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"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits." –Hyman Minsky

We have grown more cautious regarding market exposure in our portfolios since the election. Most notable about the last three quarters of outperformance is that we have managed to do so while reducing risk – both in terms of leverage and market exposure. Our job is foremost to manage risk, which we define as the potential for a permanent loss of capital. We believe that tail risks to financial asset prices are greater today than they were prior to the election. Yet, on the surface, financial markets seem more stable than they have been over the past several years. This stability should not be taken as a sign that all things are good ad infinitum. As economist Hyman Minsky argued, long periods of stability in financial markets can lead to a false sense of security, which in turn increases instability when things correct – which they inevitably do. We are skeptical of – and not excited about – a rising market detached from fundamentals.

When it comes to portfolio management, one of the hardest things for an investor to do is not do anything. Not trading while markets constantly move around requires discipline. For long-term value investors, moments of doing nothing to the portfolio should be frequent; what is often called for is letting carefully selected positions purchased at a discount do their work. This work can take years. In the meantime, our job is to be ready with equally good companies when the time comes to sell out of an existing position. The hope is that one of these companies will sell at a significant discount to our estimate of its intrinsic value when we are ready to make a purchase.

One of our current priorities is to ensure that we can take advantage of a market dislocation when it occurs. It is important to note that while we remain fully invested, we are not betting on the market going up. Currently, we are invested in twenty companies, many of which have company-specific catalysts that investors have not priced in. Others are strong operators which are undervalued relative to the market. As a group, these companies are cheap in our view. This does not mean that if markets selloff, our stocks will remain unscathed. This does mean, however, if markets selloff and some of our stocks become materially cheaper, we would have confidence to add to our positions (all things being equal). In sharp market selloffs, correlations for all risk assets approach one. Investors tend to run for the exits at the same time, seeking the safety of cash.

This brings us to the "option value" of cash. Cash increases in value in times of market distress. For example, during a -20% market selloff in which a couple of our high conviction stocks fall -40%, cash would maintain its value. If we use that cash to double down on our two favorite stocks that fell -40%, we would suddenly be able to purchase 67% more shares after the decline – with the same amount of cash. In other words, cash becomes more

valuable as asset prices decline. The irony is most people either do not have cash when markets are declining or are too afraid to put cash to work during periods of market turbulence. The aim is to increase cash in periods of stability to take advantage of dislocations in periods of instability. This is more art than science and requires discipline and patience as well as acceptance of periods of underperformance in return for potentially better long-term returns.

In periods of high market valuations, in addition to higher cash levels, our portfolios may grow more concentrated. As we sell overvalued positions, we may choose to reallocate cash into current high conviction positions that trade cheaply. In such instances, we would stay within our concentration limits. The more concentrated a portfolio is, the more volatile it is likely to be, and the more company-specific factors will affect portfolio volatility. We agree with Warren Buffett and Charlie Munger when it comes to concentrated investing: volatility of returns is not risk, and diversification for diversification's sake is merely a way to protect against ignorance. Lack of volatility in portfolio returns does not mean a better portfolio. While we understand that many investors cannot stomach volatility, we believe that volatility is what creates the best long-term opportunities. We measure ourselves on long-term returns, irrespective of short-term volatility.

The topic of diversification leads us to passive investing. Many investors today choose to put their money to work in low-cost exchange traded funds (ETFs), most of which are tied to market indices, such as the S&P 500. Passive assets make up 30% of assets under management in the U.S. and are growing rapidly, while assets under active management are shrinking. Ironically, investor preference for passive investing – which is driving outflows from active strategies – creates more opportunities for skilled active investors focused on company fundamentals. Passive investing requires no stock selection skill; instead, the focus is on technology, trading, index replication and scale.

As more passive assets pour into ETFs that replicate market indices, movements of the index's underlying stocks are increasingly driven by passive assets. These assets have complete disregard for underlying companies and their fundamentals. Subsequently, underlying stock prices can become disconnected from company fundamentals. In sharp selloffs, passive money exacerbates falls in indexes as investors pull money out of ETFs. Adding to declines is short selling of ETF shares by traders looking to make a quick profit. This selloff dynamic indiscriminately drives down share prices of all index components. Occasionally, there is an opportunity for the skilled active investor who has already done his research to grab shares of great companies with strong fundamentals at a sharp discount. This opportunity is more likely in stocks that make up a large share of an index or are components of multiple indexes replicated by popular ETFs. The popularity of low-cost passive investing that is putting pressure on the business model of active investors is also creating more opportunities to generate alpha over the long-term. Knowledge of market dynamics and passive index construction is instrumental to figuring out when to act. That – along with good stock selection – is one of the value-adds of an astute long-term investor.