

January 14, 2016

Quarterly Commentary

4th Quarter 2015

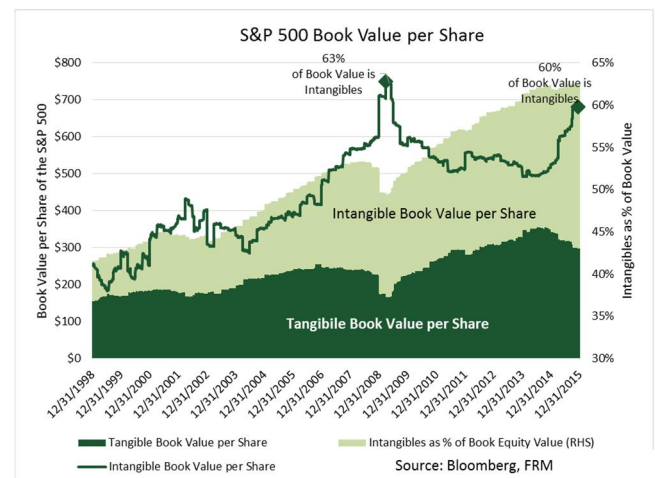
Goodwill to All

No, we are not leading off with glad tidings for the New Year. That comes later.

We are leading off with a topic that we believe to be very important to our work in determining risk and the intrinsic value of securities we consider for your portfolio. You hopefully remember our discussion from our 2nd Quarter 2015 Commentary relating to financial engineering of earnings per share through corporate stock buybacks. We stated that, in general, goodwill and other intangible assets have been growing at a much faster rate than tangible assets for the last few years. This is due to financial engineering and a plethora of merger and acquisition activity. We noted that this has left shareholder book value with an increasingly high component of intangible assets and creditors with fewer tangible assets covering the obligations due them.

Goodwill is the residual amount recorded as an asset when the purchase price paid in an acquisition is above the fair value assigned to all other assets. Until 2001, intangible assets were depreciated (amortized) ratably over a long period. The current accounting treatment is to not amortize them, but to treat them like a permanent asset unless the business the intangible assets are tied to has difficulties that are deemed permanent. At that point, a valuation adjustment is made by expensing a portion (or all) of the intangible assets in a process that is at least as subjective and imprecise as the original assignment of value.

Perhaps by now you are beginning to get a feel for the risk of putting too much faith in goodwill. As you can see from the nearby chart, goodwill and other intangible assets declined as a percentage of total assets during The Great Recession. Write-downs



were made to reflect the abandonment of originally inflated, hopeful valuations assigned as a result of high prices paid for acquisitions. In other words, they vanished into thin air, proving their risky nature. The chart shows that the S&P 500 is almost all of the way back to where it was just prior to the financial crisis and Great Recession in terms of intangible book value as a percentage of total book value. As touched on earlier, this is the result of merger and acquisition activity and stock buybacks the likes of which have never been witnessed.

We approach the risk associated with intangibles very cautiously. At year-end, a composite of our equity positions had a weighted average of intangibles as a percentage of book value of 30.7%. Much of that is contained in our long-term large pharmaceutical positions that are closer to our sell targets than our buy targets. Were you to exclude those, the rest would contain a weighted average of 16.4% intangibles as a percent of total book value. Both of these measures are considerably less than the 60% intangibles that the S&P 500 book value per share contains.

While our caution relative to goodwill valuations has not been rewarded as of late, our training and discipline requires that we continue to be conservative in this area. History says that conservatism in valuation, including valuation of intangible assets, will one day be rewarded.

Commodity Update

Referring back to the above chart for just a moment, one can see that it is not only intangible assets that are subject to valuation charge-offs. The absolute decline in tangible book value per share for the S&P 500 during the last 2 years has largely been the result of impairment write-downs in the energy and materials sectors. We allocated a sizable portion of this space one year ago to review the conditions in those sectors important to us, the near-term outlook and the long-term demographics that could possibly support growth. What follows is an update one year hence.

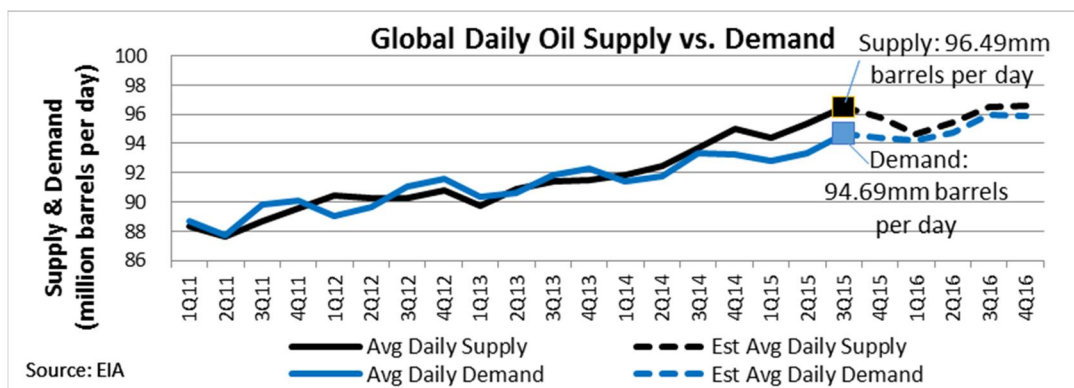
Oil and Natural Gas

It is estimated by Barclays from their semi-annual survey of 175 oil and gas entities around the world that global capital spending for exploration and production declined by roughly \$130 billion, or 20%, in 2015. According to *Oil and Gas Investor*, 2016 is expected to be the first time since the mid-1980s that capital spending for oil and gas exploration and production will have declined for two consecutive years. Though it is very early in the process, it is estimated that 2016 is expected to see a decline in capital spending of approximately 8%.

While reductions in capital spending of this magnitude seem almost certain to eventually impact global supply, it has not happened yet, much to our chagrin. This time last year we were expecting that global production would now be on the decline in response to significantly lower oil prices. The fourth quarter 2014 rebound in oil prices to around \$60/barrel temporarily postponed the painful industry cutbacks required to impact supply. More importantly, Middle East producers in OPEC, most notably Saudi Arabia, have chosen not to

cut back on production or capital spending. The anticipation of Iran coming on line with an exportable surplus in 2016 is also weighing on the market. OPEC currently claims about 33% of world oil production.

The good news for downtrodden investors in oil and gas from all this is that capital spending declines will eventually impact supply. It has already happened in North America,

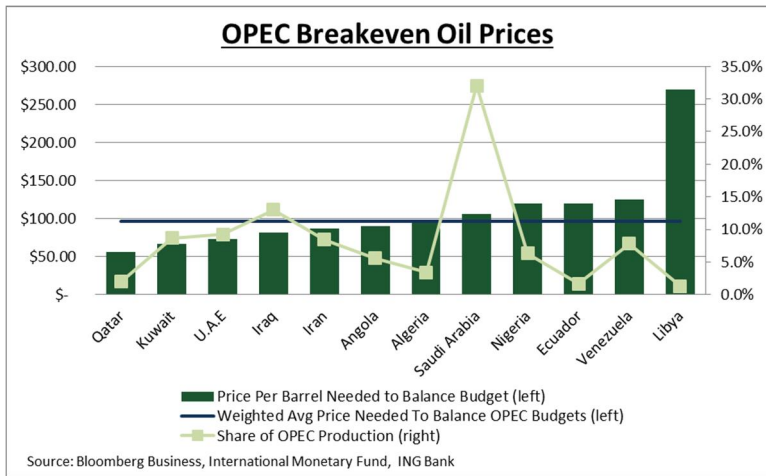


where capital spending is estimated to have been cut more than 35% in 2015. North American oil production turned down in the second half of the year, and ended the year about 4% below its peak in terms of daily production. Loans from the banking sector for smaller producers are expected to be much more difficult to obtain going forward.

Another positive for the supply/demand case is that demand grew at the fastest pace in the last five years during 2015. That is not all based on growth in developing nations either, as total miles driven in the U.S. has finally surpassed the previous high set in 2007 just prior to The Great Recession. SUVs and light duty trucks continued to gain U.S. market share at the expense of traditional light car sales according to *Scientific American*. Hybrid sales were down sharply throughout 2015.

Obviously OPEC is the wildcard in the supply/demand equation for oil, and there are a couple of interesting forces at work that might impact the direction OPEC moves next.

In just the last few days of the year, Iran has once again thumbed its nose at the U.S. by first launching two ballistic missile tests which are prohibited under the new nuclear accord. Iran followed that up with firing some unguided rockets that were launched less than a mile from where the aircraft carrier USS Truman was cruising in the Strait of Hormuz. Following this saber rattling, the Saudi Arabian embassy came under attack in Tehran after the Saudis executed a lone dissident Shiite cleric in a mass execution which included 46 Sunni extremists. The two countries, already backing opposite sides in civil wars in Syria and Yemen, have severed diplomatic ties. In the not so distant past, such dust ups would almost always send the price of oil shooting upward, but the Middle East risk component in the price of oil has been largely ignored in the last couple of years. Up to now, political discord among OPEC members and civil wars in the Middle East has only been met with complacency in the oil market.



The other factor at work in OPEC strategy for the long-term is the fiscal condition of its members. OPEC is dominated by countries with ruling monarchies or dictators. The ruling factions in many of these countries have striven to maintain power by giving their people large amounts of government entitlements. According to data from the International Monetary Fund (IMF), OPEC members are paying a dear price for the decision to

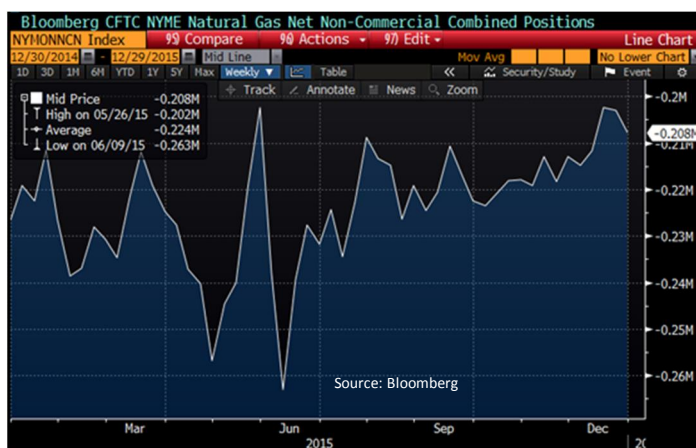
produce at full capacity. Only very small surpluses were being generated in 2013 and 2014, even though oil prices were high at that time. The entitlements have continued in the low oil price environment, creating large deficits. The IMF estimates that Saudi Arabia exhausted 22% of its fiscal reserves in 2015 alone, with another 19% depletion estimated for 2016. The nearby chart shows each OPEC member's break even oil price requirement. All currently have budget needs in excess of today's oil price. It is interesting to note that the OPEC countries in general did not take action during 2015 to lower their domestic spending. Revised IMF estimates in December for OPEC breakeven levels increased for seven of the 12 member countries, one remained the same and the other four were estimated to have slight decreases. Saudi Arabia, by far OPEC's largest producer with 32% of OPEC production, had its credit rating downgraded by Standard and Poor's to A+ in the fourth quarter. The country relies on oil exports for 80% of its government's revenue. Its current budget deficit is estimated to be running at a whopping 16% of GDP.

While Russia is not a member of OPEC, low oil prices have had a devastating impact on its economy and its currency. Efforts to stop the outflow of capital have resulted in the Russian government raising short-term interest rates as high as 17%.

It remains to be seen whether fiscal erosion of member governments will be the catalyst that will enforce OPEC production discipline. It is hard to imagine that there will be much of a backstop for these countries in the debt markets if low prices were to persist beyond the short-term.

Natural gas has continued to see declines in drilling activity throughout 2015. The year began with promise as inventory carryover levels were the lowest of the last five years. A cooler than average summer and a mild start to the winter currently has reversed the situation, and storage levels are currently at above average levels for this time of year.

It appears, however, that the domestic gas industry may be near the bottom of its cycle, as prices seem to have stabilized recently. While oil prices have been falling rapidly in the last few weeks, domestic natural gas prices have been on the rise. We have taken note that since the beginning of the summer non-commercial players (read speculators) in futures and forward contracts have halted their selling and reversed course (see accompanying chart). This is important because it is not common for speculators to be sold short as a group as the chart indicates. The fact that they have been net buyers since summer may provide an important psychological and technical support for the market. What transpires weather-wise for the balance of the winter and early spring will determine whether we will see a rally in the gas market in 2016.



The world market for liquefied natural gas (LNG) has also taken a beating in 2015. The delivered prices for LNG reflected above are significantly lower than those shown this time last year. Much of that has to do with LNG developing into a market that is indexed to the price of oil. Additionally, the economic slowdown in China, along with prospects for Japan's nuclear re-starts has served to dampen the all-important Asian market. The current disarray in the fledgling worldwide LNG market has halted planning and construction of LNG projects worldwide. Those projects that were well along in the construction phase at the beginning of the year appear to us to be the only ones that will be coming online any time soon. All others have come to a screeching halt. The fact that buyers are insisting on linking the price of LNG to oil will add additional risk and complexity for energy producers when analyzing future LNG production possibilities.

World LNG Estimated October 2015 Landed Prices



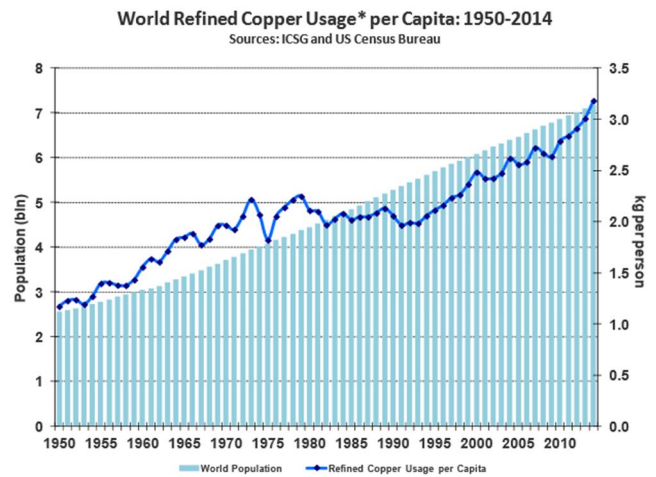
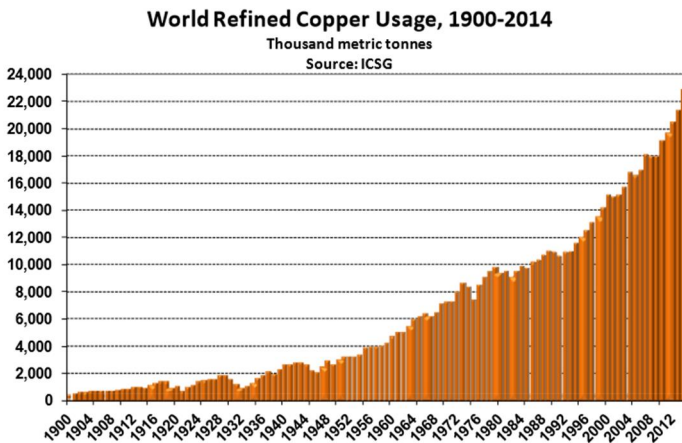
Source: Watstone Energy, Inc. Data in \$/MMBtu. Landed prices are based on a netback calculation. Note: Includes information and Data supplied by IHS Global Inc. and its affiliates (IHS). Copyright (publication year) all rights reserved. Prices are the monthly average of the weekly landed prices traded during the prior month.

Updated: November 2015

Copper

The world copper supply appears to be adjusting to lower market prices. The International Copper Study Group (ICSG) now calculates that for 2015 supply and demand were in balance. Earlier in the year they had projected a 360,000 metric ton production surplus. For 2016 they

now project a deficit, or demand in excess of supply of 130,000 metric tons, primarily based on production cuts announced in the second half of 2015. Admittedly, these projections



are highly dependent on China's usage, as they currently consume approximately 40% of world production.

Demographics and the Long-Term

On the heels of the depression in commodities comes the news in the fourth quarter that China has now adopted a two child policy, replacing the one child policy established in the late 1970s. While it will take years to see what impact that change will have on world population growth rates, it is hard to imagine that there would not be some increase that results.

The long-term trend in the commodities discussed above is growth in the quantity of demand. In the near-term, a slow-down in economic growth has interrupted the long-term trend. However, the primary culprit in the current temporary supply/demand imbalances in many commodities is, without a doubt, artificially low interest rates. We believe that artificially low interest rates have caused a misallocation of capital to the production of and speculation in many commodities. Risk has been mispriced. Hopefully we are closer to the end of such policies than the beginning.

In Closing

While 2015 was a challenging year performance wise, it was a very good year in other aspects. We mentioned last year that Lauren Sanders had passed the CPA exam in the fall, and she became licensed this year. Some of us believe that we cannot have too many CPAs around here, and we are very proud of Lauren and the work she put forth to acquire this designation. That gives us five CPAs and six Chartered Financial Analysts with another in the offering this summer (no pressure, Meredith). While we have known the value of humility in our business for a very

long time (and are having the lesson hammered home again), we do admit to being very proud of our entire staff. They are totally committed to serving you.

We are thrilled to report that Mark finally pushed home a score in the grandbaby competition this past year. Michael Boyd Ivory was born on June 12, weighing in at a Crimson Tide potential of 8 pounds and 13 ounces. Actually it's Mark and Mary that wear the hounds tooth. Boyd's parents, Wes and Elizabeth Ivory of Little Rock, have a split allegiance between the Cowboys of Oklahoma State and the Arkansas Razorbacks. We trust that Elizabeth will raise him right (WPS!). Mark and Mary are also proud to share that their youngest son, George, upon completing a Masters at the University of Michigan, was hired as a professional violinist by the New World Symphony in Miami.

More good news on the grandchild front came at the end of the year when Hunter Lee Shelton was born to Luke and Meredith Shelton on December 15. Hunter checked in at 7 pounds and 13 ounces and made it just in time for the best Christmas present possible. Brother Jake seems to have adjusted well thus far. That makes four in four years for Greg and Janet, and they are hoping to keep the streak alive in 2016, though a pep talk is probably going to be necessary.

Tom and Debbie finally got a little relief, as Sarah Hill finished her MBA at Baylor and has accepted a position with Essilor in Dallas. Just days after graduation came news of her engagement with plans for a July wedding. Tom may need counseling to help him through all of the check writing! Elizabeth graduated magna cum laude with a B.A. in English from Baylor, and Anna and Mary Claire are scheduled to receive their bachelors' degrees in the spring from Baylor as well. The Waco and Baylor economies have a rude adjustment facing them without the Hill girls.

You are regularly in our prayers, and we ask that you keep us in yours as well. May He bless you and each of your families with health, happiness and prosperity in 2016.