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Ovis Capital – Winter 2016

Fund and Market performance

Set forth is the fund's performance against its benchmarks[i]:

		MSCI World	S&P 500	The Fund	Limited Partner (Net of Fees)
Ovis Capital	**2016**	**8.1%**	**12.0%**	**32.2%**	**25.8%**
	2015	-0.1%	1.4%	18.4%	13.4%
Capra Capital	**2014**	5.2%	13.7%	34.5%	27.2%
	2013	24.0%	32.4%	60.9%	47.5%
	2012	6.0%	3.0%	47.2%	37.8%
Compounded		**49.3%**	**76.1%**	**398.6%**	**268.8%**

The following table summarizes the rolling three and five years' returns:

		MSCI World	S&P 500	The Fund	Limited Partner (Net of Fees)
5 Years	**2012-2016**	49.3%	76.1%	398.6%	268.8%
3 Years	**2014-2016**	13.6%	29.1%	110.5%	81.5%
	2013-2015	30.3%	52.6%	156.2%	112.8%
	2012-2014	38.3%	55.1%	218.6%	158.5%

The mid-year letter detailed the fund's first period of negative performance and it was also the first time it has underperformed its benchmarks. However, the real surprise was what happened next. Immediately after sending the half-year letter I received an enormous number of thank-you notes. I knew I had great partners, but to have had such a positive response post a period of underperformance, is immensely encouraging. I feel fortunate to have a group of partners like you, a group that takes the long-term view.

By now you know that the reason I am pleased with the results is not that we became collectively $7,823,302 richer, nor is it that the fund gained 32% for the year, but because we have outperformed our benchmarks by more than our stated goals of 5-10% annually over the past three and five years.

That wraps up the good news.

As you know, our investment portfolio concentrates our capital amongst a small number of undervalued, high quality businesses. Over the long term, I believe that our strategy should yield satisfactory results. However, this says nothing about any short-term period, which is why I always ask that our performance be evaluated on a rolling three year period, with preference to five years. Your take-away from 2016 should <u>not</u> be that every time we underperform, things will rapidly turn around, but rather that periods of underperformance are inevitable. Future recovery times are more likely to be measured in years rather than in months.

The principle reason for this unfortunate reality is that not only are the short-term movements of stock prices close to random, but also, we concentrate capital among a small number of stocks. Moreover, we often invest in companies the market is pessimistic about. No one promises us that Mr. Market will change his mind quickly!

I am sure that by now you must be tired of me promising the bad years while reporting the good ones, so let us examine the experience of the greatest investor in history, Warren Buffett. Had one invested with him from the beginning of his time at Berkshire Hathaway (51 years ago) the gain would have been enormous -

over 15,000 times the original investment. However, during that time, investors have experienced drops of 50% on four different occasions[II]. It is for this reason that I advise people who cannot stomach a 50% decrease (or more) to avoid the stock market altogether – whether they are investing through Ovis Capital or not.

My other concern has also to do with expectations.

Expectations and Anchors

> *"The secret to happiness is to lower your expectations"*
>
> Charlie Munger

The fact that human minds are prone to biases is certainly not new. One surprising bias is known as the Anchoring Bias and it is best illustrated by an example. In a study by Amos Tversky and Nobel laureate Daniel Kahneman, participants observed a roulette-like wheel that was predetermined to stop on either 10 or 65. Participants were then asked to estimate the percentage of the United Nations members that come from Africa. Participants whose wheel stopped on 10 guessed lower values (25% on average) than participants whose wheel stopped on 65 (45% on average)[III].

Please pause for a minute to reflect on this. A random number shown to rational human beings, unconsciously influenced their answer to what is a clearly an unrelated question!

If that is the effect an unrelated question had on the answer, one must wonder what influence a related question would have had.

This, brings us to the matter of expectations.

The results experienced so far should not anchor your expectations. Our chances of repeating this performance over the next five years are small, very small. To illustrate how out of line they are, let us examine the track-record of the 26,000 mutual funds in the Morningstar database[IV].

Out of the 26,000 funds, 17,398 have at least a five-year track-record. Out of these, only 2,547 outperformed the S&P 500[V] during the period. This means that over 85% of funds underperformed the S&P500. This figure is understated, as many underperforming funds were closed within the five-year interval. Only 128 funds outperformed the S&P500 annually by 5% and this included only 33 funds which outperformed by 10% (as a side note, all these 33 funds were leveraged funds (i.e., used credit to boost the returns of the deployed capital)).

Our goal remains unchanged – to outperform our benchmarks by 5-10% per annum. However, the statistics detailed above should demonstrate how challenging this goal is (only 0.7% of funds achieved the lower end of our goal and only 0.2% met the upper end).

If that is not enough to convince you that our performance is likely to slow, let us look to the master himself. Warren Buffett, before taking control of Berkshire Hathaway and building it into the empire it is today, was running an investment partnership (from which, as you know, I borrowed most of our operational principles).

In the first five years of operation, his partnership gained 251% before fees.

Say you are a coach of a basketball team that owns a player who was lucky enough to have had a season with better numbers than Michael Jordan (and in investing, a five years' period is like a single season, at most). Would it be prudent to extrapolate this player's future using Michael Jordan's numbers? In fact, extrapolating our track-record into the future is like extrapolating with better numbers than Jordan's - highly unlikely!

The good news is that we do not need the sort of returns we have enjoyed so far to generate satisfactory results. Achieving our goal, 5-10% outperformance of our benchmarks over the long term, will by itself be highly accretive for our common wealth.

The Wells Fargo Ordeal

"You are remembered for the rules you break."

Douglas MacArthur

As the regular readers know, in this part of the letter I normally refrain from addressing our specific holdings. However, recent events that have transpired to a company I have owned since 2009, compelled me to share a few thoughts.

Norman Pearlstine, known as the editorial soul of Time Inc., said that every feature story fits into one of three archetypes: "How the mighty have fallen", "David v. Goliath" or "The Hole in the Donut" (AKA man-bites-dog type of stories). Wells Fargo, opening two million unauthorized accounts, definitely fits into the first category – the pristine reputation of the last untarnished big-bank, just got smeared.

First, a quick recap of the facts. Following complaints and an L.A. Times article, the company found two million accounts for which it was unclear whether a customer had requested for the account to be opened. These accounts were either inactive or had been closed shortly after being opened. It does not mean that all the two million accounts were fraudulent, but by this point, Wells Fargo's management did not want to take a chance and deemed all two million accounts as if they were unauthorized openings.

Over the previous five years' period, every time the bank discovered such a practice, the culprit was fired. Consequently, over the period the company let go of 5,300 employees. That is an annual employment attrition rate of about 1% of the 100,000 associates working in the regional banking business.

To keep this scandal in perspective, over the five-year period in question more than 92 million new accounts were opened. Additionally, it turns out that of the two million fraudulent accounts just 115,000 incurred charges and those averaged $20 (per account, for the entire period). Hence, the wrongly opened accounts generated cumulative revenue of $2.5**M**. During the same period, Wells Fargo generated over $400**B** in revenue. It is clear see that the financial impact was negligible and certainly cannot have served as motive.

The obvious question is how did a celebrated team of leaders allow two million unauthorized and non-income producing accounts to be opened?

The Power of Incentives

"The White Throated Swift is the fastest horizontal flying bird in the world, topping out at 70 MPH. Unless, you put a female White Throated Swift in its proximity during mating season. Then, and only then, it can reach speeds of 105 MPH."

Peter Kaufman

You will not be surprised to learn that the incentive scheme for the management team at Wells Fargo is not tied to opening bogus accounts to unsuspecting customers. Instead, they are measured against metrics such as Return On Equity and Earnings Per Share - metrics that align their pay with creating shareholder value.

What is likely to have happened is that management wanted to enhance these metrics by growing loans and deposits and the easiest way to achieve that is through doing more business with existing customers (AKA cross selling).

In the previous letter, I showed just how accretive loan growth is to a bank's earnings. As we are discussing the subject from a different angle, I will reprint:

> *Simply put, banks use $1 they own, along with $9 raised from deposits at a low rate (say 2%) to lend the $10 for an interest spread, of say 3%, for a total of a 5% interest loan. Hence, each dollar retained*

allows the bank to lend $10 with an interest spread of 3%. This adds $0.3 to a retained $1, or 30% incremental pretax returns (before loan losses and incremental expenses).

Being well-aware of that math, the company set incentives for the whole company, from bank tellers to regional managers, to grow the number of accounts hoping that it would lead to more business.

At this point, I am sure the folly is clear. Associates were incentivized to open as many accounts as they could, but profitability – the ultimate goal - was neither tested nor incentivized.

At the 2016 Berkshire Hathaway annual meeting, Warren Buffett was asked about the incentive plan for Berkshire's auto insurer, GEICO, which he described in two simple points:

1) Growth in new policies.
2) Profitability of existing policies.

It seems like Wells Fargo management left out the second part from the associates' incentive plan. Constructing an efficient incentive program is a hard task, but it is obvious that the plan should have included a profitability test, exactly to avoid these kinds of mishaps.

Another example of what I believe to be a great incentive plan, is our partnership. I only get paid when you get returns and being the largest investor in the fund, no one would lose more than me when we lose money. Incentives also work out nicely on the fund's expenses side. What better way to know that only necessary expenditures are being incurred than to have the fund manager pay for them out of his own pocket? Me being on the hook for the fund's expenses helps in two ways:

1) It makes me care about costs.
2) It makes you pay for performance and ONLY for performance.

Back to Wells Fargo. Warren Buffett said that "Intensity is the price of excellence" and this is what I believe went wrong at Wells Fargo. Management wanted to push as hard as they could to stimulate growth, alas without a mechanism to check that the growth was profitable.

Unbelievably, this faulty incentive plan remains common practice among US banks (and let me immediately clarify that a 'but everyone else is doing it' excuse has not been working well for my kids and should not work for corporate executives).

On top of using a flawed incentive system, management had been slow in understanding the magnitude of the issue and even slower in rectifying it. That was wrong and with an ousted CEO, I am sure they have learned their lesson. However, I think there is one more lesson to be learned here.

The Right to Err

"Show me a guy who's afraid to look bad, and I'll show you a guy you can beat every time"

Lou Brock

In business, as in other aspects of life, mistakes are part of the game. In recent history, we saw Target[VI] overcharging customers, Facebook[VII] providing misleading ads data, Yahoo[VIII] jeopardizing one billion users' personal information, Chipotle[IX] infecting dozens with E. coli and GM[X] knowingly not recalling faulty vehicles. I find all these missteps to be worse than Well Fargo's. However, no other company suffered as much media attention or calls from the legislator for criminal prosecution of its leadership. I view this as populist and counterproductive. A business environment in which criminal prosecution is the expected outcome for managers who make honest mistakes is one that encourages mediocrity and back-covering.

So long as the mistake was honest, as evident in this case – no personal or business gain was realized by this poorly constructed incentives plan – I think society would benefit most through demanding compensation for damages and moving on.

One of our partnership's biggest advantages is that I am not afraid of making mistakes (detailed discussion can be found on page 2 of the Fall 2015 letter). I think that the same should be applied to our companies' leaders.

Our Investments

Our portfolio held 12 different companies of which the top 6 holdings account for 84% of the fund. Total assets under management at the end of the period were $31.8M.

Please refer to Appendix A for a more detailed discussion of our holdings.

Discussion of Holdings Sold

During the period we sold one holding that was purchased earlier this year. It rose immediately after we started buying it. Since I was unable to build a position, I sold it. Although this earned us a 22% return in a short period, the position was too small to move the needle. At this point, I am not disclosing additional information about the company as I hope the market will give us another buying opportunity in the future.

As always, I'm at your disposal for any questions,

Liron Manor

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1) Funds return are unaudited and refer to a partner that invested at start of period and did not deposit or withdrew funds since. In the coming weeks partners will receive the personal report on assets and returns from Vistra.
2) First 9 months of 2015 results are of Capra Capital, a Israeli LP that Liron Manor ran from March 20th 2012 to September 30th 2015. The last 3 months of 2015 are Ovis Capital's returns.
3) 2012 returns are reported from Capra Capital's fund inception on March 20th 2012. Capra Capital's returns were audited on a NIS basis. The USD returns are unaudited and brought for information only.
4) The Benchmarks are industry standard ones and include dividends. From a practical point of view, a benchmark can't be directly invested in and a trust fund or an index fund needs to be purchased and those funds charge a commission that would have reduced the benchmarks' return.
5) The Limited Partner return was restated to the return that would have been received by partners had the base currency been USD and not NIS. USD NAV for Capra Capital is available by request.
6) Due to lack of readily available information return for the MSCI World is calculated based on the return of the iShares MSCI World ETF (including dividends and excluding commissions). Returns available https://www.ishares.com/us/products/239696/ishares-msci-world-etf.
7) The above includes an abbreviation of the terms and conditions for Ovis US Feeder Fund, L.P. and Ovis Offshore Feeder Fund, LTD. The full and binding terms are included in the partnership agreement and its appendices.
8) Ovis returns are the Master fund return. The feeder returns may have variations due to dividend withholding tax differences.
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11)

II http://www.cnbc.com/2014/03/14/warren-buffett-on-cnbc-berkshire-has-eliminated-most-of-its-us-catastrophe-insurance-business-due-to-low-rates.html

III https://en.wikipedia.org/wiki/Anchoring

IV For the period ending December 31st 2016

V Added back 1% to fund returns to reflect gross performance.

VI http://fox5sandiego.com/2015/02/11/target-to-pay-4m-fine-for-overcharging-customer/

VII http://www.cnbc.com/2016/09/22/facebook-overestimated-key-video-advertising-metric-wsj.html

VIII http://www.nytimes.com/2016/12/14/technology/yahoo-hack.html?emc=edit_na_20161214&nlid=65234695&ref=headline

IX http://www.fda.gov/Food/RecallsOutbreaksEmergencies/Outbreaks/ucm470410.htm

X https://en.wikipedia.org/wiki/General_Motors_ignition_switch_recalls