



Tuesday, July 18, 2017

Dear Investors,

For the quarter ending June 30, 2017, the core portfolio was down 2.43% net of all fees and expenses compared to a gain of 4.68% for the MSCI All Cap World Index. Year-to-date the core portfolio is down 4.06% net of all fees and expenses compared to a gain of 13.36% for the MSCI All Cap World Index. Since inception in June 2016 through the end of the second quarter 2017, the core portfolio has returned 13.48% net of all fees and expenses compared to 20.59% for the MSCI All Cap World Index. Returns in separately managed accounts may differ from the core portfolio based on initial investment date. For the quarter ended June 30, 2017, all accounts were down 1.68%, YTD all accounts are down 2.81%, and since inception, all accounts are up 9.02%.

The end of the 2017 second quarter marks the first full 12-month period of operations for Massif Capital.

2nd Quarter 2017 Commentary

Markets in 2017 continue to be difficult to interpret. New highs are being made on a regular basis by the major indices, and consumer confidence is at a sixteen year high, but the backdrop is domestic and international political tension, record corporate and sovereign debt levels and years of tepid economic growth. In short, numerous conflicting signals have made judging where we are in the business cycle difficult.

Not wanting to be caught off guard by an overly stubborn adherence to my negative interpretation of the data, I reexamined some of the conflicting signals this quarter to see if I had not only misinterpreted them but also to try and find a more coherent narrative to explain how all the pieces fit together. I sought to understand how we could have a bull market in equities and high corporate profits but have tepid economic growth and a toxic political environment.

I started my review by looking at the way I had characterized this post-election leg up in the markets, specifically the view held by myself and others that this was a very narrow bull run confined to a few sectors, and dominated by the FAANGs.¹ As it turns out, this characterization appears wrong, or more specifically, the idea that the degree to which 2017 index gains have been atypically driven by just a few names is wrong. This suggests that the breadth of the bull move is not out of step with historical bull moves.

Recent work by hedge fund AQR indicates the degree to which this year's returns and last year's returns have been driven by just a few names is completely normal. The top five contributors to S&P 500 performance last year, and thus far this year, have made performance contributions to the index in line with the average performance contributions of the top five return contributors dating back to 1994. Unfortunately, this fact makes my recent underperformance all the more disappointing as it means we have not only missed out on

¹ FAANGs: Facebook, Amazon, Apple, Netflix, Google

the nice rally since the November Presidential Elections but we have missed out on a relatively broad rally as well.

Attempting to understand why I missed the rally led me to examine the portfolio's exposure to companies held by ETFs, and it is almost zero. From my perspective, this is a new wrinkle/risk (I can't decide which it is) for active investment managers. When a company is not part of an ETF, it misses out on huge flows of value insensitive capital into the market. At the same time, the lack of attention paid to such names creates opportunities for investors focused on fundamentals. This tension warrants further study as the growing allocation to passive investments puts the value discovery mechanism of markets at risk.²

The core portfolio's largest position at the current time is CNXC Coal Resources. According to Morningstar, CNXC is owned by one ETF and that ETF has a position roughly the same size as our position. The fund's second largest position, Diamond Offshore, is owned by far more ETFs, roughly 55, but that is our only position owned by more than 5 or so ETFs. Given that the number of ETFs now traded on US public equity exchanges outnumbers the number of publicly traded companies I am surprised I have managed to construct a portfolio so insulated from the tsunami-like flow of money into passive investments.

I am encouraged by the fact that the portfolio is made up of mostly overlooked investments, which means I am doing something very different than everyone else, and that is the only way to generate returns that are above average in the long run. At the same time, I am wary of what the trend towards passive might mean for the time it takes markets to recognize the value of assets not held by an ETF.

I spent significant time this quarter thinking and reading about what the passive investing flows into the market might mean for the long run. Most people believe the move to passive is the result of the underperformance of active managers. I agree that has played a role, but I am unconvinced that is all that is going on. Traditionally, the narrative around significant flows of money into risk assets like equity would be that it is a sign of optimism. Currently, such a narrative does not appear to fit with the world around us or the economy.

The only counter explanation for this odd situation is to suggest that passive investments, regardless of what assets they flow into, should be considered low confidence decisions by investors, not only in regards to the ability of active managers but the market system in general. As Peter Atwater, a financial consultant who studies the impact of societal mood on markets recently noted in an interview on Real Vision TV passive investments are: "almost a capitulatory, I'm never going to get it right, it's gamed against me, I'm going to go for the lowest cost option and hold my nose and just commit." I am sure there are less pessimistic ways of looking at it, but this interpretation seems more in keeping with sluggish economic data and a low volatility rise in the markets than to suggest investors are optimistic enough about the future to be rushing into risk assets in the way that capital flows into passive investments might suggest.

The last data point I studied this quarter was corporate profits. Specifically, how to explain record high corporate profits and years of sluggish economic growth. These two facts seemed the most conflicting of all the macro economic data floating around these days until I pulled out an Econ 101 textbook and reread the

² Note I said the value discovery mechanism of markets, as opposed to the more commonly heard price discovery mechanism of markets. Well-functioning markets converge on value over time not price. This may seem like a minor point but it is not. Price is what you pay, value is what you get. I make investments based on value and look to pay a price significantly less than the value I receive in exchange. As such, the investments I make depend on the convergence of market price with asset value over time. This convergence is driven by the markets value discovery mechanism.

section on monopolies. For those who took Econ 101 many years ago, a brief reminder: monopolies are price makers, as they don't face competition, and seek to maximize profits by charging a higher price for a given supply of goods than they would be able to charge in a competitive market. One can see the effect of a monopoly firm on markets in the chart on below. The green area represents supernormal profits earned via a monopolies ability to set prices, and the pink triangle is a deadweight loss to society. In essence, lost economic gains relative to if the market was competitive.

I am not suggesting that the US or the Global economy is made up of monopolies. Rather, a combination of increasing concentration of productive capacity at a handful of large firms and a regulatory environment, especially in the US, that favors large corporations has created a trend towards monopoly-like characteristics in the economy. Increased concentration of corporate revenue and profits is the most obvious demonstration of this trend. For example, the overall revenue of the Fortune 500 has risen from 58% of nominal GDP in 1994 to 73% in 2013, and the Fortune 100 have seen revenue grow from 33% of nominal GDP in 1994 to 46% in 2013. Meanwhile, per the Economist, the weighted average share of industry revenue earned by industries top four firms, has risen from 26% to 32% over the period from 1997 to 2012.

Growing concentration is rarely good for corporate competition, and a lack of competition is rarely good for the economy. It is reasonable to assert much of the growing economic concentration, particularly in the US, is the result of regulatory decisions on the part of the government. Specifically, the growth and focus of government regulation on the day to day operation of companies at the expense of antitrust regulation.

For example, in the US banking sector, there is no end to the number of operational regulations the government has put in place, yet the government has rarely balked at a banking merger. The level of compliance for banks has reached such high levels that Citibank now employs 29,000 people in its compliance department, making the department roughly the same size as Goldman Sachs.

While the government has been focusing on day to day operations of supposedly systemically important financial institutions, they appear to have given up on ensuring that the banking sector is not overly concentrated, an oversight that seems like it might also be the reason systemically important financial intuitions exist in the first place. The Economic Research Department of the Federal Reserve tracks three different measures of Banking Market Concentration: the H-Statistic, the Lerner Index, and the Boone Indicator. At the current time, both the Lerner Index and the Boone index suggest that the US banking industry is highly concentrated, while the H-Statistic suggests that the banking industry is a Monopoly industry. The lack of government antitrust regulation has allowed concentration in the industry to flourish and overly zealous and costly day to day regulation of the sector has made competition from start-ups near impossible.

Between 2008 and 2015, only five banks were started in the US, down from an average of 100+ a year before 2008. Given the day to day regulatory burden the government has created, this is unsurprising. As the Dallas

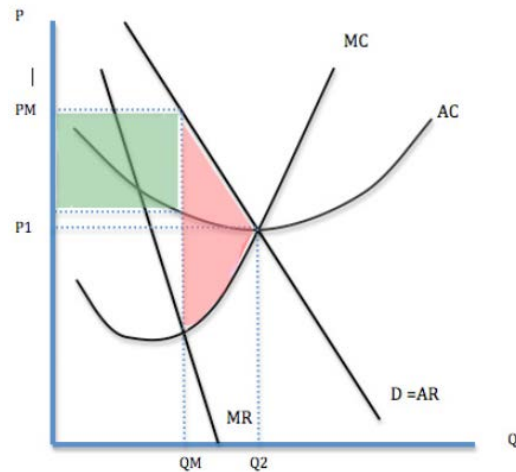
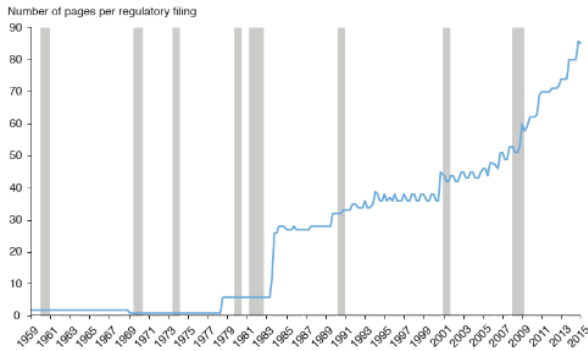


Figure 1: Monopoly Industry

Federal Reserve Bank recently reported the impact of regulation on small community bank formation has been significant. Federal Reserve researchers supported their conclusions with the provided charts that

Chart 3 After Great Recession, Pages in Bank Regulatory Filings Upsurge



NOTES: Gray bars indicate recessions. Maximum number of report pages for domestic banks only.
 1959:Q4–1983:Q4 Forms FFIEC 010, FFIEC 011, FFIEC 012, FFIEC 013, FFIEC 015 and temporary reporting supplements.
 1984:Q1–2000:Q4: Forms FFIEC 032, FFIEC 033 and FFIEC 034.
 2001:Q1–present: FFIEC 041.
 SOURCE: Federal Financial Institutions Examination Council, Call Report.

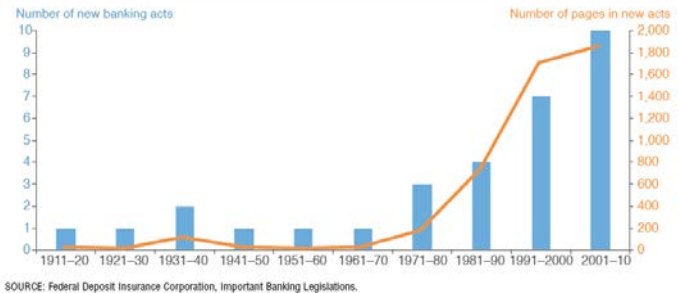
illustrate the dramatic growth in legislative complexity and volume of bank regulations. The regulatory impact on the banking sector has significant second order effects on economic growth. Small and medium size banks account for 55% of US lending to small businesses. Decreased lending to this sector of the economy only serves to increase the concentration of productive capacity in the largest firms in other industries. As such, how the government has regulated, the banking sector has not only negatively impacted the banking sector but has also negatively impacted the broader economy.

Industry concentration and barriers to entry result in the continued growth of large firms that act in increasingly monopolistic ways, resulting in a

situation where profits can be at a record high while the economy just putters along. When the corporate landscape and economy are viewed through this admittedly pessimistic framework, the high profits appear more likely a symptom of a frail and ill-structured economy than they do a healthy one.

My exploration of the economy this past quarter should not be understood as an indication that I am raising a white flag, bull markets lay the foundation for future bear markets and bear markets the foundation for future bull markets. I continue to search for value in the markets every day and am ready to deploy capital when opportunities present themselves. Although I made a misstep in my interpretation of this post Presidential election bull run, I believe the evidence supports the idea that we are closer to the end of this bull market than we are the beginning. I do not know for sure if we are approaching the top or have already passed it, but I continue to engage with the data and try to sift signal from noise. Hopefully, this review has provided you with some context for the portfolio's recent underperformance and provided greater insight into my thought process.

Chart 4 Over the Past Century, Legislative Complexity Soared



SOURCE: Federal Deposit Insurance Corporation, Important Banking Legislations.

Full Portfolio Review

Barnes and Nobles Education (BNED): BNED is a 2015 spin-off from Barnes and Nobles focused on an attractive niche retail segment - university and college bookstores. The campus store retail niche is highly fragmented, with roughly 52% of all campus bookstores run by their college and only one large direct competitor to BNED, Follett. The Q1-2017 acquisition of MBS Inc. makes BNED the largest source for used textbooks in the United States, the largest contract operator of virtual campus bookstores and one of the largest distributors of digital course materials in the US. Expansion of existing store offerings to include beauty supplies and other toiletries/essentials has added new higher margin revenue channels, as have partnerships with companies like Starbucks. The market, in my opinion, poorly understands industry

dynamics and assumes too much change in the way education is delivered as a product, and as such is missing the value in this company.

Current Share Price: \$7.85

Intrinsic Value Estimate: \$16.00 to \$18.00

Bollore (BOL): BOL is a complex family owned European conglomerate with significant investments in global logistics (freight forwarding and port operations) and significant European Media and Advertising businesses. The complex ownership structure has obscured the actual free float of the company, after accounting for shares of the company owned by the company, a subsidiary or the parent, shares outstanding are roughly 50% of the stated float. Ongoing consolidation and simplification of subsidiary businesses is likely to straighten out the share structure and reveal value (for example the proposed merger of Vivendi and Havas).

Current Share Price: €4.04

Intrinsic Value Estimate: €6.00 to €8.00

CNXC Coal Resources (CNXC): CNXC is a thermal and metallurgical coal master limited partnership spun off from natural gas focused CONSOL Energy. CNXC currently owns 25% of a single Pennsylvania longwall call mine that produces North Appalachia coal that can be sold domestically as thermal coal or internationally as metallurgical coal. Compared to other coal companies in the United States, CNXC has a conservative balance sheet, strong free cash flow, and a very appealing unit distribution (currently 13%).

CNXC remains a solid income producer for Massif Capital and is 13% of the core portfolio. I will be keeping a very close eye on the CNXC over the next few quarters as CONSOL Energy, the general partner of CNXC has decided to spin-off the firms remaining coal assets into a publicly traded company.

Current Share Price: \$16.00

Intrinsic Value Estimate: \$18.00 to \$20.00

Diamond Offshore (DO): DO is the owner and operator of the youngest, most conservatively financed offshore drilling fleet currently operating. Backed by owner/operator Loews, currently run by the Tisch family, the company's fleet consists of 24 offshore drilling rigs including 19 semisubmersibles (8 are currently contracted, 10 are cold stacked, and 1 is warm stacked), four dynamically positioned drillships (currently contracted) and one jack-up (currently contracted). DO is one of the few offshore companies focused on technological innovation as a source of competitive advantage.

At the current time, our position in DO is about 8% of the portfolio. I have made good use of above average volatility to add to our position at favorable levels but due to the size of my first purchase, a 5% position, my ability to add to the position and reduce our average cost significantly has been limited. At the current time, our average purchase price is \$14.19. Our next purchase will be if DO moves below \$10.

Current Share Price: \$11.62

Intrinsic Value Estimate: \$25.00 to \$35.00

Lucara Diamond (LUC): LUC is a diamond miner with a single operating mine in Botswana focused on the production of exceptional rough diamonds (10.8+ carats). The business is run by the Lundin family, who has a 50%+ ownership stake. The company has a pristine balance sheet with strong free cash flow and an operating focus that generates strong returns on invested capital.

I believe LUC is a unique investment in a highly profitable mining project and is a good example of the traits I am increasingly looking for in our mining investments. Specifically, a single producing asset in an obscure location with a strong balance sheet.

Current Share Price: \$2.27

Intrinsic Value Estimate: \$3.25 to \$3.50

Nevsun Resources (NSU): NSU is a mid-tier Copper-Zinc miner with one operating mine in Eritrea, Africa and a world-class copper development project in Serbia (Timok). Management has stewarded a difficult Eritrean asset from exploration to production, ahead of schedule and under budget at every stage for the last ten years. They have maintained a debt-free, cash-heavy balance sheet throughout a difficult period for many mining firms. Management's patience, in regards to capital deployment, was rewarded in 2016 with an opportunity to buy the Timok project at an attractive price.

I expect that this position may take longer than I had hoped to produce significant positive results. The combination of limited news about the firm's world class Timok copper/gold project in Serbia and ongoing struggles with the refinement of copper concentrate at the Bisha mine have weighed on the stock price. There is the potential for a rerating of the stock in the second half following the release of the long awaited pre-feasibility study of the upper zone of the Timok project, but it is difficult to know what the impact of a highly technical geological/engineering document will have on the firms stock price.

Current Share Price: \$2.26

Intrinsic Value Estimate: \$10.00 to \$15.00

Och-Ziff (OZM): OZM is our most contrarian portfolio position as the firm is an actively managed long-short equity hedge fund. The stock sold off significantly in recent years due to a combination of bad press related to a bribery scandal in Africa, and the general shift of investors away from active management towards passive management. Additionally, the firm has suffered significant withdrawals of capital from investors that appear negative but only return AUM to a level (around \$30 billion) that the company had in 2012. Management is focused on setting the firm on a surer footing following the Africa bribery scandal and reviving the nimble opportunistic equity investing of years past.

Current Share Price: \$2.46

Intrinsic Value Estimate: \$6.00 to \$8.00

Steel Partners (SPLP): SPLP is an industrial conglomerate run by former hedge fund manager Warren Lichtenstein. Subsidiaries include industrial parts manufacturer Handy and Harman, niche lender WebBank, oil field services provider Steel Excel, and a 6% position in aerospace and defense firm Aerojet Rocketdyne. The firm has significant unrecognized balance sheet value that is in the process of being realized via a simplification of the business, for example, the recent acquisition of Steel Excel and purchase of Handy and Harman.

Current Share Price: \$18.60

Intrinsic Value Estimate: \$20.00 to \$25.00

Rolling SPY Put Option Position: I am currently buying SPY Put Options with a strike price roughly 30% below current market price, 90 days out and rolling the options forward monthly. This position is a bet on a

significant market sell-off in the future. Some might term this a tail risk hedge, which I deem an inappropriate characterization. It is a historically informed wager that a significant market correction will occur and that the correction will be in line with past bear market corrections (over the last 100-years US bear market corrections have averaged -46% from peak to trough). This is not a bet on the timing of the downturn, only that a sell-off will occur and that a negative beta position will benefit the portfolio overall. The position responds best to a 30% to 40% sell off in the market occurring over a period of three to six months allowing additional benefit to be captured via the roll.

New Investments/Investment Pipeline

I continue to look for new opportunities in places where physical assets provide downside protection, and the emotional excesses of human behavior have created an oversold situation. Industries that I believe fall into this category include: shipping, certain mining industries (Gold, Nickel, Platinum and Palladium Group Metals, Uranium), publicly listed active money managers, and niche small and mid-cap industrial companies in unloved and overlooked geographies (unloved: Russia, anyplace in Africa overlooked: France, Sweden, Netherlands, etc). I have also found some interesting businesses among small and mid-cap Asian conglomerates, which tend to be invested in some of the industries mentioned above, along with large allocations to real estate and manufacturing.

As I did last quarter, I will make a reading suggestion for investors. Given the ongoing extremity of both central bank action (don't think just because the US Fed is tightening, central bankers are not running wild elsewhere in the world; global QE in the first half of the year topped \$1.5 trillion) and tepid growth, a reminder/review of classical Austrian economics seemed relevant. With that in mind, I read and would recommend the book [Austrian School for Investors](#) by Ronald Stoferle, the portfolio manager of a European Based Hedge Fund Incrementum AG. This book is well deserving of not only one read but perhaps the occasional re-reading as it reminds the reader of the link between philosophy and action and of the need for consistency in philosophy and action.

The basic common-sense approach to economics outlined by the Austrian School thinkers in a pre-data/model driven era is the clearest explanation of how the economy works that I know of. Certain economic trends, such as QE and dramatic debt growth, have become so common place these days that we have forgotten just how far we have allowed them to go. [Austrian School for Investors](#) reintroduces the reader to first principles and thus puts the experimental/extreme corporate/central bank actions of the present into perspective.

Best Regards,



Will Thomson