Tuesday, October 1st, 2019

"Eh. We're oh-for-two on asset plays so far."

- **Andrew Kuhn to Geoff Gannon, explaining why we could skip schlepping four miles through Manhattan to see a half-built condo tower in person**

	Q1	Q2	Q3	Q4	Year	S&P 500
2018 (last 27 weeks)					-8.1%	-8.4%
2019	+13.3%	+11.0%	+9.6%		+37.8%	+20.5%

To Focused Compounding Capital Management Clients:

Returns (*GROSS*): The model portfolio returned 9.6% in the third quarter versus 1.7% for the S&P 500. The portfolio is now up 37.8% in 2019 versus 20.5% for the S&P 500. Neither the year-to-date return in the S&P 500 (up 20.5%) nor the year-to-date gross return in the model portfolio (up 37.8%) is sustainable. I expect both those numbers – on average – to be lower in future years.

With this letter, we've switched to reporting ***GROSS*** returns instead of net returns. Clients in the managed accounts pay 2.5% of assets per year deducted monthly (0.2% per month). This means net returns in each quarter tend to be 0.6% below gross returns. For example: a typical client's net returns would have been 9.0% for the third quarter versus 1.7% for the S&P 500 and 35.9% for the year-to-date versus 20.5% for the S&P 500.

Why the change? Aren't ***NET*** returns the only returns a client should care about?

They are. And those of you in a managed account can check your own personal account's balance, your returns over various periods, etc. online through Interactive Brokers literally 24/7. I suggest you do that instead of relying on the numbers I give you. Your own precise returns in any one account will vary a bit depending on the timing of when you became a client, if and when you added or withdrew money, etc. If you have any questions about how to check your returns – email, text, or call Andrew (***info@focusedcompounding.com / 469-207-5844***).

The reason we're switching to reporting gross returns in these letters from now on has to do with the announcement below.

Announcements: Andrew and I have partnered with Willow Oak Asset Management to launch a private investment partnership on January 1st, 2020. Most of our current clients will ***NOT*** be able to invest in this new fund. To become a limited partner in the new fund, an investor must prove (you will be required to provide actual evidence allowing Willow Oak to verify your claim) that you are a *"qualified investor"*. Qualified investors can join funds like the one we are launching January 1st and they can pay a percent of profits instead of a percent of assets.

The minimum investment in the new fund is $250,000. There is no management fee. The sole fee is 25% of profits. However, limited partners who put in over $1 million before January 1st, 2020 will pay a reduced rate of 15% of profits. Likewise, limited partners who put in over $5 million before January 1st, ***2021*** will pay the same reduced rate of 15% of profits. These reduced rates come with lock up requirements. Money that is not locked up can be withdrawn on the first day of any quarter (4 days a year) provided written notice was provided before the first day of the preceding quarter (that is, at least 90 days before the desired withdrawal date).

Okay. But, what does the launch of this new fund have to do with the way we report returns?

When the fund launches, there will be two different Focused Compounding Capital Management vehicles people are invested in (the managed accounts and the fund) and two different fee structures in the fund (25% of profits or 15% of profits).

So, the people reading this letter will actually be getting 3 different net returns depending on which vehicle they are in and what fee structure they pay within that vehicle. I can promise you now that this is as complicated as Andrew and I ever intend Focused Compounding to get. But, it's already plenty complicated. As I see it, there's a simple solution to this. Starting with my April 1st, 2020 letter – I'm just going to report the ***FUND'S*** gross returns. Limited partners can simply multiply that gross return by 0.75 (if they are paying 25% of profits) or 0.85 (if they are paying 15% of profits) to get their own net returns.

What about the managed accounts?

I'm going to stop reporting returns in the managed accounts. I'm sure this feels like neglect. Like I am treating the new limited partners in the fund better than I'm treating you, the old managed account clients. However – when it comes to reporting results – managed account clients are actually at an advantage over investors in the fund. A managed account comes with complete and immediate transparency. You can see what you are invested in. You can look up your own returns at any time. An investor in the fund can't. So, the best way for a managed account client to stay up-to-date on the exact net returns he's earning is to make use of Interactive Brokers and to ask questions of Andrew (***info@focusedcompounding.com / 469-207-5844***). Meanwhile, investors in the fund won't have that level of transparency. They will only know what stocks they are invested in, at what cost, and what those stocks have returned when I choose to tell them in the quarterly letter. For that reason – starting April 1st, 2020 – I'm going to limit discussion of returns to a discussion of the ***FUND'S*** returns. I will, however, write about my reasons for buying a particular stock in the managed accounts. Any written commentary about stocks will cover both stocks held in the fund and in the managed accounts. It is just the reporting of returns that will change.

Also changing will be the length of these letters and their frequency. I had been writing to managed account clients on a monthly basis. Each letter was usually quite short (often about one page). Starting with the letter you're reading right now, I'll only be writing to you once every 3 months (on January 1st, April 1st, July 1st, and October 1st of each year). However, as I'm sure you can already tell with this letter – I'm going to be expanding the length of these letters quite a bit. I'll do my best to cover every stock, every aspect of our approach, etc. that clients might be wondering about. If there's a particular question you have or a particular topic you'd like covered in a future quarterly letter, let Andrew know (***info@focusedcompounding.com / 469-207-5844***). Andrew and I talk daily. And he makes sure to bring me any suggestions from clients that might be useful in shaping future letters.

The question I'm sure every client will have every quarter is: *"What's been going on with my portfolio?"*. So, I'll start by answering that one.

Portfolio Overview: During the quarter, we completely sold off two stocks: **Keweenaw Land Association (KEWL)** and **Computer Services (CSVI)**. We bought one new stock: **Nekkar (NKR)**.

Let's start with the loser: Keweenaw. And let's return to the quote I opened this letter with:

"Eh. We're oh-for-two on asset plays so far."

The speaker was Andrew. The listener me. The scene: Central Park. It was the day after the Willow Oak annual meeting. Andrew and I were spending each night at my parents' house in New Jersey (he in the upstairs guest room, me on the Futon in the basement) and commuting into the city each day to see whoever wanted to meet us. On this particular day, one person had wanted to meet us at 1 p.m. and another at 7:30 p.m. Our first meeting was at Rockefeller Center. After that – it being some 20 degrees cooler in September in New York than it usually is in Dallas – Andrew had wanted to see Central Park. As always, I had my Kindle with me. Andrew had his iPhone with him. We found an open bench. And, after just a few minutes – I'd read the last pages of *"Railroader"* (about Hunter Harrison) and was now starting Jim Grant's latest book: *"Bagehot"* (since I read the Kindle version instead of listening to the audiobook – I'm happy to report I now know everything about Bagehot except how to pronounce his name). That's when Andrew's iPhone died.

Where would we go now? How would we pass the time?

I suggested 77 Greenwich Street.

Since ***MY*** iPhone told us that was a 4-mile trek straight through the middle of Manhattan – Andrew's reluctance to make the trip needs no explanation.

My desire to make the trip does…

77 Greenwich Street is a condo building currently under construction. It's owned by a publicly traded company called **Trinity Place Holdings (TPHS)**. Trinity Place Holdings is the old Syms. Syms was an *"off-price"* clothing store chain that owned some valuable property – such as 77 Greenwich Street – when it filed for bankruptcy in 2011. I started my *"Gannon on Investing"* blog way back in 2005. So, I was reading all the value bloggers who were following Syms, investing in it, arguing about its possible value in liquidation, etc. during the business's final few years before it filed for bankruptcy. It took Syms over 5 years to emerge from bankruptcy. The stock continued to trade during this time (and often at prices much higher than where it sells for now). But emerge it did in 2018. Despite having a market cap of only $135 million and having recently (like 18 months ago) emerged from bankruptcy – Trinity Place Holdings is not as *"overlooked"* as most stocks Andrew and I analyze. Major shareholders include: Michael Price, Third Avenue Value, and Kahn Brothers (all New York based value investors). Usually, there are no well-known investors among the shareholder rolls of the companies we own.

However, Trinity Place Holdings does fit the two criteria Andrew and I use to decide if a stock is sufficiently overlooked:

1) What percent of the stock's total shares outstanding trade in an average year?
2) What's the stock's beta?

As I write this, Trinity Place Holdings has an average daily volume of 60,000 shares against total shares outstanding of 31.9 million. Assume 252 trading days in a year. That's 60,000 times 252 equals 15.1 million shares. And 15.1 million shares divided by 31.9 million shares outstanding is a 47% annual share turnover rate. That's at the very high end – I'm not sure Andrew and I would usually buy a stock where more than 50% of shares were likely to change hands in a single year – of what I'd call *"overlooked"*.

Our reason for using *"beta"* as a test for an overlooked stock requires more explanation. Those of you who know anything about beta probably know that it measures volatility. So, a stock with a beta of 0.4 is supposed to be less volatile than a stock with a beta of 1.2. A beta of 1 would indicate the same volatility as the index the stock is being benchmarked against.

The explanation I just gave is not true. However, I bet it may tend to sort of ***SEEM*** true for most of the stocks in your portfolio. It may seem that beta is just a measure of volatility. That is, you probably will notice that the stocks you own with lower betas seem to bounce around less in price than the overall market and the stocks you own with higher betas seem to bounce around more in price than the overall market.

However, beta is actually a measure of two things. One, how much the stock tends to move up or down (volatility). And two, how much the stock tends to move up or down ***WITH*** the market (correlation). The fact beta is a measure of general market volatility – as opposed to ***SPECIFIC*** stock volatility – is important when considering whether the stock is overlooked. If a stock is volatile in much the same way the market is volatile – then, what exactly is causing most of that stock's volatility?

The market.

And what is *"the market?"*

It's the group of buyers and sellers of stocks. In other words, it's the institutions and individuals that tend to be holders of stocks. Everything this group buys and sells among itself is volatile, because it is being bought and sold by this group. This kind of volatility is not a coincidence. People don't just happen to trade assets that move around a lot in price. Assets tend to move around a lot in price because people trade them.

If timberland has a low correlation with the S&P 500 – that's probably because different people tend to hold timberland than hold the S&P 500.

Beta is crowd based volatility. You personally can lower your own beta by moving away from the crowd. But, the crowd as a crowd can never lower volatility by moving *en masse* to other assets. It won't work. If more and more of the sort of folks who now own the S&P 500 become the sort of folks who own timberland – then, the volatility in timberland's returns will start to become more and more correlated with the S&P 500. Note that it's only the volatility – and not the long-term, central tendency of timberland's rate of compounding – that will be affected by who owns the asset. What price you get quoted on an asset from day-to-day, week-to-week, month-to-month, and quarter-to-quarter will largely be determined by who else owns the asset you own and what kind of mood they are in and what their own balance sheets look like at the moment (basically: are they feeling financially flush or financially stressed). The decade-to-decade rates of compounding you see in an asset will tend not to be determined by who owns the asset. Rather, long-term returns will tend to reflect inherent traits of the asset itself.

Two good businesses – one illiquid and unknown to most investors and the other very liquid and very well-known – will have totally different betas even though they may have similar long-term rates of compounding. For example: as I write this, **Computer Services (CSVI)** – a stock I'll be talking about in a minute – has a beta of 0.41 and **Jack Henry (JKHY)** has a beta of 1.10. Jack Henry is not a *"riskier"* stock than Computer Services despite the higher beta. Both companies are in the same industry (they do *"core processing"* for U.S. banks). And Jack Henry's competitive position within that industry is every bit as good as CSI's (probably better).

However, about 125% of Jack Henry's shares change hands in a given year. Meanwhile, only about 16% of CSI's shares change hands in a given year. All this extra trading in Jack Henry shares relative to Computer Services shares means that the influence of the mood of the usual suspects is affecting the quote you're getting in Jack Henry more than it is affecting the quote you're getting in CSI. You can see this in the long-term return of each stock. While the betas of Jack Henry and Computer Services look very different from each other – both stocks have blown away the S&P 500 when measured over the last 15 years. So, the fact that Jack Henry has a beta of 1.1 (which is very close to a market beta of 1) does not mean that Jack Henry will necessarily have a long-term rate of return that looks anything like the market.

What the share turnover rate (125%) and beta (1.1) of Jack Henry tells me and Andrew is that while Jack Henry may be a good business – it's not an overlooked stock. At Focused Compounding, we only focus on overlooked stocks. I'll explain more about why that is in a minute. But, first I want to lay out an extended metaphor about the *"inside"* and *"outside"* price risk you face in a stock.

As an investor: you face two kinds of risks related to the price of the stocks you own. One risk has to do with the inherent qualities of the stock you own (*"inside"* risk). You could have paid too much for the stock, the quality of the underlying business could prove to be poor, things like that. The other price risk you face has nothing to do with the asset you own. It has to do with your co-owners in the asset. This second risk is beta (*"outside"* risk).

The easiest way to think of this is to imagine each stock as an island. Each of these islands will have different climates and different inhabitants. Any one person on any island will face a variety of problems. Some of these problems will be location based problems (caused by the island they're on). Others will be population based problems (caused by the people they're living among).

Now, imagine you're born on an island where something is wrong with the climate – let's say the winters are so long and the growing season so short it's difficult to produce enough food to feed everyone. Well, the inhabitants of that island can all collectively move to another island with a better climate and solve their starvation problem. But, let's say this home island of yours actually has two problems. One, the people are starving because the climate is lousy. Two, some of the people are suffering from syphilis.

One of these problems can be fixed by switching islands (the climate problem). The other problem will stay with the inhabitants wherever they go as a group (the colonists are going to take syphilis with them wherever they go). It does not matter if the syphilis ridden group finds an island where the inhabitants already living there are free from syphilis. Pretty soon they won't be. Syphilis is a problem you bring with you.

In investing: beta is like syphilis. If art, cash, gold, or bonds are inherently lousy, low returning assets (barren islands) – then, institutions and individual investors can simply switch into inherently more productive assets like stocks, farmland, timberland, real estate, etc. (fertile islands) and collectively lower the risk they won't achieve their long-term financial goals.

However, if investors are concerned that art, cash, gold, or bonds are too volatile (the risk of an adverse price quote on any given day is too high) they can't – ***AS A GROUP*** – move away from volatility any more than syphilis ridden islanders can move away from syphilis. General price volatility (beta) has nothing to do with which island you're on – it only has to do with who you're sharing that island with.

Andrew and I are looking for an island with a good climate and – as yet – no syphilis. The long-term rate of compounding in a stock is a good measure of the inherent favorability of that island's natural climate. The amount by which a stock's beta is below 1 is a good measure of the (current) absence of syphilis on the island.

Once you understand that a stock's beta is not just volatility, but volatility that is correlated with the volatility in other stocks because the same people are trading this stock who are trading most other stocks – you can see why Andrew and I want to find low beta stocks. A low beta stock should be more overlooked. It should be less popular. And – we believe – it has a better chance of being mispriced.

Specifically: the two metrics we're looking for are a combination of low share turnover and low beta. This isn't some theoretical epiphany I had. It's something I noticed again and again when doing the practical work of sorting through endless numbers of potentially overlooked stocks. Once I'd done all my research on a stock, I had no problem telling if it was or wasn't overlooked. But, I didn't have a good method for identifying overlooked stocks before starting to research them.

That's when I noticed that any time you found a stock with ***BOTH*** a combination of a low beta (nearer to zero than 1) and a low annual share turnover (nearer to 0% than 100%) – you were almost always looking at a stock that everyone would agree was overlooked. The reverse was also true. Any stock with annual share turnover well above 100% and a beta well above 1 was not overlooked. And almost all reasonable people would agree with that verdict.

Now, this is where I need to bring a warning into the discussion. My guess is that the reason I like low beta stocks and the reason clients like low beta stocks are not the same reason. Remember, beta is a measure of two things: volatility and correlation with the overall market. What I think clients are looking for is low volatility. What I know I'm looking for is low correlation with the overall market.

I'll use the past returns in an account I managed before starting Focused Compounding to explain this point. From 2009-2017, the account I managed had both somewhat higher returns and somewhat higher volatility than the S&P 500. Because the account I managed had higher volatility than the S&P 500 – you might guess it had a beta above 1. In reality, it had a beta far below 1. That's because the account's ***CORRELATION*** with the S&P 500 was very low. This is easy to see if I compare results in extreme years. During this time period, the S&P 500's best year was 2013. The index rose 32% that year. The account I managed ***FELL*** 1% in 2013. I don't know if that's a feat I should be proud of. But, it's a feat that's pretty difficult to pull off when you're 100% invested in stocks. The reverse situation – where the S&P 500 had a pretty poor year and the account I managed did fine – also happened a couple times. In 2011 and 2015 the S&P 500 was up 2% and 1% respectively. Meanwhile, the account I managed was up 22% and 11% respectively. Basically, if I provided you with a table of annual returns showing just the S&P 500's returns and leaving my returns blank – you'd have a hard time guessing what should be put in the blank column based on the index's returns. That's what I mean by a low correlation.

So, I don't know if your returns as a Focused Compounding client will be less volatile than the S&P 500 or more volatile. They may turn out to be more volatile. But, I do know that your returns will be less ***CORRELATED*** with the S&P 500 than your returns in any other equity investments you have. For example, between 2009-2017, the account I managed had far less correlation to the S&P 500 than *"market neutral"* funds did. Market neutral funds short stocks. I don't. So, you can imagine that the long side of a market neutral fund must tend to be very similar to the S&P 500 – and the long side (which is everything) of my portfolio must tend to be very dissimilar to the S&P 500 – for the overall result of the long and short portfolios of a market neutral fund to be more correlated with the S&P 500 than the account I managed was.

My point in bringing up my own past returns is to break the concept of beta down into two parts. Beta is not just volatility. Beta is volatility caused by the correlation between movements in the price of a specific stock and the general market. Andrew and I are not in the business of avoiding volatility. We are in the business of avoiding correlation with the general market. So, your account may be volatile. But, it's going to be volatile in specific ways that will feel different than the general volatility you're used to when owning groups of stocks that move more in line with the S&P 500.

This explains why I'll sometimes bring up a stock's beta. What Andrew and I are looking for is a mispriced stock. That stock might turn out to be very volatile or not very volatile. But, if that stock is volatile in the same general way the market is volatile – then, that stock is probably owned by the same people who own stocks generally. And a stock that is owned by the same people who own stocks generally is less likely to be mispriced in some way specific to that stock.

Owning a group of low beta stocks – which, as a Focused Compounding client, is the position you'll find yourself in every quarter – is not any guarantee of getting better or worse returns than the S&P 500. It's just a guarantee of getting ***DIFFERENT*** returns than the S&P 500.

Which brings me back to that bench in Central Park…

Trinity Place Holdings was barely overlooked enough (47% share turnover / 0.36 beta) for Andrew and I to consider. But, using my island analogy – that only tells us that the island isn't infected with the syphilis of general market volatility (beta). Trinity Place Holdings isn't a crowded island. But, is it an island with the right kind of climate?

Is it a good business?

No. It's an *"asset play"*.

Before I talk about what an asset play is and how unsuccessful I've bee picking these for your account, I'm going to take you back 30 years to something Warren Buffett wrote in 1988:

"…our insurance subsidiaries sometimes engage in arbitrage as an alternative to holding short-term cash equivalents. We prefer, of course, to make major long-term commitments, but we often have more cash than good ideas. At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments. (Charlie's sign off after we've talked about an arbitrage commitment is usually: 'Okay, at least it will keep you out of bars.')"

Andrew and I are always looking for investments that provide a combination of 3 things:

1) **An overlooked stock**
2) **That's also a good business, and**
3) **That's selling for a cheap price**

We're least flexible on #1 (Focused Compounding's investment universe is strictly limited to *"overlooked"* stocks) and most flexible on #3. But, I'm still a natural born value investor. So, when I say I'm more flexible on price than I am on whether a stock is both overlooked and a good business – I mean only that I'm sometimes more willing to pay 12 times earnings for a business where I feel the future is more certain than I am to buy something selling for 6 times earnings with a less certain future. Nonetheless, I'm just not going to ever pay 30 times earnings for anything – no matter how certain its future seems.

Sometimes, this reluctance to pay up in price creates a problem. If we are in a period where most investors are willing to pay a lot for good businesses – then, good businesses will get bid up in price to the point where they are out of my reach. I then have to decide what to do instead of buying good businesses. I can hold cash. But, I don't like doing that. The long-term average return in cash is well below the long-term average return in even not very cheap stocks. A basket of – by my somewhat stricter than the market's standards – slightly expensive stocks will still tend to outperform cash every year. Also, I'm aware that clients think of the money they have me managing as being invested in stocks. They intend for that money to compound over time. It's not meant to be a rainy day fund. If they wanted one of those, they could have kept it in a bank account and skipped paying me a fee on the assets.

But, then – how do we *"keep me out of bars"* as Buffett said above. The really interesting line from Buffett's 1988 letter to shareholders is: *"...arbitrage…cools any temptation we may have to relax our standards for long-term investments."*

And this, I think, is the problem with asset plays. Whenever you see an asset play in your account, you can be sure that we've – and when I say *"we"* I mean *"me"* as the quote from Andrew makes clear – been tempted to relax our standards for long-term investments. Basically, when we can't find a good business that's cheap enough we're tempted to buy something else – like a not terribly productive asset – that is cheap enough.

Andrew and I started the managed accounts in mid-2018. We had promised you we'd try to find 5 stocks – originally, it was 6-8 stocks (but I quickly backtracked on that promise as 6-8 stocks proved far too many investment *"slots"* to fill) – to put your account in.

When we started the managed account: I didn't have 5 equally good ideas. I had one stock that was definitely ***VERY*** overlooked, ***VERY*** good, and ***VERY*** cheap. That would be **NACCO (NC)**. And I had another stock that wasn't very cheap – but, it was cheap enough (especially relative to other stocks like it) and definitely super overlooked and super high quality as a business. That would be **Computer Services (CSVI)**. After those two ideas, the quality of the ideas I had dropped off quite a bit.

And that explains how some of your account ended up in asset plays like **Maui Land & Pineapple (MLP)** and **Keweenaw Land Association (KEWL)**. Those two stocks – Keweenaw much more so than Maui – accounted for all the negative performance since we started the managed accounts. This is basically true on ***BOTH*** an absolute and relative basis. Not only were Keweenaw and Maui the only stocks that had meaningful declines while you owned them – they're actually the only stocks that meaningfully underperformed the S&P 500 while you owned them. So, the performance of the managed accounts would've been better if I'd never bought either Maui Land & Pineapple or Keweenaw Land Association. And it would have been ***A LOT*** better if instead of buying MLP and KEWL, I simply put more of your money into stocks like NACCO, Computer Services, and **OTCMarkets (OTCM)**. In other words: you would've been a lot better off if I'd limited myself to buying only operating businesses and ignored asset plays entirely.

Now, there's obviously some element of luck to this. We've only been running the managed accounts for a little under a year and a half now. And we've only invested in two asset plays. Remember, what Andrew said to me in Central Park:

"Eh. We're oh-for-two on asset plays so far."

You wouldn't judge a hitter on just two at bats. Statistically, a sample size of two isn't going to tell you very much. But, there are some other hints – both logical and empirical – that suggest I should've known better and avoided these asset plays. I should've stuck to investing your money only in good businesses.

I started investing in the late 1990s (a couple years after Andrew was born). So, I've been picking stocks now for more than half my life (about 60% of all the years I've been alive). In that time: I've had some bigger winners. None of them have been asset plays. I've had a couple big losers too. Some of those have been asset plays. And some of those have been operating businesses. The problem is not so much that the risk in Maui Land & Pineapple or Keweenaw Land Association was so great. It might be bad luck they declined while we owned them. But, I can tell you right now that the upside in either stock was never as big as it was in NACCO or Computer Services. And that's a problem. When the upside in a stock is as small as it was in Maui Land & Pineapple and Keweenaw Land Association – I'll quantify the upside in each in

just a second – the risk you're taking in that stock has to be very, very small. In fact, it ought to be quite close to no risk at all.

In 2018, we bought shares of Maui Land & Pineapple at a stock price equivalent to about $250,000 an acre. This counts only the undeveloped land the company owns at its Kapalua resort. It owns some other stuff (mostly a lot of conservation land) that may have value. But, we know those roughly 900 acres of undeveloped resort land does have value. How much? Maybe $500,000 an acre. Maybe $600,000 an acre. I don't know. But, probably not a lot less than $500,000 an acre. The stock was selling for $250,000 an acre. So, at the time we bought Maui Land & Pineapple stock it might have been selling for a 50% discount to what it was worth.

That sounds good. But, I actually think that at the times we bought NACCO and Computer Services – those stocks were probably selling at a similar 50% discount to what they were worth. This brings me to the curse of the Ben Graham type value investor.

There's nothing wrong with buying something at 50% of what it's worth. But, Maui Land & Pineapple stock was trading at the same price per share when we bought it as it had been selling for 22 years earlier. That doesn't mean the underlying business didn't generate any return. It did. The land itself grew in value over those 22 years. The stock's price just got enough cheaper relative to the value of land it owned to offset that growth in value. But, the growth in the underlying value of raw land – even in West Maui – isn't as good as the return in an excellent business. Before corporate costs, it's possible that land values would rise 5-6% a year. That's a terrifically high rate for raw land (there's very little developable land left on Maui, obviously) but it's not a very impressive rate for a business. During the 20th century, U.S. public companies generally managed to grow earnings per share by 5-6% a year while also paying a 3% dividend yield. And that's a Dow Jones Industrial type company. It should be possible for a hardworking business analyst to turn up a handful of companies that can grow faster or pay higher dividends while they grow.

Compare this to Computer Services. In 2018, we paid what – for a value investor – was not a low price for the stock. Our first purchase was made in June of last year at a (split-adjusted) price of $24.58 a share. We sold those shares a little less than 15 months later at a price 79% higher. We also collected dividends each quarter. Our annualized return in CSVI was probably a bit better than 60%. The stock now trades at something like 26 times earnings. That's not cheap. And that's a big part of why we sold the stock (we found a cheaper business to buy). But, CSVI at 26 times earnings is not a worse long-term investment than West Maui land at $500,000 an acre. It just isn't. Speculatively, MLP looks a lot cheaper to a value investor today at $11 a share than CSVI looks at $44 a share. But, if you own the two stocks long enough – even at today's prices, I'm not at all sure you'll do better in Maui Land & Pineapple.

I'll talk more about Computer Services a little later. It's a good example of a *"quality"* stock. We got lucky in how quickly the stock was re-rated from something that should trade at like 15 times earnings to something that should trade at 25 times earnings. But, Computer Services – because it's a good, constantly growing business – is a stock you can afford to get stuck in. Maui Land & Pineapple is not. It's very hard for an asset play to outperform a good business over the long-run. And it's very easy for a value investor – like me – to convince myself that something

selling at 50% of the value of land it owns is cheaper than something trading at 15 times earnings. The truth is that – even now – Computer Services is not more expensive than its closest public peers. It's actually quite a bit cheaper. The bigger core processor stocks have P/Es of around 40. So, is Computer Services expensive at 26 times earnings? It was expensive enough for us to sell and buy a much cheaper business. But, I'm not sure it's expensive enough for us to sell and buy Maui Land & Pineapple at half what the land it owns is probably worth. In fact, I think I've come around to the view that it would be a mistake to sell something like Computer Services at anything less than a truly absurd price (and 26 times earnings is not an absurd price for a core processor) just to buy something like Maui Land & Pineapple.

Which brings me to Keweenaw Land Association. In 2018, you owned some MLP stock. You never owned as much MLP as you did KEWL. You didn't own MLP for as long. And MLP never declined as much as KEWL did. So, the ink I just spilled on explaining my error in Maui Land & Pineapple was really just a prelude to the one truly costly error I've made in your account so far: owning Keweenaw.

Keweenaw Land Association is a timberland company. Like Maui Land & Pineapple, it's a stock I'd known about for a very long time. I'd probably first looked at it over a decade before I bought it for your account (the same was true of MLP). The value in KEWL stock comes in the form of the roughly 0.14 acres of Upper Michigan timberland backing each share of stock. The company has some debt. But, it also has some mineral rights and a bit of cash offsetting the value of some (but not all) of that debt. To keep the math simple here, I'd say that buying 8 shares of KEWL stock would be equivalent to owning about 1 acre of Upper Michigan timberland outright. As I write this, the stock last traded at $70 a share. And $70 * 8 shares equals $560. An acre of timberland in Upper Michigan is worth a lot more than $560. For example, the firm hired in 2018 to appraise Keweenaw's timberland gave a per acre value of $809. So, we're probably talking about a stock that is trading at two-thirds of the appraisal value of its timber. And, actually, if you read that appraisal report (it's on the company's website) you'll see that the appraiser used a method that's likely to somewhat understate the actual value per acre KEWL's land would fetch in a sale. Basically, the *"comparable sales approach"* alone would put a much higher value than $800 an acre on the company's land.

So, again we have an asset play that was fairly easy for me to appraise. In the case of Maui Land & Pineapple, I…

- Read some write-ups of the stock
- Read some old Hawaiian government reports
- Read some old academic papers
- Read some Hawaiian media stories
- Put together an Excel sheet of list prices in various condo communities, etc. in the area
- Asked someone in Hawaii to dig up information on what West Maui land is worth
- Asked Andrew to do some scuttlebutt such as talking with local realtors

The figure that came back was close to the number I gave you (about $500,000 an acre versus the $250,000 an acre the company was selling for in the stock market). There was a lot more data on KEWL's timberland than on Maui Land & Pineapple's acreage. In fact, that might have been

part of the problem. The amount of exact data I could collect on KEWL was part of what hooked me on the stock as an asset play.

In my defense, timberland – like West Maui resort land – is not a bad asset long-term. It has a history of holding its real value, producing income, etc. at a better clip than many forms of real estate. Unleveraged returns in timberland are better than unleveraged returns in most other kinds of real estate.

Nonetheless, returns in timberland aren't all that amazing compared to returns in good businesses. Just a moment ago, I paired the investment choices of Maui Land & Pineapple and Computer Services. Here, I'll pair off the investment choices of Keweenaw Land Association and NACCO to show how inferior KEWL was to NC.

Now, in my defense, this comparison isn't 100% fair. I did put 20% or more of your account into NACCO. The only way I could've chosen NC over KEWL more than I actually did would be to further concentrate you in NACCO. That might have been the rational choice. But, it would have been extremely unconventional. Andrew and I already target concentration levels – around 20% of the portfolio in each stock – far beyond those practiced by almost any other investment managers.

There's nothing wrong with diversification. Given the choice between putting 40% into a single investment idea or 20% each into two equally good investment ideas – I'd much prefer putting 20% each into two equally good ideas. But, the first rule of diversification has to be that it doesn't become *"di-**wor**sification"* as Peter Lynch would say. It makes sense to make a lot of good bets. But, it never makes sense to make even a single bad bet for the purposes of diversification.

KEWL may have been a bad bet. NACCO certainly wasn't.

When we bought each stock, NACCO might have been trading for two-thirds or less of what value investors often call "intrinsic value" or what I just call my "appraisal value" of the stock. It's more likely that NACCO was trading for closer to half of what I thought it was then worth. I now think it's worth a lot more than that original appraisal. I'll explain why when I get to the section of the letter dealing specifically with NACCO. Here, we just need to talk about how cheap NACCO was when we bought it versus how cheap Keweenaw was. NACCO was cheaper. We paid a variety of prices for KEWL shares. But, even the lowest price we paid was probably not much less than two-thirds of my appraisal of the stock. With NACCO, we managed to buy a lot of shares closer to half of my appraisal value. The difference between buying at half or two-thirds of a stock's appraisal value might sound like a small difference. But, even over a holding period as long as 10 years, the gain from a stock closing a value gap by going from 65 cents on the dollar to a full dollar is only 4.4% a year compared to 7.2% a year when you close a value gap from 50 cents on the dollar to the full dollar. So, even for very long-term investors, buying at 50 cents on the dollar instead of 65 cents on the dollar is likely to add 2.5% to 3% a year to your returns. In my experience, stocks tend to close any value gap a lot faster than 10 years. A more common waiting period is probably 5 years (or less). A 65 cent dollar that trades up to a full dollar in just 5 years adds 9% a year to your returns. Meanwhile, a 50 cent dollar that trades up to

a full dollar in the same 5 years adds 15% to your returns. As a rule, buying at half of intrinsic value instead of two-thirds of intrinsic value will probably improve your returns by more than 5% per year. In some cases, it'll be a lot more than 5% per year.

Asset plays bought at deep discounts – like at prices well below half what you think they're worth – aren't usually the problem. The problem tends to be buying asset plays at high prices relative to intrinsic value. For example, a lot of our purchases of Maui Land & Pineapple and Keweenaw Land Association were probably done at prices anywhere from 40% to 80% of the market value of their assets. A discount of 20% to 60% versus intrinsic value is not a bad price to pay for a good business. But, it's not always a big enough discount to pay for a low returning asset.

This is where the difference between a truly good business and just a cheap asset comes into play. An asset bought at less than half what it's worth may be a good deal – especially for a shorter-term investor – compared to a good business trading at a price very close to intrinsic value. But, that's often not the opportunity cost Andrew and I are paying. We're not passing on a business trading for about what it's worth to buy an asset play. Usually, we're passing on a business we like trading at say 75% of what we think it's worth to instead buy an asset trading at 50% of what we think it's worth. That's less likely to be a good choice. And, the longer we hold the asset play – the more likely it is to underperform the good business.

So, why do it? Why did I buy Maui Land & Pineapple and Keweenaw Land Association and why was I interested enough in Trinity Place Holdings to suggest visiting 77 Greenwich Street?

I think the answer has to do with certainty. There is a certainty to a price quote provided by someone else, to an appraisal, to similar transactions that there isn't in your own calculations of intrinsic value. How do I know what Computer Services is worth? How do I know what NACCO is worth? I sit down and try to project the future – will it grow as fast as inflation, as fast as the overall economy, will more capital need to be put into the business to grow, how much, etc. – and I look at the price being paid today versus the starting free cash flow we're getting and how much we expect that yield to grow or shrink and for how long. Computer Services often signs up clients for longer than 5 years. And it retains most of those clients when the contract expires. At the time we first bought shares in NACCO, all of that company's future cash flows were tied to contracts with between 13 and 28 years left on them. Some of those customers could fail. And the company's biggest couple customers accounted for most of its free cash flow. So, there is a risk there. But, there are risks with Maui Land & Pineapple and with Keweenaw Land Association too. The difference – I think – is the exactness with which a value investor can calculate an appraisal value for MLP and KEWL versus the inexactness with which they must calculate an appraisal value for CSVI and NC. We are used to thinking of land in terms of the value others are paying for similar parcels today. But, we're not used to thinking of future cash flows in terms of the present value they should have today for a buy and hold shareholder. Stocks like CSVI and NC – where the value is in the future cash flows – seem harder to value. Even if they're not riskier – they seem less certain. I'm not sure a positive investment outcome is really less certain in these stocks. But, I am sure that there is no helpful outside appraisal. Someone else can provide a quote for an asset. I have to be the one to appraise future cash flows.

So, there's nothing wrong with buying asset plays at deep discounts to what I think they're worth. But, it's a mistake to overvalue the certainty of having a price quote or an appraisal from someone else.

For the last couple years, I've miscalculated. I've overestimated the attractiveness of asset plays versus good businesses. I've been willing to buy asset plays at half or two-thirds of what I think they're worth even when there were good businesses also trading at half or two-thirds what I thought they were worth.

In the future, I think I'll be less likely to do this. But, I'm not immune to it. And I don't expect to get immunized any time soon. The more expensive good businesses become, the more tempting it is to fall back on buying asset plays where I feel sure I'm not overpaying for the stock. This is because – as a value investor – one of my biggest fears is the fear of overpaying for whatever stock I buy.

That may not be the most rational fear. The truth is that in cases where I've made bad investments – where things really turned out badly, and there was at some point a real risk of a permanent loss of capital – paying a much lower price for the same asset wouldn't have helped me much. Where I've made mistakes – my mistake was always buying the wrong asset. It really hasn't been paying too high a price.

Over time, I've shifted a bit from the Ben Graham approach to value investing. I am not – and probably never will be – all the way over at the Phil Fisher side of things. But, I have come to the realization that perhaps all I should be aiming for is to be very smart about which asset I buy and then just avoid being very stupid about the price I pay. As long as I'm smart about what I'm buying – I no longer think it's so important to be smart about the price. Often that has resulted in being too clever by half. Anytime I've made big money in a stock, it's been in something that was very simple to see. Price is still important. But, price is often very simple. It's simple to see that paying 13 times earnings for a good business is fine while paying 30 times earnings isn't. In those situations, you don't need to apply much intelligence to answering the question of "at what price?" You only need to apply intelligence to the question of "what to buy".

So, for now, I will pass on Trinity Place Holdings. Andrew and I never did make the trip to 77 Greenwich. Since starting the managed accounts, the best advice anyone has given me is:

"Eh. We're oh-for-two on asset plays so far."

For those interested: TPHS stock does look cheap. The company gave a presentation last year where they laid out the value of the stock under different sale prices per square foot for the condo project. Right now, the stock is trading below the value you'd get from any sales per square foot assumption that seemed reasonable a year and a half ago. But, Manhattan condo prices may have come down a lot in the last year and a half. They may not be done coming down. And those condos aren't sold yet.

I'll do my best to find businesses worth buying instead of settling for asset plays like Trinity Place Holdings.

Like I said, we sold Keweenaw Land Association. The reason for the sale was simple. I made a mistake. I paid too much for an asset play. The stock remains cheap today versus its appraisal value per share. If you'd like to own timberland – Keweenaw Land Association is a cheap way of investing in it. But, we were able to find some businesses I like better. Once we did, I sold out of KEWL. We sold out at a big loss. It was by far the biggest loss realized on any stock you've owned. In fact, since inception of the managed account's KEWL shares have continually accounted for the vast majority of any negative influence on your performance. Almost everything else – Maui Land & Pineapple is the "almost" – has worked out somewhere between okay to great.

So, let's talk great. Let's talk about the other stock I sold this quarter: **Computer Services (CSVI)**.

Computer Services was a simple idea. The one hurdle was curing me of my value investing ways enough to pay a higher price than I usually like to. Last year: the model portfolio paid a split-adjusted price of $24.58 a share. Let's call that $25 a share. A little under a year later (in May of this year), the company reported earnings per share of $1.62 a share (also split-adjusted). There was no "forward P/E" on the stock when we bought it, because Computer Services – as an over-the-counter stock that doesn't file with the SEC – isn't really covered by analysts who give EPS estimates a year out. But, if there had been, I suppose you could say it was $25/$1.62 = 15 times earnings. The company had no debt. There was a bit of net cash. So, the stock was trading for about 15 times forward earnings while employing zero leverage. That's not expensive. But, it's not the kind of price a value investor usually pays for an over-the-counter stock. As I write this, a couple of your stocks have P/E ratios under 10. I'm looking at another stock to buy for you right now with a P/E ratio of 6. And I just bought a stock – which I'll discuss with you in a second – where the price paid was a bit below net cash. Here, I paid more than 15 times last year's earnings for a stock. For me, 15 times earnings is a hell of a lot to pay for a stock. To buy CSVI, I had to get over that hurdle.

I did. And we continued to hold the stock till the last few weeks of this past quarter. So, we owned the stock for something like 15 months. The annualized rate of return was a bit better than 60%. Even at 26 times earnings – the stock is still not expensive when compared to its publicly traded peers like Jack Henry. But, there was another business I liked that was cheaper. So, I sold CSVI to fund that purchase. Before I discuss that new purchase with you, I'm going to include a table that illustrates the appeal of CSVI. I often talk about *"good, predictable"* businesses with *"high retention rates"* and a low need for retained earnings to fund growth.

This is what that looks like:

YEARS ENDED FEBRUARY 28 AND 29,	2019		2018		2017		2016	
Income Summary								
Revenues	$ 266,494		$ 249,558		$ 234,901		$ 224,725	
Operating expenses	213,256		201,839		184,920		176,608	
Operating income	53,238		47,719		49,981		48,117	
Gain/(loss) on sale of investment	4,093		-		-		-	
Interest income (expense)	796		124		93		48	
Income before income taxes	58,127		47,843		50,074		48,165	
Provision for income taxes	13,169		9,012		19,153		19,025	
Net income	44,958		38,831		30,921		29,140	
Net loss attributable to the noncontrolling interest	-		-		-		-	
Net income attributable to Computer Services, Inc.	$ 44,958		$ 38,831		$ 30,921		$ 29,140	
Financial Position								
Working capital	$ 58,218		$ 52,218		$ 44,017		$ 30,387	
Current ratio	2.0		2.3		2.3		2.1	
Net tangible assets	$ 153,977		$ 121,012		$ 103,753		$ 89,469	
Property and equipment, net	$ 41,600		$ 37,044		$ 35,420		$ 34,655	
Capital expenditures, net	$ 18,023		$ 20,630		$ 13,678		$ 19,914	
Depreciation and amortization	$ 17,686		$ 16,322		$ 15,489		$ 15,024	
Total debt	$ -		$ -		$ -		$ -	
Total debt to total capitalization	-	%	-	%	-	%	-	%
Earnings before interest, taxes, depreciation and amortization (EBITDA)	$ 70,924		$ 64,041		$ 65,470		$ 63,141	
Net cash provided by operating activities	$ 55,179		$ 46,485		$ 49,650		$ 45,064	
Free cash flow	$ 37,158		$ 25,855		$ 35,972		$ 25,150	
Return on average shareholders' equity	22.2	%	22.0	%	19.5	%	19.7	%
Per Common Share								
Net income, basic	$ 3.23		$ 2.78		$ 2.21		$ 2.07	
Weighted average common and common equivalent shares outstanding, basic	13,909,303		13,963,394		14,007,182		14,106,805	
Net income, diluted	$ 3.23		$ 2.78		$ 2.21		$ 2.07	
Weighted average common and common equivalent shares outstanding, diluted	13,909,303		13,963,394		14,007,182		14,106,805	
Cash dividends paid, regular	$ 1.34		$ 1.18		$ 1.06		$ 0.94	
Cash dividends paid, special	$ -		$ -		$ -		$ -	
Book value at year-end	$ 15.80		$ 13.39		$ 11.88		$ 10.85	
Market value at year-end	$ 58.00		$ 45.50		$ 45.00		$ 35.96	
Price-earnings ratio at year-end, diluted	18.0		16.4		20.4		17.4	
Dividend yield, regular	2.3	%	2.6	%	2.4	%	2.6	%
Dividend yield, including special dividend								
Dividend payout ratio, regular	41.5	%	42.4	%	48.0	%	45.5	%
Dividend payout ratio, including special dividend								
Margins								
EBITDA as a percent of total revenue	26.6	%	25.7	%	27.9	%	28.1	%
Operating income as a percent of total revenue	20.0	%	19.1	%	21.3	%	21.4	%
Income before taxes as a percent of total revenue	21.8	%	19.2	%	21.3	%	21.4	%
Net income as a percent of total revenue	16.9	%	15.6	%	13.2	%	13.0	%
Effective tax rate	22.7	%	18.8	%	38.2	%	39.5	%
Growth Rates								
Revenue	6.8	%	6.2	%	4.5	%	1.5	%
Net income	15.8	%	25.6	%	6.1	%	4.7	%
Earnings per common share, diluted	16.2	%	25.8	%	6.8	%	5.1	%
Cash dividends per common share, regular	13.6	%	11.3	%	12.8	%	23.7	%

Now, on to the stock we bought with the proceeds from Computer Services: Nekkar.

Nekkar is a Norwegian micro-cap (the current market cap is around $30 million in U.S. terms – the stock trades in Norwegian Kroner). An investor from Norway suggested this stock to me back when the company was still called TTS Group. TTS Group had reached an agreement in early 2018 to sell almost all of itself in a merger that would leave a tiny rump business called "Syncrolift". Syncrolift is a ship moving technology used at shipyards as an alternative to a drydock. That business – plus some new ventures like cages for land based salmon farming – will form the basis of the new Nekkar. In recent months, the stock often traded between 6.50 NOK and 7 NOK per share. They planned to pay a dividend of 4 NOK (which they now have). That meant you could buy the stock at an equivalent – after the dividend was returned to you – of less than 3 NOK for the remaining business. At the time, the company was holding about 1 NOK per share in cash at corporate and another 2 NOK at the Syncrolift subsidiary level. Much of the cash held by Syncroflift is cash prepaid by customers. The company has a backlog that should keep them busy for the next 3-4 years. Some of that backlog is paid for in cash up front. So, here we had a company trading for less than net cash (though some of the cash was unearned revenue – also known as "float" – provided by customers) with no further needs for capital. Since Syncrolift is paid partially up front and has very little need for PP&E and things like that it would normally have negative invested capital in the business. This means that if Syncrolift were to grow revenue, earnings, free cash flow, etc. by about 6% a year – which is about what it probably has done over the last 25 years – it would be able to pay shareholders a dividend of literally everything it reported in earnings and that dividend would also increase at 6% a year. That's the beauty of a business with no need for additional capital as it grows. As a shareholder, you get to have your cake and eat it too. Cake here being *"free cash flow"*. Historically, the average U.S. public company traded at something like 15 times earnings (an earnings yield of 6% a year) and grew those earnings by 6% a year. This might sound like the average U.S. public company returned 12% a year. But, it didn't. To grow 6% a year, many companies retain more than half of their reported earnings. This is cake that you can either have or eat. But, not both. So, instead of your return being 6% earnings yield plus 6% growth – it's been more like 3% dividend yield (0.5 times the 6% earnings yield) plus 6% growth equals 9% return. The need to reinvest earnings probably trimmed at least 3% a year off the annual return on stocks during the 20th century. Syncrolift has no need for retained earnings. What the company will do with cash as it comes in is another question. But, other things equal, a growing business with no need for incremental capital from shareholders is a better investment than a growing business that needs to retain incremental capital instead of paying it out to shareholders.

There are some other things I like about Nekkar. It sells capital equipment without doing much service work on that capital equipment. Usually, maintenance work and spare part sales and so on are the most profitable part of these kinds of businesses. The company has grown over time. And it is a bit of a "hidden champion" in the sense that it's very small and yet has very high market share in the tiny niche – shiplifitng drydock alternatives – it serves. It's a Norwegian company. But, the market it serves is global.

I have no idea if the cages for land based salmon farming will ever turn into a meaningful contributor to profits. But, it's not too far outside the company's circle of competence.

On an EV/EBITDA basis, the price we paid for Nekkar was obviously low (EV was negative). However, the price we paid on a looking forward type P/E basis isn't going to be that low. If the company does nothing with the cash it has on hand, if corporate costs stay high relative to the small size of the Syncrolift business unit, etc. it's possible we'll have gotten only a normal P/E type price here. So, there are two ways of looking at it. If you count the net cash as a reduction in our purchase (which I think is too aggressive) – we got a growing business with theoretically infinite returns on capital and a 3-4 year backlog already in place for free. If you don't count any of the net cash as a reduction in our purchase price (which I think is too conservative) we got a growing business with theoretically infinite returns on capital and a 3-4 year backlog already in place for like 15-20 times earnings.

The truth is somewhere in between. Nekkar's future is a lot less certain than CSI's. For one thing, Syncrolift is an insanely cyclical business. It's much more likely I could misjudge Nekkar than CSI. On the other hand, Nekkar was a lot cheaper than Computer Services had gotten. I hope it'll prove to be a profitable switch out of CSVI shares and into Nekkar shares. But, my past record selling a good business I knew well when it got a bit expensive to switch into a cheaper business I knew less well is not so good. Generally, my sell decisions haven't added much value to my returns. And, when selling a good business I knew well, I've often lowered my future returns. Obviously, I wouldn't make the switch unless I thought I was right this time. But, you've been warned.

So, we've covered the two stocks I sold this quarter: Keweenaw Land Association (for a big loss) and Computer Services (for a big gain). And we just covered the one stock I bought this quarter (Nekkar). That leaves only the one big unrealized gain you had this quarter: **NACCO (NC)**.

NACCO is your biggest position. And, because NACCO has gone up in price faster than other stocks you own – it's become an even bigger position as a percent of your portfolio. As I write this, NACCO is now double the percentage weight of your second biggest holding. I didn't originally intend for NACCO to have such a huge weighting in your portfolio. But, I have discussed before how I won't just trim back a stock that has gone up to rebalance your portfolio. I don't believe in rebalancing. I believe in owning the most of the best and cheapest stocks in your portfolio. So far, NACCO has seemed to me to be one of the best and cheapest stocks in your portfolio. But, I am always on the lookout for a stock of equal quality and cheapness that I could replace half of your NACCO position with (thus bringing NC back down to a more normal 20% weight in your portfolio).

I haven't trimmed it yet. Why not?

So, I bought NACCO for the model portfolio at around half of today's price (low $30s per share versus a share price of $64 a share today). Because many of our clients opened their accounts later, many have a higher costs basis in NACCO. However, as always, when I talk about the prices at which we bought and sold I'm going to use *"model portfolio"* numbers (which tend to reflect the first time we did anything).

NC entered the model portfolio around $32.50 a share or so. At the time, I thought NACCO was probably worth about double that. Maybe – if I was being conservative – it was only worth about 1.5 times that (in other words, it was trading for two-thirds of what I thought it was worth). This would suggest my original appraisal value was somewhere in the range of $50 to $65 a share. Since NACCO is now trading at nearly $65 a share – shouldn't I have sold it by now?

The company has changed. It's gotten more valuable. A big part of that is simply time. NACCO generates a lot of free cash flow. The company hasn't done anything with this free cash flow except pay a dividend (which doesn't eat up much of total FCF). As a result, the amount of net cash per share on the company's balance sheet has gotten to be meaningful. This cash adds over $5 a share to my appraisal of the stock. The actual net cash position is much higher than that – like $12 a share – but, the company has obligations related to mine closure costs, pensions, etc. that I'm using to cancel out much of the actual net cash position. In reality, the last balance sheet was for a date (June 30th) almost 90 days ago, and NC has probably continued to pile up meaningful cash since then. At this time of year, it's not impossible NACCO added like $2 a share in cash during those 90 days. I can't be sure. It'd depend on things like capital spending. My point is just that a decent amount of the change in appraisal is caused by simple cash build. Each share might be appraised about 10% higher today than it would've been in June of last year, because cash has risen and debt has fallen during the last 15 months.

Then there's the natural gas royalties. This is the big item. So, NACCO was earning some royalties back when we bought the stock in 2018. But, basically, I valued the company entirely on the earning power of its lignite coal operations. I assigned very little value to other mineral rights it had. NACCO owns land in Ohio (it has old coal mines there). There is a lot natural gas coming out of the Utica Shale now. So, NACCO is earning a lot in natural gas royalties. In fact, at the rate things are going in 2019 – NACCO may get more of its earnings, free cash flow, etc. from natural gas royalties than from its contract coal mining operations.

How long will these natural gas royalties last?

I don't know. I've done some research and tried to come up with some guesses. I know that a lot of people who have sold out of the stock in recent months while we've stayed in it sold out because they can't know how long NACCO's natural gas reserves will last. The company does not even disclose how many acres it has in Ohio. Because I don't know enough about NACCO's natural gas holdings and – even if I did – I can't project future royalties from natural gas with much certainty, I really can't give you any idea of the upside in this stock. However, there's no appraisal I'd make right now where the combination of future natural gas royalties and lignite coal mining earnings add up to less than $65 a share. To me, the value of NACCO stock is definitely uncertain. But, I don't think that makes it risky. Risk is the chance that intrinsic value is below the current market price. So, I don't see a lot of risk here. I just see a lot of uncertainty.

And then we have the recent news that may partially explain the increase in NC's share price near the end of the quarter. NACCO announced that it has signed a 20-year deal to do all the contract mining for a planned lithium mine in Nevada. We don't have a lot of financial details on this project. What we know is that NACCO will put in $3.5 million to start and also up to $50 million in equipment (all of which the customer will pay back over time). The deal is for 20 years. The customer plans to produce 20,000 tons of lithium per year in the mine's first phase. I've read the presentations on the mine, looked through the website, etc. I did some research on the price of lithium (as compared to the price of lignite, which is what NACCO mostly mines). I made some guesses based on what the customer says the net present value of that lithium mine is and my best (completely uninformed) guess of sort of the order of magnitude of how much they might give up in NPV to a contract miner doing the extraction work for them.

Honestly, I think the market's reaction to this lithium mine is somewhere between appropriate and a bit of an overreaction. In the time since the deal was announced, the market price of the stock rose by a greater percentage than I'd adjust my own appraisal price by (based on the news). I don't assign a 100% probability to actual mining work starting on this project and NACCO being paid for a full 20 years of work. I should mention here that the mine's estimated life is actually closer to 50 years than 20 years. So, there's always a chance NACCO actually does the mining at this site for even longer than the 20-year term of the deal. I just think that lithium mining is more speculative than the mining of lignite coal. The customer's financial position is not as strong as a utility's financial position normally is. The value-to-weight ratio for lithium – it's an input in electric batteries for cars and other products – is extremely high. So, it's a global market with price swings like you'd see in other globally traded commodities (think oil, copper, etc.) instead of being a market with basically local pricing like lignite coal. Also, the method NACCO is going to use at the customer's mine – extracting lithium from surface mining of clay – is (as far as I know) not yet a method any other lithium producer is successfully using at the moment. I'm not saying it won't be successful. I'm sure other producers will be trying the same thing. Lithium producers are probably going to try all sorts of different methods over the next decade, because the projected supply increase needed to meet global demand for lithium in 2030

is huge. This might be a good deal for NACCO. My best guess is that – once earnings materialize in like 3-4 years or so – the increase in NACCO's earning power will be meaningful. It's not a small project at all. But, the way the math on something like this works is that if I assume a 50/50 chance of this actually happening and then I further assume that the first cash flow back to NACCO won't appear till nearly 5 years from now – the probability adjusted present value of the eventual 20 years of cash flow isn't as high as the market's reaction to this news.

So, the lithium deal adds value. But, I'm not sure it adds as much value to my appraisal of NC shares as the market has already added to the price of those same NC shares. Nonetheless, I think that the combination of NACCO's 5 buckets of value: net cash already on the balance sheet, lignite coal mining, natural gas royalties, the lithium mine deal, and the contract mining of limerock does add up to over $65 a share. I don't want to get into exactly how much over. But, it's enough that I haven't sold the position yet.

I would like to trim your position in NC back to about half of what it is now. But, I'm not going to do that till I find something that's comparable in terms of safety, cheapness, and quality. At the moment, I have only one prospect that comes close. So, you might see us sell ***PART*** of your NACCO position to fund a new stock purchase. That could happen as soon as this quarter. It's unlikely we'll sell the entire NACCO position any time soon.

This is the last communication you'll be getting from me till January 1st. From now on, I'll be writing to you on a quarterly schedule. If you're the kind of client who feels a bit more comfortable with hearing from your portfolio manager on a regular basis – I do record two podcasts a week with Andrew. You can listen to those podcasts through your Apple Podcast app. Or, you can see me (and Andrew) by going to the Focused Compounding YouTube page. We have way over 100 episodes up there. There are literally days and days worth of me and Andrew talking about stocks. I think anything you want to know about my investment philosophy, temperament, style, etc. can be learned from those podcasts.

As far as hearing from me specifically about your account, I will be back with another letter (of similar – some might say excessive – length in January). So, you'll be hearing from me less frequently (once a quarter instead of once a month). But, in much greater depth.

Finally, Andrew is always available to talk with you via email, text, or phone. I've included Andrew's name, email address, and phone number at the bottom of every single page of this letter as a not so subtle reminder that he is the correct contact person for anything and everything having to do with your account.

Andrew and I meet daily. If something needs to get to me, it can go through him.

Finally, I'd like to thank Andrew and Willow Oak. If it was not for Willow Oak, Andrew and I would not be launching the new fund. And, if it was not for Andrew – I wouldn't be managing your account right now. Andrew handles literally everything other than deciding which stocks to buy. That's all I concern myself with each day.

Which reminds me: I am constantly in need of new stock ideas. The better your account's performance is right now – the tougher that means it will be to have good performance in future quarters. This is because – when your account's value is rising – the stuff you already own is getting more and more expensive and therefore I need to find cheaper stocks to replace the expensive stuff with.

If you know of any stocks anywhere in the world that meet our two criteria – let Andrew know.

He'll bring the idea to me at our next meeting.

Our two criteria for selecting stocks remain:

1) An ***overlooked stock***
2) That's also ***a good business***

I'll be back with your year-end 2019 results on January 1st.

Sincerely,

GEOFF GANNON

Disclosure

*Returns are based on the Focused Compounding Capital Management Model Portfolio. Performance data of this model is produced directly from Interactive Brokers. It is important to note that each client may experience slightly different results from the model depending on the timing of deposits, withdrawals, the fee structure specific to each account, and other timing issues. The valuations of your investments at the time of purchase may be significantly different than the valuations at the time of purchase in the model because of these timing issues. We expect the results of the model account to roughly equal the results of client accounts over time.