July, 2017

Dear Partners,

Laughing Water Capital (LWC) returned ~9.0% net during the 1st half of 2017. As always, returns may vary based on the timing of your investment, so please view your individual statements. The SP500 and R2000 returned 9.3% and 5.0% respectively over this period. As always, I remind you that LWC makes no attempt to track the indices, and thus our performance will frequently diverge, sometimes to our benefit, and sometimes to our detriment. Our portfolio is concentrated, and thus volatile over short periods.

Our small margin of underperformance vs. the SP500 may seem unimpressive after last year's trouncing, but we should be perfectly fine with that as six months is far too short of a period to be of any real consequence. Importantly, over long periods, small amounts of outperformance per year result in large differences in ultimate value due to the magic of compound interest. For example, $1M invested at 6% per year for 30 years turns into $5.7M, while $1M invested at 9% per year for 30 years turns into $13.3M. Every little bit counts over longer periods of time, so I am content to get every little bit over short periods of time. Most importantly, while there have been some stumbles of late, for the most part our companies are making progress, and are continuing to increase their intrinsic value. The market can do whatever it wants over shorter periods of time, but over longer periods of time, as long as our management partners can continue to improve our companies, we will be rewarded.

Much of our portfolio is viewed by the market as a collection of under-appreciated odd balls, castoffs, and hobbled companies. We invest with a variant perception, and often deliberately choose our investments because they are presently suffering from some sort of optical, operational or structural difficulty which causes the market to misappraise their true worth. These near-term difficulties are anchors, and a rising tide does not necessarily lift all boats when some of the boats are anchored. Much of our strategy is predicated on the idea that over time our skilled management partners will be able to cut themselves loose from these anchors, which will likely lead to periods of rapid appreciation, independent of the market. We can never know in advance how much time our management partners will need to work through their problems, although we try to make reasonable projections. As such, our returns will be lumpy, and at times we will be left behind by the market. Patience is essential.

Accepting this state of affairs is a key competitive advantage in the investing world. Everyone says they want to "buy low and sell high," but the simple fact is that most people are not wired to behave this way. Buying low often means buying during a period of difficulty, which means "missing out" on other investments that are performing well. For most people, the idea of missing out over short periods of time is an insurmountable hurdle to long term investment success. This despite the fact that the evidence is clear: accepting the possibility of short term under-performance greatly increases the odds of long term outperformance.

LWC aims to build a partnership of exceptional individuals who are able to focus on the unique circumstances surrounding our management partners and their businesses, not on the prices that the market is willing to pay for those businesses at any given moment. We aim to outperform over time not by being the smartest or having the best information, but rather by relying on common sense, patience, and the occasional insight that the manic crowd misses. We are focused on long term compounding of wealth, and believe that the price of long term out performance is a willingness to accept volatility in the short term. I am happy to pay this price, and for this reason, almost the entirety of my and my family's assets are invested in our strategy. Our interests are aligned.

Alternative to What?

Customer: "Can you make a martini?" Bartender: "Make a martini do what?"

As many of you know, I spent much of my formative years working in my Uncle's bar/restaurant, where drinks were often served with a side of snark, and the above comment was often repeated. Pulling taps and sweeping floors did not give me an early start on investing prowess as a job caddying for the Wall Street crowd might have, but it did provide a strong foundation of common sense, and a fondness for probing the literal intent of a passing comment. These are valuable lessons in the investing world.

Market action in the first half of the year has been unusually calm, with the market doing a good job of ignoring the negative headlines (N. Korea, Russia, Trump, Central Bank policy, etc.) and drifting upwards almost without interruption. This environment has made it unusually easy for investors to stick with passive strategies, much to the detriment of active, or "alternative" strategies such as our own.

Warren Buffett has commented, "an investment in a low cost SP500 index fund is the best choice for most investors." I agree with this sentiment as evolution has quite literally ensured that most people feel safest in the herd, because thousands of years ago those that strayed from the herd were less likely to survive and pass on the "I'm going to leave the herd" gene. Generally speaking, the more an investor is inclined to watch CNBC, listen to Jim Cramer, or otherwise pay attention to the world around him or herself, the better off he or she is by focusing on reducing fees rather than out performance.

However, as the bartender questions what he should make the martini do, investors should question what it means to say "the best choice for most investors." Probing the literal intent will reveal that the SP500 has been designed quite specifically not to be "the best choice for most investors," but rather to be "the best choice for THE most investors."

If this simple twist makes you want to grab a drink, allow me to explain a bit further.

The SP500 is an amorphous blob of ~500 companies that have been chosen specifically because of how easy it is for the most people to invest in them. Intuitively it makes sense that this would include the ~500 largest companies, and that these ~500 companies would be a good representation of the economy as a whole, but careful thought reveals some problems. For "alternative" funds such as our own, these problems represent opportunity.

The SP500 is "market cap weighted," and "float adjusted." In layman's terms, market cap weighted means that if there were two companies that were completely identical except that one was more expensive than the other, the SP500 would own MORE of the expensive company. If you are keeping score at home, this is equivalent to "buying high."

Float adjusted means that if there were two companies that were completely identical except that at one company, the management team owned a lot of shares (presumably because they think the stock will go up), the SP500 would own LESS of this company. Again, for those keeping score at home, this means that the more confidence the management team has, the less stock the SP500 owns.

These two attributes make sense for "THE most investors," but they completely fail the common sense test. Would you rather own more of the expensive stocks? Would you rather own less of the stocks that management is most confident in?

Our fund is built on the belief that it is possible to carefully select approximately 15 companies that are more likely to provide satisfactory returns than the SP500 over longer periods of time. At present, our long term competition is trading at a trailing P/E of ~25x, with margins above their "normal" level, and its growth will ultimately be linked to inflation. From this point, even Jack Bogle, the founder of Vanguard and the world's leading proponent of index funds, has opined that SP500 returns over the next decade are likely to be 4% per year. This might be the best option for THE most people, but for those with the fortitude to think and act differently than "most people," I think there is a better alternative.

<u>We are not trying to re-invent the wheel; we are simply trying to do the same thing that the world's greatest investors did when they managed small pools of capital</u>.

Rather than focusing on what is best for "most people," we are focusing on what is best for people who are comfortable avoiding the crowds, thinking independently, and waiting for unique opportunities. We are specifically trying to build a portfolio of businesses that are prevented from being well represented in indexes such as the SP500. These are businesses that are led by managers who are highly incentivized to see their businesses succeed, and that are trading at abnormally low multiples of their normalized earnings power or asset value. Conventional wisdom says these opportunities do not exist, but by digging through the forgotten corners of the investment universe, we believe it is possible to find 3 or 4 investment anomalies per year, and build an uncommon portfolio.

While day to day, month to month, quarter to quarter and even year to year stock prices move randomly in concert with human emotion, over longer periods of time, <u>fundamentals matter</u>. Thus, over longer periods of time our investment results will be predicated on the ability of our incentivized management partners to unlock the value we see in their temporarily hindered companies, and by our ability to remain rationally focused on fundamentals in a world that is irrationally obsessed with headlines.

To us, this sounds like a good "alternative."

A Word on Volatility

"Volatility is a welcome creator of opportunity."

~Seth Klarman

As mentioned previously, the market has been a smooth ride of late, and our headline performance would indicate the same has been true for our portfolio. However, over the last 6 months, every one of our starting top 5 investments declined by at least 15% from high to low at one time or another, and 2 of those investments are no longer in our top 5. In general, it is best to ignore this trading noise, and consider it no differently than a private business owner would consider someone who tried to buy his business for

$100 one day, and $85 a month later. Business values simply don't move that quickly in the more rational world of private business.

However, in the public markets, it is essential to monitor price movement in relation to business performance. Any sizeable divergences are decision points, and we faced several in the first half of 2017. In some cases we bought more on weakness, in some cases we did nothing, and in some cases we trimmed our position. On a portfolio level the net effect was performance that was largely in line with the SP500. However, it is important to understand the gyrations of the individual businesses we own.

In my view, most of our businesses have the potential to double, triple or more in value over the next several years, but it is a certainty that future success of this magnitude will not come in a straight line. Even the best businesses in the world – for example, Berkshire Hathaway – have seen their stocks suffer short term declines in excess of 50% as they continued their march forward. Price declines are not a reason to panic, as panic will surely lead to missed opportunities.

For example, consider our investment in Iteris (ITI), which suffered five (5!) declines of 15% or more during the last 6 months. These gyrations can come at any time – it is impossible to time them, and a waste of time to try to avoid them, although many market participants convince themselves otherwise. If we had tried to avoid them, we likely would have missed out on owning a very good business that is executing at a very high level. Despite the wild ride, Iteris returned 76% over the period.

Comments on Selected Investments

EZ Corp (EZPW) - EZPW traded off substantially in the first half, despite executing at a very high level, and continuing to drive improving fundamentals. In late June, I attended and spoke at the Value X Vail conference, where I gave a presentation on EZPW, which is included with this letter, and available at www.LaughingWaterCapital.com.

I believe the presentation painted a compelling picture of why EZPW is undervalued (non-economic selling tied to portfolio positioning and tax strategy), as well as the substantial opportunities the company has to drive intrinsic value (margin improvement, a return to growth in Mexico/Latin America, improving their capital structure). However, the presentation is now somewhat outdated as on June 28th the company announced they would be refinancing their debt and potentially acquiring a Latin American operation, as we had hoped.

This news led to a sharp sell-off in shares as the refinancing is taking the form of a convertible bond. Much of this selling is likely tied to arb players positioning themselves for the bond which will soon reverse, but we are also disappointed by the potential dilution to equity inherent to a convert. In our view, equity capital is precious, and should not be used lightly, and we have adjusted down our upside price targets, as well as our faith in management's ability to steward our capital.

Despite our general disagreement with dilutive capital raises during a period when equity is undervalued, a case can be made that it makes sense to sell cheap equity to purchase cheaper assets, and we are withholding final judgement on the convert until we learn more about the company's acquisition plans, which should excite the market. EZPW is under-scaled in Mexico and Latin America, and it is possible that inclusive of synergies we will be able to buy Latin American pawn assets at an absurdly low multiple.

Perhaps more importantly, it is hard to see any downside from today's prices given the company's fortified balance sheet, continued excellent execution, and likely growth, and near-term upside remains in excess of 100% despite our lowered targets. Longer term, EZPW continues to have multi-bagger potential through a return to growth, and the eventual dissolution of the dual share structure, and we are happy to own a defensive business that should benefit if the economy softens as the economic recovery continues to age. We added shares of EZPW prior to the announcement of the convertible bond offering.

Gaia, Inc. (GAIA) – GAIA has impressed the market by growing faster than expected, and spending less money on growth than forecast. The company has only recently started to expand its foreign language offerings, and management has indicated they have received inbound interest from potential foreign customers, eager to gain access to GAIA's offering. Given that Netflix recently made headlines as international subscribers became a larger percentage of the total than domestic subscribers, foreign language offerings should aid Gaia in their continued pursuit of new customers.

Perhaps most interestingly (and completely missed by the market), the company recently organized a social gathering for some of its "Truth Seeking" customers which was an enormous success. It is difficult to put value on something like this, but it is possible to envision scenarios where the company is able to monetize its community through events similar to Comic-Con. This would be icing on the cake as GAIA continues its march toward 1.6M subscribers, and $2.50 per share in earnings, which would likely lead to upside of several hundred percent. Most important from a valuation standpoint, if the company were to slow the pace of its incredible growth it would be profitable right now, justifying today's prices and then some.

Iteris, Inc (ITI) – Despite its considerable appreciation over the last year and a half, ITI remains under-valued. In fiscal 2016, the company reported that its transportation businesses generated $11.7M in operating income and $8M in free cash flow. In fiscal 2017, the company reported that its transportation businesses generated $18.3M in operating income, yet they have not changed the $8M free cash flow estimate in their marketing materials. Extrapolation suggests that the transportation businesses are now producing in excess of $12M in free cash flow. If the transportation businesses are viewed as a simple consulting business, absent corporate expenses they would deserve a valuation in excess of current market prices, meaning that the fast-growing agricultural business is currently free to investors.

However, it is becoming increasingly clear that Iteris's transportation businesses are not just a simple consulting business. In the coming decades, the intelligent transportation market and autonomous vehicles could be worth trillions of dollars. To date, the market's attention has been focused almost exclusively on autonomous vehicles and their ability to communicate with each other. However, it seems clear that in order for the future of transportation to develop as envisioned, autonomous vehicles will have to not only communicate with each other, but also with the sensors that control intersections and pedestrian traffic. Iteris is not only the leading player in this sensor market, they are literally leading the development of the Architecture Reference for Cooperative and Intelligent Transportation (ARC-IT) under the U.S. Department of Transportation, which essentially sets the standards for how intelligent transportation and autonomous vehicles should be developed. When we bought Iteris, we were looking backwards at a very boring traffic management business. Looking forward, the future is anything but boring.

Returning to the agriculture business, the company has continued to make progress with several notable customer wins in recent months, although management has indicated that enterprise level sales to key customers will likely take place in 2019, rather than 2018 as originally hoped. Curiously, management has also created a new, separate legal entity to house the agriculture/weather business, which suggests that an eventual sale of this business is somewhere on their radar. Comparable transactions indicate that a sale of this business could lead to multi-bagger gains, but investors are not paying for that potential at today's prices.

As mentioned earlier, ITI is a very volatile stock, and we added to our position in ITI during the first half of the year.

Now Inc (DNOW) – DNOW has been a laggard during the first half of the year as the market is worried that increasing Western oil production is more than offsetting production cuts from OPEC, preventing oil from appreciating. Day to day the market treats DNOW as a proxy for oil prices, assuming that there is a direct relationship between the two, but the reality is much more complex. In the intermediate and longer term DNOW's business is dependent on oil volumes, not price. Of course, there is a relationship between volume and price, but ultimately volume is a function of demand. Our investment has been predicated on the belief that as a dominant player in the distribution of parts for energy-end-users with a rock solid balance sheet and ample liquidity, any difficult times would allow DNOW to gain market share as they acquired struggling independent operators. This thesis has been playing out to some extent, but not as aggressively as we had hoped. As such, we have not added shares on recent weakness, and DNOW has dropped out of our top 5 investments.

Revlon (REV) – Revlon started the year with gains of 20%, but later sold off as domestic sales suffered, largely due to a channel shift from mass (drugstores etc.) to specialty (Ulta, etc.). Much of our thesis has been focused on the successful integration of Elizabeth Arden and international growth, but success in these areas has been over-shadowed by the domestic difficulties which I failed to fully appreciate. However, as inventory overhangs in the mass channel clear, pricing will come back, and controlling shareholder Ron Perelman has been aggressively buying shares of late, seemingly putting a floor beneath them. In my view, his open market purchases have increased the likelihood that the business will be taken private before ultimately being sold to a strategic buyer. While a go-private would benefit our shares from current prices, the likely shortened timeline reduces upside targets as we may not be able to enjoy years of compounding growth as the company re-aligns its domestic channels and completes the integration of Elizabeth Arden. As such, I chose to slightly reduce the position, and Revlon is no longer in our top 5.

New Investments

During the first half, we made one new investment worth discussing, and 3 smaller investments that I will refrain from commenting on as we may seek to add to the positions in the coming months.

The investment worth discussing is Points International (PCOM), a Canadian company focused on the consumer loyalty market which entered our portfolio as a mid-sized position. PCOM's main business is providing the software and know-how to airlines and hotels to allow consumers to "buy, gift, transfer" loyalty points (think airline miles). A representative transaction would be someone who has 20,000 points, but needs 25,000 for a "free" flight. PCOM's white labeled platform allows consumers to buy the extra 5,000 points, and thus unlock the value of the existing 20,000 points.

A few short years ago PCOM was a growth-crowd darling, and traded at 100x EPS. However, a series of bumps in the road and a re-focusing of their business toward lower margin, longer term contracts, as well as investments in 2 not-yet-profitable business lines led to a ~75% decline in share price, at which point we became partial owners.

I was attracted to the business by its asset light nature and its long-term contracts, and attracted to the investment by its mis-leading GAAP financials, a pending (since completed) change to the way the company reports segment earnings, and the complete turnover in the shareholder base as panicked growth investors threw in the towel. While management does not own as much stock as I would like, I gained comfort from the fact that noted small cap activist investor Cannel Capital is the 2nd largest institutional holder, and that the Chairman of the Board owns 7% of the company and formerly managed a small cap focused value hedge fund and is thus presumably focused on unlocking value. Lastly, management agreed with my assessment that the public markets were a difficult arena for this company to focus on building out its 2 new business lines.

I limited the size of the investment because the loyalty market is quickly evolving, making it difficult to have a strong opinion on what this business will look like 5 to 10 years from now. However, with 75% of revenue-partners locked in for 3 years, 3 growing business units, a management team that conceded they would likely be better served outside of public markets, strategic value that could be quite high, and a noted activist likely to push for a sale, I think it is unlikely that the 10 year (or even 3 year) future will matter in this case. This view was reinforced shortly after we made our investment when Cannel nominated Chuck Gilman to the board of directors. I have met Chuck several times over the years in Omaha at the Berkshire Hathaway meeting, and I believe his addition to the board greatly increases the odds that PCOM will be sold in the not too distant future. Importantly however, a sale is not necessary for a successful investment, as the company continues to strengthen its offering, and the core business produces plentiful cash flow, which the market should recognize as the newer businesses reach break-even levels in 2018.

Other News

A few months ago I was invited to my alma mater, The College of the Holy Cross, in order to give a guest lecture to members of the finance club. The focus of my talk was the power of compound interest, which given a long enough time line is virtually guaranteed to make anyone who follows even the most basic investing strategy very wealthy. According to the actuarial tables, the students who I spoke with have in excess of 5 decades in front of them to allow compound interest to work its magic, meaning that discipline is the only thing preventing them from being able to someday write a very large check to Holy Cross. If you or anyone you know who might be interested in LWC has teenage or college age children, I would be happy to go through this presentation with them. By definition, the earlier they understand the power of compound interest and the value of a long time line, the better off they will be. They can reach me through www.laughingwatercapital.com.

Also worth mentioning, in April I was approached by the investing website *Seeking Alpha*, and asked if I would be willing to participate in an interview. *Seeking Alpha* has a wide variety of content, and while much of it is a mile wide and an inch deep, and thus not very useful to us, I have found that some of the content on their "Pro" offering is quite good, and I myself have submitted writeups in the past. I have attached a copy of the interview to this letter.

Where Are We Now?

Reminders that the bull market is aging are everywhere. What is less well understood is that based on monthly data, for the current bull market to be the longest ever, it would have to continue until….. (wait for it…) the fourth quarter of 2023. This fun fact should serve as a reminder that it is not possible to time the markets. As such, we don't waste time trying to predict them. Rather, for the most part we seek to own businesses led by incentivized management teams that should perform well through a cycle.

It is a simple fact of life that sometimes stock prices go down, and in my opinion, those that claim that their investment strategy is meant to perform through all market environments should be viewed as liars or fools. The key to long term investment success is to do your best to ignore the good times and prepare for the bad times. When the market cracks, our portfolio will suffer losses. At the same time, when the market cracks, tremendous opportunities will be created, and we will seek to take advantage of them. Our long term focus positions us ideally for such an event.

If you have any questions, comments, or best of all, compelling investment ideas, please do not hesitate to contact me at any time.

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