized return of 29.2%, versus the S&P 500's 1.7%. Staying true to form, I want to caution investors that the level of historical outperformance is unsustainable and bound to decrease.

Also in 2011, we undertook a few housekeeping efforts that allowed us to consolidate and simplify the funds. Midway through the year we closed the original AVM fund - ending an eleven-and-a-half year track record averaging 18.3% per annum, gross of fees (15.9% net), versus 0.9% for the S&P 500 - transferring investors into AVM Ranger LP. We also transferred tax-exempt investors to our new offshore vehicle, AVM BVI. Though it may have felt like a financial fire drill, the changes were made with your interests in mind. The new structures now allow symmetry between all funds.

I feel obligated to once again impose my annual diatribe regarding short-term results: we think short-term measurements are poor assessors of long-run ability, and believe sounder judgments are made scrutinizing results over longer time frames.

As an aside: A friend recently pointed out that long-term perspectives may yield benefits beyond financial gains. Well-worn studies confirm the *financial* utility of long-term viewpoints; however, behavior psychologists augment the case by showing investors dislike losses two to three times more than they like gains. If short-term gains/losses carry 50/50 odds, then the disdain for losses implies that infrequent monitoring and long-term horizons aide both *mental health* and *financial wealth*. In short, Winston Churchill's quip on revenge may aptly apply to myopic investment habits: "Nothing costs more and yields less."

Out of curiosity, my partner Ben (he does the heavy lifting around here) mined the last five years of AVM data, uncovering our historical odds of outperforming the S&P 500 in any given month. The data confirmed our suspicions: AVM outperformed 55% of the time—nearly a coin flip. This offers an interesting takeaway when combined with investors' inert psychology: had we reported monthly results, investors would've had the bizarre experience of disliking their exposure to top-notch gains (AVM's five-year annualized return of 18.7%, net of fees, versus -0.4% for the S&P 500 would rank second out of 6,000 US equity funds tracked by Morningstar). We set the bar high at Arlington, preferring both solid gains and happy partners.

At risk of flogging a dead horse (or worse, a dead audience), we think fixating on short-term results is bound to harm investment managers and investors alike. Low scores are rarely shot while being critiqued mid-swing on each and every hole.

Anyone employing the enviable habit of monitoring their investment annually likely had a sedated response at year end. Yet those with a sharper eye towards quarterly moves were subjected to agitating volatility as fear and anxiety plagued the marketplace, causing frenzied mood swings among the "fast money" crowd. "Mr Market" repeatedly displayed his bi-polar personality, oscillating between a "risk-on" and "risk-off" mentality as the market digested oft-recycled fears (i.e., debt ceiling, Euroland crisis, Middle East tensions, Chinese hard landing, etc.).

The tense environment helped us acquire two new positions at bargain basement prices. Near-term macro worries and lingering scars from 2008-09 worked to punish the share prices of these financial firms, which both fell more than 50%. While fearful climates can drive investors to the verge of hysterics, our buying behavior was more akin to exuberance, like Black Friday shoppers laying claim to bargains. We buy stocks the way we buy toilet paper: high quality, on sale, and in bulk sizes.

Though comfort accompanies investing with consensus optimism, prohibitively high prices tend to shadow upbeat outlooks, effectively buffering prospective returns. We think waiting for both low prices and all-clear signals resembles a belief in financial fairytales. We favor low prices over optimistic viewpoints and feel that letting macro concerns abolish buying quality companies at attractive prices is equivalent to letting one's stomach hijack the brain.

While hesitant to dismiss popular worries, we realize divorcing risks from the marketplace is like trying to separate humor from comedy. We strive to intelligently manage risks, not avoid them completely. Furthermore, financial crises are like thunder storms—you hear stomach-jolting thunder *after* lightening has struck; rarely do the media and masses telegraph financial catastrophes in advance.

Our preference for navigating risky waters is to own durable businesses that provide compelling value to customers in all economic environments; this lets us go through economic dustups, instead of trying to dart in, and out, and around them. For added protection we strive to pay attractive prices for our ownership interests.

PORTFOLIO REVIEW

Although the portfolio didn't register major gains in 2011, we did make a few meaningful adjustments. Beyond the two unnamed financial additions, we trimmed a few long-held holdings and added to others. Continuing the mistake de-jour of 2010, Berkshire (BRK) declined while

AutoZone (AZO) clipped ahead. As BRK declined in price (though in our opinion, increased in value), we bought more—a lot more: able to borrow at around 1.5%, we levered BRK into a 50%+ position. Though not advocates of leverage, we believe the low cost and modest amount, combined with BRK's iron-clad safety and cheap price, makes our action sensible.

Conventional fund management holds dogmatic disdain for highly concentrated positions. Needless to say, we hold a different view. To us, as a BRK owner, the contempt for concentration is acutely illogical as BRK provides ample diversity, with exposure to disparate businesses (more than 70), sectors, and asset allocations. Not only is BRK well diversified and awash in cash-generative companies, it also holds a slug of blue-chip equities (worth $75-plus billion), sits atop a mountain of cash (nearly $40 billion), and is a titan of financial strength privy to sweetheart deals. Additionally, it's run by a guy out of Omaha who's considered a premiere risk manager and "oracle" of capital allocation who nearly works for free! In short, we think our huge BRK position fortifies, not weakens, the portfolio.

Warren Buffett surprised many by announcing a share buyback in September. Though we applaud the buyback our heavy BRK position was established beforehand, and is firmly based upon assets and earning power. Questioning future cash allocation, and whether it accrues to shareholders, is a common concern investing in cash-rich companies generating healthy cash flows. On this score, we have few worries. Warren Buffett's 50-plus year track record and the deep-rooted culture within BRK supplies ample confidence that accumulated capital won't be squandered at shareholders' expense. BRK's solid earning power and absurdly cheap price makes brilliant reinvestment rates unnecessary to support our thesis—assurance that accumulated cash will accrue to owners suffices.

With a reasonable timeframe, we think BRK is all but certain to surpass our low cost of debt—likely by a comfortable margin. The key concern (when operating with leverage) is being able to play out our hand under unforeseen scenarios. We've thought through low probability events, and begrudgingly added a modest amount of market hedges, insuring endurance under even remote circumstances. We think BRK is handsomely overcapitalized (implying latent value beyond healthy cash flows) and smartly undervalued—a tremendous value proposition.

Next time you're at a cocktail party you can officially claim to be a "wildcatter"—after which, to keep people from getting any funny ideas, you may want to explain that it's a term used in the oil industry. Though "wildcatter" may not apply in the truest sense of the term, two years ago we did gain exposure to the oil patch via our position in Sandridge Energy (SD), a domestic exploration and production (E&P) company headquartered in Oklahoma. Don't let our historical absence from the oil industry scare you, we think SD has unique characteristics worthy of a place in our portfolio. CEO Tom Ward displayed savvy foresight four years ago, impressively transforming SD from a natural gas focused producer to predominantly oil focused today. Incredibly, Tom acquired assets four years ago that trade hands today for more than ten times SD's cost.

SD's appeal rests upon its enviable acreage holdings, a low-risk high-return drilling program, low and stable operating costs, and a screamingly cheap stock price. SD's niche operation combines a low-risk drilling strategy (conventional shallow carbonate/permeable reservoirs with long histories) with an aggressive hedging program, letting it lock-in selling prices at attractive rates of return. Hedging is not a universal panacea, and in fact can be fraught with danger; fixed selling prices and escalating costs can result in financial calamity. However, SD's unique market position enables stable operating/servicing costs as few competitors vie for an abundance of operating equipment, making an aggressive hedging program both safe and sensible.

Tom Ward has paired a conservative drilling strategy with an aggressive funding program, needing to raise significant sums of capital to capitalize on vast acreage holdings. So far, SD has had little trouble raising capital as attractive acreage has proven to be enticing bait to capital markets and strategic partners. The main risk to SD is a large and sustained decline in oil prices. We deem this probability remote and feel SD's low price is generous compensation for assuming the risk.

SD also holds considerable natural gas assets, a commodity that has plunged in price over the past few years. If the historical relationship between natural gas and oil re-emerged (on an energy equivalent basis), via natural gas increasing in price, significant value would be unlocked for SD shareholders.

Also noteworthy in 2011 was a management change at Express 1 - since renamed, XPO Logistics (XPO) - a small transportation-focused company I mentioned in last year's report. Express 1 was infused with cash (not needed in our opinion) and taken over by Bradley Jacobs, former founder and CEO of United Rentals. Though we weren't thrilled with the deal terms, we opted to hold our shares and support the new team. We like XPO's assets, reputation, and market position, but the future success of our investment largely resides on managements ability to execute a roll-up strategy. Jacobs, who has a nice track record of rolling up companies, seems to grasp the important variables (treating owner-operators in a first-class manner, managing receivables, etc) and has implied he will preserve XPO's most valuable asset: its well-regarded reputation.

We think there is enormous potential for XPO to attractively grow far into the future. It's worth re-highlighting the appeal of XPO's business: XPO employs an asset-light business model that generates high returns on invested capital and spins off free cash flow to owners in nearly all economic environments. Most important, XPO has a sterling reputation for reliability and service. The segments that XPO targets are littered with small (and less well-capitalized) mom-and-pop operators, aggregating to a $200-billion market opportunity, providing a long runway for attractive growth. It's far too early to pass judgment but we're optimistic about XPO's future.

We further trimmed our long-held holding in Fairfax Financial. We reluctantly pared back the position (currently a 5% position) to increase allocations elsewhere. Not only has Fairfax performed exceptionally well since we bought our stake five years ago, we think it's a terrific

company with a solid future. For FFH fans cringing upon hearing this decision, there's a decent chance in the future you'll receive consolation by uttering that timeless phrase: "I told you so."

Another large position, Lowes (L), had a negligible impact in 2011. Lowes, run by Jim Tisch, is a diversified holding company primarily focused on energy and insurance. Jim Tisch and co. have a nice track record of conservatively managing Lowes and judiciously deploying capital. We believe Lowes is a low-risk proposition with significant upside.

The vast majority of our portfolio is invested in low-risk businesses that should prove rewarding over time.

PROCESS, PHILOSOPHY, ETC.

Friends and colleagues back East and across the pond occasionally give me flak for not "getting out enough." With that in mind, I'll briefly address a few common topics related to Arlington's process and philosophy, and to what makes us different (besides being located above a taco shop), in case my frequent flyer miles come up short in 2012. I hope investors find them useful.

The investment opportunity we seek is simple: we're looking for the rare combination of business safety, an attractive price, and clear understanding that leads to low risk and market-beating returns. Our strategy requires us to emphasize Ben Graham's sage advice: "There are two rules in investing. Rule number one, don't lose money. Rule number two, don't forget rule number one." I deem the second rule far more important than the first.

Others may view us as the avant-garde of the fund industry; however, our ideas and policies are all structured with one goal in mind: to cultivate a culture that encourages rational decision making that ultimately leads to solid risk-adjusted returns. We prioritize the research process above all else—gathering assets, frequent communication, snappy marketing material, and investor meetings all ride shotgun to investment performance.

While our investment process is difficult to compress into a plug-n-play formula, the basic principles are simple and enduring. First and foremost, we adopt the mentality of a business owner buying for keeps. To us this means thinking about staying power, competitive threats, economics, and comparing price to value. In a time when financial television keeps score of quarterly "beats" (meaning a company beat estimates) we ignore financial models and are oblivious to consensus estimates. We don't think quarterly "beats" are germane to intrinsic value. We prefer betting on company fundamentals, not investor psychology.

We strive to be conservative and realistic in assessing opportunities, paying close attention to our own limitations. While the revered "margin of safety" concept is frequently cited and often beneficial, in my opinion, it's prone to misuse. The old saying comes to mind: "It's not the bad

ideas that cause problems—it's the good ideas taken too far." Intellectual honesty and accurate analysis is paramount for successful application of business valuations.

The value of a company is derived from what it produces for owners over its lifetime—usually many years, often decades. This supports a mindset calibrated towards longevity, forcing us to hone in on variables related to durability: barriers to entry, technological obsolescence risk, bargaining power, value being provided to customers, and threats of all kinds. In most cases, what's critical is not next quarters earnings, or next year's numbers (what Wall Street emphasizes), but rather the earnings over the next decade and beyond. If the valuation takes place upon a shaky qualitative backdrop or uncertain competitive understanding, then valuations and a perceived margin of safety can turn out to be a mirage.

Our business owner mentality causes us to think about broad macro topics, yet allows us to virtually ignore the constant babble of short-term macro noise. In fact, short-term macro challenges are often a boon to owners of quality companies, as marginal competitors fade away to the benefit of incumbents.

I believe the biggest difference (and our main advantage) between Arlington and the average fund is our ability to implement a framework of analyzing businesses like a long-term owner, which is enabled by selectively taking on compatible limited partners. Though references to long-term ownership are common in the fund industry, we believe the rhetoric often differs from actions. Arlington's unorthodox policies serve to inoculate our partners and encourage a culture that allows our actions to sync up with our philosophy.

While our focused portfolio is sometimes criticized by the financial mainstream, we think the judgements lack substance. We are a risk-adverse fund looking for low-risk layup-type investments while other funds are akin to a run-and-gun offense that routinely takes a smattering of low-percentage shots. To further the basketball analogy: we're like a basketball team playing without a shot-clock, patiently waiting for layups and slam-dunks, while the opposition operates within the confines of a 24-second shot-clock forced to take a raft of unbridled shots.

Though we stand out for being different, we simply don't have the stomach to operate conventionally in order to raise assets (which equals large paychecks), while leaving investors worse off for entrusting us with their capital—the typical practice of the industry. We want a symbiotic partnership where we earn our fees, building wealth with our LPs, not off them. The common practice of hugging a benchmark index to ensure sticky assets leaves us cold considering the deceptive practice of touting track records (often besting a benchmark by less than 2%, usually worse) that fail to add value after accounting for fees ***and taxes*** (the average tax drag is a meaningful 2.2%).

We can't promise returns but we do promise to adhere to our unique policies that we deem beneficial to a rational framework of investment. We believe our structure and culture are critical to solid execution, and act as a buffer to the corrosive emotional whirlwinds endemic to

the industry. If you think I'm overstating the importance of emotions and culture, maybe Warren Buffett can persuade you:

> *To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.*

Arlington's limited partners and our unusual policies are strong antidotes to the emotional corrosion Buffett speaks of. Thank you for your continued support. I look forward to reporting to you next year.

Sincerely,

Allan Mecham

February 26, 2013

Dear Partners,

Ben and I couldn't be having more fun, and we feel fortunate to have terrific limited partners. You're a huge tailwind and again helped us book strong returns in 2012. I'm happy to report that for the year ended December 31, 2012, AVM Ranger[1] recorded a gain of 35.7% (29.2% net) versus 16% for the S&P 500. This gain brings AVM Ranger's 4.5-year annualized return to 36.5% (30.1% net) versus 4.8% for the S&P 500. This 4.5-year annualized return, and the level of outperformance, has surpassed my most optimistic aspirations. Partners hoping for an encore performance (over the next 4.5 years) will certainly be disappointed—there's a better chance of the tooth fairy leaving trillion dollar coins under your pillow.

AVM Ranger ended the year on a high note despite the overbearing macro and political fears that perpetually dominated the news. The steady drumbeat of macro fears has caused many managers to question the virtues of old fashioned stock picking, suggesting that a plain vanilla bottoms-up approach is incomplete and dangerous. We hold the opposite view and question the wisdom of letting macro forecasts drive investment behavior. Our approach is akin to that of an NBA basketball player shooting clutch free-throws: We try to tune out the noxious crowd.

Tuning out the crowd worked well in 2012. Lets take a look at the highlights and lowlights.

PORTFOLIO REVIEW

In last years report I mentioned that we acquired positions in two financial firms at the end of 2011. The two firms, Jefferies and Bank of America, both made healthy contributions to our 2012 results. In both cases conjecture swirled and short sellers pounced, producing attractive entry points for long-term investors as the share prices plunged.

Catalyzed by the MF Global bankruptcy in Q4 2011, the vitriol hurled at Jefferies (JEF) became especially heated. As the share price sank we capitalized on the opportunity and became co-owners in a conservatively managed investment bank at an average cost of roughly $11.00 per share. This price was attractive (equal to 70% of book value), requiring only modest profitability for an attractive return on our investment.

Under CEO Rich Handler, JEF has a sterling track record of managing risk, exemplified by navigating the 2008-09 financial storm with deftness and skill. While peers were being carried out on stretchers in government care, JEF made due on its own.

[1] AVM Ranger, LP is the successor to Arlington Value Management, LLC

Management's long-held habit of prudence anchored our decision to invest. As the price rose we opted to sell for two reasons: one, we're not overly enamored with the investment banking business and two, we liked the idea of reducing our margin balance.

Bank of America (BAC)

Levered institutions dependent on capital and trust have always been susceptible to speculation and self-fulfilling prophecies. Bank of America's (BAC) vulnerabilities, aided by a long history of undisciplined expanse (conducted by prior management) were rudely uncovered by the financial crisis of 2008-09. The crisis exposed reckless acquisitions, inadequate capital levels, a bloated cost structure, and a culture gone awry. The value destruction of prior periods coupled with unknowable legacy costs led investors to fear that yesterday's sins foreshadowed a future in financial hell.

Those past sins caused BAC to emerge from the financial crisis of 2008-09 battered and bruised, carrying a fragile balance sheet riddled with uncertain liabilities. Yet underneath the heap of headline-grabbing challenges, BAC harbored attractive assets with solid long-term earnings power.

Management's strategy and actions were critical to preserving value and were key ingredients that piqued our interest. Just as prior management embarked on an unwieldy strategy of growing bigger, current CEO, Brian Monyihan set the opposite course—diligently selling assets, cutting costs, reducing leverage, simplifying the business, and getting back to old-school banking values. In essence, BAC has grown stronger by shrinking.

Although BAC has made large strides in focusing operations and reducing risk, current earnings are being masked by large charges from the folly of prior periods. We believe that these charges (related to delinquencies, mortgage put-backs, litigation expenses, and an inflated cost structure to deal with one-time issues) are temporary and as they subside a powerful earnings stream will emerge.

We still hold a large BAC position and couldn't be more impressed with the turnaround. In rough terms, we believe BAC can earn between 1% and 1.4% on assets, equating to roughly $2-3 per share of normalized earnings power. This underlying earnings stream represents an attractive yield relative to today's price. Although our comfort in BAC is rooted in safety and staying power, it's interesting to note BAC's depressed Net Interest Margin (partly due to unusually low rates) and decade-low Loans-to-Deposits ratio. We think these two data points reflect latent earnings power and risk reduction, which both foreshadow a bright future for BAC shareholders.

Some might wonder how we can invest in such an uncertain regulatory environment, and indeed we have no special insight into future regulations that may impact banks. However, we believe that under a raft of likely environments BAC holds significant upside, and that under low

probability draconian environments we still wouldn't incur major losses, a proposition that's the bread and butter of our investing playbook.

Berkshire Hathaway (BRK)

Speaking of financial strength and low risk, our Berkshire holding epitomizes both. I'm happy to report that BRK lumbered to a 17% gain in 2012. We continue to carry a 50%+ position, founded upon unmatched business safety and a cheap price—representing mouthwatering odds.

Such a large allocation runs counter to standard practices among managers, which may cause you to wonder if pudding and padded walls are a part of my office. Yet somewhat baffling, most critics of our large weighting would likely agree it prudent for a pro-rata allocation to BRK's subsidiaries if each were independently traded, yet when bought under the single umbrella of BRK (a far more favorable structure) the practice is eschewed. We believe our large holding sits atop logic and clients' interest, whereas the critiques seem tethered to crowd comforts and a vertigo-like fear of quotational loss.

Our enthusiasm for BRK is underpinned by a culture that's chock-full of unusual qualities that cause it to stand out from the herd. The uniqueness of BRK's ethos is only surpassed by its effectiveness in building shareholder value, having produced a jaw-dropping compounded annual growth rate of 20% spanning 48 years.

Berkshire's ethos is set at the top by Warren Buffett. Not only is Buffett a tycoon, he's also tight. While most corporate chiefs can't resist the common perks seen showered upon peers, BRK shuns excess costs and runs lean—bordering on anorexic—managing a 250 billion dollar behemoth with a mere 24 people at headquarters. Buffett also lays claim to a tidy pay package that's unique for what it lacks—no bonuses, no options, and no multi-million dollar stipend; just a modest 100k salary that hasn't wiggled in decades.

Berkshire's unique structure, ethos, and reputation have helped create a business juggernaut that combines an enormous insurance engine with savvy capital allocation talents. This combination has proven to be a potent cocktail. With discipline and diligence BRK has parlayed its insurance assets into two other engines of value: a massive investment portfolio (tallying roughly $110,000 per share) and a diverse collection of wholly owned operating businesses that reliably spin cash earmarked for Omaha. Differing from many conglomerate and private equity competitors, BRK acquires for keeps (no exit strategy) and endorses a policy of autonomy. This unusual culture produces the following positive side-effects: BRK's current earnings power is not overly reliant on Warren Buffett, and its hands-off reputation provides a competitive advantage in business acquisitions.

The by-product of BRK's unusual make-up is a rock-solid company with reliable earnings power. In last year's BRK annual report Warren Buffett illustrated the inherent safety and strength in BRK's diverse operations. It's worth sharing:

Indeed, we are far more conservative in that respect than most large insurers. For example, if the insurance industry should experience a $250 billion loss from some mega-catastrophe—a loss about triple anything it has ever faced—Berkshire as a whole would likely record a moderate profit for the year because of its many streams of earnings. Concurrently, all other major insurers and reinsurers would be far in the red, and some would face insolvency.

Furthermore, consider 2005 when Hurricanes Katrina, Rita, and Wilma caused insured losses that were double those from any of the previous 25 years and more than 500% the average losses for the previous quarter century. During this period BRK's five largest reinsurance competitors had underwriting losses averaging 15% of capital, while BRK's reinsurance arm incurred only slight losses, and its combined insurance operation generated an underwriting profit. This says nothing of BRK's non-insurance subsidiaries and their associated $12+ billion of earnings power.

Not only is BRK unusual in strength and safety, it's also cheap—a nirvana-like combination. We employ the two-column approach to appraise BRK's value. It's a simplified approach yet still a useful guide. Essentially we split BRK into two parts: the investment portfolio, and the operating businesses. This exercise, after taking the investments at market value, exposes a juicy earnings yield in relation to the implied price of the operating companies. In addition, and importantly, this yield is married to very low risks due to the diverse sources of earnings.

We're very comfortable with our large BRK position and feel a pedestrian-size consensus weighting, as a way to mitigate risk, would be equivalent to Michael Phelps wearing floaters in the Olympics to guard against drowning. At our average cost BRK was a no-brainer opportunity without parallel. I'm happy we acted accordingly.

Sandridge Energy (SD)

While Berkshire's corporate ethics are exemplary, Sandridge Energy's are revolting.

Two years ago I made a mistake by investing in SD (what's worse, it's taken me two years to realize it). In retrospect, my decision-making process was littered with sloppy optimism that looked past management's reprehensible track record of governance. I foolishly let SD's unique assets outshine an egregious culture that was staring me in the face. Worse still, I made hash of investment tenets I hold in high esteem: first, by investing in a company saddled with debt and second, by investing with a management team that's infamous for loose corporate ethics.

SD's unique assets caused me to act like a teenage boy transfixed by a girl wearing a provocative shirt—I got tunnel vision that warped my view of the total package.

At the beginning of the year we were optimistic with our SD holding. However as the year progressed our confidence was shaken as SD's strategy became increasingly disjointed and seemed to lack a clear barometer. The original strategy of drilling in shallow low-risk reservoirs

where SD encountered little competition, thus allowing stable costs and solid returns, seemed to be partly dismantled when SD acquired an off-shore company financed by more debt and expensive equity. Though taken aback, we steadied our nerves and held our position until another shocker was announced. In late October SD announced that it would sell its low-risk Permian assets and use the proceeds to pay down debt (alas!) and finance its vast, yet less proven, Mississippian assets. This disjointed behavior combined with outlandish spending on frivolous perks caused us to rethink our commitment.

After revisiting our thesis, I reduced our position and was leaning towards selling out completely when two large shareholders publicly aired their dissatisfaction with SD's management and signaled they'd attempt to affect change. The battle became heated, a flurry of letters broke, and a proxy battle ensued. This development has complicated our decision to sell. With the right management team we believe SD's assets could be harvested to benefit shareholders. In addition, SD would see material benefits from an increase in natural gas prices (a matter of when, not if, in my opinion). Yet I'm leery of compounding a mistake with inertia and more optimism. Also, SD's riskier nature nags, as it feels out of character with our historical playbook.

As of this writing we still hold a position, though it's been reduced, and are inclined to hold steady while awaiting the proxy results.

In retrospect SD has been a mistake, yet it's a mistake we can live with. We've long endeavored to limit mistakes and have consciously honed in on our investing "batting average." This batting average focus, some reference a "mistake rate," is not a novel concept, yet it's a useful mentality in investing. It is, however, important to distinguish between mistakes. A mistake that wipes out 85% of capital invested isn't remotely comparable to one that brings a 10% loss, roughly what we've lost in SD. The 85% loss requires a 566% return to get back to par, while a 10% loss requires only an 11% return. I'll certainly make mistakes in the future, but I hope to avoid major blow-ups that cripple returns.

XPO Logistics (XPO)

For the past eight years we've witnessed an impressive corporate metamorphosis with our XPO holding. In 2005 we bought into a company called Segmentz, a fourth-rate operator that was statistically very cheap. Shortly thereafter Segments acquired Express-1 led by Mike Welch. Today we are owners in XPO Logistics, a fast growing and ambitious company, led by Bradley Jacobs. In last years report I expressed our uneasiness with the change. Today we are thrilled to be co-owners.

While the old XPO (Express-1) under Mike Welch was focused on the expedited market, Jacobs has set his sights on additional, larger markets, especially the $50 billion truck brokerage market. The industry is ripe for consolidation as the markets for both truck operators and truck brokers are littered with small mom-and-pop competitors. The trucking side is very fragmented with over 250,000 trucking companies; on the brokerage side it's also deeply fragmented with inefficiencies

and archaic pricing. Additionally, only 15% of truck operators use brokers, a number we think will increase over time.

While some companies gain cost advantages through economies of scale, XPO and large truck brokers gain scale advantages through better data. A larger network provides better optics, which enable sharper pricing and better service. We think the advantages of scale predispose the industry to cascade towards a handful of large competitors. We're betting XPO will be one of the players.

We're always a tad uneasy with acquisitive strategies as it takes a shrewdly disciplined operator to not get carried away with trying to grow at any cost. Fortunately this is old hat for Jacobs, who has a background in consolidating industries and seems adept at integrating and scaling up acquisitions. So far Jacobs has shown a measured hand, completing 4 small-to-medium sized acquisitions in 2012, and seems on track with their integration. Though not necessarily showing up in the numbers—yet—we're happy with both the approach and results, and we think XPO has enormous potential.

Although XPO appears richly priced we've opted to hold and have had a minor epiphany over the years: Selling *great* companies with large growth potential, even at seemingly rich valuations, is usually a mistake. An example from Arlington's early years illustrates this point—albeit in a painful way. In 2002, I allocated a small position to Hansen's Natural, at the time a niche soft drink maker with $92 million in sales. In typical fashion, we sold out as the price rose, smiling at our neat profits. Over the next 18 months my smile turned to a grimace as the shares tripled, settling at 26-times earnings in Q1 2004. Usually 26-times earnings is not a valuation that piques my interest, and in fact most often strikes me as expensive; however, this faulty thinking (towards Hansen's) would have caused one to miss out on a 5,860% gain over the next 9 years. Fortunately, we didn't miss out on this 58-bagger; unfortunately, I sold 18-months prior, causing us to miss out on a 200-bagger—where $100,000 would have turned into $20,000,000.

Although the forgone gains make us chuckle, we feel ok because we didn't foresee the energy drink explosion that propelled Hansen's to such incredible gains. The point still holds and can be illustrated with other examples. Consider Home Depot, which in 1984 traded for 48 times earnings and even from such a lofty valuation went on to compound at 20% over the following 29 years. The lesson is clear: If you've correctly identified a young derby-contending thoroughbred, resist the urge to sell, even when richly priced, and instead hold on for dear life. Obviously, the trick is distinguishing the "derby contenders" from the "claimers" as young Home Depots are extremely rare. Though XPO is not likely to be the next Home Depot, we do think it harbors sufficient qualities that support holding our shares to benefit from a long runway of business expansion.

Rounding out the actions taken in 2012, we exited Loews to reallocate the proceeds among more compelling opportunities within the portfolio. We also found one new name we're particularly excited about. Because this report tends to get passed around, I'm omitting the name until next year's letter, as we're keen to increase the position.

GENERAL COMMENTARY

In each annual letter my aim is to report our results, account for actions taken—both good and bad—and expound upon our general investment thinking in the hopes of nurturing cohesion between GPs and LPs. While industry operatives advise that we're swimming upstream (for raising assets) we feel the current is squarely behind us for investment success. Considering our off-beat approach, perhaps it's worth highlighting a few things we don't do.

We don't diversify and splash around in numerous companies, securities, and markets. As our office walls are barren of fancy diplomas, we think it's prudent to focus on relatively few ideas we understand well. We're skeptical of managers marketing all-weather portfolios, dabbling in a bit of everything, who act on a large swath of opinions across the global marketplace. My favorite FT author may have it right: *"Managers who know the future of everything are more often dangerous fools than great visionaries."*

We also don't engage in short-selling. We're not fans of shorting stocks for two main reasons: One, we don't like the math; shorting exposes you to unlimited liability with limited potential for gain—the opposite equation of investing "long." Two, shorting has the potential to cause distracting agitation that could create unintended consequences.

The common practice of hugging a benchmark (usually resulting in common results) is a practice we eschew. Ignoring this practice has allowed us to significantly exceed the return of the S&P 500 over the course of 13-years; however, it almost guarantees that we will have periods where we underperform, perhaps significantly. To us it makes little sense to invest in industries we don't particularly like, or understand well, only to have to find the least bad idea of the group, in order to maintain semblance to a benchmark index.

Much of conventional portfolio management strikes us as irrational, and tends to accompany poor track records to boot. We're somewhat astounded by the many funds that tout their people, processes, and philosophies, yet own 10-year track records (sometimes longer) that lag an unmanaged index. Apparently they agree with George Costanza in Seinfeld, when he told Jerry, "It's not a lie if you believe it."

Our aim is to keep portfolio management grounded in a mentality of long-term business ownership. We've tried to stack the odds, via our policies and procedures, to promote a business minded approach—not a fund manager approach—that allows the four most important investment principles to flourish: patience and discipline, and more patience and discipline. Our reasoning is simple: It's easy to do dumb things in investing. And it's *really* easy to do dumb things if you have overactive investors measuring results on a monthly and quarterly basis, i.e. taking away one's ability to be patient and disciplined.

We think the typical fund structure creates a conflict in the way managers are measured and the nature of business valuation, which coerces managers to focus on short-term results and Mr. Market's mood, even though business value is rooted in long-term earnings.

Our mindset is based on gaining returns from business performance, as opposed to dancing in and out of companies we wouldn't be enthused to own long-term, or hoping a sporty buyer pays a happy multiple of earnings a few years out.

We think a mentality of long-term ownership is a solid beacon in an environment fixed to 24-hour news cycles and myopic measuring, and helps us ignore the market's timeless sucker's bet—waiting for cheap prices and macro certainty. While internally alluring, we think such a practice is detached from reality.

Given that Arlington's investment strategy is fastened to inactivity we had time on our hands to illustrate this point. Our intern Tim helped Ben and me comb through microfiche focusing on perilous time periods and headlines doused in uncertainty. We then looked at a number of companies and their performance over the following 30 years. Not only did the headlines seem every bit as daunting as today's, they repeatedly flared up every few years. Yet investors who sold great companies back then due to "uncertain" macro outlooks would be kicking themselves today. The clippings below highlight two examples.

THE WALL STREET JOURNAL, MONDAY, DECEMBER 8, 1941 3

Securities Markets in Liquidated Position To Meet Impact of War; No Foreign Selling Overhangs; Trading Accounts Well Margined

After First Shock, Stocks Are Expected to Fluctuate on Pacific News

BY OLIVER J. GINGOLD

Sharp surprise, but no trace whatever of panic, was the financial community's reaction

High Grade Bonds Believed In Postion To Withstand Shock

Japanese Bonds Have Been Selling Here at Large Discounts —Volume Small

BY JOHN BRODERICK

Ordinarily not very actively traded, Jap-

Japan's Economic Status

Her Production of War Equipment Extremely Vulnerable —80% of Materials Have Been Coming From Present Enemies

Japan, going to war with the strongest nation on earth, is by far the most economically vulnerable of all the major powers today.

Hers is a fight against time.

And in the bright light of overwhelming economic facts, she has not one chance in a hundred to come out the victor.

Wars today are only finished on the seas

In normal times, it is estimated, from 20% to 25% of her factory workers are employed in plants associated with the cotton industry.

But she doesn't produce her own cotton. She must get it (if the mills are to keep going) from Brazil, India, the U. S. (over 2 million U. S. bales in 1939), Egypt. And after she has turned out the finished cloth, she must sell a great part

cently has dwindled to a trickle—and now it's all shut off.

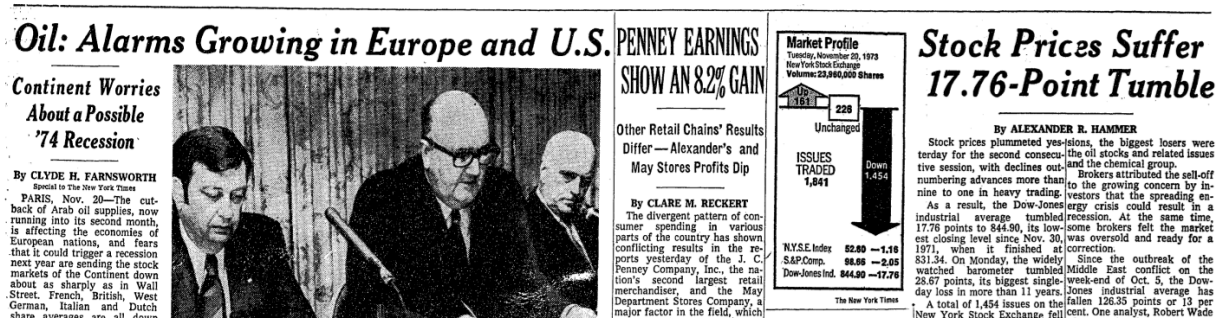
The materials which Japan, now under Pacific blockade, will be able to bring home from the Asiatic mainland will be of no great help to her either in her war industries or her major peacetime industries.

Foodstuffs are among the items which she can get from the continent to supplement her own production, but in this connection it is significant that the Tokyo government recently issued a rationing order covering fish.

Japan does not have a wide variety of meat foods. The Japanese meat diet is preponderantly fish. As her war machine henceforth gobbles up increasingly heavy amounts of precious gasoline, there will be less and less gasoline for the little fishing boats.

Board of Trade Memberships

On December 8, 1941, the day after Pearl Harbor, the Wall Street Journal read: "***Securities Markets in Liquidated Position to Meet Impact of War:*** *The securities markets, from a trading standpoint can be regarded as in a liquidated condition. Not only have there been new lows for the year established recently, but the industrial average is only a few points above the 1940 low reached at the time of the fall of France.*" The above headline was one of many laced with fear and uncertainty. However, even amidst entering World War II, it would have been wise to hold onto great companies with bright long-range futures. As an example, if one owned $100,000 of IBM stock in 1941, on the day Pearl Harbor was attacked, and held through 6 ensuing recessions, the Cuban Missile Crisis, the Korean War, and the Vietnam War, thirty years later that investment would've been worth $42,000,000.



WEDNESDAY, NOVEMBER 21, 1973 The New York Times BUSINESS/FINANCE 51

Oil: Alarms Growing in Europe and U.S.

Continent Worries About a Possible '74 Recession

By CLYDE H. FARNSWORTH
Special to The New York Times

PARIS, Nov. 20—The cutback of Arab oil supplies, now running into its second month, is affecting the economies of European nations, and fears that it could trigger a recession next year are sending the stock markets of the Continent down about as sharply as in Wall Street. French, British, West German, Italian and Dutch share averages are all down

PENNEY EARNINGS SHOW AN 8.2% GAIN

Other Retail Chains' Results Differ—Alexander's and May Stores Profits Dip

By CLARE M. RECKERT

The divergent pattern of consumer spending in various parts of the country has shown conflicting results in the reports yesterday of the J. C. Penney Company, Inc., the nation's second largest retail merchandiser, and the May Department Stores Company, a major factor in the field, which

Market Profile
Tuesday, November 20, 1973
New York Stock Exchange
Volume: 23,960,000 Shares

Up 161 | 228 Unchanged | Down 1,454 | ISSUES TRADED 1,841

N.Y.S.E. Index	52.60	—1.16
S.&P. Comp.	98.66	—2.05
Dow-Jones Ind.	844.90	—17.76

The New York Times

Stock Prices Suffer 17.76-Point Tumble

By ALEXANDER R. HAMMER

Stock prices plummeted yesterday for the second consecutive session, with declines outnumbering advances more than nine to one in heavy trading.

As a result, the Dow-Jones industrial average tumbled 17.76 points to $844.90, its lowest closing level since Nov. 30, 1971, when it finished at 831.34. On Monday, the widely watched barometer tumbled 28.67 points, its biggest single-day loss in more than 11 years.

A total of 1,454 issues on the New York Stock Exchange fell

sions, the biggest losers were the oil stocks and related issues and the chemical group.

Brokers attributed the sell-off to the growing concern by investors that the spreading energy crisis could result in a recession. At the same time, some brokers felt the market was oversold and ready for a correction.

Since the outbreak of the Middle East conflict on the week-end of Oct. 5, the Dow-Jones industrial average has fallen 126.35 points or 13 per cent. One analyst, Robert Wade

In late 1973, OPEC nations stopped exporting oil to the U.S. and other western nations as punishment for their support of Israel. The future source of energy was suddenly in doubt. On November 21st, 1973, The New York Times read: ***"Oil Alarms Growing in Europe and US / Stock Prices Suffer 17.76-Point Tumble:*** *Stock prices plummeted yesterday for the second consecutive session.... Brokers attributed the sell-off to the growing concern that the energy crises could result in a recession."* However, even amidst the uncertainty, it would have been wise to hold onto a $100,000 investment in Wal-Mart and continue to hold the investment during the ensuing oil crash of 1979, the hyper-inflation of the 1980s, the Saving and Loan crisis, Black Monday of '87, and the technology bubble of the late 1990s. By November 2003, 30 years later, a $100,000 investment in Wal-Mart would've grown to approximately $210,000,000.

Related to the above newspaper headlines I can guarantee two things: One, there were hundreds of similar headlines, and two, the headlines were not comforting to managers tasked with investing capital.

We will continue with the investing playbook we've used for 13+ years, which focuses on undervalued businesses we understand well, those that harbor durable earnings power capable of withstanding the inevitable economic dust-ups.

Finally, it's long past due that Ben be recognized for his herculean efforts that are crucial to our investment performance. Ben sets the table so that when I wake up each morning I'm unable to distinguish between work and play. Our returns would be far lower without Ben's savvy efforts.

And of course both Ben and I are very appreciative of your trust and capital commitment. I look forward to reporting again next year.

Sincerely,

Allan Mecham

March 14, 2014

Dear Partners,

We had a great 2013. I'm happy to report for the year ended December 31, 2013, AVM Ranger gained 51.5% (42.6% net) versus 32.4% for the S&P 500. Though a sharply rising market put wind in our sails, we'll take 51.5% in any year. For us, 51.5% is rarified air, having only topped it a few times over Arlington's fourteen-year history.

While we're happy with our 2013 return, we're thrilled with our returns since inception (five and ½ years[1]): compounding at 39% versus 9% for the S&P 500. Unfortunately, both our one-year and five-year results are certain to come down.

Though returns are sure to decrease, they won't decline because of poor incentives or lack of engagement—both Ben and I have 99% of our liquid net worth invested alongside yours.

Let's review the portfolio to see what affected our collective net worths in 2013.

The major theme driving 2013 results—and those of the last fourteen years for that matter—was a lack of major losses. We didn't have a single holding register a meaningful decline...perhaps not a great feat in a market that rose 32%.

Berkshire Hathaway (BRK)

Our largest holding, Berkshire Hathaway (BRK), galloped to a 33% gain in 2013. The business performed well, and the stock followed suit. Though our comfort and enthusiasm has changed only slightly, we opted to pare back our BRK position in the name of prudence and flexibility as the discount to intrinsic value narrowed. Some managers are pleased with performance in light of their cash holdings; we feel similarly satisfied with our performance considering our huge BRK position. BRK is hunting-dog healthy (harboring roughly $50 billion in cash and spitting out $15+ billion annually) and a solid rudder to the portfolio.

Bank of America (BAC)

Bank of America (BAC) continued to make steady strides in 2013, executing the plan they articulated over three years ago. Though the legal issues can seem never ending, Moynihan's efforts have paid off, with BAC now sitting on a solid foundation. Not only is BAC on solid footing, it continues to look cheap based on the thesis we laid out in last year's letter.

[1] AVM Ranger, LP began on July 23, 2008

BAC's conservative culture and increasingly strong balance sheet underpin our confidence in our hefty 15% position. The combination of strong capital levels and conservative practices led the FED to approve a $10.5 billion capital return program in March ($5.5 billion redeeming preferred stock and $5 billion buying in common stock). We expect another FED stamp of approval in 2014 with increased provisions for returning capital to shareholders.

Investors frequently question how we can invest in banks, inevitably referencing 2008–2009 as proof that banks are equivalent to "black boxes." Indeed, there is no way for us to know all the underwriting risks within a bank. However, we can gain insight and a solid view by scrutinizing the filings and applying critical thought to both the numbers and management's actions. To us it's crystal clear that today's BAC is much stronger than the BAC heading into 2008. The asset side of the balance sheet has healed, while underwriting standards have tightened considerably. A few statistics can help show BAC's freewheeling days of extreme leverage and loose credit are a thing of the past.

Looking at BAC's tangible asset–to–tangible equity ratio, a crude and simple look at leverage, though difficult to manipulate (unlike other measures), reveals dramatic change at BAC. In 2007, this ratio stood at twenty-seven, while today it sits at thirteen. And while leverage has decreased, asset quality has improved. BAC's latest 10-K reveals credit quality improvements since current CEO Brian Moynihan took over in 2009. For brevity I'll highlight just a few important loan buckets.

- In late 2009, 23% of BAC's residential mortgages had loan-to-values greater than 100%, meaning that nearly a quarter of homeowners were upside down on their homes. Today only 10% are underwater. Furthermore, 40% of BAC's $250 billion residential mortgage portfolio is FHA insured, up from 10% in late 2009.

- BAC's credit card portfolio also tells a credit improvement story: At the end of 2009, 16% of credit card customers had FICO scores (a reliable indicator of default rates) under 620, while today it's less than 5.5%. This is a massive improvement, a point driven home by the fact that FICO scores between 600 and 649 experience a six-fold increase in delinquency rates compared to scores of 700 to 749.

Similar improvements can be found in BAC's home equity portfolio, evidence that Moynihan has succeeded in instilling a conservative culture throughout the company. Additionally, the funding mix has trended toward stable, low-cost retail deposits, while long-term debt has been cut by $250 billion.

Though some investors' behavior toward bank investing mimics Mark Twain's cat that sat on the stove, we view the environment today as low risk in light of buffered capital levels and tight scrutiny by investors, regulators, and Washington. We're very comfortable with our BAC position and applaud Moynihan's stewardship.

Vistaprint (VPRT)

Last year I played coy with a company we were buying. The company, Vistaprint (VPRT), performed well in 2013, resulting in solid gains for Arlington as we were able to acquire a sizable position (15%) at an average cost of around $31 per share.

After a little work, VPRT's appeal became apparent: a strong track record, compelling economics, intelligent management with significant ownership, and our favorite, a dominant market position with powerful competitive advantages.

Robert Keane founded VPRT in 1996 with the idea of serving the small business market by selling business cards on the cheap. Keane's intuition proved savvy as VPRT grew from zero to over $500 million in sales by 2009. Today, VPRT revenue tops $1 billion, selling an array of custom products from business cards to T-shirts, and the VPRT brand is increasingly first of mind among small business owners.

Key to any good business analysis is identifying levers of competitive advantage (i.e., the moat) and figuring out if they're durable. In VPRT's case, the moat appears deep and durable and is based upon scale. As VPRT grows, unit costs decline.

VPRT's dominant market position, being magnitudes larger than local print shops, produces a powerful cost advantage (manifest by 65% gross margins versus 35% for the industry) that's difficult for competitors to match. Imagine trying to compete against a competitor that invests fifteen times more on efforts to improve quality and efficiency than you have in sales (VPRT spent $164 million in 2013 on tech and development versus industry average sales of $11 million). VPRT's advantages combine to produce a compelling value proposition via quality custom products at low prices.

In early 2012, management shifted strategies slightly, moving from a deep discount model intended to drive traffic and scale—a sensible "land grab" in the early years—to a heightened focus on quality, service, and the lifetime value of customers. This shift in strategy increased investments, which in turn depressed margins and slowed growth (a deadly combination for the fast-money crowd focused on steady earnings growth), though it hasn't altered VPRT's moat. We believe the hiccup to earnings is temporary, and we support management's decision to sacrifice near-term earnings for greater long-term value.

Like any investment, VPRT carries risks. Most prominent to us is the risk that technological innovations change consumer habits and cause chunks of VPRT's business to decline or disappear. For instance, consumers exchanging contact information through cell phones rather than business cards.

It's also no secret that print marketing has long been in decline, a trend that both scares investors and is likely to continue—though we don't believe this trend mutes investment success. While

industry headwinds have ravaged weaker competitors, VPRT has thrived, growing smartly over the past seventeen years. Just as Starbucks has flourished amid declining per capita coffee consumption (which dropped roughly 30% over the past thirty years and 50% since 1950), VPRT has done well amid print marketing headwinds.

We take comfort being co-owners with VPRT's management team. Keane and company are large shareholders and have demonstrated savvy capital allocation decisions, balancing the long-term investment needs of the business with outside opportunities, such as acquisitions and share buybacks. VPRT is a nice addition to the portfolio and has a long runway ahead of it.

C.H. Robinson (CHRW)

Another notable addition to the portfolio is C.H. Robinson (CHRW). CHRW is a competitor to XPO Logistics, though it's much larger and operates globally. Similar to XPO, CHRW employs an asset-light model with a variable cost structure, allowing flexibility amid challenging times. The business has low capital requirements and generates true free cash flow, which management has been delivering to shareholders via share buybacks and dividends. CHRW holds an impressive track record, generating consistently high returns on capital and growing earnings at a rapid clip over the past twenty years.

Lately however, margins have narrowed and earnings growth has stalled. Many question if new entrants, like XPO, and breakthroughs in technology haven't permanently altered the industry's economics, producing lower margins for both CHRW and competitors alike. Others point to the placid economic environment as the culprit for the industry's struggles. We can't say for sure, though we lean more toward the latter and believe CHRW's size and global footprint remain advantages over smaller competitors.

We view the risk/reward as attractive. Buying in at depressed margins and with a weak economic backdrop gives us confidence that the downside is limited. Yet if margins revert to the mean or the economy picks up steam, while free cash continues to be intelligently deployed, earnings growth could rise sharply.

Sandridge Energy (SD)

Shortly after writing last year's letter, we sold out of SD completely. In our office we've filed SD under "Lessons Learned...Again"—fortunately SD was an inexpensive lesson. While some fund managers tout the virtues of "constantly reassessing their theses," we've found frequent reassessing often signals we've waded into murky (too risky) waters.

A final insight nudged us to exit: the combination of ambiguous asset values and a heavy debt load can sedate conservative thinking and force management into overoptimistic projections under pressure to sell assets and raise capital.

As an aside, we've found investments based on asset values, as opposed to earnings and free cash, can lead to mistakes. All too often, asset-plays being sold as yachts heading to St. Tropez turn out to be Higgins boats headed toward Omaha Beach.

Rounding out the portfolio are a handful of smaller positions whose collective performance added modestly to our 2013 return. Most notably, XPO Logistics gained 51% as Bradley Jacob's rollup strategy kicked into high gear, growing sales at triple-digit rates. Though only nine positions account for 99% of the portfolio, we feel confident in the businesses, management teams, and valuations.

GENERAL MUSINGS

"The only man who never makes mistakes is the man who never does anything."

–Theodore Roosevelt

Longtime partners familiar with our investing style may wonder if we've taken up Roosevelt's quote as a challenge.

In today's environment it's increasingly difficult for managers tasked with managing to embrace inactivity. Perhaps many of us have been reared under the Christian creed that teaches idleness is the hand of Satan (clearly the ecclesiastic person responsible for that nugget of wisdom was not a successful fund manager). Or more likely, managers manage to how they're measured—quarterly, monthly, or daily. Or maybe to help raise assets, "timely" strategies are created, teams are assembled, stratagem meetings are held, and eager managers spring into action. Granted, a bustling office filled with people and energy lends an air of legitimacy.

Our office feels more like an abandoned library with a couple of bums loitering around. We have yet to be swayed by the virtues of analyst teams and investment meetings. We're old school. We mostly just sit around reading, thinking, and waiting. A quip by Stanley Druckenmiller describes our process best: "I like to be very patient and then when I see something, go a little bit crazy."

In truth, we like a little action like anyone else; we just don't find ideas worthy of action on a regular basis.

In meeting with potential investors, Ben and I rarely miss an opportunity to emphasize the importance of partners, as compatible LPs allow a properly assembled portfolio to unleash its biggest weapon: sheer inertia. Our all-star LPs (you), backing us with confidence and patient capital, are an enormous asset. You allow us to ignore two common pitfalls that routinely tempt managers: market timing and hugging benchmarks. In contrast, the typical mutual fund can't afford to time markets (safer to closet index), and the typical hedge fund can't resist it (hello, 2 and 20).

The environment we've collectively created puts very little pressure on me to keep up with benchmarks on a short-term basis, nor does it cause me to carry a risky bat and swing for the fences. I'm afforded the freedom to run the portfolio exactly like I'd run my own money. Ben and I couldn't be more pleased with the results, and thankful for our partners.

Strong returns have caused our band of partners to grow, swelling assets to $400 million at year-end 2013. Though we're still a small fund, a growing asset base is unequivocally bad news for partners. So far our asset growth hasn't caused noticeable ill effects, though a different environment could accentuate the penalty of size. We think we've got a good deal of headroom before size imposes meaningful pain.

More than likely, we will close the fund in the not-too-distant future and reopen when opportunity allows capital to be deployed. In the meantime we'll candidly asses the effects of our size with you as the years roll by.

We're honored to be partnered with such a great group of LPs and appreciate your continued trust and capital commitments. I look forward to reporting to you again next year.

Sincerely,

Allan Mecham

March 11, 2016

Dear Partners,

2015 was a difficult year. I'm disappointed to report that AVM Ranger registered its first loss in 7+ years (Arlington's first loss in over a decade). We finished the year down 6.7% vs. a gain of 1.4% for the S&P 500. This brings our 7.5-year annualized return to 30.9% vs. 8.7% for the S&P 500. (All figures are gross of fees as we have two different fee structures.)

(For long-term Arlington LPs, our 16-year annualized return is 20.1% vs. 4.1% for the S&P 500.)

Being down in any given 12-month period doesn't necessarily demand disappointment, as price and value often diverge. More than sixty-five years ago, Ben Graham introduced his "Mr. Market" concept: a bipolar business partner who each day offers to buy your interests or sell you his—occasionally at irrational prices. This apt parable has passed the test of time, as history is littered with silly investment behavior. Ben Graham's other adage has also retained merit: "In the short-run the market is a voting machine, in the long-run it's a weighing machine."

Unfortunately, part of our poor performance in 2015 can't be attributed to a manic "Mr. Market" as it reflects mistakes I made. The poor results do not stem from a bevy of blunders; rather, my discipline slipped and execution suffered.

Though I'm disappointed with our results, bouts of volatility and underperformance at Arlington are not without precedent. A look back over Arlington's 16-year history reveals multiple periods of volatility and lagging performance. The table below provides historical context:

Time Period	Return for Time Period	1 Year Later	3 Years Later	5 Years Later
Mar 02 - Mar 03	(35.9%)	+106.9%	+65.8%	+98.5%
Jul 05 - Jul 06	(42.7%)	+34.5%	+124.2%	+358.0%
Sep 08 - Feb 09	(26.5%)	+150.6%	+273.1%	+562.5%
Apr 11 - Sep 11	(29.9%)	+53.0%	+180.6%	N/A

Twelve years ago I penned my annual letter and referenced a study that highlighted 5 funds with 15-year records that handily beat the S&P 500 yet underperformed 30% of the

time. Back then I speculated that if we were to continue to outperform we would need to accept periods of underperformance as well.

After 16+ years my opinion hasn't changed. In fact, I think a dispassionate attitude toward potential quotational loss is a prerequisite to achieving solid long-term results. Our preferred antidote is to don a business owner's hat (who buys for keeps), instead of a fund manager's hat who's unduly concerned with short-term measures. This common-sense attitude helps calibrate our analysis to think about long-term earnings power and intrinsic value; although, it doesn't guarantee mistake-free investing.

PORTFOLIO OVERVIEW

2015 was a tale of two halves: the first half was marked by muted action (minor selling) and a cash position, while the second half saw excessive activity and poor returns. Unlike the Vegas slot-player however, the stock market's instant-feedback system doesn't always accurately reflect success or failure. In investing, mistakes occur when decisions are made yet sometimes don't vest until much later. I'm a big believer in learning from mistakes (unfortunately, I keep furthering my education); however, I think it's dangerous to let short-term wiggles drive frenetic postmortems. Conversely, I try to be alert to hairline cracks in my analysis, irrespective of stock price action.

Outerwall Inc. (OUTR)

The major black eye impacting 2015 (though the decision was made in late 2014) was our investment in OUTR. This was a mistake I should have avoided. My assumptions appear faulty, and I clearly underestimated the effects of substitutes on consumer behavior.

Further, I should have insisted upon first-class stewardship before considering an investment given the challenges at Redbox. With scarce reinvestment options and a declining business, capital allocation (important in any business) takes on critical importance. The conditions prevailing at OUTR demand thoughtful capital allocation, not a blind devotion to venture-like investments in kiosk businesses and systematic share buybacks without reference to value or opportunity costs.

In hindsight, I should have recognized the folly of investing alongside executives with poor incentives (no skin in the game), and a destructive record of capital allocation. I naively thought our overtures would nudge management and the board in the right direction and produce smart results … Lesson learned.

The critical variables at OUTR rest upon Redbox's future decline rate (and associated level of cash flows) and the efficacy of future capital allocation. Given the many

variables at play, it's hard to know if Redbox's recently reported decline rate will continue apace, accelerate, or perhaps snap back slightly (given better content buying and a stronger release slate) and moderate in the years ahead. Equally important is our unease with the current management and board of directors.

As of this writing there's hopeful news: Glenn Welling at Engaged Capital (an "activist" hedge fund) has taken a large stake and is advocating urgent change. Engaged Capital's top priorities are to redirect capital allocation and sell the company. In the near term we plan on working with interested parties to support rational behavior and value creation.

Unfortunately, even under new leadership OUTR will likely remain a candidate for my "wall of shame," serving as a reminder to avoid similar mistakes in the future. If we were to sell out of our remaining position today–around $34 per share–OUTR would end up costing us roughly 4.5% of capital, one of the worst losses in our 16-year history.

NOW Inc (DNOW) & MSC Direct (MSM)

Beyond OUTR, we had a few new positions suffer declines in 2015, though I don't believe they're mistakes. Midway through the year, feeling happy with a 10% gain and idle cash, I was attracted to two companies, DNOW & MSM, that harbored key elements I look for in businesses: staying power and unique competitive positions within their respective industries. Both companies are distributors with business models that generate cash in downturns and require minimal capital expenditures. Further, both DNOW and MSM enjoy scale advantages, strong balance sheets, and seasoned management teams with strong track records.

In both cases, what appeared moderately cheap (perhaps I could have exercised better price discipline) became cheaper as industry headwinds intensified. I was somewhat ambivalent to the declines (which reflected industry challenges), as part of the investment appeal rested upon my view that growing stress would benefit both companies at the expense of competitors.

MSC CEO Erik Gerstner explains in the most recent Q:

> *Economic slowdowns are the times when MSC makes its greatest strides. These are the times when the local and regional distributors that make up 70% of our market suffer disproportionately. History tells us what will happen to local distributors if this downturn prolongs. Reducing their inventory leaves customer service vulnerable. Clamping down on receivables disrupts long-standing customer relationships. Laying off people creates hiring opportunities to acquire industry talent not typically available.*

We are just starting to see the very early signs of these things occur in the marketplace. The pace will accelerate the longer these conditions hold. We are pleased with our share gain performance to date and would anticipate it to continue or even accelerate the longer these conditions last, and that will lead to disproportionate top-line growth when the environment does improve.

Although there are important nuances among distribution companies (I'll spare you the details), I believe both DNOW and MSM share significant competitive advantages. We're confident the challenging conditions that now prevail will create opportunities for both firms to gain market share, improve underlying economics, and grow intrinsic value over time.

Leucadia National (LUK)

Leucadia is a diverse conglomerate we started accumulating in September of 2014. Similar to DNOW and MSM, LUK has a strong balance sheet, conservative culture, and leadership that's experienced in taking advantage of opportunities in a distressed market.

We've long followed LUK and admired the business acumen of Joe Steinberg and Ian Cummings, the legendary duo that founded LUK in 1978 and went on to produce one of history's great track records. Watching the investing prowess of this duo produced a lot of head-scratching and immense value creation for shareholders.

In early 2013, as a solution to succession planning, Ian Cummings and Joe Steinberg merged LUK with Jefferies and turned over the reigns to Rich Handler and Brian Friedman, two executives with an impressive track record running Jefferies. LUK's long history with Jefferies, as a customer and investor, gave us added confidence that the cultures of the two firms would sync up.

Today LUK is run by Rich Handler and Brian Friedman, with Joe Steinberg serving as chairman of the board. LUK's eclectic group of subsidiaries touch numerous industries, from beef processing to investment banking, and while a few of LUK's subsidiaries are firing on all cylinders, most are struggling, earning sub-par returns on capital amid challenging conditions. We believe the difficulties afflicting many of LUK's subsidiaries will prove temporary, and earnings power will rise in the future. In the meantime, LUK's opportunistic culture, strong balance sheet, and savvy stewardship offer a good prospect of value creation via opportunistic investments: the hallmark of LUK's success.

Cimpress (CMPR)

CMPR's largest business, Vistaprint (accounting for 70% of CMPR's sales), turned in a solid year with key metrics improving across the board: customer loyalty strengthened, average order values grew, and net promoter score increased. Robert Keane and team are large owners and long-term thinkers, focused on reinvesting capital to expand the moat and grow intrinsic value. We're thrilled to be co-owners and support the heavy spending and long-term focus. It's worth noting, even amid aggressive spending, the Vistaprint business sports healthy margins and attractive returns on capital.

In addition to large outlays at Vistaprint, management has ramped up investments in the Upload and Print space, acquiring a handful of companies of late. This market caters to higher-expectation customers and looks like an attractive fit for CMPR. During CMPR's annual investor day in August, management laid out their long-term plan to create a Mass Customization Platform built upon CMPR's network of businesses and third party affiliates. The goal is to leverage CMPR's strengths (production, technology, and logistics) to create an unmatched value proposition serving the print marketing needs of small businesses worldwide.

CMPR is chock-full of business qualities we crave: dominant and durable businesses in niche markets, run by owner-oriented managers who are laser focused on growing intrinsic value per share. We're confident that CMPR's powerful competitive advantages, attractive underlying economics, and long runway ahead will produce growing earnings and shareholder value.

Additionally this year, we decided to sell a large chunk of SNE as the price rose significantly. While SNE's management is executing well, they compete in fiercely competitive markets that make sustainable strong returns elusive. We sold as the price approached a more reasonable representation of value and the margin of safety shrunk. We also exited Allegany and BAC after nice gains to reallocate the proceeds elsewhere.

CONCLUSION

I'd like to reiterate our appreciation to all of Arlington LPs. The mistakes I made in 2015 were all self-imposed with zero outside pressure. After some reflection, I think a long run of solid returns and a cash position sedated my discipline slightly, nudging me toward excessive activity.

While some positions declined in 2015, the ultimate arbiter of our future performance will largely be driven by the underlying operating results of the businesses we own. We're lucky to have LPs that share our long-term attitude, allowing our theses to

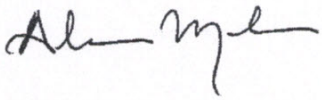
play out. I have confidence that with the passage of time, the businesses we own will generate results that support satisfactory returns for Arlington.

Our band of partners grew further in 2015 with total assets under management tallying roughly $750 million as of this writing. As we've grown, Ben and I have thought long about the appropriate level of assets under management. Each dollar we take in works against LPs interests–though to date we think the penalty has been very slight. To reciprocate your trust and support, we've decided to close the fund when assets reach between 1 and 1.2 billion: a level that we believe is small enough to preserve our ability to add value to LPs.

I'm never comfortable predicting short-term stock price movements and can't guarantee that we will rebound in 2016. However, I can guarantee that Ben and I will continue to have 100% of our liquid assets (outside of real estate) invested alongside you with zero outside commitments to other funds or securities. This commitment speaks to our long-term confidence in Arlington.

I look forward to reporting again next year.

Sincerely,



Allan Mecham

March 14, 2017

Dear Partners,

I'm happy to report that AVM Ranger was back in the black in 2016. We ended the year with a gain of 29.1% (before fees) versus 12.0% for the S&P 500. I'm thrilled with this result (hopefully you are too), yet it's akin to birdieing a hole in golf: it's nice, but the 18-hole scorecard is what really matters.

Our longer-term scorecard is more satisfying: over 8.5 years AVM Ranger has compounded at 30.7% per annum (before fees) versus 9.1% for the S&P 500. Needless to say, 30% is not a hurdle rate we try to sustain, and the usual disclosure applies: we have no chance of maintaining this level of performance long-term. As a sanity check for those immune to my warnings, consider this: if we continued to compound at 30.7% for the next 30 years (we won't), a 100k investment would turn into $307 million. That said, we hope our relative performance over the S&P will continue to add value to partners over time.

At the risk of being uninvited to parties based upon my dour warnings, it's worth noting that even small margins of outperformance, say 4%, over long stretches produce dramatic wealth creation given compounding's wonders (4% outperformance produces roughly 3x value over 30 years). Beating the market by 4% is a tall task, though a recent article stating that 60% of millennials trade on Trump tweets bolsters our confidence that we've got a fighting chance.

GENERAL COMMENTARY

Charlie Munger has famously espoused on the wisdom of figuring out what to avoid in pursuit of success. If you follow this wisdom then you'll be comforted to know that Arlington abstains from trying to forecast and profit from market-moving events. This stance served us well in 2016, as it was a year that baffled the odds-makers: early in the year, whispers of rising interest rates incited market tremors and a sharp selloff, portending a dire outlook for the market (the market finished up 12%); further jolts occurred in June as "Brexit" stunned pros and pundits alike; and closer to home, outside candidate Donald Trump shocked handicappers by winning the White House in November. While the media does not portray President Trump as having a calm, predictable disposition, the market found comfort in his election: since Nov 8th, a halcyon market has steadily glided higher, having gained 11% through February. The events of 2016 reinforce my attitude to avoid an education in forecasting the old fashioned way, by experience: *experience is what you get when you get what you didn't want.*

Our reaction to the noise around us was more muted. Other than taking a few toe-hold positions, we trimmed most holdings as prices rose and the risk/reward shifted. Our decision to pare back

most holdings left us with a large cash position, tallying 25.5% at year-end. While I'm no fan of cash as an asset class (it has lost 97% of its value over the past 100 years), I'm optimistic that the position will be temporary. We have two advantages that stoke my optimism: our small asset base, and a philosophy that requires only a handful of ideas.

It's worth adding: our cash position is not a "market call," it simply reflects an absence of ideas that we find attractive. We've never made hay by hoarding cash in anticipation of market corrections; a quick trip down memory lane serves as a reminder that we entered both bear markets (2002 & 2008) fully invested. We prefer partial ownership in businesses over snappy trades that require gazelle-like instincts to dart away from any hint of danger. We think attempting to time markets (knowingly or unknowingly) is a fool's errand and agree with Peter Lynch: "*Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.*"

PORTFOLIO COMMENTARY:

Despite the drag-effect of cash, we still managed to produce solid results in 2016. For the most part, what hurt us last year helped us this year: MSC, DNOW, and LUK.

MSC Direct

MSC has been besieged by stiff industry headwinds for the better part of 2 years. Amid these difficult conditions, MSC management has performed admirably. They have deftly managed the business by keeping a sharp eye on customers and costs. These efforts have produced outstanding results in the form of stable margins and growing market share, leaving MSC in a healthy position for future growth. MSC's business is poised like a coiled spring, ready to unleash strong operating leverage should headwinds abate and business activity pick up—which appears to be happening in early 2017.

NOW Inc (DNOW)

Wayne Gretzky once said, "*skate to where the puck is going, not to where it's been.*" My initial thesis behind DNOW—a unique competitive position to take advantage of distressed competitors, growing bargaining power translating into better economics, and technological advances that benefit DNOW's customers and support drilling activity—may have seen me skate past the puck. While it's probably too early to evaluate confidently, DNOW's results and underlying economics have been disappointing. Tighter working capital management and pricing leverage have not materialized to generate the returns on capital we expected. Higher oil prices and a growing rig count are positive developments, yet if DNOW's growing suite of products and services don't translate into greater bargaining power, the business economics will likely fall short of our expectations. Given a rising stock price and our waning confidence, we chose to sell a large part of our position.

Berkshire Hathaway (BRK)

Sticking with the hockey theme: If DNOW was my attempt at a difficult tic-tac pass and deke finish, BRK was the quintessential open-net tap-in goal. Past letters have expounded on BRK's unique qualities (they remain unchanged), which continue to produce impressive financial results: for 2016, BRK's world class insurance engine grew float to over $91 billion, at negative cost (meaning BRK got paid to hold $91 billion), produced over $12,500 in pre-tax earnings per share, and had roughly $170,000 in investments per share, including over $85 billion in cash at year end.

Berkshire resembles a meat grinder that relentlessly piles up value year over year (and decade over decade). Over the past ten years, the two pillars of value, earnings from operating businesses and investments per share, have steadily grown at 9.0% and 7.8% respectively—impressive performance considering the enormous asset size. We think the current figures, combined with the likelihood of future growth, support attractive prospective returns for current owners.

Given that most of you know I'm a big fan of Warren Buffett, it's worth emphasizing that BRK is not a museum piece that sits in the portfolio based upon admiration alone. Rather our position is anchored to value. When attractively priced we've done well buying it.

Cimpress (CMPR)

Cimpress is a tale of two businesses: Vistaprint, and everything else. Vistaprint is a gem of a business with fantastic economics and a growing base of loyal customers. Its dominant market position (10 times larger than its closest competitor) and huge scale advantages have produced unmatched low costs and leading mindshare among small business owners. Vistaprint's core products are custom marketing materials—the face of a small business—at low price points, providing stability in most economic environments. Our ongoing research suggests that Vistaprint's competitive moat is widening; a trend we think will continue in the future.

The balance of CMPR is led by the Upload and Print (U&P) segment. CMPR's aggressive foray into the U&P space (having spent over $550 million on 7 acquisitions since 2014) is part of management's vision to create a Mass Customization Platform (MCP) that serves the marketing needs of a broader segment of small businesses worldwide. This vision entails a full-throttle capital spending program aimed across the company to build out the platform. And while the ambitious project carries payoff potential down the road, it also entails risks. The main risks are two-fold: one, an overly-aggressive capital spending program that fails to deliver adequate returns, and two, integration issues that alienate customers (quality control problems, order routing, late deliveries, etc.).

While it's still early, recent U&P results underscore our growing concern that capital allocation may fall short of expectations. The torrential pace of spending has seen debt grow to over $800 million (pushing the top end of debt covenants) due to a flurry of acquisitions and organic investments. This raises risk and reduces flexibility to opportunistically buyback shares—a favored option that's produced great results in the past. We hope the U&P adventure doesn't result in a lesson in "diworsification" as acquisitions fail to measure up to Vistaprint's standards.

Our somewhat cautious tone shouldn't be misconstrued: CMPR is still our second largest holding and we think the good qualities outweigh the risks that we highlighted. If capital allocation meets management's hurdles, and MCP is successful, shareholders will do well. If not, we feel our downside is limited.

Leucadia National (LUK)

Leucadia gives off the *impression* of a bad abstract painting: it's hard to describe and easy to dislike. Its disjointed make-up has caused bewilderment among Arlington followers, from our brokers to LPs—not necessarily a bad sign to a fund manager interested in buying undervalued securities. While LUK may cause confusion to outsiders, the appeal to us is simple: it's safe, cheap, and conservatively run by an owner-oriented management team that's focused on creating long-term value.

For over three decades LUK has displayed a conservative, yet opportunistic culture, that's been focused on sensibly allocating capital and creating wealth for shareholders. We think this culture has a long shelf life and believe the carrying value of its businesses (the book value), understates the intrinsic value of the company. A small example in LUK's 2016 annual report highlights Conwed, which recently sold for $295 million (with potential for $40 million in earn outs) versus the $101 million it was carried on the books. We think this example is a microcosm that applies to LUK in total.

While many of LUK's subsidiaries have struggled over the last few years (green shoots can be seen at National Beef and Jefferies), we think the challenges will prove to be temporary. Over time we're confident that the stock price will reflect LUK's intrinsic value and provide satisfactory returns to shareholders.

CLOSING

Arlington hit several milestones in 2016. Midway through the year Ben and I made the decision to close the fund to outside capital at year end (assets under management equal roughly $1.2 billion). Additionally, we hired Peter Lawrence to assist me in research (our first official hire since inception).

The two decisions were somewhat related, as closing the fund to outside capital allows me to work closely with Peter and focus on research, unencumbered by time-consuming marketing meetings. Further variables affected our decision as well: we have a growing cash pile and a trickle of ideas; conservatively closing at a small size (huge assets drag down returns) is reciprocation for your trust in Arlington; and both Ben and I gain enormous satisfaction from adding value to partners and feel a smaller asset base increases the odds of producing solid future returns. We'd prefer to be among the best, rather than the biggest.

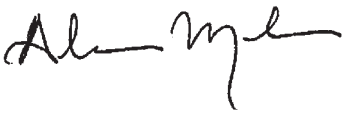
In this regard, we think Peter Lawrence will help us achieve our goals. As I mentioned in my October note, I met Peter a few years ago in NYC and have grown to appreciate his intellect and energy (plus he's a NY Rangers fan). Even before he was hired, Peter has consistently shown that he takes the high road by giving more than he gets. He's a good fit and we're happy that he agreed to join us.

While our atypical ideas and policies have not made for a fast or smooth ride, they have helped attract compatible partners, which has made the journey enormously satisfying. We've always held to the business motto of building a house we want to live in. We can't reiterate enough how grateful we are to our fantastic Limited Partners. You have helped us build a business that we love coming to work for each day, and you provide a huge advantage in our pursuit to invest intelligently (even if unconventionally) over the long-term.

And finally, hedge funds were frequently in the news this past year, having earned heaps of bad press for atrocious results. Hedge fund returns have dramatically underperformed for years. And while we're largely considered a hedge fund (even though we don't hedge) we're happy to cap assets to help ensure that the shingle outside our office door never mimics the industry's slogan: *Come for the underperformance, stay for the high fees!*

I look forward to reporting to you again next year.

Sincerely,



Allan Mecham