

URI | *Capital Partners*

For the full year 2013 URI Capital Partners returned 27.4% after all fees and expenses. That brings its return to 32.4% after all fees and expenses since its opening in early August 2012. While those may be considered good results, recognize that we are investing for the long term and any short term measurement carries many caveats, not the least of which that future market volatility could reverse some or all of those gains. With that in mind however, I believe the companies we own are very well positioned for the long term. They are above average companies and we own them at below average valuations. In short, I remain optimistic about our long term performance but cannot and will not attempt to prognosticate how we will perform in the short term.

“Shallow Risk vs Deep Risk”

Returning to the idea of market volatility, I want to touch on a compelling description I read about risk during this past year.

In a recently published book called “Deep Risk,” author William Bernstein discusses the difference between what he calls “shallow risk” and “deep risk.” Think of “shallow risk” as the risk of short to medium term volatility. Put another way, this is the risk that stock prices will fall. The inevitable ebbs and flows of the market ensure that any investment in the stock market will carry such “shallow risk.” “Deep risk” is risk of a different color however and much more problematic. While “shallow risk” entails temporary losses (even if temporary can feel like a very long time), “deep risk” is the risk of a permanent real (after inflation) loss of capital.

“Shallow risk” is a stock price dropping day to day, month to month or even year to year. “Deep risk” is where a business permanently goes away or where an investment’s value is permanently lost. There are many company specific paths to “deep risk” but the most common and enduring source of deep risk in inflation. And in that way, a business can continue to operate and still be subject to deep risk. Say a company is worth \$1 today and that investment could be sold to buy an entire candy bar. In 20 years, that business could still be worth \$1 but has actually suffered a permanent investment loss since that \$1 20 years from now may only be able to buy a stick of gum. You did not lose money in absolute terms (you still have the \$1) but that investment which used to be able to buy an entire candy bar can then only buy a stick of gum. You most certainly have lost in that scenario even while holding on to that same \$1 in absolute value. Interestingly, some in the financial and academic community would say you have taken on no risk since the value of that \$1 did not move around; there was no volatility and thus the investment was “safe.” You might ask that person for their candy bar in exchange for your piece of gum.

Now, the hard part: to mitigate “deep risk” you have to take on a level of “shallow risk.” As economists would say there is no free lunch. There is no perfectly safe path to sustainable wealth creation. Recent history has shown the depth to which “shallow risk” can grab a hold of stock prices. In March 2000, the S&P 500 hit a then record of 1527. It returned just past that high to close in October 2007 at 1565. Fast forward to early 2009 and the S&P 500 hit a low of 676. The S&P closed 2013 at 1848. It certainly was a wild ride from March 2000 to the end of 2013. There was much in the way of “shallow risk”. That being

said, through a dot com collapse and a near Depression aptly named the Great Recession, the S&P returned generated an aggregate positive return through the roughly 13 year wild ride. Add in the dividends paid through that period of time and the overall returns were higher still.

So, what is hard about “shallow risk?” In short, it is our emotions. It is wrenching to watch the market fall, particularly when it is carried play by play on CNBC. Add on the proliferation of news sources that capture and disseminate “information” on the whys and the ins and outs of market declines and it can become too much to bear. For a moment however, contrast the excessive amount of information that we sometimes attribute to knowledge and understanding with how you would approach owning a private business not subject to a stock price whipping around.

Let’s say you own a McDonald’s at the corner of a busy intersection. You likely own an incredibly successful business. What if however there was a major road project that slowed your customer traffic for a few months or even many months. While there would be some amount of short term pain, there would be no long term reduction in the value of your business. In fact, the road project may over time increase the amount of cars and customers that pass your McDonald’s. Given those facts, you would never consider selling your business for half the value you ascribed to it before the road project began. In fact, if you had a partner who was willing to sell at that price you would likely find a way to buy his stake.

So, why do we often desire to sell our publicly traded companies when they are on sale after they have declined precipitously in value? It comes back to emotions amplified by the noise created when we and others try to make sense of why the market is going down. The proliferation of time dedicated to financial markets has led for a hunt for information that often leads to too much information and opinions crowding out our search for actionable knowledge. We should focus on the performance of businesses and what their long term future holds rather than trying to understand and explain what causes stock prices to move around in the short term.

So, how can one cope with the emotional pulls of “shallow risk?” It starts with a strong emotional and financial foundation. First, put all things financial in perspective with their relative importance. As for finances, have a strong and stable cushion of cash available for emergencies and difficult times so you have the fortitude to stick with your longer term investments. You might be asking: isn’t cash a sure path to “deep risk” since it is nearly guaranteed to lose purchasing power over time by way of inflation? Yes, but a certain level of cash is both prudent and required to maintain your long term horizon in the face of ebbs and flows in the market as well as ebbs and flows in your own personal finances.

As for the fund, we will remain concerned with how businesses perform and their ability to generate real (after inflation) rates of return on our investments over the long term. In effect, we are concerned with “deep risk” while recognizing that we must subject ourselves to “shallow risk.” In that regard, we embrace the tradeoff that our quarterly statements may move down in value through the volatility of stock prices driven by short sighted, emotion drive decision making in order to sustain longer term after inflation wealth creation.

To summarize, we are targeting strong long term returns while having less concern for our short term performance.

“Invert, Always Invert”

I have been reading all the Berkshire Hathaway annual letters from 1964 to today. The letters are a treasure trove of information *and knowledge*. You can trace market history, economic history and even the history and cycles of insurance and other industries. Importantly, there are many wise pieces of counsel about investing and business that are distilled down to easy to understand stories and examples.

One such trove of knowledge comes from the 1981 annual letter which contains a discussion on the importance of owning “good” businesses relative to “bad” businesses.

To set the stage, remember that interest rates were much higher than they are today (long term taxable bond yields exceeded 16% and long term tax exempt bonds yielded 14% in 1981 as an example). To justify a productive investment in a business requires that business to generate returns on equity above prevailing interest rates while also paying a fair price for the equity that generates such returns. With the hurdle rates being so high in the early 80s only the best companies generating high returns on equity could sustain inflation adjusted wealth creation.

Now, fast forward to today and, as Charlie Munger would say, “Invert, Always Invert.” We are in the near inverse of the early 80s today with short term rates hovering near zero and longer term rates struggling to move above three percent. While the rate dynamic is nearly the inverse today, the need to own high quality businesses that generate high returns on equity remains true even if prevailing low rates “blind” us to that need.

With interest rates as low as they are, there is little “penalty” for being in bad businesses. The opportunity cost when rates are so low is very small. Thus, it does not hurt like it ordinarily would to be in businesses or investments that generate low rates of return. Bonds are the most obvious example of this with the return on loaning money to the government for ten years staying below three percent. This however is just the most obvious example. Companies that trade at multiples of their earnings well past 100 would be much more difficult to justify if rates were higher. Companies that generate low returns on equity can slide by with rates as low as they are today but would look much less attractive at higher hurdle rates of return.

Meanwhile, there does not appear to be an appropriate premium placed on some businesses that generate tremendous levels of free cash flow at high rates of return on the capital employed to generate such free cash flow. In effect, there has been little opportunity cost to owning subpar businesses and in fact many such businesses have attracted a lot of investment and a lot of attention. Those businesses often are perceived to have a bright future some numbers of years down the road. Today, waiting for the future does not seem to cost that much so valuations on future prospects carry a disproportionately higher weight and higher value than they should. In effect, too much is being paid for the hope of tomorrow while not enough weight is placed on the reality of today and this is at least in part created by the low cost of time as reflected by low interest rates.

But what if tomorrow is different than today? What if rates do eventually rise? How will all that hope for the future be priced? It is impossible to know the how and when of changes in interest rates. It is however reasonable and prudent to assess the various risk profiles associated with such potential changes. At this point, it is more likely (though not guaranteed) that rates will go higher than lower over the medium to long term. If rates were to go higher, what would be the impact? What would you want

to own? To me, the answer is clear. You want to own high quality companies that generate high returns on equity while producing large amounts of free cash flow that require minimal amounts of capital expenditures to grow and sustain the business.

Companies

The fund now owns 15 companies and a relatively modest cash position. We have and will continue to increasingly focus on our best ideas which means we hope to dedicate increasing percentages to our top ten companies.

Four companies were specifically mentioned in last year's annual letter: Berkshire Hathaway, Viacom, JP Morgan and Microsoft. We still own all four. Much of our thesis remains but a short update on each follows in addition to a short discussion on two new investments in 2013.

Berkshire Hathaway: in what is likely to remain a constant theme, the business of Berkshire continues to grow and improve. While not as attractive as in late 2012 Berkshire remains a solid long term holding (this will also hold for the other companies we discuss). In fact, Berkshire remains the fund's largest holding. Berkshire's insurance operations continue to profitably underwrite and generate tremendous levels of cash which then are allocated and invested in wholly owned companies and large publicly traded companies. In essence, the business will continue to spin cash and increasingly build out its portfolio of wholly owned and partially owned companies. The company also continues to trade below our estimate of intrinsic value (a larger discussion on valuation using 2012 finances was in last year's letter).

JP Morgan, like many of the large banks, had a difficult year when measured by negative headlines. Absent the large litigation related expenses however, JP Morgan had an incredibly profitable year. It is hard to talk about normalized earnings power with the combination of elevated litigation costs and very low interest rates but JPM continues to trade at historically low valuation levels even against a very challenging operating environment. A return to even some level of normalized interest rates will greatly increase the earnings power of their franchise. In effect, the very low cost deposit funding base that is endemic to and a huge advantage to JP Morgan (and Wells Fargo and Bank of America) is undervalued and in some ways "unseen" in today's low rate environment. Importantly, few financial institutions have truly low cost and sticky deposit franchises. Once rates return to a more normal level their earnings power will surge and the unique value of these low cost deposit franchises will be more accurately seen (the fund also owns Well Fargo and Bank of America and did at year end 2012 as well). JP Morgan remains at very reasonable valuations today in a subpar earnings environment and will be even more attractive in a more robust operating environment with higher rates.

Viacom had a very strong 2013. A key aspect of the Viacom investment thesis is their combined focus on business performance and thoughtful capital allocation. They have turned the corner in improving the important Nickelodeon franchise which has led to substantially stronger financial performance. Additionally, through the year, they continued their aggressive share buyback program using their improving free cash flow and strong balance sheet to repurchase a significant number of its outstanding shares. Further, late in the year they accelerated this buyback program by layering in an added \$2 billion repurchase over the course of a few months on top of their already strong and consistent repurchase program. In summary, Viacom has generated stronger earnings and cash flow

while taking advantage of their ability to aggressively buy back a significant amount of their outstanding shares creating significant shareholder value.

Microsoft remains a very good company that generates tremendous levels of free cash flow and is available at reasonable valuations. The core cash generating engine of the business are the enterprise focused software businesses that create sticky and recurring streams of revenue and cash flow. With all those positives however, there are negatives and two paragraphs from the 1984 Berkshire annual letter paint the picture quite well (although obviously not in direct reference to the Microsoft of today). See below:

“Many corporations that consistently show good returns both on equity and on overall incremental capital have, indeed employed a large portion of their retained earnings on an uneconomically, even disastrous, basis. Their marvelous core business, however, whose earnings grow year after year, camouflage repeated failures in capital allocation elsewhere (usually involving high priced acquisitions that have inherently mediocre economics)....”

“In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock (an action that increases the owners’ interest in the exceptional business while sparing them participation in subpar businesses).”

There is a wonderful business inside Microsoft that dominates its cash generating capabilities and requires minimal incremental capital. There have also been many acquisitions (aQuantive being maybe the worst example of such poor use of shareholder capital) and internal capital allocation towards businesses far inferior to its core engine. Crying over spilled milk is not a strategy so the question is what can be done today. Ideally, those subpar businesses could be sold or spun out so they can find a shareholder base more amenable to these lower return, more speculative businesses. And importantly, capital allocation could improve dramatically by enhancing shareholder returns through large share buybacks. This would dramatically improve the overall business and its share price would likely respond in kind.

So why does the fund still own Microsoft? I go back to the first sentence about Microsoft: Microsoft remains a very good company that generates tremendous levels of free cash flow and is available at reasonable valuations. Our hope is just the situations becomes yet even more attractive with some of the moves discussed above. Activist investor ValueAct has recently taken a Board seat at the company and other large shareholders have become more vocal so there is hope for positive change.

We own another old and seemingly boring technology company, Oracle. This position was initiated in the summer of 2013 and has been added to since. Like many of the companies we own, it faces perception issues. Stepping back from the perception however, the company generates tremendous free cash flow and requires minimal capital to sustain its growth. To the free cash flow, it routinely converts well over 100% of its net income into free cash flow. The company in the last year has dramatically improved its capital allocation by bolstering its buyback program to nearly \$10 billion per year (net of share issuances to employees). This is a dramatic increase from prior years and the company has committed to this heightened pace. The vast majority of the company’s earnings power is derived from a consistently growing base of very *high margin recurring revenue* comprised of maintenance and support from existing users. As they sell new software, this base of recurring revenue grows and value is created.

From a valuation standpoint, Oracle trades at a very reasonable valuation relative to earnings and free cash flow. Accounting for the net cash position of the company yields an even more attractive valuation. If we can find recurring revenue streams tied to products with wide moats inside of a company with high returns on capital and thoughtful capital allocation, we invest; and those characteristics hold for Oracle.

We also initiated a position in Comcast (the K shares) in the summer of 2013. Comcast is a large scale provider in an industry where scale is critically important and that scale has enabled it to generate higher returns on capital while generating high levels of recurring free cash flow. Importantly, Comcast opportunistically accelerated the completion of its NBC Universal acquisition early in 2013 bringing its content business under full ownership and control. The market may be confused as to whether they are a distributor of content or a creator of content but they are a combination of two great businesses available at a reasonable valuation.

As referenced above, Comcast found a motivated seller of NBC Universal and was able to accelerate the completion of its NBC Universal acquisition when they could do so issuing low cost, long term debt and that should prove to be a value creating event for Comcast and its shareholders over time. The content business of Comcast includes NBC, CNBC, MSNBC, USA, Bravo, E! and many other cable networks in addition to the Universal movie and theme parks businesses.

We place a higher value on the recurring revenue streams of Comcast than the market does and the same could be said for the recurring revenue streams at Oracle and Microsoft.

Finally and most importantly, thank you all for your belief in what we are working to accomplish. I take the responsibility of stewarding your investment very seriously. To paraphrase from the Book of Luke 12:48: "To Whom Much is Given, Much is Expected". That should hold true for all of us both personally and professionally and it certainly does for me.

Warmest Regards,
Brian Pitkin
URI Capital Management, LLC

URI | *Capital Management*

Important Disclaimers:

The net rate of return is calculated using a time-weighted methodology. Returns are unaudited. The performance listed above is being provided to you for informational and discussion purposes only. Actual returns are specific to each investor.

This report is being provided to you for informational and discussion purposes only. This report is not intended for public use or distribution. The information contained herein is strictly confidential and may not be reproduced or used in whole or in part for any other purpose.

In considering any performance data contained in this report, you should bear in mind that past or targeted performance is not indicative of future results and there can be no assurance that the fund will not sustain material losses. Nothing in this report should be deemed to be a prediction or projection of future performance.