Dear Partners,

I decided to write this letter a month prior to the actual end of Q3 because a lot has happened that I'd like to update you on. I know you're all eagerly awaiting performance data, which is why I put it at the very end, so you're forced to read the context that goes around it first. If you're really impatient, you can flip to the top of page 12, and I won't blame you. Just make sure you come back here after that.

Rather than getting shorter, this letter has gotten longer… because there's lots to discuss. This goes beyond the standard quarterly update and elaborates in-depth on the development of Askeladden. Feel free to skim.

<u>Your Patience + My Transparency = Our Partnership</u>

It's a pity that BS has no caloric value, otherwise we as a species would have a perpetual source of renewable energy. Someday, I should compile a list of go-to corporate excuses for bad earnings and turn it into a book or a Twitter feed, a la @GSElevator. For example: most citizens of the real world are attuned to the fact that not every day in America is warm and sunny. Yet every year, certain Ivy-League MBAs heading up major public companies are shocked, shocked I tell you: *it rained, omg*, that's why we had a bad quarter.

Some more obscure, but still awesome excuses I've seen:

- "the only way you can actually test for [whether the pants are see-through] is to put on the pants and bend over" (that is a verbatim quote from a CEO on a conference call)
- and another time, a balance sheet reported in some mythical metric called "constant-currency leverage." That is, what debt-to-EBITDA would have been if an imploding Canadian dollar hadn't taken a baseball bat to earnings power while significant debt remained payable in U.S. dollars. I mean, you can try to pay your bank back in fantasy "constant-currency dollars," but you're not going to feel full of joy and confidence while you're making that phone call. [i]

As much as fund managers may love to rag on buck-stops-anywhere-else-but-me executives, in truth, we investors (as a collective) are probably not much better than highly-paid professional-agent CEOs when it comes to taking responsibility. How many times have you heard a long/short fund say "… we're underperforming this year because the market's up too much," and then turn right around the next year and say, "we're underperforming this year because it's a tough market for small caps." Hmm.

Admittedly, sometimes these excuses are valid: value investing could be defined as *the art of being right while often looking wrong*. It's well-documented that some of the best investors of all time – Charlie Munger, for example – underperformed the market frequently and severely during plenty of short-runs on their way to a phenomenal long-run you wouldn't trade in for a new model any day. I would certainly hope that my investors have patience with me during the inevitable periods when I feel like I'm making good decisions, but the market's not rewarding me for them, in the short term.

All fund managers say this, of course; what many don't do is return the courtesy in the other direction. If you want people to be patient during tough times, I feel like you also have to be transparent about the sources and meaning of strong performance during good times. Over the short term, returns aren't always indicative of a good/sustainable/repeatable process, *and that doesn't just apply to bad performance*. It applies to good performance too. After an exceptional start to the year, the question I have to ask myself is:

<u>Am I smart, or did I just get lucky?</u>

For some context on what I mean here, we'll turn to a quote from Howard Marks in *The Most Important Thing*:

> *"In the investing world, one can live for years off one great coup or one extreme but eventually accurate forecast. But what's proved by one success? When markets are booming, the best results often go to those who take the most risk. Were they smart to anticipate good times and bulk up on beta, or just congenitally aggressive types who were bailed out by events? Most simply put, how often in our business are people right for the wrong reason?*
>
> *The point is that even after an investment has been closed out, it's impossible to tell how much risk it entailed. Certainly the fact that an investment worked doesn't mean it wasn't risky, and vice versa. With regard to a successful investment, where do you look to learn whether the favorable outcome was inescapable or just one of a hundred possibilities?"*

Yes, yes, I am entirely aware I quoted these exact paragraphs in last quarter's letter. … but really, why bother reinventing the wheel? It's a critical concept to convey, and pithy enough to quote twice.

Last time, I used that quote to segue into a discussion of my newfound Madden skills (an e-sport from which I am now retired). In a last-ditch effort to top the shock value of writing a hedge fund letter about a video game, we'll turn to… drumroll please… the incomparable GQ interview of Stephen Colbert: [ii]

> *Back at his office, Colbert delivered a soliloquy on the necessity of focus and intention, being fully present for whatever moment you are in. He was talking about comedy, and how to make a TV show 200 times a year, but it also felt like a text lifted from the Buddha's sutras. The final goal, the product, is beside the point. "The end product is jokes, but you could easily say the end product is intention. Having intentionality at all times… The process of process is process."*

Colbert's jokes don't just materialize out of thin air; they're the function of a repeatable, sustainable process that enables him to keep America laughing week after week after week. Indeed, it reads similarly to interviews I've read of other great humorists, like Matt and Trey of South Park fame. If something as creative and "fluffy" as humor can be reduced to a repeatable, sustainable process, then surely investing can as well?

Most great value investors believe this to be the case: results, over the long term, are a function of investment process. I take that a step further and believe, like Colbert, that process is a function of intentionality: utilizing personal agency (free will) to thoughtfully determine the optimal course of action, and most importantly, stick to it day in and day out (while occasionally zooming out to make sure what we're doing still makes sense!).

So I wanted to take this opportunity to dive into my thought process, which translates to my investment process, and highlight what's working (helping lead to some of our gains), while also discussing what hasn't (which is important, because our actions today are what will set us up for continued gains in the future.)

After process, I'll talk about the noncontrollable elements of luck and timing embedded in our performance – one that has benefited us tremendously so far this year, but has already started to swing the other way on some more recent investments we've made. Finally, I'll talk about some open questions that I'm working through – those to which I don't have clear answers (yet), but hope to soon. Balancing open-minded evolution with firm conviction in fundamental principles is the tightrope on which I walk; I want you to understand how, where, and why my thinking is evolving (and where it is staying the same). Bear in mind that our notes in these sections will be <u>very rough and probably not entirely coherent</u>, and we will likely turn these into additional whitepapers over the course of the fall – but we wanted to give our investors and friends a "sneak peek" into what we're thinking about philosophically.

<u>What's working: identifying decent-to-high-quality small-caps trading for unreasonable prices, swinging heavily at easy pitches, and being patient/objective/opportunistic.</u>

We'll start off on a positive note: our core process of looking for decent-to-high-quality businesses trading for unreasonably low prices continues to be profitable. Our most preferred source of ideas is from our internal watchlist - i.e., companies which we like which we have been following for months or years, patiently waiting for the right price. **Franklin Covey** (FC) and **Fogo De Chao** (FOGO) are two such examples – companies which we had been following for 12+ months prior to initiating a position. We believe these investments will have a higher probability of success, since fully understanding the nuances of a business takes time, and even intensive short-term work on a company can often overlook key insights.

However, when we come across a cheap stock (whether sourced internally, from friends/colleagues, or from write-ups on investment idea sites), we are willing to initiate a small position, either scaling up or getting out as the situation and valuation progresses. We did this earlier in the year with **LGI Homes** (LGIH), a Texas homebuilder where we met management, toured a community, and thought that the stock was unreasonably cheap. We purchased a few shares in the low $20s, but waited to scale up the position because we felt we needed to better understanding the broader dynamics of homebuilders, as well as how LGI's model would scale as they started building communities in markets outside of Texas. While we grew more confident in the thesis over time, so did the market – LGIH shares now trade hands in the high $30s, and as such we never really built up our position as we would have intended.

More recently, **Fiesta Restaurant Group** (FRGI), the owner of restaurant concepts Taco Cabana and Pollo Tropical, is another such example – we had read several idea write-ups on the stock published by other investors, and after conducting our own analysis, while we disagreed with the probability of long-term growth in new states and the unit economics that these investors were assuming, we still thought that shares in the low $20s assigned little value to potential growth or self-help initiatives.

However, <u>we remain objective and our views evolve as the facts do</u>. In this case, subsequent to our token investment in early August, several developments occurred: first, near-term comp trends worsened, both for Fiesta and the broader restaurant industry, erasing some (but not all) of the discount to fair value that we saw. Second, the company conveyed to the market that unit economics on new restaurants were not performing as expected (something we had already noticed and priced in when we made our initial investment.) Third, CEO Tim Taft, who had a long history of operating various restaurant concepts in Texas, announced his impending retirement, while the company also announced that it is undergoing a strategic review to reevaluate certain elements of its business plan. Taft appears to be "checked out" from his role and our conversations with the CFO and IR do not suggest there is any organizational urgency around improving service levels at restaurants (which should be basic blocking and tackling). Concurrent with all of this, the stock rose 10% from our cost basis, eliminating the asymmetry of the risk-reward opportunity which we originally saw, and leading us to question whether continuing to own the stock made sense.

Without getting into the weeds of the analysis (as it's beyond the scope of this letter – although I'm happy to discuss elsewhere), I came to the conclusion that I just don't like this company enough (especially not at this price) to justify the amount of monitoring and further analysis which continuing to own it would require. Resource allocation is the fundamental challenge of every organization, and simply put, my time is better spent working on other ideas which are more compelling than trying to bang my head against the wall on FRGI. I'm usually loath to incur short-term capital gains, but I also don't want to let the tax tail wag the capital dog – and in this case, particularly given our other restaurant holding (FOGO) which I am much more comfortable adding to at this price, I decided that it was best to thank FRGI for the quick gains and keep that powder dry for future opportunities. I am happy that I avoided "commitment bias" and "endowment effect" on this investment thesis – I feel that my objectivity was not colored by my ownership, allowing me to make the business decision to allocate our time and money elsewhere.

Before we move on to the aspects of our process that we're improving on, I did want to address the elephant in the room: i.e., our mega-sized position in Liquidity Services, which for better or worse, will continue to be a significant driver of our returns. Even after its run from under $5 in February to over $10 as I write this, we continue to believe that Liquidity Services is one of the best risk-rewards in the market today. Auctioneer Ritchie Bros just purchased private competitor IronPlanet for a valuation that would imply LQDT is worth $18 - $22 per share. While we believe this is an aggressive valuation, it does at least provide an additional data point corroborating our belief that LQDT is worth $15 - $20 over the next two years – dramatic upside, with risk limited by the $4 per share in cash on the balance sheet.

In context of the Howard Marks quote that I'm so fond of citing, what you should be asking me as an investor is: <u>are you a one-hit wonder, Samir?</u> Indeed, I have been open (with LPs and fellow investors) in describing Liquidity Services under $6 as a once-in-a-career investment opportunity, as we had the option to buy a leading online e-commerce platform with a motivated owner-operator CEO for close to free (net of the cash on the company's balance sheet). As such, we do believe that our performance YTD is unlikely to be repeated over multiple iterations of the universe, and would caution investors that past performance is not a good indicator of future results.

All that said, I think it does bear noting that our process continues to yield a fairly diverse set of fruit – while we would typically be happy with a good idea or two per quarter, we have, so far this year, generated substantially more ideas than that. For your reference, I have prepared a table listing the absolute and relative performance of every security we have purchased this year, from date of first purchase through the present:

Security	**First Trade Date**	**First Trade Price**	**Price Today**	**Return (Absolute)**	**+/- Relative To S&P 1000 TR Over Same Time Period**
ADT	1/11/2016	$ 30.30	$ 42.00	39%	17%
BOOM	3/11/2016	$ 6.62	$ 10.31	56%	43%
CRAI	1/11/2016	$ 19.18	$ 26.44	38%	16%
CSWI	7/1/2016	$ 32.35	$ 31.20	-4%	-9%
EHTH	1/11/2016	$ 10.06	$ 11.25	12%	-10%
FC	4/7/2016	$ 14.95	$ 16.11	8%	-4%
FOGO	6/24/2016	$ 13.03	$ 12.20	-6%	-14%
FRGI	8/3/2016	$ 21.90	$ 25.07	14%	13%
KFY	7/22/2016	$ 23.67	$ 24.46	3%	2%
LGIH	3/10/2016	$ 24.15	$ 38.50	59%	45%
LQDT	1/11/2016	$ 5.80	$ 10.06	73%	52%
ORN	1/11/2016	$ 3.59	$ 5.30	48%	26%
PB	1/11/2016	$ 42.35	$ 54.71	29%	8%
SNC	8/26/2016	$ 10.25	$ 10.11	-1%	-2%
WIN	1/11/2016	5.95	8.62	45%	23%
Average				28%	14%
Median				29%	13%

(Note that we have excluded Essex Rental [ESSX] from the calculations as we consider it a special situation; our strong gains from our modest investment in this security should be viewed as non-recurring.)

A few things to note here. First, even an equally-weighted portfolio of the ideas we generated this year would have outperformed the market over the past 8 months (for what little that's worth.) i.e. while we are not suggesting that this level of performance is sustainable (by any means), we did want to highlight that even were it not for our outsized position in Liquidity Services, we would be having a pretty darn good year on both an absolute and relative basis.

Second, as demonstrated by the fact that actual returns far outstrip equal-weighted returns, <u>we clearly added value via portfolio management – when prices were attractive, we allocated heavily to our best ideas.</u> We scaled up in PB when it dipped into the $30s for no reason, and similarly swung hard at FC when it dropped into the $13s and $14s after earnings due to market misunderstanding of the company's deferred revenue (as you may remember from the write-up we sent around). We also bought additional EHTH when it fell into the $9s on news of long-time CEO Gary Lauer's retirement.

We will come back to this notion of opportunism later when discussing the fund's cash position (which to our knowledge, remained double digit at all points in the year; it stands at over 20% today and has bounced around between 15 and 25% for most of the year – so our <u>excess returns are not the function of leverage</u>, which we do not intend to utilize unless circumstances become extraordinary.)

Third, and perhaps most importantly, <u>patience is important</u>. While we look pretty smart today for buying names like LQDT, CRAI, and ADT at the prices we did, <u>we had to endure significant volatility to earn our returns.</u> Below is a table demonstrating just how low these securities' prices fell before they ran up to current levels (note that in the case of ADT, I'm using the buyout price):

	Initial Purchase Price	**Year Low**	**Current Price**	**Biggest Mark To Market Loss**	**Gain To Date**
ADT	$ 30.30	$ 24.22	$ 42.00	-20%	39%
CRAI	$ 19.18	$ 16.50	$ 26.44	-14%	38%
LQDT	$ 5.80	$ 4.55	$ 10.06	-22%	73%

In all three cases, no fundamental event occurred to justify the significant share price decline. We will never exactly time the bottom, and we're fine with that.

Similarly, if you scroll back to the table above, you will notice that we are down on some of our newer investments like FOGO and CSWI. This does not concern us, the same way we were not concerned when we were down significantly on ADT, CRAI, and LQDT (all of which ended up being very lucrative investments). In some cases, we are utilizing the dips to increase our position; in other cases, we are sitting patiently. We will come back to this concept in the performance section.

<u>What didn't work: disorganization and poor prioritization.</u>

Amidst a year with the sort of performance we've had (which we haven't numerically disclosed yet… but we've hinted it's very good), it would be easy to pat ourselves on the back and say that everything's going swimmingly. But as I've now stated repeatedly, future returns are a function of current process, and as such I am always critically examining my process and finding areas for improvement.

The biggest area where I needed to improve on the investment side (and have taken steps toward doing so) is <u>organization and prioritization</u>. I was the kid who never made his bed and always had books strewn all over the floor… and let's face it, I still am. I have bigger fish to fry than whether my bed has hospital corners: it's just not a good use of my time.

In other areas of my life, however, organization is critical: woe would be me if my response to a random Texas State Securities Board audit were to be "I'm sorry, I misplaced that document." Similarly, I've quickly realized that my investment process needed an additional dose of organization. As you know, part of my process is to build a database/repertoire of intriguing companies that I follow over time. While I had prepared a spreadsheet for this purpose, I was simply bad about updating it, and taking simple "blocking and tackling" steps like setting up price alerts and filings alerts for companies.

As a result, in retrospect, I have realized that there were several attractive investment opportunities I missed in Q1, particularly in February, that I should have made. These were names which I was familiar with and had already done most of the work on (in Pareto Principle terms, the "80%.") All I had to do was pay attention and do a little bit more work, and I could've made those investments. The fact that I didn't is patently unacceptable to me – I was focused on other, lower-priority, lower-payoff research projects and frankly just dropped the ball. Worse yet, this happened again in June with Korn/Ferry – the idea was served up to me on a silver platter by a fellow fund manager whose analysis I respect. I had the opportunity to buy shares at an even more attractive price than that at which I eventually bought them a month later, but I was procrastinating on working on the name while working on other, less attractive names that were less likely to yield interesting ideas.

Going back to results vs. process, it's interesting to note that I don't think there really would have been any material difference to portfolio results – perhaps I would have held a little less cash and we'd be up an additional 50-100 bps, or perhaps I would've just run a little more diversified portfolio and ended up in the same place. But remember, not every year will be like this year, where we have a plethora of interesting investment ideas. And how stupid would I feel if I missed the next Liquidity Services, after already having done the work on it, because I wasn't paying attention?

Mistakes happen, and I have a growth mindset[iii]: rather than berating myself for making a mistake, I'm using it as a learning opportunity. I have adjusted my process and am focusing hard on being more organized. I'm keeping notes more arranged; I'm making sure each security I analyze gets a price target in my spreadsheet, and I am in the process of determining how best to track all the companies I follow. My ad-hoc methods sufficed when I was following a small number of companies, but as my list grows ever-larger, I need to be more organized and diligent – a small up-front investment of time in keeping things tidy will have a big back-end payoff by allowing me to efficiently surface the highest-priority research projects at any given point in time. I apologize for this unforced error and promise it is being corrected.

The role of luck.

Luck is not strictly quantifiable: it is impossible to disaggregate how much of our performance this year is due to skill, how much is due to opportunity set, and how much is due to luck. The three factors blend together. But it's undeniable that I can control WHAT I buy, and at WHAT price, but unfortunately, I cannot control WHEN the market gives me opportunities, or WHEN the market will recognize the same things I do and bid the stock up to a higher price reflecting fair value. The latter two are luck; all we can do is be prepared for it.

Compare and contrast the examples of Charles River Associates and LGI Homes this year with that of ADT or LQDT in previous years. For all intents and purposes, both CRAI and LGIH normalized to fair value within 6 months of purchasing them – there were small dips and bumps along the way, but it was pretty much a straight line up.

On the other hand, I initially purchased ADT shares a few years ago around $30, at a similar price to where I purchased them this January. I firmly believed that the company was worth more than that, and was eventually validated by Apollo's buyout at $42 – which delivered a fantastic IRR on our purchase in January. That being said, my IRR over a longer timeframe from my initial investment would not look nearly as favorable; while it was solid (somewhere in the teens depending on the exact tranche of stock), it certainly wasn't as good as it looks. (Note: this is why we moved from using static point-fair values to an IRR/CAGR based approach – to ensure that we don't get trapped in dead-money value traps.)

Similarly, I actually bought my first shares in Liquidity Services at $10 in late 2014, and continued to build my personal position at prices starting with $7 and $8 through 2015 – meaning that in my personal account, my performance on Liquidity Services does not look nearly as exceptional as it does within the fund.

Again, portfolio management and sizing positions proportionately to the magnitude of the opportunity makes discussions like this a little simplistic, as the first price at which you buy a stock doesn't matter nearly so much as your weighted cost basis on it. Moreover, I certainly learn something (and hopefully improve from) every decision I make that doesn't work optimally. But while I am pleased with how this year has gone, you should not yet view it as a validation of my process: eight months means very little. I still have a lot to prove.

Taking this discussion a little further, last quarter we discussed our new investments in **CSW Industrials** (CSWI) and **Fogo de Chao** (FOGO). Since our initial investments, the fundamental outlook for both companies has modestly deteriorated – CSW was hit by an unexpected further downturn in the railcar market due to continued low oil prices, while Fogo was hit by softening comparable store sales trends (along with the rest of the restaurant industry). It is almost certainly likely that these securities will not go up in a straight line for the next six months as some of our holdings earlier in the year did. However, validating our approach of buying high-quality businesses at a discount, even the reductions to fair value estimates that we made as a result of unforeseen softening of the macro-environment for these companies still left our purchase prices looking cheap relative to fair value, and we remain completely confident that they will prove to be attractive investments over our multi-year time horizon (even if they don't look that way in the short term.)

I am impressing this concept of patience upon you because <u>I want to set realistic expectations</u>: we are unlikely to have another year like this one, ever, and on the other hand, it is very likely that there will be down years, flat years, and modest/so-so years on our journey. I judge my own performance in the short term by whether or not business fundamentals are tracking to my expectations; if the businesses we own do what I expect them to, then over the long term, the stock prices should take care of themselves, hopefully leading to long-term annualized returns for investors in the low to mid-teens (net of all fees, i.e. that's what I want you to take home). This is obviously not a guarantee, but it's what I'm striving for: and given current market valuations and the performance of most funds, it would be an exceptional long-term track record.

<u>Open question: the role of cash</u>

A perpetually challenging question on which many smart investors have divergent opinions is the proper role of cash in a portfolio. I am undoubtedly going to irritate a lot of our friends and colleagues with this statement, but: I think that many fund managers who are (and have been) holding substantial cash balances and whining about valuations/the Fed/macro/whatever are using cash positions as an excuse not to do their jobs: i.e., to spin underperformance as a good thing, while still pocketing a tidy sum of fees. Boo!

In my opinion, this approach represents blatant intellectual dishonesty and laziness. While finding ideas in today's market environment is not easy by any means, my research is still unearthing plenty of securities that meet my quality threshold and are trading below reasonably conservative estimates of their fair value - so I have no reason to cower in cash. (I'll get to explaining my current 21% cash allocation momentarily.)

Outperforming the index is hard, which is why most funds don't want to tie their performance to doing so. They want to be able to utilize excuses such as "low net exposure" or whatever to charge high fees while delivering performance worse than what you could get, for nearly free, by investing in an index fund. I firmly believe that I'm not doing my job if I don't outperform the index, which is why I've set up my performance allocation to only kick in <u>when I outperform the index over our three-year investment time horizon.</u> If I don't outperform, I don't earn a performance bonus – it's as simple as that.

As has been discussed (and will be imprinted upon you one more time), I won't outperform the index every month, of course, nor every quarter nor every year nor every rolling three year period – but if we're sitting here in five years' time and I haven't delivered significant gross and net outperformance versus the index, even from the starting point of already having significantly outperformed YTD, then you should probably pull your money and put it elsewhere.

To this end, then, there's a balancing act between maintaining enough cash to be opportunistic while also not setting the bar for new positions so high that we end up sitting around with way too much cash and not earning returns. What a lot of investors who are trying to time the market don't consider is the notion of opportunity cost. Say that you're holding cash in hopes of a market downturn, but that you could allocate that cash for a 12% return if the market didn't go through a significant correction. Whatever your cash position may be, if we go two years without a 25%+ market correction, you would, mathematically, have been better off investing that money. (Going back to analytical vs. behavioral edge – this is a math problem that a reasonably competent 12-year-old could do. It's not hard to figure out. The question, of course, is whether anyone is bothering to think about it clearly and make a good decision.)

Ultimately, we see a lot of people who claim to be value investors but in reality incorporate a heavy dose of macro timing into their approaches. This is not our game. As we have conveyed on numerous occasions, I don't believe I have any special ability to predict the macro, or market valuations, or monetary policy or whatever things other investors apparently care about.

What I'm good at is understanding individual businesses, and what they are likely worth. So I focus on that, to the exclusion of what people may or may not think about overall market valuations. An analogy: it really confuses me why someone would not pick up free dollar bills on the sidewalk outside an overpriced ice cream shop. Maybe that shop eventually has to lower its prices, but what does that have to do with the free dollar bills? It doesn't. If I find an attractive security, it's a complete waste of time worrying about what <u>other securities that I don't own</u> (i.e., "the market") may or may not be worth. That has zero fundamental bearing on what I should be willing to pay for the security I'm looking at, or whether I should be willing to own it (in bulk) if it trades at an attractive enough discount.

So why the targeted 15 – 25% cash allocation, if not because "macro fed fed fed wahhh," then? Simply put, we have been through corrections – either in the market or in individual securities – where fantastic opportunities arose and we didn't have dry powder to deploy. Therefore, we use the cash position to allow us to pile into exceptional opportunities like Liquidity Services at $6 or Franklin Covey at $14. In the words of former Baupost partner Brian Spector, who spent a long time working with Seth Klarman,

> *One of the most common misconceptions regarding Baupost is that most outsiders think we have generated good risk-adjusted returns despite holding cash. Most insiders, on the other hand, believe we have generated those returns BECAUSE of that cash. Without that cash, it would be impossible to deploy capital when we enter a tide market and great opportunities become widespread. Seth has said on a number of occasions in both types of markets, 'If you have great ideas, you will have capital to deploy.' This is incredibly motivating to our investment team.*

Charlie Munger also calls cash a "call option on every other asset." But the key here is that the cash isn't being held for its own sake! You have to be willing to deploy it when exceptionally attractive opportunities come along, and we fully intend to do so. Trust me… we're eager and looking. But we remain patient and need something compelling to "fire our last bullet" so to speak. Our views on cash may evolve over time, but at the moment, we believe having cash around to build one or two big positions at really favorable prices is a nice balance of not being *too* conservative with also providing us the flexibility to be opportunistic.

<u>Open question: investment time horizon</u>

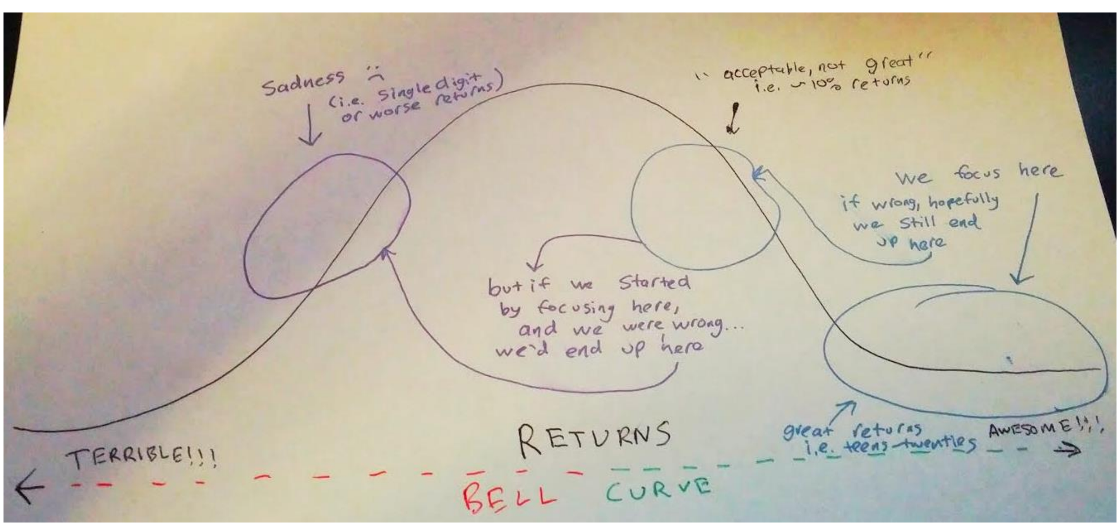
Perhaps one of the greatest challenges investors face is balancing being an adaptive, open-minded learner who is willing to evolve, with the imperative to stay focused and stick to a well-defined process. There are many investment approaches that are philosophically defensible, but there are some (for example, asset plays) which we are just not interested in exploring at all due to the frequency and severity of our bad experiences with them – and others (like merger arb or short-selling) which we are just not interested in thinking about because they don't suit my skillset and personality types.

That said, within our overarching framework of "decent to high quality businesses selling for less than they're worth," there is a lot of room for flexibility. I have had conversations with many smart investors with differentiated perspectives from mine, who are more willing to buy good businesses and hold them for a longer time horizon than my typical ~3 year outlook. Their argument is that truly great businesses are so rare that if you find one selling for a discount, you should be willing to take a long time horizon and take the "sure" 12-13% compounded return over a multi-year period vs. trying to optimize for maximized annual returns over any given 3-year period (which is my core process, with the 20% 3-year hurdle rate/etc.)

Admittedly, in an expensive market where compelling ideas are hard to find, this approach looks tempting – there are several high quality "compounder" businesses (State National, CSW Industrials, and Prosperity Bancshares) which we have bought stakes in notwithstanding that they didn't meet our hurdle rate, as we believed the business quality and other intangible factors were enough to outweigh the fact that they didn't quite make it to our hurdle rate.

However, although we're willing to do this occasionally, and in small quantities, my current belief is that I'm best optimized to find good-to-great businesses selling at deep discounts, and selling them once they normalize to fair value. Conceptually, imagine the stock market as a bell curve. Because I'm focused on a small number of small companies, with a small amount of capital, I am able to take a very imprecise approach to valuation and purchase only those companies which are obviously pretty far out on the bell curve – that is to say, the truly exceptional opportunities, where even if you're a little wrong you're still pretty right.

But once you no longer have a quantitative margin of safety via a deep discount, predicting things more precisely becomes more important to generating above-average returns – at the edge of the bell curve, even if I'm wrong by a lot, I'll still earn good returns (shoot for the moon, fall into the stars). Whereas when you get closer to the center of the bell curve, if you're wrong by a little, that can mean a lot from a returns standpoint. I prepared the diagram below to try to demonstrate this:



Beyond this logic, I simply feel like there are a lot of people who assess business quality probably better than I do – they run funds in which you could invest – whereas my strategy is a little more unique (to my knowledge). Our small size will also allow us to be more nimble and capture those opportunities like FC or LQDT trading at a deep discount for absolutely no fundamental reason at all – so we will continue to look for those opportunities.

Open question: depth vs. breadth of research

Going back to process improvement, another issue which has come to my attention is that my research efforts during the first half of the year were probably too deep, and I need to back off a little bit. (No, you are not going to hear another fund manager tell you, to your face, "I'm going to research companies in less depth going forward.") Hear me out here.

First, go read this paper that I wrote on why primary research is overrated.[iv] Second, go back to the bell curve… the truly exceptional opportunities are a combination of great business (which are usually pretty easy to notice) and can't-miss valuation (which is also usually pretty easy to notice). To my recollection, there is not a single time when I've spent eons working on a business to discover that the market was missing some small detail that made it a great buy – rather, I notice such things early on, and due diligence is just to confirm that there's nothing weird or wonky that I'm missing. Due diligence is a reason to say no, not yes.

This isn't to say that deep research can't be valuable; I've previously mentioned my extensive work on **Dynamic Materials** (BOOM) including multiple trips to meet employees and tour facilities. However, at the end of the day, all this did was confirm our notion that Dynamic Materials was a high-quality, well-managed company whose fate as an investment *is heavily tied to the price of oil.* Arguably, we would have been better off spending that time sourcing another three potentially intriguing companies to add to our watchlist.

While, over time, I will likely spend more time delving deeper into watchlist names rather than sourcing new names – as, to some degree, there is a finite list of potentially interesting companies that meet our size and business quality criteria – I have decided that the most valuable thing I can do with the last four months of the year is to rapidly build up our watchlist of potentially interesting companies while continuing to monitor existing companies (see process commentary earlier). If the valuation isn't immediately obvious on new companies, then I have plenty of time to dig into the details over the coming months and years.

But it is important to always be looking. As a smart investor who I was conversing with via email put it:

> *This work is largely about turning over stones to see what is underneath and learning to be strategic about which stones to turn. If you are not good at or improving those skills, you will lose to someone that is. That said, just because you are looking, doesn't mean you will find stuff but you increase your odds of finding something the more things you look at and you build your cumulative knowledge to be well positioned for the future when prices change. It's way easier getting up the curve on something (stock, industry, etc) you've already reviewed than starting fresh...*

Business and Personal Update

More than any other section of this letter, this is the one I'm most proud of. =) There have been a lot of developments in the past few months that bear mentioning.

First, as many of you know, Askeladden's launch process during the first half of this year involved significant frustration; I spent a lot of time and mental energy on non-productive, non-value-added things. Moreover, as is the case for all startup funds, capital raising was challenging – particularly since I stuck to my guns and didn't spend a lot of time (actually, any time) actively marketing. On top of all that, it was definitely an adjustment period going from the stability (and laziness) of a consistent paycheck to being a full-time business owner – one who holds all 17 job titles and is, at the end of the day, responsible for literally everything. That takes practice and thought to learn how to get right without going crazy.

Recently, most of the compliance/operational issues have settled down and I've gotten much better at what I jokingly referred to, in a conversation with a high schooler I'm mentoring, as "entrepreneur-ing" and "adult-ing." That is to say, balancing all the stuff on my plate, and rolling with the punches as they come.

Speaking of rolling with punches: last time, I mentioned that I was applying for a part-time role as a GMAT tutor to bridge my cash flow needs until such time as the fund scales. While was invited to New York City after no fewer than three successful auditions, I was unfortunately not ultimately selected for the position. Don't cry for me; I got a cronut out of the trip – and something much sweeter: traction with capital raising.

What I have discovered is that my unconventional approach of authenticity, radical transparency, and a calm/clear/thoughtful/logical investing process resonates with a certain kind of investor who is tired of the dog-and-pony-show put on by many advisors who talk a big game but ultimately don't deliver. Unlike those advisors, I don't pretend to know everything and I don't pretend to be someone I'm not and don't pretend to do things I can't, even though this honesty closes me off to a substantial majority of potential investors.

Over the past few months, the number and quality of capital conversations I've had has picked up dramatically. Almost all of these conversations have arrived via people encountering my idea write-ups or thought pieces/interviews on sites like Seeking Alpha, Harvest, or SumZero. This kind of "passive marketing" is particularly effective because it doesn't take very much time at all (I'm a fast writer), and means that any conversations I have are already screened – i.e. there's no chance of wasting time talking to someone who just won't be a philosophical fit.

Finally, on the cash flow side, I'd like to inform you that I've made the decision – at least in the medium term – to focus entirely on the fund and not seek additional sources of cash flow (beyond Seeking Alpha) to pay fund and personal bills. (I made it to the final round of interviews for the GMAT tutoring role, but the company ultimately didn't select me, which may be a blessing in disguise.) Given recent traction gained with capital raising, as well as strong recent performance, I'm confident that I will attract enough assets to get the fund to breakeven within the next 12 months (if not sooner.) Considering that I have enough money saved up to pay fund and personal expenses for over six years, I believe it's time for me to stop being "one foot in and one foot out" and make an all-in bet on myself – Askeladden is my future and it's what I'm focused on.

Performance

What you've all been waiting for… all the usual caveats[v] apply:

	YTD through 8/31
ACP Gross	~55%
ACP Net	~44%
S&P 1000 Total Return	~21%
Gross Outperformance	~34%
Net Outperformance	~23%

Now you know why I wanted to set the context first. Things are going well, but this sort of absolute or relative performance during any eight-month period is unlikely to be repeated over multiple iterations of the universe.

Just to reiterate why patience is necessary, and why you should never get too excited (or depressed) about any given month, we wanted to give you some context on how we got from point A to point B:

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
ACP Performance (Gross)	~+7%	~--12%	~+10%	~+9%	~+10%	~+9%	~+4%	~+10%
S&P 1000 TR Performance	~+1%	~+1%	~+8%	~+1%	~+2%	~+5%	~+5%	~+1%
ACP +/-	~+6%	~--13%	~+2%	~+8%	~+8%	~+4%	~--1%	~+9%

Note: numbers are approximate; pulled from our statements but there may be typos… this is for illustrative purposes only.

As you can see, February was unkind to us, in no small part thanks to our investment in Liquidity Services – an investment which we are obviously happy to have not only made, but added to. Just bear in mind that if you had joined the fund on Feb 1, you would likely not have been very happy when you opened your month-end statement to find us down 12% (gross) during a month when the index was up 1% - but this is the price that Askeladden investors must pay for excess returns. You can have steady returns, or you can have good returns, but you can't have both: and we are optimizing for maximizing long-term returns with absolutely no consideration of interim volatility. Our concentrated small-cap strategy lends itself to periods of very high volatility (but is also what will hopefully enable us to deliver superior long-term returns). Please expect many more months like February. If I make mistakes, I will acknowledge them clearly and let you know what went wrong and why… but in many instances, short-term results (whether great or terrible) mean little to nothing.

I realize this letter was long, but I've decided that I'll write my letters exactly as long as they need to be to transparently convey everything that's on my mind and what I'm working on. You are more than free to skim them, or not read them, but for those who are interested in more depth, this is a more efficient way of providing the basics rather than spending my time repeating the exact same information via multiple one-on-one conversations (thus allowing me to instead allocate that time to value-added research).

You are of course free to follow up with me with any specific questions, thoughts, or comments you may have.

Westward on!

Your friendly neighborhood hedge fund manager,

Samir

Endnotes

[i] If you were wondering, no, I am never going to stop quoting Matt Levine's Swiss Franc article from January 2015, because it's just basically the pinnacle of snarky finance journalism and I can never hope to best it.

[ii] This interview ranks up there on my list of "most important pieces of content in my personal development" right along with Covey's *7 Habits*, Achor's TED Talk, Brene Brown books, Ayn Rand and Aristotle, etc. You should go read it. It's really great.

[iii] http://www.edweek.org/ew/articles/2015/09/23/carol-dweck-revisits-the-growth-mindset.html

[iv] https://www.hvst.com/public-pages/askeladden-capital-management/posts/69311-why-primary-research-is-overrated

[v] Verbatim disclosure quote from the Q2 letter: *Each investor's performance and fees will vary depending on their entry date into the fund; the results we present here are very approximate (hence the lack of decimal-point precision) and are intended as directional color rather than gospel truth. The numbers in the blue box are the most important – what you get to take home, and how much better (or worse) we're doing relative to the benchmark. For the purpose of evaluating the performance of your investment, please rely upon your monthly statements from Fund Associates and your annual audited statement and K-1 from Spicer Jeffries. Please remember past performance is NOT indicative of future results.*

Fees in that table are calculated assuming the investor is a "qualified client" charged the standard 1.5% management fee and 30% performance allocation on any outperformance vs. the index. To reiterate, we believe this aligns our interests with yours, as I will earn substantial performance fees during periods when we do very well, and will not earn performance fees during periods when we're underperforming. In other words, if we don't do well, our fee structure is like a (somewhat expensive) mutual fund; if we do well, it converts to more of a hedge-fund like structure. Accredited but non-qualified clients are charged a flat 1.95% management fee since we cannot legally charge performance allocations. We wish we could, but… if I do my job, a flat 1.95% will likely be cheaper for you.