**Record Highs and a Record Win!**
**Q2 2019 Investor Letter**

Equity markets notched another fine quarter to close out the first half of the year with gains across the board. The first six months of the year marks the strongest stock market since 1997. There are many reasons markets are hitting all-time highs: employment is strong, the economy just broke the record for the longest expansion in history, and most investors now expect the Federal Reserve will cut interest rates this year.

We are happy to see a strong economy and robust stock market; however, continuing the theme of our Q12019 letter, the bond market is not showing the same bullishness as the equity market. The yield curve remains flat to negative and rates are still at historically low levels - even with the economy as strong as it is. Our ten-year government bond stands just around 2%, guaranteeing any buyer a 2% return to maturity before any inflation. If inflation creeps up to 2.5% (the 30-year average in the US vs. 3.22%)[1] investors will be blessed with a negative real return for the next ten years. While certainly not ideal, this would be better than what is offered today on $13 trillion of government debt in Europe and Asia or 20% of all sovereign debt in the world.[2] There, investors are paying their governments for the right to buy their debt. Germany, for example, as of the date of this letter, has a negative .26% yield on its ten-year bonds – guaranteeing a negative nominal return to maturity.

Only time will tell if the stock or bond market is a more accurate near-term indicator of the direction of the economy. Historically, the bond market has a better track record.

Another group with a superb track record is the US women's national soccer team. They just notched a historic fourth World Cup victory and second in a row! Women's games have generated $1.9 million more in revenue over the last three years than the men's team, yet women are paid less than the men.[3] A lawsuit filed this year by the women's team alleges that they are paid just 38 cents on the dollar compared to their male counterparts.[4] The crowd chanting "Equal Pay!" just after the final game ended is a loud indication that fans support the women in their fight for equality. Inequality on the pitch is unfair. Similarly, in the corporate setting, lack of diversity at the senior levels is not only unfair but also creates barriers to a company's success. Numerous studies have been published concluding that diversity in any group including the board and senior management at large companies enhances financial performance.[5]

We encourage and educate our company management teams and boards as to why they should consider filling future positions with more diverse candidates – by age, gender, race, education and most importantly diversity of thought. When smart and driven people come from different backgrounds there is a lower probability of failure due to ignorance or blind spots. One enlightening anecdote comes from Microsoft. A recent New York Times article highlighted the work of a lone female engineer on the late stages of a project where the device being developed did not work for her or her children but did for her husband. After taking the product home to test, she was able to prevent an embarrassing release for the team because of the diversity she brought to the

[1] https://inflationdata.com/Inflation/Inflation_Rate/Long_Term_Inflation.asp
[2] https://www.marketwatch.com/story/value-of-debt-with-negative-yields-nears-12-trillion-2019-06-18
[3]https://www.cnbc.com/amp/2019/06/19/us-womens-soccer-games-now-generate-more-revenue-than-mens.html?__twitter_impression=true
[4]https://www.washingtonpost.com/politics/2019/07/08/are-us-womens-soccer-players-really-earning-less-than-men/?noredirect=on&utm_term=.e4345f82165b
[5] https://www.credit-suisse.com/corporate/en/articles/news-and-expertise/higher-returns-with-women-in-decision-making-positions-201610.html

group. The software was mistakenly designed by men and their body types and did not work for average height women or children.[6]

It is this type of diversity we look for when evaluating the ESG efforts of companies. We will continue to engage with the companies we own and encourage them to consider environmental, social and governance improvements in their practices. Companies that embrace ESG not only position themselves for greater financial performance, but also make a positive contribution to society.

All the best,

    

Adam Cindy Laura Matt Nathan

**SMID Strategy**

Small and mid-cap stocks had a nice second quarter and a banner first half. We try to keep pace in up markets and do better when markets decline. When the market rallies like it has this year we normally trail, but so far, we have outperformed.

We made no new buys or sells and only added one existing name last quarter, Verso Corp (VRS). Verso is a leader is the US paper industry. We had just bought Verso in the first quarter and took advantage of the weakness in the stock price to increase the position size. We believe the slight weakness in their end market that contributed to higher inventory levels is transitory and does not justify the weakness. (down 11.7%) Additionally the company has hired an investment bank to explore strategic alternatives (read sell the company). They had hired the same bank about 19 months ago with no action. We think this time is different because the new interim CEO previously sold the last paper company he ran. Also, we think that a much-improved and close to debt free balance sheet will be attractive to both strategic and private equity firms that prize prodigious free cash flow generating companies like Verso.

The only company that had a noticeable negative impact on performance was Agrofresh (AGFS) which was down about 50% this year. This was the worst performing company in the portfolio last quarter and unfortunately is retaining the title. They sell numerous products to keep food fresh. We are still believers in the CEO and his strategy and continue to hold, but with the decline the position is now less than a 1% weight. We've debated adding to it, but thankfully have not yet acted. Though the CEO, CFO and three Agrofesh directors have been buying stock over the last six months. This does give us confidence that the world is not coming to an end even with the severe decline in the stock. The stock was a standout star for us a couple of years ago when it was valued similarly and then ended up increasing four-fold.

Agrofresh's performance was fully offset and then some by Biofrontera's (BFRA) performance. Biofrontera is a biopharmaceutical company that manufactures topical creams to treat precancerous skin conditions and skin cancer. It was up close to 50% this quarter (at much larger position size) after they announced a tender offer at a material premium to the stock price. We are bullish on the company's future and decided not to tender any of our shares.

[6] https://www.nytimes.com/2019/06/17/business/artificial-intelligence-bias-tech.html

We also had one company that announced they were selling, Legacy Texas (LTXB). Legacy is a dominant bank in the Dallas area, and we believed that many banks would take an interest in them. We were right, but unfortunately there was little to no premium in the deal. We continue to hold while the deal close is pending as we look for a suitable replacement.

**Large Strategy**

Large capitalization stocks had a nice quarter and surprisingly outperformed their small and mid-brethren. Relative to its benchmark, the Russell 1000 Value, our Large Strategy performed in-line for the quarter.

While we were quite active last quarter on the trading front this quarter was a snooze fest. There were no buys and no sales, no adds and no trims. We reviewed a few compelling new ideas last quarter and would expect to add a new name this quarter. We have a slightly elevated cash level.

Our best performer in the quarter was Disney (DIS) and our worst performer was State Street Corp (STT). Disney's outperformance was driven by the following factors: (1) the announcement of the 2019 rollout of the Disney+, a direct-to-consumer service and continued traction at Hulu and ESPN+, all of which are going to be formidable competitors to Netflix; (2) solid performance at the studio (Avengers: Endgame, Toy Story 4, and the upcoming remake The Lion King); (3) parks, Experiences & Consumer Products trends are strong, aided by the opening of Star Wars Land at Disneyland; (4) the combination of Disney and Fox make the Company a content powerhouse in the industry for years to come.

State Street underperformed based on an overall onerous macro environment involving shrinking fees over time, falling interest rates, and less volatility. Investors are skeptical about the purchase of Charles River they made last year and believe it may eventually be another free product that State Street offers, thus squeezing margins. While State Street looks cheap on many metrics based on history, it might be difficult to overcome the secular headwinds in the industry and a lack of catalysts near-term. This is on a short leash and remains at the top of our watchlist.