

ROSEN PARTNERSHIP INC.

2016 Letter to Investors

February 6th, 2017

1. 2016 Market Returns

In 2016, the S&P 500 generated a return of 9.5% in USD (and 11.8% with dividends included and before taxes). The index generated a return of 6.5% in CAD (and 8.7% with dividends and before taxes). The US indices experienced a "huge" increase after the so-called "Trump effect" due to investor favorable reaction to a more accommodating business environment. After several years of underwhelming returns relative to the US indices, the S&P TSX generated a return of 17.5% in CAD (and 20.8% with dividends and before taxes) on the backdrop of a rebound in oil/commodity prices and a buoyant real estate market.





2. Portfolio Returns

The average fully invested unconstrained portfolio earned over 10% net of fees in CAD in 2016. This was typically achieved with a cash position, a short position and undervalued securities (significantly different from Index composition). There may be variations in performance from account to account due to objectives, constraints and other individual considerations (namely inflows and outflows). A detailed performance assessment will be presented during our individual annual reviews.

3. Types of Investments

The firm's investments can be categorized into 3 distinct buckets. Allocation to each bucket will vary depending on compelling opportunities available in the market place. The three types of investments can be summarized as followed:

Generals - Private Owner Basis

These are investments that are inexpensive on a private owner basis. Typically, the equity is trading at close to net tangible book value or the company has an exceptional track record of free cash flow generation and trades at a very low current multiple to free cash flow. In this category, there is no specific timetable in which the undervaluation may correct itself. Currently, the firm's composite portfolio contains a 13% allocation to companies in this bucket. In a rising/lofty market, these opportunities become more scarce.

Relatively Undervalued

These are investments that are inexpensive relative to peer group or have similar valuation but better risk reward profile. This category may also contain securities that are relatively undervalued compared to historical valuation. Currently, the firm's composite portfolio contains a 60% allocation to this bucket. This category will typically continually offer opportunities (regardless of market prices except during periods massive overvaluation). In addition, a high-quality company can be held for a very long time (but must be purchased at a decent price). During exceptionally ebullient markets, we can

hedge part of this exposure by shorting similar companies, sectors or the market itself for risk management purposes.

Special Situations/Workouts

This category focuses primarily on M&A arbitrage, spinoffs/split offs and other special situations. These types of opportunities become more attractive in a lofty market. For instance, M&A arbitrage contains a specific timetable for completion but may have to clear regulatory or financing hurdles. Currently, the firm portfolio contains a 4% allocation to this bucket. This past year, we completed (fully exited) one transaction in this space that yielded a 3% return in about a month and a half. This amounts to a 24% annualized return.

4. Outlook

In my opinion, predicting the yearly price return of a market is certainly a terribly difficult exercise. However, we can have a substantiated view on the overall temperature of the market based on valuation. Currently, (as of this writing) the trailing P/E ratio of the S&P 500 is 19.6x operating earnings and 25.5x “as reported” GAAP earnings. These figures are on the higher end of the historical averages. It is always important to incorporate future growth and interest rates to get the whole picture. In any case, my view is to purchase undervalued securities regardless of market environment and have sufficient cash and/or short positions to fund purchases during drawdowns when they happen. I believe that this will help us outperform the indices in flat or negative years. I view a -5% year when the S&P did -15% as a very favorable outcome. We are really concerned about 3, 5 and 10 year returns.

5. Notes

Future fund: I am still closely evaluating the feasibility of a pooled fund to ease operations, lower trading costs, have every account uniform and allow smaller accounts (i.e. TFSA) to have same investments as larger accounts. I've contacted several service providers over last year and want to find the best price/service possible. All operating costs will be paid by fund but to compensate I will lower management fee so that the overall fees will either be the same or lower.

AMF Audit: I just finished a routine (every Quebec registered firm goes through it during first 2 years of operations) AMF (Autorite des Marchés Financiers – Quebec Regulator) audit where my entire firm was scrutinized on a financial and compliance basis. Bottom line - I will have new forms for you to sign! Please do not get overwhelmed with excitement ☺ This is the new environment we live in – very consumer centric but a little bit extreme for growing managers.

From the 1996 Berkshire Hathaway Letter to Shareholders:

"To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses - How to Value a Business, and How to Think About Market Prices."

Sincerely,

A handwritten signature in dark ink, appearing to be 'BR' followed by a long horizontal stroke.

Brian L. Rosen, MBA, CFA