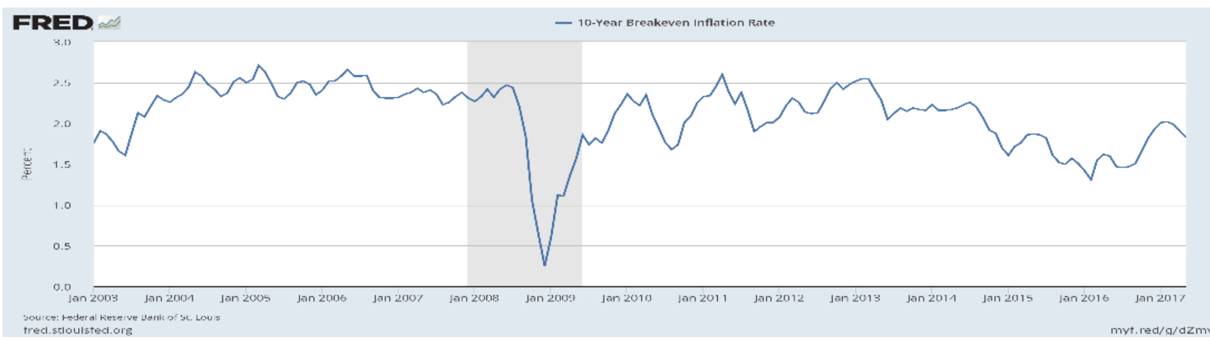
SECOND QUARTER COMMENTARY

A preeminent challenge confronting investors is the proper investment outlet under a prolonged period of low interest rates. Except for the 2008-2009 credit crisis, interest rates have held fairly steady with fear indexes ebbing, as manifested by the 5 and 10-year Fed break-even rates (Figure 1), the VIX, and yield spreads. The odds of low rates continuing has been enhanced in relation to the push-back in the statutory rate and political doings in Washington. Our response lies below.

Figure 1 10 Year Fed Break-Even Measure of Expected Inflation

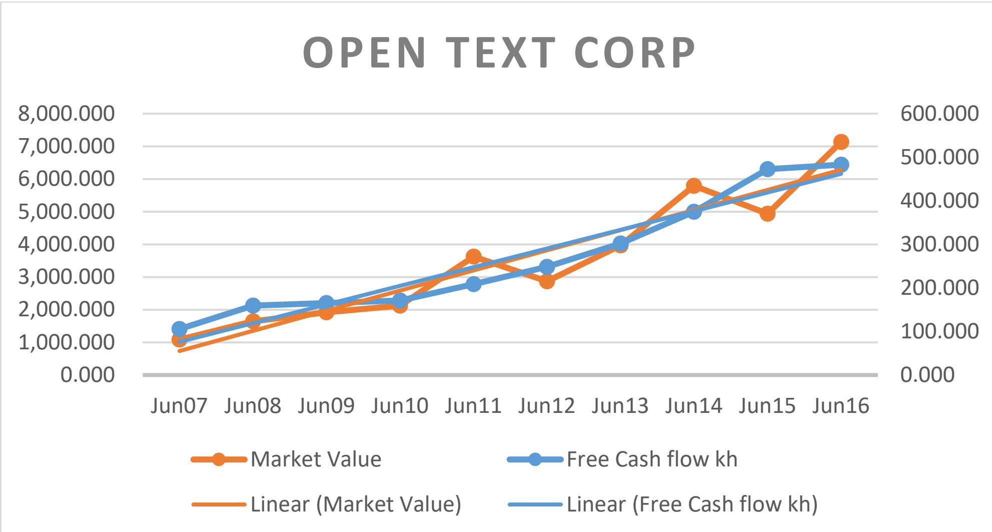


Obviously, investors have taken heed by assuming levels of risk they would ordinarily find unacceptable, bidding up those few popular stocks thought immune to the realities of extrapolating short-term trends. This risk-free investing philosophy was again seen upon Amazon's proposal to acquire Whole Foods, prompting a widespread sell-off in a number of sectors. We discuss this in the next section inasmuch as it impacted our holdings of CVS and Walgreens.

Though **five-year performance remains solid**, such was notably impacted in the last week of the quarter when interest rates rose a scant 11 basis points and technology, a sector overweight for us, saw a considerable drop in its most creditworthy names offering good consistent returns on capital.

If investors suspect change, even if unfounded, they drag the entire sector down without proper analysis. As shown below, there are exceptions, and we believe we own those, including Open Text, whose consistent free cash flow growth bears strong relation (see trend lines in Figure 2) with growth in its market value under good return on capital and low cost of equity. Over the past decade Open Text has reported just one slight down year in sales and consecutive growth in free cash flow, a trend we fully expect to continue.

Figure 2 Open Text Free Cash Flow Vs Market Value



ACHIEVEMENT OF OUTPERFORMANCE DURING LOW INTEREST RATE PERIODS

A salient point not well understood by investors or corporate boards alike is, due to the elongated period of very low interest rates, how a small—even seemingly minor— improvement in a firm's real return on capital can lead to a larger than typical improvement in the fair value of the firm. A 25 basis point improvement in relation to the current risk free rate, the ratio being 11% at quarter's end, can bump up fair value typically between 9%-14% as contrasted to when the risk free rate is 4%, or a typical 4%-6% rise in fair value, when cost of equity is held constant. Because yields are already so low, by contrast, a 25 basis point reduction in the risk-free rate would lead to a 3% rise in estimated fair value through the cost of equity capital if return on capital were held constant.

And so our firms, having been selected in part due to their history of value-adding acquisitions and operational improvements, should be in fine fettle going forward while **it is imperative firms avoid deals that are not immediately additive to return on capital even if without undue harm to their credit**. It should be kept in mind that **changes in the risk free rate could well impact valuations differently**. For example, a slight rise in the current risk free rate, in general, could (depending on the cause) be positive for valuations if investors perceived the increase as a sustainable reflection in the outlook for economic growth coming out of recession or sub-par growth in revenues.

Therefore, it is imperative upon firms to sustain improvements in all facets of their business at the current stage of the economic cycle given the level and slope of the yield curve. Failure to do so will lead to historically severe underperformance relative to those firms taking and succeeding in aggressive campaigns to improve efficiencies in cost and use of capital.

There was potentially positive news for our energy construction stocks as the House of Representatives approved by voice vote on June 20 legislation, with a companion bill in the Senate, that would expand the nuclear power production tax credit. This news did not receive publicity and was summarily ignored, yet if expanded to new construction would be very positive for the group. Our investments also benefit from advancements in alternative fuels and LNG plants such as Fluor's signing of such a deal with Saudi Arabia this month.

We sold our sole position in the integrated energy sector this quarter, a function of the rise in its cost of capital, brought on by an increase in CDS pricing, large downward price volatility in crude, market sales risk and share valuation challenge. **Our cost of capital worksheets picked up credit deterioration in the sector going on two years now and so we have had only minor exposure to the group.** We continue to own two natural gas pipeline, storage and logistics firms which are seeing increases in free cash flows and should continue to see same with above average sector stability (MPLX 95% fee-based, 40% hedged on active portion) and as their sponsors have announced aggressive drops in assets onto their balance sheet at value-creating multiples.

DON'T EXPECT AMAZON TO TAKE OVER DRUG DELIVERY

Despite the historic success of Amazon as an on-line retailer of consumer goods, the financial literature is quite clear with respect to industry leaders venturing outside their area of dominance, even if tangentially, such as Google's purchase of Motorola Mobility as well as the and scores of manufactures buying component, raw material suppliers or downstream distributors. Even vertical integration requires skills including operational adeptness, manufacturing and warehousing, integration of corporate culture, state issues, supply chain, technology, labor, managerial time, and many other issues.

In the real world, Walgreens reported a good quarter and its shares rose; yet the world of rumor also impacted its shares.

Should Amazon enter the drug delivery sector its current success is unlikely to be replicated, and to us would smack more of Mobil's 1976 purchase of Montgomery Ward, in which they sunk $2.3B into the retailer before it filed for bankruptcy. if Amazon were to enter the sector thru acquisition of a market leader like a CVS and its 90M customers, a financial requirement in the neighborhood of a $100B, there is no reason to think they would be a better owner, and would likely result in an immediate severe credit downgrade. If they were to go it alone, the dominant players, unlike the big-box retailers have mammoth market values and substantial resources, historic alliances, accompanied by very aggressive managements and Boards, and possess deep experience in sector software, supply chain and delivery.

Amazon's current strength lies in its business model, technology, market penetration and continuous improvements in the supply chain relative to the historically slow-to-act retail consumer goods firms punctuated by tens of thousands of competitors, simply not the case in pharmacy delivery. The sheer financial strength and size of our current holdings, CVS and Walgreens and their over 23,000 locations, is a far different business model than how Amazon achieved its great success. Other sectors have learned this lesson, and the financially strong are copy-catting their innovations.

Such challenges as regards to the high wall of pharma will prove, for Amazon, unacceptably insurmountable without severe harm to their return on capital and financial strength, so while investors may have feared Amazon's entry into pharma this past month and quarter, the firm will now have their hands full in the shrinking-margin ultra-competitive world of grocery against firms like Walmart, Costco, Kroger and against the already successful deep discounters, to say nothing on potential large cuts in the government SNAP program.

Amazon also faces potential large tax risk both domestically ($1.5B IRS assessment currently in the court) and overseas. The benefits of favored sovereign deals resulted in an overseas loss and $4.8B of foreign NOL's, including those related to transfer pricing which could eventually cost Amazon in the many billions of dollars (Table 2) and sure to impact analysts estimated future cash flows, placing a damper on any large expansion plans and carrying credit risk. **Base erosion is a risk facing all international firms as an increasing number OECD countries are requiring firms to file monthly reports showing the captions found in a General Ledger together with master files**

of transactional data showing supplies and purchase transactions. Software is allowing tax authorities to review adherence in a way not possible a number of years ago, including (soon) India and Latin America, where real-time data is required, matching customer and supplier payments with invoices.

Table 1 Stark Difference Between Cash and Reported Rates

AMAZON.COM INC

	Cash Tax Rate	Reported Tax Rate
Dec07	3.6%	27.9%
Dec08	5.9%	27.7%
Dec09	4.2%	21.9%
Dec10	5.0%	23.4%
Dec11	3.6%	31.6%
Dec12	28.8%	110.0%
Dec13	38.9%	37.0%
Dec14	-239.2%	-225.7%
Dec15	17.7%	61.4%
Dec16	10.9%	37.5%
Average (ex. 2014)	13.2%	42.1%

Down the road Amazon will due to size (already a $460BN market equity value) find its natural growth limited to that of its various markets and as such is hoping to cannibalize new sectors, yet as seen with the formerly "invincible" Walmart ($482B sales), its multiple will too compress. And **consumers, at some point, might, as it true with companies, be reluctant to have all their wares supplied by a single source**.

AS SALES SLOW, OWN HIGHER THAN BENCHMARK CREDITS

A 2.30% 10-year treasury yield is certainly atypical eight years into an economic expansion, a reflection of world economies struggling for growth and no noticeable signs a pick-up is around the corner or even in the next town. Even so, our firms continue to produce respectable free cash flows and cash-based return on equity capital aided by patient and productive outlet of their financial resources.

> A 2.30% risk free rate is a symptom of slow growth and a financial system awash in liquidity. As such the proper outlet for investors to maximize long-term returns are firms producing a safe cash-based return on capital above a properly defined cost of equity, with deployment of excess cash under the same hurdles. Firms taking on excess risk due to an ability to raise cheap debt capital are doing their investors no favors, and that includes acquisitions, which now become riskier, if even tangentially outside their historical "wheelhouse."

Our holdings enjoy large market shares, a diverse product and service portfolio in their respective businesses and given their historical use of capital, there is little reason to suspect their normalized historical cash returns on capital will not carry forward, protected by strong calls on credit available to boost future free cash flows should value-additive acquisitions be presented or a financial "event" precipitate such need. Debt maturities over the coming two years have, by and large, been extended ahead of time and at cash flow saving yields.

Our insurers have just modest exposure to low liquidity assets and below-investment grade securities. Additionally, they maintain high levels of capital.

While academia would argue our firms' holdings of higher than necessary cash increases risk, I have not found that to be true for both poorly and well-managed firms, as the latter can use that low after-tax interest-bearing cash in lieu of borrowings to reduce cost of debt capital (which would rise if the interest deduction becomes limited) for projects, value-adding acquisitions, hiring's, and reduction of pension liabilities. Though our firms have more stable than benchmark cash flows, which would argue for lower cash balances, the credit crisis proved all firms are cruelly impacted**.**

*A drop in the cash tax rate would alter leverage ratios due to the deferred tax accounts***.**

With a dour economic outlook, investors should expect a step-up in acquisitions, many of which will, as always, induce operational and credit issues. As these events unfold, we feel we are in a unique position to weigh the financial impacts and, if available, take advantage thru proper evaluation of risks, as has been the case in the past.

While we are always concerned with credit strength and management, we are particularly so as the economy ages, growth slows and the probability of "black swan" events unfold. Though high valuation multiples by itself improves credit quality and is a component of our cost of capital, history is clear: credit can undergo abrupt deterioration, nirvana for stronger firms.

WHAT RATE OF RETURN CAN INVESTORS EXPECT ON STOCKS?

Caveat: Estimates of potential returns should almost always be viewed with caution, especially shorter-term forecasts.

Even so, several observations are certainly in order: any analyst/investor who claims stock valuations are unusually high are lacking in the fundamental principles of security analysis. Such claim must be accompanied and supported by other metrics, such as interest rates (inflation), growth rates in key metrics, consumer confidence, sovereign risk, credit, and other components of cost of capital (risks to prospective real cash flows).

If the bull market is to end it is quite unlikely it will be a result of valuation in and of itself, **but a perception of risk in relation to valuation.** The excesses for most sectors are simply not present while credits, in general, have improved, especially for the financial sector which dragged the world toward the abyss in 2008-2009**. Bear in mind, the S&P 500 benchmark, a difficult yardstick for most advisors, is not composed with valuation in mind, but of quality**. Likewise, firms are not removed from the index due to concerns regarding valuation, save for deep financial distress.

There is every reason to believe stocks will continue to outperform both bills and bonds given inflation is confidently expected to remain low. So while the risk premium has indeed dropped with inflation, **investors must expect and recognize the realistic nominal returns from equities should likewise drop as evidenced during the 2007-2016 period of Table 3**. **Fortunately, for US based firms, a lower sovereign risk should bring higher returns that those found overseas, given the relative greater risks in those countries.**

Annual Returns on Stocks, Treasury Bills, and Ten Year Treasury Bonds

Table 2 Geometric Mean

S&P 500	*S&P 500*	*3-month T-bills*	*10-year T. Bond*
1928-2016	9.53%	3.42%	4.91%
1967-2016	10.09%	4.83%	6.66%
2007-2016	6.88%	.73%	4.58%

Source: Data from NYU Stern: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Boards of Directors today pay particular attention to share prices and will mandate further improvements to the cost structure up and down the organization. **Hence, valuation multiples could expand for those effecting managerial leverage via operational, investing and financing improvements**.

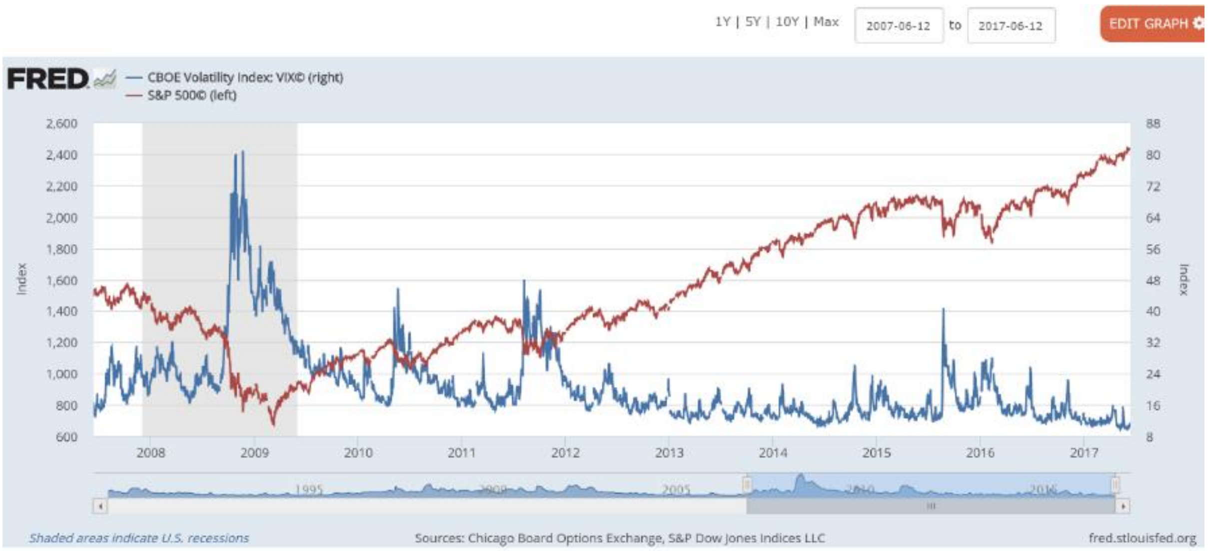
In addition, **there has always been a strong correlation between the level of growth in real (inflation-adjusted) return on capital and the lowering of cost of equity capital with share prices, and especially so when the margin between the two is viewed as sustainable**.

Under the CT Capital worksheets, in which we assess both quantitative and qualitative risks, we conclude a fair estimate of the likely return on benchmarks to be a real 7.2% per year over the coming 5 years, just slightly above the 2007-2017 annual return. We believe our portfolio will return, on average, 8.4% with lower than benchmark risk given its superior credit with higher and sustainable return on capital. As stated, all to be taken as a best guess, but not a bad exercise given the stage in the economic cycle, drop in the risk premium and current structure of interest rates, and superior real business returns on our holdings which continue to engage in value-adding deals.

Lastly, as shown in Figure 2, the VIX has been a forbearer on multiple occasions, including the sharp credit crisis of 2008-2009 though it actually began its normalized ascent in 1993; it began its sharp decent five months prior to the beginning of the bull market where it has been in a general normalized decline ever since. For this reason, the VIX is also a component of the St. Louis Fed stress index[1] as well as our estimate of cost of equity. In fact, the drop in the VIX was much more precipitous following the credit crisis than the Fed stress measure, which is biased toward yields. Yield spreads are also a component in our cost of capital estimate.

[1] See https://www.stlouisfed.org/news-releases/st-louis-fed-financial-stress-index/stlfsi-key for all components.

Figure 3 VIX and S&P 500, 10-Year Comparison



Source: St. Louis Federal Reserve

CONCLUSION

Sooner or later, credit related factors becomes an integral part of security analysis. This has not been the case over the past year, and as seen this past week, investors did not distinguish between credits upon selling of technology shares.

Going forward, firms' ability to improve return on capital, even modestly, will empower their shares above benchmark indexes, assuming its spread with cost of capital widens as well.

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