LOUNTZIS® ASSET MANAGEMENT, LLC

February 15, 2018

RE: 2017 YEAR-END REVIEW

As we write in late January, all three major stock indices – the S&P 500, DJIA and Nasdaq Composite – have continued their unprecedented rise since the Presidential Election. Investors anticipated many positive changes with the new administration, including healthcare reform, reductions in both corporate and individual tax rates, a reduction of government regulations across industries, the repatriation of foreign profits and infrastructure spending, to name a few. While many political initiatives have not yet come to fruition, the Tax Cuts and Jobs Act became law on December 22, 2017. The tax bill should have both positive and negative consequences. Throughout 2017, the stock market continued its strong upward climb as shown here:

Stock Market Index	**2017**	**2016**	**2015**
S&P 500	21.8%	12.0%	1.4%
Dow Jones Industrial Average	28.1	16.5	0.2

PERFORMANCE OF KEY HOLDINGS

A breakout of the performance of our key holdings for 2017, which followed strong performances in 2015 and 2016, are shown below.

Company	% Change **for 2017**	**Company**	% Change **for 2016**	**Company**	% Change **for 2015**
Progressive Corp.	58.7	Martin Marietta Mat'l.	62.2	Martin Marietta Mat'l.	23.8
Mohawk Industries	38.2	Brown & Brown	39.7	Mohawk Industries	21.9
UnitedHealth Group	37.8	UnitedHealth Group	36.0	Progressive	17.8
Zoetis	34.6	BB&T	24.4	UnitedHealth Group	16.4
Lowe's Companies	30.7	Berkshire Hathaway B	23.4	Lab Corp.	14.6
Lab Corp.	24.3	US Bancorp	20.4	Zoetis Inc.	11.4
Berkshire Hathaway B	21.6	World Fuel Services	19.4	Lowe's Companies	10.5
Brown & Brown	14.7	Loews Corp.	17.6	PepsiCo Inc.	5.7
PepsiCo. Inc.	14.6	Bank of New York	14.9	Bank of New York	1.6
Bank of New York	13.7	Zoetis Inc.	11.7	Wells Fargo & Co.	-0.8
Wells Fargo	10.1	Progressive Corp.	11.6	Brown & Brown	-2.5
BB&T Corp.	5.7	Mohawk Industries	5.4	BB&T Corp.	-2.8
US Bancorp	4.3	PepsiCo Inc.	4.7	US Bancorp	-5.1
Martin Marietta Mat'l.	- 0.2	Lab Corp.	3.8	Loews Corp.	-8.6
World Fuel Services	-38.7	Wells Fargo	1.4	Berkshire Hathaway B	-12.1
		Lowe's Companies	-6.5	World Fuel Services	-18.1

WARNING - DO NOT CONFUSE INVESTMENT SKILLS WITH A NINE-YEAR BULL MARKET

Given the continued rise in the current nine-year bull market, where everyone is happy and feeling smart with solid gains, it is important to remember the father of value investing and Warren Buffett's mentor, Benjamin Graham, who stated, **"The essence of investment management is the management of risks, not the management of returns. The investor's chief problem, and even his worst enemy, is likely to be himself."**

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THE WORLD IS AWASH IN LIQUIDITY - MONEY, MONEY EVERYWHERE

In the pages that follow, we will provide a perspective on **historical stock market valuation levels, the rare stock market pullbacks during this very calm nine-year bull market, and future returns, including our views on probable solid earnings growth in 2018 and 2019 - much of it fueled by the recent tax cuts. We have always found it helpful to consider a historical perspective on current stock prices, though we never make predictions about their future.**

Overall, both the US and Global economies continue to do well, though at lower growth rates than in prior recoveries. In fact, global economies are all growing in a synchronized fashion for the first time in many years.

The **world is awash in liquidity fueled by artificially low interest rates, created by Central Banks around the world, including our own Federal Reserve Bank, that have expanded their balance sheets to unprecedented levels. This is an experiment which has never been utilized to this extent before. Reducing their balance sheets may be more difficult than anyone anticipates.**

On the investment front, there is simply **way too much money chasing too few good investment ideas across the global investment landscape. There are enormous amounts of capital available from a broad range of investors including sovereign wealth funds and firms operating in the private equity, venture capital and real estate sectors. These pools of capital are seeking investment opportunities in various asset classes including stocks, fixed-income, private equity, venture capital and real estate, to name a few. The result has been rising prices across most asset classes.**

We remain concerned over our **Federal Government's Budget, rising US debt levels of over $20 trillion with rising deficits and rising global debt levels, as well as dangerously underfunded state and municipal pension and corporate pension plans.** There are also several **consumer credit related areas of concern domestically**, such as **auto loans, credit cards and, especially, student loans, which now total over $1.4 trillion and have the highest delinquency rates at over 10%.**

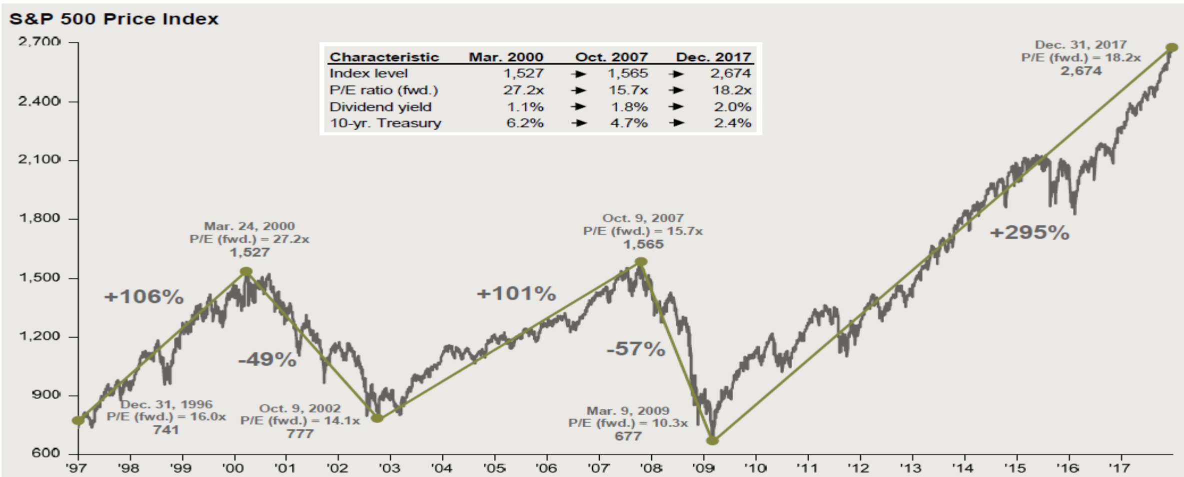
We touch on several areas of **possible "bubbles" including cryptocurrencies, levered exchange traded funds and real estate in several countries and cities.**

Finally, we will discuss the **purchases and sales of securities for our client portfolios, our views on fixed-income securities as well as equities, and our key holdings.**

Before we begin the main body of our letter, our team wanted to share an observation we have found in studying businesses and industries over the past 30 years. This is a new stock market investing environment with less stocks to choose from, fewer bigger winners and many more losers, as it is becoming more of a **winner take all world.** Globalization and technology are creating enormous barriers to competition and long runways for growth, with fewer and fewer companies to dominate, as **industry concentration continues to rise.** On the one hand, there will be **fewer companies with higher profit margins, stronger competitive barriers and dominant market shares, while on the other hand, there will be a large number of companies with lower profit margins, weaker competitive barriers and declining market shares.** Therefore, **the future of successful investing will require even more thoughtful research and analysis to truly generate unique differential insights for our client portfolios. While capital is currently in abundance, great ideas remain scarce and ever more valuable.**

HISTORICAL STOCK MARKET VALUATION LEVELS 1997-2017

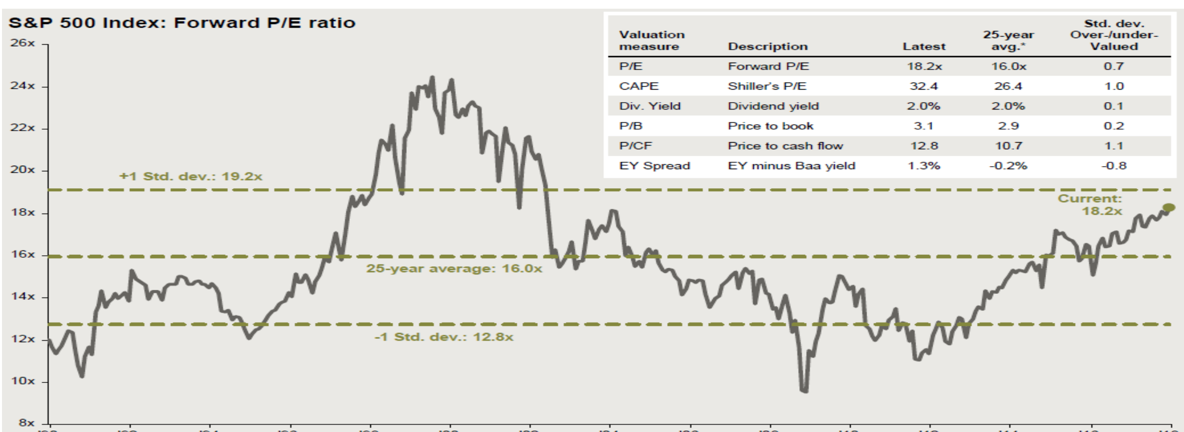
The stock market, as measured by the S&P 500, has fluctuated with several increases and decreases over the past 20 years. Each several-year increase has been followed by meaningful declines of varying duration. In March of 2018 we will have reached the ninth year of the current bull market which began on March 9, 2009. A breakout of the S&P 500 Index's performance since 1997 is illustrated below:



Source: Compustat, FactSet, Thomson Reuters, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price to earnings ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2017.

J.P.Morgan

The stock market's valuation level, as measured using the S&P 500 Index on a forward price/earnings ratio, was 18.2x on December 31, 2017, above the 25-year historical average of 16x, as illustrated below:

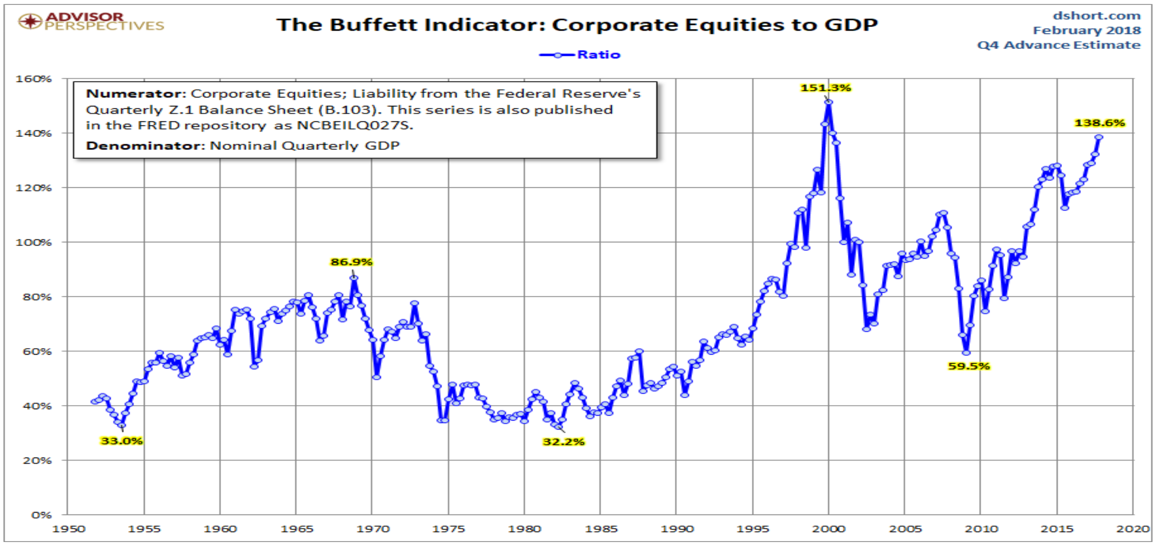


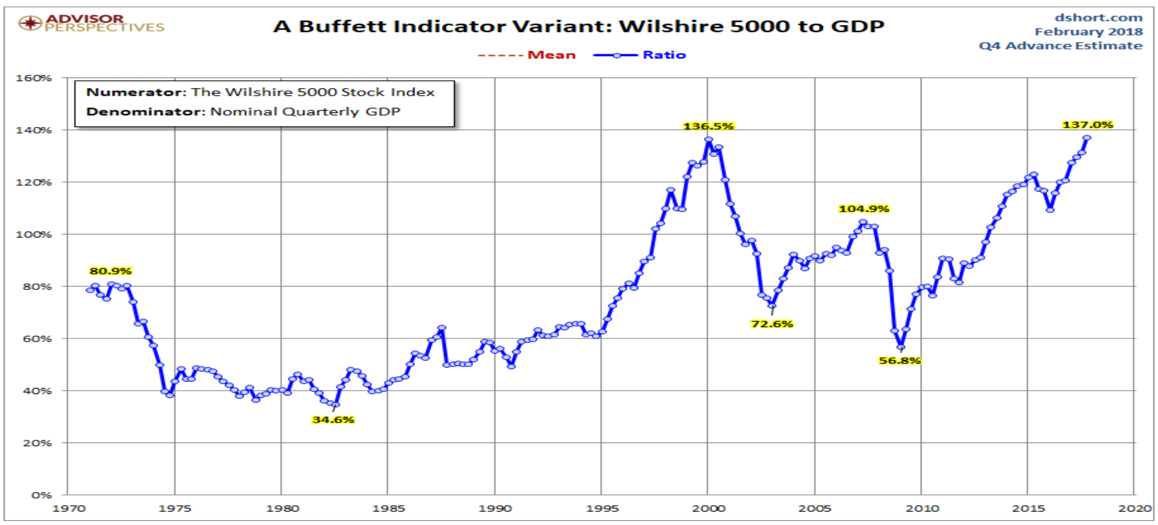
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.2x	16.0x	0.7
CAPE	Shiller's P/E	32.4	26.4	1.0
Div. Yield	Dividend yield	2.0%	2.0%	0.1
P/B	Price to book	3.1	2.9	0.2
P/CF	Price to cash flow	12.8	10.7	1.1
EY Spread	EY minus Baa yield	1.3%	-0.2%	-0.8

Source: FactSet, FRB, Thomson Reuters, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for December 31, 2017. Average P/E and standard deviations are calculated using 25 years of FactSet history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2017.

J.P.Morgan Asset Management

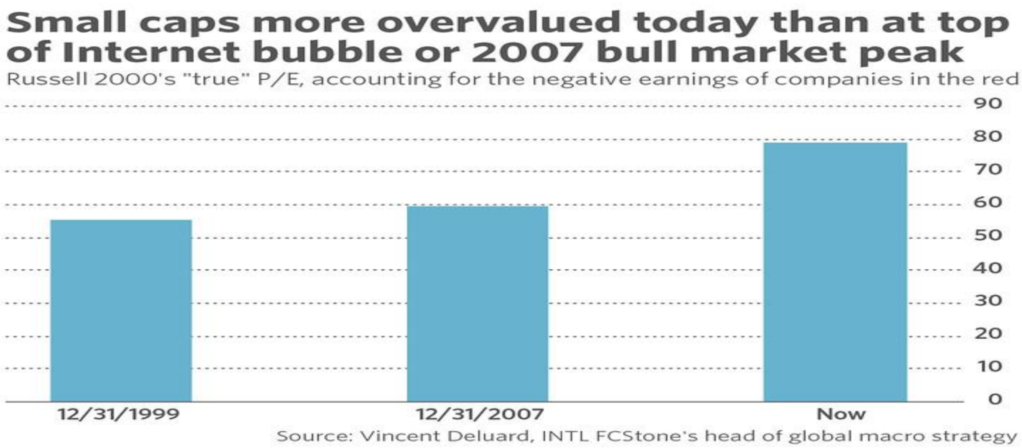
One of Warren Buffett's favorite stock market valuation measures is the value of corporate equities to GDP. Another measure we also review is the Wilshire 5000 Index to GDP. Both measures provide a historical perspective on the stock market's relative valuation to our country's productive output as measured by GDP. The charts on the following page are as of February 2018 and the current elevated levels are only exceeded by the 1999-2000 technology, media and telecommunications bubble.



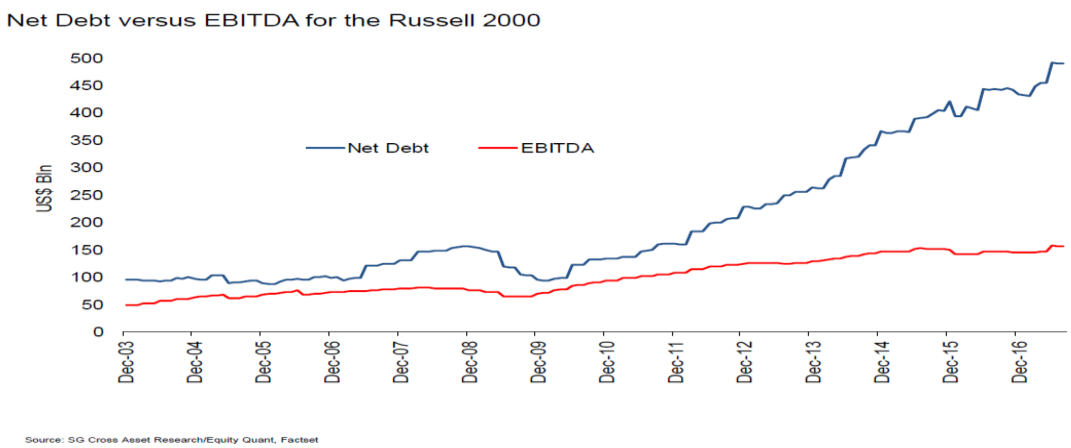


It is estimated that **technology firms have accounted for over 40% of the increase in the stock market's market capitalization since 2014 and in 2017, less than 20 companies with average price/earnings ratios of 28x, have accounted for 50% of the appreciation in the S&P 500 Index while representing less than 25% of its market capitalization.**

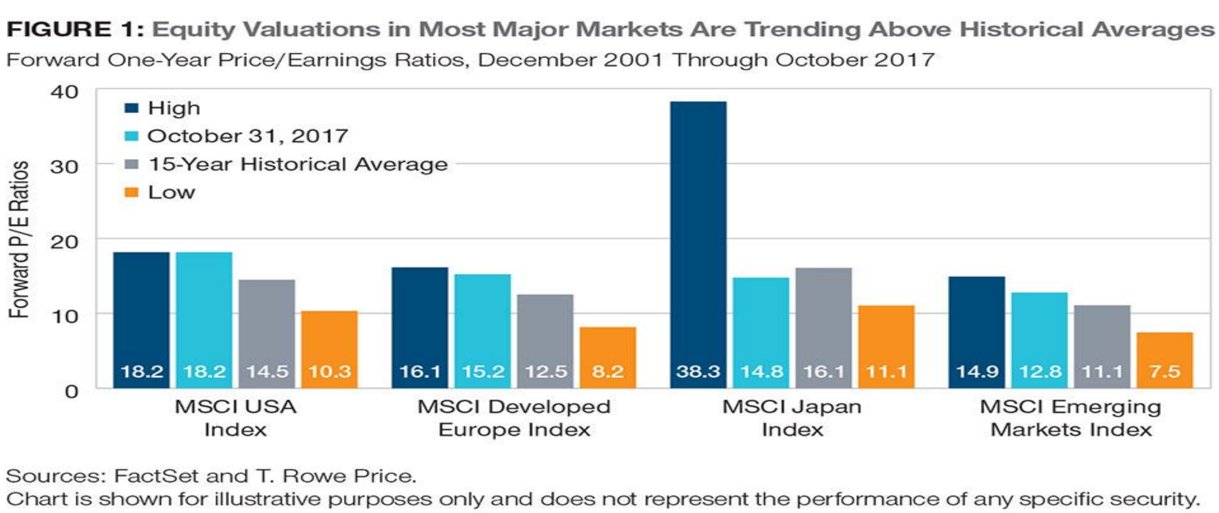
Furthermore, over **1/3 of the stocks** in the **Russell 2000 Index** are **losing money**, yet this Index still generated over 14% annualized returns over the past 5 years. Adjusted for these negative earnings, according to Mark Hulbert, working with INTL FCStone's Vincent Deluard, the **Russell 2000 Index in late summer 2017 was trading at just under 80x earnings,** a **higher multiple** than achieved during the **technology bubble in 2000, or the 2007 peak prior to the global financial crisis** as shown on the following page:



According to Société Générale, risk levels for the Russell 2000 Index have risen a great deal as net debt levels have more than tripled since 2009, as shown below.



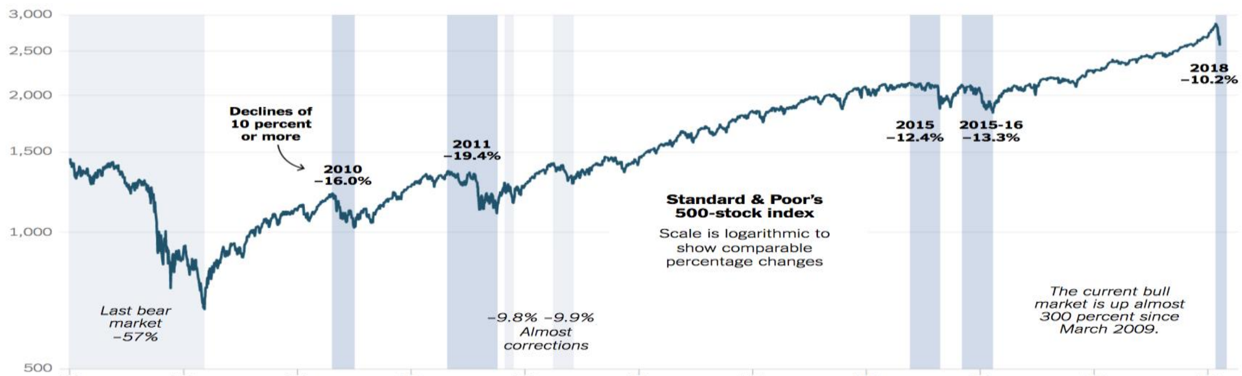
While the above tables are focused upon the US stock market, most global markets are also trading above their 15-year historical averages, though they are cheaper than the US stock market as indicated below.



Finally, regarding the search for acquisition candidates and respective **valuation levels**, **Warren Buffett** stated in the 2017 Berkshire Hathaway annual report, “In our search for new stand-alone businesses, the key qualities we seek are durable competitive strengths; able and high-grade management; good returns on the net tangible assets required to operate the business; opportunities for internal growth at attractive returns; and, finally, **a sensible purchase price. The last requirement proved a barrier to virtually all deals we reviewed in 2017, as prices for decent but far from spectacular, businesses hit an all-time high. Indeed, price seemed almost irrelevant to an array of optimistic purchasers.”**

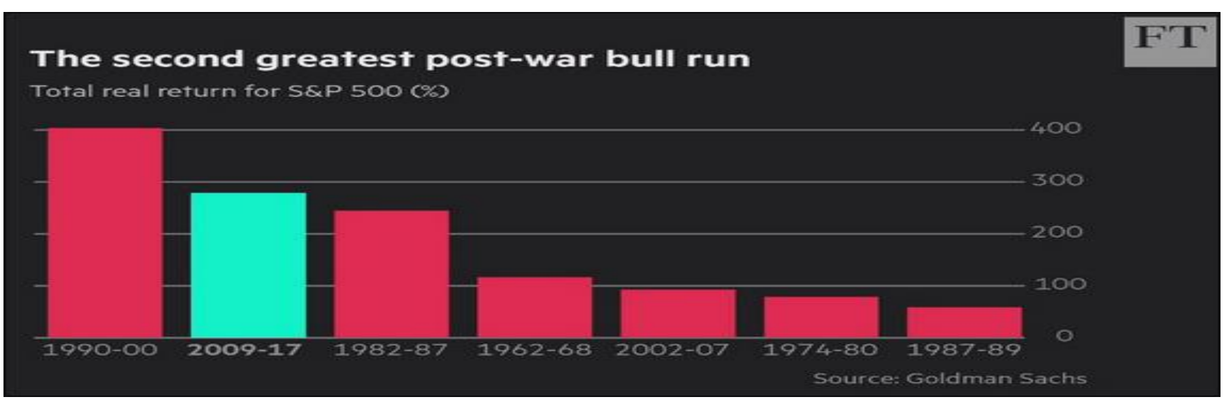
STOCK MARKET PULLBACKS FROM 2008 THROUGH EARLY 2018

Since the last bear market - which ended in March 2009 - through early February 2018, the stock market has continued its climb with only **5 minor corrections** in the **past 9 years** with none exceeding 20%, (which defines a bear market).



Including the current one, there have been five corrections of the Standard & Poor's 500 during the bull market that began almost nine years ago.

The current nine-year bull market return is the second-best S&P 500 total return, post-World War II, trailing only the period from 1990 to 2000, as shown here.



Source: @acemaxx, @FT, @josephncohen;

In addition, the stock market, as measured by the S&P 500, continues to achieve **new records, as 2017** represents the **first year** ever, **dating back to 1928**, that it **rose every month of the year.** And, going back to the Presidential election of November 2016, it represents 14 consecutive up months.

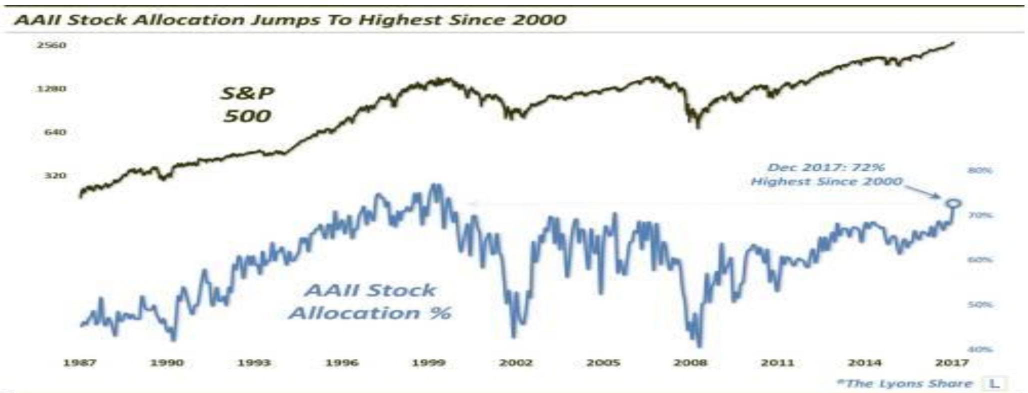
The S&P 500 has achieved positive results in 14 out of the past 15 years, with 10 of those years achieving double digit returns.

While we often focus upon the S&P 500 as a broader and better overall indicator of the stock market, the Dow Jones Industrial Average (DJIA) has hit 96 new highs since the November 2016 Presidential election and 71 new highs in 2017. That follows a strong 2016 when the DJIA achieved 26 new highs.

The **DJIA** has also **breezed through four 1,000-point milestones in 2017**, from **20,000 to 24,000** before reaching its **highest point ever** on **January 26, 2018 at 26,616.7**.

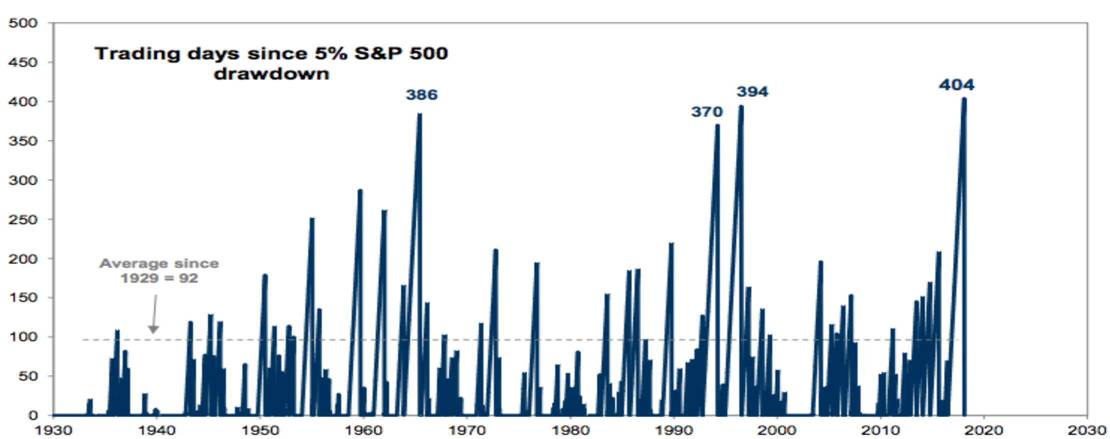
INVESTOR EUPHORIA IN THE CALMEST STOCK MARKET IN HISTORY

Investor euphoria continues in the 9th year of the current bull market. Investor optimism is the highest it has ever been over the past 30 years according to the American Association of Individual Investors, as shown below.



The **S&P 500 Index** had **not** experienced a **5% pullback in over 400 days,** prior to early February 2018, the **longest ever.** This level of **complacency** is **unprecedented** in stock market history as shown in the following chart.

Exhibit 1: S&P 500 recently ended its streak of 404 days without a 5% drawdown
as of February 5, 2018



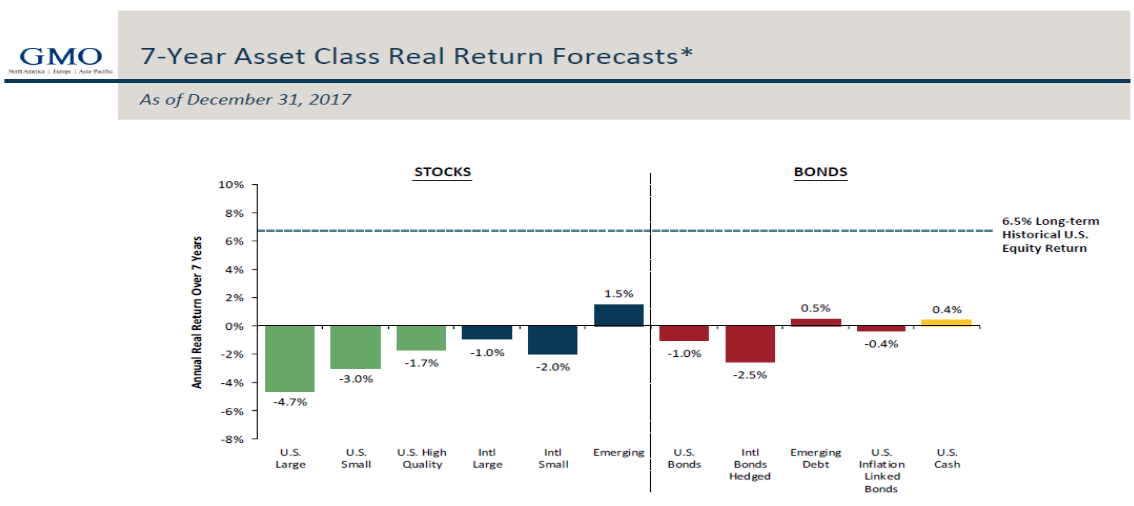
In **2017 the DJIA was the calmest it has ever been,** experiencing **239 trading days with less than a 1% intraday range between high and low**. Furthermore, from **1990 through 2016** the **VIX** (CBOE SPX Volatility Index) had **closed below 10 less than 5 times.** However, in **2017 the VIX closed below 10** on **52 occasions,** illustrating the truly incredible calm of this stock market.

We certainly **have no crystal ball** but **do NOT believe that this level of stock market complacency will persist in the years ahead.** We would speculate that with the Federal Reserve tightening, along with elevated stock market valuation levels, and possibly several other variables, these unprecedented calm markets will become adversely affected. As **Axel Weber, the Chairman of UBS,** stated at the World Economic Forum in Davos, Switzerland, **"I wouldn't take this benign environment, as one that is here for good."**

Given the robust current stock market valuation levels and very high investor sentiment for stocks, it is interesting to note **former Federal Reserve Chairman Alan Greenspan's** recent comments on CNBC; "**Let me put it to you this way. I think there are two bubbles. We have a stock market bubble, and we have a bond market bubble. I think at the end of the day the bond market bubble will be the critical issue……we are working our way to a major increase in long-term interest rates."**

<u>FUTURE STOCK MARKET RETURNS</u>

Given the **outstanding stock market returns achieved over the past 9 years,** we believe that the **probability of those outstanding returns continuing over the next 7 to 10 years is highly unlikely.** We never make any predictions regarding stock market valuation levels, and we are certainly not predicting another significant decline as during the Great Financial Crisis of 2008-2009, however we believe **investors must prepare for far lower returns over the next decade.** Grantham, Mayo, Van Otterloo, a leading Boston based investment firm has an outstanding track record of projecting future 7-year Asset Class Real Returns and their forecast as of December 31, 2017 is shown below.



Source: GMO
*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

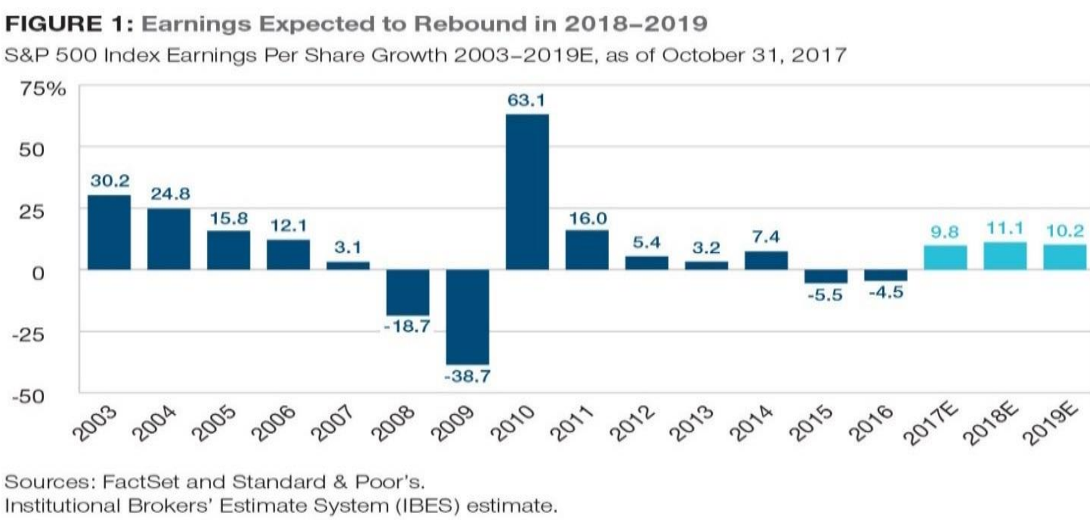
As the chart above illustrates, **every stock classification is forecasted to have negative real returns over the next seven years** with the **exception of emerging market stocks,** and **similar results** are forecast in the **fixed-income space** as well. Clearly, after such strong stock market returns for so many years, the future will likely not be as robust and it is incumbent among all investors to anticipate **lower returns in the decade ahead.**

Furthermore, when the trailing price/earnings multiple has hit 25x in the past, the subsequent 12-month returns have been negative. This is shown below.

We want to be clear that we are **not forecasting where the stock market will be next week, next month, next year or in five years.** What we do want to do is strongly communicate that **now is not the time to go further out on the risk curve, but rather to exercise extreme caution and prudence in all investment decisions.**

SOLID EARNINGS GROWTH IN 2018 AND 2019

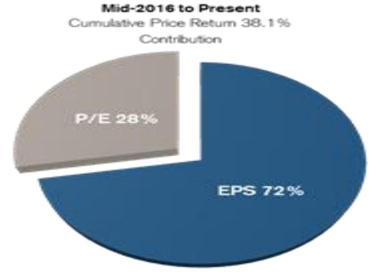
With the new tax law taking effect, 2018 and 2019 are both anticipated to be solid years of earnings growth for most companies in the S&P 500 Index, as illustrated below:



While much of the stock market's rise in the past nine years has been driven by price/earnings multiple expansion, since mid-2016 the largest factor driving the increase in stock prices has been strong earnings growth as illustrated on the following page.

S&P 500 Return Decomposition (Mid-2016 to Present)

The rally has been driven by fundamentals not animal spirits



Source: Credit-Suisse

While the backdrop of strong earnings growth for 2018 and 2019 provides tailwinds for attractive stock market returns, the Federal Reserve’s tightening represents headwinds which may have a negative impact over the next few years.

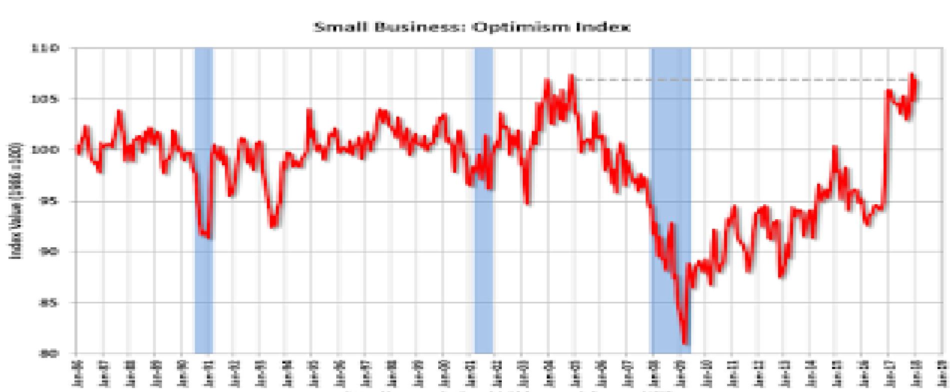
We estimate **2017 S&P 500 earnings at $130**, or so, **rising in 2018 to over $140.** However, with **the tax law changes, 2018 earnings may exceed $150 while 2019 earnings may rise above $160. The result is a price/earnings multiple of 16-17x 2019 earnings, only slightly above the historical average of 15-16x.**

THE US AND GLOBAL ECONOMIES

The US economy continues to do well, albeit at lower growth rates in this recovery than past ones. Over the past eight years, our country’s real GDP has increased at over 2% per year while unemployment has declined from 11% in 2009 to 4% today. **Current unemployment levels are near record lows, output is rising, inflation remains subdued, consumer and business confidence are very high and virtually every major economy around the world is doing well, creating synchronized global growth for the first time in many years.**

Fueled by the US tax cut, the January jobs report showed solid gains and a healthy increase in wage growth. While that caused some concerns and may have contributed to the stock market sell off, over the long term reasonable wage growth is a positive development as it has been many years since wages have achieved solid increases. It remains to be seen if this continues but it is certainly a welcome and positive development.

Small business optimism is at its highest level in over a decade, as the chart below shows.



The current US economy, evaluated on several variables compared to past recessions, appears to be in an expansionary mode, with no indications of an imminent recession, as shown in the table below.

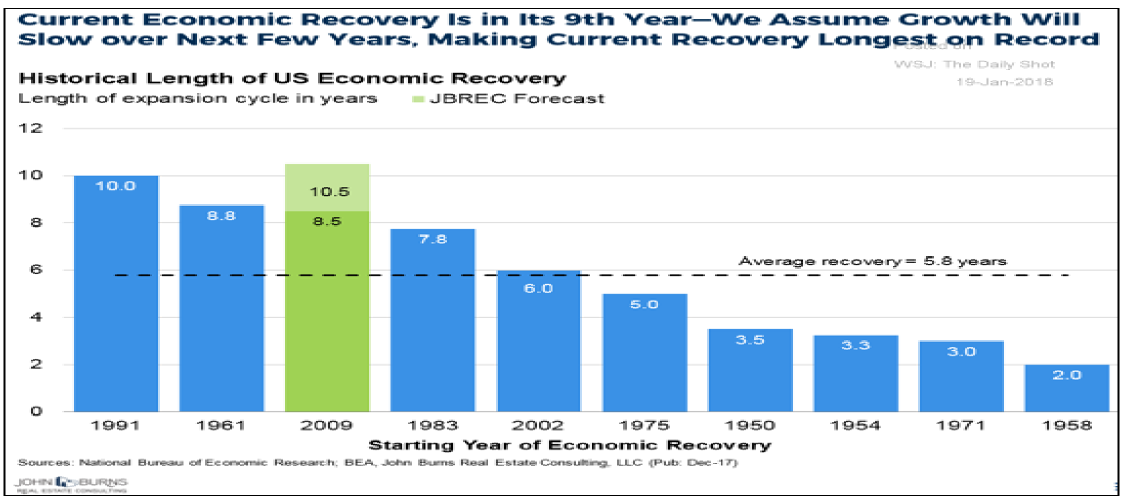
Recession Dashboard

Start of Recession	Yield Curve	Inflation Trends	Labor Market	Credit Perform	ISM Mfg.	Earnings Quality	Housing Market
Nov-73	⬇	⬇	⬇	⬇	⬇	--	⬇
Jan-80	⬇	⬇	⬇	⬇	⬇	--	⬇
Jul-81	⬇	⬆	⬆	⬇	⬇	--	⬇
Jul-90	⬇	⬇	⬇	⬇	⬇	⬇	⬇
Mar-01	⬇	⬇	⬇	⬇	⬇	⬇	⬌
Dec-07	⬇	⬇	⬌	⬇	⬇	⬇	⬇
Present	⬆	⬆	⬆	⬆	⬆	⬆	⬆

Key: ⬇ Recessionary ⬆ Expansionary ⬌ Neutral

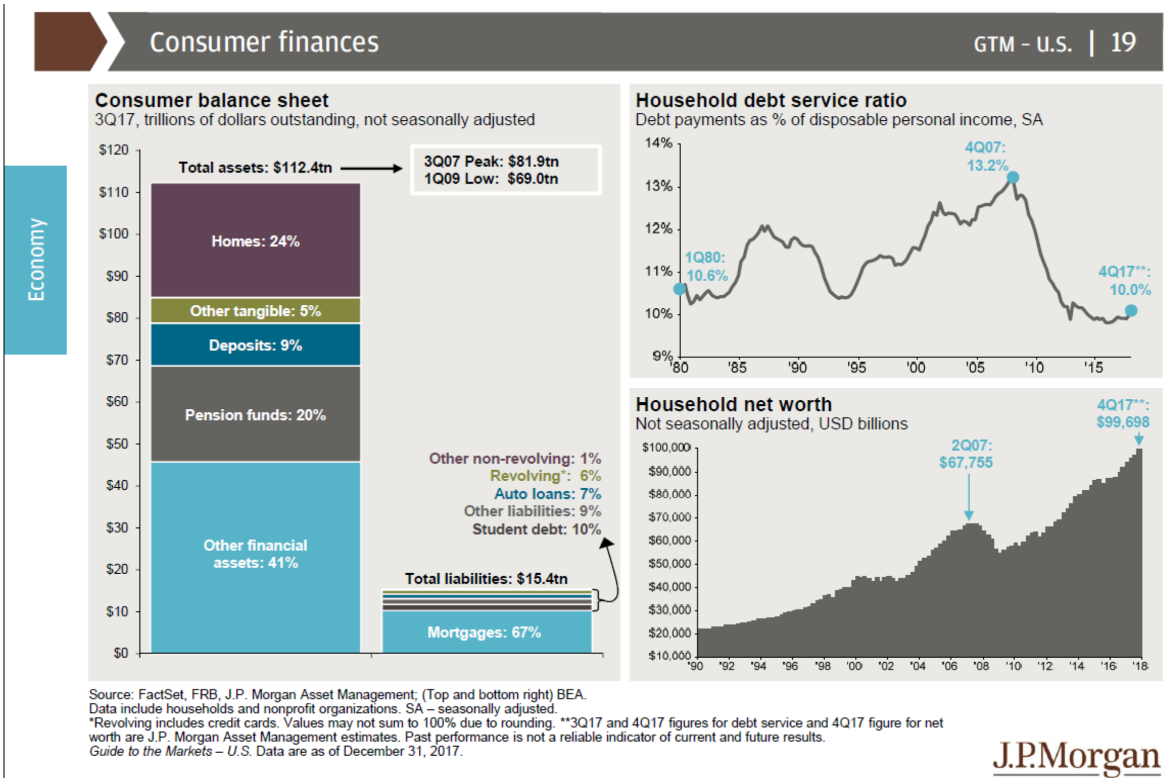
Source: Standard & Poor's, Federal Reserve, BLS, National Statistical Agencies, NBER, ISM, Census Bureau, Haver Analytics®, Credit Suisse

The US economy is in its 9th year of recovery which represents the 2nd longest economic expansion on record and is well positioned to be the longest if our recovery continues for another 18 months to 2 years as the table below illustrates.

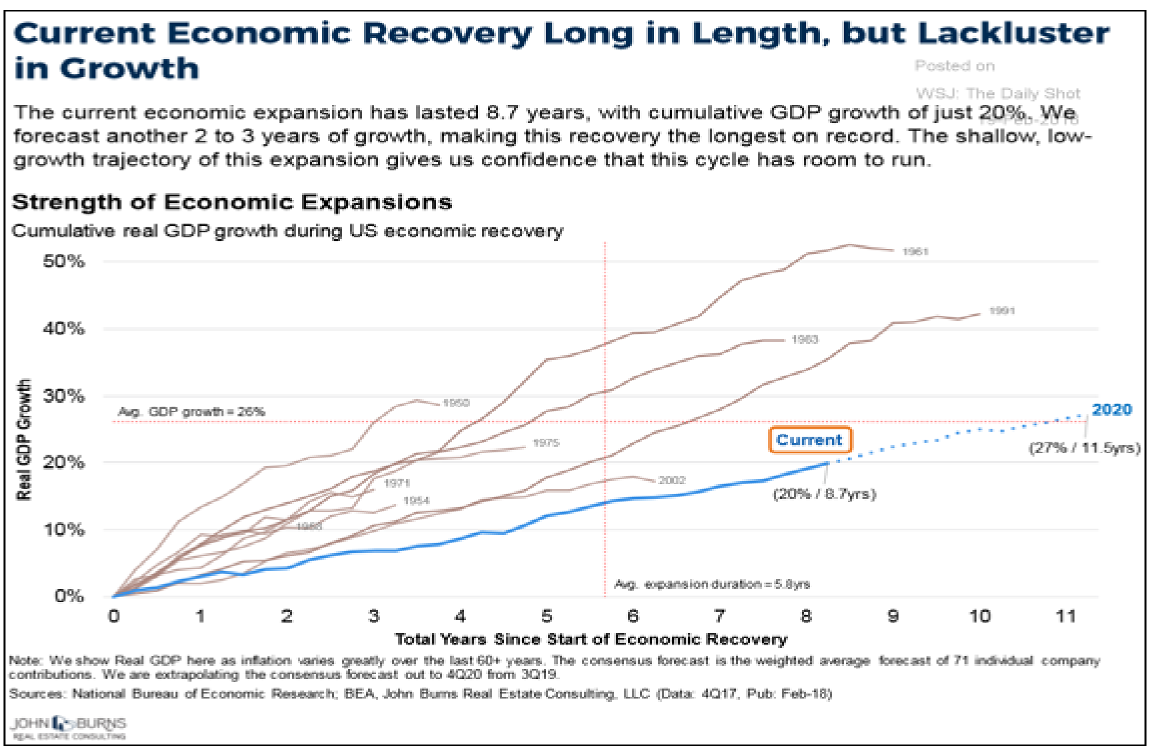


As long as the Federal Reserve does not tighten too aggressively, it is anticipated that the economy will continue to do well for the next few years.

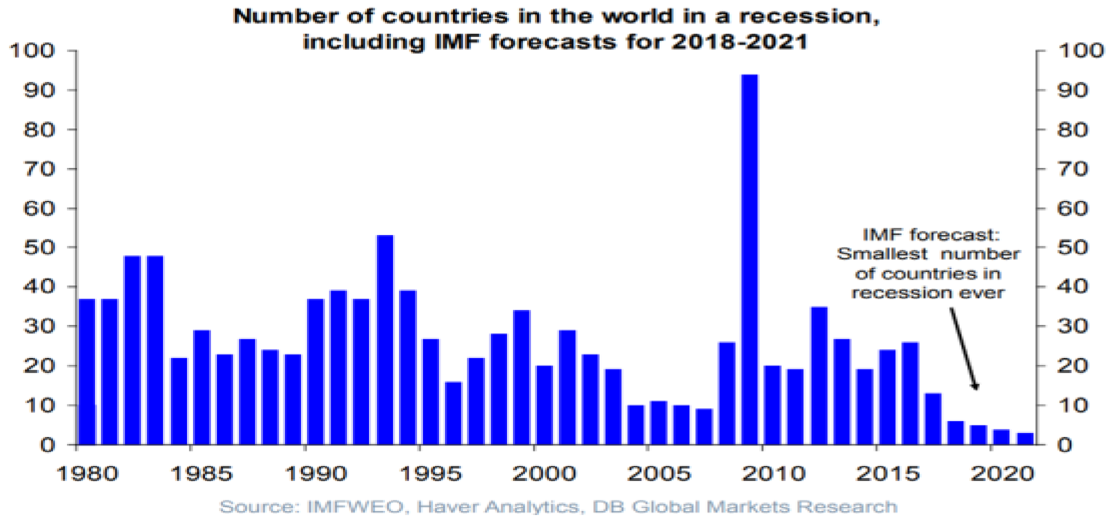
Also, **despite some concerns with student loans, car loans and credit card debt, households are in overall pretty good shape as household assets exceed \$112 trillion**, (up from the 1st quarter 2009 low of \$69 trillion), **household net worth is just under \$100 trillion and household debt service is 10%, well below the 13.2% peak of the 4th quarter of 2007** as shown on the following page.



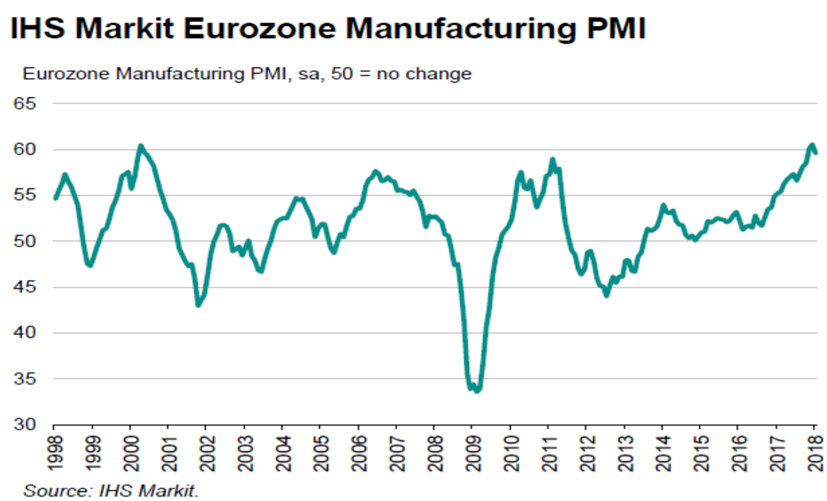
While the current economic expansion may be the longest in history, it is also shaping up as one of the slowest in terms of GDP growth, as shown below:



The Global economy also is doing well, as all 45 of the Organization of Economic Co-operation and Development (OECD) countries grew together in 2017 for the first time since 2007, as illustrated in the chart below:



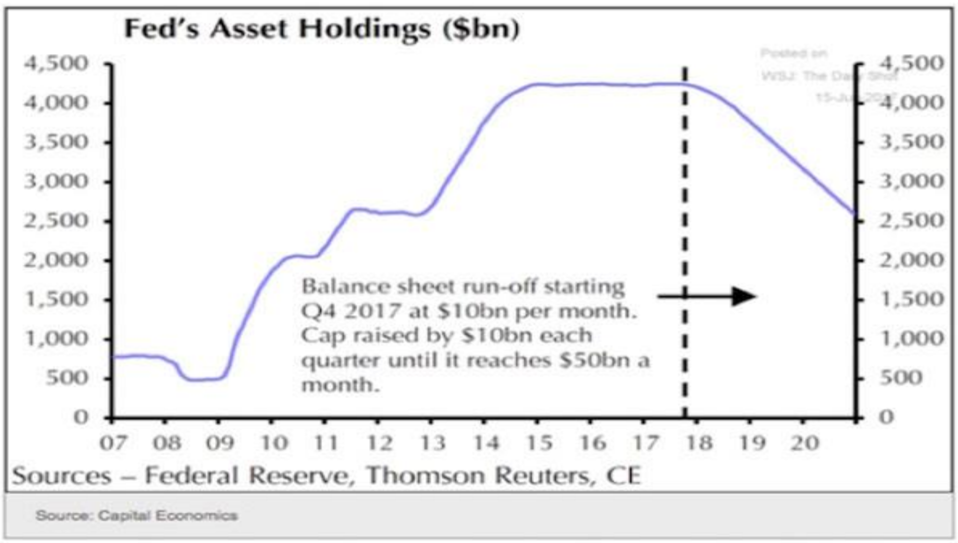
Many other economic indicators are also doing well for countries around the globe, including low inflation, growing GDP and declining unemployment. The **IMF is forecasting global GDP growth of 3.5%,** a welcome rise from the levels during the Global Financial Crisis in 2008-2009. According to IHS Markit, the Eurozone Manufacturing PMI is the highest it has been since 2000. Several European countries are at record levels and many are at multi-year highs indicating a solid economic manufacturing environment, with Germany leading the way with a PMI of 62.5. A number **at "50" or above indicates an expanding economy.**



LIQUIDITY-FEDERAL RESERVE

The Federal Reserve reduced the federal funds rate from 0% to .25% in December 2008, the lowest in our country's history in response to the Global Financial Crisis, which they had kept unchanged for 8 years. Finally, with an improving economy and low unemployment they raised the federal funds rate 25 basis points in December 2016 and followed with 3 similar increases in 2017. Despite inflation remaining stubbornly below its 2% target, the Fed is still suggesting three rate hikes in 2018 and two increases in 2019. The Fed has also begun the process of unwinding its $4.5 trillion balance sheet. It will start by allowing $6 billion in Treasury securities and $4 billion in mortgage backed securities to mature every month. Eventually the cap will climb to $30 billion and $20 billion, respectively, per month. **No one is certain how this will play out,** as it is unprecedented.

Between now and the end of 2019, the **Fed will extract more than $1 trillion from the financial markets through quantitative tightening.** Just as **quantitative easing created money and pushed asset prices higher, quantitative tightening will have the opposite effects, though no one knows the timing or the magnitude of the impact on our economy or asset values.** There are many different scenarios, if the Fed tightens too quickly, asset values in both stocks and real estate to name two could rapidly decline, while credit may contract and the economy could fall back into severe recession. It is simply impossible to know what will happen as again, this situation is unprecedented in American history. Certainly, the **Federal Reserve and central banks around the world are walking a tightrope while simultaneously reducing their balance sheets and seeking to maintain reasonably stable financial markets and asset values.**



As legendary investor **Stan Druckenmiller** has stated, **"Earnings don't move the overall market; it's the Federal Reserve Board…. Focus on the central banks and focus on the movement of liquidity…. Most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets."**

"We are in the throes of a burgeoning financial bubble, If I had a choice between holding a U.S. Treasury bond or a hot burning coal in my hand, I would choose the coal." - Paul Tudor Jones

LIQUIDITY - CENTRAL BANKS AROUND THE WORLD

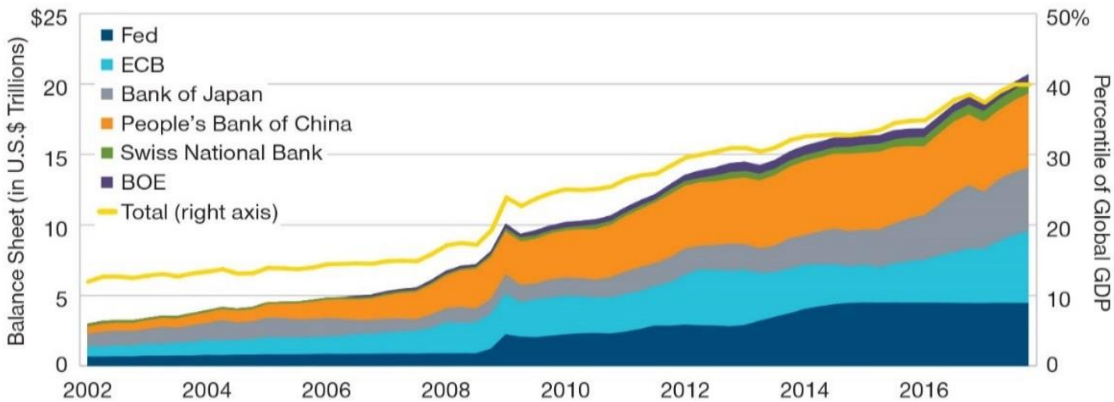
Central Banks have fueled low interest rates globally as they have significantly increased their balance sheets to $20 trillion, or 40% of global GDP. These unprecedented moves were necessitated by the 2008-2009 Global Financial Crisis; however, **we believe that rates have been kept too low for too long.** The result has been a **world awash in liquidity that has fueled mis-allocation of capital, most notably by raising risk levels as cheap debt drives investors to take on more risk as they seek returns above the very low fixed-income returns available in traditional securities**.

As **Jeffrey Sprecher**, the **CEO of Intercontinental Exchange** has stated**, "A flood of central bank liquidity has lowered interest rates globally and lowered volatility globally,** so it's been very hard for traders and [clearing members] to make money, which leads to consolidation." We could not agree more and while consolidation is one result, there are many other consequences of low interest rates and low volatility, including greater risk taking along the investment landscape, which may lead to large future losses.

As mentioned, central banks now have balance sheets exceeding $20 trillion, or 40% of Global GDP as shown in the following chart, which is unprecedented. The US Federal Reserve is the first of the global central banks to begin tightening but over time the rest of the world should follow. This has never been done before; it is an experiment whose outcome is simply unknown as there are many risks in unwinding these large balance sheets.

FIGURE 1: Central Bank Support Is Set to Wind Down

Central Banks Balance Sheet Versus Percent GDP, as of September 30, 2017



Sources: Haver Analytics and T. Rowe Price. Based on moving sum of last four quarters' GDP figures.

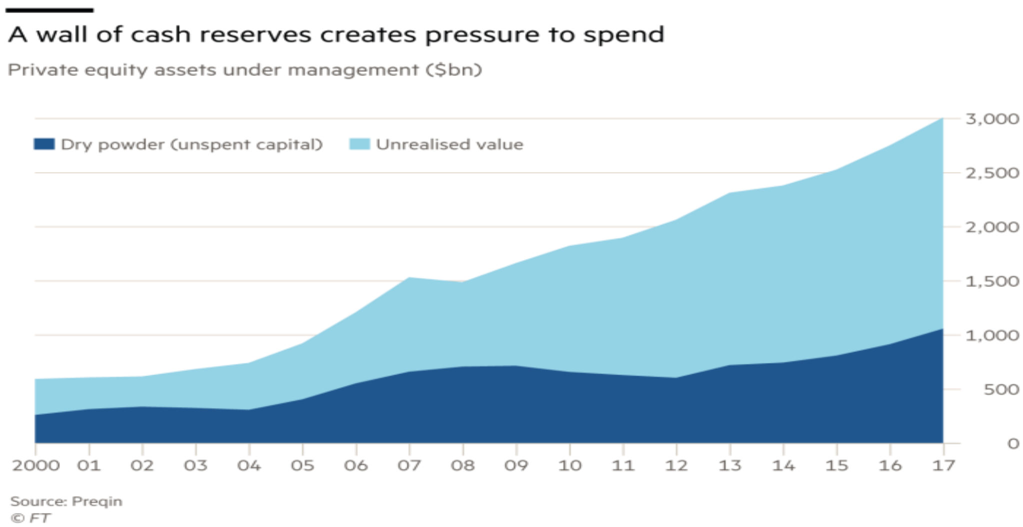
SOVEREIGN WEALTH FUNDS

Sovereign wealth funds represent an **enormous global pool of capital seeking investment opportunities around the world.** Norway's Government Pension Fund is the largest with over $1 trillion followed by several other large funds, as shown below:

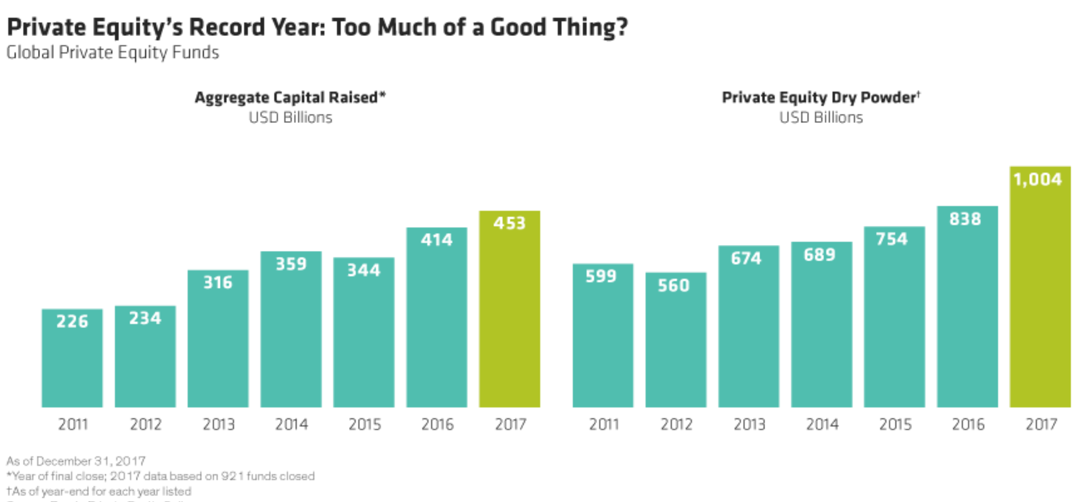
PRIVATE EQUITY AND VENTURE CAPITAL

Private equity firms are awash in liquidity, as investors chase returns they believe are unavailable from the public equity and fixed-income markets, exacerbated by a deluge of cheap available credit. Furthermore, pension funds, both public and private, as well as Sovereign Wealth Funds, are seeking opportunities to achieve their targeted rates of return necessary to pay their rapidly rising obligations in a fixed-income world with very, very low returns. Since 1980, the private equity industry has exploded in both the number of firms and assets under management, rising from only 24 firms to almost 7,000 today, and overseeing just below $5 trillion of invested assets and cash awaiting to be invested.

According to Preqin, private equity firms have **over $1 trillion dollars in dry powder** to invest as well as unrealized values of over $2 trillion, as shown below.

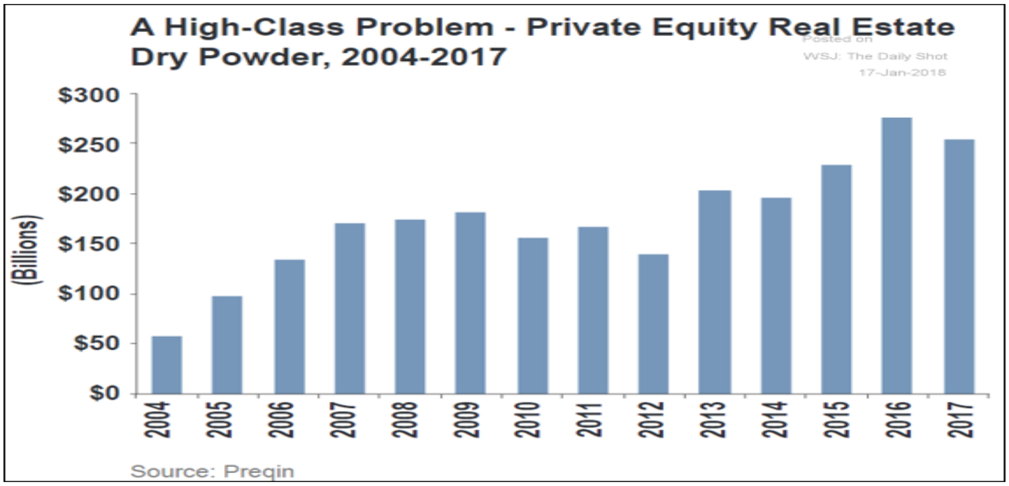


Despite the large amounts of uninvested cash, the private equity industry continues to raise capital, as **global fundraising rose to $453 billion in 2017,** while investments declined 11% to $526 billion reflecting elevated purchase prices. Apollo Global Management, a leading private equity firm, in 2017 raised the **largest fund in private equity history at $24.6 billion.** In fact, several private equity firms have turned down capital for some of their newer funds, reflecting the robust investment landscape for private equity investments.



Tony James, the Chief Operating Officer of The Blackstone Group, recently commented that he could see prices in the private equity market decline "10 to 20% sometime this year."

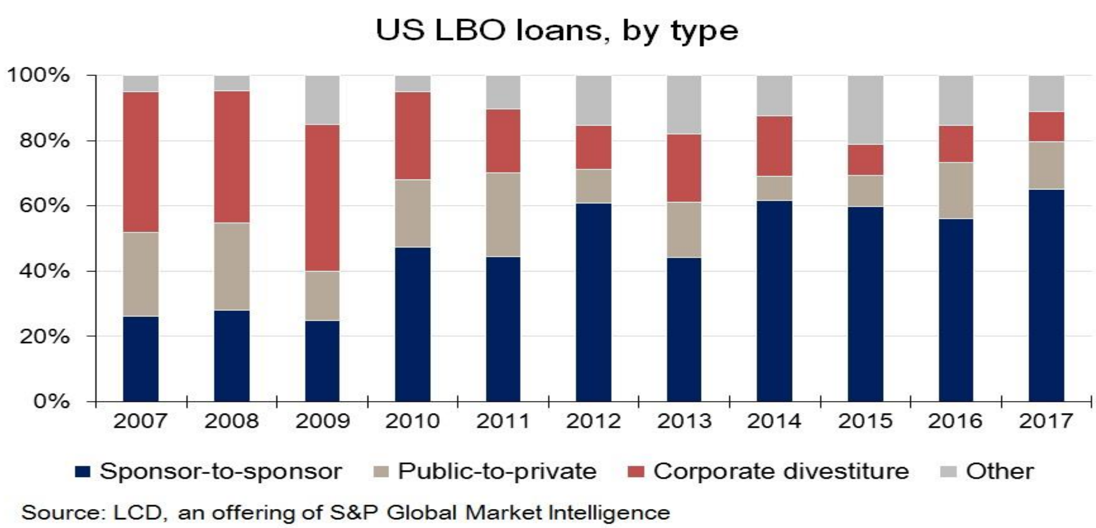
Private equity real estate dry powder is also at high levels.



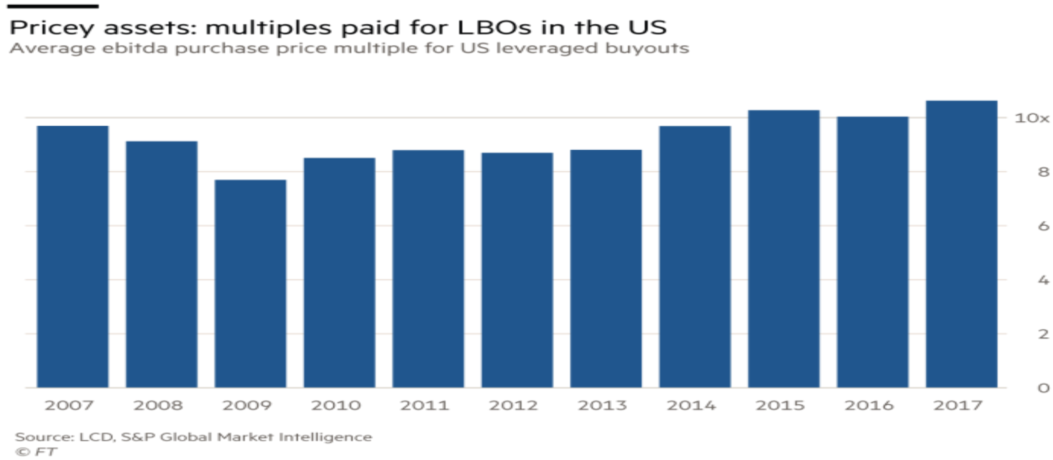
Source: Park Madison Partners

The **venture capital space is also raising record levels of cash** from investors. **Sequoia Capital,** one of the oldest and finest venture capital firms, is seeking to **raise up to $8 billion** in their **new fund,** up from $5-6 billion sought at the end of 2017. The new fund would be **Sequoia's largest ever** as well as the industry's largest to date. Of course, we'd be remiss not to also mention Masayoshi Son's SoftBank Vision fund based out of Japan, with $100 billion of investable assets – about 40% deployed to date, more than all of U.S. venture capital combined in 2017 ($84 billion per the National Venture Capital Association).

As private equity firms find it challenging to find buyers to exit deals, given the elevated price levels in both public and private markets, **secondary buyouts,** or **purchases amongst private equity firms, continues to rise.** For example, in the U.S. leveraged loan market, secondary buyouts represented 65% of transactions, a new record surpassing 2014's 62% level, as shown below.



Private equity purchase price multiples continue to rise above the high levels of 2007, while levels of debt are also rising as illustrated in the two tables that follow.



With the current elevated valuations levels, it will become **increasingly difficult for private equity firms to achieve their internal rate of return targets,** often exceeding **25-30%** or more. Historically, private equity firms sought to pay 4-7x EBITDA multiples and when combined with low interest rate financing, attractive internal rates of return were often achieved. Going forward, **paying over 10x EBITDA when combined with rising interest rates is likely to result in future rates of return that are muted from past levels.** Rare exceptions will be those companies that are able to achieve very attractive growth rates.

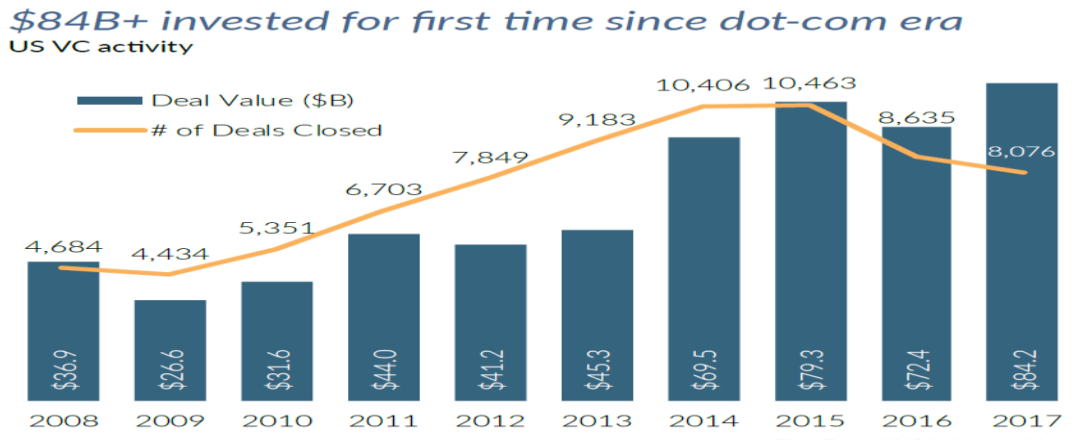
Hellman & Friedman purchased Scandinavia's largest payment processor Nete A/S for $5.3 billion, a 30% premium to the stock price or 24x earnings. **Hellman & Friedman co-CEO, Patrick Healy**, comments, **"Any time you buy something today, it is at the highest price."** There have been several deals where many of the leading private equity firms have dropped out of the bidding, as prices were simply too high to achieve their target returns.

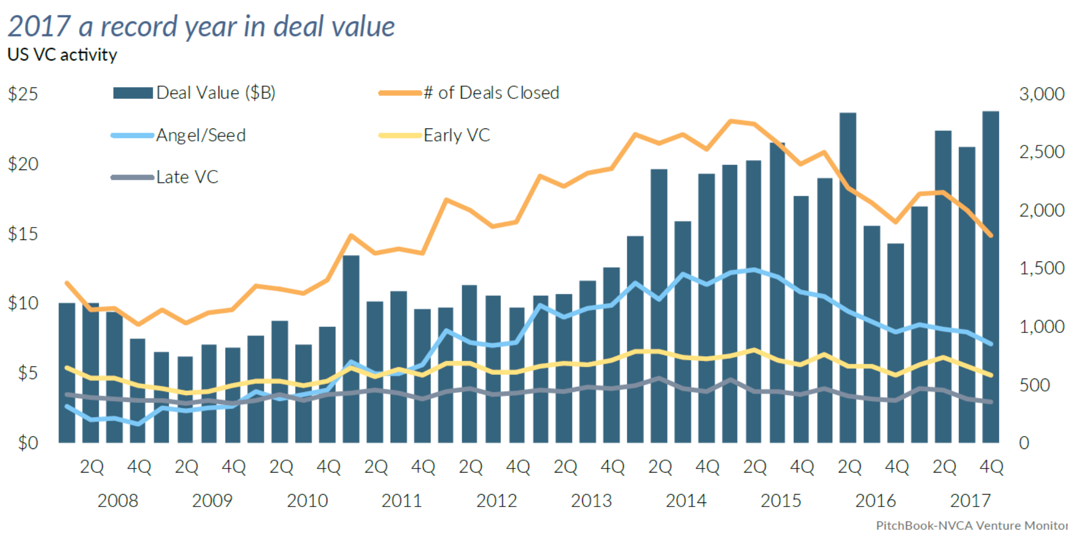
Venture capital is also overflowing with capital. At a recent conference, a leading venture capital investor, **Bill Gurley** from **Benchmark Capital**, made several statements regarding the easy availability of enormous amounts of cash available, "**We are in an environment where if you're a successful company you're now being handed hundreds of millions of dollars pre-IPO".**

With very low interest rates combined with large amounts of capital available to invest, venture capital firms have lowered their stringent parameters overseeing investments and startup management teams have much easier access to capital and are less accountable to their investors, which could result in terrible consequences. Gurley called the situation “unprecedented”.

Gurley also went on to say, **“Watch out, it’s a dangerous time.”**

Some data points that illustrate the robust environment in venture capital follow.





In **2017, worldwide mergers and acquisitions exceeded $3 trillion for the fourth consecutive year and that should continue in 2018,** fueled by cheap debt and the need for many companies to supplement limited organic revenue growth.

<u>FEDERAL GOVERNMENT BUDGET</u>

One of the biggest challenges we face as a country is fully reflected in our Federal Government Budget. The data presented on the following page forecasts an $873 billion deficit in fiscal 2018 that will rise to almost $1 trillion in fiscal 2019. A second table illustrates the rapidly rising expenditures for Social Security, Medicare, Medicaid and interest expense, which are enormous challenges for our government to address.

Table S-1. Budget Totals [1]

(In billions of dollars and as a percent of GDP)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	Totals 2019–2023	Totals 2019–2028
Budget Totals in Billions of Dollars:														
Receipts	3,316	3,340	3,422	3,609	3,838	4,089	4,386	4,675	4,946	5,231	5,506	5,818	19,344	45,520
Outlays	3,982	4,214	4,407	4,596	4,754	4,941	5,160	5,348	5,526	5,748	5,955	6,181	23,858	52,615
Deficit	665	873	984	987	916	852	774	672	579	517	450	363	4,513	7,095
Debt held by the public	14,665	15,790	16,872	17,947	18,950	19,946	20,809	21,495	22,137	22,703	23,194	23,684		
Gross domestic product (GDP)	19,177	20,029	21,003	22,069	23,194	24,369	25,605	26,900	28,253	29,647	31,089	32,602		
Budget Totals as a Percent of GDP:														
Receipts	17.3%	16.7%	16.3%	16.4%	16.5%	16.8%	17.1%	17.4%	17.5%	17.6%	17.7%	17.8%	16.6%	17.1%
Outlays	20.8%	21.0%	21.0%	20.8%	20.5%	20.3%	20.2%	19.9%	19.6%	19.4%	19.2%	19.0%	20.5%	20.0%
Deficit	3.5%	4.4%	4.7%	4.5%	3.9%	3.5%	3.0%	2.5%	2.1%	1.7%	1.4%	1.1%	3.9%	2.8%
Debt held by the public	76.5%	78.8%	80.3%	81.3%	81.7%	81.9%	81.3%	79.9%	78.4%	76.6%	74.6%	72.6%		

[1] Outlays and deficits are standardized to 12 monthly benefit payments, as shown on Table S–4.

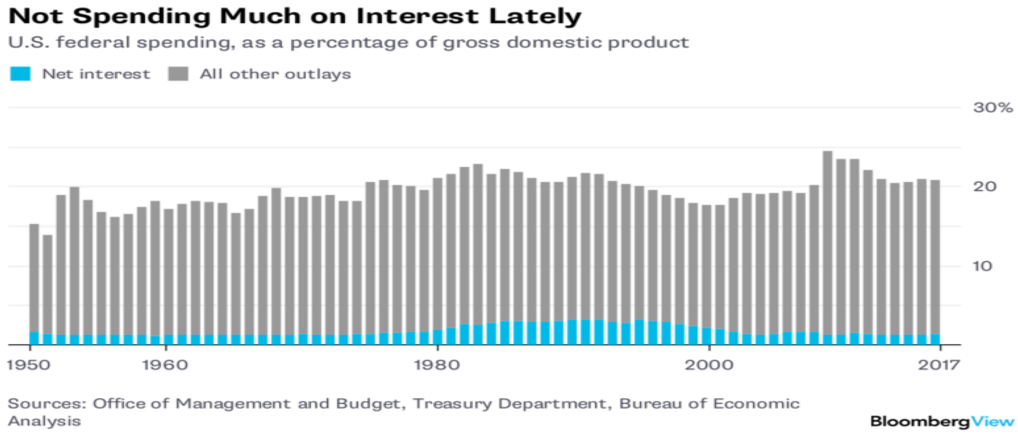
Gross Domestic Product	18,407	19,120	19,924	20,671	21,380	22,165	23,037	23,951	24,905	25,896	26,927	27,999	107,178	236,856

Table S–3. Baseline by Category [1]

(In billions of dollars)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	Totals 2019–2023	Totals 2019–2028
Outlays:														
Discretionary programs:														
Defense	590	611	637	668	678	690	705	719	737	755	774	793	3,378	7,156
Non-defense	610	661	656	659	670	669	676	689	705	721	738	756	3,330	6,940
Subtotal, discretionary programs	1,200	1,271	1,293	1,327	1,349	1,359	1,381	1,408	1,442	1,476	1,512	1,549	6,708	14,096
Mandatory programs:														
Social Security	939	987	1,047	1,109	1,174	1,245	1,319	1,398	1,480	1,566	1,656	1,752	5,894	13,745
Medicare	591	582	640	688	743	845	876	902	1,005	1,103	1,196	1,353	3,792	9,350
Medicaid	375	402	420	439	464	490	519	549	583	624	661	701	2,332	5,450
Exchange subsidies (including Basic Health Care Program)	39	48	48	48	49	52	54	57	60	63	66	69	251	565
Other mandatory programs	574	570	576	589	612	654	655	658	684	745	764	815	3,086	6,751
Subtotal, mandatory programs	2,519	2,588	2,731	2,873	3,042	3,286	3,423	3,564	3,811	4,100	4,343	4,689	15,355	35,861
Net interest	263	310	364	447	515	577	636	684	727	772	815	859	2,538	6,396
Total outlays	3,982	4,170	4,388	4,647	4,906	5,222	5,439	5,656	5,980	6,348	6,670	7,098	24,601	56,353
Receipts:														
Individual income taxes	1,587	1,660	1,687	1,790	1,917	2,050	2,198	2,348	2,504	2,700	2,883	3,062	9,642	23,140
Corporation income taxes	297	218	225	265	273	314	374	417	435	417	406	414	1,451	3,539
Social insurance and retirement receipts:														
Social Security payroll taxes	851	852	905	941	995	1,049	1,103	1,164	1,226	1,296	1,361	1,442	4,994	11,483
Medicare payroll taxes	256	259	275	287	304	322	339	359	379	401	422	448	1,528	3,535
Unemployment insurance	46	48	47	47	47	46	47	48	49	50	52	55	233	488
Other retirement	10	10	11	11	12	12	13	14	14	15	16	17	59	135
Excise taxes	84	108	108	112	118	121	124	128	132	136	140	146	584	1,265
Estate and gift taxes	23	25	17	18	19	21	23	24	26	28	29	31	98	236
Customs duties	35	40	44	47	48	50	51	52	53	55	56	58	240	515
Deposits of earnings, Federal Reserve System	81	72	55	49	52	59	67	73	77	82	86	91	282	691
Other miscellaneous receipts	48	48	50	47	47	49	50	52	52	54	56	57	243	515
Total receipts	3,316	3,340	3,424	3,613	3,833	4,095	4,389	4,678	4,948	5,233	5,508	5,820	19,354	45,541
Deficit	665	829	964	1,033	1,073	1,127	1,051	978	1,032	1,115	1,162	1,277	5,247	10,812

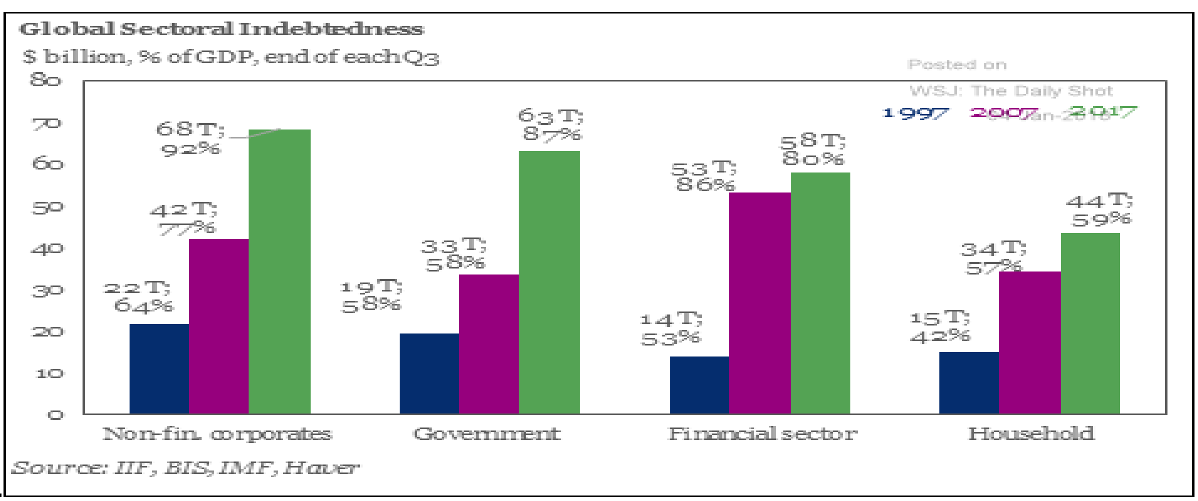
Furthermore, in fiscal year 2007, federal debt was $9 trillion, or just under 62% of gross domestic product, rising to over $20.2 trillion, or 105.5% of gross domestic product at the end of fiscal 2017. **While federal debt has risen by over $11 trillion over the past 10 years, interest payments have actually fallen, as a percentage of gross domestic product, given the artificially low interest rates during this period, as the table on the following page illustrates.**



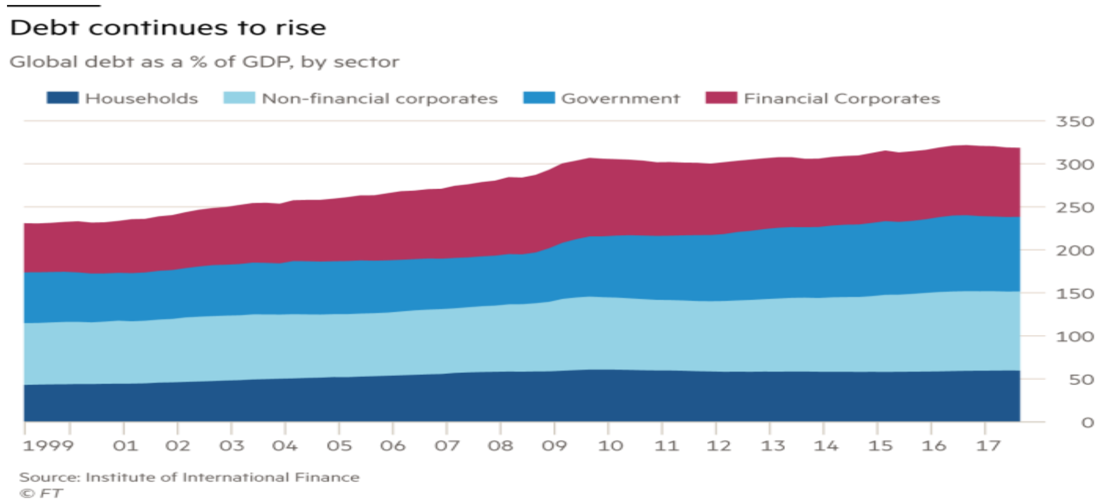
However, with the Federal Reserve now raising rates, combined with much more federal debt, interest payments will skyrocket over the next few years, both in absolute terms as well as a percentage of gross domestic product. The table above may very well understate the interest expense, given the new tax law that was passed and the level of future interest rates, as the Federal Reserve continues to raise them. I want to again emphasize that **while government debt more than doubled over the past 10 years, interest payments have only risen by 5% or so - this is going to come to an end as rising interest payments, combined with escalating entitlement program expenses for Social Security, Medicare and Medicaid, will create an enormous obligation for our government to satisfy.**

GLOBAL DEBT LEVELS - DEBT, DEBT AND MORE DEBT

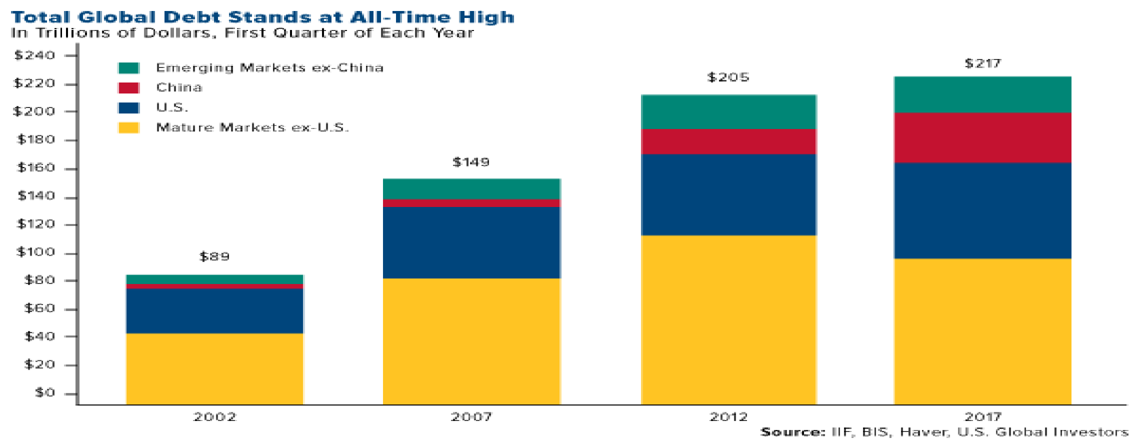
As central banks around the globe focused upon creating and sustaining low and even negative interest rates to allow economies to recover from the Great Financial Crisis of 2008-2009, several derivative effects have resulted. By keeping rates artificially low for too long, cheap debt has been growing rapidly for a decade. According to the Institute for International Finance, global debt outstanding increased by $16.5 trillion in the first nine months of 2017 to a new record $233 trillion or 318% of global debt to GDP. In fact, **global debt levels have risen from $162 trillion in 2007 just before the Global Financial Crisis to $233 trillion today.** The two charts below illustrate the composition of the $233 trillion in global debt by sector over the past two decades and as a percentage of GDP since 1999.



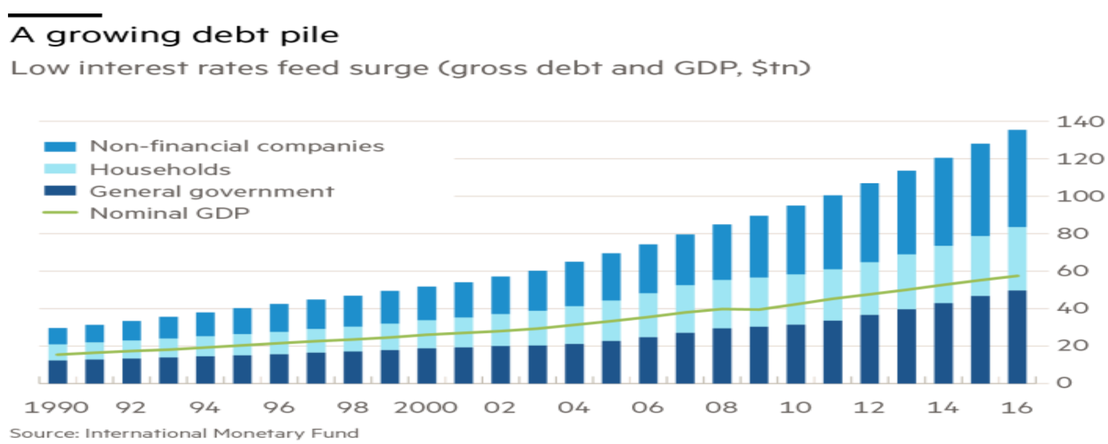
Source: @IIF



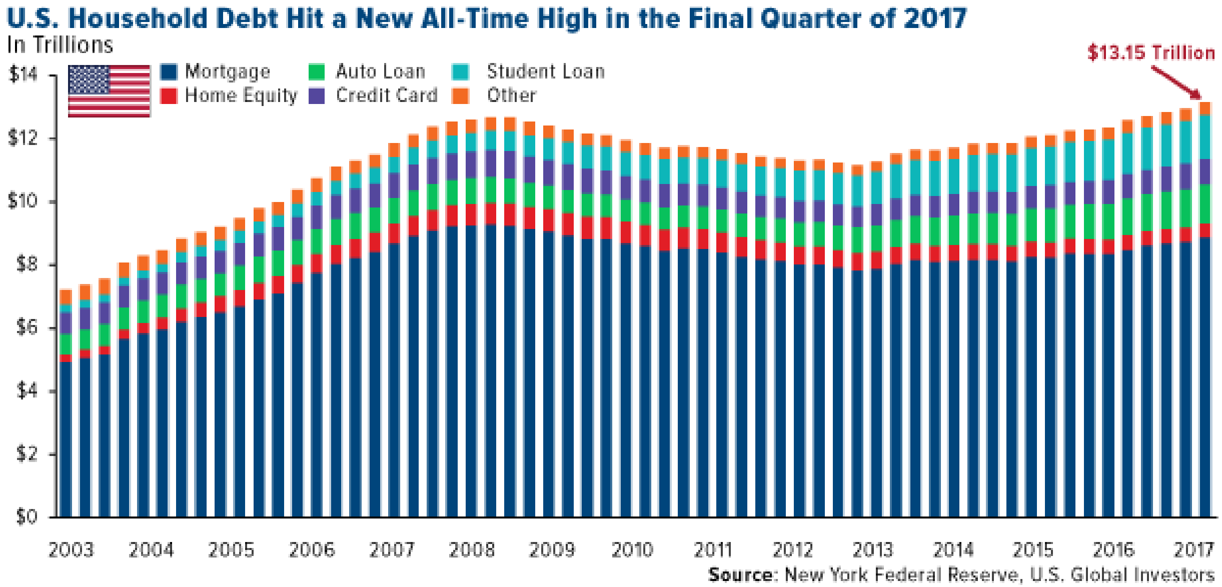
According to several economic firms, total global debt stands at an all-time high and just slightly below the numbers quoted above from the International Institute of Finance as shown below.

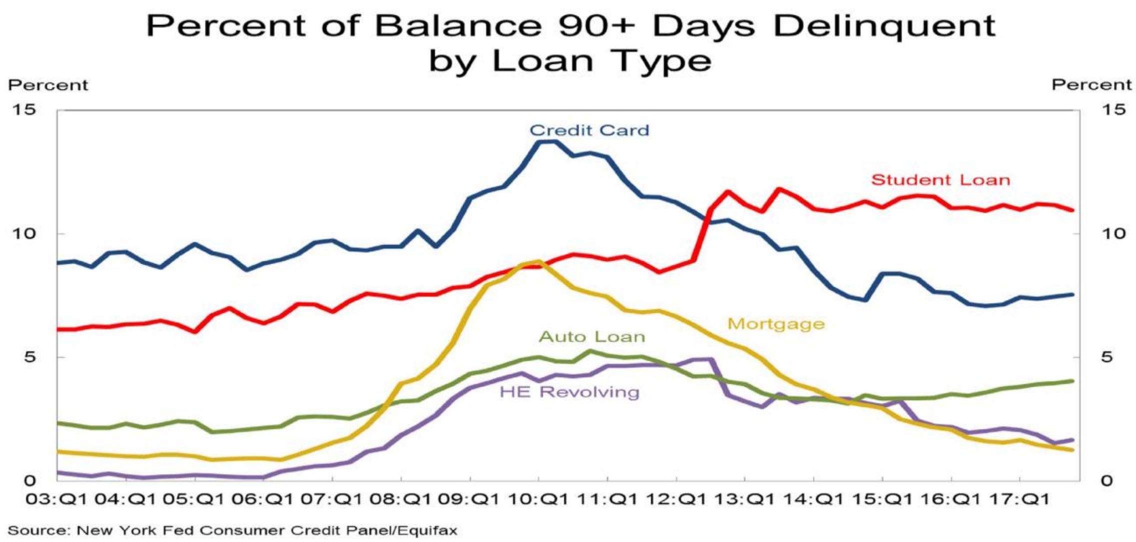


The International Monetary Fund in October 2017 warned of the large indebtedness of the G20 Countries with $135 trillion in debt or 235% of GDP, as shown below:



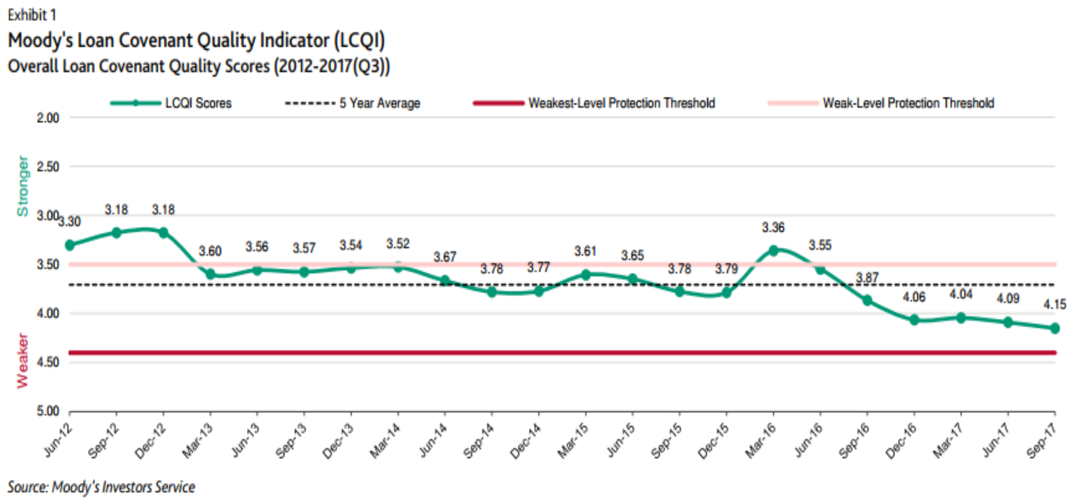
In the United States, corporations have increased their borrowings to fund stock buybacks and raise their dividends. **Nonfinancial corporate debt is almost 80% higher today than it was in 2008.** Households have also increased their debt levels, surpassing $13 trillion for the first time ever, surpassing the prior peak by almost $500 billion reached in the 3rd quarter of 2008. The largest increases are in non-housing debt, especially student and auto loans.



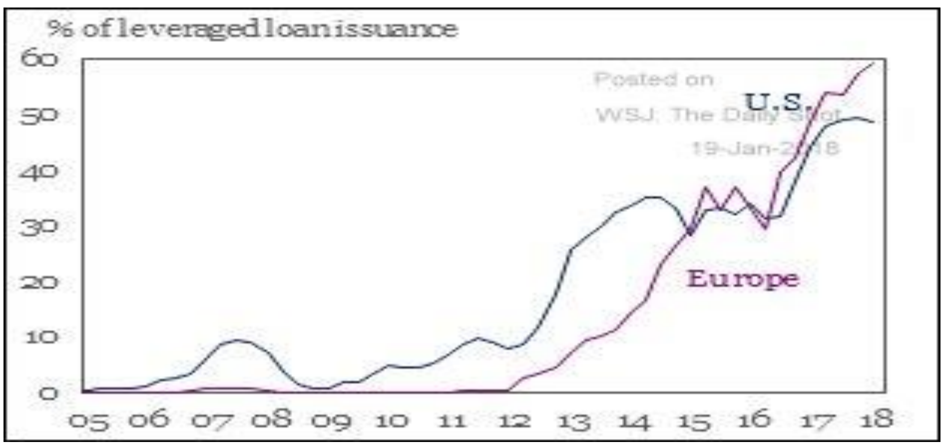


The United States, with over $20 trillion in government debt and China, with over $30 trillion or 259% of GDP, will face rising challenges to service that debt along with all their other growing obligations.

Credit markets also continue to have fewer protections, as **looser loan covenants** are becoming the norm. In a recent Moody's report, its Loan Quality Indicator (LCQI) is now at the **lowest level ever recorded,** as illustrated on the following page.



The issuance of loans with **covenant lite features** - that is, **weaker lender protections -** have continued to rise, hitting new highs as illustrated below.



Source: @IIF

UNDERFUNDED PENSIONS-STATE AND MUNICIPALITIES

I have included a few of my comments from last year's letter with a minor addition to again emphasize the enormous financial burdens facing our state and local government entities. Among their largest are unfunded pension liabilities. According to a Hoover Institution essay entitled *"Hidden Debt, Hidden Deficits"* from Joshua Rauh, a finance professor at the Stanford Graduate School of Business, unfunded pension liabilities are at $1.6 trillion, though under newer, more conservative accounting standards, they are over twice that at $3.4 trillion and growing.

A Pension Task Force created by the Actuarial Standards Board is evaluating recommendations that would raise the level of unfunded state and local pension obligations to an estimated $5 trillion, while Moody's has issued a recent report asserting that state public pensions will be underfunded by $1.75 trillion in fiscal 2017. Whatever the ultimate unfunded status is, it is clear that state and local governments in the United Sates are facing unprecedented financial burdens that will be difficult to overcome in the years ahead without major tax increases and budget cuts reducing vital services and significant sacrifices from all their constituents.

Since 2010, 13 cities have filed for bankruptcy protection, including; Detroit, MI, Stockton, CA, San Bernardino, CA, Central Falls, RI, and Vallejo, CA. Pension shortfalls have been contributors to several of these bankruptcy filings.

Moody's has created a table illustrating the top 20 state pension liability exposures for fiscal year 2016, as shown below:

Illinois pension burden leads the states

		Moody's State Adjusted Net Pension Liability (ANPL)	
State	Rating	FY 2016 ANPL in billions	FY 16 ANPL as % of Own Source Revenue
Illinois	Baa3	$200.63	486.6%
Alaska	Aa3	$10.87	442.8%
Connecticut	A1	$53.74	285.0%
Kentucky	Aa3*	$37.42	265.4%
New Jersey	A3	$94.97	249.5%
Massachusetts	Aa1	$65.19	201.5%
Maryland	Aaa	$46.21	194.2%
South Carolina	Aaa	$22.88	173.0%
Pennsylvania	Aa3	$66.60	163.7%
Texas	Aaa	$108.62	162.2%
Montana	Aa1	$4.87	152.5%
Maine	Aa2	$6.66	144.5%
West Virginia	Aa2	$9.14	141.8%
Colorado	Aa1*	$19.78	140.4%
Rhode Island	Aa2	$5.67	130.9%
Kansas	Aa2*	$16.15	126.7%
California	Aa3	$192.54	116.9%
Hawaii	Aa1	$8.39	114.7%
Michigan	Aa1	$36.82	114.7%
Vermont	Aaa	$4.02	112.9%

Various measures are being taken by cities to resolve their financial dilemmas. Recently, Connecticut Governor Daniel Molloy proposed transferring over $400 million in annual teacher pension costs from the state to cities and towns in Connecticut, as the state faces a $1.7 billion budget deficit. Rhode Island, under State Treasurer Gina Raimondo (now Governor), in 2011 was one of the first states to enact pension reforms to combat a $6.8 billion funding gap. Despite being taken to court twice by public-sector unions, Raimondo remained focused on working through the challenges to resolve the funding gap.

Richmond, California, on the eastern shore of the San Francisco Bay, is one of several cities at risk of bankruptcy. The city has cut 20% of its workforce, or over 200 jobs since 2008, as it fights to battle its ever-rising pension costs that have risen from $25 million to $44 million in the past five years. It is estimated that in just four years, 2021, pension obligations could exceed $70 million, or 41% of the city's revenues.

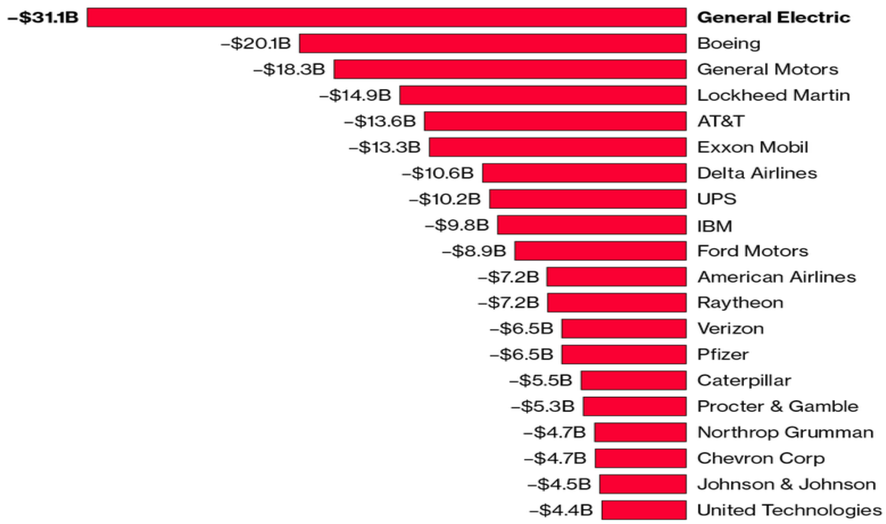
Public pensions are also overstating future returns in their model projections with almost 75% projecting returns of 7-8%, which may be unattainable and are far above more conservative return estimates of 5% or so.

States and municipalities throughout the country have enormous challenges ahead of them as they face these **rising pension and healthcare obligations, aging demographics, declining populations and the negative employment consequences brought about by globalization and technology.**

UNDERFUNDED CORPORATE PENSIONS

In addition to pension obligations faced by our states and municipalities, corporations are also facing enormous pension and healthcare benefit challenges. The table on the following page illustrates US companies with the largest pension deficits.

Companies With the Biggest Pension Deficits



Source: Bloomberg

These pension obligations place enormous burdens on companies, operating in an ever-increasing competitive environment, and present a significant competitive disadvantage. Companies must utilize both human and financial resources away from their core focus to develop strategies that will help fund their ever-rising pension and healthcare obligations. In many cases, they may be forced to make difficult decisions such as selling assets or foregoing investments to do so.

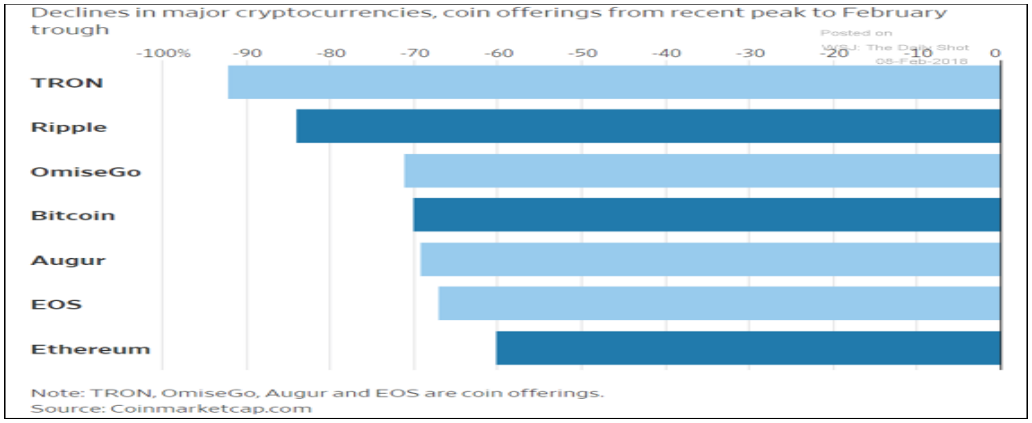
General Electric, on their November 2017 conference call, announced plans to borrow $6 billion to help plug some of its pension deficits. Furthermore, corporate pensions have been casualties of the very low interest rate environment that has persisted since December 2008. This has limited their opportunity to achieve the necessary rates of return they need to fund their pension obligations. General Electric also borrowed heavily over the past several years, spending over $45 billion for share buybacks.

POSSIBLE BUBBLES

Given the artificially low interest rates fueled around the globe by central banks, there are areas of concern where prices are at "bubble" levels, including: cryptocurrencies, financial markets such as levered ETF's, real estate in several countries, fixed-income securities, and private company valuations. We discussed the "bubble" levels in fixed-income securities and private company valuations in last year's letter.

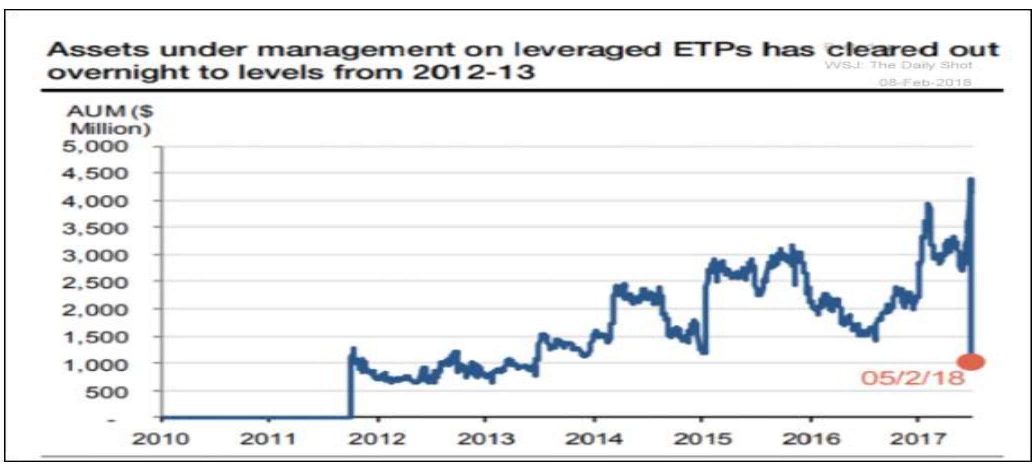
Cryptocurrencies have been in the headlines it seems every day with new millionaires created almost daily, at least for a while not long ago. While we believe blockchain represents an interesting technology, we do not think that cryptocurrencies represent sound investments at this time.

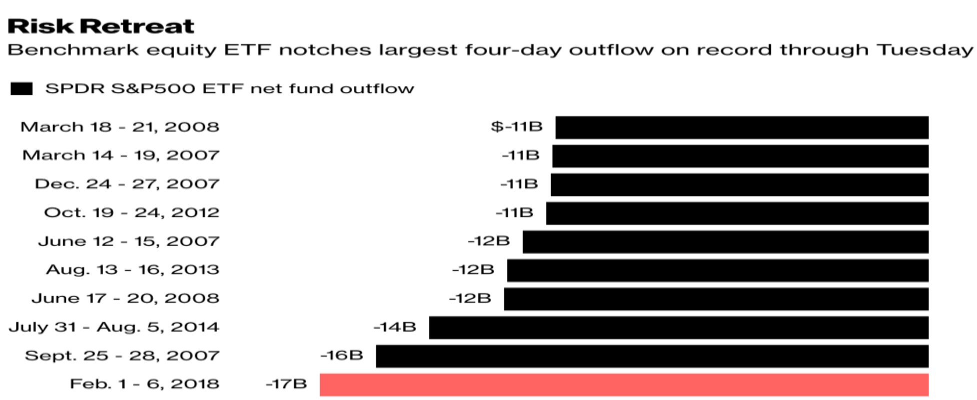
Cryptocurrencies, after rising exponentially over the past several years, have recently experienced significant declines from their recent peak, illustrated on the following page.



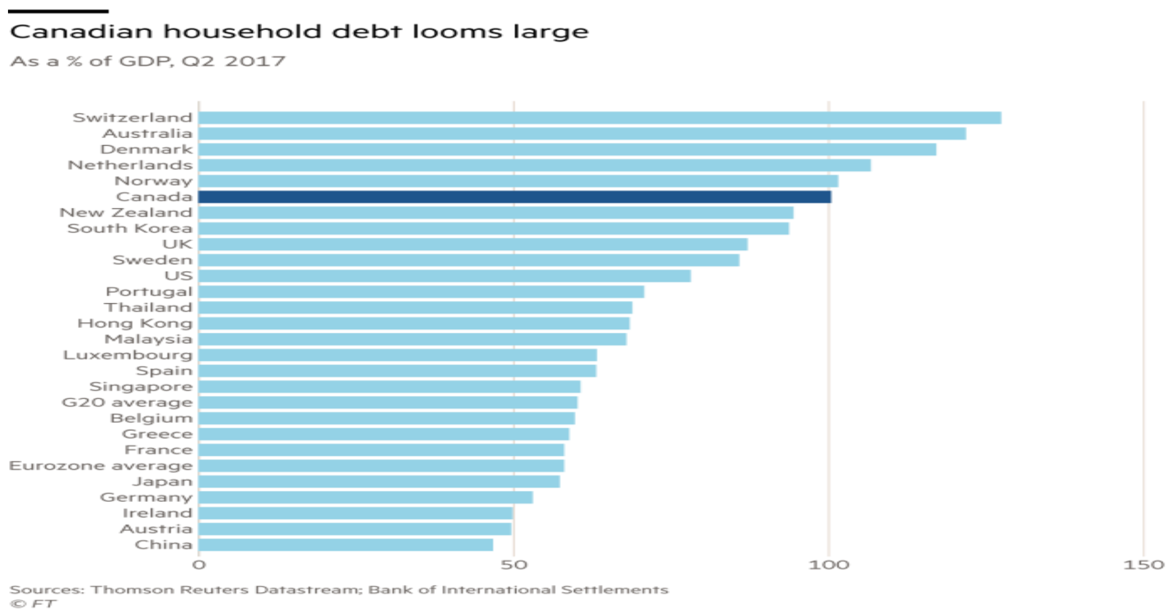
Wall Street is a **product creating machine, first and foremost,** and the emergence of exchange traded products linked to the VIX (the volatility index) was a **very successful trade for several years given the lack of short-term stock market fluctuations.** For example, the **VelocityShares Daily Inverse VIX Short-Term exchange traded note rose to a $2 billion value** on the CBOE Volatility Index and achieved a **46% compound annual return since its inception in 2010 to early February 2018.** However, in **early February,** the **value dropped by 95% to less than $15 million and trading was halted.**

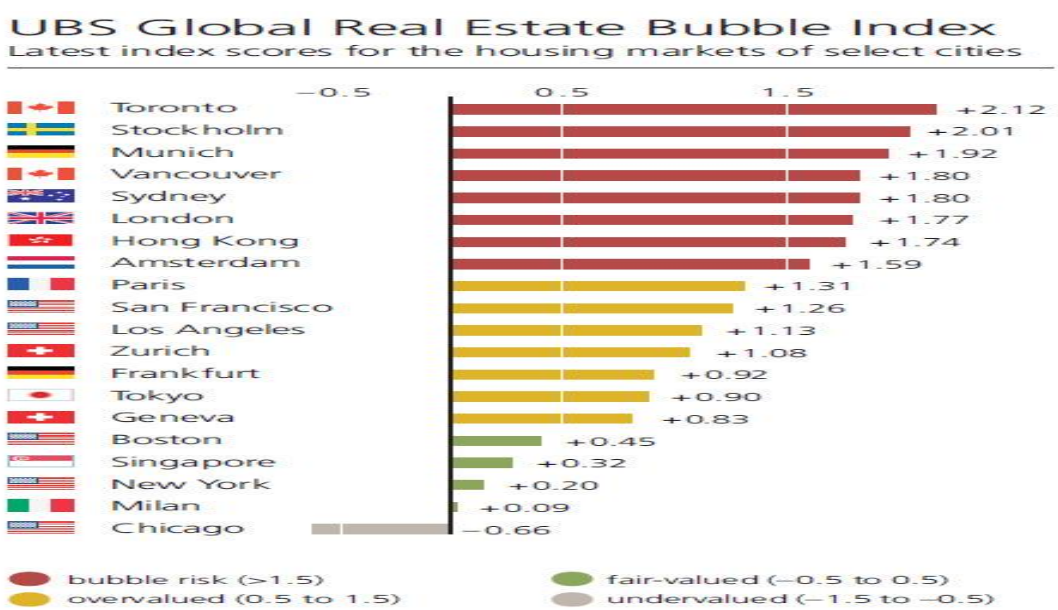
These levered exchange traded products represent highly risky investments, with assets rapidly fleeing in a very short period of time, as the tables below from the Wall Street Journal and Bloomberg illustrate.





Finally, several countries and cities are experiencing **"bubble" levels in real estate,** as illustrated in the charts below.





<u>**2017 PORTFOLIO ACTIVITY - EQUITIES**</u>

As the stock market has continued to rise since market lows in March 2009, **we have gone from being very active buyers to very selective sellers in 2017.**

Throughout 2017, we remained very patient and sold **very small portions** of a few **of our core holdings,** some of which we have owned for over a decade, including **Brown & Brown, Lowe's, Mohawk Industries,** and **Zoetis.** These **small sales throughout 2017 address elevated company valuation levels that we believe lack an adequate margin of safety and represent greater risk than reward.** During much of 2017, the higher valuation levels made it increasingly difficult to find securities that met our valuation thresholds, and importantly those with an adequate margin of safety (loosely defined as selling at a 30% or greater discount to our estimate of the intrinsic value 3-5 years out). However, while we had hoped that the stock market declines in early 2016 would continue and provide us with some attractive investment opportunities in 2017, that did not materialize and thus we remain patient, disciplined and ready to act when investments with our required risk/reward characteristics become available. In early 2016, we purchased a few of our current holdings for new accounts **including BB&T, Berkshire Hathaway, US Bancorp, Wells Fargo** and **World Fuel Services** during company-specific price declines. The very calm stock market of 2017 provided few opportunities to invest in stocks, but we will remain patient, as inevitable declines such as the recent one in February 2018 provide opportunities to invest.

<u>2017 PORTFOLIO ACTIVITY – FIXED-INCOME</u>

We have remained focused upon the US fixed-income market, which offers higher rates, more liquid markets and overall less risk than global fixed-income markets. We have continued to selectively purchase several fixed/adjustable rate preferred stocks of outstanding companies with coupons that range from over 4% to almost 8%, and with yields to the call date from over 3% to almost 5.5%. We have discussed several of these securities in detail in our past letters and believe them to be excellent choices for high quality income, tax benefits and interest rate protection when held to the callable dates.

We purchased several of these preferred stocks at, or slightly above, par over the past several years. The dividend payments on each of these, at purchase, were yielding approximately 200-300 basis points above those of 10-year Treasury obligations, with much shorter durations of often 1-3 years, while also providing significant tax benefits. They also begin as fixed rate securities and convert to an adjustable rate if they are not called by their respective issuers. This rare adjustable rate feature reduces both interest rate risk and the security's duration.

The Federal Reserve raised the federal funds rate 3 times in 2017 and it is anticipated that they will increase rates at least 3 more times in 2018. The results are impossible to predict, as rising interest rates have enormous impacts throughout the economy. What is more important is the rapidity of interest rate increases and the magnitude of those increases. As I discussed at length in the section on the Federal Reserve, we are in unprecedented territory as never before has our Federal Reserve or Central Banks around the world dealt with reducing these historically large balance sheets. The Federal Reserve is walking a very fine line and successful execution without major disruptions will be very difficult.

The fixed-income markets in the United States remain challenging nonetheless. **After over 30 years of declining interest rates, virtually all fixed-income investments are yielding historically low yields, including: Treasury Bills, Notes and Bonds, Municipal Bonds, Corporate Bonds, Agency and Mortgage Backed Securities, Bank Loans and High Yield Securities. We continue to find the majority of fixed-income securities to be unattractive as the risk/reward is, simply, unfavorable. As such, we have avoided most of these instruments. The only other area we believe where solid risk-adjusted value exists is in fixed/adjustable rate preferred stocks of the finest financial institutions in the country.**

This low interest rate environment encourages borrowing, distorts capital allocation decisions, and punishes individual savers, as well as institutions, including pension funds, insurance companies and banks. Furthermore, **low interest rates incent increased risk-taking by investors, both individual and institutional, as they seek higher yields to satisfy their income needs and obligations.** Virtually all fixed-income instruments continue to offer historically low yields for desperate investors seeking income. These include: US Treasury bills, bonds and notes, corporate bonds, municipal bonds, bank loans, high-yield securities, government agency debt and other securities.

The key risks to our adjustable preferred stocks that we see are: 1) they are perpetual securities with no maturity or mandatory redemption date; 2) credit risk, as they are junior to most securities other than common stock; 3) regulatory risk, as Dodd-Frank and other regulations may change, resulting in the banks redeeming these securities early at par; 4) tax law changes that may impact the qualified dividend treatment for these issues; and 5) interest rate risk, mitigated to some extent by the adjustable feature.

Another short-term risk is that the prices of these securities will fluctuate, often rising above and even falling below their par value. In fact, **several of our holdings have risen as much as 20% above par and some have declined as much as 3-5% below par, and in the current volatile markets these price fluctuations may increase and result in prices well above or well below par.** These fluctuations do not concern us; rather they provide opportunities to purchase more of these outstanding securities, particularly when trading below par. **We caution our clients to please focus on the long-term income generated by these securities and not on the price fluctuations up or down.** We anticipate holding the majority of our holdings until the call date, with few exceptions. Please recall, we view risk in terms of the **probability of permanent capital loss, not short-term price fluctuations.**

An important benefit for our clients with taxable accounts is that these dividends represent qualified dividend income, or QDI, and are considered dividend income for federal tax purposes, which is taxed at favorable capital gains tax rates. For most of our clients that will be either 15% or 20%, though with the additional 3.8% tax from the healthcare bill's medical surtax, 18.8% or 23.8%. These rates are still well below ordinary income tax rates now approaching 40%.

With such low interest rates, many yield-starved individual investors that need investment income to live on, and with pension funds, endowments, insurance companies and others with specific obligations to meet, are chasing yield in higher risk instruments, as higher quality securities are not providing the required yields. We feel many investors who do so are taking excessive risks that may prove harmful down the road.

Our primary focus in our fixed-income investments remains capital preservation, and secondarily, income. While rates of return remain at historically low levels, we are unwilling to either reduce our credit quality standards or take undue interest rate risk by purchasing long maturities. With rare exceptions, we always hold our fixed-income securities to maturity.

EQUITY HOLDINGS

I discuss our key holdings in the paragraphs that follow, but feel it is most appropriate to begin by discussing our poorest performer, World Fuel Services, as well as Wells Fargo, which continue to face operational and regulatory challenges.

WORLD FUEL SERVICES (INT) is a global leader in fuel logistics, engaged in the marketing, sale, distribution and financing of aviation, marine and land fuel products and related services. World Fuel Services was founded in 1984 and in 2017 generated $33.7 billion in revenue. The company provides one-stop shopping for customers in this highly-fragmented industry, utilizing several of their advantages, including a global network, centralized purchasing, and a strong balance sheet to provide credit and hedging services for customers, to name a few.

World Fuel operates in a very competitive industry, evidenced by the large revenues they generate and the low margin of net income achieved. The company reported very poor results in the fourth quarter of 2016 and in the third quarter of 2017. While earnings met estimates, the challenges in the marine fuel pricing along with management's conference call comments on fierce competition contributed to a decline in the stock price from the mid-30's to the mid-20's. During the third quarter conference call specifically, they discussed some of these challenges, including unseasonably warm weather in the UK for their Watson subsidiary in residential fuel oil, hurricanes, Colonial Pipeline issues, and the bankruptcies of a few shipping companies.

World Fuel's **aviation business** continues to do well. The global aviation market is a 70-75 billion-gallon market, of which World Fuel's 10-12% market share represents about 8 billion gallons. The company operates in two aviation segments, Commercial and General. The Commercial aviation segment, representing 60%, is a predictable business with pricing done once a year, resulting in management visibility into total gallons sold during the year. General aviation is much more variable and accounts for 40% of business, of which half is for service related jobs. This is far less predictable, creating variability in results. Over the past several years, the company has had a very profitable business in Afghanistan serving our troops, which represented 20% of the aviation segment's gross profit, generating $5-6 per gallon, much higher than the majority of their business. As our country's operations have declined in Afghanistan, there has been a significant decline in gallons used and a reduction in volumes and profits. However, with the integration of the Exxon acquisition they have been able to continue to do well in aviation.

World Fuel's **marine segment** continues to struggle as industry dynamics remain very poor, though volumes have been reasonably consistent. The global marine fuel market is 250-275 million metric tons and they have a 10-12% market share, or a 30 million gallon-plus run rate. The company faces headwinds from the decline of global trade, as well as shipping companies going bankrupt, impacting credit losses and declining prices. The company has also been negatively impacted by the decline in the number of offshore oil rigs, which have been reduced by half over the past few years, as this represented another very profitable segment. The marine segment is also highly unpredictable as the entire business is based on spot pricing with little visibility going forward. Additionally, the company has not been able to provide marine fuel hedging for customers, due to less fluctuation in prices, further impacting revenues and profits. Finally, we believe management has been slow in right-sizing their cost structure in this segment.

World Fuel's **land segment** has been the **biggest disappointment** over the past several years, but also represents their largest opportunity. The global market in the land segment is enormous and highly fragmented with thousands of companies competing. Total market size is over 650 billion gallons, of which World Fuel has a 1% share. About 50% of the business is predictable, providing visibility with 7-10-year contracts while the remainder is much more variable. The company made several acquisitions in this space beginning in 2008 with Texor and followed by Lakeside and Western Gas. They have had a very difficult time integrating all the acquisitions, as each company is very different in their products, geographies and customer bases. The recent hiring of Jeff Smith as Chief Operating Officer, formerly of IBM, is aimed at driving the integration of technology further throughout the firm and integrating the aforementioned acquisitions. To begin, the company is integrating all of the acquired companies onto an Oracle system, both on the front and back end. Hopefully, these developments will provide a platform for growth into the future where World Fuel has a very small market share in a very large global market.

After the financial crisis of 2008-2009, the company benefited on several fronts, as many of their smaller competitors lacked World Fuel's strong balance sheet, size and scale. World Fuel was able to offer credit to customers, as they required more working capital to manage higher oil prices, which reached $140 per barrel in May 2008. Today, the large decline in oil prices has reduced the working capital needs of customers, and smaller players are able to compete. The fluctuations in oil prices also provided large opportunities for the company to provide very profitable hedging services for customers, which has also declined along with oil price fluctuations over the past few years. Finally, as I mentioned earlier, profits from offshore oil drilling and serving our troops in Afghanistan, both of which have been significantly reduced, have provided additional headwinds.

Despite our disappointment, we will continue to monitor the situation very closely as the company continues to address its challenges. It remains to be seen if management can exploit their core strengths and opportunities.

WELLS FARGO (WFC) is the fourth largest bank in the country with average assets of $1.9 trillion at year-end 2017. The company generated operating revenues of $88.4 billion in 2017 with net income of $22.2 billion and diluted earnings per share of $4.10.

We have spoken at length about Wells Fargo's unauthorized account openings in both our 2016 Semi-Annual letter and again in our 2016 Annual Letter. An excerpt of our comments is below:

"The company will continue to be investigated, as new investigations have been announced by other states, and will also likely continue to remain in business headlines. However, we believe that despite these extremely disappointing findings, Wells Fargo will do whatever it takes to resolve these issues and assure that the appropriate steps have been taken to eliminate these behaviors going forward. We do not believe that the company has systemic permanent flaws that cannot be corrected and therefore we will continue to keep our holdings, while simultaneously carefully and continually evaluating all the information available to us regarding the company's resolution of these problems."

As stated above, the regulatory burdens have continued as Janet Yellen and the Federal Reserve imposed a consent order in early February 2018 on Wells Fargo with several specific operating and board governance requirements. We believe that Wells Fargo is focused and deeply committed to fulfilling all the requirements requested by the Federal Reserve Board of Governors.

"In business as well as in life, integrity is the most important quality of all, creating the foundation for building trust with customers, vendors, employees and shareholders. Wells Fargo has broken that trust with many customers and must work diligently, quickly and thoughtfully to regain that trust with its customers. We believe they will do so and, over time, Wells Fargo will regain its stature as a premier financial services company serving the financial needs of its customers."

Despite the continuing challenges, we believe that Wells Fargo's diverse business model will continue to thrive in various economic environments and will benefit when interest rates rise, augmenting the net interest margin to once again exceed 4%, a level that it has fallen well below over the past several quarters. Wells Fargo remains an outstanding financial services company with leadership positions in several businesses including a leading mortgage originator and servicer; originating one of every three mortgages in this country. We estimate the company can earn in excess of $4.90 per share in 2018.

ABBOTT LABORATORIES (ABT) is a leading diversified healthcare company operating in the following areas: pharmaceuticals, diagnostics, nutritionals and medical products. In 2017 the company generated sales of $27.4 billion from four diverse business units: Nutritionals 25%, Medical Devices 38%, Established Pharmaceuticals 16%, and Diagnostics 20%.

Abbott completed the acquisition of St. Jude Medical, a global device manufacturer, on January 4, 2017 having paid $23.6 billion, with $13.6 billion in cash and $10 billion in Abbott stock.

For the full year 2017, Abbott generated in excess of $5 billion in operating cash flow and over $4 billion in free cash flow. Excluding specified items, Abbott should generate adjusted 2018 earnings per share of $2.80-$2.90 in 2018.

BANK OF NEW YORK MELLON (BK) is a leading trust bank with assets under custody and management exceeding $33 trillion. It is a global leader in several segments in which it operates. Few competitors have comparable global reach and scale. Approximately 80% of its revenues are recurring and fee-based, stemming from institutional services and with less reliance on the higher credit risk from lending.

In 2017, BK generated operating revenue of $15.5 billion and pre-tax income of $4.6 billion, representing a 30% pre-tax operating margin with $3.55 in earnings per share. Low interest rates continue to negatively impact results as they have over the past few years, while the bank continues to work diligently on its initiatives to cut expenses and selectively raise prices on many of its products. We believe the bank can earn $3.90-$4 in 2018, representing a multiple of 14x earnings, while paying a 2% dividend yield.

BB&T (BBT) is a leading, financial services holding company based in Winston-Salem, North Carolina with $221.6 billion in assets, operating over 2,000 financial centers in 15 states and Washington D.C. It offers a broad range of consumer and commercial banking services, securities brokerage, asset management, mortgage and insurance products. The company's geographic footprint includes the more rapidly growing southeastern United States with a growing presence in North Carolina, South Carolina, Georgia, Florida and Texas.

For the full year 2017, BB&T generated $7.5 billion in interest income and $4.8 billion in non-interest income for total revenues of over $12.3 billion and net income of $2.4 billion or $2.74 per diluted share. The company's solid credit culture, as well as geographic and product line diversity provide us with a solid institution, well positioned to continue to grow organically and through acquisitions in the years ahead. We believe BB&T should earn in excess of $3.90 in 2018, or 14x earnings and over $4.25 in 2019 representing a multiple of 12.9x earnings.

BERKSHIRE HATHAWAY (BRK-B) is a holding company of subsidiaries operating across a broad range of industries, including: Insurance and Reinsurance, Railroads, Utilities and Energy, Manufacturing, Services and Retailing, Finance and Financial Products. The company also has a large investment portfolio of stocks, fixed-income securities and cash. Berkshire Hathaway represents our largest holding; we believe the "B" shares have a long-term value of over $260 per share, utilizing various valuation measures. With Warren Buffett and Charlie Munger at the helm, the company is led by perhaps two of the greatest investors ever. While they are not immortal, the two have in place great leadership at their owned operating businesses, as well as two outstanding investors to effectively allocate capital going forward. Additionally, highly-regarded Greg Abel and Ajit Jain will serve as key leaders going forward for the company.

BROWN & BROWN (BRO) is a leading insurance broker with an outstanding corporate culture that helps generate the highest margins in its industry. Total 2017 revenue was $1.9 billion, a 6.5% increase from 2016, while fully diluted earnings rose to $2.81 per share from $1.82 in 2016.

After several years of sparse growth, Brown & Brown has begun to grow organically while continuing to maintain the highest profit margins in the industry. In fact, during the 1997 to 2007 insurance cycle, Brown & Brown grew EPS at 20% per year, but since that 2007 earnings peak, organic growth has slowed significantly. We believe the company can continue to achieve organic growth rates in the 5-9% range over the next couple of years.

LABCORP (LH) is the second largest provider of clinical laboratory testing services in the United States. In 2017, Lab Corp generated revenue of $10.4 billion, operating income of $1.4 billion, a 13% operating margin and free cash flow of $1.1 billion. Their Covance purchase continues to progress well and significantly diversifies LabCorp's revenues, though the purchase price was certainly a full one. We believe that free cash flow will now be applied to paying down debt rather than stock repurchases, which has been a key use of free cash flow over the past several years. The company believes it can grow 2018 revenues by 8.9%-10.9%, on a constant currency basis and generate adjusted earnings per share of $11.30-$11.70, an 18-22% increase from the 2017 adjusted earnings per share of $9.60. The 2018 increase includes a lower tax rate of 25%, or $1.30 in adjusted earnings per share.

LOWE'S (LOW), a leading home improvement retailer, should generate revenues of $68 billion in fiscal 2017 with diluted earnings of $4.20-$4.30 per share. The company continues to generate significant free cash flow exceeding $4.5 billion in 2017, contributing to a solid dividend yield of just under 2%, with continued share repurchases. While Home Depot continues to perform better than Lowe's as measured by same store sales and operating margins, we believe that Lowe's will continue to improve its merchandising operations, raise margins to over 10% and continue to buy back significant amounts of stock. Lowe's announced a new $5 billion stock repurchase program on January 18th, 2018, which adds to the existing $2.1 billion remaining on an earlier buyback program as of the end of November 2017. Lowe's stock price continues to appreciate, having risen 40% in both 2012 and 2013, 39% in 2014, 11% in 2015, -6.5% in 2016 and 31% in 2017.

MARTIN MARIETTA MATERIALS (MLM) is the second largest domestic producer of construction aggregates and a producer of magnesium-based chemicals and dolomitic lime. "Aggregates" refers to the business of selling crushed stone, rocks and sand and is an attractive business. It enjoys significant barriers to entry, including the challenges in obtaining permits for new quarries. The low value to weight ratio of aggregates creates local oligopolies that enable solid pricing power. As I mentioned in prior letters, it is one of few businesses I have ever studied that has experienced enormous volume declines yet been able to continue to raise prices, illustrating the power of their business model.

The company purchased Texas Industries in July 2014, which expanded their geographic presence and market share in several markets and also provides additional products.

MLM remains well positioned for solid growth in its largest markets, achieving 2017 revenues of $4 billion a 5% increase from 2016 with EBITDA of over $1 billion and earnings per diluted share of $11.25. Aggregates pricing in the fourth quarter of 2017 rose 4% and EBITDA increased 14%% from 2016.

With the significant need to rebuild our bridges and highways, we believe that MLM is well positioned to experience strong future growth, as our country begins spending the required capital on our rapidly deteriorating infrastructure. The 2016 passage of the Fixing America's Surface Transportation (FAST) Act, a five-year Federal highway spending bill, will continue to help the company prosper in addition to our President having expressed a keen interest in investing in our country's antiquated infrastructure. The recent passage of Tax Cut and Jobs Act in December 2017, along with the President's latest $1.5 billion infrastructure program, are all positive catalysts that should benefit the company.

MOHAWK INDUSTRIES (MHK) is a leading manufacturer of flooring products whose revenues continue to increase, as the economy and the housing markets in particular continue to rebound. Sales in 2017 were $9.5 billion with net earnings of just $972 million or $12.98 per diluted share. The company's 2017 operating income of $1.4 billion and EBITDA of $1.8 billion were both records.

The company continues to aggressively acquire, including the 2013 purchase of Marazzi Group, the fifth largest producer by volume in the ceramic tile industry. Combining Mohawk's existing ceramic division, Dal Tile, with the Marazzi Group creates the largest ceramic tile company in the world on a revenue basis. Currently, about 9% of U.S. flooring consumption in value is made of ceramic tiles, a much lower percentage than in most other nations around the world. In Western Europe tile represents 30%, and in countries like Italy tile can exceed 55-60%. In January 2015, Mohawk purchased IVC, a European based manufacturer of sheet vinyl, luxury vinyl tile and laminate sold in Europe and the U.S. The purchase price of $1.2 billion is 10 times trailing EBITDA and the acquisition should be $0.30-0.50 accretive in the first 12 months. In January of 2017, Mohawk acquired another small tile manufacturer in Italy to complement their leadership position there. In 2017, the company made four acquisitions in Italy, Poland and the United States to continue to broaden their product offerings.

We anticipate continued improvement in the housing markets and in the U.S. economy, which bodes well for Mohawk Industries in 2018 and beyond. Mohawk is projecting 1st quarter 2018 earnings of $2.93-$3.02.

PEPSICO (PEP) is the leading global snack and beverage company that manufactures and markets a variety of salted and convenience snacks, carbonated and non-carbonated beverages, and foods. The company operates through four segments: Beverages North America, Frito-Lay North America, PepsiCo International, and Quaker Foods North America.

Revenues generated in 2017 were $63.5 billion with operating income of $10.5 billion and core earnings per share of $5.23 that should rise 2018 to $5.70 per share. For 2018, the company is projecting over $6 billion in free cash flow. The company also announced a new $15 billion share repurchase program extending to 2021.

The company continues its focus on cost reductions, forecasting over $1 billion in incremental savings per year over the next five years. We believe the company can generate in excess of $10.8 billion in operating profit in 2018, even while facing strong headwinds from the rising dollar and slowing global economies, as over 50% of company sales are outside the United States.

PROGRESSIVE (PGR) is the fourth largest auto insurer in the country and generated earned premium revenues of $25.7 billion in 2017, a 14% increase from 2016 with pre-tax operating income of $2.1 billion, or $2.72 per diluted share. Progressive's impressive growth in premiums earned and profits continued in January 2018 as premiums written rose 22%, premiums earned rose 18%, net income rose 145% to $0.77 per share and the combined ratio declined to 87.4% from 89.7%. We believe that in 2018 Progressive could earn $3.25-$3.30, a 36% increase from 2017, reflecting a 17.5x price earnings multiple. Progressive's strong position in direct sales, along with Geico, provides a strong foundation to continue its solid growth in the fastest growing segment of auto insurance.

UNITEDHEALTH GROUP (UNH) is a leading diversified managed health care company serving 75 million individuals and operating through two segments: UnitedHealthcare, and Optum. The UnitedHealthcare segment serves employers and individuals, communities, states, Medicare and retirement. The Optum service businesses include Optum Health, Optum Insight and Optum RX. Overall company revenues in 2016 were $201 billion with operating earnings over $15.2 billion and adjusted net earnings per share of $10.70, a 25% increase from 2016.

The UnitedHealthcare Segment has the #1 market position in several areas including: Medicare Advantage, Medicare Supplement, and Medicaid, and is number two in commercial insurance. Furthermore, the company's geographic and product diversity serve to reduce business risk.

The Optum segment of UnitedHealth Group is a health services business serving the broad health care marketplace, including payers, care providers, employers, government, life sciences companies and consumers. Using advanced data, analytics and technology, Optum helps improve overall experience and care provider performance. Revenues for the Optum segments in 2017 were $91.2 billion with earnings from operations of $6.7 billion. Of the three Optum segments, Optum Insight is a leader in healthcare data analytics, generating revenues of $8.1 billion for the year, a 10.3% increase over 2016. The company is projecting 2018 revenues of $223-$225 billion and net earnings per share of $11.65-11.96 and operating cash flows of $15-$15.5 billion.

US BANCORP (USB) is one of the top 10 largest banks in the country with assets of $462 billion at year end 2017. The company has an outstanding credit culture, resulting in low credit losses and generates substantial fee income providing greater stability and predictability in its earnings. In 2017, the company generated $12.5 billion in net interest income and $9.4 billion in fee income. Operating revenues were $21.9 billion and net income was $5.9 billion or
$3.51 per share.

The company's financial metrics are among the best in the industry with a return on common equity of over 14%, and a return on assets of 1.4%. We believe US Bancorp is well positioned to continue to build upon its outstanding franchise both organically and through selective acquisitions in the years ahead. The company should earn $4.00 to 4.10 in 2018, or 13.7x earnings, rising to over $4.40 in 2019, or 12.6x earnings - a fair valuation for an outstanding diversified financial institution. Furthermore, with a large fee income stream the bank is better able to weather low interest rate periods than most competitors who lack such a large recurring fee income stream.

ZOETIS (ZTS) is a leading animal health provider serving the livestock and companion animal markets with 2017 revenue of $5.3 billion, adjusted net income of $1.2 billion and adjusted diluted earnings per share of $2.40. The company was spun out of Pfizer in 2013 and continues to be the industry leader operating globally in both pharmaceuticals and vaccines serving the livestock market (64% of revenues) and the companion animal market (36% of revenues). The company is the industry leader in several categories and continues to do an outstanding job both operationally and financially.

Zoetis' leadership position in many segments, along with the company's broad diversity by product, geography, therapeutic category and species, should lead to solid long-term results for this outstanding company. The company is projecting 2018 revenues of $5.7 to $5.8 billion and adjusted diluted earnings per share of $2.96 to $3.10.

IN CLOSING

We would like to thank all of our clients for the privilege of serving your investment needs. We are grateful for the confidence and trust you have placed in us for this enormous responsibility. We always welcome your thoughts, questions and comments.

Paul J. Lountzis
President