February 24, 2017

For the year ending December 31, 2016, Broyhill generated low-to-mid-single digit returns across the majority of our separately managed accounts. Detailed quarterly reports, including portfolio allocations, individual account and benchmark performance, portfolio holdings, and transaction history, have been posted to our investor portal.[1]

Few investors truly understand what their managers do or how they do it. We write these letters to provide that context. We share our thinking. We highlight our concerns. We explore our mistakes and review our decision making process. Education is important as it helps all parties make informed decisions and plays a key role in allowing us to think rationally. More on this after addressing the elephant in the room.

Source: DonkeyHotey, Trump vs. The RNC

[1] *Since we construct each client's portfolio from the bottom up, the performance of individual accounts will vary based on the opportunities then available in the market. A fundamental truth of value investing is that the higher the price one pays for a given set of cash flows, the lower the future return one can expect. Consequently, we work hard to preserve the integrity of our initial purchase decisions, rather than blindly chasing previous purchases higher as new accounts are funded. While this makes a discussion of our "portfolio" more difficult, we believe this discipline is ultimately in the best interest of our clients and that any performance dispersion will narrow over time.*

It's Business Time

If you haven't read Ayn Rand lately, it might be a good idea to dust some of her work off your bookshelf to put today's political mindset in perspective. We'd also suggest George Orwell's 1984, but last we checked it was sold out on Amazon's best seller list.[2]

There has been plenty of ink spilled on the ideological shift which has occurred since last November. So we'll resist the urge to add our two cents. Instead, we'll offer the following perspective from a recent Barron's cover story:

> *"Judging by the stock market's reaction, the Trump administration so far has been a grab bag of policy proposals, some good for the economy, some bad, some potentially disastrous. Our future depends on the president's ability to champion the good ones and his willingness to back off the disastrous ones."*

Kicking and screaming like a toddler who was just told he can't wear his Spider-Man costume to dinner will not make Spider-Man a more acceptable dinner guest.[3] Rather than kick and scream about how the world should be, our job as investors is to see the world as it is and position accordingly. Stephen Dubner, co-author of *Freakonomics*, demonstrates how one's moral compass can impact decision making:

> *"If you try to approach every problem with your moral compass . . . you're going to make a lot of mistakes. You're going to exclude a lot of possible good solutions. You're going to assume you know a lot of things, when in fact, you don't, and you're not going to be a good partner in reaching a solution with other people who don't happen to see the world the way you do."*

Successful investing requires an open mind to approach complex problems. Investors are a confident bunch, but it's dangerous to assume you know a lot of things. Flexibility and humility allow us to admit what we don't know, and accept that there is little to gain from investing as it should be.

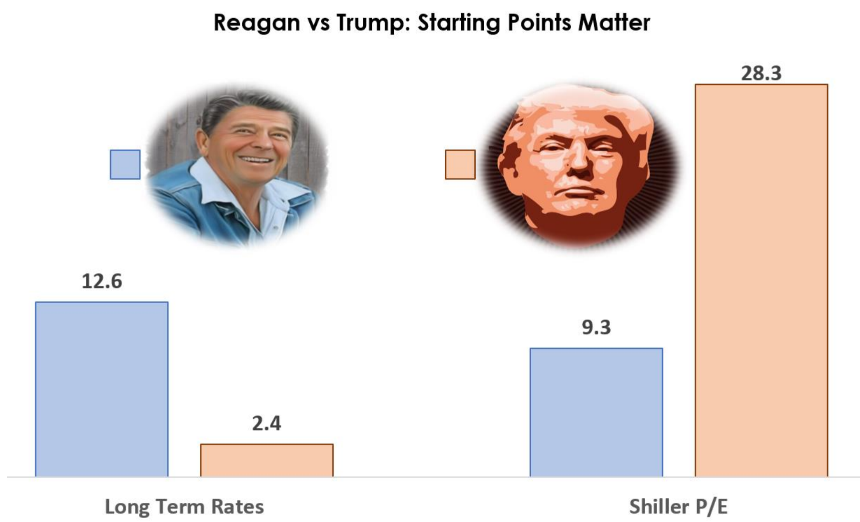
A strong moral compass will do many things for you in life, but it will not help you navigate capital markets. Seeing the world as it is rather than as you wish, will. Today, investors are seeing the world as they wish. They've watched stocks climb to new all-time highs and have concluded that the president's policy proposals must be good for the economy and for the markets. They have decided that perilously high valuations can be ignored and rising uncertainty is of no concern.

---

2 It appears that Jeff Bezos may agree with this sentiment. Since our initial draft of this letter, Amazon has made 1984 available for free on Kindle via Amazon Prime. Thank you Jeff!

3 *Unfortunately, I am speaking from experience here, although Spider-Man is a better dinner guest than you might imagine.*

The consensus views the current backdrop analogous to Ronald Regan's shift to the right. There are a number of similarities which make it easy to reach this conclusion. But all analogies are imperfect. In this particular case, starting points matter.



Source: Broyhill Asset Management, Robert Shiller

Markets are applauding early efforts to stimulate domestic manufacturing and return traditional blue collar work to the US. Yet, few seem to be thinking through the dangerous implications of increasing protectionism and decreasing globalization.

Free trade has not been all rainbows and unicorns in this part of the country. But that doesn't mean unwinding free trade will bring them back. We've tried this before. It didn't work out so well last time.

The Smoot–Hawley Tariff, signed into law in 1930, raised U.S. tariffs on over 20,000 imported goods. The tariffs "successfully" cut American imports in half, but retaliation by our trading partners ensured that US exports fell the most. Made in America has a nice ring to it. But with personal consumption still making up nearly 70% of GDP, that ring may sound more like an alarm when our returning blue collar work force has to shell out $75,000 for a Chevy Malibu.

Bottom Line: Investors are chasing momentum and buying more of what has gone up the most. The fear of missing out on the climb to new highs has blinded investors to the risk of falling back to reality. Valuations don't matter as long as there is a greater fool to buy your shares at a still higher price. There are always plenty of fools around to play this game. They just aren't around very long. They'd be wise to consider that the end of every two-term presidential cycle has been greeted by a recession within twelve months. But then, I suppose, they wouldn't be called fools.

Benchmark Envy

Now that we've addressed the elephant in the room, let's talk about the gorilla.

We underperformed the major equity indices last year. In fact, along with most active managers in the industry, we've underperformed the major averages for the past few years. But unlike most of our peers, we don't worry much about market returns.

Our goal is to construct portfolios capable of generating as high a return as possible, without subjecting your wealth to significant loss. Our priority at Broyhill is protecting your capital.

In any given year, you should assume that someone or some index will do better. This can be torturous. Nothing clouds judgment more than watching your neighbor get rich. But you don't get rich by taking risk at the end of the cycle. You get rich by buying cheap assets. You stay rich by being patient. Our goal is to keep you rich. It is far more important than outperforming the herd in the short term.

We report index returns to investors as a basis for comparison, but warn that short-term index envy is inconsistent with long term capital preservation. In a rising market, our results may be inferior to market indices. But this says more about the timing of results than the ultimate outcome.

We have no control over the timing of our results or those of market indices. We can, however, exercise control over the quality of our research process and our investment decisions.

Only a focus on the inputs can determine the long run success of the outputs.

The discussion below attempts to provide you with additional perspective on the inputs and outputs of previous investment decisions. Our investment in Time Warner (TWX) was our largest contributor to performance for the year and a good illustration of the difficulty in predicting near term outcomes. SeaWorld, our largest detractor, demonstrates the importance of focusing on process rather than outcome.

As usual, we'll begin by examining a mistake before discussing a more positive outcome.

Orcas and Drunken Sailors

Time travel is impossible (that is of course, unless Elon Musk knows something we do not). Yet, traveling back in time is necessary to effectively evaluate past decisions.

We must replace the question "Did it have a good outcome?" with the more difficult question, "Was it a good decision?" Was our judgment correct? Was it reasonable given the information available at the time?

Putting yourself in the position of someone else (or even yourself) at a prior point in time is difficult. Philip Tetlock and Dan Gardner provide us with an example in *Superforecasting: The Art and Science of Prediction:*

> *A novice may overestimate the probability that the next card will win her the hand, bet big, and win, but winning doesn't retroactively make her foolish bet wise. Conversely, a pro may correctly see that there is a high probability of winning the hand, bet big, get unlucky, and lose, but that doesn't mean her bet was unwise.*
>
> *Good poker players, investors, and executives all understand this. If they don't, they can't remain good at what they do – because they will draw false lessons from experience making their judgment worse over time.*

In evaluating any investment, we begin with a thorough consideration of risk. We ask what could go wrong. We quantify how much we can lose if we are wrong. We estimate the probability of loss. And we consider our time horizon before purchasing a single share.

Time is the friend of a wonderful business. A good business can compound wealth for shareholders for decades. Lesser businesses, by contrast, are on the clock. If you buy a bad business at a low enough price, a positive surprise can give you the chance to sell at a decent profit. Like the proverbial cigar butt found on the street, it may not offer much of a smoke, but a bargain purchase can make that last puff all profit. Just be careful that you don't get burned.

Theme parks are mediocre businesses. They earn low returns on capital and pile on debt to juice equity returns for investors. That being said, they do benefit from several attractive characteristics, so at the right price, theme parks can provide a very profitable smoke.[4]

We thought we bought SeaWorld at the right price. We initiated a position in August 2014 at what we believed was the point of maximum pessimism, following the backlash from *Blackfish*. Our investment thesis correctly identified the company's animal rights challenges as a temporary problem likely to be solved via the passage of time.

More importantly, we recognized that the heightened competitive environment represented a bigger risk to the business. But we incorrectly assumed that the unique experience that SeaWorld has successfully offered for decades would be enough to differentiate the parks from Disney and Universal today.

---

[4] *Broyhill Asset Management, Cheap Thrills, June 2013*

Our research showed that the theme park industry has gone through prior periods of boom and bust. When attendance is strong and park visitors are opening their pockets, management teams are emptying their pockets on bigger and better attractions. Previous investment cycles have spiraled into quite the pissing match. But perhaps none of this magnitude.

Source: Broyhill Asset Management

Every investment cycle sows the seeds for its own conclusion. Excess spending reaches a level which is unsustainable, and industry participants eventually figure out that if they cut back on ridiculous levels of spending, profits quickly improve.

We assumed this cycle would be no different. Famous last words. Last we checked, Disney and Universal were still spending like drunken sailors. And new attractions at SeaWorld failed to drive the rebound in attendance we expected, despite a temporary lull in activity from Disney and Universal. With Star Wars, Toy Story, Avatar, Harry Potter and King Kong in the pipeline, Shamu is likely to move even further back-stage.

Two years seemed like a sufficient time horizon for SEAS to get its house in order. Yet, the data suggest that the business has deteriorated further since our initial purchase. Even though we bought SEAS at a bargain price, the heightened competitive environment gradually eroded our margin of safety. It's possible it may completely vanish before the winner of Orlando's pissing match is declared.

We lost money on our investment in SeaWorld. That's a bad outcome. Despite the loss, I believe our judgement was sound. We identified the primary risk to our investment before getting involved and bought with a sufficient margin of safety which limited our downside risk. We estimated that a rebound in attendance, driven by fading headlines and new attractions, could result in a double in shares. In Tetlock's terms, we saw a good probability of winning big. We bet big. And we lost. But that doesn't mean the bet was unwise. Over time, odds like this should shake out in our favor. A collection of investments with similar payoff profiles should result in quite satisfactory long-term gains.

Time is On My Side

In last year's annual letter, we rehashed our investment thesis in Time Warner (TWX) which was our largest position and also our largest loser for the year. Here's what we said at the time:

> *"We are disappointed, but we do not believe recent price declines reflect intrinsic value. We have no preference as to who highlights the value; if current management fails to do so in short order, we believe someone else will."*

Less than one year later, in October 2016, AT&T announced it would acquire Time Warner in a stock-and-cash transaction valued at $107.50 per share, more than $20 per share higher than what 21st Century Fox bid for the company over two years ago.

If we jump in our time machine and travel back to July 2014, we would see that we incorrectly assumed Rupert Murdoch would increase his bid. We were wrong on the timing, but more importantly, we were proved correct in our estimate of value.

Short term results are unpredictable and beyond our control. This holds true for individual investments and for our portfolio in aggregate.

An investor with perfect foresight would not have purchased shares of Time Warmer at $80 knowing those shares would be available at $60 one year later. But for the average investor, who lacks a time machine and the ability to peer into the future, what's wrong with buying shares at $80, and cashing out at $107.50 a couple years later? That would represent a 34% gain!

In a nutshell, this is precisely how investors confuse risk and volatility. The majority of investors incorrectly focus on volatility. Volatility is the 25% decline from $80 to $60. Trust me. It doesn't feel good. But just because something doesn't feel good, doesn't mean it's risky.[5]

Volatility is like a visit to the doctor who tells you, "This is going to hurt," right before he gives you the shot you need to get back in the game. At Broyhill, we focus on the only risk that matters - permanent capital loss – and we are willing to take our medicine to win the long term game.

---

[5] *Darwin's theory of evolution can help us understand why investors, and all humans, are "pleasure seekers." Natural selection is a simple process - species that produce offspring tend to survive. For example, sex feels good because it motivates us to do it more frequently, thereby generating next generations. If it didn't feel good, we wouldn't do it. Hence, we are naturally programmed to avoid things (like buying stocks that are falling) that don't feel good.*

The Equity Yield Curve

Returns are greatest for those willing to take the risk before the light at the end of the tunnel. Things often get worse before they get better and the best returns typically come when things appear darkest, just before the light begins to shine.

The majority of investors recognize this concept of a "value-premium" described above. Yet most investors still find the urge to micromanage the day-to-day volatility of individual positions S*imply Irresistible*.

Increased competition for returns has resulted in shorter time horizons. It's human nature.

We've all read the same research that clearly demonstrates the benefits of patience and the costs of increased trading. We all understand the potential gains that come with a longer-term horizon. Yet, the temptation is just too great for most to overcome. There are so many buttons to push in a given day, but most of them do little more than provide a brief dopamine high.[6]

The only thing we can do to stop a dopamine loop, and make better decisions for our investors, is to turn off the cues. While many managers measure their importance by the number of screens on their desk, we reserve our desks for books and company filings. While others measure their P&L minute-to-minute, we have relegated our Bloomberg terminal to its own room, where it is unable to pester us unless invited. Perhaps including a "Break Glass in Case of Emergency" sign would work even better.

Patience is a virtue. It's also the greatest advantage we have in a world where price is set by investors focused on the next tick. This world is highly competitive. This world makes it impossible to purchase an asset worth $107.50 for $80 if you fear it may first make a brief stop at $60. But the path it takes is impossible to know in advance. We can only improve our odds by correctly assessing value and waiting for the market to agree with our assessment.

This world forces our peers to overlook long-term opportunities for fear of short term underperformance. We can't win in this world. Winning here requires dozens or perhaps hundreds of correct decisions in a given year. Very few can do this consistently. It's a hard game to win. So we don't play it.

[6] *Dopamine controls the "pleasure" systems of the brain. It makes you feel good and therefore motivates you to seek out certain behaviors, such as food, sex, and drugs. It's easy to get in a dopamine-loop. You start seeking, you get rewarded for the seeking, and it becomes harder and harder to stop looking at email, checking messages, and social media. And it's most powerfully stimulated when information is short and sweet like a text or tweet. Constant stimulation of the dopamine system is exhausting. It's also highly destructive of long-term investment performance.*

To win in the long term, we must do something different. We see little to gain in staring at our screens all day. Rather, our odds are greatly improved by making fewer decisions over a longer time horizon where competition has dwindled.

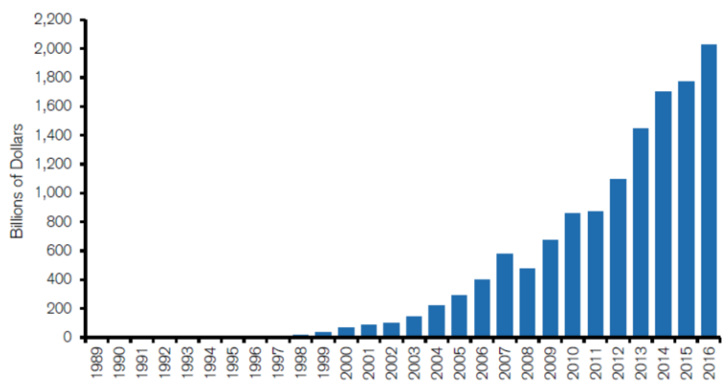
For those willing to stomach some short-term volatility, the long term rewards are as great as they've ever been. By playing in a different arena than the crowd, we can expect to beat them.

Passive Aggressive

There's nothing wrong with passive investing. Just ask Jack Bogle. The problem isn't with the indexes per se. It's simply another example of user error.

Even a good idea, taken to the extreme, results in crowding. Suffice it to say, segments of the market are getting awfully crowded today.

Assets of US Equity Exchange-Traded Funds



Source: Credit Suisse

In theory, passive investing is perfectly rational. If you can't beat the index, why bother trying? If you can't beat them, join them. **In practice, nothing is easy.**

An increasing number of investors have decided to "lock in" the long-term returns offered by broad market indices. This is the theory. In practice, these same investors are the most active traders of indices.

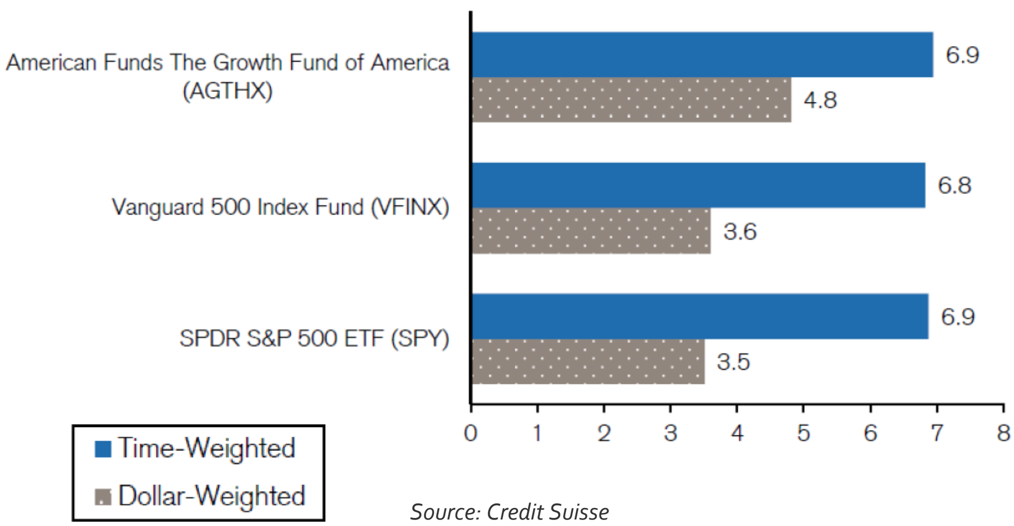
For perspective, consider that annualized stock turnover is about 120 percent, meaning the average stock is held for about ten months. Annual ETF turnover is more like 880 percent! So the average investor in an ETF holds the fund for about a month.[7]

[7] *Financial Times, Jack Bogle: The Lessons we must take from ETFs*

The movement toward passive index funds is well supported by empirical data. In practice, however, the consensus does not have a great track record of capitalizing on investment theory.

It's tough to earn the long-term returns of the market if you only hold "the market" for a month. As a result, the actual returns earned by many mutual fund investors are far lower than the fund's reported returns.

Dollar-Weighted and Time-Weighted Returns - Ten Years Ending December 2016



Source: Credit Suisse

For every investment strategy there are two (sometimes very) different performance records investors should consider. One is the "buy-and-hold return" reported by the fund. This is the number investors assume they will earn if they buy and hold a passive fund.

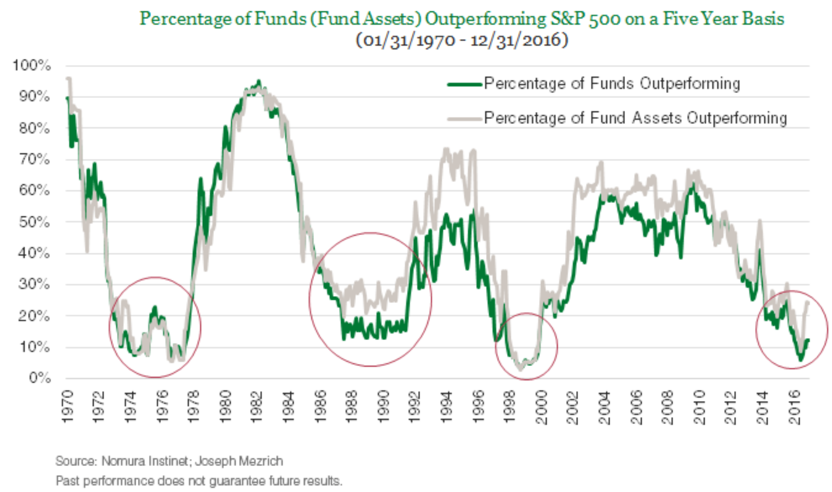
The actual performance realized by most investors is better described as the "buy-and-bail" return. It's about half of the "buy-and-hold" return.

We Have Been Here Before

According to Morningstar, the average US equity manager has underperformed the S&P 500 Index over the past one, three and five years. Given the natural tendency to chase what's working and ditch what's not, "the death of active management" is becoming a popular consensus sentiment.

Before writing off active management, investors would be well served to pause and reflect. Might this be a cyclical phenomenon? If so, when have we seen this in the past? And most importantly, how did it play out last time?

Spoiler alert: yes, this is cyclical; yes, we have seen this in the past; and no, it didn't turn out so hot for overvalued indices overweighted in overvalued large caps. The chart below illustrates how extreme this cycle has been. It also illustrates how extreme prior cycles have snapped back.



During the later stages of a bull market, the growth of passive funds can create an artificially high demand for stocks widely held by market indices. As a result, the indices benefit from the bubble they create. But once passive investing starts to distort pricing, the ultimate result is the underperformance of the original beneficiaries of that distortion. **The future performance of any investment strategy is significantly altered once it has been widely imitated. Don't write off active management just yet.**

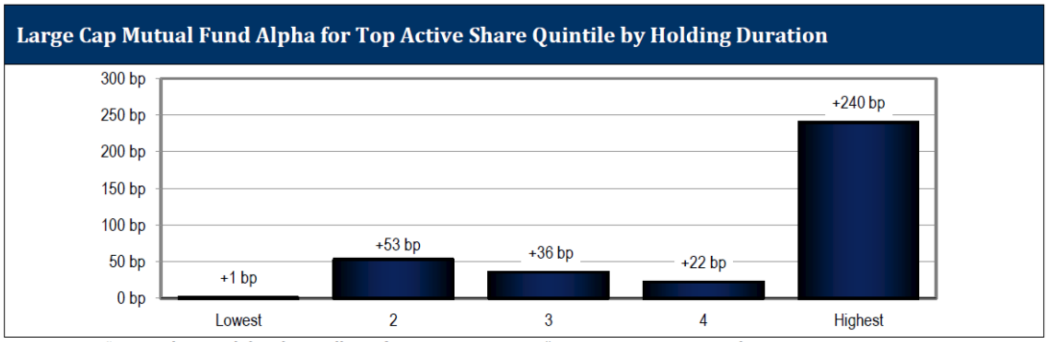
Earning Our Keep Doing Nothing

An absolute focus on "beating the benchmark" forces institutional investors to view "the benchmark" as home base. What this means is that proceeds from stock sales must be reinvested in the benchmark or a similar security or the manager risks veering too far from the index. Let's stop and think about this for a moment. In what world should the price to buy something have any relationship with the decision to sell something else?

In our world, these decisions are very different. We keep them separate so that the decision to sell a stock is not influenced by our menu of purchase options. Our default option is cash. We construct the portfolio deliberately one investment at a time. As a result, cash has accumulated in the absence of attractively priced opportunities, but conditions can change rapidly, and we can deploy large chunks of capital quickly.

Most investors in active strategies expect their managers to be . . . well, active. It's what they are paying for after all, right? If you are not active, why not save your money and stick with a passive strategy? It's this line of thinking that leads active managers to demonstrate activity to earn their keep.

Doing nothing is hard to do, especially when we are paid to do something. Inaction is easier said than done. Inactivity may be confused with not doing anything, but the decision to do nothing is an active one. And it is often far more difficult than doing something, which probably explains why it is far more rewarding.



Source: "Active Share and the Three Pillars of Active Management," Martjin Cremers, December 2016

We only initiated one new equity investment during the second half, although it was not for lack of effort. We exited several positions as the year came to a close:

We harvested losses in Arcos Dorados (ARCO) and Coca-Cola FEMSA (KOF). We decided to take our lumps, offset some realized gains and take some time to reevaluate both investments from a distance.

We exited our position in Paypal Holdings (PYPL) as the stock approached our estimate of fair value and no longer provided an adequate margin of safety given increasing subprime credit exposure at the ~~subprime lender~~ payment processor. As usual, Charlie Munger said it best, "If you think you know what's going to happen to payment systems 10 years out, you're probably under some state of delusion."

At year-end, our largest equity positions were Time Warner, Oaktree, Gilead, CDK, and LabCorp.

Gen Yers & Microbrews

The Broyhill Family Office was founded over three decades ago. I was too early in my investing career to be involved on day one (I was just starting elementary school), but it's hard to believe twelve years have gone by since moving south.

It has been quite the adventure. While my first decade in this business was like drinking through a fire hose, most of what I've truly learned in my career has come in the second decade while continuing to define and refine our investment philosophy at Broyhill.

I wouldn't have been able to accomplish any of it without the support and collaboration of our team. The majority of us have worked together for more than a decade. And twelve years later, Carol is still tucking the tags into my shirts.

We've also been fortunate to work with some talented young analysts over the years in addition to summer interns from Carolina, Wake and of course, Appalachian State. It's hard to believe that Mike and I have worked so closely together for nearly three years now. Time flies when you are having fun, and there is nothing Mike enjoys more than visiting our local microbreweries with a pile of Ks and Qs. Unlike most of his fellow "Gen Yers" who have no memory of life without computers or the internet, Mike is perfectly content without a screen (most of the time).

The Resident Skeptic

We all miss Nancy Walsh who resigned last year to be closer to family, but perhaps none of us as much as Mike. Nancy was the gate keeper of the office gummy vitamins and we are still looking for a replacement to monitor Mike's gummy intake.

In the interim, we are extremely excited to welcome Dr. Andrea Sefler aboard. I've known Andrea for almost as long as I've known North Carolina through our involvement with the CFA NC Society. She is a good friend, a rational sounding board and one of the brightest minds I've ever encountered. While Andrea is not an investment analyst by training – although she did take the CFA for sh*ts and giggles – her scientific background makes her the ideal *Resident Skeptic* at Broyhill.

I can't begin to express how excited I am to learn what is in store for us in decade number three. Please give us a call if you have any questions on the portfolio or just miss talking to us. We value your continued confidence and work hard to earn your trust each day.

Sincerely,

Disclosures

Past performance is not indicative of future returns. *This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives.*

Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. This document contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice.

The views expressed here are the current opinions of the author and not necessarily those of Broyhill Asset Management, LLC ("Broyhill"). The author's opinions are subject to change without notice.

There is no guarantee that the views and opinions expressed in this document will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. No representations, expressed or implied, are made as to the accuracy or completeness of such statements, estimates or projections, or with respect to any other materials herein.

Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. There are risks associated with purchasing and selling securities and options thereon, including the risk that you could lose money.

The S&P 500 Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. Index returns assume that dividends are reinvested and do not include the effect of management fees or expenses. You cannot invest directly in an index. For additional information about other indices or strategies mentioned here, you can contact us at info@broyhillasset.com.

Additional information is available upon request. More information on Broyhill Asset Management LLC ("Broyhill") is also available at www.broyhillasset.com.