



April 19, 2017

Dear Investor:

The Russell 2000 finished up +2.5% for the quarter, digesting large gains achieved in the back half of 2016 and lagging its larger peer for the quarter. The S&P 500 finished up +5.7%, putting it out in front thus far this year. Taken together, this puts the Small / Large Blended Benchmark up +3.4% for the quarter. Choice Equities Fund, LP (CEF), was up +9.4% and +7.5% on a gross and net basis, respectively.

As is usual in our quarterly letters, we will offer some brief comments on the portfolio and the current investment environment. Given this is our first letter reporting as CEF, we will provide an update on company operations and revisit our partnership goals, philosophy and investment approach.

## **BUSINESS ACTIVITY**

We have a number of items to report. First and foremost, we are pleased to announce a successful transition to CEF in March. We formed Choice Equities Capital Management, LLC earlier this year to serve as the investment manager for CEF and put together a first-class team of service providers to ensure smooth operations and timely and accurate reporting. Existing investors made successful transitions over from the Focused Distribution Strategy, and we are delighted to welcome a number of new investors into the partnership this spring.

Additionally, we have formed two new relationships to bolster our resources and position our business for success at this level and beyond. On the investor relations front, we have partnered with John Pitt, owner of Culbreath Capital, LLC, to assist us in our business development efforts. I have known John since our days at Kenan-Flagler over a decade ago and am pleased to continue to be able to work with him in a professional capacity. On the research side of the business, we have formed a relationship with Burke Koonce, owner of Helicon Research, LLC. I have known Burke for the better part of a decade and am excited to welcome him and his 18 years of investment experience as contributors to our team. In the initial stages of our relationship, he will primarily serve as a sounding board, a potential source of investment ideas and in assistance with our development of a moderate short book, an area where he has significant experience.

Finally, in early March I had the good fortune to attend a “best ideas” presentation dinner at the Yale Club in New York with a number of like-minded value investors (albeit ones with larger operations). I was thrilled to receive the invitation which came about after a rather opportune phone call I had this past winter with the host of the event, a well-known investor and former board member of one of our holding’s peer companies. (In short, I called him out of the blue to try to pick his brain about the company. To my surprise, this impromptu call turned into an actual conversation which proved to be a nice point of due diligence and ultimately led to an invitation to the dinner.)

As for my presentation, I laid out the investment case for BXC, an investment that as of yet has certainly not worked out quite as intended. But as we have maintained in these letters, management continues to execute soundly, and though the stock remains as unloved and underfollowed as it was when we first found it, significant upside remains. For the investment to work, shares simply needed the envisioned catalysts to unfold and a little bit of attention from the investment community. Three days after the dinner, the company reported solid Q4 2016 results that support the investment thesis. Since then, shares have been moving higher while volumes have picked up meaningfully. As I had described in my presentation, the catalysts are here and the results are now showing up in the financials. While I was content with the dinner just to have an opportunity to bring some much-needed attention to the stock, I was also excited

to hear many intriguing stock pitches and learn of two companies that may one day have a place in the CEF portfolio.

## **CEF COMMENTARY**

The quarter's strong results were driven by our most recent purchase SITE, a holding we profiled in the 2016 yearend letter. Shares are up nearly +50% since our purchase last fall after an almost +40% gain this quarter. BXC was also a contributor to the positive performance, with shares up just over +20% for the quarter. LAWS, the portfolio's largest holding, was the most significant detractor for the quarter, with shares finishing down about -5% for the quarter.

Portfolio Entries & Exits – There were no new entries or exits for the quarter, though some portfolio weightings have been adjusted.

## **CEF: GOALS, PHILOSOPHY AND INVESTMENT APPROACH**

Given the change in name and the notion that CEF now operates as a stand-alone and independent entity, we believe our investors would appreciate an update on how we expect to conduct our business going forward.

GOALS - Our first two goals remain the same. We seek to generate market-beating returns over a multiyear investment horizon while minimizing the risk of permanent impairment of capital. Additionally, we seek to communicate with our investors in a transparent and straightforward manner and treat them as the partners in our business they indeed are. If we are successful on these two scores, we expect to succeed on our third goal which is to build an investment manager that stands the test of time. As a stand-alone company, all business building initiatives since our recent formation and moving forward will be evaluated through the lens of what is good for the next decade, not just the next 12 months.

PHILOSOPHY - The thinking behind our investment approach remains unchanged, and we continue to approach investing in public equities as an opportunistic businessman would. We spend most of our time studying businesses and building circles of competence in areas likely to offer attractive investment opportunities - preferably today but oftentimes in the seemingly distant future. We view risk primarily as the likelihood of a permanent impairment of capital and pursue a carefully balanced willingness to trade some portfolio fluctuations and volatility for the opportunity to earn a higher return. We focus on growing, understandable businesses and seek to buy them at a substantial discount to our estimate of their intrinsic value. When we find them trading at attractive prices, we act in size and weight our best ideas accordingly. And all things being equal, we prefer to devote more of our efforts to small stocks where we believe greater price/informational inefficiencies can often be found.

APPROACH - As before the portfolio remains designed to generate returns that approximate the business performance of a few companies chosen with highly discriminating standards; however, we anticipate a few changes in the look of the portfolio to unfold gradually. Over the coming year, we expect to tilt the total portfolio holdings from five to eight equities towards 10 to 15. This gives us a few more bites at the apple, but still maintains the high portfolio concentration levels we prefer. We also expect to expand our investments to business models beyond solely distribution. It is not that there is anything wrong with our distributors. Many remain fabulous businesses where we have the great benefit of having followed them closely for five years now. But there are other compelling investment candidates out there too, and as long as we stick to our circles of competence and are confident in our understanding of the business and its potential risks, then we are more than willing to swing the bat when our expected return thresholds are met.

Similarly, we continue to maintain discriminating investment requirements. We seek to buy companies that offer us a reasonable chance to generate an annualized return of 20% or better over a three-year holding period. To do this, we look for good businesses that meet four criteria. We seek businesses that have: a durable moat that enables the business to earn high returns on capital; reasonably predictable and growing cash flows; management with integrity and capital allocation prowess; and of course, ample reinvestment opportunities. While we aim for a three-year hold or longer in our initial investment horizons, we seek to mitigate risk by trimming holdings or reallocating capital as future expected returns decline. In pursuit of this process, we come to work every day focused on making sound, long-term oriented investments that can compound capital in a tax efficient manner, but we readily acknowledge the often-turbulent markets do not always fit neatly into this framework and know some trading activity is sure to follow as a result.

The final area we expect to see a few changes to the portfolio comes from our market risk mitigation techniques. Where before we aimed to protect capital by passing on unfavorable investments and holding sometimes large amounts of cash, moving forward we intend to add two new arrows to our quiver that we believe will enhance our ability to guard against sustained portfolio drawdowns. As opportunities present themselves throughout the year, we intend to introduce a moderate short book to the portfolio. In the short book, which will likely comprise 20% gross exposure at the most on any near-term horizon, we will look to individual stocks primarily to generate absolute profits while we will use industry or market specific ETFs for broader hedging purposes. We will also look to employ some options hedges when conditions suggest a cautionary stance is appropriate. While the principal benefit of these additional instruments is to protect capital, they also carry the benefit of positioning us to accept more market exposure on the long side. And that is precisely what this portfolio configuration is all about – positioning us to participate as owners in a handful of attractive equities.

## **2017 OUTLOOK**

We have no significant updates to offer from our outlook just a few months ago. Broad market valuations look to be skewed toward the full side of fair and much of the investment discussion is focused on how much of President Trump's pro-business agenda can be put forward. A subtle debate seems to have emerged recently as investors scrutinize economic data and weigh surging, survey-oriented "soft" readings against weaker, output-oriented "hard" readings. One can never be sure, but history tells us the hard data catches up to the soft data more often than not. Regardless, as always, our focus remains on earnings, which are improving and may post double digit growth here in 1Q 2017 – which is worth noting considering that if it did, it would be the best quarterly earnings growth reported since 4Q 2013.

## CONCLUSION

As always, we are happy to discuss any portfolio holdings or our investment outlook with you at any time. Please simply contact us at your convenience. In closing, we are honored and privileged to have the responsibility you have entrusted in us in managing your capital, and we look forward to continuing our relationship further into the future.

Best regards,



Mitchell Scott, CFA  
Portfolio Manager

- 
1. All market and company data is sourced from Factset and company filings and is current as of 3/31/17.
  2. CEF uses the S&P 500, Russell 2000, a custom Blended Small/Large Benchmark and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The custom Blended Small/Large Benchmark is provided to capture a larger proportion of small cap performance versus large cap performance (at a 3:1 ratio) due to the similarly high proportion of small caps found on the Good Businesses Focus List as well as the strategy's general preference of having an investment mix more heavily weighted towards investment in small caps. The Barclays Hedged Long/Short index (an index of equities-based hedge funds) serves as an appropriate benchmark over the long term given the index has a similar long term goal of capital appreciation through equities investing.
  3. CEF Net Returns are hypothetical results calculated from actual gross results in a manner consistent with the 1% management fee and 18% performance fee offered to clients.