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I'd like to begin with an evaluation of our process and overall framework.

Process – Our value-investing framework works over time. It is my job to stay disciplined, especially when it appears not to work in a given time period – 2018 was good example of that idea in practice. I remain focused on our process and I am pleased with its implementation.

Patience – We aim to hold our investments for years, and when companies are performing well we will hold them indefinitely. Two to three years is a starting point for us, and my preference would be to hold investments for 5-10+ years. Our 2018 dollar-weighted turnover remained low at approximately 30%. During the year we made four new investments – two of them were significant while the other two were quite small. One of those small new investments has already been sold, and we also exited three other small investments during the year as we eliminated some marginal performers and concentrated our capital in the investments that most deserved it.[1]

Partnership – We strive to be a true partnership. I'm glad to say that I would be satisfied if our roles were reversed. Applying that "golden rule" keeps us focused on our purpose.

Returns – Our rolling three-year compounded annual return – what I believe is the most insightful measure of our performance – notched a slight improvement over the result reported a year ago. I wrote a year ago that "I cannot predict volatility and there is plenty of reason for worry in the world, but I believe there is attractive value and more than sufficient safety in the portfolio today. The broader market could suffer a decline at any point, but I believe all the companies we own would be more valuable 3-5 years from now." I reiterate those sentiments today. Without offering a specific forecast for 2019 I am optimistic about our future returns.

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Our investment opportunity is as good today as it has been in several years. Accordingly, our cash balance is as low as it has been since we launched the predecessor entity in January 2013.[2] Good investments can always get cheaper, of course, and I am not implying a strong view on the near-term direction of the economy or overall market for securities.

I am saying, however, that now is a good time to invest in our style over a multi-year horizon. For the first time since early 2016 I see interesting opportunities in many areas at once. The priority now is allocating between the investments we own to concentrate in very best ideas, raising the "opportunity cost" for everything in our portfolio and all new ideas under consideration.

In 2018 there were plenty of cross-currents – healthy consumers, low unemployment, and

modest wage gains versus rising interest rates, trade wars, political instability, increasing levels of public and corporate debt, and inflated expectations for growth. The bullish and bearish arguments both have merit, in my view, and the only wrong conclusion is a strongly held one. There are plenty of reasons for concern, but those concerns have created attractive investing opportunities by way of lower, glass-half-empty asset prices.

Commodity prices were weak in 2018 (the Bloomberg Commodity Index fell 13%), and corporate credit showed some marginal weakness too.[3] Equities got most of the headlines as the Russell 2000 declined 11.0% while the S&P 500 declined 4.4% (both figures include dividends). December was exceptional: over the first 15 ½ trading days of the month, the Russell 2000 declined by more than 17% before recovering some lost ground to finish the month down 12%. By some measures many financial assets just had their worst week, month, quarter, or year since the Global Financial Crisis of 2008-09 (even though conditions now are not even close to those dark days).

The underlying performance of many businesses has been solid, so it's fair to say that the recent sell-off was a forecast of a significant downturn in business conditions and/or a result of inflated expectations. I have no definitive pronouncements about what will happen in the macro economy or in the broader markets in 2019. There is a range of possibilities, but I don't think that range has changed very much in recent months. It also helps that our portfolio had a cautious construct – as always – going into the recent meltdown. By combining modest expectations, agnostic and base-rate driven forecasts, and an avoidance of fads we can avoid many of the worst investment mistakes.

Our performance in 2018 was defined by a handful of *days*, as the price of almost all of our individual investments declined significantly in December.[4] Such dramatic price movements are not typical, but they're also nothing to get worked up about. Markets fluctuate, and life moves on. The important part is expecting – and preparing for – periods of tanking market prices, and we've done just that.

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I believe one of an investor's most important attributes is self-awareness. As a simple exercise I think it would be helpful if everyone made a declaration as a "business-first" investor or a "security-first" investor. A business-first investor considers an entire business on its merits and *then* looks to see if the securities offer an attractive investment opportunity. A security-first investor considers a security first and the business second (if at all).

Business-first investors care about:

- the value of the entire business and the likelihood of growth or decline in that value;
- actual cash flow that is available to the business's owners, which is the primary numerical input in the valuation process;
- the reliability and duration of cash flow;
- the stability of the capital structure;
- the opportunity to grow and the options for financing that growth;

- the culture of the organization and the caliber of the people inside the business;
- and numerous qualities that cannot be quantified.

Security-first investors are focused on:

- abstract notions of valuation (such as multiples and yields);
- proxies for cash flow, especially over the next quarter or year;
- liquidity and the activity of other market participants;
- statistical and/or technical analysis; and
- only those things that can be quantified.

There are some areas of overlap between the two groups, but a clear litmus test can be made using the first thought that comes to mind. If I mention an investment in Alaska Airlines, your mind will either jump either to the business or (more likely) to the stock. You are thinking about the cash flow produced by a small fractional ownership in an airplane overhead, or you are thinking about the future direction of a blinking number on the screen in front of you. Just as I think the order of research matters – I start with objective data in regulatory filings and save other people's opinions for last – I think the order in which investors evaluate businesses and securities can be determinant.

This is not to say that business-first investor should ignore the signals and techniques employed by the security-first camp. As a business-first investor I still need to consider market liquidity, and I use many numbers and analytical techniques that overlap with security-first investors. Even though I'm starting with business-level analysis, I'm trying to apply those insights to take advantage of market opportunities. At a higher level, markets and algorithms are often correct; our job is to ignore the countless times they're right and find the one opportunity that is interesting. By starting with the business, I find it easier to do that while avoiding mistakes and investing with patience.[5]

I also find it counterproductive for business-first investors to spend too much time thinking – or whining – about the influence of the Federal Reserve or the algorithms or anything else. I want to understand those outside influences, if I can, but only with a dispassionate approach. I have to accept the opportunities as presented and choose to invest or move on. I need to understand the business and generate a reasonable view of its potential path over the next few years, and then I need securities that offer attractive investment returns with room to be wrong. If things don't line up, I wait for better prices or try to find something else. In neither scenario would it help to focus a lot of time and attention on extraneous influences.

To forestall one of the common responses to this line of thinking, I am not a "macro ostrich" just sticking my head in the sand. I pay close attention to reams of economic data, and I realize that macro factors can swamp fundamentals in certain situations.[6] I want to be aware of the broader macro situation, with a particular focus on our position in various cycles. My ability to generate investable macro insights, however, is limited, and my focus remains on microeconomic details and business analysis.[7] I think businesses are fascinating, dynamic creatures and I want to study them as much as possible. I want to read everything available, talk to employees, and walk in the shoes of customers. As an outside

investor I will never achieve complete knowledge of a business, but trying to understand the business as if I owned all of it is the most effective form of business-first research.

We are – and always will be – business-first investors. With that in mind, let's refocus on a few features of the companies in our portfolio. All of our companies are profitable and generating free cash flow. They have stable, well-capitalized balance sheets. They have strong, adaptable business models. When a recession comes, they will be affected – sales may decline and margins may contract – but these companies will be resilient even in a nasty recession. In fact, a broader pullback in the economy would give them a chance to play offense and use their balance sheets and business advantages to beat their competitors.

I have a limited ability to forecast how security prices will react in a given scenario, but I account that when making and selling investments. Forecasting prices is also less important to our process than being able to identify the companies that can survive and thrive in periods of adversity. The path will not be straight or simple, but our companies are very likely to be bigger and more profitable three, five and 10 years from now. If we can take advantage of temporary blindness to that fact and then sit tight, the reward will be worth the wait.

[1] To give a sample of holding period for our largest investments, we begin investing in each of AWI and OCFC in 2015 and in ALK and SAVE in 2017. We also hold two investments that were originally made in the predecessor entity in 2013. Taking a dollar-weighted approach shows an average current holding period of about 2 ½ years (and rising).

[2] The predecessor entity contributed its securities in-kind to Anabatic Fund, L.P. upon opening in January 2014.

[3] The Bloomberg Commodity Index is a basket of 22 raw materials. https://www.bloomberg.com/quote/BCOM:IND

[4] The goofiness of 2018 might be best summarized by the fact that for the first time I can ever remember I was active in the market on Christmas Eve (apparently the abbreviated session of December 24, 2018 was the worst-ever Christmas Eve for the S&P 500). To put that in context, we executed buy or sell orders on only two to six days each month for a total 48 days during all of 2018. One happy side effect of that relative inactivity is that our gross commissions paid to our broker were less than $900 for the year.

[5] As an aside, I don't understand the current fad of narrow, compartmentalized "check-the-box" funds. It is crucial to invest only in companies that are within my ability to understand, but if there are a couple of industries and asset classes I understand at a deep level, and I can compare and contrast opportunities across market cycles, isn't that a superior option to an artificially narrow approach?

[6] The beginning of my career as an investor looking at financial and housing-related companies in April 2007 could not have been a better teacher in that regard. Overwhelming evidence combined with the favorable odds of market prices lead me to establish large short positions in many securities. But just like my macro insights, such opportunities are few and far between.

[7] I also want to make it 100% clear that I have no issue with security-first investors. There is nothing wrong with technical analysis, momentum, relative value, macro strategies, "value trading," speculation, or anything else. Every investment strategy must be conducted within the bounds of legality and prudence, of course, but I don't think there's room for dogma. Unemotional, unsentimental discipline is one of main the reasons certain quantitative strategies are successful.